

NPA Management – Always a Critical Issue for Banking Industry

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Abstract

After the prologue of financial sector reforms in India, the non-performing assets of the banking industry have been getting highly focused attention. Non-performing Asset (NPA) has emerged since over a decade as an alarming threat to the banking industry in our country sending distressing signals on the sustainability and endurability of the affected banks. Therefore, the question of NPA in banks is a cause of worry to all concerned, may it be the management of banks, the government, industry, federation of the public at large. The NPAs have direct impact on banks' profitability, liquidity and equity. The NPAs of Indian Banks are relatively huge by international standard. Therefore, the biggest ever challenge that the banking industry now faces is management of NPAs. It is true that banks have to restrict their lending operations to secured advances only with adequate collateral securities, because NPA is an important parameter in the analysis of financial performance of banks.

- I. On the one hand income from the NPA account will not be received therefore it cannot be reckoned in the profit and loss account.*
- II. On the other hand banks will have to create provisions for the amount involved in the NPA accounts.*

Keywords: *NPA, Financial reforms, Banking industry, Efficiency, Profitability, Capital Adequacy ratio, Liquidity*

Meaning and Introduction

The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 hence the problem of credit management. While the primary function of banks is to lend funds to various sectors such as agriculture, industry, personal loans, housing loans etc., in recent times they have become very cautious in extending loans, the reason being mounting non-performing assets (NPAs). An NPA is defined as a loan asset, which has ceased to generate any income for a bank whether in the form of interest or principal repayment. The issue of Non-Performing Assets (NPAs) in the financial sector has been an area of concern for all economies and reduction in NPAs has become synonymous with functional efficiency of financial intermediaries. 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 they have been actually received. Therefore, this has become a 'critical performance area' of the banking sector as the level of NPAs affects the profitability of a bank. Therefore, an NPA account not only reduces profitability of banks by provisioning in the profit and loss account, but also increases their carrying cost which results in excess and avoidable management attention. Apart from this, a high level of NPA also puts strain on a bank's net worth because banks are under pressure to maintain a desired level of Capital Adequacy and in the absence of comfortable profit level, they eventually look to their internal financial strength to fulfil the norms thereby slowly eroding their net worth.

Following is a definition of Non-performing assets: -

- An asset becomes Non-performing when it ceases to generate income for a Bank.
- It is also a credit facility in respect of which the interest and/or instalments of principal have remained 'past due' for a specified period of "two quarters".

Presence of NPAs indicates asset quality of the balance sheet and hence future income generating prospects. This also requires provisioning which has implications with respect to capital adequacy. Declining capital adequacy adversely affects shareholder value and restricts the ability of the bank/institution to access the capital market for additional equity to enhance capital adequacy. If this happens for a large number of financial intermediaries, then, given that there are large inter-bank transactions, there could be a domino kind of effect. Low capital adequacy will also severely affect the growth prospects of banks and institutions. The level of NPA acts as an indicator showing the bankers' credit risks and efficiency of allocation of resources, because it is a loan which is due or outstanding from the customer within a stipulated time. Or in other words Non- Performing Asset is a result of asset liability mismatch. Accounting treats NPA as an asset because it indicates the amount receivable from the defaulters.

Non-performing assets, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest are not being made on time. Loan is an asset for a bank as the interest payments and the repayment of the principal create a stream of cash flows. It is from the interest payments that a bank makes its profits. Banks usually treat assets as non-performing if they are not serviced for some time; if payments are late for a short time a loan is classified as past due. Bank Assets are classified into two categories

Performing assets - are those assets on which interest or instalments are correctly paid by a customer within prescribed time.

Non-performing assets - are those assets on which interest or instalments have not been paid for a period of more than 180 days.

The following example will explain this technical jargon of banking and financial industry. A bank gave a loan to a businessman to start business and Rs 50,000 instalment is fixed per month. But the business went into losses or the businessman was a cheat and did not pay any amount back to the bank. In this case the bank has a certain time limit by which it starts getting its recovery. But if not by then the

bank's capital is finished. This amount is called NPA.

Why NPA needs attention in Indian Banking Industry: -

NPAs are a serious strain on the profitability as, on the one hand, the banks cannot book income on such accounts and on, the other they are required to charge the funding cost and provision requirement to their profits. The problem of NPAs is multi-dimensional and unless it is checked and the NPA level is brought down to the international standard of 2 to 3% of the total loan assets, it is bound to weaken the banking industry. No wonder NPA has, become an important term in the banking industry now a days, because the aforesaid factors have far-reaching implications on the bottom lines of the banks which are already undergoing the rigours of the reform process.

NPA management has, now become an important term for better thinking in Indian banking industry after the globalization and liberalization of Indian economy. At present the NPA level in Indian banks as compared to foreign banks is much higher. If we talk about gross NPA level then it is 5 or 6% more than foreign banks. So it is now necessary for Indian banks to come up with international standards and to try to bring down the NPA level. The following table gives an indication of the NPA in the various categories of Indian banks for the past 5 years.

Table 1: Non-Performance Assets as Percentage of Total Assets (in %)

S.N.	Bank	Gross NPAs / Total					AssetsNet NPAs / Total Assets				
		04-05	05-06	06-07	07-08	08-09	04-05	05-06	06-07	07-08	08-09
1	Nationalized Banks	3.0	2.2	1.6	1.3	1.1	0.9	0.6	0.5	0.4	0.4
2	State Banks	2.5	1.8	1.6	1.5	1.4	1.0	0.9	0.8	0.8	0.8
3	Private Banks	2.1	1.4	1.2	1.4	1.7	1.0	0.6	0.5	0.6	0.7
4	New Private Banks	1.6	1.0	1.1	1.4	1.8	0.8	0.4	0.5	0.7	0.8
5	Foreign Banks	1.4	1.0	0.8	0.8	1.5	0.4	0.4	0.3	0.3	0.7

(Source – Report on trend and progress of Banking in India, Reserve Bank of India)

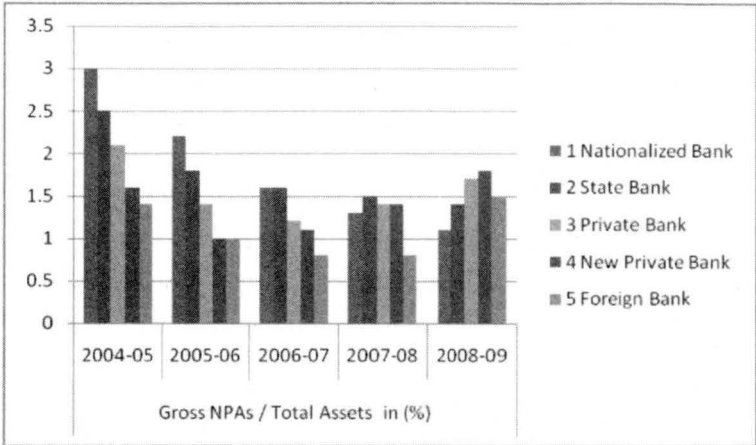


Figure 1. Level of Gross NPA

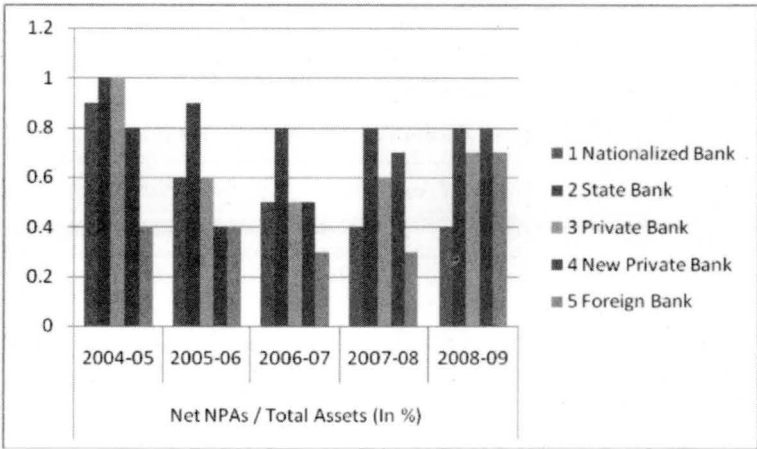


Figure 2. Level of Net NPA

It is clear from the above table, that the level of NPAs in the nationalized banks and public sector banks, which provide the major portion of bank credit, is much higher than that in new generation private banks, and foreign banks operating in India. But even the gross and net NPA levels of all banks are now showing an improving trend as compared with the starting years of data table.

A different thing which comes out from the table is that state banks and nationalized banks have shown tremendous improvement in gross level of their NPA as well as Net level. It always came down from the beginning years. For example, the gross and net NPA of nationalized banks were 3% and .9%, in the year 2004-05 but came to 1.1% and .4% respectively in the year 2008-09. Equally the State bank group has reduced the level of its NPA. This shows the signs of efficiency in these banks, but the other group of banks including foreign banks and all private banks has shown a fluctuating trend, for the last 2 years the level of nonperforming assets has touched

an upward level in percentage. The high incidence of NPAs in these banks has resulted in a lower return on advances; even the loss of yield on advances is adversely affecting the profitability of banks. Thus NPA management has become very important to banks for their survival and they need to adopt some scientific techniques for it.

Reasons for an asset turning NPA

There are various reasons, behind an asset turning NPA. Here it may be very important to understand that only the borrower is not always at fault. At times, systemic faults can also adversely affect the profitability of financial intermediaries. The following discussion will clarify various reasons of NPA -

1. Reasons from the economy side

- Political – mindset regarding paradigm, proactive, fiscally responsible (national income accounts)
- Economic – growth, distribution, efficient allocation of resources
- Social – acceptability, mobility, education
- Technological – advances in use of IT
- Legal – enforceability of loan contracts
- Environmental – liberalization and globalization

2. Reasons from the industry side -

- Global competition
- Cyclical downswing
- Sunset industry
- Frequent changes in regulatory norms

3. Reasons from the borrower's side

- Misconceived project
- Poor governance
- Product failure
- Inefficient management
- Diversion of funds
- Dormant capital market
- Regulatory changes

4. Reasons from the banking system side

- Parameters set for their functioning were deficient: incorrect goal perception and identification – lazy banking.
- Directed banking and lack of freedom to choose products and pricing.
- Lack of systems and procedures – audit and inspections.
- Banks lacked the ability to handle enormous growth in liabilities and assets.
- Lack of a mechanism of credit information dissemination.

- Lack of an effective judicial system for recovery from defaulters.
- Collateral based lending leading to idle assets.
- Lack of an effective IT system and MIS.

5. Reasons from the loan structuring side

- High debt equity ratio
- Timing of raising equity
- Discrepancy between the rate of interest charged and the realistic rate of return
- Inconsistency between revenue generation and the loan repayment schedule
- Lack of binding penal clauses and performance guarantees

6. Reasons from the security side – collateral vs cash flow

There is a tendency among banks and institutions to depend excessively on collateral for advancing loans. While this is important, it presumes from the very beginning that the borrower would default and the security would need to be encashed for recovery of the loan. Clearly, this logic is unacceptable. Emphasis should then be on cash generation and a charge on this should be built into the loan contract through some escrow mechanism.

7. Reasons from the regulatory side

Frequent regulatory changes can turn assets non-performing. Accounting reason like reduction in income recognition norms from 180 days to 90 days could be one such reason. Pollution related issues could be the other reason. Distance between two sugar mills could be a third.

Recommendations for NPA Management:

We make the following recommendations for the management of NPA.

1. Adoption of a sound credit granting process.
2. Building a sound and reliable MIS.
3. Establishing a tested credit risk evaluation model with features for risk assessment in dynamic market conditions.
4. Evolving policies with a focus and thrust on sound risk management system.
5. Proper control mechanisms and feedback analysis for corrective actions.
6. Eliminating the fear psychosis and creating a climate of confidence through proper motivation and creating a healthy environment based on trust and confidence.
7. Setting NPA management as the organizational goal and ensuring that the spirit pervades all through the organization.
8. Monitoring of assets on an on – going basis with intelligence of the industry to which the borrower belongs and in initiating a preliminary trouble shooting exercise.

For better management of NPAs, it is useful to first assess the causative factors for

accounts turning into NPAs and then take suitable steps for corrective actions. Normally, the following are the causes of an account turning into an NPA –

1. Diversion of funds, mostly for the expansion/ diversification of business or for promoting associate concerns.
2. Factors internal to business like product / marketing failure, inefficient management, inappropriate technology, labour unrest.
3. Changes in the macro – environment like recession in the economy etc.
4. Inadequate control / supervision, leading to time / cost overruns during project implementation.
5. Changes in govt polices like import duties etc.
6. Deficiencies like delay in the release of limits / funds by banks/ FIs.
7. Willful defaults, siphoning of funds, frauds, misappropriation, promoters/ management's dispute.
8. Intention of the borrower.
9. Industrial or economic trend.
10. Health of the unit (viability of the unit, management expertise, experience etc)
11. Absence of the upgradation of unit / plugging back of the profit.

Conclusion

Presence of NPAs indicates asset quality of the balance sheet of a bank/institution and hence future income generating prospects. This also requires provisioning which has implications with respect to capital adequacy. Declining capital adequacy adversely affects shareholder value and restricts the ability of the bank/institution to access the capital market for additional equity to enhance capital adequacy. Thus, if a resolution strategy for recovery of dues from NPAs is not put in place quickly and efficiently, these assets would deteriorate in value over time and little value would be realized at the end, except may be its scrap value.

Therefore, to solve the problems of existing NPAs, quality of appraisal supervision and follow up should be improved. The NPAs can be avoided at the initial stage of credit consideration by putting rigorous and appropriate credit appraisal mechanism. In order to recover the NPA debt, the judicial system should be revamped and it is essential to enforce the SARFAESI Act with more stringent provisions to realize the securities and personal assets of the defaulters. NPA is a crucial problem for the banking industry now a days, after current US recession, Indian banking industry is very much concerned to reduce the level of nonperforming assets. The simplified reason is adverse affect on the level of profitability and efficiency of banks. Instantly the Government and the RBI need to come with effective measures to reduce the level of NPA. It is highly impossibility to have zero percentage of nonperforming assets in banking industry, but at least new Indian banks can try to maintain international standards for NPA.

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