Relevance of NPA in Indian Commercial Banking Sector

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Abstract

Recent news of increasing non-performing assets (NPAs) and instances of bribery and corruption have put the banking and financial services sector in a distress situation. The Public Sector Banks (PSBs) continue to be under stress, on account of aggressive lending in the past. NPA is one of the major concerns for the banking system around the globe and the Indian banking system is not an exception to this universal phenomenon. The environmental limits on bank operations cannot be tackled by reforms at bank level alone as will be discussed in a section below. Another paper by Rajaraman and Vasishth (2002) performed panel regression on NPA data of twenty seven public sector banks covering a five year period from 1995-96 to 1999-2000. Among banks with higher than average NPAs, the exercise identifies two groups. In one case, high level of NPAs is explained by poor operating efficiency ,and in the other case, the operating indicator does not suffice to explain the high level of NPAs and leaves an unexplained intercept shift. Over the years bank advances increased much faster rate than that of NPA and thereby reduced the share of gross NPA in gross advances to 14 percent by the end of the decade and close to 9 percent in 2003. In terms of total assets of these banks, it was found that around 11 percent of these assets were non-performing in 1994, this ratio however substantially declined to 6 percent in 2000 and close to 4 percent in 2003. This happened not because of the substantial recovery of NPA but due to a rapid increase in bank advances and assets.

The problem which was largely hidden earlier has now come to the forefront in recent years. The bad loan crisis at Indian Public Sector banks continues to worsen with 26 banks together reporting gross non-performing assets of more than Rs 7.31lakh crore. India's bad loans are fifth highest in the world and surged dramatically after March 2015. In the following research paper the author has tried to explain the causes, impact and measures to tackle the menace of NPAs through descriptive analysis.

***Keywords**: Non Profitable Assets (NPA), Public Sector Banks (PSBs), Reserve Bank of India(RBI).*

Introduction

The rise in Non-Performing Assets (NPAs) of the Indian banking sector is a cause of concern for the economy. The Economic Survey also devoted considerable attention to India"s Twin Balance Sheet problem i.e., distressed companies and the rising NPAs in Indian Public Sector Banks (PSBs). NPAs in public sector banks increased by about Rs 6.2 lakh crore between March 2015- 2018. According to the Reserve Bank of India (RBI), banks will continue to face deterioration in their non-performing assets (NPAs) or bad loans. Non-performing assets (NPAs) in the Indian banking system, specifically in the public sector banks (PSBs), have adverse effects on credit disbursement and money supply. Now, an increasing amount of bad loans have prompted the banks to be extra cautious, which has dried the credit channel. According to the – "Reserve Bank of India's Financial Stability Report of December 2017, NPAs currently stand at 10.2 per cent of all assets, while stressed assets, which are believed to be NPAs in effect, stand at 12.8 per cent".

Increasing cases of wilful defaults and frauds have recently been in the news. These cases are often perceived as the primary reason behind the accumulation of bad loans in the Indian banking sector. However, the principal factor is the over-expectation of economic growth, which makes the banking system disburse credit more during the boom period of the business cycle. If the high expectation of growth does not materialise, bad loans accumulate as borrowers are unable to repay due to stalling or closure of the big development projects. The aggregate gross NPAs of SCBs increased primarily as a result of this transparent recognition of stressed assets as NPAs, from Rs 3,23,464 crore, as on March 31, 2015, to Rs 10,35,528 crore, as on March 31, 2018.

Taking advantage of loopholes in the old banking law, PSBs developed enough laxity to accumulate a large volume of NPA. It is clear from the figures of NPA that are available for each year since 1993. Gross NPAs in the PSBs have increased rapidly from Rs 39 thousand crores in 1993 to Rs 54 thousand crores in 2003 as shown in table 1. It grew at a rate of around five percent per annum during the period excepting the last year when it declined. Sheer size of NPA and its growth rate over the greater part of the 1990s indicate the ill health of the Indian public sector banks. In the year 1994, it was found that almost a quarter of the total volume of existing advances made by these banks remained non-performing. After implementations of the Narasimham Committee Report (1991) banks could no longer show interest on an accrual basis but it had to make provisioning from its income while granting of advances. This led to a situation in which a large number of the PSBs started reporting negative profit in 1992-93. Banks fulfilling certain conditions were allowed to write off these losses against their capital. This called for recapitalisation of these banks.

Further, recapitalisation was required to a large extent in order to write off bad debts. The total bad debt written off by 27 PSBs in 1997-98 was Rs 2,800 crores. A number of profitable Indian PSBs recorded huge increases in bad debt write offs in 1998-99 as compared to previous years. One more compelling reason for recapitalisation was to enter into capital market . Since the beginning of banking reforms in the early eighties, the government has contributed Rs 20,046 crores towards recapitalisation and allowed banks to write off Rs 3,978 crores.

Clearly, in the pre-reform era, when provisioning was not done, the profits of PSBs were overstated in their accounts. However, it is interesting to note that recapitalisation started as early as 1985-86, as noted by Mathur (2002). This is indicative of the malfunctioning of the banks which started much before Narasimham Committee and continued throughout the nineties.

Table 1: Gross and Net NPAs of PSBs (amounts in Rs crores)

End March	Gross NPAs (1)	Gross Advance (2)	(1) as a % of (2) (3)	(1) as a % of tot. Asst (4)	Net NPAs (5)	Net Advance (6)	(5) as a % of (2) (7)	(6) as a % of tot. Asst (8)	Increment in Gross NPAs (9)	Incre-ment in gross Adv. (10)	(9) as a % of (10) (11)	Gross minus net NPA (12)
1993	39,253	169,194	23.2	12								
1994	41,041	165,488	24.8	11					1788	-3,706	-48.25	
1995	38385	196,846	19.5	8.7	17567	164,178	11	4	-2656	31,358	-8.47	20,818
1996	41661	231,450	18	8.2	18297	205,584	8.9	3.6	3276	34,604	9.47	23,364
1997	43577	244,214	17.8	7.8	20285	220,922	9.2	3.6	1916	12,764	15.01	23,292
1998	45653	284,971	16	7	21232	260,459	8.2	3.3	2076	40,757	5.09	24,421
1999	51710	325,328	15.9	6.7	24211	297,789	8.1	3.1	6057	40,357	15.01	27,499
2000	53033	379,461	14	6	26187	352,714	7.4	2.9	1323	54,133	2.44	26,846

2001	54672	442,134	12.4	5.3	27,977	415,207	6.7	2.7	1639	62,673	2.62	26,695
2002	56473	509,368	11.1	4.9	27958	480,681	5.8	2.4	1801	67,234	2.68	28,515
2003	54086	577,813	9.4	4.2	24963	549,351	4.5	1.9	-2387	68,445	-3.49	29,123

Source: RBI website: rbi.org.in

Objective:

This paper seeks

1. To estimate the NPA impact on the Indian economy; finance in crisis
2. To evaluate the financial loopholes of banking sector

NPA nomenclature

Taking advantage of loopholes in the old banking law, PSBs developed enough laxity to accumulate a large volume of NPA. It is clear from the figures of NPA that are available for each year since 1993. Gross NPAs in the PSBs have increased rapidly from Rs 39 thousand crores in 1993 to Rs 54 thousand crores in 2003 as shown in table 1. It grew at a rate of around five percent per annum during the period excepting the last year when it declined. Sheer size of NPA and its growth rate over the greater part of the 1990s indicate the ill health of the Indian public sector banks. In the year 1994, it was found that almost a quarter of the total volume of existing advances made by these banks remained non-performing. After implementations of the Narasimham Committee Report (1991) banks could no longer show interest on an accrual basis but it had to make provisioning from its income while granting of advances. This led to a situation in which a large number of the PSBs started reporting negative profit in 1992-93.

Banks fulfilling certain conditions were allowed to write off these losses against their capital. This called for recapitalisation of these banks. Further, recapitalisation was required to a large extent in order to write off bad debts. The total bad debt written off by 27 PSBs in 1997-98 was Rs 2,800 crores.The chances of loan defaults that a bank now faces cannot be expressed in terms of pure risk (that is, known probability distribution of defaults for different categories of loans) but more in terms of uncertainty. This problem may be taken care of to an extent by introducing memory in the process of lending by the bank that can make subjective assessment of chance of default for the borrower by studying his past record, his surroundings, his business activity, etc. Thus, screening of borrowers for the purpose of lending by a bank is important to avoid uncertainty to an extent. But some of the problems originating from adverse selections, moral hazards, principal agency relations or political interference may still haunt the banking sector as discussed below.

The very existence of banks is often interpreted in terms of its superior ability to overcomes three basic problems of information asymmetry, namely ex-ante, interim and ex-post information asymmetry, over an individual lender.

Prior to this it was insignificant implying that in the peak period of NPA problem there was no marked association between high risk lending with high interest rate on the one hand and the high incidence of NPAs on the other. However, it is interesting to note that the correlation and the level of confidence improved throughout the second half of the 1990s when most of the PSBs also improved their NPA ratios. It was since the beginning of the next decade that the association again loosened RBI report (1999) on NPA pointed out lacunae in credit recovery, largely arising from inadequate legal provisions on foreclosure and bankruptcy, long drawn legal procedures and difficulties in execution of the decrees awarded by the court. The legal system does not permit early recovery of dues.

The report said that the Indian legal system is sympathetic towards borrowers and works against bank's interest (defaulter friendly legal system). It may also be mentioned that there is no social stigma attached to the defaulters, especially wilful defaulters. Further, it is becoming increasingly futile to keep the litigation alive for long, as it is only a drain on resources. These legal procedures are highly time consuming as the matters get invariably delayed with law courts granting adjournments one after another for any small reason. More money is spent than what is hoped to be recovered by pursuing these cases in the courts of law. Despite most of the loans being backed by security, banks are unable to enforce their claims on the collateral, when loans turn non-performing, and therefore loan recoveries remain insignificant. Un-sustainability of litigation in cases where borrowers are neither paying up nor likely to do so makes provisioning against these NPAs a losing proposition. The bank may feel that a write-off against such loans would help clean up the balance sheet and induce greater transparency. Thus there may be a tendency to write off a small amount of advances in the face of prohibitive legal and administrative cost and inordinate delay in final settlement.

Table 2: Asset classification based on quality (Amount in Rs crores)

Year	1 Standard Assets	2 Sub-standard assets	3 Doubtful assets	4 Loss assets	Total assets	1 as % of total assets	2 as % of total assets	3 as % of total assets	4 as % of total assets
1993	130087	12552	20106	393	163138	76.8	7.4	11.9	2.3

1994	124580	12163	23317	4073	164133	75.2	7.4	14.1	2.4
1995	158967	7758	22913	3732	193370	80.6	3.9	11.6	1.9
1996	189660	9299	24707	4351	228017	82.0	4.0	10.7	1.9
1997	200637	12471	26015	5090	244213	82.2	5.1	10.6	2.1
1998	239318	14463	25819	5371	284971	84.0	5.1	9.1	1.9
1999	273618	16033	29252	6425	325328	84.1	4.9	9.0	2.0
2000	326783	16361	30535	6398	380077	86.0	4.3	8.0	1.7
2001	387360	14745	33485	6544	442134	87.6	3.3	7.6	1.5
2002	452862	15788	33658	7061	509369	88.9	3.1	6.6	1.4
2003	523724	14909	32340	6840	577813	90.6	2.6	5.6	1.2
Growth Rate 1993-2003 (%)	15.86	4.85	5.15	19.04	14.24				

Source: RBI website: rbi.org.in

Moral and social implication of NPA

A micro-level probe would reveal that non-economic factors, like moral hazards, adverse selection, screening and monitoring problems, principal agency problems, are highly important - some of which are operating through political and bureaucratic channels and some others through banks' own administrative channels in granting loans and in preventing recovery of dues. In case of Indian PSBs this has become a rampant and all-pervasive phenomenon. In fact high incidence of default in the priority sector lending may be attributed to a great extent to the political factors. Similarly, there are ample evidence of big borrowers in the non-priority sectors who defaulted but the banks could not penalise and confiscate their assets because the latter wielded enormous political power and at times influence over the board of members of the banks. The problem of confiscation of asset was further aggravated by two important factors – legal factors that take a long time to settle any dispute, and highly imperfect or inadequately formed markets for confiscated assets.

Banks, therefore, often fail to realise the value of the defaulted amount by disposing of the confiscated assets. All this leads the banks to go for compromise with the defaulters giving several concessions to the latter and this encourages the others to default. The evolving policies of settlement of NPAs are being frequently thwarted by legal injunctions and are yet to be concretised.

Thus, NPA formation depends not only on banking rules, regulations and practices that are part of its institutions, but also on the external institutional environment within which PSBs operate, like the political will, cultural practices or the social customs/moral fabric of the society, and overall economic conditions. Several of these internal and external institutions have degenerated over the decades, some of which are worth mentioning.

Table6: Growth rate of schedule commercial banks' deposits and investments in government securities

Period	Growth rate of commercial banks' deposits (%)	Growth rate and investments in government securities (%)
1970-80	20.68	21.16
1980-90	17.96	19.22
1990-2002	17.07	20.62

Till the initiation of reforms in 1992, Indian PSBs, had been operating not as an independent organization, but as if a subsidiary to the government with the objective of meeting the financial requirements of the state. They operated under the strict guidelines of the RBI, which were all encompassing. Although most of their deposit came from the private sector, i.e., households, a major part of their lending was confined to the government, and they also made substantial investment in government bills/securities as shown in the table 6. The share of investment in government securities in aggregate deposits of the commercial banks slowly increased from 23.6 percent in 1970 to 25.97 percent in 1990, thereafter it rapidly increased to 30.48 percent in 1995, to 35.32 percent in 2000 and to 40.75 percent in 2001. On the other hand, a reasonable return (excepting the amount deposited as CRR and the assets held as SLR) with full security is also beneficial for the bank. The developmental policies of the state-requiring mobilisation of a large sum of money made the state a major customer of the PSBs. RBI acted as the mediator between the state and PSBs more or less determining the amount/share of the deposit to be allocated to the state and the private sectors. For the private sector lending it fixed ceiling and floor rates of interest depending on the type of loan, size of loan, type of borrower, nature of collateral.

Steps by Government of India to counter NPA problem

The Government of India is also striving to come out of the clutches of stressed asset of banking sector in order to show its corruption free and transparent growth agenda.

a. The government, last year announced Rs 2.11 lakh crore bank recapitalization plan to pull out state-run banks from various challenges. Six new Debts Recovery Tribunal have been established to expedite recovery.

b. Union Finance Minister Piyush Goyal on July 2, 2018 approved the suggestions of Sunil Mehta Committee for a 5- prolonged strategy to tackle the Non- Performing Assets (NPA). The report of the committee is titled as „Project Sashakt‟3 to tackle stress in the banking sector.

c. To avoid recurrence and for stringent recovery, the Insolvency and Bankruptcy Code, 2016 (IBC) has been enacted. Insolvency and Bankruptcy Code (IBC), a platform for timebound recovery of bad loans. It will create a Unified Framework for resolving insolvency and bankruptcy matters. The Banking Regulation Act, 1949 was amended, to provide for authorization to RBI to issue directions to banks to initiate the insolvency resolution process under IBC.

d. To reduce incidence of default on account of and to effect recovery from willful defaulters, as per RBI‟s instructions, willful defaulters are not sanctioned any additional facilities by banks or financial institutions, their unit is debarred from floating new ventures for five years, and lenders may initiate criminal proceedings against them, wherever necessary. The wilful defaulters are debared from taking initiatives as promoters/directors from accessing capital markets to raise funds.

e. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) has been amended for faster recovery with a provision for three months imprisonment in case the borrower does not provide asset details and for the lender to get possession of mortgaged property within 30 days.

Some suggested Measures for mitigation

The problem of NPAs in the Indian banking sector has become a major cause of worry for the policymakers. There is a much-needed step that will help revive stranded assets and resume credit flow to industry.

Implementation of Basel III norms: RBI‟s internal governance as well as its regulation of NPAs needs improvement. Extending the time frame for full implementation of Basel III norms from the current deadline of March 2019. The Basel III norms are international standards that lay strict requirements on banks‟ equity and capital ratios.

Strengthening RBI governance and regulation

a. RBI lacks supervisory capacity to conduct forensic audits and this must be strengthened with human as well as technological resources. The public sector banks, need to come up with proper guidance and framework for appointments to senior level positions.

b. The credit sanctioning process of banks needs to be strengthened. All banks will need to maintain strict vigilance during pre- and post-sanction of credit. They must fortify their internal processes to effectively monitor funds.

c. The capital market was expected to emerge as a substitute of these institutions. Capital market can also be tapped to source funds. Project-specific bonds can be floated in capital markets. The banks should also consider "raising capital" to address the problem of NPAs.

d. The money being pumped into start-ups should be in the form of a share in the stake, rather than a loan. Bank convert debt to equity and instead of acting as lenders, become www.aensi.in /Index in Cosmos ISSN 0025-1348 (P), 2456-1356 (O) UGC APPROVED Received: 4 December Revised: 9 December Accepted: 19 December

126 The research journal of social sciences January 2019 volume 10 number 1 the shareholders of these companies, appoint boards, govern these companies and bring them back to profit.

e. The government should back the recommendations of the P. J. Nayak Committee (Governance in Bank Boards, 2014). Presently, substantive governance reforms have not been implemented. For example, all the governance functions including selection of bank chairpersons continue to be controlled by the Ministry of Finance.

f. Banks should examine the balance sheet which shows the true picture of business. When banks give loan, they should examine the purpose of the loan. To make sure safety and liquidity, banks should grant loan for productive purposes. Bank should examine the profitability, viability, long term acceptability of the project while financing.

g. Banks continued to be the primary source of long-term big-ticket investment projects in India, from roads and ports to power and steel. Any form of public investment and involvement of public-sector banks in financing big development projects should be reduced.

h. New avenues of finance such as sovereign wealth funds, private equity funds and entrepreneur‟s risk capital should be developed. A sovereign wealth fund could be created which is professionally managed. This could help "trickle down" good governance practices to PSBs.

i. A proper and effective Management Information System (MIS) needs to be implemented to monitor warnings. The MIS should ideally detect issues and set off timely alerts to management so that necessary actions can be taken. The use of Artificial Intelligence for the supervision of financial transactions could prevent financial fraud.

j. The terms of bank chairpersons must be elongated in order to effect meaningful changes and to hold them accountable. The Punjab National Bank fraud demonstrates the extent of operational and risk management failures in PSBs. Improvements to HR practices can help mitigate behaviour like frauds.

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

l. Indian law treats an individual and his company as two different entities. So if company has borrowed loan and defaults, at best bank can seize properties of the company, but cannot seize property of individual. There are many companies which have defaulted but their promoters/owners have properties worth billions of dollars. In such cases, govt. can pass laws and see if it is feasible to make the owners pay for the default. Willful defaulters will have to be dealt with a heavy hand, but political interference is a huge issue.

Conclusion

In today‟s era of globalization, the role of banking sector is not limited to providing financial resources to the needy sectors but the banks act as agents of financial intermediation and also plays a major role in the fulfillment of social agendas of the Government. However, a steady rise in the NPA‟s of banks affects not only the banking sector but the country‟s economy as a whole. Some experts have suggested creating a single „bad loan‟ bank, under which all bad loans will be consolidated, so that they can be resolved with simpler and faster decision-making while keeping in mind sectoral complexities and multiplicity of lenders. However, creating a bad bank remains a politically volatile idea and is difficult to implement. Privatization of PSBs is not the solution. In the recent past we have seen many private banks such as Global Trust Bank and other private banks run in the co-operative sector going bust and thereafter either being wound up or merged with some other bank.

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