Non- Performing Assets scenario in Indian Banking Sector

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Abstract

A businessman takes a loan from bank, it increases the production of goods & services and sales and profits which raise the money supply in the economy and finally the growth in the economy. Banks grant loans and advances for economic growth. These loans can be used for funding a start-up to buying appliances for newly purchased house. Recycling of fund's received back from borrowers constitute a major part of funding credit dispensation activity apart from raising resources from fresh deposits etc. Non recovery of instalments and interest on the loan given negates the effectiveness of this credit cycle process. It also effects the profitability of banks as well as capital and reserve cushion of the bank. The issue of non-performing assets (NPAs) has become more important due to transparency disclosure norms initiated by RBI in recent years. Also, the Basel Norms are designed to ensure that financial institutions maintain enough capital on account to meet their obligations and also absorb unexpected losses. They are the international banking regulations issued by the Basel Committee on Banking Supervision, (BCBS). The present research paper examines the causes, impact and measures taken for non-performing assets issue in India with brief introduction of loans and advances. It will also discuss the Basel Norms initiatives in this regard.

Keywords: Loans, Non-performing assets, Basel Norms, India.

Loans and Advances- Introduction

The term loan refers to money borrowed by one entity from another, repayable after a defined period with a definite rate of interest. In banking terms, loan means capital borrowed from a bank or a financial institution. These institutions charge interest against lending money for a certain period. Banks consider a prospective borrower's income, credit score and debt levels before deciding to offer them a loan. A loan may be secured by collateral and ensure repayment such as a mortgage or it may be unsecured such as a credit card. The bonds and certificate of deposits (CDs) are types of loan. A bond is a debt security and certificate of deposit is a fixed-income financial instrument governed under the Reserve Bank of India (RBI). It is issued in a dematerialized form. The withdrawal amount is assured from the beginning. A CD can be issued by any financial institution or a scheduled commercial

bank to individuals, companies, etc. They are a type of investment that have a short-term maturity period.

The main source of income for banks is the difference between the amount charged from borrowers and the amount paid to depositors. This amount is known as interest. For debtors, loans are the source of long-term financing. In the retail side, the important products offered by banks are loan for home, car, agriculture, credit card, personal, education, gold and for business ventures. Loans help existing companies expand their operations on one side and increase the competition on the other side, by offering loans to new companies. A businessman takes a loan from bank, it increases the production of goods & services and sales and profits which raise the money supply in the economy and finally the growth in the economy. Loans are generally granted against the security of certain assets. A loan may be repaid in instalments. For some people, bank loans are a way to meet emergencies while for others, loans act as a catalyst for growth. It all depends upon the purpose and the type of loans that the borrowers need to avail.

The Interest rate is very important variable not only for loans but also for the cost to the customer. The interest rate on loans is of two types, simple rate of interest or compound rate of interest. Simple interest is an interest charge that a borrower pays to a lender (bank) for a loan. It is calculated using the principal amount only. Compound interest is calculated on both the initial principal and the accumulated interest from previous periods. Therefore, it refers that calculation by compound interest makes borrower to pay more interest on loan, than by simple interest. The banks generally charge compound interest on loans offered to customers.

Advance means a credit facility provided by the bank to address short-term financial needs of its customers. The most common advances of banks are sundry debtors, inventories, cash and bank balances, loans and advances, cash credit, bank overdraft, discounting of bill of exchange among others. Advances are issued by banks and they are repaid within one year.

Loans and advances, both can be repaid in a flat sum, in instalments or on demand. The lender and customer, both make an agreement regarding terms and conditions of loan like rate of interest, repayment time and other related matters. Loans and advances undertaken are recorded on the liabilities side of a borrower's balance sheet as it must repay the amount.

Various types of bank loans are available that a borrower can access. Based on security, loans can either be secured loans or unsecured loans. Based on repayment, loans can be installment loans, time loans, (a loan with a definite maturity date), or demand loans. Secured loans are those loans that are provided against collateral security. The borrowers need to furnish security for availing of secured loans. In the case of secured loans, lenders face a lower risk of default by the borrower. In case the borrower is unable to repay the loan, then the lender can sell the asset to recover its dues. This is the

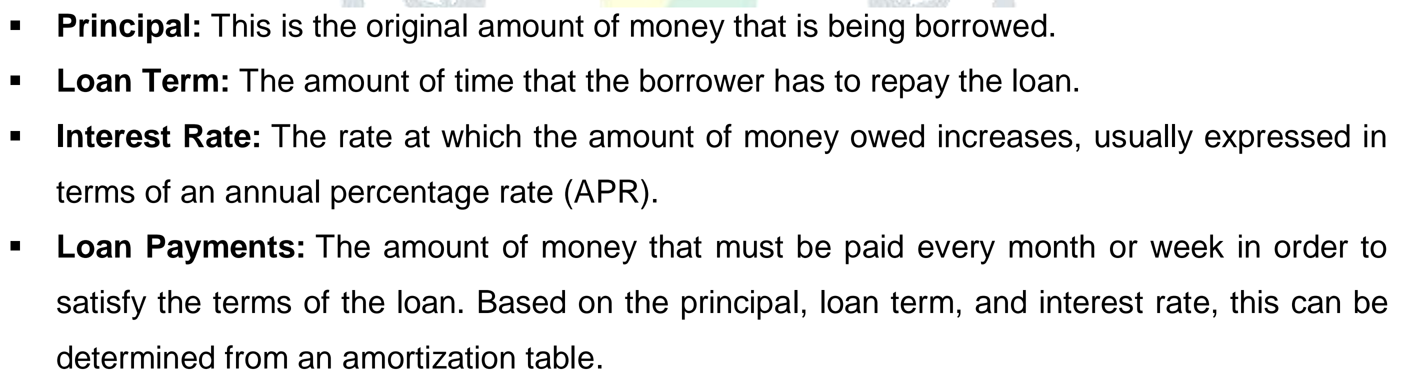
main reason why secured loans carry a lower interest rate than unsecured loans. Eg. Car loans is a secured loan, as it is backed or secured by collateral security, the asset, car itself.

An unsecured loan means that the borrower does not have to offer any asset as collateral security. In that case, the lenders are very cautious when assessing the borrower's financial status. These type of loans increase the risks of the lender because in case of default by the borrower, there is no security available with the lender/ bank from which it can recover its dues. Therefore, loan is provided against the income or the prospective income-earning capacity of the borrower and lending institutions charge a higher interest rate for unsecured loans. Credit card is an unsecured loan as they are not backed by any collateral. The interest rates on unsecured loans keep on changing as they get affected by many factors.

Further, loans can be revolving loan or term loan. As its name suggests, in revolving loan, the amount is used and then paid back and then is used again and so on. eg. credit card. In term loan, the amount of loan is paid back in equal monthly instalments over a given time. Retail asset products are loans provided by the banks to the borrowers. Loans can be utilised for various things today. It can be used for funding a start-up to buying appliances for newly purchased house.

Components of a Loan

There are several important terms that determine the size of a loan and how quickly the borrower can pay it back:



- **Principal:** This is the original amount of money that is being borrowed.
- **Loan Term:** The amount of time that the borrower has to repay the loan.
- **Interest Rate:** The rate at which the amount of money owed increases, usually expressed in terms of an annual percentage rate (APR).
- **Loan Payments:** The amount of money that must be paid every month or week in order to satisfy the terms of the loan. Based on the principal, loan term, and interest rate, this can be determined from an amortization table.

In addition, the lender may also add on additional fees such as an origination fee, servicing fee or late payment fees. For larger loans, they may also require collateral security such as real estate or a vehicle. If the borrower defaults on the loan, these assets may be seized to pay off the remaining debt.

Non-Performing Assets

The main purpose of banking is to grant credit facilities for economic growth. Recycling of fund's received back from borrowers constitute a major part of funding credit dispensation activity apart from raising resources from fresh deposits etc. Non recovery of instalments and interest on the loan given negates the effectiveness of this credit cycle process. It also effects the profitability of banks as well

as capital and reserve cushion of the bank. The issue of NPA has become more important due to transparency disclosure norms initiated by RBI in recent years.

Concept: The concept of Non- Performing Asset, (NPA), was first introduced in the Narasimham Committee report in 1991. The committee recommended that income recognition policy based on recovery should be considered as an objective. Therefore, for uniform and consistent application of norms, classification of assets and provisioning requirements is recommended, on the basis of classification of assets into standard, substandard, doubtful and loss categories. RBI decided to implement them in a phased manner from the financial year, 1992-93. An asset in any firm refers to its resources that hold a certain economic value, and that economic value can provide future benefit to the firm. Non-Performing Asset is an asset which ceases to generate income for the bank. It is that asset, on which either the instalments of interest or principal or both remain overdue for 90 days then it becomes non -performing asset. The new RBI rules require NBFCs to treat such accounts as NPA until the borrower updates the account by paying all the EMIs due. The banking sector follows an automated system for tagging accounts as NPAs, under which the accounts are tagged as NPAs on the day the account becomes overdue for more than 90 days. The basic factor is the record of recovery to determine the asset NPA. The gross NPA and net NPA are expressed as a percentage of advances. Gross non-performing assets, (GNPA) is an absolute amount. It tells the total value of gross non-performing assets for the bank in a particular quarter or financial year, as the case may be. The government has taken various reforms following which asset quality of public sector banks has been improving. The gross non-performing assets (NPAs) ratio of Indian banks has witnessed two consecutive declines due to covid-19 pandemic but became 6.78 percent in the 2020–21 financial year from 8.2 percent in 2019–20. Net NPA (NNPA) is the amount remaining after deducting doubtful and unpaid debts from the GNPA. It is the actual loss suffered by the bank. (Substandard + Doubtful + Loss) assets. Net NPAs = Gross NPAs – Provisions. It does not qualify the organization's actual loss.

Causes of NPAs: The main reasons of Non-Performing Assets in Indian banks are:

- The Indian economy was doing well in the initial years of 2000s, due to which the banks provided a considerable amount of loans to the companies. These companies borrowed huge amounts to take advantage of the opportunities. But they were not able to pay their debts. This led to the rising NPAs and costs and the recession of 2008.
- Some changes were made in monetary policy, like repo rate, reverse repo rate, but rising cases of NPAs were still prevalent.
- The relaxed lending norms to the corporate houses contribute greatly to the increase of NPAs in the banking sector. The banks provide unsecured loans without proper analysis which greatly contributes to the increase of NPA.
- During that period, there were bans on mining projects, which greatly affected the industries such as the iron and steel sector. Their operating cost was higher than income, so they were unable to pay back their loans to the banks. This mainly affects the public sector banks of India.

- The priority sector lending contributed to the increment of NPA by giving loans for agriculture, education, MSMEs and housing.
- In some cases, although the borrowers were competent to pay the loan but deliberately they avoided to pay back.
- The lack of proper credit appraisal also contributed for the rise in NPAs.
- In India, the farmers need to depend on seasonal rainfall for their crops apart from many other factors. Therefore, in case the production of crops is not good, then he is not able to pay back the bank loan amount.
- The lockdown is largely in effect in most parts of the country, this prolonged closure has paralyzed businesses and resulted in large-scale job losses which will have a corresponding impact on the bank NPAs.
- The RBI moratorium to borrowers was extended by another three months till August 31, 2020 and asset quality stress and results will be reflected in the following financial year.

Impact of NPAs on Banking Sector: The high NPAs on banks creates a negative impact on both the credibility and functioning of the banks as mentioned in the following points:

- The high NPAs, reduces the profitability of the banks. This NPA also affect the capitals and reserve base of the public sector banks and so lack of credibility. Banks face severe crises while trying to stabilise again.
- The account holders lose their trust in the banks and withdraw their money. This hugely affects the banking system and the bank comes the verge of collapse.
- The banks are forced to decrease their interest rate on saving deposits to increase the margin as a result of high NPA accounts.
- Interest margins of banks are highly affected by the rise in NPA, as a non-performing asset will stop generating income. Therefore, the interest earned normally by the bank will diminish, but the banks still need to pay the interest on their deposits.

Measures taken for NPAs: The government has taken various reforms following which asset quality of public sector banks has improved significantly. Banks deal with NPAs through methods such as asset reconstruction, debt recovery tribunals, and Lok Adalats. The following are some of the methods:

- **Credit Information Bureau:** Credit Information Bureau collects the information from various sources like, financial and nonfinancial institutions, microfinance institutions and credit card companies and shares comprehensive consumer credit information with value-added services such as credit scores to lenders. This system is required to make better appraisal process of clients and so better decisions by lenders.

- **Lok Adalats:** They have been set up for recovery of dues in doubtful and loss assets category. They help retrieve small loans up to 5 lakhs by way of compromise settlement under Lok Adalat. They are positive in dealings and they avoid cases to face legal system.
- **The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act:** This Act helps the banks and other financial institutions in auctioning the properties of the defaulter. Initially, bank sends a notice and still the borrower does not pay back the loan amount, bank takes the appropriate action to recover the loan amount.
- **Debt Recovery Tribunals:** Debt Recovery Tribunal empowers financial institutions to quickly collect debts of 10 lakhs or more.
- **One Time Settlement (OTS) Scheme:** Under this scheme, the eligible borrower has to submit a simple letter to the concerned branch of the bank expressing willingness for one-time settlement of the NPA account. As per the scheme, the borrower has to pay 10% of the One Time Settlement amount at the time of submission of the application.
- **Asset Reconstruction:** Restructuring of loans and advances is a procedure to modify the terms and conditions of an existing loan in order to alleviate the difficulties in repayment by the borrower due to temporary cash flow problems or general economic downturn.

Basel Accord

Concept: The Basel norms or Basel accords are designed to ensure that financial institutions maintain enough capital on account to meet their obligations and also absorb unexpected losses. They are the international banking regulations issued by the Basel Committee on Banking Supervision, (BCBS). The Basel norms are an effort to coordinate banking regulations across the globe with the goal of strengthening the international banking system. The Basel Framework is the full set of standards of the Basel Committee on Banking Supervision (BCBS) which is the primary global standard setter for the prudential regulation of banks.

The Basel Accords are a series of three sequential banking regulation agreements (Basel I, II, and III) set by the Basel Committee on Bank Supervision (BCBS), that established capital requirements and risk measurements for global banks. The Committee provides recommendations on banking and financial regulations, specifically, concerning capital risk, market risk, and operational risk. The accords ensure that financial institutions have enough capital on account to absorb unexpected losses. The regulations are considered to be the most comprehensive set of regulations governing the international banking system. The latest accord, Basel III, was agreed upon in November 2010.

The BCBS describes its original aim as the enhancement of "financial stability by improving supervisory knowhow and the quality of banking supervision worldwide." Later, the BCBS turned its attention to monitoring and ensuring the capital adequacy of banks and the banking system.

Basel I: The Basel Accords were developed over several years. The Basel Committee on Banking Supervision, (BCBS) was founded in 1974 as a forum for regular cooperation between its member countries on banking supervisory matters.

In the year, 1974, the concept of the formation of a G-10 group of bank supervisors had emerged for formation of the Standing Committee on Banking Regulation and Supervisory Practices, or the Basel Committee. The initial function of the Committee was to share and apply the knowledge of each other. Basel I Accord was developed through consultations among central bankers from major countries, who were at that time working comprehensively toward building new harmonised international financial structures. In December, 1987, International Convergence of Capital Measures and Capital Standards, i.e. Basel Accord, (Basel I) was achieved and in next year July, the Basel I Capital Accord 1988 was created. The meetings are named "Basel Accord" since the BCBS is headquartered in the offices of the Bank for International Settlements (BIS) located in Basel, Switzerland.

The breakthrough achievement of Basel Accord 1988 was the introduction of discipline through imposition of capital standards as measures of strength of banks, as well as intervention device by supervisors under the prompt corrective action, (PCA) scheme. However, many shortcomings in the Basel I framework were noticed over a period of time, like capital adequacy norms were criticised for 'one size fits all' approach that was unable to differentiate between assets with different risk levels. The fast changing financial markets and so the complex nature of financial transactions with innovative technology reduced the importance of Basel I as a risk managing framework for big banks. India adopted the Basel norms in a phased manner, as a part of banking sector reforms. India stipulated capital to risk weighted assets ratio, (CRAR), at 9% as against the international norm of 8%.

Basel II: With this backdrop, BCBS initiated the New Capital Adequacy Framework for International Convergence of Capital Measurement and Capital Standards, (Basel II), in June, 2004, with the objective of aligning minimum capital to underlying risk profile of banks and better risk management. The Basel Accord II, also called the Revised Capital Framework, served as an update of the original accord. It focused on three main areas: minimum capital requirements, supervisory review of an institution's capital adequacy and internal assessment process, and the effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices including supervisory review. Together, these areas of focus are known as the three pillars, designed to reinforce each other. Basel II accord made it mandatory for the banks to set aside sufficient capital to be able to withstand any losses resulting from credit risk, market risk and operational risk. Basically, in Basel II framework banks use the capital more dynamically to make it flows to its most efficient use. Therefore, it is moving towards capital efficiency from capital adequacy. India prescribed the capital charge for market risk in June 2004, in line with the 1996 amendment in Basel norms. The RBI released many guidelines for implementation of Basel II norms in February 2005. In India, Basel II framework became

fully operational from March 2009. Although, various measures were taken by RBI to make a smooth migration to Basel II norms in the banking sector but the migration to advanced approaches faces many challenges to the banks and RBI. The first challenge is the availability of reliable, good quality time-series data for calculating the risk parameters under these approaches. Second challenge is the internal validation of use of risk models by the banks which are required under Basel II advanced approaches. Third challenge is the effective implementation of advanced approaches of risk management, need skills in RBI and in the banking system.

In the context of financial conglomerates, implementation of Basel II norms needed co-operation, information sharing and co-ordination of policies among sectoral supervisors.

Basel III: As per the circular issued by Reserve Bank of India on March, 27, 2014, it was stated that "in view of the implementation of Basel III Capital Regulations, banks need to improve and strengthen their capital planning processes. While conducting the capital planning exercise, banks may consider the potential impact of the changing macro-economic conditions and the outcomes of periodic stress tests on the adequacy and composition of regulatory capital.

The capital requirements may be substantially lower during the initial years as compared to later years of full implementation of Basel III guidelines. Accordingly, banks should keep this aspect in view while undertaking their capital planning exercise." RBI had extended a year till March 31st, 2020, for the fully implementation of Basel III norms.

The key difference between Basel I, II and III is that Basel I is established to specify a minimum ratio of capital to risk-weighted assets for the banks whereas Basel II is established to introduce supervisory responsibilities and to further strengthen the minimum capital requirement and Basel III to promote the need to improve and strengthen their capital planning processes.

Suggestions and Conclusion: From the banks point of view, although the situation regarding non-performing assets has been improving but further it is suggested that senior executives of the banks should take the responsibility for the lapses. There is a need for more efforts for good corporate governance over the banks. The government should give the banks more authority and flexibility to handle the problem of high NPAs. The effective Management Information System (MIS) is a must to implement for maintaining effective credit risk management. To check the stressed assets, there should be the setting up of reconstruction companies. The Basel norms are an effort to coordinate banking regulations across the globe with the goal of strengthening the international banking system. Although, various measures were taken by RBI to make a smooth migration to Basel II norms in the banking sector but the migration to advanced approaches faces many challenges to the banks and RBI. Basel III focus is to promote the need to improve and strengthen the capital planning processes. The capital requirements may be lower during the initial years as compared to later years of full implementation of Basel III guidelines. Therefore, banks are advised by RBI to keep this aspect in view while undertaking their capital planning exercise.

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