Nature and Trends of Non-Performing Assets: An Indian Scenario

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ABSTRACT
Non-performing Asset is an important parameter in the analysis of financial performance of a bank as it results in decreasing margin and higher provisioning requirements for doubtful debts. NPA is a virus affecting banking sector. It affects liquidity and profitability, in addition posing threat on quality of asset and survival of banks. The problem of NPAs, which was ignored till recently, has been given considerable attention after liberalization of the financial sector in India. This exploratory paper examines the trends of NPAs in India from various dimensions and explains how mere recognition of the problem and self-monitoring has been able to reduce it to a great extent. It also shows that public sector banks in India, which function to some extent with welfare motives, have as good a record in reducing NPAs as their counterparts in the private sector.

NPA - INDIAN BANKING SECTOR
This paper analyses the performance of 26 public sector banks (PSBs) and 16 banks in the private sector (private banks) for the quarter and financial year ended March 31, 2014 and presents the outlook for the Indian banking sector for FY2015. The 42 banks collectively account for more than 90% of the total credit portfolio and deposits of all commercial banks in India as of March 2014. Indian banks’ (PSBs + private) credit growth was muted at 14.7% during 2013-14 and PSBs profitability saw a significant decline, in line with ICRA’s expectation of single digit return on net worth for PSBs for FY2014. The aggregated profit after tax (PAT) of PSBs declined by 27% (year-on-year, or y-o-y) to Rs. 370 billion during FY2014 from Rs. 507 billion during FY2013. The PSBs net profitability (PAT/ATA2) declined to 0.50% in relation to average total assets (ATA) during FY2014 vs. 0.78% during FY2013 and their return on net worth dropped to 9.1% in FY2014 from 14.2% in FY2013.

Banks’ (PSBs + private) gross NPA% increase over the last one year from 3.3% to 3.9% as on March 2014 (ICRA estimate was 4.2%). The increase in gross NPA% was due to higher fresh NPA generation rate (3.5-3.6% for PSBs in 2013-14, 3.4% in Q4, 2014 as against 3.1% in 2012-13). PSBs gross NPA% increased from 3.6% as on March 2013 to 4.4% as on March 2014. As for Q4, FY2014, Gross NPA% of PSBs declined by 30 basis points (bps) from December 31, 2013 levels. This reduction is due to higher recovery efforts towards the end of the financial year, higher write offs and sale of assets to asset reconstruction companies. None of these are likely to be sustained in Q1, FY2015, thus the gross NPA% could move back to December 2013 levels (~4.1%) in the first quarter itself. Restructured advances of the PSBs remain at elevated levels of 6.2% as on March 31, 2014. Private sector banks were able to hold on good asset quality as reflected in their gross NPAs of 1.8% as on March 2014 (vs 1.9% as on December 2013).

There are primarily two reasons, the first being their attitude and approach towards financing and recovery particularly of SMEs and the second are the lack of full knowledge about the law and practice of banking and the violations of RBI directives through their circulars which are mandatory to be followed by the banks and the financial institutions.

The net non-performing assets (NPAs) of banks had gone up 51% in FY13 to Rs. 9,2825/- crores. According to a recent CRISIL report, the gross NPAs of banks are slated to increase from 3.3% in March 2013 to 4% by March 2014. The pertinent question is, will the banks and the financial institutions shed their jaundiced view towards declaring the accounts as NPA and recovery of their dues coming under the category of NPA and will they take a new and pragmatic and practical approach of focusing on “efficiency and fairness” and taking a tolerant view of “genuine difficulties while coming down on mismanagement or fraud.” The present approach and attitude of the banks and financial institutions are taken into consideration in the matter of recovery of dues and financing.
ACCOUNTS ARE CLASSIFIED AS NPA
An account is declared as NPA based on the recovery of instalments and interest on loans and advances and other aspects as per RBI norms. The updated norms to declare the account as NPA are as follows as per RBI guidelines:

- An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.
- A non-performing asset (NPA) is a loan or an advance where:
  (i) Interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
  (ii) The account remains ‘out of order’ in respect of an Overdraft/Cash Credit (OD/CC), if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit / drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as ‘out of order’.
  (iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
  (iv) The instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,
  (v) The instalment of principal or interest thereon remains overdue for one Crop season for long duration crops,
  (vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
  (vii) In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

CAUSES OF RISING NPAs
The rise in the NPAs of both Public and Private Sector Banks to diversion of funds away from the original purpose for which they were granted, as well as wilful default (or misappropriation of funds) by borrowers. That apart, adverse economic and market factors, ranging from recessionary conditions, regulatory changes and resource shortages to inefficient management and strained labour relations have impacted the health of businesses, and driven them to default on their loan repayments. Sometimes the banks themselves are to blame – delay in loan disbursement can throw a project off track, and have a cascading effect on its viability and capacity to repay. Banks have also been known to take comfort in collateral, and hence not follow up diligently enough on loan dues. Were the market value of the collateral to drop, there is an immediate impact on the quality of the related loan asset.

There are also other, less transparent reasons why NPAs are on rise. For one, the process of (non-performing) asset disposal is riddled with legal impediments and delay. Secondly, highly connected corporate debtors have been known to use political pressure to get banks to waive their dues or restructure terms in their favour. Come election time, political parties make populist promises – such as the offer of easy credit to the Small Scale and Rural Sectors which may not yield the expected results – which commercial banks are forced to honour.

IMPACT OF RISING NPAs
The health of a bank is reflected not only by the size of its balance sheet but also the return on its assets. NPAs generate no interest income for the bank; the bank is required by law to provide for future loan losses arising from its bad assets (at a coverage of 70%), out of current profits. Banks can no longer account the interest on NPAs loans as income unless and until it is actually paid by the borrower. This not only affects profitability but also liquidity because now, the bank has fewer funds to lend out or recycle. High NPAs degrade a bank’s credit rating, lowering its credibility as well as its ability to raise fresh capital. The incidence of high NPAs in the Indian banking industry points to a deteriorating credit market. As per law, every bank must maintain a Capital Adequacy Ratio (CAR), which is the ratio of total capital to risk weighted assets, of 9% (10% for new Private Banks) or higher. As NPAs go up, to do the aggregated risk weighted assets, forcing the bank to allocate further capital in order to maintain the ratio. Commercial banks in India are struggling to meet CAR norms.

MEASURES TO CONTROL NPAs
REGULATORY MEASURES
As India’s banking regulator, the RBI defines a framework to monitor and regulate the increase of non-performing loans in the country. In this, it is guided by international practice as well as the recommendations of the Narasimham Committee. The RBI mandates that banks must follow an objective policy of income recognition, based on actual recovery, i.e. they must only recognize income when it is received as payment from the customer, and conversely, must reverse (or derecognize) any entries that are not backed by actual payment. It is worth mentioning that under manual classification, income de-recognition happens rarely, which will change once automated processing comes into play.
Banks are advised to fix realistic repayment schedules—based on the borrowers’ actual cash flow—at the time of sanctioning loans. At times banks pressurize customers into accepting terms that are obviously not feasible and only end up increasing their non-performing loans. The RBI is also keen that banking institutions establish appropriate internal systems, which will eliminate the tendency to defer NPA recognition, especially in the case of high value defaults.

**OPERATIONAL MEASURES**

Besides adhering to the above, banks must establish an appropriate Credit Assessment and Risk Management mechanism to ensure proper assessment of credit prior to the sanctioning of loans. It is also important for banks to diversify their revenue stream in favor of fee-based income. Indian banks – unlike their developed world counterparts – are excessively dependent on interest income, which accounts for about 86% of their total income. There is a need to monitor potential and borderline loan accounts closely and take early remedial measures to prevent them from turning delinquent.

Banking institutions must also maximize recovery from NPAs to release locked up funds. They are required to examine all cases of willful default of Rs.1 Crore and above at the Board level, after which they may file criminal charges against the offenders and also affix accountability on the concerned staff.

**REDRESSAL STRUCTURE FOR NPA RECOVERY**

There are several institutions, offering different types of services towards the recovery of NPAs. Debt Recovery Tribunals are empowered to attach the property of the defaulters’ dependents before the delivery of judgment. Disobedience of a tribunal’s order attracts penalties. Asset Reconstruction Companies (ARC) specialize in the recovery and liquidation of assets. Banks, which wish to clean their balance sheet at one go, may divest their NPAs to an ARC at a discounted value, after which it is the latter’s responsibility to recover the outstanding dues from the borrowers directly. Although this option doesn’t seem to have worked in the case of Public Sector Banks, Private Banks has transferred sizeable NPAs to ARCs. In western markets, asset reconstruction companies have been very successful as they buy loans outright, whereas in India ARCs pay only 5% of the agreed price and the remaining based on recovery. Corporate Debt Restructuring (CDR) Consortia

Comprising multiple banks can put together a timely and transparent mechanism to restructure the debts of viable corporate entities. They typically work on exposures exceeding Rs.20 Crores. CIBIL (Credit Information Bureau of India Limited) maintains a database of borrowers that banks and financial institutions may easily access. The RBI also plays its part by circulating lists of willful defaulters of banks and financial institutions and of borrowers facing lawsuits for recovery, to caution the industry against issuing fresh loans to the concerned companies, their promoters or directors.

**WHETHER BANKS ARE FOLLOWING RBI GUIDELINES IN THE TRUE SPIRIT**

Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter. The said guidelines further elaborate certain other aspects of Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances and loans.

A close look at the way the banks and financial institutions declare the accounts as NPA shows that the very fundamental principles as envisaged by RBI in their preamble are being overlooked which states, “the Reserve Bank of India has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts.”

Further, RBI also expects, “The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms.” RBI again exhorts the banks and financial institutions, “Banks are urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows with borrowers. This would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.” Thus it is evident that the crux of the problems of recovery of loans in the banks and financial institutions lies on the aforesaid facts as stated by RBI in their guidelines.

**VIEWS OF RBI ON NPAS**

To improve the efficiency of the recovery system, especially at a time of economic uncertainty like the present. Recovery should be focused on efficiency and fairness—presenting the value of underlying assets and jobs where possible, even while redeploying unviable assets to new uses and compensating fairly. All this should be done while ensuring that contractual priorities are met. The system has to be
tolerant of genuine difficulties while coming down on mismanagement or fraud."

- Early formation of a lenders’ committee with timelines to agree to a plan for resolution.
- Incentives for lenders to agree collectively and quickly to a plan – better regulatory treatment of stressed assets if a resolution plan is under way accelerated provisioning if no agreement can be reached.
- Improvement in current restructuring process: Independent evaluation of large value restructuring mandated, with a focus on viable plans and a fair sharing of losses (and future possible upside) between promoters and creditors.
- More expensive future borrowing for borrowers who do not co-operate with lenders in resolution.
- More liberal regulatory treatment of asset sales - Lenders can spread loss on sale over two years provided loss is fully disclosed.
  - Takeout financing/refinancing possible over a longer period and will not be construed as restructuring.
  - Leveraged buyouts will be allowed for specialized entities for acquisition of ‘stressed companies’.
  - Steps to enable better functioning of Asset Reconstruction Companies proposed.
  - Sector-specific Companies/Private equity firms encouraged to play active role in stressed assets market.

**STEPS AHEAD**

RBI as regulator and the Government as the owner of the largest number of banks in the country must crack the whip to the large defaulters. RBI in its discussion paper has addressed the issue and suggested an embargo on the promoters of such defaulting companies. However the same, as RBI recognized, needs active support of the Government. RBI recommendations will help taming the galloping rise in NPA in future but the same will require revival of economic growth from less than 5% as of now. Clearly only RBI as regulator cannot clear the Augean stable of bad loans. The Government is on its way out and has little influence on policy issues. RBI will attempt to control the increase in NPA but the solution will require macroeconomic and policy support from the Government.

The Government must address the following issues:

- Providing for the estimated stressed assets of PSU banks
- Recapitalising the banks to enable the sector to address the stressed assets
  - Penal provisions for the recalcitrant borrowers
  - Identifying the lax management that caused the bad loans and bringing them to book
- Strengthening RBI as regulator by refusing political/governance interference.

The future of India’s economy hinges on how promptly the overhang of huge stressed assets is cleared and banking sector starts functioning without stress. Point to note is that cost of fund for the economy, therefore the future rate of growth, is dependent on a transparent and stress free financial sector.

**CONCLUSION**

Banking system plays a very significant role in the financial existence of the nation. The strength of the economy is closely related to the reliability of its banking system. The problem of NPAs can be achieved only with appropriate credit appraisal and risk management mechanism. It is required that the banking system is to be equipped with prudent norms to reduce if not completely to keep away from the problem of NPAs. It is better to avoid NPAs at the budding stage of credit consideration by putting in place of precise and proper credit appraisal mechanisms. So, it is very necessary for bank to keep the level of NPA as low as possible. Because NPA is one kind of barrier in the success of bank and affects the performance of banks negatively so, for that the management of NPA in bank is necessary. And this management can be done by following way:

- Credit assessment and monitoring
- Timely sanction and or release of loans by the bank are to evade time and cost overruns.
- Working personnel should inspect the level of inventories/receivables at the time of evaluation of working capital.
- Identifying reasons for rotating of each account of a branch into NPA is the most significant factor for advancement of the asset quality, as that would help begin suitable steps to raise the accounts.
- The recovery machinery of the bank has to be modernized; targets should be set for field officers / supervisors not only for recovery in general but also in terms of upgrading number of existing NPAs.
- Due to lower credit risk and consequent higher profitability, greater encouragement should be given to small borrowers

**REFERENCES**


