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Study of Non-Performing Assets of Commercial Banks and Its Recovery in India

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Abstract – The Indian banking sector has been facing serious problems of raising Non- Performing Assets (NPAs). The NPAs growth has a direct impact on profitability of banks. Non- performing assets are one of the major concerns for scheduled commercial banks in India. The recommendations of Narasimham committee and Verma committee, some steps have been taken to solve the problem of old NPAs in the balance sheets of the banks. It continues to be expressed from every corner that there has rarely been any systematic evaluation of the best way of tackling the problem. There seems to be no unanimity in the proper policies to be followed in resolving this problem. NPAs reflect the performance of banks. A high level of NPAs suggests high probability of a large number of credit defaults that affect the profitability and net-worth of banks and also erodes the value of the asset. NPAs affect the liquidity and profitability, in addition to posing threat on quality of asset and survival of banks. The problem of NPAs is not only affecting the banks but also the whole economy.

Keywords: Non- Performing Assets, NPA, Scheduled Commercial banks

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1. INTRODUCTION

The banking system in India comprises commercial and cooperative banks, of which the former accounts for more than 90 per cent of banking system's assets. Besides a few foreign and Indian private banks, the commercial banks comprise nationalized banks (majority equity holding is with the Government), the State Bank of India (SBI) (majority equity holding being with the Reserve Bank of India) and the associate banks of SBI (majority holding being with State Bank of India). These banks, along with regional rural banks, constitute the public sector (state owned) banking system in India The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 and hence credit management.

Asset quality was not prime concern in Indian banking sector till 1991, but was mainly focused on performance objectives such as opening wide networks/branches, development of rural areas, priority sector lending, higher employment generation, etc. While the primary function of banks is to lend funds as loans to various sectors such as agriculture, industry, personal loans, housing loans etc., but in recent times the banks have become very cautious in extending loans. The reason being mounting nonperforming assets (NPAs) and nowadays these are one of the major concerns for banks in India.

Bankers are the custodians and distributors of the liquid capital of the country. Therefore most important function of the banking system is to mobilize the savings of the people by accepting deposits from the public. The banker becomes the trustee of the surplus balances of the public.

Deposit mobilization promotes the economic prosperity by controlling the money circulation and canalizing for development and productive purposes. In order to mobilize deposits, the commercial banks undertake deposit mobilization through various deposit schemes suited to the different sections of the people. The deposits along with other sources of funds namely capital, reserves and borrowings, form the sources of funds for the banks. The lending and investment activities of the bank are based on the sources of funds.

The banks, in their books, have different kind of assets, such as cash in hand, balances with other banks, investment, loans and advances, fixed assets and other assets. The Non- Performing Asset (NPA) concept is restricted to loans, advances and investments. As long as an asset generates the income expected from it and does not disclose any unusual risk other than normal commercial risk, it is treated as performing asset, and when it fails to generate the expected income it becomes a "Non-Performing Asset".

In other words, a loan asset becomes a Non Performing Asset (NPA) when it ceases to generate income, i.e. interest, fees, commission or any other

dues for the bank for more than 90 days. A NPA is an advance where payment of interest or repayment of installment on principal or both remains unpaid for a period of two quarters or more and if they have become ‘past due’. An amount under any of the credit facilities is to be treated as past due when it remain unpaid for 30 days beyond due date.

Non-Performing Assets are also called as Non-Performing Loans. It is made by a bank or finance company on which repayments or interest payments are not being made on time. A loan is an asset for a bank as the interest payments and the repayment of the principal create a stream of cash flows. It is from the interest payments that a bank makes its profits. Banks usually treat assets as non-performing if they are not serviced for some time. If payments are late for a short time, a loan is classified as past due and once a payment becomes really late (usually 90 days), the loan is classified as non-performing. A high level of nonperforming assets, compared to similar lenders, may be a sign of problems.

Narasimham Committee that mandated identification and reduction of NPAs to be treated as a national priority because NPA direct toward credit risk that bank faces and its efficiency in allocating resources. Profitability and earnings of banks are affected due to NPA numbers. If we glance on the numbers of non-performing assets we may come to know that in the year 1995 the NPAs were Rs. 38385 crore and reached to 71047 crore in 2011 in Public sector banks and comparatively in the year 2001 the NPAs were Rs. 6410 crore and reached to Rs. 17972 crore in 2011 in Private sector banks.

Banking reforms were initiated to upgrade the operating standards, health and financial soundness of banks to internationally accepted levels in an increasingly globalized market (Pathak, 2009). The reforms have been undertaken gradually with mutual consent and wider debate amongst the participants and in a sequential pattern that is reinforcing to the overall economy (Badola and Verma, 2006). These reform measures substantiate the views that highlight the key role in economic development that could be played by a banking system free from the types of controls on interest rates and quantities that were prevalent at the time (Barajas *et al*, 2012).

Non-Performing Asset - Loans and advances given by the banks to its customers are an Asset to the bank.

Just for the sake of simplicity, we can understand that a loan (an asset for the bank) turns as NPA when the EMI, principal or interest component for the loan is not paid within 90 days from the due date. Thus a Bad Loan is a*n asset that ceases to generate any income for the bank*.

Asset or Loan Classification Norms

The assets or loans are classified as:-

Standard Assets

Sub-standard Assets

Doubtful Assets

Loss Assets

Now, in order to ensure that banks are not affected due to defaults, RBI has directed the banks to make **provisions or set aside money** when an account turns bad. 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.

A Loss Asset is considered uncollectible and of such little value for the bank in retaining the account on its book and ideally, such loans should be written off. Thus, Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

Apart from above, there are Guidelines by RBI for provisions under special circumstances.

‘Unsecured exposure’ is defined as an exposure where the realizable value of the security, as assessed by the bank/approved valuers/RBI’s inspecting officers, is not more than 10%, ab-initio, of the outstanding exposure.

‘Exposure’ includes all funded and non-funded exposures.

‘Security’ are tangible security properly discharged to the bank and do not include intangible securities like guarantees, etc.

Restructuring of assets

‘Standard Assets’ upon restructuring –> Sub-Standard Assets

Also, an NPA upon restructuring can also be up-graded to the ‘standard’ category after observation of ‘satisfactory performance’ during the specified period i.e. on repayment of outstanding amount by the borrower.

Provisioning Coverage Ratio (PCR):

The ratio of provisioning to gross non-performing assets

Indicates the extent of funds a bank has kept aside to cover loan losses.

2. REVIEW OF LITERATURE

Many published articles are available in the area of non-performing assets and a large number of researchers have studied the issue of NPA in banking industry. A review of the relevant literature has been described. Kumar (2013) in his study on A Comparative study of NPA of Old Private Sector Banks and Foreign Banks has said that Non-performing Assets (NPAs) have become a nuisance and headache for the Indian banking sector for the past several years. One of the major issues challenging the performance of commercial banks in the late 90s adversely affecting was the accumulation of huge non-performing assets (NPAs). Selvarajan & Vadivalagan (2013) in A Study on Management of Non-Performing Assets in Priority Sector reference to Indian Bank and Public Sector Banks (PSBs) find that the growth of Indian Bank's lending to Priority sector is more than that of the Public Sector Banks as a whole. Indian Bank has slippages in controlling of NPAs in the early years of the decade. Singh (2013) in his paper entitled Recovery of NPAs in Indian commercial banks says that the origin of the problem of burgeoning NPA's lies in the system of credit risk management by the banks. Banks are required to have adequate preventive measures in fixing pre-sanctioning appraisal responsibility and an effective post-disbursement supervision. Banks should continuously monitor loans to identify accounts that have potential to become non- performing. Gupta (2012) in her study A Comparative Study of Non-Performing Assets of SBI & Associates & Other Public Sector Banks had concluded that each bank should have its own independence credit rating agency, which should evaluate the financial capacity of the borrower before credit facility, and credit rating agencies should regularly evaluate the financial condition of the clients. Rai (2012) in her study on Study on performance of NPAs of Indian commercial banks find out that corporate borrowers even after defaulting continuously never had the fear of bank taking action to recover their dues. This is because there was no legal framework to safeguard the real interest of banks. Chatterjee C., Mukherjee J. and Das (2012) in their study on Management of non-performing assets - a current scenario has concluded that banks should find out the original reasons/purposes of the loan required by the borrower. Proper identification of the guarantor should be checked by the bank including scrutiny of his/her wealth. Kaur K. and Singh B. (2011) in their study on Non-performing assets of public and private sector banks (a comparative study) studied that NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. Prasad G.V.B. and Veena (2011) in their study on NPAs Reduction Strategies for Commercial Banks in India stated that the NPAs do not generate interest income for banks but at the same time banks are required to provide provisions for NPAs from their current profits, thus NPAs have destructive impact on the return on assets in the following ways. Chaudhary K. and Sharma M. (2011) in their research stated that An efficient management information system should be developed. The bank staff involved in sanctioning the advances should be trained about the proper documentation and charge of securities and motivated to take measures in preventing advances turning into NPA. Karunakar (2008), in his study Are non - Performing Assets Gloomy or Greedy from Indian Perspective, has highlighted problem of losses and lower profitability of Non- Performing Assets (NPA) and liability mismatch in Banks and financial sector depend on how various risks are managed in their business. The lasting solution to the problem of NPAs can be achieved only with proper credit assessment and risk management mechanism. Bhatia (2007) in his research paper explores that NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. Kaur (2006) in her thesis titled Credit management and problem of NPAs in Public Sector Banks, suggested that for effective handling of NPAs, there is an urgent need for creating proper awareness about the adverse impact of NPAs on profitability amongst bank staff, particularly the field functionaries. Bankers should have frequent interactions and meeting with the borrowers for creating better understanding and mutual trust. Balasubramanyam C.S. (2001) highlighted the level of NPAs is high with all banks currently and the banks would be expected to bring down their NPA. This can be achieved by good credit appraisal procedures, effective internal control systems along with their efforts to improve asset quality in their balance sheets.

3. TYPES OF CREDIT/ LENDING SCHEMES OFFERED BY PRIVATE BANKS

Indian Private Banks finances the working capital requirements of their customers. The main credits of financing in our country are Term Loans, Cash Credit, Overdrafts, and Loans Repayable on demand, bills purchased and discounted.

Cash credit:

It is the main source of lending by banks. Under this scheme bank advances loans for a given period on the security of shares, debentures and movable and immovable properties. Generally, banks charges interest on the amount which has been withdrawn by the account holder. The main advantages of this facility are it encourages savings, allows easy

payment and provides flexibility. The disadvantages are that it encourages speculation, creates monopolistic tendencies and create inflation pressure.

Overdraft:

When a bank allows its customers having current account to withdraw the amount more than the deposits in the account it is called Overdraft. The Overdrafts depends on the credit of the customers. Such facility is given for short term and emergency purposes. Banks requires security from the customer for such facility. Such facility is given on the current account only. The main advantage of overdrafts is that it provides flexibility and easy and quick arrangement of cash flows. The disadvantages are that it carries high cost and it need to be secured.

Term loans:

A Term Loan is a loan in which a borrower pays interest only for a set period. Term loans always mature between 1 to 10 years. The term loan is generally provided as working capital for acquiring income producing assets that generate the cash flows for repayment of the loan. They are the source of long term debt; they are generally obtained for financing large expansion, modernization. The advantages of term loans are that they are more flexible as compared to others; they usually have fixed interest rate. The disadvantages of term loans are that it carry repayment facility.

Bills purchased and discounted:

It is also a method for borrowing from banks. Under this method bank provides credit against the dated bills of exchange before its maturity. Seller writes such bill and buyer accept it. The buyer promises to pay in the given period. Such bills are discounted by banks and a payment is made to the customers. If the buyer does not make the payment of the bill then the bank gets payment from the seller.

4. CHARACTERISTICS OF PRIVATE BANKING SECTOR:

Private Banks have played an important role in the economic development. The bank loans in India are provided to trade and industry. The main features of Private Banks are:

1. Encourage savings:

Banks collect the small savings scattered in different parts of the country. These savings are used in trade and industries. Thus banks collect savings one hand and put them in productive uses from the other.

2. Financing of trade and industry:

Banks provide finance to trade and industry. Modern trade and industry requires capital in huge quantum. Additional resources are raised from the public by banks and these resources are used for making loans and advances to industry and trade.

3. Security of loans:

Private Banks guarantee loans taken by industrial and business units from national and international sources. It helps industrial and business units in getting loans from these sources.

4. Personal credit:

Banks provide consumer loans to the customers on the basis of personal credit. These loans are provided to purchase consumer goods.

5. Financial assistance:

Private Banks provides the financial assistance to new enterprises and through new innovations the economy gets a continuous momentum. Credit and financial facilities are provided by these institutions.

With respect to the performances of private banking sector, foreign and national experts have undertaken a number of studies. Alejandro Micco, Ugo Panizza, Monica Yanez(2007), used a new dataset to reassess the relationship between bank ownership and bank performance, providing separate estimations for developing and industrial countries. Their study finds no strong correlation between ownership and performance for banks located in industrial countries. In order to test whether the differential in performance between public and private banks was driven by political considerations, the study checked whether the differential widened during the election years and found strong support for this hypothesis. John P. Bonin, Iftekhar Hasan, Paul Wachtel(2005), Used data from 1996 to 2000 to investigate the effects of ownership, especially by strategic foreign owners, on banks efficiency for eleven transition countries in an unbalanced panel consisting of 225 banks and 856 observations. They concluded that privatization by itself was not sufficient to increase bank efficiency as government-owned banks were not appreciably less efficient than domestic private banks. They also found that foreign-owned banks were more cost-efficient than other banks and they also provided better service, in particular if they had a strategic foreign owner. Giuliano Iannotta, Giacomo Nocera, Andrea Sironi (2007) compared the performance and risk of a sample of 181 large banks from 15 European countries over the 1999–2004 periods and evaluated the impact of alternative ownership models; together with the degree of ownership concentration, on

profitability, cost efficiency and risk. Xiaochi Lin,Yi Zhang (2009) assessed the effect of bank ownership on performance. They specifically conducted a joint analysis of the static, selection, and dynamic effects of (domestic) private, foreign and state ownership. They found that the “Big Four”state-owned commercial bank were less profitable, less efficient, and had bad asset quality than other types of bank except for the “policy” bank. Omran (2007) analyzed both private and government banks‟ relative performances and also evaluates the bank privatization process in Egypt by comparing the pre- and post privatization, performances of privatized banks and reported that private banks outperformed government banks. Chowdhury and Islam (2007) stated that deposits and loan advances of Nationalized Commercial Banks (NCBs) were less sensitive to interest rate changes than those of Specialized Banks (SBs). So SBs should not make abrupt change in lending or deposit rates by following the NCBs. If NCBs change their lending or deposit rates, their deposits or loans and advances will be less affected than those of SBs. Moreover, deposits of NCBs have higher volume and higher volatility than those of SBs. On the other hand, loans advances of NCBs show a higher volume and higher volatility than those of SBs. However, SBs offer higher deposit rates and charge higher lending rates than NCBs. Hence the interest rate spread of SBs was higher than that of NCBs. Jahangir, Shill and Haque (2007) stated that the traditional measure of profitability through stockholder’s equity was quite different in the banking industry from any other sector of business, where loan-to- deposit ratio worked as a very good indicator of banks' profitability as it depicts the status of asset-liability management of banks. But banks' risk is not only associated with this asset liability management but also related to growth opportunity. Smooth growth ensures higher future returns to holders and there lies the profitability which means not only current profits but future returns as well. So, market size and market concentration index along with return to equity and loan-to-deposit ratio grab the attention of analyzing the banks‟ profitability.

Hossain and Bhuiyan (1990) stated that there is no universally accepted operational definition of performance measures. In broad sense performance level of an enterprise can be measured by the extent of its organizational effectiveness. In the context of services rendered towards public the performance of an organization can be viewed as „the extent to which its work is carried out within established specifications for goods and services produced, to the general satisfaction of the clientele served, within given cost and time constraints, and in such a manner as to support or contribute to the achievement of the organization objectives. Prashanth K Reddy (2002) in his study focused on the comparative study of Non Performing Assets in India in the Global context - similarities and dissimilarities, remedial measures and concluded the importance of a sound understanding of the macroeconomic variables and systemic issues pertaining to banks and the economy for solving the NPA problem along with the criticality of a strong legal and legislative framework. Foreign experiences must be utilized along with a clear understanding of the local conditions to create a tailor made solution which is transparent and fair to all stakeholders.

CONCLUSION

In this study some major points concluded, like NPA are becoming a major threat to the profitability of both Public as well as Private sector banks. The level of NPA is more in Public sector banks than private banks and the most important reason of high level of NPA in public sector banks is priority sector lending or directed loan system. Besides this, various studies show that the other important reason for rising NPA level are poor credit appraisal system and poor follow up of the borrower. And unavailability of credit rating information about the borrower is also not available. Among the important ways of curbing rising NPA level is that banks should have their own independent credit agency and a proper credit appraisal of the projects should be done before granting loan to anyone. And effective follow up should be done once the loan is granted.

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