Non-Performing Assets - A Major Problem Faced by The Indian Economy

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ABSTRACT

Non Performing Assets- an alarming issue which is the root cause of the recent global financial crisis and has been drawing the attention of the policy makers and the academicians alike. It is a major problem faced by most of the banks and needs to be handled cautiously so as to preserve the financial health of the banks and the entire financial system; otherwise it will prove fatal on its survival and sustenance. Managing NPA should be a pro active function rather than a reactive response.

A Non Performing Asset is a credit facility in respect of which the interest and/ or instalment of principal has remained outstanding for a period of more than 90 days. The debt is classified as an NPA when it ceases to generate income for the lender over and above the specified period. NPA is the key term for the banking sectors as it shows the competence of the performance of the banks.

The main objective of this exploratory paper is to study the root cause of the Non Performing Assets, its emerging trends, the relevance of the decisions of the policy makers and the pre and post banking scenario while NPA became a threat to the Indian economy. The data for the present study are based on the secondary sources including banking reports, books, websites and journals.

Keywords : NPA, bank, policy makers, finance

When a borrower does not repays the borrowed amount, then after 90 days it is declared as Non-Performing Assets or bad loans because it ceases to generate income for the lender. The assets of the banks are the loans and advances which it lends to its customers and when either the interest or the principal amount or both are not repaid, the loan turns into a bad loan.

According to RBI, when the amount of interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of term loans, it is called as a Non Performing Asset. However, in case any account remains out of order for a period of more than 90 days in respect of overdraft/ cash credit; any bill remain overdue for a period of more than 90 days in case of bill discounted, it is also the scene of Non-Performing Assets. In Agricultural sector, the borrowed amount turns into a Non-Performing Assets when in case of short duration crops; any interest and/ or instalment of principal remain overdue for two crop seasons and in case of long duration crops any interest and/ or instalment of principal remain overdue for one crop season.

When bank lends to its customer any amount then on the basis of performance of the

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repayment of that particular amount, banks classify the assets in various categories :

i. When the borrower keeps on paying each instalment of the borrowed amount regularly, then the asset is to said to be a Standard asset.

ii. Before an asset to be declared as an NPA, banks identify early warning signals of the borrowed amount to be turned into a Non Performing Asset/ a stressed asset in the future period. For this purpose that particular loan amount is categorized as Special Mention Accounts (SMA). When the default in instalment to be paid is initial, then for a period of the first 0-30 days that borrowed amount is sub categorized as SMA -0. On the 31st day if still the default continues then it is shifted to SMA-1 for a period of 31-60 days. On the 61st day, if still no amount of repayment is seen then that particular loans/ advances are shifted to SMA -2 and are kept there for the next 30 days.

iii. After completing a cycle of 90 days, now the loan is to be categorized as a sub standard asset for a period of 12 months.

iv. Now for the next 12 months after becoming a sub standard asset; that borrowed amount is classified in the category of doubtful asset. After being categorized as a doubtful asset, the loan is now only a step behind of being declared as a bad loan.

v. After the completion of the 12 months period of being in a category of doubtful asset, the particular loan account is declared as a bad loan / a Non Performing Asset by the bank's internal or external auditor or the RBI do so after an inspection.

'Provisioning' is a term which is used in the banking sector ever since the banks came into existence. It means to keep aside certain amount to deal with any sort of contingency in the future. So, banks keep a certain percentage of each and every loans and advances as provisions in order to write off the amount of bad loans in the future. The ratio of the lend amount which is set aside to cover the losses in the future is known as the Provisioning Coverage Ratio (PCR). As per the norms, banks have to maintain a general provision of 0.40% for all loans and advances except which is given towards agriculture and Small and Medium Enterprises (SME) sector.

RBI's report noted that public sector banks have seen the sharpest improvement in the Provisioning coverage Ratio (PCR). On an aggregate level, public sector lenders saw their PCR rise to 60.6% in March 2019 from 48.3% a year ago. The PCR for private sector was lower at 57%.

The banks which maintain a larger percentage of their operating profit as PCR's is more likely to cover the losses in a better way than the one with a lower provision. A greater amount set aside as provisions are also an indication of improved profitability. A provisioning Coverage Ratio of the bank is calculated by dividing Net Equity (equity minus net NPA) by total assets less intangible assets). i.e., PCR = (Equity – Net NPA) / (Total Assets – Intangible Assets). On the other side it can also be seen that the banks who keep aside a larger portion of their operating profits as provisions are left with lesser amounts to be further used in lending loans and advances. Since, these loans and advances are the assets of the banks and less lending will in turn lead to increase in interest rates on the borrowed amount which will further result into a hampered economic growth. The growth of the economy slows down as the loans and advances will become costly and will not be easily accessible to the common citizens which will hamper the development process on a greater scale. It can even be thought that due to slow developments taking place unemployment will also rise and again low employment will lead to low incomes, low savings and low investments.

Since last few years if any issue is plaguing the entire economy, then it is the issue of Non Performing Assets in the banking sector. Almost all Indian banks are dealing with such issue. These Non Performing assets are classified as Gross and Net NPA's.

Gross NPA: It is the summation of all loan assets that are classified as NPA as per the RBI guidelines. As per the RBI regulation, as soon as an asset is declared NPA, interest receivable cannot be debited to the NPA account. The banks will record the interest receivable from the NPA account in a separate account and covers the same after the account is regularized by the borrower.

Net NPA: The Reserve Bank of India defines Net NPA as Gross NPA minus the following amounts:

i. Balance in interest suspense account
ii. DICGC / ECGC claims received and held pending adjustment
iii. Part payment received and kept in suspense account
iv. Total provisions held

As of March 31, 2018, provisional estimates suggest that the total volume of gross NPAs in the economy stands at Rs 10.35 lakh crore. About 85% of these NPAs are from loans and advances of public sector banks. For instance, NPAs in the State Bank of India are worth Rs 2.23 lakh crore.

In the last few years, gross NPAs of banks (as a percentage of total loans) have increased from 2.3% of total loans in 2008 to 9.3% in 2017 (Figure 1).

A decline in the profitability in the banking sector can be seen in the last few years making the condition more vulnerable to risk (Figure 2).

Figure 1: Gross NPAs (% of total loans)

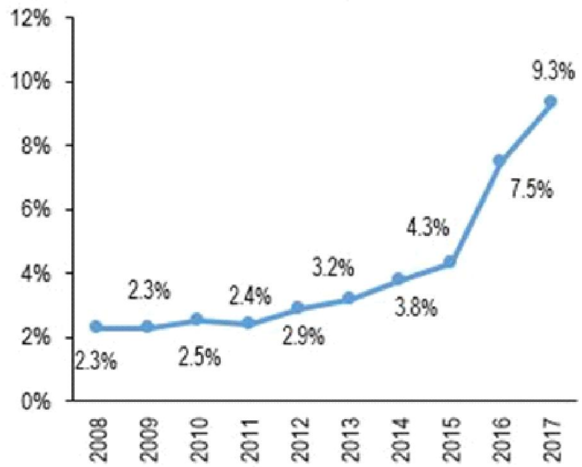
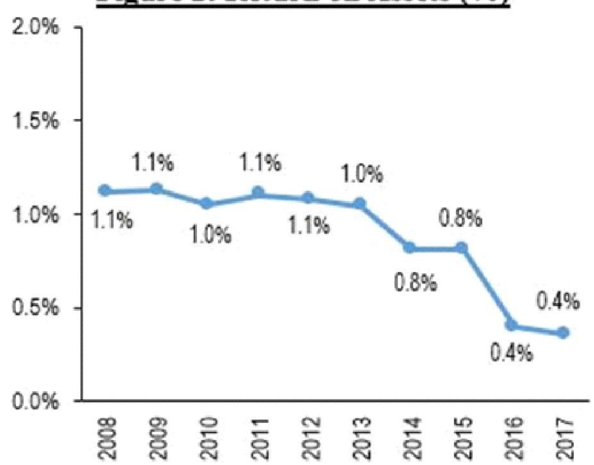


Figure 2: Return on Assets (%)



There are many reasons behind the rise in Non Performing Assets. Some are extrinsic factors while others are intrinsic. Extrinsic factors include the rise in global commodity prices which led to slower exports. For the intrinsic factors basically the responsibility falls on the Indian banking sector itself.

The existence of NPA as an alarming issue was marked in the beginning of 2000s when the economy was booming and the business outlooks also seemed to be prosperous. At that time loans were made easily available on lower interest rates to the business men with a view to aid the businesses in their growth and development on a larger scale.

Twin Balance Sheet problem basically means a problem with two balance sheets; one with the Indian Companies and the other with the financial institutions like banks. Thus, it can be seen that twin balance sheet problem is a two-fold problem which are :

(i) Companies- Companies are over leveraged. They are heavily burdened with debts, unable even to pay the interests amount.

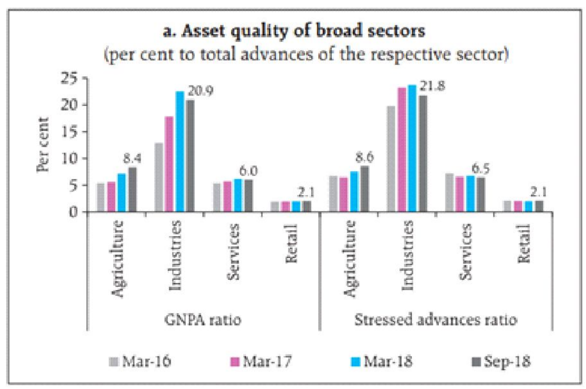
(ii) Banks- The loans / advances which are the assets of the bank cease to earn further turning into a Non Performing Asset. The banks will run shortage of funds leading to distress in the economy as the companies will fail to return the money back.

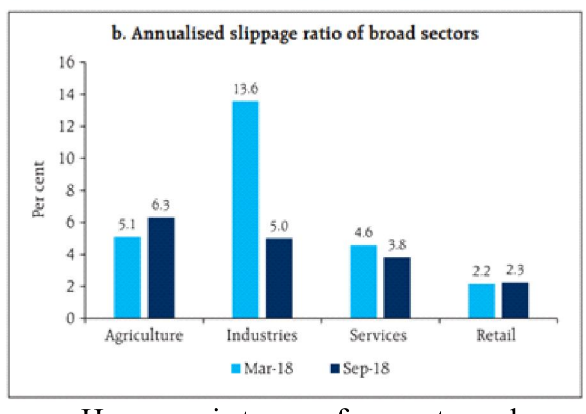
The various scams in the banking sector worked as pouring oil on the flames in this case. One of the most recent scam took place in PNB, the second largest bank in the public sector. It was a scam by Nirav Modi who was a jeweler. This scam led to hold an opinion that liberal policies till some extent was responsible behind it as several scams have been found in PNB in past 6-7 years turning the profitability concerns of the bank in a great trouble. The root cause behind this Nirav Modi scam was the delinking of the Society for Worldwide Interbank Financial Telecommunication with the Core Banking Solution.

SWIFT provides a network that enables financial institutions worldwide to send and receive information about financial transactions in a secure, standardized and reliable manner whereas CBS is also a networking which enables customers to avail banking services from any branch of the bank on CBS network. Usually CBS is linked to SWIFT but it was not so in case of Nirav Modi scam. So there was no entry regarding loans sanctioned to him. This ultimately resulted in a massive scam.

In order to have a keen eye on the rise in NPA during the year, slippage ratio is calculated which indicates the increase in NPA during the year. Slippage Ratio is basically defined as the ratio of increase in NPA during the year in respect to the total standard assets at the beginning of the year. The formula to calculate it is:

(Fresh accretion of NPAs during the year/ Total standard assets at the beginning of the year)*100





However, in terms of percentage change in the asset quality of large borrowers, the proportion of stressed amount has come down from 30.4%in March 2018 to 25.4%in September 2018.[1]

Banks utilize Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 and Insolvency and Bankruptcy Code (IBC) as an effective tool for bad loans (NPA) recovery. If a borrower defaults banks have the following powers :

i. Take possession, sell or lease the property
ii. Take over the management of the business

Loans which are not eligible under the SARFAESI Act are:

i. Loans outstanding up to Rs. 1,00,000
ii. Agricultural land cannot be sold
iii. The amounts which are outstanding less than 20% of principle and interest (80% or more already recovered).

Earlier, cases regarding bad loans were taken to civil courts. Thereafter, to ease the process special courts were established. It includes Debt Recovery Tribunal (DRT) and Debt recovery Appellate Tribunal (DRAT).

Some policies adopted by the Reserve Bank of India in this regard include the Prompt Corrective Action (PCA). To ensure that banks don't close down, RBI has put in place some trigger points to access, monitor, and control and take corrective actions on banks which are weak and troubled. The process or mechanism under which such actions are taken is known as Prompt Corrective Actions (PCA). The parameters to measure such risks and place the banks in their respective categories include :

i. Capital to Risk Weighted Assets Ratio (CRAR)
ii. Return on Assets (ROA)
iii. Non Performing Assets (NPA)

On the basis of these parameters, banks are placed in different categories and the restrictions are then imposed on them according to their respective risk limits. The categories and their restrictions include :

i. Risk Threshold 1- It includes restrictions on dividend distribution or remittance of profits
ii. Risk Threshold 2- It includes restriction on branch expansion, domestic or overseas in addition to all the restrictions of Risk Threshold 1.
iii. Risk Threshold 3- It includes restriction on management compensation and directors fees in addition to all those restrictions imposed in Risk Threshold 1 and 2.

Thus, the RBI's Prompt Corrective Action (PCA) has significantly helped the banks in lowering risk to a great extent.

The government's 4R strategy has helped to reduce NPA to a great extent. It includes Recognition, Resolution, Recapitalization and Reforms. Gross Non Performing Assets (GNPAs) of Public Sector Banks jumped over two-fold to Rs 8.95 lakh crore in FY18 from Rs 2.79 lakh crore in FY15, according to RBI data, mainly on account of the recognition of stressed assets as a bad loan by the central bank. As per RBI provisional data on global operations, gross NPAs of Scheduled Commercial Banks (SCBs) stood at Rs 9.49 lakh crore during FY19. Bad loans of public sector banks have declined by Rs 89,189 crore to Rs 8.06 lakh crore during the financial year 2018-19, according to government data. Provisional data showed that Gross Non Performing Assets (GNPAs) or bad loans of the public sector banks (PSBs) declined by Rs 89,189 crore to Rs 8.06 lakh crore as on March 31, 2019.[2] Thus it can be seen that NPA problems of the bank shows a weakness of the corporate sector balance sheets and despite several measures taken by the centre and Reserve Bank of India, Non Performing Assets in the Indian Banking System still remains an unfinished agenda.

Conclusion

Thus the growth of the economy to a much greater extent depends upon the efficiency and profitability of the banking sector and NPA directly impacts it by measuring its financial condition. It can be seen that NPA problems of the bank shows a weakness of the corporate sector balance sheets and despite several measures taken by the centre and Reserve Bank of India, Non Performing Assets in the Indian Banking System still remains an unfinished agenda.

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