International Journal of Research in Finance and Marketing(IJRFM)
Available online at :http://euroasiapub.org/current.php?title=IJRFM
Vol. 6 Issue 12, December - 2016, pp. 150~157
ISSN(o): 2231-5985 | Impact Factor: 5.861 |Thomson Reuters Researcher ID: L-5236-2015

NPA IN BANKING SECTOR: AS AN INDICATOR OF FINANCIAL INEFFICIENCY

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Abstract

Banking sector plays very important role in any economy. A healthy and a sound banking system are very essential for growth and development of the economy. Nonperforming assets (NPAs) are one of the best indicators for the health of the banking industry. It reflects the performance of banks. NPA has a direct impact on the profitability, liquidity and solvency position of the bank. Higher NPA indicates inefficiency of the bank and lower NPA indicate better performance and management of funds. To improve the efficiency and profitability of banks the NPA need to be reduced and controlled. Indian banks are struggling with challenges related with NPA's and it has become a major concern for the Indian economy and there is need to adopt various measures to controlled NPAs. This paper is about current situation of NPAs in banking sector.

Key words: Banking Sector, Public Sector, Private Sector, Non Performing Assets (NPAs)

Introduction

For a sound economy, one should have a sound banking system. One of the important parameters for judging the performance of the banking system is the NPAs. These are an inevitable burden on the banking industry. Banks need to monitor their standard asset regularly in order to prevent any account becoming an NPA. Today the success of the bank depends upon the proper management of NPAs and keeping them within the controlled level. NPA causes serious strain on the profitability as, on the one hand banks cannot book income on such accounts and in a second way, charge for funding cost is required and provision required for the profits. In order to keep debtors friendly we keep the provision of NPAs. In the Indian context, the lending policy and credit policy have crucial influence on non performing loans (Reddy, 2002 and Karunakar et al., 2008).NPA is generally termed as dormant assets means these assets does not bring any substantial income to its owners. The assets of the banks which don't perform (that is – don't bring any return) are called Non Performing Assets (NPA) or bad loans. Bank's assets are the loans and advances given to customers. If customers don't pay either interest or part of principal or both, the loan turns into bad loan. According to RBI, terms loans on which interest or installment of principal remain overdue for a period of more than 90 days from the end of a particular quarter is called a Non-performing Asset. However, in terms of Agriculture / Farm Loans; the NPA is defined as under: For short duration crop agriculture loans such as paddy, Jowar, Bajra etc. if the loan (installment / interest) is not paid for 2 crop seasons , it would be termed as a NPA. For Long Duration Crops, the above would be 1 Crop season from the due date
The RBI has issued guidelines to banks for classification of assets into four categories.

- Standard Asset: Standard asset are those which are not NPA. These are regular and performing and there are no adverse features. They do not disclose any credit problem.
- Doubtful Asset: They are NPA which remain as such for a period exceeding two years.
- Sub - standard Asset: They are those which are NPAs for a period not exceeding two years.
- Loss Asset: Are those NPAs where 100% loss has been identified and it is not yet written off in the books of accounts .(http://www.gktoday.in/non-performing-assets-npa/)

Factors contributing to NPA

According to the recent study conducted by RBI, the factors contributing to NPA are divided into 2 segments (i) Internal factors (ii)External factors (iii) Other factors

Internal factors	External factors	Other factors
• Diversion of fund for expansion, diversification, modernization or for taking up new projects. • Diversion of fund for assisting or promoting associate concerns. • Time or cost overrun during the project implementation stage. • Business failure due to product failure, failure in marketing etc. • In efficiency in bank management. • Slackness in credit management and monitoring. • In appropriate technology or problems related to modern technology.	• Recession in the economy as a whole. • Input or power shortage. • Price escalation of inputs. • Exchange rate fluctuations • Change in government policies	• Liberalization of the economy and the consequent pressures from liberalization like several competitions, reduction of tariffs etc. • Poor monitoring of credits and failure to recognize early warning signals shown by standard assets. • Sudden crashing of capital market and inability to raise adequate funds. • Mismatching of funds i.e. using loan granted for short term for long term trans actions. • Granting of loans to certain sectors of the economy on the basis of government directives rather than commercial imperatives.

NPA - Impact on Balance Sheet

The problem of NPAs in the Indian banking system is one of the foremost and the most formidable problems that had impact the entire banking system. Higher NPA ratio trembles the confidence of investors, depositors, lenders etc. It also causes poor recycling of funds, which in turn will have deleterious effect on the deployment of credit. The non-recovery of loans effects not only further availability of credit but also financial soundness of the banks.

1. **Profitability:** NPAs put detrimental impact on the profitability as banks stop to earn income on one hand and attract higher provisioning compared to standard assets on the other hand. On an average, banks are providing around 25% to 30% additional provision on incremental NPAs which has direct bearing on the profitability of the banks.
2. **Asset (Credit) contraction:** The increased NPAs put pressure on recycling of funds and reduces the ability of banks for lending more and thus results in lesser interest income. It contracts the money stock which may lead to economic slowdown.

3. **Liability Management:** In the light of high NPAs, Banks tend to lower the interest rates on deposits on one hand and likely to levy higher interest rates on advances to sustain NIM. This may become hurdle in smooth financial intermediation process and hampers banks' business as well as economic growth.
4. **Capital Adequacy**: As per Basel norms, banks are required to maintain adequate capital on risk-weighted assets on an ongoing basis. Every increase in NPA level adds to risk weighted assets which warrant the banks to shore up their capital base further. Capital has a price tag ranging from 12% to 18% since it is a scarce resource.
5. **Shareholders' confidence:** Normally, shareholders are interested to enhance value of their investments through higher dividends and market capitalization which is possible only when the bank posts significant profits through improved business. The increased NPA level is likely to have adverse impact on the bank business as well as profitability thereby the shareholders do not receive a market return on their capital and sometimes it may erode their value of investments. As per extant guidelines, banks whose Net NPA level is 5% & above are required to take prior permission from RBI to declare dividend and also stipulate cap on dividend payout.
6. **Public confidence:** Credibility of banking system is also affected greatly due to higher level NPAs because it shakes the confidence of general public in the soundness of the banking system. The increased NPAs may pose liquidity issues which is likely to lead run on bank by depositors. Thus, the increased incidence of NPAs not only affects the performance of the banks but also affect the economy as a whole.
7.

Present Scenario of NPA in banking sector

Gross bad loans at commercial banks could increase to 8.5 per cent of total advances by March 2017, from 7.6 per cent in March 2016, according to a baseline scenario projection by the Reserve Bank of India (RBI) in its Financial Stability Report, "The macro stress test suggests that under the baseline scenario, the gross NPA may rise to 8.5 per cent by March 2017," the RBI noted in the report. "If the macro situation deteriorates in the future, the gross NPA ratio may increase further to 9.3 per cent by March 2017." The central bank has been pushing lenders to review the classification of loans given by them as part of an Asset Quality Review (AQR). The resultant sharp surge in provisions for bad debts has eroded profitability, especially at state-owned banks, in recent quarters. The gross bad loans of public sector banks increased to 9.6 per cent as of March 2016, from about 6 per cent a year earlier, RBI data showed.

There was an almost 80 per cent jump in gross bad loans in 2015-16, according to the report. Gross bad loans of Indian banks widened to 7.6 per cent from 5.1 per cent in September and from 4.6 per cent in March 2015. In 2004, gross bad loans in the Indian banking sector touched 7.8 per cent, while the ratio was 11.1 per cent in 2002.

According to RBI report banking sector gross NPA is at 7.6%, highest in 12 years; expected to rise further to 8.5% by March 2017 Gross bad loans at commercial banks could increase to 8.5 per cent of total advances by March 2017, from 7.6 per cent in March 2016, according to a baseline scenario projection by the Reserve Bank of India (RBI) in its Financial Stability Report released on , "The macro stress test suggests that under the baseline scenario, the gross NPA may rise to 8.5 per cent by March 2017," the RBI noted in the report. "If the macro situation deteriorates in the future, the gross NPA ratio may increase further to 9.3 per cent by March 2017."

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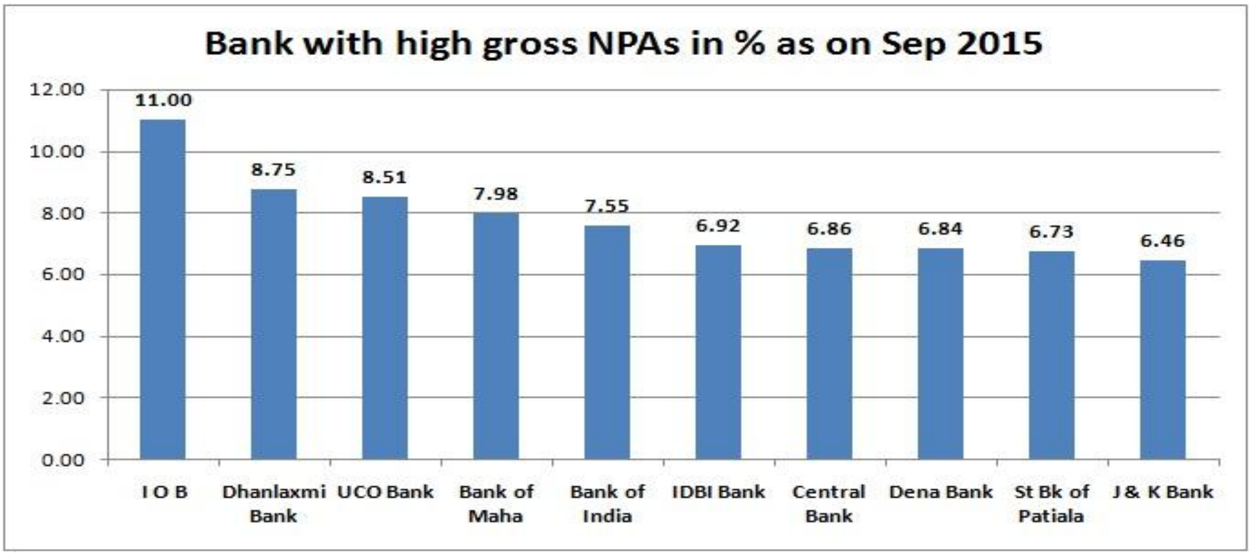

Measures to Solve Problems of NPA

The problems of NPA have been receiving greater attention since 1991 in India. The Narasimham Committee recommended a number of steps to reduce NPA. In the 1990's the Government of

India (GOI) introduced a number of reforms to deals with the problems of NPA.
Major steps taken to solve the problems of Non-Performing Assets in India :-

1. **Debt Recovery Tribunals (DRTs):** Narasimham Committee Report I (1991) recommended the setting up of Special Tribunals to reduce the time required for settling cases. Accepting the recommendations, Debt Recovery Tribunals (DRTs) were established. There are 22 DRTs and 5 Debt Recovery Appellate Tribunals. This is insufficient to solve the problem all over the country (India).
2. **Securitisation Act 2002:** Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 is popularly known as Securitisation Act. This act enables the banks to issue notices to defaulters who have to pay the debts within 60 days. Once the notice is issued the borrower cannot sell or dispose the assets without the consent of the lender. The Securitisation Act further empowers the banks to take over the possession of the assets and management of the company. The lenders can recover the dues by selling the assets or changing the management of the firm. The Act also enables the establishment of Asset Reconstruction Companies for acquiring NPA. According to the provisions of the Act, Asset Reconstruction Company of India Ltd. with eight shareholders and an initial capital of Rs. 10 crores has been set up. The eight shareholders are HDFC, HDFC Bank, IDBI, IDBI Bank, SBI, ICICI, Federal Bank and South Indian Bank.
3. **Lok Adalats:** Lok Adalats have been found suitable for the recovery of small loans. According to RBI guidelines issued in 2001. They cover NPA up to Rs. 5 lakhs, both suit filed and non-suit filed are covered. Lok Adalats avoid the legal process. The Public Sector Banks had recovered Rs. 40 Crores by September 2001.
4. **Compromise Settlement:** Compromise Settlement Scheme provides a simple mechanism for recovery of NPA. Compromise Settlement Scheme is applied to advances below Rs. 10 Crores. It covers suit filed cases and cases pending with courts and DRTs (Debt Recovery Tribunals). Cases of Willful default and fraud were excluded.
5. **5. Credit Information Bureau:** A good information system is required to prevent loans from turning into a NPA. If a borrower is a defaulter to one bank, this information should be available to all banks so that they may avoid lending to him. A Credit Information Bureau can help by maintaining a data bank which can be assessed by all lending institutions

The Union Finance Minister, Shri Arun Jaitley said that the Government has taken various measures to deal with the issue of Non Performing Assets (NPAs) in Banking Sector especially in case of Public Sector Banks (PSBs). The Finance Minister said that there are two categories of defaulters, viz. those who are unable to pay back due to economic slowdown both in domestic and global market and other reasons outside their control as well as wilful defaulters including loans sanctioned without due diligence by the banks. The Finance Minister said that the

Government has taken various measures to deal with both these categories of defaulters
He said that in order to deal with default due to economic slowdown, the Government has taken various measures to revive the stressed sectors which mainly include steel, textiles, power and roads among others. The Government has also done recapitalization of banks by providing Rs. 25,000 crore in the last year Union Budget 2015-16 as well as in this year's budget 2016-17. He said that transparency and professionalism has been brought in appointment process for top management positions in the PSBs including Chairmen and Managing Directors. The Government has taken various measures to make the management professional, has given full autonomy to the banks in taking commercial decisions without any interference from the Government..

Conclusion

Prevention is better than cure. Proper evaluation of credit proposals definitely helps the banks in detecting the unviable projects at the first instance. Full information about unit, industry, its financial stake, management etc., should be collected. Lending being a focused segment, there is an urgent need to develop specialized skills in the area of appraisal, monitoring and recovery to ensure the quality of credit portfolio. Managing credit risk plays an important role and its effectiveness lies in an efficient recovery and exit strategy. Banks should be equipped with latest credit risk management techniques to protect the bank funds and minimize insolvency risks. Banks should explore the possibilities to develop credit derivatives markets to avoid these risks. Timely follow up is the key to keep the quality of assets intact and enables the banks to recover the interest/installments in time. To have better control on the assets created out of borrowings, banks need to watch the functioning of the units by paying frequent visits and this is to be done to all the units irrespective whether the account is performing or non-performing one.

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