Non-Performing Assets: The Worst Nightmare for Banks in India

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Abstract

The Indian banking sector has witnessed a rapid transformation. Over the years, due to keen competition from the private and foreign banks and contributing to the call of the nation on Financial Inclusion, the Public Sector Banks in India have grown by leaps and bounds. In the race of aggressive lending, banks have focused towards inflating their balance sheets without adequate safeguard towards asset quality. Today Non Performing Assets (NPA) are one of the major concerns for banks in India particularly Public Sector Banks. The sharp rise in the levels of NPA needs to be dealt with urgently, before the situation worsens further. Banks have been largely using the strategy of restructuring and evergreening to postpone the NPA problem all these years. How did the bad loans pile up to this extent? Was this a result of regulatory oversight? Is it a consequence of political intervention or dominance? Or is it a consequence of Window Dressing?

The relentless rise of Stressed Assets in Indian banks, particularly in the Public Sector Banks, is a cause of worry. It is gradually putting pressure on banks' capital and pulling down the profitability of banks. Truly it is a tough challenge and a difficult task for the banks to recover the rising Non Performing Assets. Reserve Bank of India has set up a deadline for the banks, March 2017, to clean up the balance sheets. The major clean up exercise, 'Swachh Bank's Mission', has been initiated by our former governor, Dr. Raghuram Rajan. Although Non Performing Assets cannot be completely avoidable as it could occur with the growth of advances, but increased efficiency in managing NPAs could definitely reduce the level of bad loans.

This paper makes an attempt to throw light on the factors responsible for Non Performing Assets in Public Sector Banks, the impact of Non Performing Assets in India, the magnitude of NPAs in the Public Sector Banks and various initiatives taken by the government and Reserve Bank of India to resolve the NPA problem.

Keywords: *Non Performing Assets, Asset Quality, Stressed Assets, Public Sector Banks, Restructuring.*

Paper Type: *Theoretical*

Introduction

The Banking Sector plays an important role in the development of an economy. The Indian banking industry has gradually evolved from a traditional, conservative organization to a liberalized, modern and technology driven system. Thanks to the then Narasimha Rao government (1991-96) who initiated and advised the policy of liberalization, thus opening up new opportunities for a number of private banks. Reserve Bank of India constituted various Committees to resort to appropriate timely measures and take the banking sector ahead in line with the International standards.

Post 1991, banks in India have witnessed certain remarkable reforms, a few of these include Deregulation of interest rates, Technological advancement, Introduction of Prudential IRAC Norms, Basel III, New Banking Licences and so on. Today, the Indian Banking system comprises of 26 Public sector banks, 25 Private sector banks, 43 Foreign banks, 56 Regional rural banks, 1589 Urban co-operative banks and 93550 Rural co-operative banks, apart from co-operative credit institutions. *(Trends & Progress of Banking in India, 2015)*

Banks made substantial progress in lowering the NPAs from their Balance Sheets during 2002-07 in absolute terms. It has been observed that the gross NPAs in percentage terms of PSBs placed at 17.8 percent at end March 1997 declined gradually to 2.0 percent at end March 2009. (RBI,http://dbie.rbi.org.in) Thereafter there was a drastic increase in the NPA levels. The weakening asset quality was more noticeable in Public Sector Banks. Public sector banks recorded the highest level of stressed advances ratio at 14.5% as on March 2016 and the Net NPA level increased from 3.6% to 6.1% from September 2015 to March 2016. *(Financial Stability Report June 2016, p.23)*

Lending always is accompanied with Credit Risk. In recent times, banks have become quite cautious and careful in extending loans due to rising level of Non-Performing Assets.

Framework of Study

Objectives of the Study

- The present paper seeks to study the status of Non-Performing Assets in Public Sector Banks.
- It also studies the causes and the impact of Non-Performing Assets (NPAs) faced by Public Sector Banks.
- To look at various channels of recovery introduced by Government of India and Reserve Bank of India.

Research Methodology

The research paper is concerned with the Non-Performing Assets of the Indian Public Sector Banks.

Secondary Data related to Non-Performing Assets (NPAs) of Public Sector Banks is used for the study.

The data has been collected from various sites, speeches, including Reserve Bank of India, CRISIL, ICRA's websites.

Scope of Study

To understand the position of Non-Performing Assets (NPAs). The scope is limited to Indian Public Sector Banks in India.

Time Period

Three years data from 2013-14 to 2015-16 is used for the study.

Overview

Classification of Assets :

In terms of Reserve Bank of India guidelines on Asset classification norms, loans are classified as Standard, Sub-standard, Doubtful and Loss Assets.

Standard Assets : Such assets are regular and performing assets.

Non Performing Assets : A non-performing asset is a credit facility which has remained past due in the form of interest and/or installment of principal for a period of 90 days or for a certain period of time as specified by RBI from time to time. It is an asset which ceases to generate periodical income for the bank. The Indian banking industry has been infected with high levels of NPAs, which can be attributed to various factors.

The Non-Performing Assets categorised as per the RBI guidelines are :

- *Sub-Standard Assets* - a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months.
- *Doubtful Assets* - an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months till 48 months.
- *Loss Assets* - Doubtful Assets after a lapse of 48 months or where loss has been identified by the bank or internal or external auditors are categorised as Loss Assets.

Asset classification is mainly for the purpose of computing the provisioning requirements that need to be made with respect to bank advances.

Non-Performing Assets are reflected in the books of banks as:

- **Gross Non-Performing Assets (GNPAs) -** The overall quantity of all loans that have stopped performing in terms of the definition of NPA.
- **Net Non-Performing Assets (NNPAs) -** Net NPAs are computed after deducting the provisions set against the Gross NPAs.

Causes of Non-Performing Assets

Factors responsible for NPAs can be classified into two categories - Internal and External factors.

Internal Factors

- Inefficient Borrower screening
- Poor Credit Appraisal System
- Long time lags between sanctions and disbursements
- Weak post disbursal monitoring
- Defective credit recovery mechanisms
- Cost overruns while implementation of projects, especially Infrastructure projects
- Poor legal mechanisms
- Ever-greening of loans by bank management
- Wrong utilisation of loans by borrowers
- Obsolete Technology
- Management disputes, frauds, misappropriation
- Discontent among the union

External Factors

- Slowdown in economic growth
- Sharp Rise in interest rates
- Exchange rate fluctuations
- Political Intervention
- Industrial recession
- Stringent government policies
- Non-availability or scarcity of raw materials

Analysis of the Generic Causes for NPAs in Public Sector Banks

Evergreening

One of the main reasons for huge NPA numbers in the banking sector, especially in the Public Sector Banks, is due to postponement of the problem in order to show higher earnings. The P. J. Nayak Committee report, 2014[1], suggests penalising the banks wherever significant 'Evergreening' is detected by Reserve Bank of India. This is the process where, just before an account slips into the category of an NPA, fresh assistance is provided in a roundabout manner and on an adhoc basis to clear the amounts that are in arrears, about to slip into the overdue category.

Political Interference

In the Report, 'The Committee to Review Governance of Boards of Banks in India', May 2014, Mr. P. J. Nayak who headed the RBI appointed Committee has rightly pointed out the need to resist politically forced bank lending by Public Sector Banks, as it usually fails to increase productivity. In the Economic Times Global Business Summit in Jan 2016, Prime Minister, in his speech has mentioned that there would be no political interference in nationalized banks.

Wilful Defaults

Wilful Defaults occur when the borrower defaults in meeting its payment obligations to the lender even when he has the capacity to honour the said obligations. As per the list released by All India Bank Employees Association (AIBEA)[2], the trade union representing the banking industry, in all 5610 accounts totalling Rs. 58,792 crores were those of wilful defaulters as on 31st March 2016. In nationalised banks, a total of 3,192 accounts were those of wilful defaulters, who owe a sum of Rs. 28,775 crore. In SBI and its Associate Banks, 1,546 accounts were classified wilful defaulters, with unpaid loans of Rs. 18,576 crore. Public Sector Banks accounted for 8.76 % of Gross NPAs in Wilful Defaults. Strict action should be taken against the defaulters as this can be considered as criminal offence adding up to the burden on NPAs.

Asset Quality Review (AQR) responsible for the sudden rise of NPAs in the Current Scenario

A special inspection was conducted in 2015-16 by RBI to check if the asset classification was in line with the loan repayment and if banks have made provisions adequately, which was called AQR. Every year an annual audit takes place where a small sample of loans are inspected. But this time the sample size was larger and many restructured loans were instructed to be classified as non performing assets.

ASSET QUALITY									
Bank Group	Gross NPAs To Gross Advances (Per Cent)			Restructured Standard Advances To Gross Advances (Per Cent)			Stressed Advances (GNPAs + Restructured Std Advances) To Gross Advances (Per Cent)		
	Mar-15	Mar-16	Jun-16	Mar-15	Mar-16	Jun-16	Mar-15	Mar-16	Jun-16
PSBs	5.4	9.8	11.3	7.8	4.6	4.1	13.2	14.4	15.4
PVT SBs	2.2	2.7	2.8	2.4	1.8	1.6	4.6	4.5	4.4
FBs	3.2	4.2	3.7	0.1	0.3	0.3	3.3	4.5	4.0
ALL SCBs	4.6	7.8	8.7	6.3	3.7	3.3	10.9	11.4	12.0

Source: RBI Bulletin, Sept 2016.

[1] Report of The Committee to Review Governance of Boards of Banks in India May 2014

[2] All India Bank Employees Association, aibea.in/upload/flashnews/Press%20Release%2019072016.pdf

Post-AQR exercise the Stressed Advances (Gross Non Performing Assets plus restructured Assets) of Public Sector Banks moved up to 15.4% as on June 2016 from 14.4% as on March 2016.

Implication of Non-Performing Assets

On the Economy

When the loans lent by the banks are not repaid, the banks facing fund crunch would slowdown from lending fresh funds to new projects thereby causing economic growth to slow down.

On the Banking Sector

Profitability - With the rise in NPAs, interest income is reduced thereby reducing the earning capacity of the bank. The Return on Assets (RoA) of the banks is adversely affected. Banks have to make adequate provisioning for its Non-Performing Assets and write offs of its bad assets which brings down the profits.

PROFITABILITY (Rs. in Crores)

Bank Group	Return On Total Assets (Annualised)		Earning Before Provisions & Taxes (EBPT) FY		Provisions For NPAs During The Year		Net Profit / Loss (PAT)	
	Mar-15	Mar-16	Mar-15	Mar-16	Mar-15	Mar-16	Mar-15	Mar-16
PSBs	0.43	(0.26)	127,419	124,810	57,842	1,44,608	30,869	(20,006)
PVT SBs	1.65	1.54	66,208	79,858	12,953	20,099	35,832	39,672
FBs	1.82	1.67	25,192	25,160	3,092	5,923	12,764	12,619
ALL SCBs	0.78	0.29	218,819	229,829	73,887	1,70,630	79,465	32,285

Source : OSMOS Returns, Domestic Operations, Figures in Jun-16 are provisional

Source: RBI Bulletin Sept 2016, Special Address by Shri S.S.Mundra, Deputy Governor, Reserve Bank of India at India Banking Reforms Conclave 2016 organised by Governance Now in Mumbai on August 24,2016.

During the period 2015-16, after the AQR exercise, the provisions for NPAs in Public Sector Banks rose from 57,842 crores as on March 2015 to 1,44,608 crores as on March 2016. This in turn impacted their Return on Assets (RoA) and Return on Equity (RoE). Public Sector Banks suffered a heavy loss during this period.

Asset Liability Management and Liquidity of banks also gets affected due to the rise in Non-Performing Assets.

Stakeholders

- Shareholders holding the concerned banks equities are negatively affected as the share price falls with the market sentiment. This shakes the confidence in the general public.
- Depositors get less returns and many times may lose uninsured deposits. Banks may begin charging higher interest rates on some products to recover the Non-performing loan losses.

New Stringent Provisioning Norms

For every loan given out, banks are required to keep aside some amount to cover up losses if something goes wrong with those loans. Provisioning increases with the age of Non-Performing Assets and it impacts profitability adversely. Reserve Bank of India, in the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated 1st July 2015, revised the provisioning norms.

With the increased compliance, RBI has stated that in cases where banks fail to report SMA[3] status of the accounts to CRILC[4] or resort to methods with the intent to hide the actual status of the accounts or evergreen the account, banks will be subjected to additional provisioning for these accounts and/or other supervisory actions as deemed appropriate by RBI.

The current provisioning requirement and the revised accelerated provisioning in respect of such non performing accounts are as under:

Asset Classification	Period of NPA	Current Provisioning (%)	Revised accelerated provisioning (%)
Sub-Standard (Secured)	Up to 6 months	15	No Change
	6 months to 1 year	15	25
Sub-Standard (Unsecured ab-initio)	Up to 6 months	25 (other than infrastructure loans)	25
		20 (infrastructure loans)	
	6 months to 1 year	25 (other than infrastructure loans)	40
		20 (infrastructure loans)	
Doubtful - I	2nd Year	25 (secured portion)	40 (secured portion)
		100 (unsecured portion)	100 (unsecured portion)
Doubtful - II	3rd & 4th Year	40 (secured portion)	100 for both secured & unsecured portions
		100 (unsecured portion)	
Doubtful - III	5th Year Onwards	100	100

Source : Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated 1st July 2015.

Loss assets should be written off and if such assets are permitted to remain in the books, for any reason, 100% provision should be made.

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[3] Special Mention Account (SMA) - Before a loan turns NPA, banks are required to identify stress in A/C by creating sub-categories.

SMA Sub-categories	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

Source : RBI Notification dated 26th Feb 2014 on 'Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)'

[4] CRILC Database - RBI has set up Central Repository of Information on Large Credits (CRILC) to collect, store and disseminate credit data to lenders. This data includes credit information on all the borrowers having aggregate fund-based and non-fund based exposure of Rs. 50 million and above.

Magnitude of NPAs

Gross and Net NPAs of Public Sector Banks

	Advances		Non-Performing Assets					*(Rs. in billion)*
			Gross NPA			Net NPA		
Year End-March	Gross	Net	Amount	As Percentage of Gross Advances	As Percentage of Total Assets	Amount	As Percentage of Net Advances	As Percentage of Total Assets
2014-15	56167.18	54762.50	2784.68	5.00	3.20	1602.08	2.90	1.80
2013-14	52159.20	51011.37	2272.64	4.40	2.90	1306.35	2.60	1.60
2012-13	45601.69	44728.45	1656.06	3.60	2.40	900.37	2.00	1.30
2011-12	35503.89	38773.08	1178.39	3.30	2.00	593.91	1.50	1.00
2010-11	30798.04	33056.32	746.00	2.40	1.40	360.00	1.20	0.70
2009-10	27334.58	27013.00	599.26	2.20	1.30	293.75	1.10	0.70
2008-09	22834.73	22592.12	449.57	2.00	1.20	211.55	0.90	0.60
2007-08	18190.74	17974.01	404.52	2.20	1.30	178.36	1.00	0.60
2006-07	14644.93	14401.46	389.68	2.70	1.60	151.45	1.10	0.60
2005-06	11347.24	11062.88	413.58	3.60	2.10	145.66	1.30	0.70
2004-05	8778.25	8489.12	483.99	5.50	2.70	169.04	2.10	1.00
2003-04	6619.75	6313.83	515.37	7.80	3.50	193.35	3.10	1.30
2002-03	5778.13	5493.51	540.90	9.40	4.20	248.77	4.50	1.90
2001-02	5093.68	4806.81	564.73	11.10	4.90	279.58	5.80	2.40
2000-01	4421.34	4152.07	546.72	12.40	5.30	279.77	6.70	2.70
1999-00	3794.61	3527.14	530.33	14.00	6.00	261.87	7.40	2.90
1998-99	3253.28	2977.89	517.10	15.90	6.70	242.11	8.10	3.10
1997-98	2849.71	2604.59	456.53	16.00	7.00	212.32	8.20	3.30
1996-97	2442.14	2209.22	435.77	17.80	7.80	202.85	9.20	3.60

Source : https://dbie.rbi.org.in

Gross Non-Performing Assets as percentage of Gross Advances have shown a declining trend in percentage terms from 1997 to 2009. Thereafter, NPAs increased significantly, catching the attention of the banks, researchers, regulators as well as the Government. From 2009 onwards, the Gross Non Performing Assets of Public Sector Banks increased almost 12 times, i.e. Rs. 449.57 billions in the year 2008-09 to Rs. 5399.95 billions in the year 2015-16.

In the recent Financial Stability Report released by RBI in June 2016, the Gross Non-Performing Advances (GNPAs) ratio has increased sharply from 5.1% to 7.6% between Sept 2015 and March 2016. This distinctive rise in the level of NPAs is the result of Asset Quality Review (AQR). Reserve Bank of India came across many restructured advances in the banks which were actually required to be classified as Non-Performing Assets.

Initiatives taken by the Government of India and Reserve Bank of India

Several measures are followed by the Government as well as Reserve Bank of India to improve the performance of Public Sector Banks to tackle the Non-Performing Assets, like Recovery Camps, Lok Adalats, Debt Recovery Tribunals, SARFAESI Act, Compromise or One-Time settlement, Sale of NPAs to Asset Reconstruction Companies, explore the services of Recovery agents, etc. Finally the Bankruptcy Code is expected to come in force, very shortly.

The government has introduced a number of measures to improvise the working of the banks. Some of them are mentioned below -

- ***Indradhanush Initiative* -** A 7-Point programme to revamp the functioning of Public Sector Banks.
- ***Recapitalisation* -** The government has earmarked Rs. 70,000 crores for capital infusion in PSBs during the period 2016-2019 in order to meet the Basel III requirement and the credit demand.

Capitalisation of PSBs	
Year	**Rs. Crore**
FY 2015-16	25,000
FY 2016-17	25,000
FY 2017-18	10,000
FY 2018-19	10,000
Total	**70,000**
Source : Government Press Release, CPR research	

- ***National Economic Intelligence Network (NEIN) Database* -** In order to check the economic offenders to prevent bad loans.
- ***Insolvency and Bankruptcy Code* -** For ease in doing business and better and speedy recovery, government has recently passed the Insolvency and Bankruptcy Code in 2016.

Reserve Bank of India has also taken a series of measures to deal with the stressed assets

- ***Joint Lenders' Forum* -** RBI advised the banks to form a Joint Lenders' Forum Empowered Group (JLF-EG) in order to take corrective action plan in the case of restructuring of assets.
- ***5/25 refinancing scheme*** for allowing the borrowers to take the benefit of their repayment schedules. Banks can provide longer amortization period of 25 years with an option of restructuring the loans every 5 or 7 years.
- ***Structured Debt Restructuring (SDR)* -** has been designed to deal with the problem loans where banks have been empowered to convert debt into equity, change management, if required or even sell assets to recover their dues.
- ***S-4A Scheme* -** Scheme for Sustainable Structuring of Stressed Assets.
- ***Asset Quality Review* -** In 2015-16, Reserve Bank of India conducted a special inspection where various accounts were inspected to check whether all these loans are classified as per the asset classification norms and whether the provisions have been complied with.

Conclusion / Findings

- Bad Loans (Non-Performing Assets plus restructured loans) in Indian Banks nearly touched Rs. 8 trillion i.e. 11.5 percent of Gross Advances as of March 2016, mainly as a result of the Asset Quality Review (AQR) exercise by the Reserve Bank of India.
- The Gross NPAs to Gross Advances in percentage terms of PSBs placed at 17.8 percent at end March 1997 declined gradually to 2.0 percent at end March 2009 and thereafter it has shown an increasing trend.
- The Gross Non-Performing Assets of Public Sector Banks increased almost 12 times, i.e. Rs. 449.57 billions in the year 2008-09 to Rs. 5399.95 billions in the year 2015-16.
- Five sectors largely contributed to high NPAs are infrastructure, iron and steel, textiles, aviation and mining within the banking system.
- Evergreening, Political Interference, Wilful defaults and Defective lending process are the factors responsible for the rise of NPAs in Public Sector Banks.
- Public Sector Banks have reported a Net loss of Rs. 20,006 crores as on March 2016 as against the profit of Rs. 30,869 crores in the previous year.
- Substantial rise in the provisioning for NPAs has been done from Rs. 57,842 crores as on March 2015 to Rs. 1,44,608 crores as on March 2016.
- Various new schemes have been introduced by the government and Reserve Bank of India to address the Non-Performing Assets issue.

Suggestions

- The process of Credit Appraisal and Credit Monitoring needs more intense focus.
- Early Warning Signals needs to be identified at various stages and corrective action has to be taken immediately.
- Proper action should be taken against loan defaulters especially the Willful defaulters without delay.
- Bankruptcy Code should be implemented.
- Follow International best practices.

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