

A Study of the Causes for Rising of Non Performing Assets and its Effects on Profitability of Public and Private Sector Banks

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Abstract:

The banking sector plays a critical role in the economic development of a country. The COVID-19 which hit the country in the early 2020 has badly affected the growth of various sectors. One such adversely affected sector is the banking sector. The Indian banking sector which is already reeling under mounting NPAs is adversely affected by this pandemic. RBI governor has said that the economic impact of the pandemic may result in higher NPAs and capital erosion of banks. The economic fallout of pandemic is expected to push up NPAs of the banking sector. It is estimated that the ratio of Gross NPAs may raise to 15.2% by March 2021 under the baseline scenario. On March 27, 2020, the RBI launched the COVID-19 regulatory package to rescue the economy where in it reduced the CRR to 100bps and repo rate by 75bps along with a three month loan moratorium followed by other systematic rate cuts and regulatory easing. The efficacy of these measures for the upliftment of the economy are bound to exert much stress over the banking sector.

Keywords: Gross NPA, Net NPA, Public banks and Private Sector Banks.

Introduction:

A **nonperforming asset** (NPA) refers to a classification for loans or advances that are in default or in arrears.

A loan is in arrears when principal or interest payments are late or missed.

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. NPAs affect the liquidity and profitability, in addition to posing threat on quality of asset and survival of banks. The Indian banking sector has been facing serious problems of raising Non Performing Assets (NPAs). The NPAs growth has a direct impact on profitability of banks. It involves the necessity of provisions, which reduces the overall profits and shareholders' value. The problem of NPAs is not only affecting the banks but also the whole economy. In fact high level of NPAs in Indian banks is nothing but a reflection of the state of health of the industry and trade. It is necessary to trim down NPAs to improve the financial health in the banking system.

The primary function of banks is to lend funds as loans to various sectors such as agriculture, industry, personal and housing etc. and to receive deposits. Receiving deposit involves no risk, since it is the banker who owes a duty to repay the deposit, whenever it is demanded. On the other hand lending always involves much risk because there is no certainty of repayment. Non-performing asset (NPA) is one of the major concern and problem for banks in India.

NPAs reflect the degree of risk and quality of assets of bank and profitability of a bank. 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 reduced income from assets and the necessity of provisions, which reduces the overall profits and shareholders' value. The level of nonperforming assets is at the alarming rate in Indian banking comparatively to other countries. This level is much higher in case of public sector banks compare to private sector bank because their directional credit to priority sector projects and social development projects. The public sector banks play an immense role in the development and growth from the very inception. The public sector banks which were operating on social model by mobilizing the huge resources and directing them to social and priority sectors for social and economic development of the country. Due to their socio economic role, there was high level of NPA's in their asset portfolio. After the liberalization in 1991, they faced high level competition from private and foreign banks. Due to this fierce competition and challenge on their survival, they were forced to improve the performance and weakness. The biggest weakness and problem they faced was huge NPA's in their portfolio. This study aims to check what is the position and level of nonperforming assets of nationalized banks which is core and heart of public sector banking in India and which handles the major portion of banking business in India.

Presently, prevalence of NPAs is considered as a big threat to banking sector. . Credit is one of the important functions of any bank. But there is risk involved in this. Banks raise resources not just through various deposit schemes but also the funds lent are recycled back into the system when payment is received. A loan when becomes NPA stops this recycling of fund and the credit creations is disrupted. NPAs require provisioning and accordingly the amount is kept aside from profit seriously impacts the bottom-line of the bank. Thus NPA is a great concern not only for the bank itself but also for the policy makers including the stake holders.

Before the liberalization and reforms in the banking industry, NPA was not a matter of concern because income recognition concept was not there. There was no priority of thinking on this important area. But after the liberalization and financial reforms, which was introduced in view of the recommendation of the Report of Narasimham Committee on the Financial System in the year 1991, international banking practices came into being, the attention of all concerned was on NPAs.

The Indian Banking Industry consists of 27 Public Sector Banks, 25 Private sector Banks, 43 Foreign banks, 56 RRBs, 1589 Urban Co-Operative banks, and 93550 rural Co-Operative banks, besides Co-operative credit institutions. However, after the amalgamation of Dena Bank, Vijaya Bank and Bank of

Baroda for consolidation with effect from 1st April,2019 followed by merger of 10 PSBs to 4 effect from 1st April,2020 the number of Public Sector Banks has come down to 12 from 27 two years ago.

In banking industry presently technology is acting as catalyst. There has been a razor-thin competition among the banks. But the problem of the swelling NPAs is drawing attention of all An effective risk management in this area has assumed a great importance. Management of NPA has become the most covenant priority to all the bankers and the Government .

Non Performing Assets Meaning:

Assets which generate periodical income are called as performing assets. Assets which do not leased asset, becomes nonperforming when it ceases to generate income for the bank With effect from March 31, 2004, a non-performing asset shall be a loan or an advance where:

- Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- The account remains 'out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit,
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes. Types of NPA:

(1) Gross NPA:

Gross NPA reflects the quality of the loans made by Banks. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss assets. It can be calculated with the help of following ratio:

$$\text{Gross NPAs Ratio} = \text{Gross NPAs} / \text{Gross Advances}$$

(2) Net NPA:

Net NPAs are those type of NPAs in which the bank has deducted the provision regardingNPAs. Net NPA shows the actual burden of banks. Since in India, bank balance sheets contain a huge amount of NPAs and the process of recovery and write off of loans is very time consuming, the provisions the banks have to make against the NPAs according to the Central bank guidelines, are quite significant. That is why the difference between gross and net NPA is quite high. It can be calculated by following

$$\text{Net NPAs} = \text{Gross NPAs} - \text{Provisions} / \text{Gross Advances} - \text{Provisions}$$

Asset Classification:**Categories of NPAs:**

Banks are required to classify nonperforming assets further into the following three categories based on the period for which the asset has remained nonperforming and the realize-ability of the dues:

Standard Assets:

Standard assets are the ones in which the bank is receiving interest as well as the principal amount of the loan regularly from the customer. Here it is also very important that in this case the arrears of interest and the principal amount of loan do not exceed 90 days at the end of financial year. If asset fails to be in category of standard asset that is amount due more than 90 days then it is NPA and NPAs are further need to classify in sub categories. Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the reliability of the dues:

Sub Standard Assets:

With effect from 31 March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardies the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

Doubtful Assets:

With effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values – highly questionable and improbable.

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.

Review of Literature:

K.V.Ramesh, Sudhakar.A., (2018) investigated the NPA management in public sector banks a case study of canara bank and state bank of India to analyse the NPA of former mentioned banks. Data was

collected for a period of ten years between 2006 to 2016. It is concluded that if the proper management of the NPAs is not undertaken it would be affects the business of the banks. The NPAs would affect business cycles, legal framework, ethical standards, regulatory and supervisory system and bank specific factors like credit appraisal system, credit recovery procedures risk management system and the motivational level of employees. It is found that there is down trend in NPAS of selected banks by establishing appropriate systems internally to reduce and eliminate at the earliest.

Srivastava V, Bansal deepak (2012) did a “a study of trends of non-performing assets in private banks in India” to find out whether there is positive trend and control of NPA“S by the private sector banks in India. The data were collected for a period of five years from 2007-2012 from various secondary sources and analysed by average and comparative percentage analysis. It was found that that the level of NPAS is alarming with public sector banks in India but there is slight improvement in the asset quality reflected by decline in the NPA percentage. The banks should take timely action against degradation of good performing assets.

Chaudhary and Sharma (2011) in their research paper on Performance of Indian Public Sector Banks and Private Sector Banks: A Comparative Study stated that it is right time to take suitable and stringent measures to get rid of NPA problem. An efficient management information system should be developed. The bank staff involved in sanctioning the advances should be trained about the proper documentation and charge of securities and motivated to take measures in preventing advances turning into NPA. Public banks must pay attention on their functioning to compete private banks. Banks should be well versed in proper selection of borrower/project and in analyzing the financial statement.

Malyadri and sirisha (2019) The Indian banking system has undergone significant transformation following financial sector reforms. It is adopting international best practices with a vision to strengthen the banking sector. Several prudential and provisioning norms have been introduced, and these are pressurizing banks to improve efficiency and trim down NPAs to improve the financial health in the banking system. In the background of these developments, this study strives to examine the state of affair of the Non performing Assets (NPAs) of the public sector banks and private sector banks in India with special reference to weaker sections. The study is based on the secondary data retrieved from Report on Trend and Progress of Banking in India. The scope of the study is limited to the analysis of NPAs of the public sector banks and private sector banks NPAs pertaining to only weaker sections for the period seven years. It examines trend of NPAs in weaker sections in both public sector and private sector banks. The data has been analyzed by statistical tools such as percentages and Compound Annual Growth Rate. The study observed that the public sector banks have achieved a greater penetration compared to the private sector banks.

Bhatia (2017) in his research paper entitled, Non- Performing Assets of Indian Public, Private and Foreign Sector Banks: An Empirical Assessment, explores an empirical approach to the analysis of

Non-Performing Assets of public, private and foreign sector banks in India. The NPAs are considered as an important parameter to judge the performance and financial health of banks. This paper aims to find the fundamental factors which impact NPAs of banks. A model consisting of two types of factors, like macroeconomic factors and bank- specific parameters, is developed and the behavior of NPAs of the three categories of banks is observed.

Vijaykumar and Aravanan (2017) his research paper examines the performance of a bank using a Non Performing Assets measures. The NPA measure includes selected ratios which capture the bank performance. Where, these ratios were assigned weights and graded according to the performance direction of the ratio. This study is undertaken using a hypothetical data for a bank and the performance measuring model is explained clearly.

Objectives:

- To present the review of literature on non-performing assets in banks in terms of the impact of non-performing assets on profitability of banks, comparative study of non-performing assets in public sector banks and private sector banks.
- To study NPA trend in last 5 years of private and public sector banks.
- To make a comparative study of NPAs of public sector and private sector banks.

Research Methodology:

Research design used to carry out this study is descriptive research because it deals with statistical data and the main aim of the report is to describe the factors affecting the problem mentioned and making comparison between banks performance in context of NPA. The present study is an analytical study. For the purpose of this project non probability convenience method of sampling is used. The banks for the purpose of study are chosen as per convenience only. The sample consists of two Public sector banks - State Bank of India, Bank of Baroda and two Private sector Banks – ICICI Bank Ltd, Axis Bank Ltd. The study is done on the basis of data for the period of 5 years from the financial year 2016-2020 and secondary data is collected mainly from the sources available at internet like the RBI website, websites of the banks etc. Data is presented with the help of charts and tables etc.

Analysis:

Table 1: Gross and Net NPA of Public sector Banks

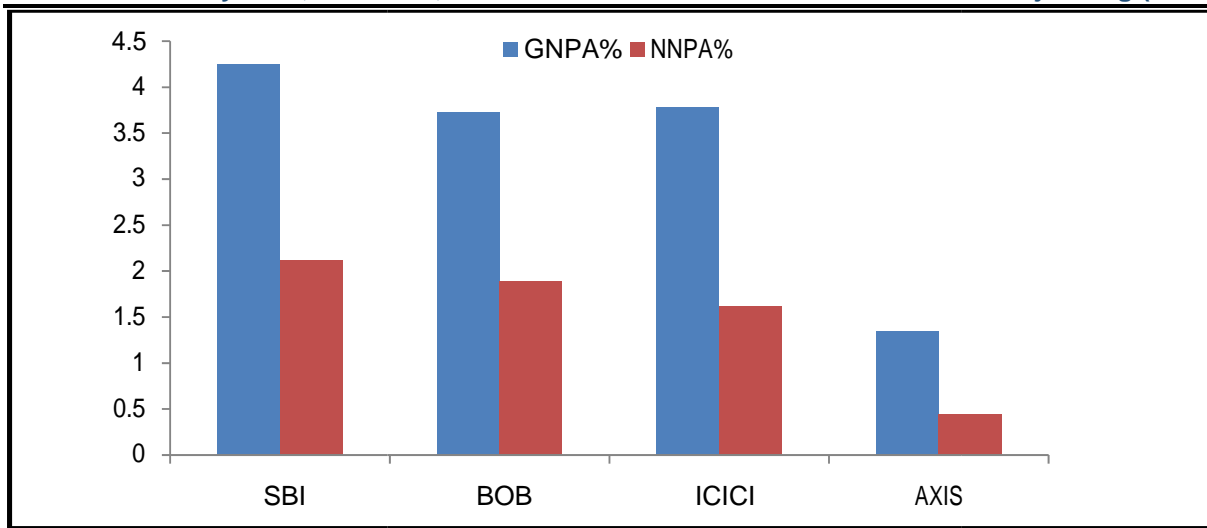
Year	SBI				BOB			
	GNPA	% GNPA	NPA	%NNP A	GNPA	% GNPA	NPA	%NNP A
2016	25326	3.28	12346	1.63	3152.5	1.36	790.88	0.35
2017	39676	4.44	15818	1.82	4464.75	1.53	1543.64	0.54
2018	51189	4.75	21956	2.1	7982.58	2.4	4192.02	1.28
2019	61605.35	4.95	31096.07	2.57	11875.9	2.94	6034.76	1.52
2020	56725.34	4.25	27590.58	2.12	16261.45	3.72	8069.49	1.89

Source: www.sbi.co.in, www.bankofbaroda.co.in and www.moneycontrol.com

Table 2: Gross and Net NPA of Private sector Banks

Year	ICICI				AXIS			
	GNPA	% GNPA	NPA	%NNP A	GNPA	% GNPA	NPA	%NNP A
2016	10034	4.47	2407	1.11	159	1.01	41	0.26
2017	9475	3.62	1860	0.73	1806	0.94	472	0.25
2018	9607.75	3.22	2230.56	0.77	2393	1.06	704	0.32
2019	10505.84	3.03	3297.96	0.97	3146	1.22	1024.62	0.4
2020	15094.69	3.78	6255.53	1.61	4110.19	1.34	1316.71	0.44

Source: www.icicibank.com, www.axisbank.com and www.moneycontrol.com



The above graph shows GNPA% and NNPA% of the year 2020. From above graph we can say that GNPA% is higher in SBI Bank in comparison to BOB, ICICI, and AXIS. In SBI GNPA % is 4.25 and AXIS it is 1.34 which is lower in comparison to SBI, BOB, ICICI. In case of NNPA% SBI is higher compare to BOB, ICICI and AXIS. Here Nationalized banks NNPA % is higher in comparison to Private banks. So we can say that private sector banks are better in comparison to nationalized banks.

Impact of Non- Performing Assets on Banks

NPAs has direct impact on the bank's profitability which is affected in following ways:

- Liquidity position: The bank is forced to raise resources at higher cost because NPA cause mismatch between the total liabilities and total assets
- Undermine bank's image: Because of high NPA the profitability is also affected by the undermine image of the bank
- Effect on funding: Since NPAs do not yield any income for the bank and results in scarcity of funds for lending to the borrower.
- Rise in cost of capital: NPAs raise cost of capital as more working capital is required .
- Higher risk: NPA also adversely affects the risk-taking capacity of the bank
- Declining productivity:/effect on ROI/profitability : A lot of time is required for preparation of documents, filing of suit, follow up for recoveries necessitating involvement of huge manpower are required and expenses also are incurred but there is no income from the NPA accounts. It affects the profitability and productivity in banks.
- Ultimate burden on society: Since no income is generated from NPA accounts, banks in order to survive charges higher rate of interest and new borrowers suffer which is affecting the welfare of the society.
- Effect on capital adequacy: As NPAs occur banks need capital infusion and capital adequacy ratio is affected badly because of higher provisions.
- Impacting share price: Because of high NPAs people lose confidence on banks and the market acts

adversely when it is revealed that the share price is impacted downward and sometimes dips below the face value of the share..

Causes Responsible for Rising NPAs in Banks

The factors attributed for turning the performing assets into NPA can be summarised as follows :-

a) External factors	b) Internal factors
Willful defaults	Defective lending process (principles of lending to be mentioned)
Natural calamities	Inappropriate technology
Industrial sickness	Improper and unrealistic repayment schedule on compliance of all terms and conditions before disbursement.
Lack of demand	The character and capacity of the promoter is not assessed properly
Unfavorable change in Government policies	Lacuna in appraisal techniques
Non availability of clearances for appropriate authority	Absence of regular industrial visit
Recessions in the industry	Managerial deficiencies (detection of borrower)
Diversion of funds	Wrong assessment of project requirement with references to technical know- how, scale of production, etc.
Lack of seriousness in recovering the money through legal steps	Improper SWOT analysis

Influence of political leaders	Poor credit appraisal system
Debt relief scheme announced by the Government from time to time	Improper follow up and supervision at post disbursal stage.
Government Risk Management policies are not fully complied	Re-loaning process

There are some other reasons which also result in accumulation of NPAs:

- Most of the borrowers do not repay loans willfully/intentionally.
- Lack of strong legal action against NPA defaulters.
- Corruption in the banking sector leads to increase in NPA.
- Prominent people or politicians influence the lending process of banks.
- Diversion of funds from the stated purpose increases the possibility of its becoming NPAs.
- High rate of interest leads to more NPA as burden of repayment increases on the borrower.
- Inadequate staff in banks to manage loan portfolio, supervision and follow-up.
- Training regarding Credit Risk Management to bank staff is inadequate.
- Mortgage lending is generally misled by legal experts / inspecting officers /valuers which results in poor credit appraisal.
- Risk management policies framed by governing bodies are not properly complied with.
- Risk analysis tools like track record verification, pre sanction audit system for early detection of default are not effectively used..
- Loans given to economically weaker section increase NPAs to a large extent.
- Natural calamities are one of the main reasons responsible for increased NPA in agriculture loans.
- Government schemes of debt waivers, debt restructuring increase the chances of being NPAs.
- One time settlement by banks or through LokAdalat increases the chances of being NPAs.
- Credits guarantee schemes and waiving collateral security increases chances of being NPA.
- CIBIL score has been ineffective in controlling NPAs.

Recovery Mechanism :

In the event of default of payment of loan and the account turning NPA, it is imperative that robust recovery measures are to be initiated as soon as possible. Any delay and slackness in this area will land the lender in dire problem as the possibility of recovery through recovery action will become useless. Recovery Mechanism is a process through which different recovery procedures are required to recover fund from the NPAs. As bank is deprived of any revenue income when the account turns bad , quick recovery action plays a great role in recycling of fund into the lenders' hand. The position of entire banking industry across all banks in respect of GNPA has been mentioned in Table no 1 and 2 above which indicates a worst scenario of accumulation of NPAs. For effecting recovery banks have two options available : Non-legal measure and legal measure.

Conclusion:

The NPAs have always created a big problem for the banks in India. It is just not only problem for the banks but for the economy too. The money locked up in NPAs has a direct impact on profitability of the bank as Indian banks are highly dependent on income from interest on funds landed. This study shows that extent of NPA is comparatively very high in public sectors banks as compared to private banks. Although various steps have been taken by government to reduce the NPAs but still a lot needs to be done to curb this problem. The NPAs level of our banks is still high as compared to the foreign banks. It is not at all possible to have zero NPAs. The bank management should speed up the recovery process. The problem of recovery is not with small borrowers but with large borrowers and a strict policy should be followed for solving this problem. The government should also make more provisions for faster settlement of pending cases and also it should reduce the mandatory lending to priority sector as this is the major problem creating area. So the problem of NPA needs lots of serious efforts otherwise NPAs will keep killing the profitability of banks which is not good for the growing Indian economy at all.

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