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NON-PERFORMING ASSETS (NPAS) IN THE INDIAN BANKING SYSTEM: UNVEILING THE FACTUAL ANECDOTE

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ABSTRACT

The Non-Performing Asset (NPA) emerges from a bank's assets in the form of loans, advances and investments. When an asset fails to create the projected income it becomes a NPA. The concept of NPA in India was introduced by RBI to reflect bank's actual financial health in its balance sheet. Provisioning for NPAs have more than doubled, which has led to a whopping 60 per cent decline in net profits for the SCBs. The aggregate increase in NPAs have almost reached to 47 per cent between March 2015 and March 2017. The present analysis deals with the current status of NPAs accruing across all SCBs in India, root causes of growing NPAs and suggest ways of minimizing its effect on the economy. In order to analyze the NPA factor and NPA based performance of the banks, Gross NPA% (GNPA), Net NPA% (NNPA) in terms of Gross Advances, Net Advances, Growth % of Gross Advances and growth % of Gross NPAs have been calculated. These ratios of the banks have been analyzed further through CAGR and regression analysis.

Keywords: Non-performing assets, Gross Advances, Net Advances, CAGR, Corporate Debt Restructuring, forensic audits, JEL: E1

1. INTRODUCTION

The banking system in India encompasses of Commercial Banks and Cooperative Banks. The commercial banks alone accounts for more than 90 per cent of banking system's assets which comprises of few foreign and Indian private banks, all public sector banks (nationalized banks, State Bank and its subsidiaries), Regional Rural Banks (RRBs) and Local Area Banks (LABs). Bankers are the custodians of reserves of the liquid capital of a country. Therefore the most important function of the banking system is to mobilize the savings of the public by accepting deposits from them. Deposit mobilization stimulates economic stability by controlling the flow of money and channelizing for development and productive purposes. In order to promote deposits, the commercial banks undertake various deposit schemes suited to the needs of

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different sections of the society. 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 built on the sources of funds.

The banks have different forms 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) emerges from loans, advances and investments. Till the time an asset produces the expected cash flow from it and does not unveil any unusual risk, it is dealt as a performing asset, but when it fails to create the projected income it becomes a Non-Performing Asset. Hence, a loan gets converted into a Non Performing Asset (NPA) when it ceases to generate further income in the form of either interest, fees, commission or any other dues for the bank for more than 90 days. Non-Performing Assets are also known as Non-Performing Loans. It accrues to a bank or when repayments are not being made on time. A loan is an asset for a bank as the interest payments and the repayment of the principal amount create a stream of cash flows. It is from these interests that a bank make profits for itself. Banks usually consider assets as non-performing if they are not refurbished for some time. If interest payments to be made are late for a short time, a loan is categorized as past due; and once the interest payment becomes long over-due (usually 90 days), the loan is then classified as non-performing. A high level of non-performing assets is a sign of problem.

The concept of NPA in India was introduced by RBI based on the recommendations of the Narasimham Committee. The idea of introducing this concept is to reflect bank's actual financial health in its balance sheet. RBI issued master circular titled "Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances, 2001".

If we give a glance at the consolidated balance sheets of the banking sector of India, we will see that the sector has been growing at a modest pace during 2015-16 with assets/liabilities expanding at 7.7 per cent as compared to 9.7 per cent in 2014-15. During 2015-16, SCBs' interest earnings and non-interest incomes had slowed down to a great extent. Falling interest income was a result of persistent slowdown in credit growth. With improved recognition of non-performing assets, provisioning for NPAs have more than doubled, which has led to a whopping 60 per cent decline in net profits for the SCBs. The aggregate increase in NPAs have almost reached to 47 per cent between March 2015 and March 2017. In figures, NPAs or bad debt went up from Rs 3,563 crore at the end of March 2015 to Rs 5,192 crore by the end of March 2017. The surge mostly took place in 2015-16, with the pace slowing down during the last financial year.

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2. REVIEW OF LITERATURE

Numerous studies have been undertaken in the area of Non-Performing assets and their impact on the Indian Banking system. Some of the relevant studies pertaining to the topic at hand is summarized below.

Tripathi, L. K. et al., (2014) has investigated the effect of priority sector advances, unsecured advances and advances made to some sectors by banks like SBI and other banks on Gross NPAs of banks. Ranjan, R. and Dhal, S. C., (2013) applied an empirical approach to analyze the Indian commercial banks' non-performing loans by using regression analysis. The empirical analysis evaluated as to how the NPA's are influenced by some economic and financial factors, i.e., terms of credit, macroeconomic shocks and bank size induced risk preferences. Srinivas, K. T., (2013) undertook to study the reasons for loans and advances becoming NPA in the banking Sector and gave some suitable solutions to overcome the said problem.

Kumar (2013) in his study on a Comparative analysis of NPAs of Old Private Sector Banks and Foreign Banks, said that Non-Performing Assets (NPAs) have become a real-time issue for the Indian banking sector for many years now. One of the major issues affecting the functioning of commercial banks in the late 90s was the accrual of huge non-performing assets (NPAs). Selvarajan & Vadivalagan (2013) made a study on management of Non-Performing Assets in Priority Sector with reference to Indian Bank and Public Sector Banks (PSBs) and found that Indian Bank's lending to Priority sector is more than that of all the Public Sector Banks as a whole. Singh (2013) in his paper on recovery of NPAs in Indian commercial banks said that the problem of escalating NPAs originated from credit risk management system of banks. The paper articulated that banks should have sufficient pre-emptive measures to continuously monitor loans and spot accounts that have the likelihood of becoming non- performing. Gupta (2012) in her study on Comparative Analysis of Non-Performing Assets of SBI & Associates & Other Public Sector Banks had concluded that every bank should have its own independent credit rating agency which should be able to assess the financial ability of the debtor before disbursing loans. Rai (2012) in her study on performance of NPAs of Indian commercial banks uncovered the fact that banks did not take actions to recover from corporate borrowers irrespective of continuous defaults in payments. Chatterjee C., Mukherjee J. and Das (2012) in their study on management of non-performing assets - a current scenario had emphasized that banks must be able to figure out the actual purpose of the loan required by the borrower. Identification of the guarantor should be authenticated by the bank that includes 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) stressed upon the fact that NPAs are considered as a key parameter to evaluate the functioning and financial health of banks.

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Balasubramaniam C.S. (2001) pointed out that the level of NPA is becoming relatively high with all banks and that they are expected to take measures to bring down their NPA levels. Some suggested measures given by the researcher were by incorporating good credit appraisal procedures, efficient internal control systems and also constantly improving the asset quality in their balance sheets.

3. STATEMENT OF THE PROBLEM

The banking system in India has witnessed many upswings since the initiation of global slowdown. Investor sentiments turned warily optimistic as the economy slowly moved towards recovery. But recent instances on the rising Non-Performing Assets (NPA) and cases of bribery has unveiled the risks faced by this sector in India. In certain situations, guarantor reliability issues have also led to banks facing the burden of the financial losses. RBI and all SCBs are leaving no stone unturned to deal with these apprehensions and minimize the effects of these risks.

The present analysis would deal with the current status of NPAs accruing across all SCBs in India. The analysis would also try to throw light on the root causes of growing NPAs and suggest ways of minimizing its effect on the economy.

4. OBJECTIVES OF THE STUDY

- To analyze the trend and performance of PSU and Private Banks through NPA analysis.
- To identify and assess the causes of mounting NPAs in the banking sector in India.
- To suggest remedial measures to minimize the triggering effect of NPA on the economy.

5. METHODOLOGY

A. Research Design: In this study, descriptive research design is used to analyze the rising trend of NPA and the reasons behind this rise. Hence, descriptive research design is used here as a fact finding approach.

B. Sampling method: The sampling method here involves the purposive sampling where the sample is chosen from selected SCBs based on the objective to be fulfilled.

C. Selection of the Sample Units: By using the purposive sampling, the entire SCBs have been categorized as State Bank of India (SBI) and its associates, other Nationalized Banks, old and new Private Sector Banks and Foreign Banks as the sample units for the study.

D. Data Collection: The data were collected through annual report from RBI and RBI statistics on Banking Sector in India and other sources such as newspapers, books and journals.

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E. Period of Study: To highlights the trends, status and impact of NPA on scheduled commercial banks, data has been collected for a period of 10 years i.e., from 2007 to 2016. In some case, data has also been given from 2003 onwards.
F. Tools used: In order to analyze the NPA factor and NPA based performance of the banks, Gross NPA% (GNPA), Net NPA% (NNPA) in terms of Gross Advances, Net Advances and Total Assets have been calculated. Growth % of Gross Advances and growth % of Gross NPAs are also calculated. These ratios of the banks have been analyzed further through CAGR and regression analysis.

6. THE NPA "CRISIS"

The threats in terms of risks associated with banks in India has undergone a sea change over the last few years. Rise in bad debts in the banking sector have been the center of media headlines, which straightaway reflects the financial conditions of the banking institutions. According to the data released by RBI, there has been a steep increase in the growth of NPAs reported by banks. This is not only distressing their balance sheets, but also impacting the economy at large.

The top 30 defaulters account for US$ 14.9 billion. The stated values are quite high, and there are new accumulations every quarter, leading to further worsening of asset quality. The portfolio of restructured accounts is aggravating to the problem, thereby ensuing a "crisis".

The table 1 depicts the amount of Gross Advances, Gross NPA, percentage of Gross NPA, Net Advances, Net NPA, percentage of Net NPA during the period of 2003-04 to 2014-15. The amount of gross advances has increased from Rs 9020 Billion in 2003-04 to Rs 75606 Billion in 2014-15. Similarly, the net advances has increased from Rs 8626 billion in 2003-04 to Rs 73881 billion in 2014-15. The amount of gross NPA has increased from Rs 648 billion in 2003-04 to Rs 3233 billion in 2014-15. Similarly, the net NPA has increased from Rs 244 billion in 2003-04 to Rs 1761 billion in 2014-15. It can also be analyzed from figure 1 that the growth in Gross NPAs had substantially increased in 2011. However, from 2012 till 2015, there was a dip in the growth of NPAs. But there was a complete turnaround in 2016 with growth rate of NPAs mounting to 60 per cent growth compared to the previous year.

The CAGR of Gross Advances of SCBS has been found to be 6.33 and similarly CAGR of Gross NPAs is 4.62 (Source: author, calculated).

It can be seen from figure 2 above that the at the beginning of the year 2003-04, the ratio of gross NPA to gross advances and ratio of net NPA to net advances have been quite high, but later on there has been quite improvement on this front and the ratio has declined notably. However,

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from 2011 onwards, it has started increasing and the same stands at 4.3 per cent in 2014-15. This rising trend definitely demands serious attention.

It can also be witnessed that sparkling contrast has started emerging in NPAs of both public and private sector banks in India during recent years. The following figure gives a clear picture of the same.

From the figure 3, it can very well be seen that NPAs of public sector banks are much higher than that of the private sector banks and in the case of the former, they have increased over the period very sharply whereas the same of the private sector banks have increased very marginally.

Apart from this, the percentage of gross NPAs to total assets is much higher for public sector banks compared to the private sector banks which can be witnessed through figure 4.

6.1 Sparks leading to the NPA Crisis

1. Non priority sector advances have contributed greatly to acceleration in total NPAs in the recent period

The table 2 very clearly reveals that Non-priority advances have increased greatly for both public and private sector banks over the years.

The table 2 demonstrates gross advances given to priority and non-priority sector by Public sector banks as well private sector banks and NPAs associated with them. As far as advances is concerned, it can be seen that the exposure for banks in the non-priority sector is more than twice their exposure in the priority sector. The share of NPAs in the non-priority sector too is much more than that of the priority sector. The non-priority sector has been responsible for the current rise in NPAs.

The exorbitant rise in NPAs of non-priority sector was contemplative of the slowdown of the economy and strained financial setbacks of corporates that trailed after the worldwide financial crisis.

2. NPAs in the retail loan segment has declined over time, but their share in aggregate NPA still remains high.

The credit flow in the retail segment has declined eventually, which has resulted in fall in the overall growth of NPAs in this sector. There was a drastic fall in the growth of retail loans from 7.5 per cent during 2001-2007 to 2.6 per cent during 2008-2012. This could be partly due to risk aversion that followed after the global financial crisis. The subsequent fall in NPAs in retail loan segment has been even bigger from 9.3 per cent to 2.5 per cent during the same period. Though

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the share of NPAs in retail loan segment has decelerated from 38 per cent in 2009 to 18 per cent by 2012, it still remains to be high and exceeding than the priority sectors like agriculture.

3. Coal and textiles industry have contributed considerably to recent deterioration in asset quality with respect to the industrial sector.

Considering the gross NPA ratio, asset quality of certain industries has declined drastically over time. The coal industry was the worst hit, with its NPA ratio being at the top. Its NPA ratio increased steeply from 0.2 per cent in 2011 to 8.2 per cent in 2012. The other industries that have contributed to growing NPAs during the recent times include other textiles, jute textiles, cotton textiles, computer software, leather and leather products (Source: RBI Publication).

4. Non-Performing loans of every bank is largely a result of inefficient management controls and systems established by them.

The growth in advances of banks is regulated by the economic and business environment. A bank with an efficient and strong credit appraisal and loan retrieval system will grow stronger with time, and such banks will be able to drive their credit portfolio to a new level, particularly when the economy is flourishing. Also, when banks have a diversified credit portfolio, they can mitigate risk during economic downturns. This will result in lower NPAs, letting them to grow robustly and endure higher frequencies of default.

However, a bank without an efficient and strong credit appraisal and loan retrieval system will not be able to push their credit portfolio the way they would want to. When these banks push their advances portfolio, the probability of their asset quality getting deteriorated become higher and will have higher NPA levels, especially when the economy witnesses average credit growth. And this has exactly happened with the Indian Banking System. With a CAGR of over 6 per cent in gross advances, the NPAs have been higher than normal levels.

This fact has been validated further through the statistical results derived out of it. To substantiate that India's banking system is witnessing higher NPAs due to higher credit growth coupled with inadequate management control and credit appraisal system, following hypotheses have been formulated and the results have been validated with the use of linear regression analysis.

H0: Growth in gross advances does not result in higher NPAs.
H1: Growth in gross advances result in higher NPAs.

Following is the result summary:

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Result Summary

R Square	0.79
F - Stat	30.8
t - Stat	5.55
p value	0.00054

(Source: Author, calculated)

The value of coefficient of Determination R2 has come out to be 0.79 which indicates that 1 per cent change in gross advances results in 79 per cent change in NPA values. Since, p-value < 0.05, the result is statistically significant at 95 per cent confidence interval, paving the way for rejecting the null hypothesis. The t-stat and the F-stat is also statistically significant at 95 per cent confidence interval with df = 9. In other words, growth in gross advances has resulted in higher NPAs in the Indian banking system.

5. Higher NPAs is a result of both internal and external factors.

As it has been already seen in the paper, gross NPAs for public sector banks have been significantly rising. While corporate borrowers have recurrently accused the economic slowdown as the crucial factor behind it, regular independent audits on borrowers have shown diversion of funds or wilful default heading to stress situations. Scrutinizing the severity of the current state, pre-sanction due diligence and sanctioning process have also been under the scrutiny of the regulator to measure the control mechanism at banks.

Bankers are of the view that the rise in NPA numbers is a result of diversion of funds to extraneous business or fraud. Bankers consider that it is an outcome of inadequacies in the post-disbursement monitoring process.

6.2 Reforming Applications – Taking Cautious Steps

Banks have been whirling under stress due to the rising number of defaults. As a result, there is a substantial increase in corporates looking at Corporate Debt Restructuring (CDR) mechanism to streamline their loans. Around 647 default cases have been transferred to CDR Cell in 2014-15. Given the rise in CDR cases, the CDR cell informed banks in 2014 to carry out forensic audits before moving the corporate case to the CDR for approval. This step was a preemptive move to track the quality and legitimacy of companies needing surplus funds for existence.

Now every bank has reflected the significance of forensic audits and that it should be made mandatory prior to restructuring of loans. Banks also believe that forensic audit would not only

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help in unclogging wilful defaulters but would also result in reducing recovery costs. Additionally, forensic audits may also assist in rational decision-making in early identification of frauds.

An important aspect that regulators have started considering before approving for restructuring is the viability of the business and the initial funds being contributed by the promoters. Project appraisals should be backed by relevant facts and ambiguities encompassing the project. Restructuring proposals often include inflated cash flow analysis, vague repayment schedule and time completion of project. Banks should therefore be able to view “window dressed” proposals cautiously and recognize the actual intent of the borrower.

Apart from discussion with the borrower and ascertaining any default past history, surprise site visits should be carried out particularly when high value loans are being sanctioned. The new RBI guidelines have also stressed on collecting independent information through market intelligence/public domain/ registrar of companies/defaulter list as a part of the pre-sanction process.

7. CONCLUSION

Assessment of the current situation in the present study reveals that banks need to frame more proactive policies or guidelines and insure that it gets implemented strongly. The new RBI norms have cited a strong roadmap for improving the overall banking management control system to manage loan frauds. Banks must adopt and implement these measures in the right way rather just considering them to be as new set of policies. The vital process to identify willful defaulters would be to assimilate and investigate transactional data (i.e., bank statements) with audit reports and information from the public domain including market information to find variances.

The path to revival is extensive and challenging. However, bankers are becoming warily optimistic that the NPA situation will get better but at a gradual pace.

8. FIGURES AND TABLES

8.1 Figures

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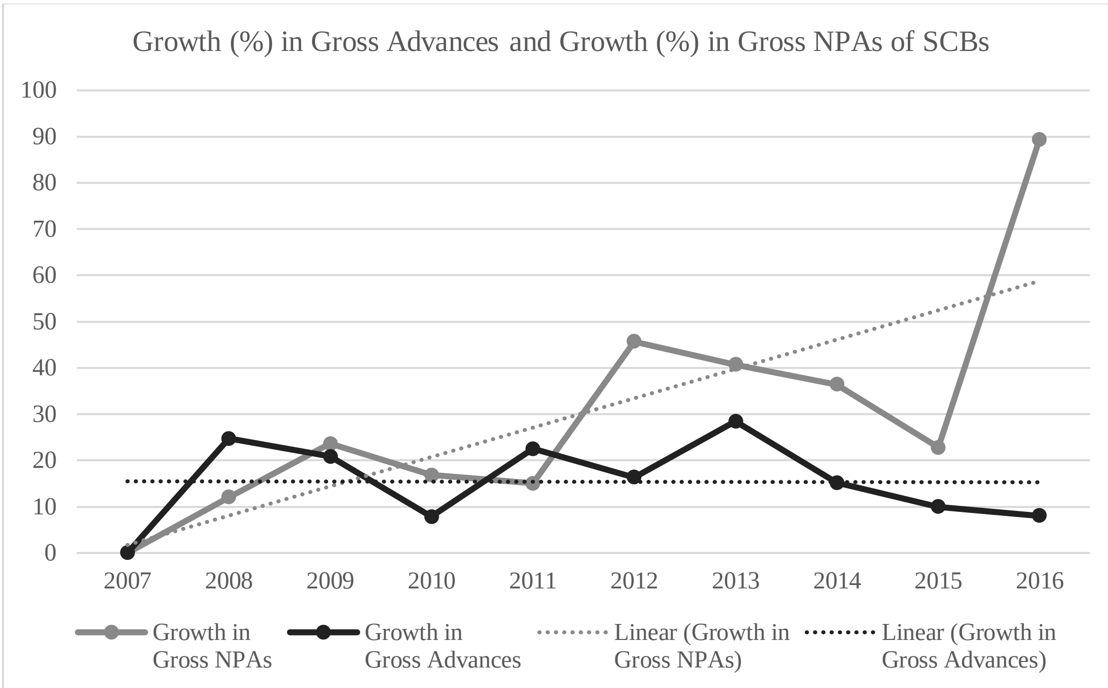

Figure 1: Growth (%) in Gross Advances and Growth (%) in Gross NPAs of SCBs. Source: Calculated by the author.

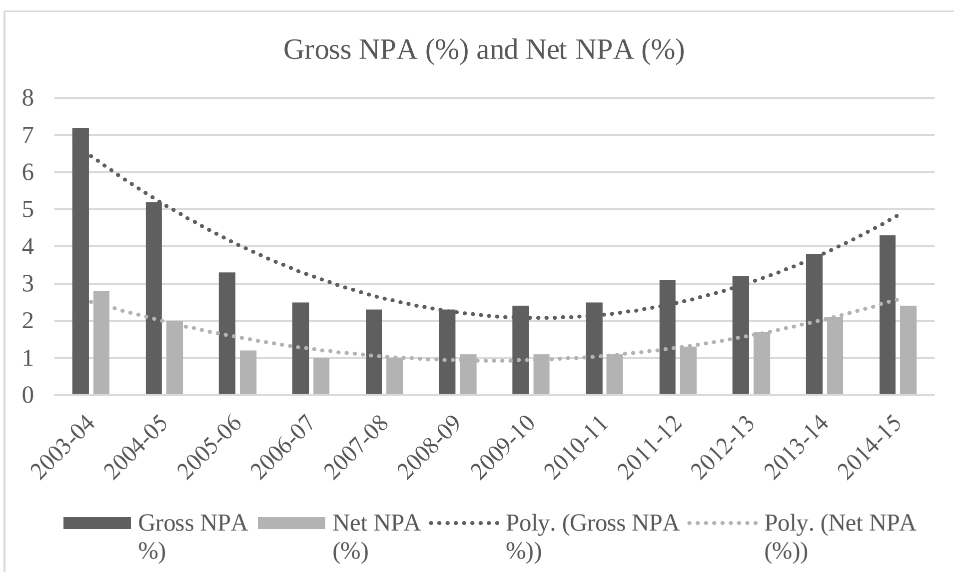

Figure 2: Gross NPA (%) and Net NPA (%) of SCBs. Source: Compiled from RBI reports

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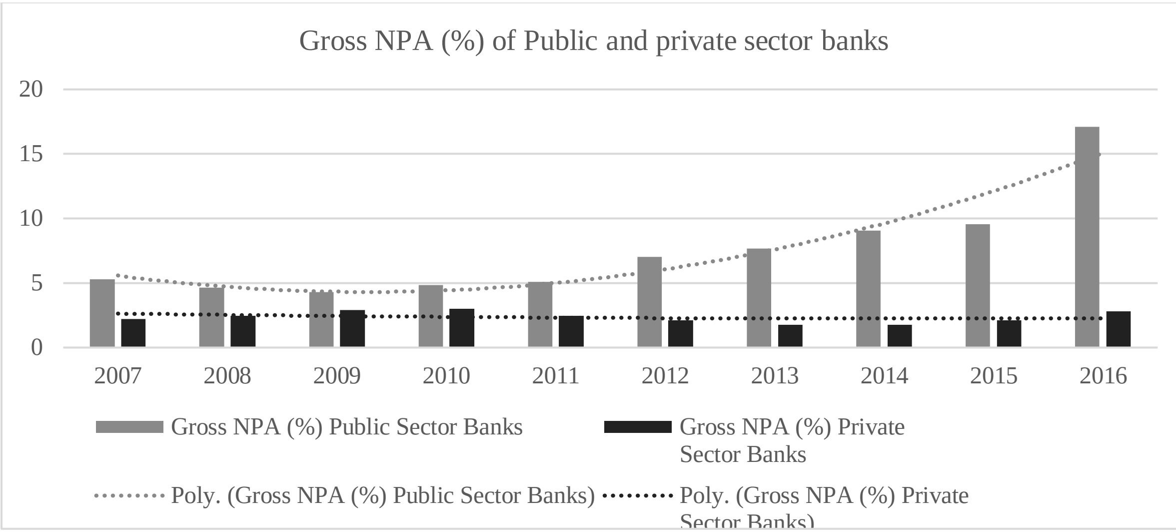

Figure 3: Gross NPA (%) of Public and Private Sector Banks.

Source: Compiled from RBI Reports.

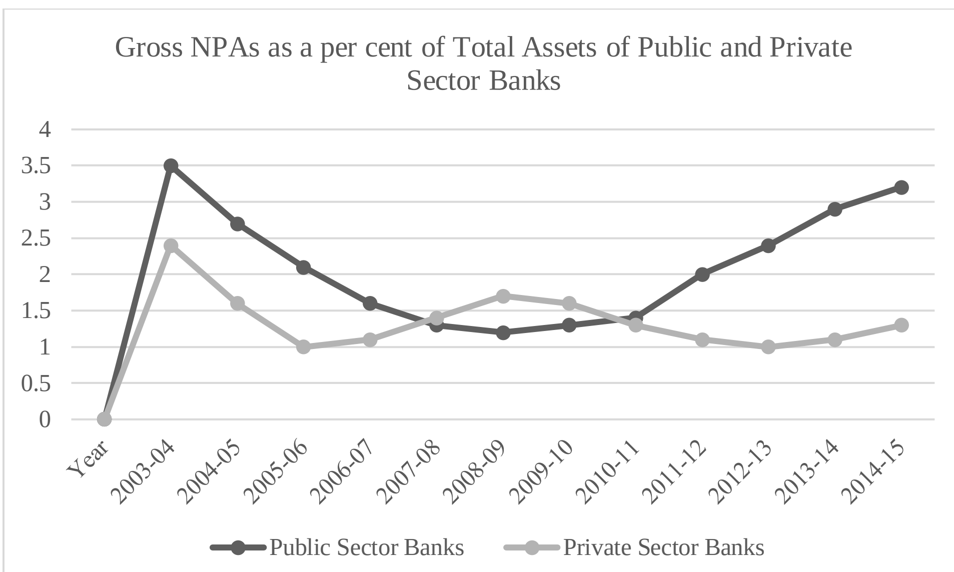

Figure 4: Gross NPA as a per cent of Total Assets of Public and Private Sector Banks.
Source: Compiled from RBI Reports.

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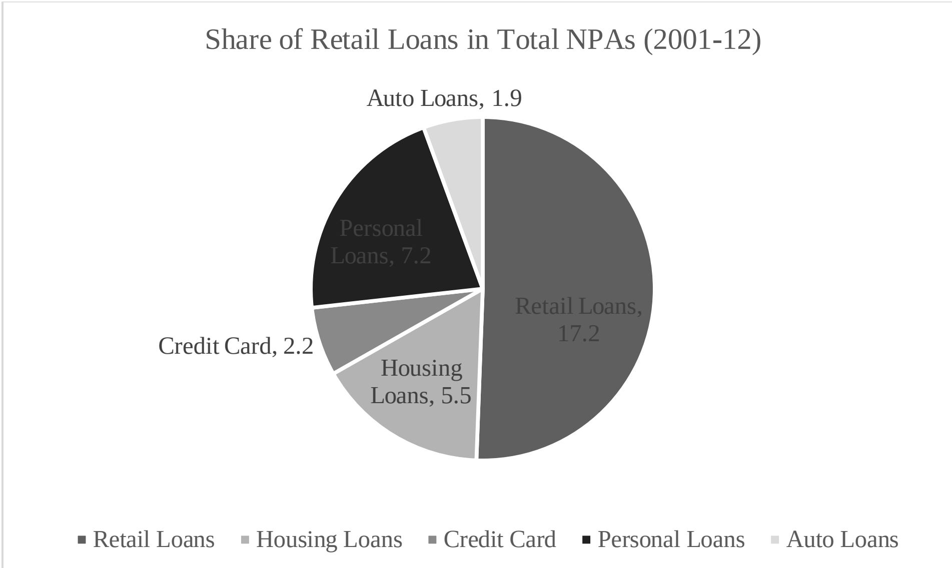

Figure 5: Share of Retail Loans in Total NPAs. Source: RBI Publications.

8.2 Tables

Table 1: Gross NPAs and Net NPAs across all SCBs. Source: Compiled from RBI Reports

Gross NPAs and Net NPAs across all SCBs					(in Rs billion)	
Year	**Gross Advances**	**Gross NPAs**	**Gross NPAs as a %age of Gross Advances**	**Net Advances**	**Net NPAs**	**Net NPAs as a %age of Net Advances**
2003-04	9020.26	648.12	7.2	8626.43	243.96	2.8
2004-05	11526.82	593.73	5.2	11156.63	217.54	2
2005-06	15513.78	510.97	3.3	15168.11	185.43	1.2
2006-07	20125.1	504.86	2.5	19812.37	201.01	1
2007-08	25078.85	563.09	2.3	24769.36	247.3	1
2008-09	30382.54	683.28	2.3	29999.24	315.64	1.1
2009-10	35449.65	846.98	2.4	34970.92	387.23	1.1
2010-11	40120.79	979	2.5	42987.04	417	1.1
2011-12	46488.08	1429.03	3.1	50735.59	652.05	1.3
2012-13	59718.2	1940.53	3.2	58797.73	986.94	1.7
2013-14	68757.48	2633.72	3.8	67352.13	1426.56	2.1
2014-15	75606.66	3233.45	4.3	73881.79	1760.93	2.4

Table 2: Share of priority/non-priority sectors in total gross advances and NPAs of public and private sector banks.

Amount in 'billion (Rs)								
Bank Group	**Public Sector Banks**				**Private Sector Banks**			
	Priority Sector		**Non-Priority Sector**		**Priority Sector**		**Non-Priority Sector**	
	Gross Advances	**Gross NPAs**	**Gross Advances**	**Gross NPAs**	**Gross Advances**	**Gross NPAs**	**Gross Advances**	**Gross NPAs**
2013	12,790	669	27,769	890	3,157	52	7,309	148
2014	15,193	792	30,712	1,375	3,831	61	8,287	167
2015	16,860	937	31,593	1,691	4,428	72	9,946	244
2016	18,675	1,271	32,146	3,749	5,620	101	12,297	382

Source: Compiled from RBI Reports

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