Causes and Effects of Non-Performing Assets in the Banking Sector

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Abstract

The banking sector is an essential financial service sector supporting development plans through channelizing funds for productive purpose, intermediating flow of funds from surplus to deficit units and supporting financial and economic policies of the government. Banks serve social objectives through priority sector lending, mass branch networks and employment generation. Maintaining asset quality and profitability are critical for banks survival and growth. In the process of achieving such objectives, a major problem to banking sector is prevalence of Non-Performing Assets (NPA). Reserve Bank of India defined NPA as “An Asset, including a leased asset, becomes Non Performing Asset when it ceases to generate income for the bank”. The major causes for NPAs are willful default, miss utilization of borrowed funds, lack of proper pre enquiry before issuing loan. The Gross NPA of Indian Banks was 10.03 lakh crores as on 30 June 2018. Public Sector Banks accounts for 88.74% of total Gross NPAs. In this, the following top five public sector banks accounts for 46.67% the five banks are SBI, PNB, IDBI, BOI and BOB. Private Sector Banks account for 11.26% of total Gross NPAs. In this the top Private Sector banks are ICICI, AXIS and HDFC. The main objective of this paper is to study the causes and effects of NPAs in Banking Sector.

Key words: Banking, Non Performing Assets, Substandard Assets, Doubtful Assets, Loss Assets, Lending, Wilful Defaults

INTRODUCTION:

A strong banking sector is important for flourishing economy. With the introduction of financial sector reforms in 1991 the faces of Indian Banking sector have extremely changed. The banking sector also has a very important role in the recovery process of the country's economy as a whole. The banking industry has moved step by step from a synchronized environment to a decontrolled market based economy. The beginning of liberalization and globalization in market development there has been tremendous changes in the transitional role of banks in India. The failure of the banking sector may have an adverse impact on other sectors. Banks today are not judged only on the basis of number of branches and volume of deposits but also on the basis of standard of assets. Non-performing assets are one of the major concerns for banks in India NPAs negatively affect on the profitability, liquidity and solvency of the banks.

Objective of the study: The main objective of this paper is to study the causes and effects of NPAs in Banking Sector.

Macro Perspective behind NPAs

A lot of practical problems have been found in Indian banks, especially in public sector banks. For Example, the government of India had given a massive wavier of Rs. 15,000 Crs. under the Prime Minister ship of Mr. V.P. Singh, for rural debt during 1989-90. This was not a unique incident in India and left a negative impression on the payer of the loan. Poverty elevation programs like IRDP, RREP, SUME, SEPUP, JRY, PMRY etc., failed on various grounds in meeting their objectives. The huge amount of loan granted under these schemes was totally unrecoverable by banks due to political manipulation, misuse of funds and non-reliability of target audience of these sections. Loans given by banks are their assets and as the repayment of several of the loans was poor, the quality of these assets was steadily deteriorating. Credit allocation became 'Loan Melas', loan proposal evaluations were slack and as a result repayments were very poor.

Meaning of NPA:

- Money or Assets provided by banks to companies as loans sometimes remain unpaid by borrowers. This late or non-payment of loans is defined as Non-Performing Assets (NPA). They are also termed as bad assets.
- In India, the RBI monitors the entire banking system and, as defined by the country's central bank, if for a period of more than 90 days, the interest or installment amount is overdue then that loan account can be termed as a Non-Performing Asset.

The issue of Non Performing Assets has been discussed at length for financial system all over the world. The problem of NPAs is not only affecting the banks but also the whole economy. In fact high level of NPAs in Indian banks is nothing but a reflection of the state of health of the industry and trade.

Types of NPA : Gross NPA and Net NPA

Gross NPA:

Gross NPA (non-performing asset) refers to overall quantity of loans that have gone bad debts. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss asset. Gross NPA is a non standard asset, on which bank has made provisions, and which is still held in banks' books of account.

"Gross NPAs Ratio = Gross NPAs / Gross Advances"

Net NPA:

Net NPAs are those advances which are obtained after deducting the provisions from Gross NPA. Net NPA shows the actual burden of banks. The banks have to make certain provisions against the NPA's according to the RBI guidelines.

"Net NPAs = Gross NPAs – Provisions / Gross Advances – Provisions"

Assets Classification

Standard Assets:

Standard Asset means which assets are not facing the problem and not more risk towards customer. Such assets are assumed to be performing asset. A general provision of 0.25% has to be provided on global loan portfolio basis.

Sub-standard Assets:

An asset would be classified as sub-standard if it remained NPA for a period less than or equal to 12 months.

Doubtful Assets

These are the assets which have remained NPAs for a period exceeding 12 months and which are not considered as a loss advance.

Loss Assets

An asset that is an NPA for a period of more than 36 months and the loss is identified by the bank through the internal or external auditor or by the central bank inspectors. The amount has not been written off wholly or partly.

Percentage of provisions to be created:

	Secured loans	Unsecured loans
Substandard Assets	15%	25%
Doubtful Assets	25%-100%	100%
Loss Assets	Written off or 100%	Written off

From March 2015 to march 2018 the value of provisions created by banks was Rs 5.10 lakh crores, for the same period the value of NPAs in Indian banks has been tremendously increased by 6.2 lakh crores. The Gross NPA of Indian Banks was 10.03 lakh crores as on 30 June 2018.

Causes for Non Performing Assets

A strong banking sector is important for a flourishing economy. The failure of the banking sector may have an adverse impact on other sectors. The Indian banking system, which was operating in a closed economy, now faces the challenges of an open economy. One of the main causes of NPAs into banking sector is the directed loans system under which commercial banks are required a prescribed percentage of their credit (40%) to priority sectors. As of today nearly 7 percent of Gross NPAs are locked up in 'hard-core' doubtful and loss assets, accumulated over the years.

The factors for NPA are 1) Internal Factors and 2) External Factors

Internal Factors:

1. **Funds borrowed for particular purpose are not utilized for the same**
2. **Defective lending process:** There are three principles that are followed by the commercial banks in lending process i.e. principle of safety, principle of liquidity, principles of profitability. Principle of safety means that the borrower is in position to pay back the loan. Therefore the banker should take utmost care in ensuring that the enterprise or business for which a loan is sought is a sound one and the borrower is competent of carrying it out successfully, he should be a person of integrity and good character.
3. **Inappropriate technology:** Due to improper technology and management information system, market driven decisions on real time basis cannot be taken. So all the branches of the banks should be upgraded with current scenario.
4. **Improper SWOT analysis:** The inappropriate strength, weakness, opportunity and threat analysis is another reason for increase in NPA's. so the bank should examine the profitability, viability, long term acceptability of the project while financing.
5. **Poor credit appraisal system: D**ue to poor credit appraisal the bank gives advances to those who are not able to repay it back. As a result the NPA's of the bank increases. So the bank should maintain proper credit appraisal system.
6. **Managerial deficiencies:** The banker should always select the borrower very cautiously and should take tangible assets as security to safeguard its interests. The banker should follow the principle of diversification of risks which means that the banker should not grant advances to a few big firms only or to concentrate them in few industries or in few cities.
7. **Absence of regular follow up:** The irregularities in spot visit also increase the NPA's, the absence of regular visit of bank officials to the customer point decreases the collection of interest and principal on the loan.
8. **Incomplete and faulty documentation:** There should thorough verification by the officials on the documents submitted by the borrowers.

External Factors:

1. **Ineffective recovery tribunal:** The government has set of number of recovery tribunals, which works for recovery of loans and advances, due to their carelessness and ineffectiveness in their work the bank suffers the consequence of non-recovery, thereby reducing their profitability and liquidity.
2. **Willful Defaults:-** The Indian Public Sector Banks are worst hit by these defaults. It is a default in repayment obligation.
   Ex: Kingfisher Airlines Ltd. Is one among many of those willful defaulters. Others are Beta, Napthol, Winsome Diamonds & Jewellery Ltd., Rank Industries Ltd., XL Energy Ltd. etc.
3. **Natural calamities:** This is the measure factor, which is creating alarming increase in NPA's of the PSBs. Basically our farmers depends on rainfall for cropping due to irregularities of rainfall the farmers are unable to attain the production level and thus they are unable to repay the loans. So the banks has to make large amount of provisions in order to pay those loans
4. **Industrial sickness:** Inappropriate project handling, ineffective management, lack of adequate resources, lack of advanced technology, day to day change in government policies produce industrial sickness therefore the banks that finance those industries end up with a low recovery of their loans, by reducing their profit and liquidity.
5. **Lack of demand:** Entrepreneurs in India could not predict their product demand and starts production which ultimately piles up their product. Thus, making them unable to payback the money they borrow to operate these activities. Therefore the banks record the non recovered part as NPA's and has to make provision for it.

Effects of NPA

The following are the some of the major problems faced by banks due to NPA's:

1) **Effect of Profitability of Banks:** As NPA's cease to generate income for the banks it will reduce the net interest income of the banks. As NPA's goes on increasing, the net income of the banks will decrease.The cumulative loss of public sector banks crossed a whopping Rs 87,357 crore in the 2017-18 fiscal.

2) **Increase in provisions of banks:** RBI has introduced prudential norms for income recognition and asset classification for Indian banks and financial institutions, to ensure proper provisioning and transparency in the published accounts. In agreement

with the prudential norms of RBI, banks need to provide provision on Non-Performing Assets. The provisions are made by banks on the basis of classification of assets into Non-Performing Assets. This provision led to substantial provisioning of Rs 5.1 lakh crore in between March 2015 to march 2018.

3) **Liquidity position:** NPA's affects the liquidity position of the banks, thereby creating a miss-match between assets and liquidity and force the banks to raise resources at high cost. The increased NPAs may pose liquidity issues which is likely to lead run on bank by depositors.

4) **Effect on MSMEs:** The disbursement of loans mainly with the large scale firms, this made banks reluctant to issue loans to small scale industries. So MSME suffer from lack of funds from the banks and has to borrow from other sources which would increase their cost of capital.

5) **Shareholders' confidence:** Normally, shareholders are interested to enhance value of their investments through higher dividends and market capitalization which is possible only when the bank posts significant profits through improved business. The increased NPA level is likely to have adverse impact on the bank business as well as profitability thereby the shareholders do not receive a market return on their capital and sometimes it may erode their value of investments.
   Example: Share price of Punjab National Bank.

6) **Burden to Government:** Since the Government is the majority shareholder in the public sector banks, it has to provide equity capital, if the banks are struggling. As NPA's are increasing PSB's are struggling, so the government needs to provide capital to the banks.

7) **Higher cost of capital:** It shall result in increasing the cost of capital as banks will now have to keep aside more funds for the smooth working of its operations. To generate income and meet the expenses the banks will increase the interest rates.

8) **Declining productivity:** Loans given by the banks are the assets to the banks. Since the Assets (NPA's) of the banks ceases to generate income for the bank there will be decrease in the income which leads to decrease in productivity of the bank's assets.

9) **Asset (Credit) contraction**: The increased NPAs put pressure on recycling of funds and reduces the ability of banks for lending more and thus results in lesser interest income. It contracts the money stock which may lead to economic slowdown.

10) **Public confidence**: Credibility of banking system is also affected greatly due to higher level NPAs because it shakes the confidence of general public in the soundness of the banking system.
11) **Ultimate burden on society:** It will ultimately affect the consumer who now will have to fetch out more money for paying higher interest. It will lead to lower growth and higher inflation because of the higher cost of capital.

Conclusion:

The Non-Performing Assets have always created a big problem for the banks in India. It is just not only problem for the banks but for the economy too. The money locked up in NPAs has a direct impact on profitability of the bank as Indian banks are highly dependent on income from interest on funds lent. In a nutshell, the high incidence of NPA has cascading impact on all important financial ratios of the banks viz., Net Interest Margin, Return on Assets, Profitability, Dividend Payout, Provision coverage ratio, Credit contraction etc., which may likely to erode the value of all stakeholders including Shareholders, Depositors, Borrowers, Employees and public at large. Although various steps have been taken by government to reduce the NPAs but still a lot needs to be done to curb this problem. The NPAs level of our banks is still high as compared to the foreign banks. It is not at all possible to have zero NPAs. . The bank needs be proactive in the selection of clients and customers while sanctioning of loans. The bank management should speed up the recovery process. The problem of recovery is not with small borrowers but with large borrowers and a strict policy should be followed for solving this problem. The government should also make more provisions for faster settlement of pending cases and also it should reduce the mandatory lending to priority sector as this is the major problem creating area. So the problem of NPA needs lots of serious efforts otherwise NPAs will keep killing the profitability of banks which is not good for the growing Indian economy at all.

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