CHAPTER-2

NON-PERFORMING ASSETS AND BANKING PERFORMANCE

2.1 Introduction

The business of banking essentially involves intermediation-acceptance of deposits and channeling these deposits into lending activities. Since the deposits received from the depositors have to be repaid to them by the bank, they are known as banks’ ‘Liabilities’ and as the loan given to the borrowers are to be received back from them, they are termed as banks’ ‘Assets’ so assets are banks’ loans and advances.

In the traditional banking business of lending, financed by deposits from customers, Commercial Banks are faced with the risk of default by the borrower in the payment of either principal or interest. In common parlance the type of risk in banking is known as credit risk and where the borrower is not able to repay the payment of interest and/or repayment of principal are treated as Non-Performing Assets.

According to RBI guidelines, any asset inclusive of a leased asset, becomes non-Performing in case it is not able to generate income for the bank. Presence of Non-Performing Asset is an integral part of banking and every bank has some Non-Performing Assets in its advance portfolio. However, the high level of NPA is a cause of worry to any financial institution.

The banking system is one of the most essential components of a robust economy for any country. India’s banking system is considered as one of the major banking networks in the world. It has witnessed a dynamic period of growth and reform over the last two decades. The banking sector growth and its sustainability can only be achieved if it is following an effective reform policies such as appropriate and effective liberalization policies, appropriate changes in the interest rate suiting international standard, strengthening of its policies of dilution of government stake in public sector banks to make public sector unit independent and competitive, and enhancing growth of market share of private sector banks.
Credit availability is essential for development and growth on the one hand and backbone of the banking structure on the other. Diminishing growth rates for credit with rising NPAs are not good news for the banking system in general. Measures need to be put in place to arrest this downward slide, and the deceleration of lending is definitely not the answer.

The future of the banking system will depend largely on the risk management dynamics and the management of credit risk is the most critical component of that framework. As Indian banks move into the new high-powered world of financial operations and trading, there will be a requirement for more sophisticated and consistent models of risk assessment – as well as post-disbursement monitoring.

Credit risk is about 70% of a bank’s total risk, the rest of the 30% being shared between market risk and operational Risk. Not much can be done about market risk, but operational risk and credit risk must be managed by banks.

As presented in a study done by Standard & Poor’s, mid-corporate and small and medium-sized enterprise (SME) lending are the key areas of challenge for Indian Banks. The non-performing loans of these segments range between 8 – 12% per annum.

There are several key reasons banks possess such a high rate of NPAs – which can be outlined as follows.

- Speculation – Investing in High Risk Assets
- Default
- Fraudulent practices
- Diversion of funds
- Internal factors such as inefficient management, and inappropriate systems and technology
- External factors

Despite the increasing demand for consumer and commercial credit that entices banks with huge potential for growth, there are also the impending challenges that come with lending in a developing economy where data provided may not always be reliable. Deregulation of the financial system and more banking licenses means increased competition and a greater need to outperform competitors. According to RBI news, the
average credit growth rate is at 10% after reaching a low of 9.4% in February (the lowest in 18 years) compared to 14.7% last year, 2014. This is still quite far away from a healthy growth rate which should be in the 15-20% range for a developing country such as India. The private sector banks however, have been more resilient and have had reasonable credit growth from the consumer sector. This sector have also better managed their NPAs in commercial and consumer credit as well.

2.2 Non-Performing Assets: A Concept

In general term, an Assets which generate income are called performing assets and the asset that do not generate income are called non-performing assets. In financial term a non performing asset is explained in term of inability of repayment by the borrowers. Accordingly a simple definition of Non-performing asset (NPA) state that “A credit facility in respect of which the interest and/or installment of Bond finance principal has remained ‘past due’ for a specified period.” Another definition of NPA, as per investopedia, “NPA is a debt obligation where the borrower has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time.”

It can be said that Non Performing Asset (NPA) is not able to give any income to the lender in the form of principal and interest payments. Many research papers, published article, are available in the area of non-performing assets and a large number of researchers have studied the issue of NPA associated with banking industry.

The history of Non-Performing Asset can be traced back from the day of Gold Smith banking in 17th century in England. The asset quality and the problem of bad loan which are generally defined in banking as Non-Performing Asset can be traced back from those period. Historical evidence depict that NPA existed in those period where many Goldsmiths’ failed because they could not fulfill their obligations due to non-recovery of their loan amounts.

The economic crisis of many nation are the result of the non-performing asset due to poor asset quality of bank and lending of bad loan to the borrowers by the bank. In other words, Non-Performing Asset (NPA) refers to a debt obligation of borrower
where he has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time.

The financial institution has classified the non-performing Asset in terms of time and put forth that once the borrower has failed to make interest or principal payments for 90 days, the loan is considered as a non-performing asset. Accordingly this move towards classification of asset and following the international best practices ensure greater transparency, it has been decided to adopt that an asset will become NPA if it is overdue for ‘90 days’ Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) is a loan or an advance where.

i) Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii) The account remains ‘out of order’, for a period of more than 90 days in respect of an Overdraft/Cash Credit (OD/CC),

iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv) 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

v) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

(Source: RBI/2012-13/64 UBD.BPD.(PCB) MC No.3 /09.14.000/2012-13)

The growing proportion of the non-performing assets (NPAs) in the advances of the banks and financial institutions has engaged the attention of the government, bankers, economists and the general public. The NPAs have been described as a misuse of the public money, which should be used with utmost care, and a sense of responsibility.

It has been recognized by all concerned that the growing NPAs can eventually destabilize and perhaps destroy the financial sector of the NPAs. An unstable and weak
financial/banking sector can jeopardize the entire process of economic development because banks have been rightly called as the nerves of economic growth.

The concept of Non-Performing Assets is not altogether unknown to India Banking. Earlier, banks had system of identifying accounts of sticky or causing concern, such accounts were known as problem credits or bad and doubtful debt. In such accounts the repayment of interest /installments was either not easily collected as per schedule or recovery thereof could not fully be effected due to erosion of securities charged to them with continuous application of interest/other charges irrespective of recovery. In either case, banks were subject to losses on account of such credit portfolio.

Partly, this was due to genuine business risks to which lending operations are subject to and partly due to the complacency and security-oriented approach. Through experience, banks found it prudent not to reckon such interest/other charges as part of their income and pay tax on unrealized income. The banks therefore adopted the practice of ceasing to charge interest in such accounts of bad or doubtful nature, and where the prospects of recovery were bleak.

2.3 Non-Performing Assets: An Evolution

The Banks, since 1976, are following well laid down norms regarding treatment to identify bad and doubtful accounts. They have directed to all their branches to cease charging interest on doubtful advances, according to the criteria laid down, irrespective of whether the suits are filed for recovery of the dues or not. The criteria then adopted for the purpose were Nonpayment of the interest applied during the last four relevant periods i.e. month/quarters/half years/years as the case may be. Existence of a provision for bad and doubtful debts or a provision is proposed to be made.

The Reserve Bank of India introduced the Health Code System of classification of borrower accounts by banks in the year 1985, exactly after three years of implementation of the system by Bank under study. Based on this classification of advances it was decided by the Reserve Bank in the year 1989 and 1990 that banks should cease charging interest compulsorily in accounts under Health Codes 5 to 8 i.e. Recalled Suit filed, Decreed and Bad and doubtful and selectively taking into account the availability and reliability of security in accounts under Health Code 4 i.e. Sick Non-viable/Sticky.
Accordingly, banks have been classifying their accounts as per Health Code System and ceasing to recognize income according to the scheme of things envisaged under the system.

The NPA concept introduced by the Reserve Bank in the year 1992 is the outcome of the Narsimham Committee recommendations on financial sector reforms. The Committee observed that the policy of income recognition of the bank should be very objective and it is to be based on record of recovery, rather than any subjective consideration.

The international practice is that an asset is treated as “Non- performing” when interest is overdue for at least two quarters. According to the committee, advances would be treated as non-performing assets, as on the balance sheet date, for the following.

- In the case of term loan, it the interest remains due for a period of more than 180 days.
- In case of overdraft and cash credit, account remains out of order for a period of more than 180 days.
- In case of bills purchased and discounted, the bill remains overdue and unpaid for a period of more than 180 days.
- In case of other accounts, any amount to be received remains past due for a period of more than 180 days.

If we look into the sources of NPAs and there constant rise it can be easily understood that it involves various macroeconomic issues. It may be economic or political reason even factors like natural calamities change in official policies, industry related issues that have their more or less effect. Even internal factors like domestic defaulters, declining production, business risks and unchecked diversions may cause rise in NPA.
2.4 Types of Non-Performing Assets

The non-performing asset (NPAs) has been classified into following two types.

a. *Gross NPA*

Gross NPA is the total number of NPAs of the bank simply added together. Gross NPA is advance, which is considered irrecoverable, for which bank has made provisions, and which is still held in banks 'books of account.

b. *Net NPA*

Net NPA is simply the total bad assets (actual) minus the provision left aside. Net NPA is obtained by deducting items like interest due but not recovered, part payment received and kept in suspense account from Gross NPA.

2.4.1 *Assets and their connection with Non-Performing Assets*

Following are the assets that contribute to NPAs.

*Standard Assets:* A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPA in the real sense. Thus, so special provisions are required for Standard Assets.

*Sub-Standard Assets:* Substandard asset are all those assets (loans and advances) which are considered as non-performing for a period of 12 months are called as Sub-Standard assets.

*Doubtful Assets:* Doubtful asset are those assets considered as non-performing, for period of more than 12 months are called as Doubtful Assets.

*Loss Assets:* All those assets, which cannot be recovered are called as Loss Assets.

2.5 Factors that Rise in Non-Performing Assets

The banking sector is facing the growing problem of NPAs in the recent years. In the recent years, the banking sector has been facing the serious problems of the rising NPAs. A sound banking system is the need for a booming economy. Growing NPAs leads to the failure of the banking sector which may have a strong adverse impact on
other sectors. With the introduction of liberalisation, globalisation and privatisation of economic policy today, banking sector faces the challenges of an open economy.

In a complex situation where on one hand bank has given protected environment which lean them culture on not to develop sophisticated treasury operations and Asset Liability Management skills, and on the other hand all the banks are issued with a combination of directed lending and social banking relegated profitability and competitiveness to the background. The net result was unsustainable leading to the problem of NPA. There are several factors responsible to make an asset NPA. These factors broadly classified into the following two:

I-External factors

II- Internal factors

2.5.1 External Factors

External factors are the factors where owner has no control over them. These factors are discussed in the following lines:

- Ineffective Recovery Tribunal
- Wilful Defaults
- Natural Calamities
- Industrial Sickness
- Lack of Demand
- Change in Government Policies
- Liberalization of Economy/Removal of Restrictions/Reduction of Tariffs
- Lax Monitoring of Credits and Failure to Recognize Early Warning Signals
- Over Optimistic Promoters
- Directed lending
- Highly Leveraged Borrowers
- Funding Mismatch
- High Cost of Funds
- Sluggish legal system
• Scarcity of raw material, power and other resources.
• Industrial recession
• Shortage of raw material, raw material\input price escalation, power shortage, industrial recession, excess capacity, natural calamities like floods, accidents
• Failures, non-payment\over dues in other countries, recession in other countries, externalization problems, adverse exchange rates etc
• Government policies like excise duty changes, Import duty changes etc
• Recession
• Input/power shortage
• Price escalation
• Exchange rate fluctuation
• Accidents and natural calamities
• unwillingness to pay leads to NPA
• domestic problems like death, divorce, illness and marriage of family members
• Financial problems of the party
• Wrong identification of
• Inaccurate pre sanction security and appraisal of loan
• Target oriented approach to lending by banks
• Absence of credit information sharing among different financial institutions
• Weak monitoring leads to NPA in repayment of loan
• Inadequate laws to take appropriate action
• Unnecessary Political intervention

2.5.2 Internal Factors

Other than, the external factors mentioned above, there are various internal factors that cause for transforming an asset into the NPA. These factors are outlined below:
• Defective Lending Process
• Inappropriate Technology
• Improper SWOT Analysis
• Managerial Deficiencies
• Absence of Regular Industrial Visit
• Faulty Credit Management
Apart from these the other internal factors are:-

- Funds borrowed for a particular purpose but not used for the said purpose
- Project not completed in time
- Poor recovery of receivables
- Excess capacities created on non-economic costs
- In-ability of the corporate to raise capital through the issue of equity or other debt instrument from capital markets
- Business failures
- Diversion of funds for expansion\modernization\setting up new projects\helping or promoting sister concerns.
- Wilful defaults, siphoning of funds, fraud, disputes, management disputed, misappropriation etc
- Deficiencies on the part of the banks viz. in credit appraisal, monitoring and follow-ups, delay in settlement of payments\subsidiaries by government bodies etc

2.6 Problems Due to NPAs

Following problems are generally encountered due to the existence of NPAs:

1. Promoter and Owners are unable to get required market return on their capital if the bank fails.
2. Lender to the bank i.e. depositors do not receive a market return on saving.
3. In this case the 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.
5. Non-performing asset may spill over the banking system and contract the money stock, which may lead to economic contraction. This spill over effect can channelize through liquidity or bank insolvency.
2.7 Remedial Measures for Controlling NPAs

To control NPAs and consequences derived from these NPAs, following measures need to be taken.

2.7.1 Managing Risk

Investing into risky venture raises the NPA level of the bank. For managing create healthy and sustainable loan portfolios, following intervention program and measures are suggested to bring about change that ensures NPA level:

Stable and standard international credit assessment framework Indian banks would need to adopt a standard, international credit assessment framework, which is designed to take into account all elements of credit risk, including: business risk, operational risk, industry risk and market risk. Despite each country market’s unique needs, the banking sector’s credit risk assessment must be of a global standard.

2.7.2 The DNA of the bank

The two dimensions of managing risk are preventive measures and curative measures. Preventive measures include pre-disbursement policies, risk assessment, risk measurement, and risk-based pricing. These are worth much more in their weight than any curative measures, which are a reactionary form of risk management. The preventive measures and credit assessment framework should become part of the bank’s DNA and the curative measures should be utilized only in unforeseen circumstances Post-disbursement loan monitoring

Credit risk is not entirely addressed at the time a loan is disbursed. While preventive measures will have a great impact on improving loan quality, early detection and management of problem loans is fundamental to ensuring a high quality, sustainable credit portfolio. Appropriate tools for post-disbursement loan monitoring must become an essential part of the credit risk assessment framework.

2.7.3 Training of Credit and Sales Personnel

Training is required to help bank employees understand and implement an objective of credit risk assessment framework. To encourage transformation, organizations will need to invest in training. First, bank employees are required to understand core credit principles, bank growth objectives, and customer’s business goals and challenges.
Second, staff must be able to apply this knowledge effectively to better serve customers, armed with specific techniques required to drive profitable business opportunities. Third, staff must be able to differentiate themselves and their bank from the competition. This can be achieved through the deployment of proven-effective training solutions and a thorough training culture.

2.7.4 **Alignment of Interests between Credit and Sales Staff**

It is as important that front-line staff such as sales person, relationship managers and branch managers are well-versed with the credit decision process as their underwriting and credit management colleagues. Sales team revenue-and-reward models should account for portfolio quality, not purely sales volume. If Indian Banks were to consider looking at all these five measures, the future probability of an expanding NPA volume is likely to be reduced.

A comparative study on the performance of various banks can be done using a ratio analysis of these parameters. There are a number of ratios that can be used to comment on the different aspects. The essential ratios that can be used for assessing the banks' profitability and sustenance are:-

i. Profitability ratio
ii. Intermediation Costs/Total Assets ratio
iii. Net Interest Income/Total Assets ration
iv. Other Income/Total Assets ration
v. Asset Quality
vi. NPAs/Total Assets ratio
vii. NPAs/Advances ratio
viii. Staff Productivity ratio
ix. Net Profit/ Total Number of Employee ratio
x. Capital/RWAs ratio

**LIST of Ratios for Analysis of Performance of Banks**

i. Profitability Ratios
ii. Interest Expenses/Total Income
iii. Non-Interest Expenses/Total Income
iv. Non-Interest Income/ Non-Interest Expenses
v. Interest Income/ Total Assets
vi. Interest Expenses/ Total Assets
vii. Net Interest Margin (NIM) = NII/ Total Assets
viii. Profit Margin = Net Profit/ Total Income
ix. Asset Utilization = Total Income/Total Assets
x. Equity Multiplier = Total Assets/ Equity
xi. Return on Assets = Net Profit/ Total Assets
xii. Return on Equity = Net Profit/ Equity
xiii. Sustenance
xiv. Capital to Risk Weighted Assets (CRAR) = Total Capital/ (RWAs)
xv. Core CRAR = Tier I Capital / RWAs
xvi. Adjusted CRAR = (Total Capital - Net NPAs)/(RWAs - Net NPAs)
xvii. Staff Productivity
xviii. Net Total Income/ Number of Employees
xix. Profit per Employee = Net Profit/Number of Employees
xx. Business per Employee = (Advances + Deposits)/Number of Employees
xxi. Break-even Volume of Incremental Cost per Employee = Cost per Employee/ NIM
xxii. Asset Quality
xxiii. Gross NPAs/ Gross Advances
xxiv. Gross NPAs/Total Assets
xxv. Net NPAs/ Net Advances
xxvi. Net NPAs/ Total Assets
xxvii. Provisions for loan losses/Gross Advances
xxviii. Incremental RWAs/ Incremental Total Assets
xxix. Total Assets
xxx. Provisions for loans and investments/Total Assets
xxxi. (RWA = Risk Weighted Assets)

Concepts used in the ratios are as follows:

a. Cash in cash-deposit ratio includes cash in hand and balances with RBI.
b. Investments in investment-deposit ratio represent total investments including investments in non-SLR Securities.
c. Net interest margin is defined as the total interest earned less total interest paid.
d. Intermediation cost is defined as total operating expenses.
e. Wage bills are defined as payments to and provisions for employees (PPE).
f. Operating profit is defined as total earnings less total expenses, excluding provisions and Contingencies.
2.8 Indian Banking Sector Transformation-Post Liberalization

Of late, there has been a lot of bad news about India and Indian banks in particular. A number of economists and analysts have expressed their fears about the current slowdown in the Indian economy. This slowdown is expected to hurt the Indian banking sector. Though it is true that Indian banks are facing some serious challenges, it is also true that they have the potential to rise to the challenges. In this context, it would be worthwhile to note how Indian Banks have successfully adapted to liberalization by transforming themselves in the following ways:

2.8.1 NPA with Respect to SARFAESI ACT

NPA is a banking jargon for bad loans. The management of NPAs by Indian banks has improved substantially post liberalization. Various reasons can be attributed to the same, like the establishment of the Debt Recovery Tribunals (DRTs), the adoption of the Corporate Debt Restructuring (CDR) mechanism etc.

A significant event in NPA management is the passage of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, (SARFESI) in 2002. This act of SARFESI has helped banks and financial institutions manage their NPAs better. The lenders can now auction properties (residential and commercial) after giving sufficient notice, when the borrowers fail to repay their loans. Though the SARFAESI Act was challenged in the courts, the Supreme Court upheld the Act (Mardia Chemicals v/s ICICI Bank) in 2004 tilting the balance for the banks. The RBI has also been encouraging banks to use the provisions of the SARFAESI Act.

The ratio of Gross NPAs as a percentage of Total Assets has fallen from 12% in 1993 to about 2.5% as on March 31, 2011. Thus, in post liberalization, banks have reduced their NPAs. However, with the current slow-down in the Indian economy, there is a worry that NPAs will rise again.

2.8.2 Risk Management through Basel I & II Point of View

Basel I was adopted by banks globally in 1988. However, it suffered from the disadvantage that it was based on a one-size approach to all banks. Therefore, a need was felt for a better methodology - the Basel II. There were three pillars of Basel II: minimum capital requirements, supervisory review, and market discipline.
The purpose of Basel II, which was initially published in June 2004, thus was to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of credit, interest, market and operational risks banks face while maintaining sufficient consistency so that this does not become a source of competitive inequality amongst internationally active banks. In this context, the capital adequacy ratio (CAR) is important.

It may be noted that alternatively CAR is also called Capital to Risk Weighted Assets ratio (CRAR) in conformation with the BASEL II accord. CRAR is the measure of the amount of a bank’s capital expressed as a percentage of its risk weighted assets. In simple terms, a bank’s capital is the cushion for potential losses, which protects the bank’s depositors. In case of Indian banks, the CRAR has shown consistent improvement in post liberalization. It has gone up by a significant 2.3% in just four years from 12.3% in 2005-06 to 14.6% in 2009-10. This again can be attributed to the improved risk management practices and prudential RBI norms followed by Indian banks.

2.8.3 Priority Sectors and Improved Financial Inclusion

As per RBIs norms, 40% of the lending has to be mandatorily extended to the priority sector. Small-scale industries, agriculture etc. are included under this priority sector. In the Post liberalization period, RBI has given a broad based definition of priority sector I and added some new sectors. For example, the definitions of small-scale sectors are changed in 1998. For a firm to qualify as a small-scale sector, the limit of investment in plant & machinery was raised substantially from Rs. 65 lakhs to Rs. 3 crores.

Consequently, even bigger firms became eligible for priority sector lending, leading to increased credit to the sector. Inclusion of housing loans up to Rs. 10 (now Rs. 20) lakhs under priority sector further boosted priority sector lending. Similarly, the addition of food processing and cold storage sectors helped increase priority sector lending. All these changes have led to Indian banks viewing the priority sector as an opportunity than an obligation.

Lending to these sectors has increased manifold leading to improved financial inclusion. Thus though much more needs to be done in terms of financial inclusion one should also acknowledge the fact that Indian banks have made progress on this front.
To conclude, present chapter summarise the definition of NPAs, reasons of NPAs of banks, and various initiatives taken by banks for managing NPAs. The work of different researchers and thinker in the field of NPAs is reviewed and is presented in the next chapter no 3.