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NPAs in Indian Banking Industry

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Abstract: The significant transformation that Indian banking system has undergone following the financial sector reforms. It is striving to become more and more resilient by adopting international best practices. Several prudential and provisioning norms have been introduced, and these are pushing banks to improve efficiency and trim down NPAs to improve the financial health in the banking system. The buildup of NPA is one of the determinants of financial stability and the growth of the banking system as NPA have a deteriorating impact on capital, liquidity and profitability. Furthermore, a high level of NPAs puts a strain on the net worth of banks and hampers their ability to recycle funds. In the last three years, since the onset of the global financial turmoil, the rising NPAs of Indian banking system have become a major source of concern. In the background of these developments, this study strives to examine the state of affairs of the Non Performing Assets (NPAs) of the public sector banks and private sector banks in India.

Introduction

A debt obligation where the borrower has not paid any previously agreed interest and principal repayments to the designated lender for an extended period of time. The nonperforming asset is therefore not yielding any income to the lender in the form of principal and interest payments. For example, a mortgage in default would be considered non-performing. After a prolonged period of non-payment, the lender will force the borrower to liquidate any assets that were pledged as part of the debt agreement. If no assets were pledged, the lenders might write-off the asset as a bad debt and then sell it at a discount to a collections agency. So, NPA is a classification used by financial institutions that refers to loans that are in jeopardy of default. Once the borrower has failed to make interest or principal payments for 90 days the loan is considered to be a non-performing asset. Non-performing assets are problematic for financial institutions since they depend on interest payments for income. Troublesome pressure from the economy can lead to a sharp increase in non-performing loans and often results in massive write-downs.

Impact of NPAs on banks' profits and lending prowess

The efficiency of a bank is not only reflected through the size of its balance sheet but by the return on its assets as well. NPAs do not accrue any interest income for the banks, but at the same time banks are required to make provisions for such NPAs from their current profits. NPAs have a deleterious effect on the return on assets in several ways. NPAs erode current profits through provisioning requirements of the banks which results in to reduced income. These higher provisioning requirements affect profits and a consequent accretion to capital funds and capacity to increase good quality risk assets in future. Also, they limit recycling of funds, set in asset-liability mismatches, etc. There is at times a tendency among some of the banks to understate the level of NPAs in order to reduce the provisioning and boost up the outlook towards the bank. It is nothing but postponing the doomsday effect, as it has happened in some of the banks with disastrous consequences, like getting branded as weak and losing credibility internationally, besides subjecting the senior management to vigilance, CBI and other judicial and quasi-judicial process. In the context of crippling effect on a bank's operations in all spheres, asset quality has been placed as one of the most important parameters in the measurement of a bank's performance under the CAMELS supervisory rating system of RBI.

Movement of NPAs over the years

A glance through the statistics on the movement of NPAs of public sector banks since introduction of prudential norms towards NPAs in 1992-1993 will help to understand the extent to which the public sector banks have made progress in reducing their NPA levels.

Year	Gross NPAs		Net NPAs	
	Amount (Rs. Crore)	As a percentage to Total Advances	Amount (Rs. crore)	As a percentage to net advances
(1)	(2)	(3)	(4)	(5)
1992-1993	39253.14	23.18	Not compiled	
1993-1994	41041.33	24.78	19690.74	14.46
1994-1995	38385.18	19.45	17566.64	10.67
1995-1996	41660.94	18.01	18297.49	8.90
1996-1997	43577.09	17.84	20284.73	9.18
1997-1998	45652.64	16.02	21232.13	8.15
1998-1999	51710.50	15.89	24211.49	8.13
1999-2000	53294.02	14.02	26187.60	7.42
2000-2001	54773.16	12.40	27968.11	6.74

Source: as mentioned in references

The level of gross and net NPAs has been coming down over the years. Gross NPA had come down from 23.18% in 1992-93 to 12.40% in 2000-01. Net NPA also showed a north-ward movement from 14.46% in 1993-94 to 6.74% in 2000-01. Still the NPA level has a significant magnitude in absolute terms costing the public sector banks more than Rs.5000 crores annually by way of loss of interest income, besides other servicing and litigation costs. Major portion of the NPAs was a legacy of the pre-prudential days, when banks were accounting for interest as income on accrual basis even when the underlying advances were not performing. It will be interesting to analyze the movement of NPAs (gross and net), as a percentage of advances, group-wise for 1998-2001. This will give an idea of where banks, as different groups, stand in regard to their NPAs.

Bank group	**Percentage of gross / net NPAs to total advances as at end March**			
	1998	1999	2000	2001
Public sector banks	16.0 (8.2)	15.9 (8.1)	14.0 (7.4)	12.4 (6.7)
All private sector banks	8.7 (5.3)	10.8 (7.4)	8.2 (5.4)	8.5 (5.4)
Old private sector banks	10.9 (6.5)	13.1 (9.0)	10.8 (7.1)	11.1 (7.3)
New private sector banks	3.5 (2.6)	6.2 (4.5)	4.1 (2.9)	5.1 (3.1)
Foreign banks	6.4 (2.2)	7.6 (2.9)	7.0 (2.4)	6.8 (1.9)
All commercial banks	14.4 (7.3)	14.7 (7.6)	12.7 (6.8)	11.4 (6.2)

Note: Figures in parenthesis denote percentage of net NPAs to net advances

It may be observed that the malady of high level of NPAs eroding the profitability of banks is not confined to public sector banks alone, but it is equally present in the private sector banks too. While some of the foreign banks loan portfolio had been affected by a few large accounts turning NPA, it is a matter of concern that some of the new private sector banks which started off on a clean slate had acquired so quickly such a large level of NPAs.

NPAs - Causes

Incidence and impact of directed lending to stock of NPAs

While analyzing the causes of buildup of NPA in the Indian banking industry, directed lending concept gets quoted as an important attribute and as a contributory factor. RBI and the Government are often accused of extending soft attitude towards banks which do not fulfill the prescribed targets for priority sector lending, particularly agriculture and small scale sector. For a proper perspective, the contribution towards NPA stock of public sector banks by various segments of borrowers should be analyzed.

Borrowing segment-wise distribution of gross NPAs	Gross NPAs as on March 31, 2001	
	Amount (Rs. crores)	Percentage to total NPAs
Public sector units	1334.05	2.44
Large Industries	11498.10	20.99
Medium industries	8658.69	15.81
Other non priority sectors	9516.62	17.37
Agriculture	7311.40	13.35
Small scale industries	10284.97	18.78
Other priority sectors	6169.33	11.26
Total	54773.16	100.00

Recovery of NPAs under priority sector advances (which is statutory in nature) particularly to agriculture and small-scale industries is sometimes hampered by externalities. There is reluctance observed from the end of large borrowers to honour their repayment obligations. In many cases, failure of banks to take effective action against some of the defaulting large corporate borrowers was also noticed. Recovery of dues by banks is directly related to the performance of the borrowal unit/industrial segments. Certain factors that contribute to the growth of non-performing assets in the Indian banking industry in both public as well as private sectors can be segregated as internal and external.

Internal factors

Funds are often misappropriated in terms of diversion towards expansion/diversification/and modernization also sometimes funds are often to be directed towards taking up of new projects and promoting the associated concerns. Trying and cost overrun during the product implementation stage. Business failure like product and marketing et cetera, inefficient management, strenuous labour relations, and appropriate technology or technical problems contribute significantly as internal factors towards the growth of NPAs in Indian banking industry.

External factors

Eternal factors represent non-systematic contingencies like recession, default of payment and other countries, infrastructure bottlenecks, supply-side constraints, unforeseen mishaps like accident and natural calamities, changes in government policies regarding text structure, duties and other environmental and prudential norms. Contribution to NPAs by factors like siphoning off funds thorough fraud/misappropriation which is often perceived as the main cause was actually less significant in comparison with other factors. Lack of effective co-ordination between banks and financial institutions in respect of large value projects does contribute to the emergence of NPAs even at the implementation stage. Susceptibility of the sanctioning authorities to external pressure, failings of the CEOs and the ineffectiveness of the Board to check his ways also contributed in no small measure to the unusual build up of NPAs in some of the banks. One of the most prominent causes for NPAs, as often observed by RBI, is the slackness on the part of the credit management staff in their follow up to detect and prevent diversion of funds in the post-disbursement stage. The controversy as to who should be held responsible for diversion of funds – banks or borrowers – may not get settled and is not that material for recovery of NPAs. Borrowers should, in the interest of the viability of the banking system on which they are dependent, resist all temptations to divert bank funds for uses other than for which they are sanctioned. Banks too on their part should be vigilant to detect and prevent diversion of funds as any failure in this front is a potential source of NPAs.

Implications of NPAs

The most important business implication of the NPAs is that it leads to the credit risk management assuming priority over other aspects of bank's functioning. The bank’s whole machinery would thus be pre-occupied with recovery procedures rather than concentrating on expanding business. A bank with high level of NPAs would be forced to incur carrying costs on a non-income yielding assets. Other consequences would be reduction in interest income, high level of provisioning, stress on profitability and capital adequacy, gradual decline in ability to meet steady increase in cost, increased pressure on net interest margin thereby reducing competitiveness, steady erosion of capital resources and increased difficulty in augmenting capital resources. The lesser appreciated implications are reputational risks arising out of greater disclosures on quantum and movement of NPAs, provisions etc. The non-quantifiable implications can be psychological like risk aversion, lower morale and disinclination to take decisions at all levels of staff in the bank.

Management of NPAs

The quality and performance of bank advances towards borrowers have a direct bearing on the profitability and viability of banks. Despite an efficient credit appraisal and disbursement mechanism, problems can still arise due to various factors. The essential component of a sound NPA management system is quick identification of non-performing advances, their containment at minimum levels and ensuring that their impingement on the financials is minimum. The approach to NPA management has to be multi-pronged, calling for different strategies at different stages that a credit facility passes through. RBI's guidelines to banks on Risk Management Systems outline the strategies to be followed for efficient management of credit portfolio. Excessive reliance on collateral has led Indian banks nowhere except to long drawn out litigation and hence it should not be sole criterion for sanction. It is common to find banks running after the same borrower/borrower groups which lead banks to lend beyond the prescribed exposure limits. It can be fine in the short run to run after niche segment but it is certainly fraught with risk. Banks should rather manage within the appropriate exposure limits. Exchange of credit information among banks would be of immense help to them to avoid possible NPAs.

There is no substitute for critical management information system and market intelligence. Close monitoring of the account particularly the larger ones is the primary solution. Emerging weakness in profitability and liquidity, recessionary trends, recovery of installments / interest with time lag, etc., should put the banks on caution. The objective should be to assess the liquidity of the borrower, both present and future prospects. Loan review mechanism is a tool to bring about qualitative improvement in credit administration. Banks should follow risk rating system to reveal the risk of lending. The risk-rating process should be different from regular loan renewal exercise and the exercise should be carried out at regular intervals. It is not enough for banks to aspire to become big players without being backed by development of internal rating models. This is going to be a pre-requisite under the New Capital Adequacy framework and if a bank wants to be an international player, it shall have to go for such a system. Banks should ensure that sanctioning of further credit facilities is done only at higher levels. A quick review of all documents originally obtained and their validity should be made. A phased programme of exit from the account should also be considered.

Measures initiated by Reserve Bank and Government of India for reduction of NPAs

The RBI / Government of India have been constantly goading the banks to take steps for arresting the incidence of fresh NPAs and have also been creating legal and regulatory environment to facilitate the recovery of existing NPAs of banks. More significant of them, being a compromise or negotiated settlement schemes of NPAs. there are several measures undertaken for faster legal processes like Lok Adalats, debt recovery tribunals et cetera. Lok Adalat institutions help banks to settle disputes involving accounts in "doubtful" and "loss" category, with outstanding balance of Rs.5 lakh for compromise settlement under Lok Adalats. Debt Recovery Tribunals have now been empowered to organize Lok Adalats to decide on cases of NPAs of Rs.10 lakhs and above. The Recovery of Debts due to Banks and Financial Institutions (amendment) Act, passed in March 2000 has helped in strengthening the functioning of DRTs. Provisions for placement of more than one Recovery Officer, power to attach defendant's property/assets before judgement, penal provisions for disobedience of Tribunal's order or for breach of any terms of the order and appointment of receiver with powers of realization, management, protection and preservation of property are expected to provide necessary teeth to the DRTs and speed up the recovery of NPAs in the times to come. The RBI has put in place a system for periodical circulation of details of wilful defaults of borrowers of banks and financial institutions. This serves as a caution list while considering requests for new or additional credit limits from defaulting borrowing units and also from the directors /proprietors / partners of these entities. Corporate Debt Restructuring mechanism has been institutionalized in 2001 to provide a timely and transparent system for restructuring of the corporate debts of Rs.20 crore and above with the banks and financial institutions. The CDR process would also enable viable corporate entities to restructure their dues outside the existing legal framework and reduce the incidence of fresh NPAs. The CDR structure has been headquartered in IDBI, Mumbai and a Standing Forum and Core Group for administering the mechanism had already been put in place.

Conclusion

NPAs are better avoided at the initial stage of credit consideration by putting in place rigorous and appropriate credit appraisal mechanism. In the changing scenario banks cannot behave imprudently while sanctioning credit and later run to supervisors or regulators for regulatory forbearance and owners or strategic partners to bail them out. Secondly, the mindset of the borrowers needs to change so that a culture of proper utilization of credit facilities and timely repayment is developed. As one of the main reasons for corporate default is on account of diversion of funds and corporate entities should come forward to avoid this practice in the interest of strong and sound financial system. Finally, extending credit involves lenders and borrowers and both should realize their role and responsibilities. They should appreciate the difficulties of each other and should endeavour to work towards contributing to a healthy financial system. Corporate entities would put their best foot forward in creating an environment where a healthy, vibrant and sound financial system can be built-up and sustained.

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