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Commerce

NON-PERFORMING ASSETS IN INDIAN BANKING SECTOR – A STUDY

KEY WORDS: Deposits mobilizations, loans, investments, borrower, economic growth

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ABSTRACT

The recommendations of Narasimham committee and Verma committee laid some steps to solve the problem of old NPAs in the bank's balance sheets. It continues to be expressed from every corner that there has rarely been any systematic evaluation of the best way of tackling the problem. There seems to be no unanimity in the proper policies to be followed in resolving this problem. There is also no consistency in the application of NPA norms, ever since these have been recognized. Non Performing Assets are also called as Non Performing Loans. It is made by a bank or finance company on which repayments or interest payments are not being made on time. The problem of NPA is not limited to only Indian public sector banks, but it prevails in the entire banking industry. Major portion of bad debts in Indian Banks arose out of lending to the priority sector at the dictates of politicians and bureaucrats. Effective monitoring system on bank loans will reduce the problem of bad debts. The top management of the banks was forced by politicians and bureaucrats to throw good money after bad in the case of unscrupulous borrowers. The present paper throws light on the concept of NPA and its related issues.

I. INTRODUCTION:

For any nation, banking system plays a vital role in the development of its sound economy. India is not an exception. Bankers are the custodians and distributors of the liquid capital of the country. The foremost function of the banking system is to mobilize the savings of the people by accepting deposits from the public. The banker becomes the trustee of the surplus balances of the public. Here-in-lies the onerous duty of the banker is in stimulating the mobilization of surpluses. Well - knit banking systems secure a good foundation for a Nation's Industrial and Economic Progress. The role of banking in promoting development and growth, especially in the context of planning to break the vicious cycle of poverty and to retrieve the economy from the trap of under-development is a matter of paramount importance, particularly when our country is on the way of development. Deposit mobilization promotes the economic prosperity by controlling the money circulation and canalizing for development and productive purposes. In order to mobilize deposits, the commercial banks undertake deposit mobilization through various deposit schemes suited to the different sections of the people. As the growth of the bank deposits is the key element in the progress of the banking business, bankers spend more time and man power in the mobilization of deposits.

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 based on the sources of funds.

In India the magnitude of the problem of bad debts was not taken seriously. Subsequently, following the recommendations of Narasimham committee and Verma committee, some steps have been taken to solve the problem of old NPAs in the balance sheets of the banks. It continues to be expressed from every corner that there has rarely been any systematic evaluation of the best way of tackling the problem. There seems to be no unanimity in the proper policies to be followed in resolving this problem. There is also no consistency in the application of NPA norms, ever since these have been recognized. NPA concerns of individual banks summarized as a whole and expressed as a mathematical average, for the entire bank cannot convey a dependable picture. The scenario is not so simple to be generalized for the industry as a whole to prescribe a readymade package of a common solution for all banks and for all times.

II. Non-performing Assets

The banks, in their books, have different kind 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) concept is restricted to loans, advances and investments. As long as an asset generates the income expected from it and does not disclose any unusual risk other than normal commercial risk, it is treated as performing asset, and when it fails to generate the expected income it becomes a "Non Performing Asset". In other words, a loan asset becomes a Non Performing Asset (NPA) when it ceases to generate income, i.e. interest, fees, commission or any other dues for the bank for more than 90 days. A NPA is an advance where payment of interest or repayment of installment on principal or both remains unpaid for a period of two quarters or more and if they have become 'past due'. An amount under any of the credit facilities is to be treated as past due when it remain unpaid for 30 days beyond due date.

Non Performing Assets are also called as Non Performing Loans. It is made by a bank or finance company on which repayments or interest payments are not being made on time. A loan is an asset for a bank as the interest payments and the repayment of the principal create a stream of cash flows. It is from the interest payments that a bank makes its profits. Banks usually treat assets as non-performing if they are not serviced for some time. If payments are late for a short time, a loan is classified as past due and once a payment becomes really late (usually 90 days), the loan is classified as non-performing. A high level of nonperforming assets, compared to similar lenders, may be a sign of problems.

III. Challenges To Banks

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. NPAs can create many challenges. Some of the important challenges are:

1. Owners do not receive a market return on their capital. In the worst case, if the bank fails, owners lose their assets. In modern times, this may affect a broad pool of shareholders.

2. Depositors do not receive a market return on savings. In the worst case if the bank fails, depositors lose their assets or uninsured balance. Banks also redistribute losses to other borrowers by charging higher interest rates. Lower deposit rates and higher lending rates repress savings and financial markets, which hampers economic growth.
3. Non Performing loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital, labour and natural resources. The economy performs below its production potential.

Non Performing loans may spill over the banking system and contract the money stock, which may lead to economic contraction. This spillover effect can channelize through illiquidity or bank insolvency;

(a). When many borrowers fail to pay interest, banks may experience liquidity shortages. These shortages can jam payments across the country,

(b). Illiquidity constraints bank in paying depositors e.g. cashing their paychecks. Banking panic follows a run on banks by depositors as part of the national money stock become inoperative. The money stock contracts and economic contraction follows.

(c). Under capitalized banks exceeds the bank's capital base.

III. OBJECTIVE OF THE STUDY

- To study the factors for the rise of NPAs in Indian Banking Sector
- To highlight the impact of NPAs on Indian Banking Sector
- To present the identification procedure and preventive measures for reduction of NPAs

IV. Research Methodology

The study is based on secondary sources of data collected from various journals, published reports, newspapers, magazines etc.

V. 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 are growing due to external as well as internal factors.

External Factors

a. Ineffective recovery - The Govt. has set up 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.

b. 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.

c. Natural calamities - This is the major 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.

d. 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.

e. 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 bank records the non-recovered part as NPAs and has to make provision for it.

f. 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.

g. Directed loans system - Under this commercial banks are required to supply 40% percentage of their credit to priority sectors. Most significant sources of NPAs are directed loans supplied to the micro sector are problematic of recoveries especially when some of its units become sick or weak.

Internal Factors

a. 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.

b. Inappropriate technology - Due to inappropriate technology and management information system, market driven decisions on real time basis can't 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.

c. Improper SWOT analysis - The improper strength, weakness, opportunity and threat analysis is another reason for rise in NPAs. While providing unsecured advances the banks depend more on the honesty, integrity, and financial soundness and credit worthiness of the borrower.

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

e. 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 The banker should follow the principle of diversification of risk based on the famous maxim do not keep all the eggs in one basket, it means that the banker should not grant advances to a few big farms only or to concentrate them in few industries or in a few cities. If a new big customer meets misfortune or certain traders or industries affected adversely, the overall position of the bank will not be affected.

f. 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.

g. Faulty credit management - like defective credit in recovery mechanism, lack of professionalism in the work force.

6. 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 longterm 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.

7. 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 borrow able 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.

8. 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.

9. CONCLUSION:

Many of the measures were implemented in the Indian banking sector, still the level of NPA is alarming and its fluctuations during financial crisis are really a reason to worry about. Hence a further research on NPA in banking is required. Therefore, the management of Indian Bank must pay special attention towards the NPA management and take appropriate steps to arrest the creation of new NPAs, besides making recoveries in the existing NPAs. Timely action is essential to ensure future growth of the Bank.

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