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An Empirical Study on Profitability and Survivability of Banking Credit Policy: Management and Culture of NPAS

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Abstract – ***This paper explores an empirical approach to the analysis of commercial banks' nonperforming loans (NPLs) in the Indian context. The empirical analysis evaluates as to how banks' non-performing loans are influenced by three major sets of economic and financial factors, i.e., terms of credit, bank size induced risk preferences and macroeconomic shocks.***

The empirical results from panel regression models suggest that terms of credit variables have significant effect on the banks' non-performing loans in the presence of bank size induced risk preferences and macroeconomic shocks. Moreover, alternative measures of bank size could give rise to differential impact on bank's non-performing loans. In regard to terms of credit variables, changes in the cost of credit in terms of expectation of higher interest rate induce rise in NPAs. On the other hand, factors like horizon of maturity of credit, better credit culture, favorable macroeconomic and business conditions lead to lowering of NPAs.

Today the Indian banking system has undergone significant transformation following financial sector reforms, adopting international best practices. Several prudential, payment, integrating and provisioning norms have been introduced, and these are pressurizing banks to improve efficiency and trim down NPAs to improve the financial health in the banking system. It is among the best in the world because Indian banks are favorable on growth, asset quality and profitability; RBI and Government have made some notable changes in policies and regulation to strengthen the sector. NPA involves the necessity of provisions, any increase in which bring down the overall profitability of banks; is the indicator of banking health in a country. In this paper, an effort has been made to evaluate the operational performance of the PSBs & Private bank in India between 2003-04 and 2007-09, NPAs Trends and issues through secondary data.

This paper analyzes how efficiently Public and Private sector banks have been managing NPA. The Indian banks are facing hard time managing their NPA. The magnitude of NPA was comparatively higher in public sectors banks compared to private banks but now, they have managed the number at lower end.

There are many mergers and acquisitions have been taken place in Indian banking industry in last couple of decade. Many reason behind it but one question is always associated that the survivability of weaker financial organization. Competition insists organizations to justifyi the earning and profitability. Reserve Bank of India I RBI) and other regulatory framework control the banking industry and individual bank. Banks cannot make big profit without giving good quality of services to their customers. Banks survive with high turnover offund and low margin. If there is undue losses like Non Performing Assets (NPA) and other deliquesce cost come in the part of expenses banks reduce their profit. There may be negative profit in the income statement.

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INTRODUCTION

The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 and hence credit management. While the primary function of banks is to lend funds as loans to various sectors such as agriculture, industry, personal loans, housing loans etc., in recent times the banks have become very cautious in extending loans. The reason being mounting non-performing assets (NPAs). An NPA is defined as a loan asset, which has ceased to generate any income for a bank whether in the form

of interest or principal repayment. As per the prudential norms suggested by the Reserve Bank of India (RBI), a bank cannot book interest on an NPA on accrual basis. In other words, such interests can be booked only when it has been actually received.

A healthy banking system is essential for any economy striving to achieve growth and remain stable in competitive global business environment. Indian banks are favourable on growth, asset quality and profitability; RBI and Government have made some notable changes in policies and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations of commercial banks. In terms of quality of assets and capital adequacy, these banks have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region.

The best indicator for the health of the banking industry in a country is its level of Nonperforming assets (NPAs). NPAs are one of the major concerns for banks in India. It reflects the performance of banks. Reduced NPAs generally gives the impression that banks have strengthened their credit appraisal processes over the years and growth in NPAs involves the necessity of provisions, which bring down the overall profitability of banks. Non-performing Assets are threatening the stability and demolishing bank's profitability through a loss of interest income, write-off of the principal loan amount itself. RBI issued guidelines in 1993 based on recommendations of the Narasimham Committee that mandated identification and reduction of NPAs be treated as a 'national priority' because the level of NPA act as an indicator showing the bankers credit risks and efficiency of allocation of resource.

The NPAs have destructive impact on the return on assets, the interest income of banks is reduced, the current profits of the banks are eroded because the providing of doubtful debts and writing it off as bad debts and it limits the recycling funds. the capital adequacy ratio is disturbed and cost of capital will go up.5. The economic value addition (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital.

The three letters "'NPA" Strike terror in banking sector and business circle today. NPA is short form of "Non-Performing Asset". The dreaded NPA rale says simply this: when interest or other due to a bank remains unpaid for more than 90 days, the entire bank loan automatically turns a non performing asset. The recovery of loan has always been problem for banks and financial institution.

Action for enforcement of security interest can be initiated only if the seemed asset is classified as Non-performing asset. Non-performing asset means an asset or account of borrower .which has been classified by bank or financial institution as sub — standard . doubtful or loss asset, in accordance with the direction or guidelines relating to assets classification issued by RBI.

LITERATURE REVIEW

In the banking literature, the problem of NPLs has been revisited in several theoretical and empirical studies. A synoptic review of the literature brings to the fore insights into the determinants of NPL across countries. A considered view is that banks' lending policy could have crucial influence on non-performing loans (Reddy, 2004).

Reddy (2004) critically examined various issues pertaining to terms of credit of Indian banks. In this context, it was viewed that 'the element of power has no bearing on the illegal activity. A default is not entirely an irrational decision. Rather a defaulter takes into account probabilistic assessment of various costs and benefits of his decision'. Mohan (2003)1 conceptualized 'lazy banking' while critically reflecting on banks' investment portfolio and lending policy.

In a study of institutional finance structure and implications for industrial growth, Mohan (2004) emphasised on key lending terms of credit, such as maturity and interest-terms of loans to corporate sector. The Indian viewpoint alluding to the concepts of 'credit culture' owing to Reddy (2004) and 'lazy banking' owing to Mohan (2003a) has an international perspective since several studies in the banking literature agree that banks' lending policy is a major driver of non-performing loans (McGoven, 1993, Christine 1995, Sergio, 1996, Bloem and Gorters, 2001).

In the seminal study on 'credit policy, systems, and culture', Reddy (2004) raised various critical issues pertaining to credit delivery mechanism of the Indian banking sector. The study focused on the terms of credit such as interest rate charged to various productive activities and borrowers, the approach to risk management, and portfolio management in general. There are three pillars on which India's credit system was based in the past; fixing of prices of credit or interest rate as well as quantum of credit linked with purpose; insisting on collateral; and prescribing the end-use of credit. Interest rate prescription and fixing quantum has, however, been significantly reduced in the recent period. The study also highlighted the issues in security-based or collateralized lending, which need careful examination in the context of growing services sector. Given the fungibility of resources, multiple sources of flow of resources, as well as application of funds, the relevance and feasibility of end-use restrictions on credit need a critical review. The link between formal and informal sectors shows that significant divergence in lending terms between the

two sectors still persists, despite the fact that the interest rate in informal markets is far higher than that of the formal sectors- the banking sector. The convergence between formal and informal sectors could be achieved by pushing the supply of credit in the formal sector following a supply leading approach to reduce the price or interest rate. Furthermore, in the context of NPAs on account of priority sector lending, it was pointed out that the statistics may or may not confirm this. There may be only a marginal difference in the NPAs of banks' lending to priority sector and the banks' lending to private corporate sector. Against this background, the study suggested that given the deficiencies in these areas, it is imperative that banks need to be guided by fairness based on economic and financial decisions rather than system of conventions, if reform has to serve the meaningful purpose. Experience shows that policies of liberalisation, deregulation and enabling environment of comfortable liquidity at a reasonable price do not automatically translate themselves into enhanced credit flow.

Jimenez and Saurina (2003) used logit model for analysing the determinants of the probability of default (PD) of bank loans in terms of variables such as collateral, type of lender and bank-borrower relationship while controlling for the other explanatory variables such as size of loan, size of borrower, maturity structure of loans and currency composition of loans. Their empirical results suggested that collateralised loans had a higher PD, loans granted by savings banks were riskier and a close bank-borrower relationship had a positive effect on the willingness to take more risk. At the same time, size of bank loan had a negative effect on default while maturity term of loans, i.e., short-term loans of less than 1-year maturity had a significant positive effect on default.

Jigar j. Soni (2007) in his study of comparative analysis of private and public sector's NPA pointed out that there is a huge difference in the
awar Ashok and Arya Maneesh Kant (2009) discussed about the wage burden after a revision of salary of bank employees and profitability of
banks. Arya Maneesh Kant and Sonwalkar J. (2009). discussed the effect on profitability and volatility of income with noil interest income of banks.

Sachin Nanda (2008) finds in his paper Challenges of NPA to PSBs in India is that the only problem that the Public Sector Banks are facing today is the problem of nonperforming assets. If the proper management of the NPAs is not undertaken it would hamper the business of the banks. The NPAs would destroy the current profit,
interest income due to large provisions of the NPAs. and would affect the smooth functioning of the recycling of the funds.

THE TERM OF NPAS

Banking business is mainly that of borrowing from the public and lending it to the needy persons and business at a premium. Lending of money involves a credit risk. When the loans and advances made by banks or financial institutions turn out as non - productive, nonrewarding and non – remunerative, they become Non Performing Assets (NPA). According to SARFAESI 2002, NPA is an asset or account of a borrower, which is classified by a bank or financial institution as sub-standard asset, doubtful asset and loss asset.

The definition of an NPA as given by RBI and its various categories is as under: An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. A non-performing asset (NPA) is a loan or an advance where;

i. interest and / or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii. the account remains 'out of order' in respect of an Overdraft / Cash Credit (OD/CC),

iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the installment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the installment of principal or interest thereon remains overdue for one crop season for long duration crops,

vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction,

vii. in respect of derivative transactions, the overdue receivables representing positive markto-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

NPA MANAGEMENT

Effective NPA Management has become very vital in view of the multifarious impact NPAs have on profitability. No income accrues from NPAs.

Provisioning eats into the profit made from other operations. Cost is involved in holding corresponding capital. Though no income is generated bank continues to incur cost on funds lent. The image of the bank also gets a beating. Effective NPA Management is a real challenge to day and the entire staff members need to be sensitized to the urgency of task on hand.

CONCLUSION

The analysis concluded that there is a diminishing trend in the ratios of non-performing assets as GNPAs and NNPAs, which clearly recommended that the measures adopted by the paper are valuable rudiments to affect the amount of NPAs. There is a high degree of negative correlation between NPA Ratios with ROA. Multiple Regression model has also repetitive the results that there can be an enhancement in profitability of the banks if the NPAs has decreasing trend continuously. Consequently, an inverse relationship among profitability and non-performing assets revealed the fact, that the bank can have an increasing trend of profitability only by the effective declining trend of NPAs. The assessment would help to improve the assets quality of banks, so that, provisioning requirement would automatically come down and it added to the profits directly which leaded to increase the overall performance of the banks. Hence, it‟s important to manage the level of NPAs for Owners and Depositors also, as they are faced many problems due to the magnification of non-performing assets, even they couldn‟t receive their appropriate return on their capital or can be lose their assets. Non-performing assets epitomize non-performing loans, which misallocate credit investments from needful projects. It may spill over the banking system and contract the money stock, which may lead to economic contraction and affect its liquidity and profitability.

The changes in the cost of credit in terms of expectation of higher interest rate induce increase in NPAs. On the other hand, factors like horizon of maturity of credit, better credit culture, and favorable macroeconomic and business conditions lead to lowering of NPAs.

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