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NPA: A Formidable Challenge for the Indian Economy

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Abstract: ***Banks are those financial institutions that constitute the heart of an economy irrespective of its current status i.e., whether developed or developing. They play an important role in the mobilization and allocation of resources for the growth of the economy. The performance of these banks is best indicated by their level of Non-Performing Asset. Indian financial structure is currently facing a crisis in credit quality as the NPAs are rising day by day. The NPAs would destroy the current profit, interest, and efficiency of the banks hence choking the credit lending capacity in turn entrepreneurship in the country. Malfeasance, lacking collaterals, political influence, competitive developed economies, and dearth of post disbursement monitoring system are few culpable factors that have triggered the catastrophe of the banks. This paper first analyzes the levels, movements, and trends in the NPAs and anatomizes the cause for increasing NPAs. The denouement part further suggests a few unique ways to tackle the problem further emphasizing why the banks need to look into the crisis for ensuring the smooth functioning of the economy.***

Keywords: Non-Performing Assets, Credit Monitoring, Corporate Debt Restructuring

1. Introduction

The Indian Banking Industry can be broadly classified into two major categories, scheduled banks, and non-scheduled banks. Scheduled banks include all the commercial banks like nationalized, development, foreign, cooperative, and regional rural banks. Non-scheduled banks are the banks that do not comply with the rules specified by the Reserve Bank of India and are not listed in the second schedule. Banks regulated by the Banking Regulation Act, 1949, are the financial institutions that accept public deposits and grant credit for the growth of the economy. Credit dispensation activity also includes recycling of funds received back from the borrowers. This lending of credit carries a risk called credit risk, which arises when the borrower fails to pay back and this non-recovery of loans forms a major hurdle in the credit cycle process. A major threat to the banking industry is Non-Performing Assets which measures the performance of the banks. High level of NPAs indicates that there is a high probability of a large number of credit defaults that erodes the value and net worth of the banks. Non-performing Assets (NPA) have emerged over a decade as an alarming threat to the banking industry in our country, sending distressing signals on the sustainability of the affected banks. Despite various correctional steps administered to solve and end this problem, concrete results are eluding. The severity of the problem is acutely suffered by Nationalized Banks, followed by the SBI group, and the All-India Financial Institutions.

2. Research Methodology

The current study uses an explorative approach to understand, discuss and bring out the issue relevant to the title. The study is primarily analytical and descriptive based on secondary data collected from RBI Publications, journals, reports, and websites of public and private sector banks in India. Articles from The Economic Times, The Times of India, and information from e-journals turned out to be extremely informative for the purpose of the study. The time period covered for the study is from 2009 to 2020. To analyse the growth in NPAs among public sector banks and private sector banks, different statistical tools like figures, bar graphs have been used.

3. Literature Review

(Rai, 2012), NPAs are one of the main reasons for the financial problems of the bank. There are various reasons for increasing NPA levels such as target-oriented approach which adversely affects the qualitative aspect of lending by the bank, lack of technical and managerial expertise on part of borrowers, ineffective supervision of loans, etc. NPA still remains a major threat for the economy and the increasing NPA levels pose a great question mark on the efficiency of credit risk management of banks in India.

(Singh A. , 2013), Highlights the serious problem of NPAs faced by the banking sector from which the author inferred how profitability and liquidity of banks are affected by credit defaults which is due to a high level of NPAs. It also analyzes the NPAs in the public and private sectors and elaborates and brings out the steps taken by the government for this problem.

(Agarwala & Agarwala, 2019), On the assessment of the private sector banks, it is revealed that the growth rate of NPAs is low as compared to the nationalized banks, as well as the SBI and its associates. The growth in poor loans has been high in the nationalized banks and the associate banks of SBI because they have failed to handle the issue of poor loans effectively.

(Singh & Kaur, 2011), NPAs are one of the drivers of the financial stability and growth of the banking sector. They are considered to be an important parameter to assess the performance and financial health of banks. Financial companies and institutions are nowadays facing a major problem of managing non-performing assets as these assets are proving to become a major setback for the growth of the economy.

3.1 Concept of NPA

NPA is defined as, if any interest and principal of an account (loan or advance) remains overdue for more than 90 days then it is termed as NPA. Banks are required to classify Non-Performing Assets within three categories-

a) Sub Standard NPA- If any NPA remains overdue up to 12 months from the date of its classification as NPA then it is termed as Sub Standard NPA.
b) Doubtful NPA- If any NPA remains overdue for more than 12 months from the date of its classification as NPA. It is termed as doubtful NPA. There is no time limit under this heading. We can keep an overdue balance under this heading until these are classified as loss assets.
c) Loss Assets- If any overdue balance seems irrecoverable i.e., bad debts then it is termed as a loss asset.

NPAs are one of the major concerns for RBI and the banks in India as NPAs reflect the financial soundness of the banking sector and a high level of NPAs suggests a 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.

A high and growing level of NPAs implies that there is uncertainty on the ability of banks to return the borrowed funds, which negatively impacts the profitability and net worth of the banks. The NPA growth requires banks to create larger provisions, which reduces the overall profits and shareholders' value.

3.2 Types of NPA

There are two types of NPA-

- GNPA
- NNPA

These are discussed in detail as follows:-

GNPA- GNPA or Gross NPA is defined as the total amount of gross non-performing asset for a bank for a year or quarter. It shows the quality of loans made by the banks. GNPA can be determined from the following formula: -

Gross NPAs Ratio= Gross NPAs / Gross Advances

NNPA-NNPA or Net NPA is the amount in which the provision made by the banks is subtracted from the gross NPA. The actual burden on banks can be determined by the amount of NNPA. There is a significant difference between GNPA and NNPA because the amount of provision to be made as per the central bank is quite significant. NNPA can be determined from the following formula: -

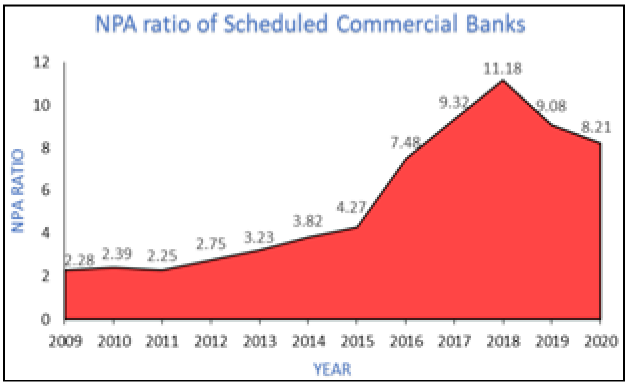
Net NPAs Ratio = Gross NPAs-Provisions / Gross Advances-Provision

3.3 History of NPA

Gross NPAs of scheduled commercial banks increased from Rs 3,23,464 crore as of March 31, 2015 to Rs 10,36,187 crore as of March 31, 2018. This means that there was a 220% increase in NPAs in just 3 years.About 85% of these NPAs are from loans and advances of public sector banks.A lot of loans currently classified as NPAs originated when the economy was booming and business confidence was bullish in the mid-2000s. Huge amounts of loans were granted to the corporations on the basis of their past growth and performance by the banks. But due to the global financial crisis of 2008, economic growth stagnated due to which the business confidence went bearish and the repayment capacity of these borrowers reduced ultimately leading to the creation and rise in NPAs.This affects the profitability and balance sheet of the banks and also limits the amount of credit available for the corporate sector leading to a decline in private investment. This is known as the Twin Balance Sheet Problem of India because the challenges faced by the banks are linked to the corporate sector.

Also, another reason for the rising NPAs is the frauds of huge amounts which happened recently. Although these are comparatively smaller than the total volume of NPAs, these frauds are increasing at an alarming rate and there is no activity of penalizing such high-profile fraudsters such as Mehul Choksi, Nirav Modi and Vijay Mallya.

However, banks' NPAs declined to Rs 8.08 crore in September 2020. Although this might look like a sign of relief for the banks as well as the economy as a whole, there is a huge challenge coming up for banks in 2021 and the years ahead.



4. Why Indian Banks will face a major NPA Challenge in 2021?

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5. Impacts of NPA on Banks and Economy

1) **Profitability**- NPA denotes the money which gets trapped in terms of bad assets which occurs because the bank took a wrong decision and lent money to a defaulter which means loss of profit of the bank by the amount of NPA. This ultimately results in loss as the same amount could have been used by the bank for lending to some other party i.e., the opportunity cost of such amount arises. So NPA indirectly also affects the future stream of profit leading to a loss of some long-term beneficial opportunity. The ROI also declines due to a decrease in profitability which adversely affects the current earning of the bank.
2) **Public's Confidence**-If a bank is facing the problem of high NPAs, then it adversely affects the value of the bank in terms of the market for credit. The goodwill, brand image of the bank gets hampered due to NPA leading to a negative impact on people who are putting their money in the banks.
3) **Shareholders Confidence**- The shareholders of bank expect a good return on their investments in the form of higher dividends, market capitalization which is only possible when the banks have higher profits through improved business and due to NPA the profitability decreases leading to shareholders not getting their expected returns and sometimes even leading to a loss in the value of their investment. As per extant guidelines, banks whose Net NPA level is 5% & above are required to take prior permission from RBI to declare a dividend and also stipulate a cap on dividend payout which ultimately means a lower return to shareholders, resulting in losing their confidence in the bank.
4) **Additional Cost**- As an aftereffect of NPA, banks have to face liquidity issues and in order to keep them operational they have to borrow capital on which they are required to pay interest leading to an additional burden on the bank. The time and efforts of management are some indirect costs that banks have to bear which could have been invested in other fruitful activities which were profitable for the bank.
5) **Asset (Credit) contraction**-The increased NPAs are also one of the reasons for an economic slowdown as it adversely impacts the recycling of funds and reduces the ability of banks for lending more and thus results in lesser interest income which contracts the money stock leading to an economic slowdown.
6) **Hampering the Economic Growth**- The infrastructure sector is one of the most important sectors in the economy as it fuels the growth of other sectors. Also, a massive amount of NPAs is due to the infrastructure sector making banks hesitant to provide funding in this sector leading to draining of resources in infrastructure which may hamper the growth of the economy.
7) **Reduction in interest rates**-Due to the high amount of NPAs bank tend to reduce the rate of interest in saving rates to increase margin which makes very difficult for banks to survive as many other investment instruments like PPF, Mutual funds which offer higher rates of interest so people tend to shift investing from the banking sector to the non-banking sector which erodes the capital with the banks.

6. How can we prevent and tackle the NPAS?

1) The enactment of the Insolvency and Bankruptcy Code(IBC) in 2016 has been an important step towards recovering the NPAs as the resolution process has become quick and efficient and the lenders can now more easily recover the NPAs from the defaulters.
2) Banks should be equipped with the latest credit risk management techniques to protect the bank funds and minimize insolvency risks the banks should also do proper credit risk management which involves credit appraisal, monitoring, and various kinds of analysis like sensitivity analysis as proper evaluation of the loan application may help in detecting the unviable projects at the first instance.
3) A separate monitoring department should be established in large branches for periodical review of accounts, comparative risk analysis, and compliance of terms and conditions of sanction.
4) Banks should be given more power to recover the NPAs from the defaulters rather than playing the game of "wait and watch". Also, alternative dispute resolution mechanisms like Lok Adalats and Debt Recovery Tribunals should be used for faster settlement of dues.
5) The senior-level executives who take the major decisions should be held accountable, not the lower-level executives, for issuing loans, which later turn out to be a NPA, without conducting a proper analysis.
6) Corporate Debt Restructuring is also another way to tackle NPAs. Corporate debt restructuring refers to the realignment of a business entity that is under fiscal distress due to its outstanding commitments and obligations and to infuse liquidity into business operations to keep it afloat. This will help the banks maintain their asset qualities.

7. Conclusion

Non-performing assets are a huge burden on the Indian Banking Sector as it is directly impacting the profitability of the banks. An economy cannot grow without the support of a healthy banking sector. Public Sector Banks hold nearly 85% of the NPAs and are suffering from falling revenues and a lack of modern technologies. This situation can be improved by rewriting the traditional banking model by way of innovation and the adoption of modern technologies. Thus, it is imperative for the RBI, government, and all the banks to ensure that a proper mechanism is built to tackle the NPAs otherwise these NPAs will keep increasing further continuing to adversely impact the other sectors as well. When the gross NPAs were down to 8.08 crores in September 2020 from 10.36 crores in March 2018, it showed that the banking sector has the potential to reduce its high NPA levels, what it needs is the continued support of the central bank, strong credit monitoring and credit risk management techniques as well as stringent measures for the recovery of NPAs.

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