

Non-Performing Assets of Indian Commercial Banks: A Critical Evaluation

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Abstract

The issue of Non-Performing Assets (NPA) in the banks is discussed. The magnitude and trend in NPA are studied for the 5 year period 2008-13, using a suitable classification of the banks. A critical evaluation of the reasons and a few recommendations are made which have positive practical implications.

Key words and Phrases: Asset Quality, Capital Adequacy Ratio, Development Envelopment Analysis, Doubtful Assets, Financial Intermediation, Financial Sector Reforms, Interest Rate Spread, Loan Servicing and Collateral, Loss Assets, Non-Performing Assets, Private Sector Banks, Public Sector Banks, Sub-standard Assets.

Introduction

The last decade has seen many positive developments in the Indian Banking sector. The policy makers who comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities have made several notable efforts to improve regulation in the sector which compares favorably with banking sector in the region on metrics like growth and profitability. However NPAs remain a cause for worry. This study evaluates and compares the NPA of public and private sector banks during the recent years and makes some suggestions for NPA management.

The banking system in India is significantly different from that in other Asian countries because of the country specific geography socio-economic characteristics.

India has a large population and land-size, a diverse culture and extreme disparities in income which are marked among its regions. There are high levels of illiteracy in a large segment of its population but, at the same time, the country has a large reservoir of managerial and technologically advanced talents. About 35 percent of the population resides in metro and urban areas and the rest is spread over several semi-urban and rural centers.

These features have left the Indian banking sector with strengths and weaknesses. A big challenge facing Indian banks is how to attain operational efficiency suitable for modern financial intermediation under the current ownership structure. While it has been relatively easy for the public sector banks to recapitalize given the increase in NPAs, as their Government dominated

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ownership structure has reduced the conflicts of interest that private banks would face.

After the merger of New Bank of India with Punjab National Bank during the era of Financial Sector Reforms, the number of Public Sector Banks (PSBs) became 27. This is reflected in the market valuation. While the bonus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success. Comparisons of bank performance based on financial ratios suffers from the limitation that ratios might overstate performance because of inaccurate reporting of NPAs or because NPAs trend to be lower in the initial years in the case of newly established banks.

The NPAs are considered to be an important parameter to judge the performance and financial health of banks. The level of NPA is one of the drivers of financial stability and growth of the banking sector. This paper adopts an empirical approach to the analysis of NPAs of public and private banks in India.

Overview of Literature

Bloem & Gorter (2001) suggested that a more or less predictable level of non-performing loans, though it may vary slightly from year to year, is caused by an inevitably large number of wrong economic decisions by individuals and plain bad luck, inclement weather and sudden price changes for certain products. Under such circumstances, the holders of loan can make an allowance for a normal share of non-performance in the form of bad loan provision or they may spread the risk by taking out insurance. Enterprises may well be able to pass a large portion of these costs to customers in the form of higher prices.

Koeva (2003) in his study on the performance of Indian Banks during Financial Liberalization, gives new empirical evidence on the impact of financial liberalization on the performance of Indian commercial Banks. The analysis focuses on examining the determinants of bank intermediation costs and profitability during the liberalization period. His empirical results suggest that ownership type has a significant effect on some performance indicators and that ownership type has a significant effect during financial liberalization. This has been associated with

lower intermediation costs and profitability of the Indian banks.

Ghosh (2003) empirically examined non-performing loans of Indian public sector banks in terms of various indicators such as asset size, credit growth, macroeconomic condition and operating efficiency. Mohan (2004) points out that although public sector banks have recorded improvement in profitability efficiency in terms of intermediation costs and asset quality in the year 1990 they continue to have higher interest rate spread but at the same time earn lower rates of return, reflecting higher operating costs. Consequently asset quality is weaker so that loan loss provisions continue to be higher. This suggests that there is enough scope for enhancing the asset quality of banks in general. Public sector banks in particular need to further reduce the operating costs.

Kumar (2004) in his article on an evaluation of the financial performance of Indian private sector banks noted that Private sector banks play an important role in development of Indian economy. After liberalization, the banking industry underwent major changes in the public and the private sectors as per the recommendations of Narashimam Committee. The Indian banking industry was dominated by public sector banks earlier. But the situation has changed now: new generation banks which use technology and professional management have gained a reasonable position in the banking industry.

Vradi & Nagarjuna (2006) in their study on measurement of efficiency of banks in India concluded that in the modern world, performance of banking is very important to stabilize the economy. In order to see the efficiency of Indian banks, they examined the force indicator profitability, productivity, assets quality and financial management for all banks in India for the period 1999–2003. For measuring efficiency of banks they adopted Development Envelopment Analysis and found that public sector banks are more efficient than other banks in India.

Singh (2006) has suggested the alternative measures for improvement in the banking industry. His study evaluated the performance of banks against benchmark and ratio analysis was employed as the tools. The analysis of the NPA observed the decline in post

liberalization period. The study insisted that the ideal level benchmark is less than 1 per cent; the segments curtail the growth rate of NPAs and followed certain policy like counterparts who had not only arrested the NPA but reduced them.

Singh (2007) examines the performance trends of the Indian commercial banks for the period 1997-98 to 2004-05. His broad empirical findings are indicative in many ways. First, the increasing average annual trends in technical efficiency for all ownership groups indicate an affirmative geniture about the effect of the reforms process on the performance of the Indian banking sector. Second, the higher cost efficiency accrual of private banks over nationalized banks indicate that the nationalized banks, though old, do not reflect their learning experience in their cost minimizing behavior due to inefficiency factors arising from government ownership . This finding also highlights the possible stronger disciplining role played by the capital market indicating a strong link between market for corporate control and efficiency of private enterprise assumed by properly right hypothesis. And finally, that concerning the scale elasticity behavior, the technology and market based results differ significantly.

Mitra & Ravi (2008) have noted that a stable and efficient banking sector is an essential precondition to improve the economic level of a country. They have evaluated the efficiency of 50 Indian banks. The efficiency can be analyzed and quantified for every evaluated unit. The aim of this paper was to estimate and compare efficiency of the banking sector in India. The analysis was to verify the hypothesis whether the banking sector fulfills its intermediation function to compete with the global players. The results are adequately insightful to the financial policy planner and identify priority area for different banks to improve the performance.

Vohra and Dhamu (2012) emphatically point out that the NPAs have a direct impact on profitability, liquidity and equity of the banks. The authors observe that NPA of Indian banks are relatively very high by global standards. Thus, they recommend restricting of lending operations only to secured advances with adequate collateral securities. They also list a few common reasons for an asset turning NPA, considering economy, industry, borrower and lender sides separately.

Objectives of the study

- To study the performance of commercial banks in India
- To examine the asset quality for commercial banks in India
- To find out the health of various categories of loan assets that contribute of NPA
- To suggest some measures for NPA management

Non-performing Loan: A Theoretical Perspective

A credit transaction involves a contract between two parties, the borrower and the creditor, subject to a mutual agreement on the *terms of credit*. These are defined over five critical financial parameters: *amount of credit, interest rate, maturity period, frequency of loan servicing and collateral*. Optimizing decision pertaining to the terms of credit could be different for the borrower and the banks. As such, the mutual agreement between the borrower and the bank may not necessarily imply an optimal configuration for both. At this juncture, a distinction between a defaulter and a non performing loan account is in order. A *default* entails violation of the loan contract or the agreed terms of the contract, while a non performing loan entails that the borrower does not renege format of the loan contract but fails to comply with the repayment schedule due to evolving unfavorable conditions. However the perspective of corporate finance is that both the cases of defaulter and non performer imply similar financial implications viz. financial loss to the banks. Moreover, in the Indian context, regulatory and supervisory process does not focus on such a distinction between the defaulter and non-performer as far as prudential norms are concerned. The Non-performing Loan (NPL) is defined as an amount past due, taking into account either no payment of interest or principal, or both. The most important reason for default could be a mismatch between borrowers' and creditors' terms of credit.

Nationalized Banks

In July 1969, 14 banks each with a deposit base of Rs.50 crores or more were nationalized. Again in the year 1980, six more private banks were nationalized bringing up the total number to twenty. These Banks were: Bank of Baroda, Punjab National Bank, Bank of India, Canara Bank, Central Bank of India, Indian Bank,

Indian Overseas Bank, Syndicate Bank, UCO Bank, Allahabad Bank, United Bank of India, Oriental Bank of Commerce, Corporation Bank, Vijaya Bank, Dena Bank, Bank of Maharashtra, Andhra Bank, Punjab & Sind Bank and, State Bank of India with its subsidiaries.

Public Sector Banks

Public sector banks are the ones in which the government has a major holding. They are divided into two groups: nationalized banks and State Bank of India and its associates. Among them, there are 19 nationalized banks and 8 State Bank of India associates. Public Sector Banks dominate commercial banking in India.

Private Sector Banks

Private sector banks came into existence to supplement the functions of public sector banks and serve the needs of the economy better. As the public sector banks were merely in the hands of the government without any incentive to make profits and improve the financial health. The main difference is that public sector banks follow the RBI rules strictly but Private sector banks could have some changes, after the approval by the RBI. Private sector banks are the banks which are controlled by the private lenders with the approval from the RBI, their interest rates being marginally higher than the rates in public sector banks

Non-performing assets

Bank Assets are classified into two categories:

Performing assets are those assets on which interest or installments are correctly paid by a customer within stipulated time. **Non-performing assets** are those assets on which interest or installments have been due for a period of more than 180 days.

- An asset becomes Non-performing when it ceases to generate income for a bank
- It is also a credit facility in respect of which the interest and / or installments of principal have remained 'past due' for a specified period of "two quarters".

Presence of NPAs indicates adversely asset quality of the balance sheet and hence future income generating prospects. This also requires provisioning which has implications with respect to capital adequacy. Declining capital adequacy adversely affects shareholder value

and restricts the ability of the bank/institution to access the capital market for additional equity to enhance capital adequacy. If this happens for a large number of financial intermediaries, then, given that there are a large number of inter-bank transactions, there could be a *domino* kind of effect. Low capital adequacy will also severely affect the growth prospects of banks and institutions. The level of NPA acts as an indicator showing the bankers' credit risks and efficiency of allocation of resources, because it is a loan which is due or outstanding from the customer beyond a stipulated time. In other words, NPA is a result of asset-liability mismatch. Accordingly some treat NPA as an asset because it indicates the amount receivable from the defaulters.

NPAs, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest is not being made on time. Loan is an asset for a bank as the interest payments and the repayments 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 by a stipulated period, a loan is classified as *past due*.

NPA and Banks

Non-performing Asset is called so because it is an "Asset" which does not bring substantial income to its owner and is just dormant. Basically, it has something that should work but which does not. The RBI has issued guidelines to banks for classification of assets into four categories. Out of these four, the following three are considered as NPAs: (a) Sub-standard Assets, (b) Doubtful Assets and (c) Loss Assets.

Sub-standard Assets: Originally a sub-standard asset was one, which was classified as NPA for a period not exceeding two years. With effect from 31 March 2001, a sub-standard asset was one, which remained NPA for a period not exceeding 18 months. With effect from 31 March 2005 the norms have been further tightened and a sub-standard asset is one, which has remained NPA for a period not exceeding 12 months.

Doubtful Assets: Initially a doubtful asset was one, which remained NPA for a period exceeding two years. With effect from 31 March 2001, an asset is to be classified as doubtful, if it had remained NPA for a

period exceeding 18 months. With effect from March 31, 2005, the norms have been further tightened, and an asset would be classified as doubtful if it remained in the sub-standard category for 12 months.

Loss Assets: A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

Standard Assets: The fourth category of loan accounts, which is not included in NPA category, is Standard Assets (one which does not pose any problems and which does not carry normal risk attached to the business).

Distinction between Gross and Net NPA

Gross NPA is the amount outstanding in the borrowers' account, in books of the bank other than the interest which has been recorded and not debited to the borrowers' account. **Net NPA** is the amount of gross NPAs less (1) interest debited to borrowers' and not recovered and not recognized as income and kept in interest suspense, (2) amount of provisions held in respect of NPAs and (3) amount of claim received and not appropriated.

The RBI defines Net NPA as equal to Gross NPA – (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held). This is generally reported as a ratio to net advances.

$$\text{Gross NPA Ratio} = (\text{Gross NPA} / \text{Gross Advances}) * 100$$

$$\text{Net NPA Ratio} = (\text{Net NPA} / \text{Net Advances}) * 100$$

The ideal value of net NPA is 0 and for practical purpose a benchmark is taken as 1 per cent. Thus, the values of net NPA which are less than one may be considered as satisfactory and the values exceeding 1 percent indicate a situation calling for improvement by reducing the NPA.

Trends in NPA

Next, we examine the gross and net NPA of Indian

banks for the five year period 2008-2013. The relevant figures are given in table form and also displayed diagrammatically.

Table 1: Group-wise Gross NPA of Indian Commercial Banks from 2008-13

Banks	2008-09	2009-10	2010-11	2011-12	2012-13
Public Sector Banks	2.10	2.28	2.32	3.17	3.84
Private Sector Banks	3.25	2.97	2.45	2.08	1.91
Foreign Banks	4.30	4.26	2.54	2.68	2.97

Figure 1: Group-wise Gross NPA of Indian Commercial Banks

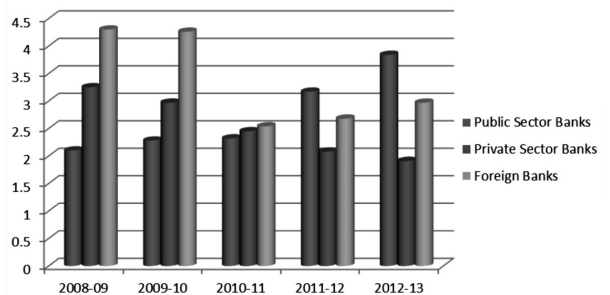


Table 2: Gross NPA of all scheduled Commercial Banks 2008-13

Year	2008-09	2009-10	2010-11	2011-12	2012-13
Gross NPA %	2.31	2.50	2.35	2.94	3.23

Figure 2: Gross NPA of all scheduled Commercial Banks

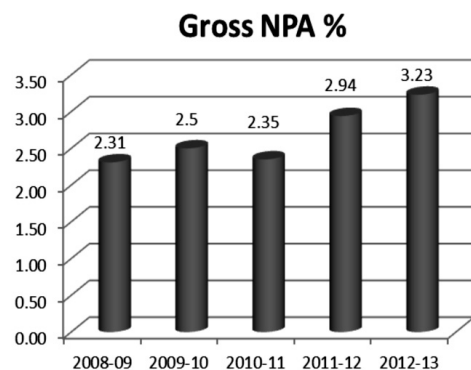


Table 3: Net NPA of Commercial Banks: 2008-13

Banks	2008-09	2009-10	2010-11	2011-12	2012-13
Nationalised	0.94	1.10	1.09	1.53	2.02
Old Private Sector	1.40	1.09	0.56	0.42	0.45
New Private	0.90	0.82	0.53	0.58	0.77
Foreign	1.81	1.82	0.67	0.61	1.01

Figure 3: Net NPA of Commercial Banks

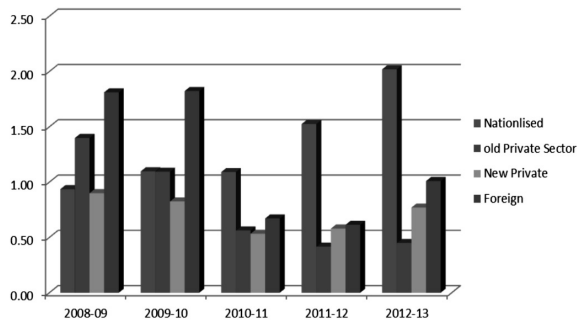


Table 4: Group-wise sub-standard Loan Assets of Banks: 2008-13

Banks	2008-09	2009-10	2010-11	2011-12	2012-13
Public Sector Banks	0.93	1.1	1.1	1.7	1.89
Private Sector Banks	2.02	1.48	0.6	0.58	0.56

Figure 4: Group-wise sub-standard Loan Assets of Banks

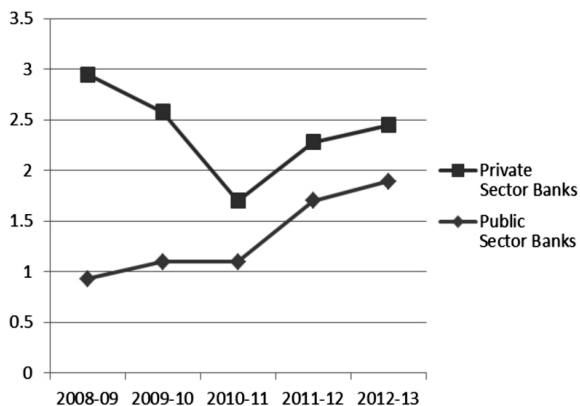


Table 5: Group-wise doubtful Loan Assets of Banks: 2008-13

Banks	2008-09	2009-10	2010-11	2011-12	2012-13
Public Sector Banks	0.99	0.98	1.04	1.33	1.81
Private Sector Banks	0.96	1.12	1.46	1.17	1.06

Figure 5: Group-wise doubtful Loan Assets of Banks

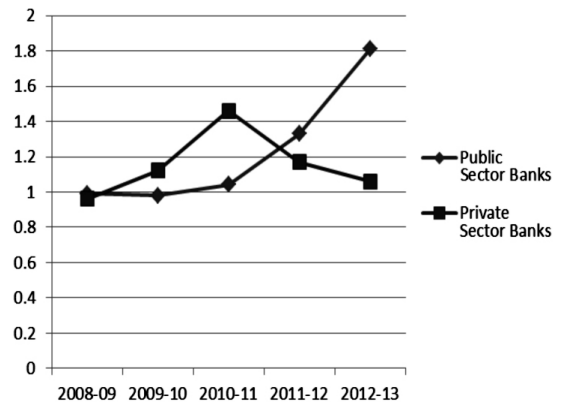
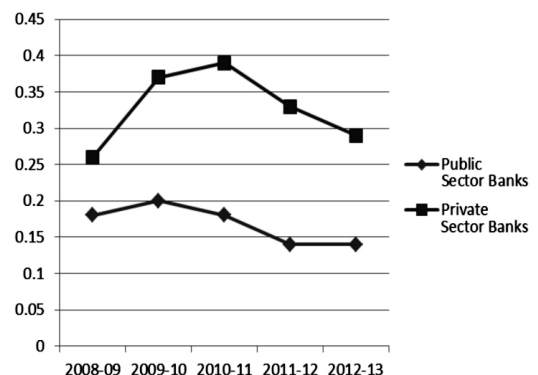


Table 6: Group-wise Loss Assets of Banks: 2008-13

Banks	2008-09	2009-10	2010-11	2011-12	2012-13
Public Sector Banks	0.18	0.20	0.18	0.14	0.14
Private Sector Banks	0.26	0.37	0.39	0.33	0.29

Figure 6: Group-wise Loss Assets of Banks



Discussion

A close look at the gross and net NPAs reported in tables 1-6 reveals the following relevant points:

1. The NPA (both gross and net) of public sector banks shows a marked rising trend during the 5 year period 2008-13. Clearly, this is an undesirable and disturbing aspect. In contrast, the other three sectors (old and new private banks, foreign banks) display a falling trend, indicating a concerted effort by these banks to reduce the NPA.
2. The private sector banks particularly those which are new have the NPA often less than one percent, which points to their efficiency of NPA management.
3. On pooling the figures, the GPA for all scheduled banks (figure 2) shows a steadily rising trend with an exception for the year 2010-11; when it was marginally lower than that in the previous year.
4. The group-wise sub-standard loan assets of the banks show an upward trend for public sector banks. The trend is reverse for the private sector banks, a feature in keeping with the contrasting positions regarding NPAs.
5. The group-wise doubtful loan assets have recorded an increasing trend in the case of public sector banks as a group. In the case of private sector banks, the trend has been upward for the first three years followed by a welcome falling trend. Also it is noteworthy that the public sector banks showed a better position than the private sector until the year 2011-12, when the latter gained the ground to be below the public sector banks.
6. Finally, with reference to group-wise loss assets, the public sector stands more favourably than the private sector (whose curve is entirely above that of the former). Individually, each of the two sectors displays a wavering trend.

NPAs pose a serious danger to the banking industry. A recent assessment (The Hindu, July 2014) of the gross NPAs for public sector banks puts the total figure at a whopping Rs.2,04,000 crores. In Karnataka state alone, there are more than 180 defaulters, each with dues exceeding Rupees One crore. NPAs deserve utmost attention, since bad loans ultimately affect the economy of the country.

Recommendations

For better management of NPAs, it is useful to first assess the causative factors for NPAs so that the corrective actions can be taken accordingly. The following steps may help for a better NPA management.

1. Developing a reliable and up to date information system.
2. Employing a tested credit risk evaluation system, which is capable of incorporating dynamic market conditions.
3. Establishing a sound control and feedback mechanism.
4. Creating an environment of trust and confidence.
5. Monitoring the assets continuously and making serious efforts for recovery of NPAs.
6. Putting in place a rigorous screening process before granting credit.
7. Public sector banks may emulate some of the effective steps taken by their private sector counterparts in this regard.

Scope for further work

The problem of NPA has far reaching implications for the banking sector and hence to the economy of the country. Further studies may examine bank-wise norms and practices to manage NPA. In particular the focus may be on a critical comparison between public and private sector banks in this respect. This may throw up some latent factors that can help to tackle the NPA problem more effectively. In the conceptual platform, the inter relation between NPAs and Capital Adequacy Ratio may be closely examined the check whether the latter can be a lever to the former.

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