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A Study on Non- Performing Assets with Reference to Banking Sector

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Abstract

The future of Indian Banking represents a unique mixture of unlimited opportunities amidst insurmountable challenges. On one hand, we see the scenario represented by the rapid process of globalization presently taking shape bringing the community of nations in the world together, transcending geographical boundaries, in the sphere of trade and commerce, and even employment opportunities of individuals. All these indicate newly emerging opportunities for Indian Banking. The project has tried to analyze the present situation in Indian banks. With the process of liberalization and globalization, the bank credit has witnessed spectacular growth as a catalyst of economic growth. With the increase in the growing volume of credit, the volume of impaired credit has also multiplied due to various factors. This burgeoning level of NPA had become a grave matter of concern for the Indian banks.

In the study conducted focus was laid on the approach of various banks to manage NPAs, the process of identification of the same, the classification and assessment of provisions and the pre-sanction appraisal methodology and the post-sanction follow-up procedure. The nature of research was descriptive as well as exploratory as the study was aimed at studying the various measures adopted by banks for management of NPAs in the banking sector.

***Key terms*: -** NPA, Banking Sector, Interest rates, loans.

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INTRODUCTION

NPA: The three letters Strike terror in banking sector and business circle today. NPA is short form of "Non Performing Asset". The dreaded NPA rule says simply this: when interest or other due to a bank remains unpaid for more than 90 days, the entire bank loan automatically turns a non performing asset. The recovery of loan has always been problem for banks and financial institution. To come out of these first we need to think is it possible to avoid NPA, no cannot be then left is to look after the factor responsible for it and managing those factors.

A 'non-performing asset' (NPA) was defined as a credit facility in respect of which the interest and/ or installment of principal has remained 'past due' for a specified period of time 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.

As a facilitating measure for smooth transition to 90 days norm, banks have been advised to move over to charging of interest at monthly rests, by April 1, 2002. However, the date of classification of an advance as NPA should not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 180 days from the end of the quarter with effect from April 1, 2002 and 90 days from the end of the quarter with effect from March 31, 2004.

NPAs IN INDIAN BANKING SYSTEM

Undoubtedly the world economy has slowed down, recession is at its peak, globally stock markets have tumbled and business itself is getting hard to do. The Indian economy has been much affected due to high fiscal deficit, poor infrastructure facilities, sticky legal system, cutting of exposures to emerging markets by FIs, etc. Further, international rating agencies like, Standard & Poor have lowered India's credit rating to sub-investment grade. Such negative aspects have often outweighed positives such as increasing for ex-reserves and a manageable inflation rate. Under such a situation, it goes without saying that banks are no exception and are bound to face the heat of a global downturn. One would be surprised to know that the banks and financial institution in India hold nonperforming assets worth Rs. 110000crores Bankers have realized that unless the level of NPAs is reduced drastically, they will find it difficult to survive.

NPA surfaced suddenly in the Indian banking scenario, around the Eighties, in the midst of turbulent structural changes overtaking the international banking institutions, and when the global financial markets were undergoing sweeping changes. In fact after it emerged as if the problem of NPA kept hidden and gradually swelling unnoticed and unperceived, in the maze of defective accounting standards that still continued with Indian Banks up to the Nineties and opaque Balance sheets. In a dynamic world, it is true that new ideas and new concepts that emerge through such changes caused by social evolution bring beneficial effects, but only after levying a heavy initial toll. The process of quickly integrating new innovations in the existing set-up leads to an immediate disorder and unsettled conditions. People are not accustomed to the new models. These new formations take time to configure, and work smoothly. The old is cast away and the new is found difficult to adjust. Marginal and sub-marginal operators are swept away by these convulsions. Banks being sensitive institutions entrenched deeply in traditional beliefs and conventions were unable to adjust themselves to the changes. They suffered easy victims to this upheaval in the initial phase. Consequently banks underwent this transition-syndrome and languished under distress and banking crises surfaced in quick succession one following the other in many countries. But when the banking industry in the global sphere came out of this metamorphosis to re-adjust to the new order, they emerged revitalized and as more vibrant and robust units. Deregulation in developed capitalist countries particularly in Europe, witnessed a remarkable innovative growth in the banking industry, whether measured in terms of deposit growth, credit growth, growth intermediation instruments as well as in network.

During all these years the Indian Banking, whose environment was insulated from the global context and was denominated by State controls of directed credit delivery, regulated interest rates, and investment structure did not participate in this vibrant banking revolution. Suffering the dearth of innovative spirit and choking under undue regimentation, Indian banking was lacking objective and prudential systems of business leading from early stagnation to eventual degeneration and reduced or negative profitability. Continued political interference, the absence of competition and total lack of scientific decision-making, led to consequences just the opposite of what was happening in the western countries.

Imperfect accounting standards and opaque balance sheets served as tools for hiding the shortcomings and failing to reveal the progressive deterioration and structural weakness of the country's banking institutions to public view. This enabled the nationalized banks to continue to flourish in a deceptive manifestation and false glitter, though stray symptoms of the brewing ailment were discernable here and there.

The government hastily introduced the first phase of reforms in the financial and banking sectors after the economic crisis of 1991. This was an effort to quickly resurrect the health of the banking system and bridge the gap between Indian and global banking development. Indian Banking, in particular PSB’s suddenly woke up to the realities of the situation and to face the burden of the surfeit of their woes.

Simultaneously major revolutionary transitions were taking place in other sectors of the economy on account the ongoing economic reforms intended towards freeing the Indian economy from government controls and linking it to market driven forces for a quick integration with the global economy. Import restrictions were gradually freed. Tariffs were brought down and quantitative controls were removed. The Indian market was opened for free competition to the global players. The new economic policy in turn revolutionaries the environment of the Indian industry and business and put them to new mixture of opportunities and challenges. As a result we witness today a scenario of banking, trade and industry in India, all undergoing the convulsions of total reformation battling to kick off the decadence of the past and to gain a new strength and vigor for effective links with the global economy. Many are still languishing unable to get released from the old set-up, while a few progressive corporate are making a niche for themselves in the global context.

During this decade the reforms have covered almost every segment of the financial sector. In particular, it is the banking sector, which experienced major reforms. The reforms have taken the Indian banking sector far away from the days of nationalization. Increase in the number of banks due to the entry of new private and foreign banks; increase in the transparency of the banks' balance sheets through the introduction of prudential norms and norms of disclosure; increase in the role of the market forces due to the deregulated interest rates, together with rapid computerization and application of the benefits of information technology to banking operations have all significantly affected the operational environment of the Indian banking sector.

In the background of these complex changes when the problem of NPA was belatedly recognized for the first time at its peak velocity during 1992-93, there was resultant chaos and confusion. As the problem in large magnitude erupted suddenly banks were unable to analyze and make a realistic or complete assessment of the surmounting situation. It was not realized that the root of the problem of NPA was cantered elsewhere in multiple layers, as much outside the banking system, more particularly in the transient economy of the country, as within. Banking is not a compartmentalized and isolated sector delinked from the rest of the economy. As has happened elsewhere in the world, a distressed national economy shifts a part of its negative results to the banking industry.

In short, banks are made ultimately to finance the losses incurred by constituent industries and businesses. The unprepared ness and structural weakness of our banking system to act to the emerging scenario and de-risk itself to the challenges thrown by the new order, trying to switch over to globalization were only aggravating the crisis. Partial perceptions and hasty judgments led to a policy of ad-hoc-ism, which characterized the approach of the authorities during the last two-decades towards finding solutions to banking ailments and dismantling recovery impediments. Continuous concern was expressed. Repeated correctional efforts were executed, but positive results were evading. The problem was defying a solution.

The threat of NPA was being surveyed and summarized by RBI and Government of India from a remote perception looking at a bird's-eye-view on the banking industry as a whole delinked from the rest of the economy. RBI looks at the banking industry's average on a macro basis, consolidating and tabulating the data submitted by different institutions. It has collected extensive statistics about NPA in different financial sectors like commercial banks, financial institutions, urban cooperatives, NBFC etc. But still it is a distant view of one outside the system and not the felt view of a suffering participant. Individual banks inherit different cultures and they finance diverse sectors of the economy that do not possess identical attributes. The scenario is not so simple to be generalized for the industry as a whole to prescribe a readymade package of a common solution for all banks and for all times.

GLOBAL DEVELOPMENTS AND NPAs

The core banking business is of mobilizing the deposits and utilizing it for lending to industry. Lending business is generally encouraged because it has the effect of funds being transferred from the system to productive purposes, which results into economic growth. However lending also carries credit risk, which arises from the failure of borrower to fulfill its contractual obligations either during the course of a transaction or on a future obligation.

A question that arises is how much risk can a bank afford to take? Recent happenings in the business world -Enron, WorldCom, Xerox, Global Crossing do not give much confidence to banks. In case after case, these giant corporate becan1e bankrupt and failed to provide investors with clearer and more complete information thereby introducing a degree of risk that many investors could neither anticipate nor welcome. The history of financial institutions also reveals the fact that the biggest banking failures were due to credit risk. Due to this, banks are restricting their lending operations to secured avenues only with adequate collateral on which to fall back upon in a situation of default.

REASONS FOR THE EXISTENCE OF HUGE LEVEL OF NPAS IN THE INDIAN BANKING SYSTEM (IBS):

The origin of the problem of burgeoning NPA's lies in the quality of managing credit risk by the banks concerned. What is needed is having adequate preventive measures in place namely, fixing pre-sanctioning appraisal responsibility and having an effective post-disbursement supervision. Banks concerned should continuously monitor loans to identify accounts that have potential to become non-performing.

To start with, performance in terms of profitability is a benchmark for any business enterprise including the banking industry. However, increasing NPA's have a direct impact on banks profitability as legally banks are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets as per the Reserve Bank of India (RBI) guidelines. Also, with increasing deposits made by the public in the banking system, the banking industry cannot afford defaults by borrowers since NPA's affects the repayment capacity of banks. Further, Reserve Bank of India (RBI) successfully creates excess liquidity in the system through various rate cuts and banks fail to utilize this benefit to its advantage due to the fear of burgeoning non-performing assets.

Some of the reasons are:

- After the nationalization of banks sector wise allocation of credit disbursements became compulsory.

- Banks were compelled to give credit to even those sectors, which were not considered to be very profitable, keeping in mind the federal policy.
- People in the agricultural sector were hardly interested in returning the loans as they were confident that the loans with the interest would be written off by the successive governments.
- The small scale industries also availed credit even though they were not sure of performing to the extent of returning the loans.
- Banks were also not in the position to press enough securities to cover the loans in calls of timings.
- Even if the assets were provided they proved to be substandard assets as the values that could be realized were very low.
- The slackness in effort by the bank authorities to collect or recover loan advances in time also contributes to the increase in NPA's.
- Lack of accountability of the officers, who sanctioned the loans led to a caste whole approach by the officers recovering the loans.
- Loans sanctioned to under servicing candidates due to pressure from the ministers and other politicians also led to the non recovery of debts.
- Poor credit appraisal system, lack of vision while sanctioning credit limits.
- Lack of proper monitoring.
- Reckless advances to achieve the budgetary targets.
- Lack of sincere corporate culture, inadequate legal provisions on foreclosure and bankruptcy.
- Change in economic policies/environment.
- Lack of co-ordination between banks.

Some of the internal factors of the organization leading to NPA's are:

- Division of funds for expansion, diversification, modernization, undertaking new projects and for helping associate concerns, this is coupled with recessionary trends and failure to tap funds in the capital and debt markets.
- Business failure(product, marketing etc.,),inefficient management, strained labor relations, inappropriate technology, technical problems, product obsolescence etc.,
- Recession , shortage of input, power shortage, price escalation, accidents, natural calamities, besides externalization problem in other countries leading to non payment of over dues.
- Time/cost overrun during the project implementation stage.
- Government policies like changes in the excise duties, pollution control orders.
- Willful default, siphoning off of funds, fraud, misappropriation, promoters/directors disputes etc.
- Deficiencies on the part of the banks like delay in release of limits and delay in release of payments/subsidies by the government.

Asset Classification
Categories of NPAs

(1) Standard Assets

(2) Sub-Standard Assets

(3) Doubtful Assets

(4) Loss Assets

(1) **Standard Assets:**

Standard assets are the ones in which the bank is receiving interest as well as the principal amount of the loan regularly from the customer. Here it is also very important that in this case the arrears of interest and the principal amount of loan do not exceed 90 days at the end of financial year. If asset fails to be in category of standard asset that is amount due more than 90 days then it is NPA and NPAs are further need to classify in sub categories.

(2) **Sub-standard Assets:**
With effect from 31 March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 month. The following features are exhibited by substandard assets: the current net worth of the borrowers / guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full; and the asset has well-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.

(3) **Doubtful Assets:**
A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.
With effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months.

(4) **Loss Assets:**
A loss asset is one which 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. Also, these assets would have been identified as 'loss assets' by the bank or internal or external auditors or the RBI inspection but the amount would not have been written-off wholly.

IMPACT OF NPA

- **Profitability:-**

NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client. Because of the money getting blocked the prodigality of bank decreases not only by the amount of NPA but NPA lead to opportunity cost also as that much of profit invested in some return earning project/asset. So NPA doesn't affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low ROI (return on investment), which adversely affect current earning of bank.

- **Liquidity:-**

Money is getting blocked, decreased profit lead to lack of enough cash at hand which lead to borrowing money for shot\rtes period of time which lead to additional cost to the company. Difficulty in operating the functions of bank is another cause of NPA due to lack of money. Routine payments and dues.

- **Involvement of management:-**

Time and efforts of management is another indirect cost which bank has to bear due to NPA. Time and efforts of management in handling and managing NPA would have diverted to some fruitful activities, which would have given good returns. Now day's banks have special employees to deal and handle NPAs, which is additional cost to the bank.

- **Credit loss:-**

Bank is facing problem of NPA then it adversely affect the value of bank in terms of market credit. It will lose its goodwill and brand image and credit which have negative impact to the people who are putting their money in the banks.

PROBLEMS DUE TO NPA

1. Owners do not receive a market return on their capital .in the worst case, if the banks fails, owners lose their assets. In modern times this may affect a broad pool of shareholders.

2. Depositors do not receive a market return on saving. In the worst case if the bank fails, depositors lose their assets or uninsured balance.

3. Banks redistribute losses to other borrowers by charging higher interest rates, lower deposit rates and higher lending rates repress saving and financial market, which hamper economic growth.

4. Nonperforming loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital, and by extension, labor and natural resources.

Nonperforming asset may spill over the banking system and contract the money stock, which may lead to economic contraction. This spillover effect can channelize through liquidity or bank insolvency:

a) When many borrowers fail to pay interest, banks may experience liquidity shortage. This can jam payment across the country.

b) Illiquidity constraints bank in paying depositors

c) Undercapitalized banks exceed the bank's capital base.

'Out of Order' status*:*

An account should be treated as ***'out of order'*** if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for six months as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as **'out of order'**.

'Overdue':

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

PREVENTIVE MEASUREMENT FOR NPA

- **EARLY RECOGNITION OF THE PROBLEM**

Invariably, by the time banks start their efforts to get involved in a revival process, it's too late to retrieve the situation- both in terms of rehabilitation of the project and recovery of bank's dues. Identification of weakness in the very beginning that is: When the account starts showing first signs of weakness regardless of the fact that it may not have become NPA, is imperative. Assessment of the potential of revival may be done on the basis of a techno-economic viability study.

Restructuring should be attempted where, after an objective assessment of the promoter's intention, banks are convinced of a turnaround within a scheduled timeframe. In respect of totally unviable units as decided by the bank, it is better to facilitate winding up/ selling of the unit earlier, so as to recover whatever is possible through legal means before the security position becomes worse.

- **IDENTIFYING BORROWERS WITH GENUINE INTENT**

Identifying borrowers with genuine intent from those who are non- serious with no commitment or stake in revival is a challenge confronting bankers. Here the role of frontline officials at the branch level is paramount as they are the ones who has intelligent inputs with regard to promoters' sincerity, and capability to achieve turnaround. Based on this objective assessment, banks should decide as quickly as possible whether it would be worthwhile to commit additional finance.

In this regard banks may consider having **"Special Investigation"** of all financial transaction or business transaction, books of account in order to ascertain real factors that contributed to sickness of the borrower. Banks may have penal of technical experts with proven expertise and track record of preparing techno-economic study of the project of the borrowers.

Borrowers having genuine problems due to temporary mismatch in fund flow or sudden requirement of additional fund may be entertained at branch level, and for this purpose a special limit to such type of cases should be decided. This will obviate the need to route the additional funding through the controlling offices in deserving cases, and help avert many accounts slipping into NPA category.

- **TIMELINESS AND ADEQUACY OF RESPONSE**

Longer the delay in response, grater the injury to the account and the asset. Time is a crucial element in any restructuring or rehabilitation activity. The response decided on the basis of techno-economic study and promoter's commitment, has to be adequate in terms of extend of additional funding and relaxations etc. under the restructuring exercise. The package of assistance may be flexible and bank may look at the exit option.

- **FOCUS ON CASH FLOWS**

While financing, at the time of restructuring the banks may not be guided by the conventional fund flow analysis only, which could yield a potentially misleading picture. Appraisal for fresh credit requirements may be done by analysing funds flow in conjunction with the Cash Flow rather than only on the basis of Funds Flow.

- **MANAGEMENT EFFECTIVENESS**

The general perception among borrower is that it is lack of finance that leads to sickness and NPAs. But this may not be the case all the time. Management effectiveness in tackling adverse business conditions is a very important aspect that affects a borrowing unit's fortunes. A bank may commit additional finance to an aling unit only after basic viability of the enterprise also in the context of quality of management is examined and confirmed. Where the default is due to deeper malady, viability study or investigative audit should be done – it will be useful to have consultant appointed as early as possible to examine this aspect. A proper techno economic viability study must thus become the basis on which any future action can be considered.

- **MULTIPLE FINANCING**

A. During the exercise for assessment of viability and restructuring, a **Pragmatic and unified approach** by all the lending banks/ FIs as also sharing of all relevant information on the borrower would go a long way toward overall success of rehabilitation exercise, given the probability of success/failure.

B. In some default cases, where the unit is still working, the bank should make sure that **it captures the cash flows** (there is a tendency on part of the borrowers to switch bankers once they default, for fear of getting their cash flows forfeited), and ensure that such cash flows are used for working capital purposes. Toward this end, there should be regular flow of information among consortium members. A bank, which is not part of the consortium, may not be allowed to offer credit facilities to such defaulting clients. Current account facilities may also be denied at no consortium banks to such clients and violation may attract penal action. The **Credit Information Bureau of India Ltd. (CIBIL)** may be very useful for meaningful information exchange on defaulting borrowers once the setup becomes fully operational.

C. In a forum of lenders, the priority of each lender will be different. While one set of lenders may be willing to wait for a longer time to recover its dues, another lender may have a much shorter timeframe in mind. So it is possible that the letter categories of lenders may be willing to exit, even a t a cost – by a discounted settlement of the exposure. Therefore, any plan for restructuring/rehabilitation may take this aspect into account.

D. Corporate Debt Restructuring mechanism has been institutionalized in 2001 to provide a timely and transparent system for restructuring of the corporate debt of Rs. 20crore and above with the banks and FIs on a voluntary basis and outside the legal framework. Under this system, banks may greatly benefit in terms of restructuring of large standard accounts and viable sub-standard accounts with consortium/multiple banking arrangements.

CONCLUSION

It was a great learning experience and a period of value addition in terms of knowledge instilled. Some of my leanings are:

- I got an insight that with increasing globalization and with diversified ownership where credit rating agencies constantly review the strength of banks, managing the level of NPAs becomes very critical. It is a fact that the most critical condition for bringing about an improvement in the profitability of banks is a reduction in the level of non-performing assets. In view of this, the RBI along with the Government has initiated several institutional measures to contain the levels of NPAs.

- During the period, I learnt about the banking industry, its history, deficiencies, composition, RBI guidelines as well as present and the future potential of this particular industry.

- The project provided with the information regarding the monitoring system used by the banks for monitoring NPAs, the performance of various Indian banks in the wake of their NPA management techniques, the process of NPA recovery, their risk management techniques and various measures adopted by banks for reduction of NPAs.

- As I have undergone the process of research in a systematic way, I clearly understood how to carry out a research. I understood various aspects of research in a more practical manner, starting from identifying a problem to eliciting the solutions to that problem.

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