



A review paper on non-performing assets in scheduled commercial banks

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Abstract

The problem of NPAs is almost in every bank no matter public or private, national or foreign, rural or urban. This problem relates with the credit issuance and the risk associated with the payback and recovery process. The causes of a loan turning into NPA can be many such as frauds, business cycles, corruptions etc. Out of them one of the important cause is the lack of effort and due diligence done during the pre-sanction process. Conducting the due-diligence process in the inattentive manner leads to rising in the levels of NPA in banking sector. This paper reviews the relevant articles and papers published addressing the problems of non-performing loans in the Indian banking sector during the period 2001- 2019. Empirically we identify the causes of the occurrence of non-performing loans to help us demonstrate the above.

Keywords: non-performing assets, Indian banking sector, credit risk management

1. Introduction

The banking system in India which comprises commercial, cooperative banks and RRBs are the fundamental components of financial system. It is also the most effective way to generate the credit flow of money in markets. The Non-Performing Assets (NPAs) concept is restricted to loans, advances and investments. The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 and hence credit management. Asset quality was not prime concern in Indian banking sector till 1991, but was mainly focused on performance objectives such as opening wide networks/branches, development of rural areas, priority sector lending, higher employment generation, etc. The banks, in their books, have different kind of assets, such as cash in hand, balances with other banks, investment, loans and advances, fixed assets and other assets. The incidence of non-performing assets in Indian public sector banks, noted in the early 1990s, raised a severe hue and cry in various quarters. In fact the problem started much earlier, which became evident from continued recapitalization of many PSBs since 1985-86. Chatterjee by the root cause, malfunctioning of the PSBs increased by the end of the 1980s. This led to the setting up of the Narasimham Committee (1991) which in fact identified NPA as one of the possible cause of the malfunctioning of the PSBs. In order to quantify the NPA problem, Narasimham committee (1991) made it mandatory on the part of the banks to publish annually the magnitude of NPA. Accordingly, as from the march, 31st 2004, NPA is an asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. A 'Non-Performing Asset' (NPA) was defined as a credit facility in respect of which the interest and/ or instalment of principal has remained 'past due' for a specified period of time. The specified period was reduced in a phased manner as under:

Year ending March 31	Specified period
1993	Four quarters
1994	Three quarters
1995 Onwards	Two quarters

An amount due under any credit facility is treated as "past due" when it has not been paid within 30 days from the due date. Due to the improvements in the payment and settlement systems, recovery climate, up gradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, with effect from March 31, 2001. Accordingly, as from that date, a Non-performing Asset shall be an advance where:

1. Interest and/or installment of principal remain overdue for a period of more than 180 days in respect of a Term Loan.
2. The account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC).
3. The bill remains overdue for a period of more than 180 days in the case of bills purchased and discounted.
4. Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two and a half years in the case of an advance granted for agricultural purposes.
5. Any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days' overdue' norm for identification of NPAs, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a Non-performing Asset shall be a loan or an advance where;

1. Interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.
2. The account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC),
3. The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
4. Interest and/or instalment 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.

- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Table: Overview of NPA classification in India

Standard Asset	It does not create any problem while paying interest/ installments of the principal. It usually carries more than normal risk attached to the business.
Sub- standard asset	NPA for a period less than or equal to 18 months
Doubtful Asset	NPA for a period exceeding 18 months
Loss Asset	An asset where loss has been identified by the bank or internal or external auditors or by the RBI inspection.

RBI in year 2014 provided the framework to the banks to identify the incipient stress in the account by creating three sub-categories under the Special Mention Account (SMA).

Table: Sub- categories under Special Mention Account (SMA) classification

SMA Subcategories	Basis for classification
SMA-0	Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress
SMA-1	Principal or interest payment overdue between 31-60 days
SMA-2	Principal or interest payment overdue between 61-90 days

The Reserve Bank of India states that, compared to other Asian countries and the US, the gross non-performing asset figures in India seem more alarming than the net NPA figure. The problem of high gross NPAs is simply one of inheritance. Historically, Indian public sector banks have been poor on credit recovery, mainly because of very little legal provision governing foreclosure and bankruptcy, lengthy legal battles, sticky loans made to government public sector undertakings, loan waivers and priority sector lending. Net NPAs are comparatively better on a global basis because of the stringent provisioning norms prescribed for banks in 1991 by Narasimham Committee. In India, even on security taken against loans, provision has to be created. Further, Indian banks have to make a 100 percent provision on the amount not covered by the realizable value of securities in case of "doubtful" advance, while in some countries it is 75 per cent or just 50 per cent.

The IMF Report on "Detailed assessment of observance of the Basel core principles for effective banking supervision, India" the high level of nonperforming assets (NPAs) in the system, the authorities should consider a more proactive approach to ensure that banks, via adequate provisioning, have proper incentives to tackle NPAs and to free up balance sheets for more productive lending.

Many steps have been taken to expedite and enable resolution of NPAs of banks, some of the important ones are as follows:

The Insolvency and Bankruptcy Code, 2016 (IBC) has been enacted, which has provided for the taking over management of the affairs of the corporate debtor at the outset of the corporate insolvency resolution process. Coupled with debarment of will-full defaulters and persons associated with NPA accounts from the resolution process, this has effected a fundamental change in the creditor-debtor

relationship. Further, the Banking Regulation Act, 1949 has been amended to provide for authorization to RBI to issue directions to banks to initiate the insolvency resolution process under IBC. As per RBI's directions under the aforesaid amended provision in the Banking Regulation Act, 1949, banks have been filed cases under IBC before the National Company Law Tribunal in respect of RBI-specified borrowers. CRISIL India Outlook in the report Uphill Trek (2019) mentioned that the resolution of large NPA accounts, especially under the IBC, will particularly help, assuming that bulk of the cases pending in the NCLT will be resolved, with higher recovery rates and faster resolution time.

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act has been amended to make it more effective, with 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. Also, six new Debts Recovery Tribunals have been established to expedite recovery.

Under the PSB Reforms Agenda, PSBs have created Stressed Asset Management Verticals to focus attention on recovery, segregated monitoring from sanctioning roles in high-value loans, and entrusted monitoring of loan accounts of above Rs. 250 crore to specialized monitoring agencies for clean and effective monitoring, and created online end-to-end One-Time Settlement platforms for timely and better realization.

As per the RBI's Financial Stability Report, June 2019 the credit growth of SCBs have improved after the recapitalization of PSBs and the provisioning of NPAs across all the banks hence increasing the resilience of the banking sector. The report also states that the NPA cycle has been controlled by recognizing the bulk of the legacy NPA in the banking books.

Objectives

- To study the status of NPAs of Indian Scheduled Commercial Banks in India.
- To trace the studies available in context with NPAs over the last 20 years.
- To identify the existing gaps in the current studies related to NPA.

Review of literature

Many published articles are available in the area of Non-Performing Assets and a large number of researchers have studied the issue of NPA in banking industry. A review of the relevant literature has been described. Balasubramaniam C.S. (2001) highlighted that the NPAs level is high in all banks and they can bring down NPAs level by adapting to good credit appraisal procedures, effective internal control systems along with the improved asset quality in their balance sheets. Ghosh (2005) [7] examined the association between corporate leverage and bank's non-performing loans and suggested that the leverage ratio can serve as a useful signpost of asset quality to improve the quality of lending by the banks. Das (2006) [4] examined the association between the risk and productivity in state banks and found that higher productivity leads to decrease in credit risk and supports the fact that efficiency, capital and risk taking tend to be jointly determined, reinforcing and compensating each other. Michael (2006) [18] in his paper studied about the NPAs in cooperative banks and explained

that when a loan turns into NPA a crisis in liquidity occurs as the funds deployed by the bank gets blocked which reduces the profitability and liquidity and hence marginalize the operational efficiency in the bank. They also emphasize on the effective credit monitoring of the loans post disbursement can be helpful in controlling the magnitude of NPA especially in the form of wilful defaults. Vallabh et. al (2007) [25] in his research paper explores that NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. Karunakar (2008) [14] in his study highlighted the problem of losses and lower profitability associated with NPAs and liability mismatch in banks and explained that how the financial sector depends on the risk management strategies being adopted by the businesses in India. Chaudhary K. and Sharma M. (2011) [3] emphasized on the development of an efficient management information system such that even a bank staff is fully aware and trained for the loan sanctioning and due diligence process so that they can take preventive measures from turning an advance into an NPA in the future. Collins NJ, et al, (2011) [19] revealed in their paper that increase in the interest rate spread affects performing assets in banks as it increases the cost of loans charged on the borrowers, such that the regulations on interest rates have far-reaching effects on assets non-performance, for such regulations determine the interest rate spread in banks and also help mitigate moral hazards incidental to NPAs. They also explained that credit risk management technique remotely affects the value of a bank's interest rates spread as interest rates are benchmarked against the associated non-performing assets and non-performing assets is attributable to high cost of loans. Prasad G.V.B. and Veena (2011) [20] stated that the NPAs do not generate any kind of income for banks but at the same time banks are required to provide provisions for NPAs from their current profits, thus NPAs have a destructive impact on the return on assets (ROA). Kaur K. and Singh B. (2011) [15] studied that NPAs are considered as an important parameter to check the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. Chatterjee (2012) [2] concluded in his paper that banks should find out the original reasons or purposes of the loan required by the borrower. Proper identification of the guarantor should be checked by the bank including scrutiny of their wealth. Rai (2012) [22] in her study found out that corporate borrowers even after defaulting continuously never had the fear of bank taking action to recover their dues. This is because there was no legal framework to safeguard the real interest of banks. Gupta (2012) [8] in her study concluded that each bank should have its own independent credit rating agency which should evaluate the financial capacity of the borrower before credit facility and credit rating agencies should regularly evaluate the financial condition of the clients. Singh (2013) [23] in his paper stated that the origin of the problem of burgeoning NPAs lies in the system of credit risk management by the banks. Banks are required to have adequate preventive measures in fixing pre-sanctioning appraisal responsibility and an effective post-disbursement supervision. Banks should continuously monitor loans to identify accounts that have potential to become non-performing. Kumar (2013) [16] said that NPAs have become a nuisance and headache for the Indian banking sector for

the past several years. One of the major issues challenging the performance of commercial banks in the late 90s adversely affecting was the accumulation of huge NPAs. Siraj (2013) [24] assessed the variables such as Gross NPA, Net NPA, Additions to NPA, Reductions to NPA and Provisions towards NPA and generated inferences based on their growth rate. He concluded that the efficiency of public banks is higher than the other banks and that the stability of Indian Banking Sector and its resilience to financial crisis is mainly because of the improved performance of public sector banks in India.

Dhar & Bakshi (2015) [5] specified certain bank-specific factors such as net interest margin, CAR possessing negative and significant impact on GNPA ratios of Indian PSBs. They also highlighted that the CAR and sensitive sector advances contribute to the variations in NPA levels. They also stated that the loan provisioning is an issue for the stability of the banking system. Vallabh et al. (2016) [26] developed a model to predict NPA which played a pivotal role in forecasting future NPAs in the Indian Banking Sector. They used linear stepwise regression model to forecast the NPAs in India Banks while sampling on SBI & its associates to test the results and predicted the NPA levels of INR 147,921 crores in year 2020. Kadioglu et al. (2017) [13] investigated in the banks of Turkey that whether NPA affects the profitability and found out that there is a significant negative relationship between non-performing loans and bank profitability which is measured by return on equity and return on asset. The higher non-performing loans, the lower asset quality, leads to the lower return on equity and return on asset and vice-versa. Kuzucu (2019) [17] analyze the effects of banking sector-specific factors and macroeconomic factors on NPLs of emerging and advanced countries. They concluded real GDP growth as the main determinant that affects the NPL ratio, and NPLs exhibit high persistence in emerging and advanced economies both for the pre- and post-crisis periods.

Research and time gap in literature

The different aspects of literature related to Non-Performing Assets of researchers over the years have been collected and used for this study, but there is a huge gap existing for the comprehensive research on quality aspects of Non-Performing Assets. Lack of study in the structure of supervision in the context of the growing diversity, complexities and interconnectedness in the priority sector lending in India. The occurrence of Non-Performing Assets in the bank's book of accounts widens the asset liability gap in the bank which minimizes the spread between the bank revenues from earning assets and the cost of issuing liabilities. Reducing entire NPAs is difficult for the banks due to its soaring stage thus there is a need to study the NPA.

Conclusion

NPAs are caused due to external factors, internal factors or both. External factors such as ineffective recovery, wilful defaults, industrial sickness, lack of demand, priority sector lending, and change in government policies reduce the profitability and liquidity of the banks, weaken the recovery process. Internal factors such as defective lending process, inappropriate technology, poor credit appraisal system, managerial deficiency, absence of post-disbursement management, lack of regular industrial visits must be

regularized in order to prevent the shocks. The preventive measures that can be undertaken are updating systems with the advanced technologies, fair process of credit appraisal. The banker should follow the principle of diversification of risk based on the famous maxim “do not keep all the eggs in one basket”, it means that the banker should not grant advances to a few big farms only or to concentrate them in few industries or in a few cities. If a new big customer meets misfortune or certain traders or industries affected adversely, the overall position of the bank will not be affected.

NPA do impact the performance and profitability of the banks. But what else they badly impact is the sentiments of investors and goodwill of the bank as a whole. NPAs badly impact the credibility of the bank and block the investor’s money in the further process of provisioning and other regulatory requirements. Not just that but if the level of NPAs is not controlled timely it will reduce the earning capacity of assets, cost of capital will go up, widen assets and liability mismatch, adverse effect on capital adequacy ratio due to the higher provisioning requirements. The economic value additions (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital.

NPAs causes to decrease the value of share sometimes even below their book value in the capital market. They badly affect the risk facing ability of banks. So, the banks have to be very cautious before extending loans. In order to control the NPA banks may incline towards less risky investments and diverse their funds. RBI is committed to maintain and enhance the momentum of resolution of stressed assets and adherence to credit discipline. In their latest circular revised its stressed asset framework to ensure speedy resolution of bad loans in the future.

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