MANAGING NON PERFORMING ASSETS IN COMMERCIAL BANKS

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Abstract

A strong banking sector is important for flourishing economy. The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 and hence credit management. While the primary function of banks is to lend funds as loans to various sectors such as agriculture, industry, personal loans, housing loans etc., but in recent times the banks have become very cautious in extending loans. The reason being mounting non-performing assets (NPAs) and nowadays these are one of the major concerns for banks in India. NPAs reflect the performance of banks. A high level of NPAs suggests 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. The NPA growth involves the necessity of provisions, which reduces the overall profits and shareholder's value. The present paper is based on the empirical study that will explore the trends in the non-performing assets of commercial banks in India in different sectors over the past five years ranging from 2005-2010 and will also suggest the strategies for reducing them.

Key Words: *Non Performing Assets, Profitability, Sectors, Strategies*

Introduction

A strong banking sector is important for flourishing economy. The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 and hence credit management. While the primary function of banks is to lend funds as loans to various sectors such as agriculture, industry, personal loans, housing loans etc., but in recent times the banks have become very cautious in extending loans. The reason being mounting non-performing assets (NPAs) and nowadays these are one of the major concerns for banks in India. NPAs reflect the performance of banks. A high level of NPAs suggests 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. The NPA growth involves the necessity of provisions, which reduces the overall profits and shareholders' value.

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Meaning of NPA

An asset is classified as Non-performing Asset (NPA) if due in the form of principal and interest are not paid by the borrower for a period of 180 days. 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 (NPA) shall be a loan or an advance where;

- Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- The account remains 'out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC),
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- Interest and/or installment 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, and w.e.f 30.09.2004 following further amendments were issued by the Apex Bank:
- A loan granted for short duration crops will be treated as NPA if the installment of principal or interest thereon remains overdue for two crop seasons.
- A loan granted for long duration crops will be treated as NPA if the installment of principal or interest thereon remains overdue for one crop season.
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

If any advance or credit facilities granted by banks to a borrower become non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status. As per the prudential norms suggested by the Reserve Bank of India (RBI), a bank cannot book interest on an NPA on accrual basis. In other words such interests can be booked only when it has been actually received.

Classification of NPA / Asset classification

Once an asset falls under the NPA category, banks are required by the Reserve Bank of India (RBI) to make provision for the uncollected interest on these assets. For the purpose they have to classify their assets based on the strength and on collateral securities into:

1. Substandard Assets (Revised norms w.e.f 31.30.2005)

- Which has remained NPA for a period less than or equal to 12 months .

2. Doubtful Assets (Revised norms w.e.f 31.30.2005)

- Which has remained in the sub-standard category for a period of 12 Months.

3. Loss Assets (Revised norms w.e.f 31.30.2005)

- Where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.
- It is an asset identified by the bank, auditors or by the RBI inspection as a loss asset.
- It is an asset for which no security is available or there is considerable erosion in the realizable value of the security.

Provisioning Norms for NPAs

After a proper classification of loan assets the banks are required to make sufficient provision against each of the NPA account for possible loan losses as per prudential norms. The minimum amount of provision required to be made against a loan asset is different for different types of assets. The details of the provisioning requirements as per the RBI guidelines are furnished below:

In terms of RBI circular No RBI/2004/254/DBOD No. BP.BC.NO 97/21.04.141/2003-04 dated 17.06.2004, the Reserve Bank of India has decided that w.e.f March31, 2005, a general provision of 10 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.

NPAs under Sub standard Assets category

The 'unsecured exposures' which are identified as 'sub standard' would attract additional provision of 10 percent, i.e a total of 20 percent on the outstanding balance. The provisioning requirement for unsecured doubtful assets is 100 percent.

NPAs under Doubtful category

In terms of RBI Circular No. 2004/261/DBOD BP.BC.99/21.04.048/2003-2004 dated 21.06.2004, Reserve Bank decided to introduce graded higher provisioning according to the age of NPAs in doubtful category for more than three years, with effect from March 31, 2005.

Consequently the increase in provisioning requirement on the secured portion would be applied in a phase manner over a three year period in respect of the existing stock of NPAs as classified as ‘doubtful for more three years as on March 31, 2004 as per clarification given hereunder: In respect of all advance classified as doubtful for more than three years on or after 1 April, 2004 the provisioning requirement would be 100 percent. Accordingly the provisioning norm for advances identified as doubtful for more than 3 years would be as indicated below as on March31, 2009.

(a) Unsecured Portion

The portion of the advance which is not covered by the realizable value of the tangible security to which the bank has the valid recourse and the realizable value is estimated on a realistic basis, provision would be to the extent of 100%.

(b) Secured Portion

Upto 1 year : 20% (D1 Category)

One to three years : 30% (D2 Category)

More than three years : 100% (D3 Category)

NPAs under Loss category

Provisioning at 100% for loss category would continue.

Review of Literature

Siddizi, Rao & Thankkar (1999) found that the diversion of fund like expansion, diversification, modernization or promoting sister concerns, etc., was the most prominent reason for the growth of NPAs. They also examined the impact of priority sector advances on NPAs and concluded that “the higher NPAs in priority sector advances have pushed up the overall proportion of NPAs of these banks by about 3% to 4%.”

The Reserve Bank of India has also conducted a study to ascertain the contributing factors for the high level of NPAs in the banks covering 800 top NPA accounts in 33 banks (RBI Bulletin, July 1999). The study has found that the proportion of problem loans in case of Indian banking sector always been very high. The problem loans of these banks, in fact, formed 17.91 percent of their gross advances as on March 31,1989. This proportion did not include the amounts locked up in sick industrial units. Hence, the proportion of problem loans indeed was higher. However, the NPAs of Indian Banks declined to 17.44 percent as on March 31, 1997 after introduction of prudential norms. In case of many of the banks, the decline in ratio of NPAs was mainly due to proportionately much higher rise in advances and a lower level of NPAs accretion after 1992. The study also revealed that the major factors contributing to loans becoming NPAs include diversion of funds for expansion, diversification, modernization, undertaking new projects and for helping associate concerns. This is coupled with recessionary trend and failure to tap funds in the capital and debt markets, business failure (product, marketing, etc.), inefficient management , strained labour relations, inappropriate technology/technical problems, product obsolescence, recession input/power shortage, price escalation, accidents, natural calamities, Government policies like changes in excise duties, pollution control orders, etc. The RBI report concluded that reduction of NPAs in banking sector should be treated as a national priority issue to make the Indian banking system stronger, resilient and geared to meet the challenges of globalization.

Baiju S. and Gabriel Simon Thattil (2000) highlighted the problem of NPAs in commercial banking sector of Indian taking the current position of scheduled commercial banks. For the purpose of analysis the number of banks with gross NPA percentage of 5 or below (International standard) has been categorized as “very good”. Banks with gross NPA percentage of 16 (national average) or less but above 5 were categorized as “good”. Banks with above 16 percent but below 20 percent gross NPA were categorized as “bad”. Banks with gross NPA of 20 percent and above were categorized as “worst”. They concluded that banks, which go a “very good” rating in terms of their NPAs, revealed that such banks were new private banks or foreign banks, One of reason given was that such banks had low network of branches, specifically in rural areas. In addition, these banks stressed upon a more stringent scrutiny of proposal and monitoring of usage for huge loans, which were the man reason for the major chunk of NPAs. They were also of the opinion that the managerial care within each banking organization ought to be educated and encouraged to lend, after considering the merit of each proposal and taking up the responsibility for its recovery. A strong banking culture ought to be developed, as diversion of funds and defaults in repayment will never be tolerated even to the smallest extent. Scrutiny of proposal and monitoring of usage should be more stringent for huge loans as they contribute to a major chunk of NPAs.

Vallabh, Bhatia & Mishra (2007) in their study explores an empirical approach to the analysis of Non-Performing Assets (NPAs) of public, private, and foreign sector banks in India. The 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. This study aims to find the fundamental factors which impact NPAs of banks. A model consisting of two types of factors, viz., macroeconomic factors and bank-specific parameters, is developed and the behavior of NPAs of the three categories of banks is observed. This model tries to extend the methodology of widely-known Altman model. The empirical analysis assesses how macroeconomic factors and bank-specific parameters affect NPAs of a particular category of banks. The macroeconomic factors of the model included are GDP growth rate and excise duty, and the bank-specific parameters are Credit Deposit Ratio (CDR), loan exposure to priority sector, Capital Adequacy Ratio (CAR), and liquidity risk. The results show that movement in NPAs over the years can be explained well by the factors considered in the model for the public and private sector banks. The co-linearity between independent variables was measured by Durbin-Watson test and VIF characteristic and it was found to be a little for public and private banks. The factors included in the model explain 97.1% (adjusted R-square value of regression results) of variations in NPAs of public banks and 76.9% of the same of private banks. The other important results derived from the analysis include the finding that banks' exposure to priority sector lending reduces NPAs.

Objectives of the study

- To study the growth of NPA in the commercial banks in India.
- To analyse the sector wise non-performing assets of the commercial banks.

Research Methodology

The study will be done on the basis of secondary data for the period of 5 years from 2005-2010. that will be collected from the various sources such as various publications of RBI for instance RBI Bulletin, Highlights of Bank Performance- IBA Publications, Mumbai (Various Issues), Annual reports on banking trend and progress in India.

Sample Size

The study is conducted on the commercial banks by dividing the banking sector into three groups:

1. SBI & its associate banks
2. Nationalised banks
3. Private Sector banks.

The criteria for selecting these banks will be the highest Business per Employee as per 31 March, 2009.

On the basis of the highest Business per Employee as per the report of the Indian Banking Association, March 2009 the following banks are selected.

Group I (SBI & its associate banks) – State Bank of India, State Bank of Patiala, State Bank of Indore

Group II (Nationalised banks) - Oriental Bank of Commerce, Corporation Bank, Bank of Baroda

Group III (Private Sector Banks) - ICICI Bank Ltd, Axis Bank Ltd, IndusInd Bank Ltd

Growth of NPAs

Table 1- Non Performing Assets as a percentage of Total Advances of SBI & its associate banks

(Amount in Rs. Crore)

	State Bank of India			State Bank of Patiala			State Bank of Indore		
Years	Gross NPAs	Gross Advances	Gross NPA/Total Advances	Gross NPAs	Gross Advances	Gross NPA/Total Advances	Gross NPAs	Gross Advances	Gross NPA/Total Advances
2006	10376	261642	3.97	543	22180	2.45	363	11876	3.06
2007	9998	337336	2.96	524	28770	1.82	294	15351	1.92
2008	12837	416768	3.08	521	36400	1.43	265	18224	1.45
2009	16346	542503	3.01	574	43634	1.32	301	21612	1.39
2010	19535	631914.2	3.09	1007	46347.23	2.17	493	23677.08	2.08

Source- Reserve bank of India (www.rbi.org)

Table 1 portrays that in the ratio of Gross NPA/Total Advances is declining in all the three banks till the year 2009 and it is again rising in the year 2010.

Table 2- Non Performing Assets as a percentage of Total Advances of Nationalised Banks

(Amount in Rs. Crore)

	Oriental Bank of Commerce			Corporation Bank			Bank of Baroda		
Years	Gross NPAs	Gross Advances	Gross NPA/Total Advances	Gross NPAs	Gross Advances	Gross NPA/Total Advances	Gross NPAs	Gross Advances	Gross NPA/Total Advances
2006	2116	35549	5.95	626	24423	2.56	363	11876	3.06
2007	1454	45395	3.20	625	30422	2.05	294	15351	1.92
2008	1280	55327	2.31	584	39664	1.47	265	18224	1.45
2009	1058	69065	1.53	559	48927	1.14	301	21612	1.39
2010	1469	83489.3	1.76	651	63202.56	1.03	493	23677.08	2.08

Source- Reserve bank of India (www.rbi.org)

Table 2 again shows the growth of non-performing assets in the nationalized banks which also shows the declining trend for all the years for all the three banks except in the year 2010 the ratio is increasing for Bank of Baroda.

Table 3- Non Performing Assets as a percentage of Total Advances of Private Sector Banks

(Amount in Rs. Crore)

	ICICI Bank Ltd			Axis Bank Ltd			IndusInd Bank Ltd		
Years	Gross NPAs	Gross Advances	Gross NPA/Total Advances	Gross NPAs	Gross Advances	Gross NPA/Total Advances	Gross NPAs	Gross Advances	Gross NPA/Total Advances
2006	2223	147625	1.51	374	22471	1.67	269	9384	2.86
2007	4126	198193	2.08	411	37022	1.11	343	11153	3.08
2008	7580	229892	3.30	486	59899	0.81	392	12897	3.04
2009	9649	223621	4.32	890	82120	1.08	255	15847	1.61
2010	9267	181206	5.11	910	86154	1.05	284	17745	1.6

Source- Reserve bank of India (www.rbi.org)

Table 3 shows that the ratio is showing an increasing trend of NPAs in case of ICICI bank and in case of Axis bank the trend is mixed one. The trend of NPAs in case of IndusInd Bank is showing an increasing trend uptil the year 2008 whereas it starts declining in the year 2009 and 2010.

Sector wise Non Performing Assets

Table 4 shows the sector wise non-performing assets of three banks which reveals that the major chunk of NPAs accrue in the Priority Sector that consist of loans to agriculture, small scale industries etc whereas the non- performing assets in public sector are least and in some cases it is almost nil.

Table 4-Sector wise Non Performing Assets of SBI & its associate banks

(Amount in Rs. Crore)

	State Bank of India			State Bank of Patiala			State Bank of Indore		
Years	**Priority Sector**	**Public Sector**	**Non-Priority Sector**	**Priority Sector**	**Public Sector**	**Non-Priority Sector**	**Priority Sector**	**Public Sector**	**Non-Priority Sector**
2006	5,906.49	33.2	4,329.83	394.23	35.1	113.62	161.83	Nil	201.1
2007	5,810.19	149.32	3,911.50	367.23	Nil	157.18	194.56	Nil	99.65
2008	7561.28	91.16	4923.64	350.33	Nil	170.61	137.26	Nil	128.12
2009	7,010	163	7,932	336	Nil	238	120	10	171
2010	9,073	235	8,529	543	Nil	463	210	Nil	283

Source- Reserve bank of India (www.rbi.org)

Table 5- Sector wise Non Performing Assets of Nationalised Banks

(Amount in Rs. Crore)

	Oriental Bank of Commerce			Corporation Bank			Bank of Baroda		
Years	**Priority Sector**	**Public Sector**	**Non-Priority Sector**	**Priority Sector**	**Public Sector**	**Non-Priority Sector**	**Priority Sector**	**Public Sector**	**Non-Priority Sector**
2006	686.48	4.99	1,424.84	252.04	0.97	372.56	1,150.70	Nil	1,113.13
2007	555.78	24.01	874.26	318.84	Nil	305.73	1,068.04	Nil	904.36
2008	694.47	Nil	585.63	362.43	Nil	221.99	1224.09	10.40	623.62
2009	610	1	448	373	Nil	186	820	2	843
2010	911	Nil	558	398	Nil	253	1,444	85	667

Source- Reserve bank of India (www.rbi.org)

Table 5 also analyses the same thing that the major chunk of NPAs of nationalized banks accrue in the Priority Sector that consist of loans to agriculture, small scale industries etc whereas the non-performing assets in public sector are least and in some cases it is almost nil.

Table 6- Sector wise Non Performing Assets of Private Banks

(Amount in Rs. Crore)

	ICICI Bank Ltd			Axis Bank Ltd			IndusInd Bank Ltd		
Years	**Priority Sector**	**Public Sector**	**Non-Priority Sector**	**Priority Sector**	**Public Sector**	**Non-Priority Sector**	**Priority Sector**	**Public Sector**	**Non-Priority Sector**
2006	94.3	0.01	2,128.28	70.85	Nil	303.03	148.09	Nil	120.74
2007	983.83	0.01	3142.22	110.01	Nil	300.59	83.41	Nil	259.33
2008	1359.34	0.01	6211.12	210.59	Nil	275.06	63.64	Nil	328.67
2009	1542	Nil	7051	352	Nil	451	76	Nil	241
2010	1,946	Nil	7,321	528	Nil	767	84	Nil	171

Source- Reserve bank of India (www.rbi.org)

Table 6 analyses a completely different view. It shows that the major chunk of NPAs in the private sector banks accrue in the Non Priority Sector which mostly consist of loans to industries, business loan, personal loan, education loan etc.

Conclusion

NPAs reflect the overall performance of the banks. A high level of NPAs suggests 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. The NPA growth involves the necessity of provisions, which reduces the overall profits and shareholders' value. Due diligence and utmost care must be taken by the branch managers before sanctioning the loans to the clients and specially in case of lending to priority sector. So, careful steps like selection of right borrowers, viable economic activity, adequate finance and timely disbursement, correct end use of funds and timely recovery of loans are absolutely necessary pre conditions for preventing or minimizing the incidence of new NPAs which will enhance the creditability of the banks and in turn make the foundation of our country strong.

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