Effects of NPA on Indian Economy

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Abstract: ***This article provides an in-depth analysis of the significant impact of Non-Performing Assets NPAs on the Indian economy, emphasizing the banking sectors crucial role in economic stability. Highlighting the vibrancy of the banking sector and its susceptibility to economic fluctuations, the text outlines the adverse effects of NPAs, including fund scarcity in security markets, increased interest rates, and diminished investor confidence. It differentiates between bank fraud and NPAs, illustrating the government and the Reserve Bank of Indias efforts to address the issue. Further discussion includes the importance of capital adequacy norms, factors leading to high NPAs, and measures to manage and reduce their incidence. The article also explores the reasons behind the rise of NPAs, particularly in the public sector, and underscores the need for effective management strategies to mitigate their impact on the banking systems health and economic development.***

Keywords: Non-Performing Assets, Indian banking sector, economic stability, capital adequacy norms, bank fraud

Any economy's health can be determined by the state of the banking sector. Any small change in the economy will have an impact on the banking sector since it is so vibrant. For the economy to remain stable, the banking sector must be in good shape. The stability of the economy is evident. History demonstrates that times of economic decline and crises have often been marked by bank failure.

The higher rates of NPA can lead to the following impacts on our economy:

- There will be a scarcity of funds in the Indian security markets as due to this increasing NPA very few banks will be willing to give a loan if they are not sure of the recovery of the due amount.
- The shareholders will find it difficult to continue its process as they will lose money where the banks will find it tough to survive.
- There will be a hike of interest rate due to the lack of confidence in the banking sectors which will, in turn, affect the investors who are willing to take loans for their projects.
- The retail customers will also have a tough time paying a higher rate of interest for the loan.
- The NPA will lead to a higher cost of capital, higher inflation, therefore, lower growth which will directly affect the Indian economy due to low take off funds.
- The estimated extent of NPA is equal to the size of the UP budget and if these amounts are recovered it will be very beneficial for the growth of Indian economy.

1) What is the difference between Bank Fraud and NPA

Non - Performing Assets is has been a bane for banks for a long time. There have been renewed efforts on part of the Government of Indian and Reserve Bank of India to tackle the problem of Non - Performing Assets.

There is a difference between bank fraud and NPA -

- Bank fraud is a criminal offense, Non - Performing Assets is a loan or advance wherein interest or instalments of principal remain overdue for a period of 90 days.
- As per the Reserve Bank of India (RBI), an asset becomes non - performing when it stops to generate income for the bank. The Non - Performing Assets in Public Banks are valued at approximately $ 62 Billion, which represents 90% of total NPA in India.

2) Capital Adequacy Norms

Capital Adequacy is considered a tool and standard measure for gauging financial strength of the banks. It is measured in terms of percentage of capital employed by a bank in relation to the adjusted value of its assets, loans and advances both funded and non - funded and investments as appearing in balance sheet by applying certain standard risk weights for arriving at their real values. A higher capital adequacy ratio means that the bank is sound and has enough cushions to take care of its loan loss provisions and payment of liabilities, if demanded. Higher non - performing assets requiring provisioning and derecognition of interest income would result in lowering of capital adequacy. [1]

As regards, banking industry in India, whose average capital adequacy ratio was quite low till 1990, RBI considered it necessary to strengthen the same in a phased manner in line with the Basel Committee norms. Meanwhile Narasimham Committee, which was appointed by Government of India on "Financial System Reforms" submitted its report, Inter alia, recommending that banks and financial institutions operating in the country should achieve capital adequacy ratio of 4 percent in relation to risk weighted assets by March 1993 and reach a level of 8 percent by March 1996 and 9 percent by 2000 irrespective of the quality of the borrower. In the new system, a bank offering credit to better quality corporate entities is likely to require less regulatory capital. Narasimham Committee on banking sector reforms had suggested an increase of the capital to risk – adjusted asset ratio (CRAR) to 10 percent by 2002. As per regulatory measures of 2007 CRAR should not be less than 9 percent by July 2007.

The capital of a bank is of two types viz. Tier I capital and Tier II capital. Tier I capital is permanently and freely available to absorb losses without the bank being obliged to cease trading. It is important because it safeguards both the survival of the bank and the stability of the financial system. It comprises of paid up capital, statutory reserves and other disclosed free reserves, if any. The equity investments in subsidies, intangible assets, and losses in the current period, if any, are to be deducted to arrive at Tier I Capital.

[1] RBI "Report on Currency and Finance".

Tier II capital consists of items less permanent in nature and generally absorbs losses in the event of liquidation of a bank, and so provides a lower level of protection for depositors and creditors. It comes into play in absorbing losses after the bank has lost Tier I Capital. It would include disclosed reserves and fully paid cumulative preferential shares.

The capital adequacy norms in India are in line with the best practices as suggested by BIS. Once Basel II Accord is implemented, the method of estimation of risk capital will undergo a significant change. The RBI has already undertaken appropriate steps to prepare the Indian banking industry for such changes. [2]

3) Factors affecting NPAs

The NPAs management has a direct bearing on the factors responsible for it. The introduction of the SARFAESI Act, the recovery scenario will change drastically. That the introduction of the Act will not only help in the recovery of the past NPAs but also would act as a preventive measure in the minds of the borrower. Presently the borrower knows that in case of default, the banker has limited options as the judicial process is slow and even if a suit for recovery is filed, it could easily be prolonged for 10 - 15 years. The new Act has empowered the bankers to seize the security without the intervention of the court or even take over the management of the company.

The other factors responsible for high NPAs in order of ranking are:

a) Change in Government policies including unfocussed liberalization.
b) Delay in release of adequate and timely credit.
c) Willful default.
d) Divergence of funds.
e) Inadequate post - follow up.
f) Non - availability of timely audited financials from the borrowers.
g) Lack of proper appraisal etc.

There are two extreme views with respect to the "inadequate post - follow up" with some bankers ranking this factor as one of the most important ones while some others ranking it last. Those who consider this factor important, feel that a strong follow up puts mental pressure on the borrower to return the government debt on priority vis–a–vis private departments. This follow up, if backed by strong legal measures to recover the money, would persuade the borrower to try his best to return the bank's money.

Once the bank has taken proper care at the pre – sanctioning stage and there are no external factors causing failure of production and/or fall in the expected income generation, the role of the management of the unit becomes very crucial. The respondents have indicated mismanagement and/or misutilisation of funds as an important factor contributing to the incidence of NPAs. Nevertheless, if the bank's monitoring and post follow up is strong then it can immediately sight the diversion and mismanagement of funds. Frequent changes in the Government policies and time overrun in the implementation of the project due to various factors can have a cumulative effect on the health of the account and can be a significant cause of NPAs. The fall in income generation, whether on account of external causes like natural calamities or Government policies or due to various factors together, constrains the ability of the borrower to repay the loan with the result NPAs rise.

Willful default, another important factor is mainly on account of laxity on part of the bank in terms of appraisal, supervision, and follow - up. The bank is either not in a position to identify a willfull defaulter or take punitive action on account of its own and/or the style of functioning of the legal system and/or non - cooperation of the government. Willful default can also arise on account of the typical mentality of the people in the area, which destroys the will and initiative to repay. Such mentality is further nursed by interference of self - centered politicians.

One of the reasons responsible for NPAs has also been the lack of proper appraisal. Though most banker's opine that proposals are appraised with respect to the activity, industry, geographical area, etc, and the details of the promoters, directors/guarantors are checked with the RBI circulated caution list, the growing NPAs do not support this opinion. The fact is that most banks do not have appraisal teams and usually resort to appraisals of other institutions/ banks, who themselves have done a cut - paste job, thereby leading to half - baked appraisals, devoid of any similarity to ground realities. Some banks have introduced a centralized cell for appraisal for proposals above a certain value, which are processed by experienced and qualified officers.

The bankers are also of the view that in some cases, irrespective of the value of the account, impractical and unrealistic sanction stipulations result in creation of NPAs. They are of the opinion that cash budgeting will be more appropriate and relevant to the present banking environment than the conventional balance sheet system. This is due to the fact that it is of the utmost importance to the bank to ascertain whether the borrowing companies have cash with them to service the loan rather than knowing the financial position as on a particular date which could be molded to suit their interest. The various factors given above have also been found to be of relevance by RBI in its internal study though they vary slightly in order of ranking. [3]

Wilful Defaulters

The RBI, in consultation with the Central Government constituted a Working Group on Willful Defaulters (WGWD) with Shri S. S. Kohli as its chairman. The Group submitted its report in November 2001. As per the new definition, a willful default would be deemed to have occurred if any of the following events is noted:

a) The unit has defaulted in meeting its payment/ repayment obligations to the lender even when it has the capacity to honour the said obligations;

[2] IBA BULLETIN, January 2004, Page33

[3] He, Dong (2008), "Resolving Non-performing Assets of the Indian banking system," MPRA (Munich personal RePEc Archive) paper No.9758, July, pp105-122.

Paper ID: SR24329214639 DOI: https://dx.doi.org/10.21275/SR24329214639

b) The unit has defaulted in meeting its payment/ repayment obligations to the lender and has not utilized the finance from the lender for the specific purposes for which finance was availed, diverting the funds instead to other purposes; and
c) The unit has defaulted in meeting its payment/ repayment obligations to the lender and has siphoned - off funds, i. e. funds are not available with the unit in the form of other assets.
d) Banks/ FIs are required to form a committee of higher functionaries headed by the executive director for classification of accounts as willful defaulters and create the redressal mechanism in the form of a committee headed by the Chairman and Managing director for giving a hearing to the borrowers who have grievances on their classification as "willful defaulters". It has been pointed out that redressal of grievances after the event is not fair in view of the damage to the reputation that cannot be easily reversed. Therefore, an opportunity is provided to the defaulter to be heard before being declared as such.

4) Factors Responsible for NPAs

The following factors confronting the borrowers are responsible for incidence of NPAs in the banks: -

a) Diversion of funds for expansion/modernization/setting up new projects/helping promoting sister concerns.
b) Time/cost overrun while implementing projects.
c) External factors like raw - material shortage, raw - material/Input price escalation, power shortage, industrial recession, excess capacity, natural calamities like floods, accident etc.
d) Business failure like product failing to capture market, inefficient management, strike/strained labour relations, wrong technology, technical problem, product obsolescence, etc.
e) Failure, non - payment/over dues in other countries, recession in other countries, externalization problems, adverse exchange rate, etc.
f) Government policies like excise, import duty changes, deregulation, pollution control orders, etc.
g) Wilful default, siphoning of funds, fraud, misappropriation, Promoters / management disputes etc. [4]

Besides above, factors such as deficiencies on the part of the banks viz. deficiencies in credit appraisal, monitoring and follow - up; delay in release of limits; delay in settlement of payments/subsidies by Government bodies, etc. are also attributed for the incidence of NPAs.

5) Reasons Behind the Rise of NPA in India

In the period from 2004 to 2009, there was a huge growth in the economy, which led to firms taking bank loans very aggressively.

a) Most of the investment was in infrastructure sectors like roads, power, aviation, steel
b) Laxity in lending norms by the banks, without analysing the financial health of the companies and their credit ratings
c) The banning of mining projects, delay in environment permit, led to a rise in prices of raw materials and a big gap in demand and supply thereby affecting the power, steel, and iron industries. This affected the capacity of the companies to repay the loans to banks which resulted in Non - Performing Assets (NPA).

6) Reasons for Growing NPAs in the Current Perspective

The rising NPAs in recent period can attributed to the affects of the global recession coupled with internal factors like the slowdown in the domestic economy which had adversely affected the performance of corporate as well as small and medium enterprises leading to a negative impact on credit quality. The asset quality of PSBs aggravated in comparison to private sector banks as big ticket corporate loans form a larger share of the credit portfolio for PSBs. Data available with the Finance Ministry showed that thirty companies together owed Rs.16, 877 crore as on September 30, 2013 to Public Sector Banks.

Another reason for sudden rise in gross NPAs of PSBs was reported to be on account of a shift to a system based recognition of NPAs from a manual one. Prior to 8 this the computation for most banks was worked out manually at branch level and was therefore subject to discretion of managers.

The RBI in its Financial Stability Report, December 2013 has indentified five sectors - Infrastructure, Iron and Steel, Textiles, Aviation, and Mining - as the stressed sectors. PSBs have high exposures to the 'industry' sector in general and to such 'stressed' sectors in particular.

Increase in NPAs of banks is mainly accounted for by switchover to system - based identification of NPAs by PSBs, slowdown of economic growth, and aggressive lending by banks in the past, especially during good times. As PSBs dominate the Indian Banking Sector and increase in the NPAs of PSBs is matter of concerns, steps are being taken to improve the situation.

7) The Scenario of NPA in India

When compared to their private - sector counterparts, India's public sector banks are the most hit by Non - Performing Assets (NPA). State Bank of India has the most Non - Performing Assets (NPAs) among the main public sector banks, with about INR 1.86 lakh crore, followed by Punjab National Bank, Bank of India, Bank of Baroda, Canara Bank, and Union Bank of India. ICICI Bank has the most Non - Performing Assets (NPAs) among India's private sector banks, followed by Axis Bank, HDFC Bank, and Jammu & Kashmir Bank.

Effective steps should be adopted by banks and other financial institutions to decrease the consequences of NPA in banking,

[4] Goyal, Kanika (2010), "Empirical study of Non-Performing Assets management of Indian public sector banks," APJRBM, Vol.1, issue.1, October, pp 114-131.

which stifle bank economic development due to inadequate fund recycling, which has a negative impact on credit deployment and bank soundness.

It is critical for both the borrower and the bank to understand the difference between performing and non - performing assets. If the asset is non - performing and interest payments are not paid, the borrower's credit and development opportunities may be harmed. It will therefore make it more difficult for them to get future loans.

Interest received on loans is a major source of income for the bank or lender. As a result, non - performing assets will have a detrimental impact on their capacity to generate sufficient revenue and, as a result, on their overall profitability.

It is critical for banks to maintain track of their non - performing assets (NPAs) since having too many NPAs can have a negative impact on their liquidity and ability to grow.

Non - performing assets (NPAs) can be managed depending on how many there are and how far past due they are. Most banks can take on a reasonable level of nonperforming assets in the short run. However, if the number of nonperforming assets (NPAs) continues to rise over time, the lender's financial health and future prosperity are jeopardized.