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A study on analysis of non-performing assets and its impact on profitability: In the context of Indian banking system

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Abstract

The banking industry plays a critical role in the Indian economy. Measuring and maintaining the asset quality of banks is important for the development of the banking sector. Nowadays, the asset quality in banks, especially the Public Sector Banks is constantly deteriorating and thus causing intolerable stress to the banking sector, regulators, and Indian economy. The objective of the present study is to understand the level of Non-performing Assets (NPA), and how it influences the profitability of the banks. Non-performing Asset is one of the prevalent problems of Indian Banking sector. For the past three decades, the banking system has several outstanding achievements to its credit. Many banks are facing the problem of NPAs which hampers the business of the banks. Non-performing assets are a drain to the banks. Various research studies have been conducted to analyze the root causes of NPA. The following study tries to understand the concept of NPA, its causes and impact on profitability. The problem of NPA impacts profitability, Liquidity and results in credit loss. Unless and otherwise proper remedial measures are taken the quantum of nonperforming assets cannot be reduced and the bank will incur losses to a great extent.

Keywords: NPA, bank, profitability, lending, ROI, global, economy

Introduction

A country's development can be better perceived through economic growth which is influenced by the prevailing financial system. The 'Financial System' plays a crucial role and it intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. A strong financial system is crucial to fulfill the objective of strengthening the real economy and for its healthy and orderly growth. Banks play a very useful and dynamic role in the economic life of every modern state: They are important constituents of the money market and their demand deposits serve as money in the modern community. Banks can work as catalytic agents of growth by following the right kind of policies in their working, depending upon the socioeconomic conditions prevailing in a country. It is realized that since banks have the required investment potentiality, they can make a significant contribution in eradicating poverty, unemployment, and they can bring about progressive reduction in inter-regional, inter-state, and inter sectoral disparities through rapid expansion of banking services.

The banking industry plays a critical role in the economy of our country. It grew in leaps and bounds and so is the complexity associated with it. Now a day's Loans measurement from time to time and recovery mechanism of NPA is a significant role in the banking industry. The asset quality in banks, especially the Public Sector Banks (PSUs) is constantly deteriorating and thus causing intolerable stress to the banking sector, regulators, and the Indian economy.

NPA are those loans dispersed by banks or financial institutions which borrowers default in making payment of principal amount or interest. When a bank is not able to recover the loan given or not getting regular interest on such a loan, the flow of funds in the banking industry is affected. The issue of Non Performing Assets has been discussed at length for the financial system all over the world. The dilemma of NPAs is not only distressing the banks but also the entire wealth of the country. In fact, the level of NPAs in Indian banks is nothing but a reflection of the state of health of the industry and trade. Providing credit for economic activities is the prime duty of banking.

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Lending is generally encouraged because it has the effect of funds being transferred from the system to productive purposes, which results in economic growth. However, lending also carries a risk called credit risk, which arises from the failure of a borrower. Non-recovery of loans along with interest forms a major hurdle in the process of the credit cycle. These loans affect the bank's profitability on a large scale. Though complete elimination of such losses is not possible; banks can always aim to keep the losses at a low level. In this situation, there is a need of the researcher to address how the non-performing assets of the banks affect the bank's profitability, growth and development.

Review of literature

The following are important reviews related to the present study. Shanabhogara Raghavendra (2018), this paper analyzed the impact of the NPA, causes of NPA, and consequences of NPA in a commercial bank. This study suggested that restructuring of the bank or financial organization, improvement in financial deepening and modernization of appropriate skills for up gradation of credit wordiness and one more thing is staff efficiency, these are a most important thing to solve the present willful defaulter's system in India and world too. Suvitha K Vikram, Gayathri G (2018), their study focused the sector, which has higher NPAs (Public/Private sector banks), causes and control measures for rising NPAs. It found out that the level of NPAs is higher in Public Sector Banks compared with Private Sector Banks. Also, focused causes, level of NPA and controlling measures were analyzed. It suggested that the root of the issue of rising NPAs lies in the nature of overseeing credit chance by the banks and wilful defaulters. Payel Roy and Pradip Kumar Samanta (2017), this analysis indicated the overall NPA position of all the banks is deteriorating over the years. It found that there is a negative high correlation between GPA and NP, the profit gradually decreases as the GNPA grows. And also point out that most of the banks' profit has reduced considerably. Some of the banks have incurred losses too. The losses due to the increase of NPA can't be avoided only by making provisions against NPA. It suggested that the Provisioning can act as a cushion for NPA losses but it can't be regarded as a solution for growing NPAs in all the selected PSBs. The banks advancing loans should be cautious enough to consider the backgrounds of the loan receiver and make the recovery procedure more stringent. Raj Kumar Mittal and Deeksha Suneja (2017). Their study revealed that the extent of NPAs is comparatively more in public sector banks as compared to private sector banks. It suggested that the government is taking many steps to reduce the problem of NPAs but banks should also have to be more proactive to adopt a structured NPAs policy to prevent the non-performing assets and should follow stringent measures for its recovery. Bankers should also consider the ROI on a proposed project and provide loans to customers who have better creditworthiness. Shiralashetti A.S. and Lata. N. Poojari (2016), analyzed the causes of NPA and impact of NPA on the profitability of the bank. The study found that there was a moderate relationship exist with Gross NPA and Net profit of the syndicate bank and also found that there was no significant difference between sector wise NPA. The study provided some suggestions to the regulators. Ombir and Sanjeev Bansal (2016), their study analyzed the recent trends in nonperforming assets (NPAs) of different

categories of Indian banks. It is found that the impact of ownership pattern in deciding the level of NPAs is investigated against the perception that public sector banks have a relatively larger level of NPAs. But there was no strong empirical evidence is found in support of this perception. Their findings suggested that public sector banks are as good or as bad as their private counterparts, however, foreign banks have relatively higher profitability as domestic public and private banks. It is also found that a higher level of NPAs negatively affects the profitability of a bank. Samir and Deepa Kamra (2013) this study found that the problem of NPA is greater in the public sector banks as compared to private and foreign banks in India. Similarly, the problem of NPAs is more in the nonpriority sector than priority and the public sector. Further, SSI sector has the largest share in the total NPA of priority sector. As a result of this, the financial health of banks has been affected adversely. The study suggested that banks in India must apply the basic principles of financial management to solve the problems of mounting NPA and improving recovery management, corporate governance, upgrading technology, etc. Rama Prasad and Ramachandra Reddy (2012), it observed from the study that there is a tremendous decline in NPAs of Andhra Bank as well in Public Sector Banks during the study period, even though enormous growth in advances. This resulted in the introduction of prudential norms. The study suggested that the use of technology like core Banking Solutions will bring change Indian Banking to manage their non-performing assets.

Non-Performing Assets (NPAs)

The concept of Non-Performing Assets (NPAs) was introduced for the first time in the Narasimham Committee on "Financial System Reforms" that was tabled in Parliament on December 17th 1991. The Committee studied the prevailing financial system, identified its short comings and weaknesses and made with ranging suggestions and recommendations in line with internationally accepted norms. Based on the recommendations of the Committee on "Financial System Reforms", the RBI evolved prudential norms on Income recognition, Asset classification and Provisioning and issued revised instructions to banks in April 1992. While conveying non-performing category and their anxiety to present rosy picture of their affairs the above instructions to banks also advised them that as per practice followed internationally, income on NPAs is not to be recognized on accrual basis but is to be looked only when it is actually realized because an asset becomes non-performing when it ceases to generate income. The above instructions of RBI have since been implemented by banks from the financial year ended March 1998.

The problem of NPAs is linked to the function of lending money. The lending of money collected from the public, for interest, instead of one's own money, was the beginning of banking. Though the present day banking does not restrict itself to traditional deposit collection and money lending, encompassing a wide sphere of financial activity, lending still remains the prime activity connected with banking. Most credit needs of the society, for carrying, commercial activities are fulfilled by the banks. The conventional credit from the banking system to the Commercial sector comprises bank loans and advances in the form of term loans, demand loans, cash credit, overdrafts, inland and foreign bills purchased and discounted as well as

investments in instruments issued by non-government sector.

Non-performing assets (NPAs) constitute integral part of banks' operations. A bank gives out money upfront and earns income over a time on the promise of a borrower to repay. When loans are not repaid, the bank loses both its income stream, as well as its capital. Lending is always accompanied by the credit risk arising out of the borrower's default in repaying the money. The level of non-performing loans is recognized as a critical indicator for assessing banks' credit risk, asset quality and efficiency in allocation of resources to productive sectors. The most calamitous problem facing commercial banks all over the world in recent times is spiraling non-performing assets which are affecting their viability and solvency and thus posing challenge to their ultimate survival. So the problem of NPAs should be nipped in the bud. It is possible only if the check is placed on NPAs from the very beginning.

The lack of preparedness and structural weakness of our banking system led to the emerging scenario and trying to switch over to globalization were only aggravating the crisis. The major reason for this situation was that the threat of NPAs was being surveyed and summarized by Reserve Bank of India (RBI) and Government of India with a bird's eye-view of the banking industry, independent from the rest of the economy.

Factors for Rise in NPAS

The banking sector has been facing the serious problems of the rising NPAs. But the problem of NPAs is more in public sector banks when compared to private sector banks and foreign banks. The NPAs in PSB are growing due to external as well as internal factors.

External factors

Ineffective Recover

The Govt. has set of numbers of recovery tribunals, which works for recovery of loans and advances. Due to their negligence and ineffectiveness in their work the bank suffers the consequence of non-recover, thereby reducing their profitability and liquidity.

Willful Defaults

There are borrowers who are able to pay back loans but are intentionally withdrawing it. These groups of people should be identified and proper measures should be taken in order to get back the money extended to them as advances and loans.

Natural Calamities

This is the measure factor, which is creating alarming rise in NPAs of the PSBs. every now and then India is hit by major natural calamities thus making the borrowers unable to pay back there loans. Thus the bank has to make large amount of provisions in order to compensate those loans, hence end up the fiscal with a reduced profit.

Industrial Sickness

Improper project handling, ineffective management, lack of adequate resources, lack of advance technology, day to day changing govt. Policies give birth to industrial sickness. Hence the banks that finance those industries ultimately end up with a low recovery of their loans reducing their profit and liquidity.

Lack of Demand

Entrepreneurs in India could not foresee their product demand and starts production which ultimately piles up their product thus making them unable to pay back the money they borrow to operate these activities. The banks recover the amount by selling of their assets, which covers a minimum label. Thus the banks record the non-recovered part as NPAs and has to make provision for it.

Change on Govt. Policies

With every new govt. banking sector gets new policies for its operation. Thus it has to cope with the changing principles and policies for the regulation of the rising of NPAs.

Internal factors

Defective Lending Process

There are three cardinal principles of bank lending that have been followed by the commercial banks since long.

- i. Principle of safety
- ii. Principle of liquidity
- iii. Principle of profitability

Inappropriate Technology

Due to inappropriate technology and management information system, market driven decisions on real time basis cannot be taken. Proper MIS and financial accounting system is not implemented in the banks, which leads to poor credit collection, thus NPAs. All the branches of the bank should be computerized.

Poor Credit Appraisal System

Poor credit appraisal is another factor for the rise in NPAs. Due to poor credit appraisal the bank gives advances to those who are not able to repay it back. They should use good credit appraisal to decrease the NPAs.

Managerial Deficiencies

The banker should always select the borrower very carefully and should take tangible assets as security to safe guard its interests. When accepting securities banks should consider the:

1. Marketability
2. Acceptability
3. Safety
4. Transferability.

Absence of Regular Industrial Visit

The irregularities in spot visit also increases the NPAs. Absence of regularly visit of bank officials to the customer point decreases the collection of interest and principals on the loan. The NPAs due to willful defaulters can be collected by regular visits.

Significance of the study

Non-performing assets of banks are one of the biggest hurdles in the way of socio-economic development of India. The level of NPAs of the banking system in India is still too high. It affects the financial standing of the banks so that it is a heavy burden to the banks. A vigorous effort has to be made by the banks to strengthen their internal control and risk management systems and to setup early warning signals for timely detection and action. The problem of NPAs is tied up with the issue of legal reforms. This is an area which

requires urgent consideration as the present system that substantially delays in arriving at a legal solution of a dispute is simply not tenable. The absence of a quick and efficient system of legal redress constitutes an important 'moral hazard' in the financial sector, as it encourages imprudent borrowers.

Objectives of the study

The study aims to achieve the following objectives:

1. To understand the concept of NPA.
2. To identify the causes of NPAs in Indian banking system.
3. To study the role of NPA in banking sector.
4. To study the preventive mechanism for NPA and Compromise settlement scheme.

Impact of NPA

1. **Profitability:** NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client because of the money getting blocked the prodigality of bank decreases not only by the amount of NPA but NPA lead to opportunity cost also as that much of profit invested in some return earning project/asset. So NPA doesn't affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low ROI (Return on Investment), which adversely affect current earnings of bank.
2. **Liquidity:** Money is getting blocked, decreased profit lead to lack of enough cash at hand which lead to borrowing money for shortest period of time which lead to additional cost to the company. Difficulty in operating the functions of bank is another cause of NPA due to lack of money, routine payments and dues.
3. **Involvement of Management:** Time and efforts of management is another indirect cost which bank has to, bear due to NPA. Time and efforts of management in handling and managing NPA would have diverted to some fruitful activities, which would have given good returns. Now day s banks have special employees to deal and handle NPAs, which is additional cost to the bank.
4. **Credit Loss:** Bank is facing problem of NPA then it adversely affect the value of bank in terms of market credit. It will lose its goodwill and brand image and credit which have negative impact to the people who are putting their money in the banks.

Preventive measurement for NPA

1. **Early Recognition of the Problem:** Invariably, by the time banks start their efforts to get involved in a revival process, it too late to retrieve the situation- both in terms of rehabilitation of the project and recovery of bank's dues.
2. **Identifying Borrowers with genuine intent:** Identifying borrowers with genuine intent from those who are non- serious with no commitment or stake in revival is a challenge confronting bankers. Here the role of frontline officials at the branch level is paramount as they are the ones who have intelligent inputs with regard to promoters sincerity, and capability to achieve turnaround. Based on this objective assessment, banks should decide as quickly as possible whether it would

be worthwhile to commit additional finance. "Special Investigation"

3. **Timeliness & Adequacy of response:** Longer the delay in response, grater the injury to the account and the asset. Time is a crucial element in any restructuring or rehabilitation activity. The response decided on the basis of techno-economic study and promoter s commitment, has to be adequate in terms of extend of additional funding and relaxations etc. Under the restructuring exercise, the package of assistance may be flexible and bank may look at the exit option.
4. **Focus on Cash flows:** While financing, at the time of restructuring the banks may not be guided by the conventional fund flow analysis only, which could yield a potentially misleading picture. Appraisal for fresh credit requirements may be done by analyzing funds flow in conjunction with the Cash Flow rather than only on the basis of Funds Flow.
5. **Management Effectiveness:** The general perception among borrower is that it is lack of finance that leads to sickness and NPAs. But this may not be the case all the time. Management effectiveness in tackling adverse business conditions is a very important aspect that affects a borrowing unit s fortunes. A bank may commit additional finance to angling unit only after basic viability of the enterprise also in the context of quality of management is examined and confirmed. Where the default is due to deeper malady, viability study or investigative audit should be done – it will be useful to have consultant appointed as early as possible to examine this aspect. A proper techno- economic viability study must thus become the basis on which any future action can be considered.
6. **Multiple Financing:** During the exercise for assessment of viability and restructuring, a Pragmatic and unified approach by all the lending banks / FIs as also sharing of all relevant information on the borrower would go a long way toward overall success of rehabilitation exercise, given the probability of success/failure.

Procedures for NPA identification

1. **Internal Checks and Control:** Since high level of NPAs dampens the performance of the banks identification of potential problem accounts and their close monitoring assumes importance. Though most banks have Early Warning Systems (EWS) for identification of potential NPAs, the actual processes followed, however, differ from bank to bank. The EWS enable a bank to identify the borrower accounts which show signs of credit deterioration and initiate remedial action. Many banks have evolved and adopted an elaborate EWS, which allows them to identify potential distress signals and plan their options beforehand, accordingly. The major components/processes of a EWS followed by banks in India as brought out by a study conducted by Reserve Bank of India at the instance of the Board of Financial Supervision are as follows:
 - i. **Relationship Manager/Credit Officer:** The Relationship Manager/Credit Officer is an official who is expected to have complete knowledge of borrower, his business, his future plans, etc. The Relationship Manager has to keep in constant touch with the

- borrower and report all developments impacting borrowable account.
- ii. **Know your client ' profile (KYC):** Most banks in India have a system of preparing 'know your client' (KYC) profile/credit report. As a part of 'KYC' system, visits are made on clients and their places of business/units.
 - iii. **Credit Rating System:** The credit rating system is essentially one point indicator of an individual credit exposure and is used to identify measure and monitor the credit risk of individual proposal
 - iv. **Watch-list/Special Mention Category:** The grading of the bank's risk assets is an important internal control tool. It serves the need of the Management to identify and monitor potential risks of a loan asset. The purpose of identification of potential NPAs is to ensure that appropriate preventive / corrective steps could be initiated by the bank to protect against the loan asset becoming non-performing.
2. **Management Resolution of NPAs:** A reduction in the total gross and net NPAs in the Indian financial system indicates a significant improvement in management of NPAs. This is also on account of various resolution mechanisms introduced in the recent past which include the SRFAESI Act, one time settlement schemes, setting up of the CDR mechanism, strengthening of DRTs. From the data available of Public Sector Banks as on March 31, 2003, there were 1,522 number s of NPAs as on March 31, 2003 which had gross value greater than Rs. 50 million in all the public sector banks in India. The total gross value of these NPAs amounted to Rs. 215 billion. The total number of resolution approaches (including cases where action is to be initiated) is greater than the number of NPAs, indicating some double counting. As can be seen, suit filed and BI FR is the two most common approaches to resolution of NPAs in public sector banks. Rehabilitation has been considered/ adopted in only about 13% of the cases. Settlement has been considered only in 9% of the cases. It is likely to have been adopted in even fewer cases. Data available on resolution strategies adopted by public sector banks suggest that Compromise settlement schemes with borrowers are found to be more effective than legal measures. Many banks have come out with their own restructuring schemes for settlement of NPA accounts. State Bank of India, HDFC Limited, M/s. Dun and Bradstreet Information Services (India) Pvt. Ltd. and M/s. Trans Union to serve as a mechanism for exchange of information between banks and FIs for curbing the growth of NPAs incorporated credit Information Bureau (India) Limited (CIBIL) in January 2001. 3) Willful Defaulters: RBI has issued revised guidelines in respect of detection of willful default and diversion and siphoning of funds. As per these guidelines a willful default occurs when a borrower defaults in meeting its obligations to the lender when it has capacity to honor the obligations or when funds have been utilized for purposes other than those for which finance was granted. The list of willful defaulters is required to be submitted to SEBI and RBI to prevent their access to capital markets.

Compromise settlement schemes

1. **One Time Settlement Schemes:** NPAs in all sectors, which have become doubtful or loss as on 31st March 2000. The scheme also covers NPAs classified as sub-

standard as on 31st March 2000, which have subsequently become doubtful or loss. All cases on which the banks have initiated action under the SRFAESI Act and also cases pending before Courts/DRTs/BIFR, subject to consent decree being obtained from the Courts/DRTs/BIFR are covered. However cases of willful default, fraud and malfeasance are not covered. As per the OTS scheme, for NPAs up to Rs. 10crores, the minimum amount that should be recovered should be 100% of the outstanding balance in the account.

2. **Negotiated Settlement Schemes:** The RBI /Government has been encouraging banks to design and implement policies for negotiated settlements, particularly for old and unresolved NPAs. The broad framework for such settlements was put in place in July 1995.

Conclusion

Because of mismanagement in bank there is a positive relation between Total Advances, Net Profits and NPA of bank which is not good. Positive relation between NPA & profits are due to wrong choice of clients by Banks. There is an adverse effect on the Liquidity of Bank. Bank is unable to give loans to the new customers due to lack of funds which arises due to NPA As per the government, the main reasons for rise in NPAs are sluggishness in the domestic growth in the recent past, slow recovery in the global economy and continuing uncertainty in global markets. Advances provided by banks need to be done pre-sanctioning evaluation and post disbursement control so that NPA can decrease. Good management needed on the side of banks to decrease the level of NPA. Proper selection of borrowers & follow ups required to get timely payment. On-performing assets are a drain to the banks. The banks in India are adopting various strategies to reduce the non-performing assets in their banks and they are also adopting various methodologies by which further addition to NPA portfolio is minimized.

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