CHAPTER 6
IMPACT AND CAUSES FOR OCCURRENCE OF NPAS.
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6.1 From the foregoing chapters on NPAs it is proven beyond doubt that NPA eats out into the profits of the banks, highlights inefficiency, affects liquidity and in general the overall financial health of the organisation. A recent case which highlights this fact is the dwindling of profits of SBI for the year 2010 which reduced to a mere 22 crores from 1800 crores due to provisioning and write offs of NPAs.

6.2 IMPACT OF NPAS:

6.2.1 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.

6.2.2 Liquidity:

Money is getting blocked; decreased profit leads to lack of enough cash at hand which leads to borrowing money for shortest period of time which leads to additional cost to the company. Difficulty in operating the functions of bank is another impact of NPA due to lack of money to make routine payments and dues.

6.2.3 Involvement of Management:

Time and efforts of management is another indirect cost which banks have to bear due to NPA. Time and efforts of management in handling and managing NPA could have been diverted to some fruitful activities, which would have given good returns. Nowadays banks have special departments to deal and handle NPAs, which is additional cost to the bank.
6.2.4 Credit losses:

If the Bank is facing problem of NPA, then it adversely affects the value of bank in terms of market credit. It will lose its goodwill and brand image. The efficiency of a bank is not reflected only by the size of its balance sheet but also the level of return on its assets. The NPAs do not generate interest income for banks but at the same time banks are required to provide provisions for NPAs from their current profits. The contaminated portfolio is definitely a bane for any bank. It puts severe dent on the liquidity and profitability of the bank where it is out of proportion. The NPAs in the public sector banks are well above the normal level. The consequences envisaged during the past several years are many. It has become a difficult task for the banks to reduce the lending rate due to the presence of large NPAs. Ultimately this is affecting the competitiveness of the Indian banks. When the bank does not enjoy the market competitiveness naturally the credit expansion would be slumped and when it happens, the profitability gets a set back. In this way the vicious circle will go on and on. Another important one is the reduction in the availability of funds for further expansion due to the unproductiveness of the existing portfolio. Sometimes it is found that the presence of large NPAs discourages banks to accept profitable but risky proposal loan from the customers. The NPAs also affect the risk taking ability of the banks. On the whole it affects the credibility of the bank and faces difficulty in raising fresh capital from the market for future requirements.

6.2.5 The NPAs have delirious impact on the return on assets in the following ways.

A) The interest income of banks will fall and it is to be accounted only on receipt basis.
B) Banks profitability is affected adversely because of the providing of doubtful debts and consequent to writing it off as bad debts
C) Return on investments (ROI) is reduced.
D) The capital adequacy ratio is disturbed as NPAs are entering into its calculation.
E) Cost of capital will go up.
F) The assets and liability mismatch will widen.
4G) The economic value addition (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital

H) It limits recycling of the funds. It is due to above factors the public sector banks are faced with bulging NPAs which results in lower income and higher provisioning for doubtful debts and it will make a dent in their profit margin. In this context of crippling effect on banks operation the slew asset quality is placed as one of the most important parameters in the measurement of banks performance under the Camel’s supervisory rating system of RBI.

NPAs are largely a fall out of banks' activities with regard to advances, both at the management and implementation levels (including overall controls by the top management), the credit appraisal system, monitoring of end-usage of funds and recovery procedures. *(Chart 6.1- Life cycle of NPA)*

(Source: Project report at N. I. F. M., Ahmedabad)

It also depends on the overall economic environment, the business cycle and the legal environment for recovery of defaulted loans. Since the overall environment is more or less same for all banks, non-performing loans of individual banks are mainly a result of management controls and systems put in place by them.

6.2.6 A bank with an efficient credit appraisal and loan recovery system will grow stronger over the years. Such banks have good management control and also inherent strengths in
terms of a highly motivated staff, good checks and balances, which are further enhanced by a regulatory and supervisory system.

6.2.7 As the growth in advances is largely determined by the economic and business environment, such banks will be able to push their credit portfolio aggressively, especially when the economy is booming. Also, as such banks have a diversified credit portfolio, it would act as a cushion during economic downturns. This will result in lower NPAs, allowing them to grow stronger and even adopt a more aggressive growth strategy and, thereby, withstand marginally higher incidences of default.

6.2.8 However, a bank without inherent strengths will not be able to push their credit portfolio the way they want to. They are characterised by poor management control, inadequate credit appraisal and even low levels of motivation among the staff. When such banks push their advances portfolio, chances of their asset quality deteriorating are higher.

6.2.9 Since asset quality will be visible only after credit disbursal, which itself depends on the regulatory definition of NPAs, any deterioration will be reflected after a time lag. Thus, banks without inherent strength will have higher NPA levels, especially when the economy has seen above average credit growth.

6.3 FACTORS AFFECTING NPAS

6.3.1 General environmental factors: These include business cycles, the legal framework, ethical standards, the regulatory and supervisory system, and the political environment.

6.3.2. Bank specific factors: The credit appraisal system; credit recovery procedures; controls, checks and balances adopted by the top management; the risk management system in place; and the motivation level of staff.

Thus, for both healthy and not-so-healthy banks, asset quality after an above average credit growth has a major effect on NPAs. One way to capture the effect of deterioration in the asset quality is to consider cumulative growth rates of credit, which also captures the time-lag effect of credit migration.
6.4 REASONS FOR AN ACCOUNT BECOMING NPA: (Chart 6.2)

6.4.1 CUSTOMERS:

a) Failure to bring in Required capital
b) Too ambitious project
c) Longer gestation period
d) Unwanted Expenses
e) Over trading
f) Imbalances of inventories
g) Lack of proper planning
h) Dependence on single customers
i) Lack of expertise
j) Improper working Capital Mgmt.
k) Mis management
l) Diversion of Funds
m) Poor Quality Management
n) Heavy borrowings
o) Poor Credit Collection
p) Lack of Quality Control
6.4.2 BANKS:
   a) Wrong selection of borrower
   b) Poor Credit appraisal
   c) Unhelpful in supervision
   d) Tough stand on issues
   e) Too inflexible attitude
   f) Systems overloaded
   g) Non inspection of Units
   h) Lack of motivation
   i) Delay in sanction
   j) Lack of trained staff
   k) Lack of delegation of work
   l) Sudden credit squeeze by banks
   m) Lack of commitment to recovery
   n) Lack of technical personnel & zeal to reduce recoveries

6.4.3 OTHERS:
   a) Lack of Infrastructure
   b) Fast changing technology
   c) Unhelpful attitude of Government
   d) Changes in consumer preferences
   e) Increase in material cost
   f) Government policies
   g) Credit policies
   h) Taxation laws
   i) Civil commotion
   j) Political hostility
   k) Sluggish legal system
   l) Changes related to Banking amendment
CLASSIFICATION ON THE BASIS OF ORIGIN:

1 Internal factors

2. External factors

6.5.1 Internal factors:

1) Funds borrowed for a particular purpose but not use for the said purpose.

2) Project not completed in time.

3) Poor recovery of receivables.

4) Excess capacities created on non-economic costs.

5) In-ability of the corporate to raise capital through the issue of equity or other debt instrument from capital markets.

6) Business failures.

7) Diversion of funds for expansion\modernization\setting up new projects\ helping or promoting sister concerns.

8) Wilful defaults, siphoning of funds, fraud, disputes, management disputes, mis-appropriation etc.

9) Deficiencies on the part of the banks viz. in credit appraisal, monitoring and follow-ups, delaying settlement of payments\subsidiaries by government bodies etc.,

6.5.2 External factors:

1) Legal reasons:
   
   - Sluggish legal system.
   
   - long legal tangles
   
   - Changes that had taken place in labour laws
   
   - Lack of sincere effort.
2) Scarcity of raw material, power and other resources.

3) Industrial recession.

4) Shortage of raw material, raw material\input price escalation, power shortage, industrial recession, excess capacity, natural calamities like floods, accidents.

5) Failures, non-payment\recession in other countries, externalization problems, adverse exchange rates etc.

6) Government policies like excise duty changes, Import duty changes etc.,

Based on the above, we can summarize the finer factors contributing to higher level of NPAs in the Indian banking sector as:

- Diversion of funds, which is for expansion, diversification, modernization, undertaking new projects and for helping associate concerns. This is also coupled with recessionary trends and failures to tap funds in capital and debt markets.

- Business failures (such as product, marketing etc.), which are due to inefficient management system, strained labour relations, inappropriate technology/technical problems, product obsolescence etc.

- Recession, which is due to input/power shortage, price variation, accidents, natural calamities etc. The externalization problems in other countries also lead to growth of NPAs in Indian banking sector.

- Time/cost overrun during project implementation stage.

- Governmental policies such as changes in excise duties, pollution control orders etc.

- Wilful defaults, which are because of siphoning-off funds, fraud/misappropriation, promoters/directors disputes etc.

- Deficiency on the part of banks, viz, delays in release of limits and payments/subsidies by the Government of India.
6.6 EARLY SYMPTOMS:

There are some warning signals which the bank can never afford to ignore if they have to effectively tackle their NPAs

6.6.1) Financial:

- Non-payment of the very first instalment in case of term loan.
- Bouncing of cheque due to insufficient balance in the accounts.
- Irregularity in instalment.
- Irregularity of operations in the accounts.
- Unpaid overdue bills.
- Declining Current Ratio.
- Payment which does not cover the interest and principal amount of that instalment.
- While monitoring the accounts if it is found that partial amount is diverted to sister concern or parent company.

6.6.2) Operational and Physical:

- If information is received that the borrower has either initiated the process of winding up or are not doing the business.
- Overdue receivables.
- Stock statement not submitted on time.
- External non-controllable factor like natural calamities in the city where borrower conduct his business.
- Frequent changes in plan.
- Non payment of wages.
6.6.3) Attitudinal Changes:

a) Use for personal comfort, stocks and shares by borrower.

b) Avoidance of contact with bank.

c) Problem between partners.

6.6.4) Others:

· Changes in Government policies.

· Death of borrower.

· Competition in the market.

Another article (Credit Management by SBI- STC, Hyderabad – Pages 1 to 190) and N.I.B. M. Project reports on NPAs states the following:

Early Warning Signals: It is important in any early warning system, to be sensitive to signals of credit deterioration. A host of early warning signals are used by different banks for identification of potential NPAs. Most banks in India have laid down a series of operational, financial, transactional indicators that could serve to identify emerging problems in credit exposures at an early stage. Further, it is revealed that the indicators which may trigger early warning system depend not only on default in payment of instalment and interest but also other factors such as deterioration in operating and financial performance of the borrower, weakening industry characteristics, regulatory changes, general economic conditions, etc. Early warning signals can be classified into five broad categories viz.

a) Financial

b) Operational

c) Banking

d) Management and e) External factors.

Financial related warning signals generally emanate from the borrowers' balance sheet, income expenditure statement, statement of cash flows, statement of receivables etc.
Following common warning signals are captured by some of the banks having relatively developed EWS

**Financial warning signals**
- Persistent irregularity in the account
- Default in repayment obligation
- Devolvement of LC/invocation of guarantees
- Deterioration in liquidity/working capital position
- Substantial increase in long term debts in relation to equity
- Declining sales
- Operating losses/net losses
- Rising sales and falling profits
- Disproportionate increase in overheads relative to sales
- Rising level of bad debt losses

**Operational warning signals**
- Low activity level in plant
- Disorderly diversification/frequent changes in plan
- Non payment of wages/power bills
- Loss of critical customer/s
- Frequent labour problems
- Evidence of aged inventory/large level of inventory

**Management related warning signals**
- Lack of co-operation from key personnel
- Change in management, ownership, or key personnel
- Desire to take undue risks
- Family disputes leading to lack of attention .
- Poor financial controls
- Fudging of financial statements Diversion of funds.
Banking related signals

- Declining bank balances/declining operations in the account
- Opening of account with other bank
- Return of outward bills/dishonoured cheques
- Sales transactions not routed through the account
- Frequent requests for loan
- Frequent delays in submitting stock statements, financial data, etc.

Signals relating to external factors

- Economic recession
- Emergence of new competition
- Emergence of new technology

This would be clear when we discuss the pattern and reasons for NPAs in the following chapter.