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Management of Non-Performing Assets: A study of Public and Private Sector Banks

Abstract

The problem of NPAs, though not new at all, has assumed different size and magnitude with the growth and structural changes in the banking sector. The banks have realized that high level of NPAs in their credit portfolio is a drag on their profitability which is already under strain. They have initiated various strategies and action points to bring down their level of NPAs and have achieved some degree of success in terms of recovery and up gradation of their existing NPAs. The present study highlights that the problem of NPAs is more serious in Public Sector Banks than Private Sector Banks. Reduction of NPAs in banking sector should be treated as a national priority to make the Indian banking system more strong and resilient.

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. However, for the past many years, almost all the Indian banks have been weighed down heavily by the enormous amounts of NPAs in their books. This has caused banking crisis in the country and sometimes threatened the very health of banking system. In spite of the prudential norms framed by RBI and continued focus of various policy initiatives of the Government of India, a continuous increase in the NPA level has been experienced by most of the Indian banks with minor variations. Apart from the internal and external complexities, increase in NPAs directly affects banks' profitability, sometimes even their very existence. If banks let it continue, they will have to face deep crises. (Reddy, Bhargavi 2004).

NPAs are those loans given by a bank or financial institution where the borrower defaults or delays interest or principal payments. Banks are not allowed to book any income from NPAs. They have to make provisions for the NPAs or keep money aside in case they cannot collect from the borrower, which affects profitability adversely. Moreover, if any advance or credit facility granted by bank to a borrower becomes non-performing, then the bank will have to treat all the advances/credit facilities granted to the borrower as non-performing without having any regard to the fact that there may still exist certain advances/ credit facilities having performance status. According to RBI guidelines, an asset is classified as non-performing asset if dues in the form of principal and interest are not paid by the borrower for a period of 180 days. However with effect from March 2004, default status would be given to borrower if dues are not paid within 90 days

ASSET CLASSIFICATION

All advances should be classified into the following four categories, taking into account the degree of weakness and extent of dependence of security for realization of dues.

Standard Asset

Standard Asset is one, which does not disclose any problem and which does not carry more than normal risks attached to the business. Such an asset is not a Non-Performing Asset.

Substandard Asset

Earlier, a substandard asset was one, which was classified as NPA for a period not exceeding two years. With effect from 31 March 2005, a substandard asset is one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

Doubtful Asset

Previously, doubtful asset was one, which remained NPA for a period exceeding two years. With effect from 31 March 2005, an asset is to be classified as doubtful if it has remained NPA for a period exceeding 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation of outstanding dues in full, on the basis of currently known facts, conditions and values-highly questionable and improbable.

Doubtful assets will again have to be classified as under, depending upon the period for which each account has remained as Doubtful Assets:

Period of Doubtful Assets Status	Asset Category
Up to 1 year	DA-I
More than 1 year but up to 3 years	DA-II
More than 3 years	DA-III

Loss Asset

A loss asset is one 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. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

IMPACT OF NPAS ON BANKING OPERATIONS:

NPAs have following impact on banking operations:

1. The interest income of banks will fall as interest is to be accounted only on receipt basis.
2. Banks' profitability is affected adversely because of provisioning for doubtful assets and writing off of bad debts.
3. Return on investment (ROI) is reduced.
4. Capital adequacy ratio disturbed as NPAs enter into its calculation.
5. Cost of capital will go up.
6. Asset liability mismatch will widen.
7. Economic Value Addition (EVA) by banks will get upset, because EVA is equal to Net Operating Profit minus Cost of Capital.
8. As the income earned on performing assets subsidizes NPAs, the ability of the bank to offer finer spreads to good customers comes down. This, in turn, makes the best customers choose other cheaper financing options and the banks' asset portfolio quality deteriorates. This results in future NPAs.
9. Since NPAs bring down the profits, these affect the shareholder value and thus adversely affect the investor confidence.
10. It also affects the ability of the bank to start other business ventures. For example, RBI stipulated minimum NPA percentage for issue of licenses for insurance business.

Thus, there are enough reasons for the banks to initiate immediate steps to contain the existing NPAs and improve the assets quality. This would be as important as adding to the profits through business growth.

FACTORS RESPONSIBLE FOR HIGH NPAS

The bulk of the non performing loans in the banking sector are due to historical reasons. The RBI study says that diversion of funds by promoters and time/ cost over runs are among the main reasons of non-performing assets in the Indian banking sector. The diversion of funds mostly for the expansion, diversification, modernisation, taking up new projects and for promoting associated concerns, are the most prominent reasons.(Shrivastav 2006)

Internal factors like business failure, inefficient management, strained labour relations, inappropriate technological problems, product obsolescence, political interference, improper appraisal of loans, delay in sanctioning loans, ineffective time consuming and costly legal measures, loan waiver schemes of govt, drawback in loan recovery systems, willful default, weak credit appraisal are the main reasons of increasing NPAs. There are also external factors which contribute to rise in NPAs. These include natural calamities, industrial sickness, recession, shortage of price escalation, power shortage, raw material and accidents, Some other reasons are changes in excise/ import duties, pollution control orders, wilful default, siphoning off funds, misappropriation etc.. Internal factors far overweighed the external ones in transforming borrowing accounts into NPAs (Singh 2002)

TRENDS OF NPAs IN PUBLIC & PRIVATE SECTOR BANKS

To have proper understanding of the problem of NPAs, the information regarding magnitude and trends of NPAs in the public as well as private sector banks is presented in the following tables.

Table 1 exhibits gross NPAs as percentage to gross advances and net NPAs as percentage to net advances of public as well as private sector banks. Both the categories of banks showed a declining trend in gross and net NPAs over the period of study but public sector banks have higher ratio as compared to private sector banks. The reason behind this is that private sector banks have a secured loan policy as compared to public sector banks. Gross NPAs ratio has declined from 23.2% to 2% in Public sector banks whereas in private sector banks this ratio has reduced from 8.5% to 2.90% in the given period. On the other hand, net NPAs ratio in public sector banks has come down from 10.7% to 0.7% whereas it declined from 9.20% in 1996-97 to 1.50% in 2008-09. So, even after implementation of prudential norms in early nineties, the problem continues to be serious due to fresh loans by banks being added to NPA category. Thus, growing size of gross NPAs in absolute form has been a real cause of worry. However, there is a silver lining, on account of the steps taken by the banks under the Securitization Act,2002. Gross and net NPAs declined in absolute terms from the year 2003 onwards because of better recovery. Stricter prudential norms for classification of assets and recognition of NPAs are one of the major reasons for increase in NPAs. With implementation of 90 days norm in NPAs recognition from 31-03-2004, NPAs increased in absolute terms. Various banks' annual reports have been citing this as one of the reasons for increase in NPAs.

Table 1: Gross and Net NPAs of Public and Private Sector Banks

	% of Gross NPAs to Gross Advances		% of Net NPAs to Net Advances	
Year	**Public Sector Banks**	**Private Sector Banks**	**Public Sector Banks**	**Private Sector Banks**
1995	23.20	NA	10.70	NA
1996	18.00	NA	08.90	NA
1997	17.84	8.5	9.18	9.20
1998	16.02	8.7	8.15	8.20
1999	15.90	10.40	8.13	8.10
2000	14.0	8.17	7.42	5.41
2001	12.4	8.32	6.70	2.27
2002	11.1	9.64	5.80	2.49
2003	9.4	8.07	4.50	2.32
2004	7.8	5.84	3.00	1.32
2005	5.0	3.77	2.06	1.85
2006	4.3	2.45	1.70	1.09
2007	2.66	2.20	1.10	0.97
2008	2.2	2.5	0.80	1.20
2009	2.0	2.9	0.70	1.50

Source: (RBI) Report on Trend and Progress of Banking in India, various issues.

Table 2 shows the distribution of Gross NPAs of Public sector banks in different sectors i.e. priority sector, public sector and non-priority sector for the period 1995 to 2009.

Table 2: Sector-wise NPAs of Public Sector Banks

(Rs. in Crore)

	Priority Sector		Public Sector		Non-Priority Sector		Total	
Year	**Amount**	**Per cent**	**Amount**	**Per cent**	**Amount**	**Per cent**	**Amount**	**Per cent**
1995	19209	50.0	1316	3.4	17861	46.5	38385	100
1996	19106	48.3	1411	3.6	19067	48.2	39584	100
1997	20774	47.7	1461	3.4	21341	49.0	43576	100
1998	21184	46.4	1362	3.0	23107	50.6	45653	100
1999	22606	43.7	1496	2.9	27608	53.4	51710	100
2000	23715	44.5	1055	2.0	28524	53.5	53294	100
2001	24156	45.4	1711	3.2	27307	51.4	53174	100
2002	25139	44.5	1116	2.0	30251	53.5	56506	100
2003	24938	47.2	1087	2.1	26781	50.7	52807	100
2004	23840	47.5	610	1.2	25698	51.2	50148	100
2005	23397	49.1	450	0.9	23849	50.0	47696	100
2006	22374	54.1	341	0.8	18664	45.1	41378	100
2007	22954	59.5	490	1.3	15158	39.3	38602	100
2008	25287	63.6	299	0.7	14163	35.6	39749	100
2009	24318	55.2	474	1.1	19251	43.7	44042	100

Source: (RBI) Report on Trend and Progress of Banking in India, various issues.

It is visible from the table that major chunk of NPAs came from priority- sector as well as non-priority sector and their combined share has varied between 96% to 99%. In priority sector gross NPAs showed a declining trend from 1995 onwards but it started increasing again after 1999.This may be due to the implementation of the one-time settlement scheme for small and marginal farmers. The scheme was operational for farmers, who owed up to Rs.50,000 as principal amount to various banks. Any interest that was included in outstanding amount or accrued on the balance outstanding was waived. In non-priority sector gross NPAs showed an increasing trend in initial years of the study i.e. 1995 to 2000 but after that it started declining. The share of public sector with regard to NPAs has been negligible and has declined from 3.4% in 1995 to 1.1% in 2009.

Table 3 shows the sector wise distribution of gross NPAs in private sector banks and public sector for the period 2001 to 2009.

Table 3: Sector-wise NPAs of Private Sector Banks

(Rs. in Crore)

	Priority Sector		Public Sector		Non-Priority Sector		Total	
Year	**Amount**	**Per cent**	**Amount**	**Per cent**	**Amount**	**Per cent**	**Amount**	**Per cent**
2001	1835	28.6	123	1.9	4452	69.5	6410	100
2002	2546	21.8	31	0.3	9090	77.9	11667	100
2003	2445	20.6	95	0.8	9327	78.6	11866	100
2004	2482	24.0	75	0.7	7796	75.3	10352	100
2005	2188	24.9	42	0.5	6569	74.7	8799	100
2006	2284	29.2	4	0.1	5541	70.8	7829	100

2007	2884	31.2	2.79	0.03	6352.51	68.75	9239.48	100
2008	3419	26.3	.01	-	9557	73.6	12976	100
2009	3640	21.6	75	.4	13172	78.0	16887	100

Source: (RBI) Report on Trend and Progress of Banking in India, various issues.

It is visible from the table that the share of non-priority sector has been much higher as compared to other two sectors i.e. priority sector and public sector. On the other hand, public sector contributed very negligible proportion ranging between 0 to 2% in total NPAs. The proportion of priority sector in Gross NPAs declined from 28.6% in 2001 to 21.6% in 2009 but on the contrary, proportion of non priority sector increased significantly from 69.5% in 2001 to 78% in 2009. The proportion of priority sector in gross NPAs has been declining in private sector banks and has also been lesser as compared to public sector banks.

Table 4 presents bank-wise analysis of net NPAs of Public Sector banks in India.

Table 4: Bank-wise Net NPAs as Percentage to Net Advances of public Sector Banks

Sr. No.	Name of the Bank	Net NPAs/ Net Advances					
		2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
	Public Sector Banks	2.99	2.1	1.3	1.1	0.8	0.7
	Nationalised Banks	3.14	1.9	1.2	0.9	0.7	0.7
1	Allahabad Bank	2.37	1.3	0.8	1.1	0.8	0.7
2	Andhra Bank	0.93	0.3	0.2	0.2	0.2	0.2
3	Bank of Baroda	2.99	1.5	0.9	0.6	0.5	0.3
4	Bank of India	4.50	2.8	1.5	1.0	0.5	0.4
5	Bank of Maharashtra	2.46	2.2	2.0	1.2	0.9	0.8
6	Canara Bank	2.89	1.9	1.1	0.9	0.8	1.1
7	Central Bank of India	5.57	3.0	2.6	1.7	1.5	1.2
8	Corporation Bank	1.8	1.1	0.6	0.5	0.3	0.3
9	Dena Bank	9.40	5.2	3.0	2.0	0.9	1.1
10	Indian Bank	2.71	1.4	0.8	0.4	0.2	0.2
11	Indian Overseas Bank	2.85	1.3	0.7	0.5	0.6	1.3
12	Oriental Bank of Commerce	Nil	1.3	0.5	0.5	1.0	0.7
13	Punjab and Sind Bank	9.62	8.1	2.4	0.7	0.4	0.3
14	Punjab National Bank	0.98	0.2	0.3	0.8	0.6	0.2
15	Syndicate Bank	2.58	1.6	0.9	0.8	1.0	0.8
16	UCO Bank	3.65	2.9	2.1	2.1	2.0	1.2
17	Union Bank of India	2.87	2.6	1.6	1.0	0.2	0.3
18	United Bank of India	3.75	2.4	2.0	1.5	1.1	1.5
19	Vijaya Bank	0.91	0.6	0.9	0.6	0.6	0.8
	State Bank Group	2.70	2.2	1.6	1.3	1.4	1.5
20	State Bank of India	3.48	2.7	1.9	1.6	1.8	1.8
21	State Bank of Bikaner and Jaipur	1.24	1.6	1.2	1.1	0.8	0.9

22	State Bank of Hyderabad	0.65	0.6	0.4	0.2	0.2	0.4
23	State Bank of Indore	Nil	1.0	1.8	1.0	0.7	0.9
24	State Bank of Mysore	2.96	0.9	0.7	0.5	0.4	0.5
25	State Bank of Patiala	Nil	1.2	1.0	0.8	0.6	0.6
26	State Bank of Saurashtra	Nil	1.4	1.2	0.7	0.9	-
27	State Bank of Travancore	1.39	1.8	1.5	1.1	0.9	0.6
	Other Public Sector Bank						
28	IDBI Bank Ltd.	-	1.7	1.1	1.1	1.3	0.9

Source: (RBI) Report on Trend and Progress of Banking in India, various issues.

It is visible from the table that net NPAs in relation to net advances have shown declining trend for most of the banks over the period of study. In the year 2003-04 some Public sector banks like Oriental Bank of Commerce, State Bank of Indore, State Bank of Patiala and State Bank of Saurashtra were able to bring down their net NPAs ratio to nil. But after that these banks could not maintain the level due to stricter prudential norms regarding classification of assets and recognition of NPAs w.e.f. from 2004. Again in 2008-09, State Bank of Saurashtra achieved its earlier position by bringing back their net NPAs ratio to nil. Apart from it Andhara Bank, Indian Bank and Punjab National Banks are other banks who have brought their net NPAs ratio to 0.2% during 2008-09. On the other hand, State Bank of India (1.8%), United Bank of India (1.5%) and Indian Overseas Bank (1.3%) are the banks having very high net NPAs ratio. These banks should try to arrest fresh slippages and maintain the quality of assets. One more thing that is visible from the table is that other Nationalised Banks are performing better than State Bank Group as it has a very high ratio (1.5%) against other Nationalised banks (0.7%).

Table 5 exhibits bank-wise distribution of Net NPAs in relation to Net Advances of private sector banks for the period 2003-2009.

Table 5: Bank-wise Net NPAs as Percentage to Net Advances of Private Sector Banks

Sr. No.	Name of the Bank	Net NPAs/Net Advances					
		2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
	Private Sector Banks	5.8	1.9	1.0	1.0	1.2	1.5
A	Old Private Sector Banks	7.6	2.7	1.7	0.9	0.7	0.9
1	Bank of Rajasthan Ltd.	9.1	2.5	1.0	0.2	0.4	0.7
2	Catholic Syrian Bank Ltd.	8.8	3.8	2.8	2.0	1.6	2.4
3	City Union Bank Ltd.	10.4	3.4	2.0	1.1	1.0	1.1
4	Dhanalakshmi Bank Ltd.	11.4	3.9	2.8	1.8	0.9	0.9
5	Federal Bank Ltd.	7.4	2.2	1.0	0.4	0.2	0.3
6	ING Vysya Bank Ltd.	2.6	2.1	1.8	0.7	0.7	1.2
7	Jammu and Kashmir Bank Ltd.	3.0	1.4	0.9	1.1	1.1	1.4
8	Karnataka Bank Ltd.	11.9	2.3	1.2	1.2	1.0	1.0
9	Karur Vysya Bank Ltd.	5.8	1.7	0.8	0.2	0.2	0.3
10	Lakshmi Vilas Bank Ltd.	10.1	5.0	1.9	1.6	1.6	1.2
11	Nainital Bank Ltd.	4.0	-	-	-	-	-
12	Ratnakar Bank Ltd.	10.6	5.5	2.6	1.9	1.0	0.7

13	SBI Commercial & International Bank Ltd.	41.3	7.7	3.8	-	-	-
14	South Indian Bank Ltd.	7.6	3.8	1.9	1.0	0.3	1.1
15	Tamilnad Mercantile Bank Ltd.	13.8	3.0	2.2	1.0	0.4	0.3
B	New Private Sector Banks	5.0	1.9	0.8	1.0	1.1	1.3
16	Axis Bank	2.9	1.4	1.0	0.7	0.4	0.4
17	Centurion Bank of Punjab Ltd.	-	2.5	1.1	1.3	1.7	-
18	Development Credit Bank Ltd.	8.2	6.3	4.5	1.6	0.7	3.9
19	HDFC Bank	1.9	0.2	0.4	0.4	0.5	0.6
20	ICICI Bank	4.7	1.7	0.7	1.0	1.6	2.1
21	IndusInd Bank Ltd.	3.3	2.7	2.1	2.5	2.3	1.1
22	Kotak Mahindra BankLtd.	0.8	0.4	0.2	2.0	1.8	2.4
23	Yes Bank	-	-	-	-	0.1	0.3

Source: (RBI) Report on Trend and Progress of Banking in India, various issues.

It is observed from the table that Nainital Bank Ltd. and SBI Commercial and International Bank Ltd. have brought their net NPAs ratio to nil from the year 2004-05 and 2006-07 onwards respectively. Apart from this, Federal Bank, Karur Vyasya Bank Ltd, Tamilnad Mercantile Bank Ltd and Yes Bank are other strong banks having Net NPAs ratio of just 0.3% in 2008-09. On the other hand, Development Credit Bank Ltd has the highest ratio of 3.9% and Catholic Syrian Bank Ltd, ICICI Bank Ltd. and Kotak Mahindra Bank Ltd. have their Net NPAs ratio above 2% in 2008-09. This indicates their their weak position and thus, some effective measures need to be taken in this regard immediately. A comparison within private sector banks shows that there is not much difference between the ratios of new and old private sector banks and both the categories have Net NPAs ratio at 1.3% and 1.5 % respectively in the year 2008-09.

SUGGESTIONS FOR NPAs RETRIEVAL

- For effective handling of NPAs, there is an urgent need for creating proper awareness about the adverse impact of NPAs on profitability amongst bank staff, particularly the field functionaries. They must understand and appreciate the urgency to bring down NPAs.
- Bankers should have frequent interactions and meetings with the borrowers for creating better understanding and mutual trust so that borrowers keep their bankers informed of any problem faced by them and need based facilities can be promptly provided.
- The cheapest mode of recovery is by sending reminders to the borrowers before the loan installment falls due. The efforts need to be strengthened at banks' level in sending reminders more frequently.
- Banks should set up independent recovery and legal departments at their corporate and controlling administrative offices manned by well-qualified and competent law officers with adequate supporting staff for effective monitoring of recovery suits and execution of decrees.
- Each bank should set up an 'Industry Cell' attached to the credit department at the head office level. This Cell should analyse the performance of industry, interpret the relevant policy guidelines of the government from time to time, and guide the appraisal officers accordingly.
- Compromise is considered to be the best measure of recovery so compromise schemes should be introduced by the controlling offices.
- Some of the banks have already set up special 'recovery branches'. The recovery branch with necessary expertise and infrastructure can surely effect quick recoveries.
- A diagnostic study needs to be conducted by each bank in respect of cases lost in the courts of law during the recent past.
- Banks should improve the quality of their appraisal for loan proposals. Further, they should also strengthen their loan monitoring system. More importance should be given to actual verification of the information provided.

- Credit audit should be introduced in respect of bigger advances so that deficiencies in credit appraisal, documentation and disbursement can be noticed well in advance.
- The loans should be segregated as per ABC analysis to identify critical borrowal accounts requiring immediate action.
- To arrest slippage is the new mantra for slippage management. The list of potential NPA accounts available from the management information system could be utilised for necessary follow up to maintain the accounts in standard category.

Conclusion

High NPAs are definitely a cause for concern. They constitute a real economic cost to the nation since they reflect the application of scarce capital and credit funds to unproductive uses. To the extent that banks seek to make provisions for NPAs or write them off, it is a charge on their profits..The quality of assets of Indian banking sector though somewhat better than what it was five years ago, still much more is required to be done for further improvement. While banks cannot be blamed for advances becoming non-performing due to external factors, there is an urgent need that banks should pay attention to the problems arising out of internal factors. This may require organizational restructuring of banks, a change in the approach of banks towards legal action and an emphasis on improving the skills of officials for proper assessment of credit proposals, risk possibilities etc. Keeping in view the present scenario, steps should be taken by policy makers and banks to further improve the quality of their assets. In other words, reduction of NPAs in banking sector should be treated as a national priority to make the Indian banking system more strong and resilient.

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