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NON – PERFORMING ASSETS IN INDIAN BANKING SYSTEM

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Introduction

The Banking industry is the key component of the financial system which provides financial assistance not only to the industrial sector but also to the agriculture and household sectors. The Indian Banking industry has contributed to the economic growth of the country. Reserve Bank of India regulates the banking industry in India and ensures monetary stability in the economy. The Banking industry is a valuable contributor to the GDP It provides the opportunity to the public to build savings, make investments, avail credit and provides safety against income shocks and emergencies. However, the Indian Banking industry is facing formidable challenges. Increasing competition, increasing level of Non-Performing Assets (NPAs) and deteriorating asset quality have become major areas of concern for the entire banking industry, and by extension, the Indian economy.

The vicious cycle of economic slowdown, corporate earnings slowdown, increase in NPAs, increase in the proportion of restructured assets and depressed profitability of the Banking sector, has led to a situation where banks, particularly Public Sector Banks (PSBs), will be severely challenged to raise the required capital to comply with the Basel III requirements. For long, banks were comfortable that competition would only come from similar entities and that the Reserve Bank of India was ensuring the least number of banks entered the market to compete with them. But as it happens in any business, technological innovation and the regulator's delay in waking up to developments have allowed a new set of companies to play the role of financial intermediaries with a different name (The Economic Times). An asset becomes non-performing when it ceases to generate income for the bank.

A Non-Performing Asset (NPA) is defined generally as a credit facility in respect of which interest and / or installment of principal has remained “past due” for two quarters or more. An amount due under any credit facility is treated as “past due” when it has not been paid within 30 days from the due date. It was, however, decided to dispense with past due. Worried over rising bad loans, a Parliamentary Panel has suo motu decided to examine the non-performing assets of the public sector banks that touched Rs 3.61 lakh crore at the end of December 2015. The combined net loss of 20 public sector banks (PSB) stood at Rs 16,272.34 crore for the fourth quarter ended March 2016 as bad loans situation worsened. PSBs registered net profit of Rs 4,063.58 crore in the corresponding quarter.

Commercial banks are the major player to develop the economy. A major threat to banking sector is prevalence of Non-Performing Assets (NPAs). 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. The NPA growth involves the necessity of provisions, which reduces the overall profits and shareholders value (Parul Khanna, 2012). In present scenario NPAs are at the core of financial problem of the banks. Concrete efforts have to be made to improve recovery performance. The main reasons of increasing NPAs are the target-oriented approach, which deteriorates the qualitative aspect of lending by banks and wilful defaults, ineffective supervision of loan accounts, lack of technical and managerial expertise on the part of borrowers (Kamini Rai, 2012).

Non-Performing Assets (NPA) is one of the major concerns for banking system around the globe and Indian Banking system is not an exception to this universal phenomenon. Narasimham committee reports I and II, Verma Committee Report, Basle –I, II and III have continuously been providing guidelines and directives regarding this burning issue. Nowadays NPA Management has become synonymous to the functional efficiency of banking system.

As per RBI directives an asset account (term loan/cash credit/ Overdraft/ bills purchase or discount) is classified as Non-Performing Asset (NPA) if it remains irregular or out of order for a period of one quarter or 90 days. The prescribed period is one quarter or 90 days since 01 -04-2004 as against two quarters prior to 01-04-2004. Major impact and effect of NPAs would be: NPA don't generate income; they require provisions, resulting in further erosion of profits substantially; they enhance administrative, legal and recovery costs; borrowed resources are locked in NPA whereas the banks have to pay for the cost of outlay of these funds, resulting in negative spread; the cost of poor quality loans is shifted to bank customers through higher interest rate on advances. One of the main causes of NPA in banking sector is the directed credit system DCS) under which commercial banks are directed to provide at least 40% of their yearly advances quota to priority sector viz agriculture, small scale industries and other segments such as small business, retail trade, small: road and water transport operators, professional and self-employed persons, housing and education loans. With this background the present paper made an attempt to assess the following which are as follows:

- Banking Environment in India
- The Status of NPAs in Indian Banking system
- Impact of Non-Performing Assets

Banking Environment in India

Post liberalisation in 1991, the government appointed various committees to review the functioning of the Indian banking sector and recommend policy changes to make the banks more healthy, competitive and efficient. Two such expert committees were set up under the chairmanship of M Narasimham in 1991 and 1998. The recommendations made by these committees (popularly known as Narasimham Committee I and II), laid out the road map for banking sector reforms in post-liberalisation India. The committees recommended several micro-prudential measures, including adoption of risk based capital standards, and uniform accounting practices for income recognition and provisioning against bad and doubtful debts. The objective was to benchmark against international best practices as embodied in the Basel I norms set by the Basel Committee on Banking Supervision (BCBS).

Following the recommendations of the Narasimham Committee 1, Indian banks were subject to a capital to risk-weighted assets system in which banks had to achieve 8% capital to risk- (weighted) assets ratio (CRAR) by 1996. The CRAR measures the ratio of a bank's paid-up capital to its advances and other assets. Narasimham Committee II also made several recommendations about asset classification, increasing banks' CRAR to 10% by 2002, and setting up of Asset Reconstruction Companies (ARCs) that would take over the stressed assets from banks Since then, RBI has progressively introduced in a phased manner, prudential norms for income recognition, asset classification, and provisioning for the advances portfolio of banks.

The Narasimham Committee I also recommended issuance of new licences to private sector entities to set up banks. Consequently, RBI issued 11 licences for setting up new privately-owned banks. While most of these new private sector banks started functioning in the mid-1990s, their share of the banking business remained modest until 2000. Other banking sector reforms based

on the committee's recommendations included interest rate deregulation, allowing PSU banks to raise up to 49% of their equity in the capital market and gradual reduction of the statutory liquidity ratio (SLR) and cash reserve ratio (CRR) to improve banks' profitability.

The banking sector has grown manifold in size since the time of bank nationalisation. From 1969 to 2015, the number of commercial banks went up from 89 to 152. The dependence on bank finance has also increased over the years. The share of household savings in bank deposits has gone up from around 30% in 1991 to close to 60% in 2013. Domestic credit extended by banks to the private sector as a share of GDP has gone up from 24% in 1992 to 53% in 2015. The share of banks in corporate borrowing has remained high, and as of 2011 was close to 60% as highlighted in the Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (RBI 2014). All these point to the fact that despite the move towards a market-based financial system since the 1990s, banks continue to play a very important role in the Indian economy.

Trends in Non – Performing Assets In Public Sector Banks

Table-1: Gross and NPA of Public Sector Bank Since 2000-2001 to 2012-2013

(Rs. Billion)

Year	Gross Non-Performing Assets Amount	Gross Non-Performing as percentage assets of Gross Advances	Gross Non-Performing Assets as Percentage of Total Assets	Net Non-Performing Assets amount	Net Non-Performing as percentage assets of Net Advances	Net Non-Performing Assets as Percentage of Total Assets
2000	530.33	14	6	261.87	7.4	2.9
2001	546.72	12.4	5.3	279.77	6.7	2.7
2002	564.73	11.1	4.9	279.58	5.8	2.4
2003	540.9	9.4	4.2	248.77	4.5	1.9
2004	515.37	7.8	3.5	19.35	3.1	1.3
2005	483.99	5.5	2.7	169.04	2.1	1.0
2006	413.58	3.6	2.1	145.66	1.3	0.7
2007	389.68	2.7	1.6	151.45	1.1	0.6
2008	404.58	2.2	1.3	178.36	1.0	0.6
2009	449.57	2	1.2	211.55	0.9	0.6
2010	599.26	2.2	1.3	293.75	1.1	0.7
2011	746.00	2.4	1.4	360.00	1.2	0.7
2012	1124.89	3.2	1.9	593.00	1.5	1.0
2013	1644.62	3.6	2.4	900.00	2.0	1.3

Sources: I. RBI Handbook of Statistics on the Indian Economy, 2005-06, 2013-14.

As it evident from the table- 1 in absolute terms Non- Performing assets continued to mount over the decade of the 1990s except for the year. On march 31, 2002 the total Gross Non – Perfuming Assets in public sector banks was 564.73 billion that is 11.1 percent of gross advances and 4.9 of total asset. There after the gross Non-Performing Assets have shown a decreasing trend and reached to level of Rs.389.68billion at the end of March 2007. But the trend reversed after 2008 when Non – Performing Assets increased form Rs.449.57 billion in 2009 to Rs. 1124.89 million in 2011-12 and further to Rs.1644.62 billion 2012-13. For the year March 2013-14, the gross Non-Performing Assets of Public Sector Banks increased by almost four times form March 2010 to March 2014

The Status of NPAs in Indian Banking System

Gross bad loans at commercial banks could increase to 8.5 per cent of total advances by March 2017, from 7.6 per cent in March 2016, according to a baseline scenario projection by the Reserve Bank of India (RBI) in its Financial Stability Report, "The macro stress test suggests that under the baseline scenario, the gross NPA may rise to 8.5 per cent by March 2017," the RBI noted in the report. "If the macro situation deteriorates in the future, the gross NPA ratio may increase further to 9.3 per cent by March 2017." The central bank has been pushing lenders to review the classification of loans given by them as part of an Asset

Quality Review (AQR). The resultant sharp surge in provisions for bad debts has eroded profitability, especially at state-owned banks, in recent quarters. The gross bad loans of public sector banks increased to 9.6 per cent as of March 2016, from about 6 per cent a year earlier, RBI data showed.

There was an almost 80 per cent jump in gross bad loans in 2015-16, according to the report. Gross bad loans of Indian banks widened to 7.6 per cent from 5.1 per cent in September and from 4.6 per cent in March 2015. In 2004, gross bad loans in the Indian banking sector touched 7.8 per cent, while the ratio was 11.1 per cent in 2002.According to RBI report banking sector gross NPA is at 7.6%, highest in 12 years; expected to rise further to 8.5% by March 2017 Gross bad loans at commercial banks could increase to 8.5 per cent of total advances by March 2017, from 7.6 per cent in March 2016, according to a baseline scenario projection by the Reserve Bank of India (RBI) in its Financial Stability Report released on , "The macro stress test suggests that under the baseline scenario, the gross NPA may rise to 8.5 per cent by March 2017," the RBI noted in the report. "If the macro situation deteriorates in the future, the gross NPA ratio may increase further to 9.3 per cent by March 2017."The central bank has been pushing lenders to review the classification of loans given by them as part of an Asset Quality Review (AQR). The resultant sharp surge in provisions for bad debts has eroded profitability, especially at state-owned banks, in recent quarters. The gross bad loans of public sector banks increased to 9.6 per cent as of March 2016, from about 6 per cent a year earlier, RBI data showed.

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Impact of Non- Performing Assets

The problem of NPAs in the Indian banking system is one of the foremost and the most formidable problems that had impact the entire banking system. Higher NPA ratio trembles the confidence of investors, depositors, lenders etc. It also causes poor recycling of funds, which in turn will have deleterious effect on the deployment of credit. The non-recovery of loans effects not only further availability of credit but also financial soundness of the banks. The impact of NPA are as given below:

Profitability

NPAs put detrimental impact on the profitability as banks stop to earn income on one hand and attract higher provisioning compared to standard assets on the other hand. On an average, banks are providing around 25% to 30% additional provision on incremental NPAs which has direct bearing on the profitability of the banks.

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.

Liability Management

In the light of high NPAs, Banks tend to lower the interest rates on deposits on one hand and likely to levy

higher interest rates on advances to sustain NIM. This may become hurdle in smooth financial intermediation process and hampers banks 'business as well as economic growth.

Capital Adequacy

As per Basel norms, banks are required to maintain adequate capital on risk-weighted assets on an ongoing basis. Every increase in NPA level adds to risk weighted assets which warrant the banks to shore up their capital base further. Capital has a price tag ranging from 12% to 18% since it is a scarce resource.

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. As per extant guidelines, banks whose Net NPA level is 5% & above are required to take prior permission from RBI to declare dividend and also stipulate cap on dividend pay-out.

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. The increased NPAs may pose liquidity issues which is likely to lead run on bank by depositors. Thus, the increased incidence of NPAs not only affects the performance of the banks but also affect the economy as a whole. 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 Pay-out, 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.

Conclusion

A High level of Non- Performing Assets suggests high profitability of a large number of credit defaults that affect the profitability and liquidity of banks. The extent of Non- Performing Assets has comparatively higher in Public Sector Banks. Various steps have been taken by government to reduce the Non- Performing Assets. It is highly impossible to have zero percentage Non-Performing Assets. But at least Indian banks should take care to ensure that they give loans to creditworthy customers.

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