



# A review on the existence of non-performing assets in the Indian banking sector

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## Abstract

The economic growth of a nation is largely dependent on the financial system of the country. A solid financial system supports economic growth and improves the standard of living of a country by offering variety of services. Banking sector is an indispensable part of the Indian financial system which engages in services that are supportive of the developmental plans of the country. Channelizing funds from savers to borrowers for productive purposes is a primary function of all the banks. Banks perform social services by indulging in priority lending and employment generation. However, extending loans to the borrowers have become a serious issue. It is not necessary that accumulating more assets would generate more profits. Nowadays banks are dealing with the problem of non-repayment of interest and principal amount by the borrowers. The non-repayment of interest and advances have significantly affected the profitability and operational efficiency of the banks. Banks must ensure stability in profits and maintain the quality of their assets as they are crucial for the growth of the banking sector and the economy in general. Thus, the study aims to develop a strong conceptual understanding of non-performing assets and addresses the issue of non-performing assets in the banking sector in detail by referring to the existing studies. The present study constructs a theoretical background for the future studies on non-performing assets in the banking sector.

Key words: Banking sector, commercial banks, private banks, non-performing assets, credit management, profitability of the banks.

## Introduction

A sound financial system supports economic growth and improves the standard of living of a country by offering variety of services. These services include collecting and channelizing funds between borrowers and depositors, clearance and settlement mechanism to facilitate domestic as well as international trade (Bollard, Hunt, & Hodgetts, 2011). Banks are specialized in evaluating the credit worthiness of the borrowers and continuously monitoring the activities of the borrowers to ensure timely repayment of the loans. Banks are rewarded for their services by the marginal spread between the rate of interest they charge from the borrowers and the rate of interest they pay to the depositors.

In the modern times, a bank performs several roles and offers different financial products while performing its traditional and most crucial task i.e. borrowing and lending. In addition to the basic service, banks act as Government's agent, sell insurance policies, mutual fund products, accept bills of exchange, sell and buy securities, provide letter of credit, act as an underwriter, referee, deals in foreign exchange, remits money, merchant banking etc.

Bank acts as an intermediary between savers and borrowers. The primary functions of all the banks is to accept funds from those who have in excess and lend to those who are in need of money. Accepting money from savers involves no risk but lending money to the borrowers is a risky affair as there are chances of non-repayment. Nowadays, banks have become extra cautious in giving loans due to the increasing level of non-performing assets, NPAs (Narula & Singla, 2014). The rising level of non-performing assets is a reason of concern as it affects the operating capacity of the banks.

Developing countries like India which are primarily bank led are concerned about the mounting level of NPAs. Existence of non-performing assets not only hampers the operations and profitability of the banks but severely impacts the growth of the economy as well. Hence, it is utmost important to identify the reasons leading to non-performing assets and design proper policies to trim down NPAs.

### **Concept of non-performing assets**

In the books of banks, there are different varieties of assets, for instance, cash in hand, investment, balances with other banks, loans and advances, fixed assets and other types of assets. The concept of non-performing assets is restricted to investments and loans and advances. When an asset generates the expected level of income without disclosing any kind of unusual risk despite the usual commercial risk, the asset is considered as performing asset. When the asset ceases to generate revenue in the form of fee, interest or commission, it is categorized as non-performing asset. A non-performing asset, NPA, is a type of an advance where the interest installment or repayment of principal amount remains unpaid for a minimum period of two quarters after becoming due (Selvarajan & Vadivalagan, 2013).

In other words, non-performing assets are called as non-performing loans for the banks. It is an advance made by a bank on which the interest amount or installment amount is not paid in time. A loan or an advance is an asset for the banks as they generate a stream of cash flows in the form of interest and repayment of principal amount. Banks earn profits usually from the interest income as banks charge a higher rate of interest on the loans and advances as compared to the rate of interest they promise to pay to the depositors on their deposits. The difference between the interest charged on borrowers and interest agreed to be paid to depositors is the income of the banks. When the payment on an advance is not received in a short time after the due date, it is termed as past due but when the payment is not received up to 90 days of being due, they are classified as non-performing assets. An alarming rise in the level of non-performing assets is a matter of concern for the banks. Hence, the issue needs to be addressed and methods to prevent non-performing assets to occur should be discovered.

Therefore, the present study addresses the issue of non-performing assets in the banking sector in detail by referring to the existing studies. The key objective of the study is to develop a strong conceptual understanding of the topic, non-performing assets. Furthermore, it aims to highlight the reasons behind the occurrence of non-performing assets, the role of banks in aggravating the problem of NPAs, the possible impact of presence of NPAs on the functioning of the banks and finally exploring methods to curb the problem of NPAs.

The study is descriptive in nature and makes extensive use of existing studies on non-performing assets to meet the abovementioned objectives. The paper contributes in building a theoretical framework for the potential empirical studies which could be undertaken on measuring the impact of NPAs on the operational efficiency of banks, the impact of provisional and prudential norms laid down by the central bank in improving the situation of non-performing assets in the banking sector etc.

### **Review of existing studies**

There exist numerous studies which focus on the existence of non-performing assets in the banking sector. They investigate the reasons behind their occurrence and how do banks deal with these assets. Some of the studies are reviewed in detail (Reddy, 2002; Malyadri & Sirisha, 2011; Collins & Wanjau, 2011; Srinivas, 2013). Malyadri & Sirisha (2011) in their study examines the trend of non-performing assets in both private as well as public sector banks pertaining to weaker sections in India for a period of seven years (2004-10). The analysis of the data, extracted from Report on trends and progress of Banking in India, reveal that the quality of assets of both type of banks has improved in the past few years. Throughout the study period it is observed that the public sector banks have outperformed in penetration as compared to private banks vis-à-vis weaker sections. A significant drop in the NPA ratio point towards an improvement in the management of NPAs in private and public sector banks. It further highlights that initiatives taken by the regulatory bodies such as provisioning and prudential norms has put pressure on the banks to monitor their performance and cut NPAs to improve the overall Indian financial system. Another study by Balasubramaniam (2011) also aims to examine the trends of NPA in the Indian Banking system. Indian banking sector has continued to display improvement in profitability and performance despite high interest rates and operating costs. The improved performance is reflected through better return on assets, higher credit growth and return on equities. It further suggests that higher level of NPAs can be brought down by effective internal control systems, better credit appraisal mechanisms. Banks would need to mobilize funds in an attempt to comply with the capital adequacy requirements and provisioning norms while satisfying Basel III norms.

Singh (2016) undertakes a study to examine the situation of non-performing assets in the Indian Banking system. The trend analysis indicate that public sector banks have higher number of NPAs in comparison to private sector banks. Despite the introduction of various reforms in the Indian banking sector, the level of NPAs is still higher than foreign banks. It states that NPAs impact the profitability level of banks, but at the same time it is not possible to have zero non-performing assets as well. Thus, banks should improve their loan recovery mechanisms. Post monitoring of loans and credit appraisal are required for easy recovery of loans. Developing healthy relations with the borrowers by providing them entrepreneurial advice is a good way to keep a track on the borrowers. The study discovers that the problem of loan recovery lies with big borrowers than small borrowers. Thus, RBI should make an effort to revise existing credit appraisal reforms.

In addition, Mishra & Pawaskar (2017) aims to develop a conceptual understanding of non-performing assets. The study describes the sectoral distribution of NPAs in Indian banking structure and suggests ways to recover loans timely. Ratio analysis is done for the period of four years 2011-12 to 2015-16 which reveals that the level of NPAs shows an upward trend. The study points out that banks should be vigilant in selecting customers for offering credit as recovery of loan is essential for growth of the banking sector and the economy as the whole. It further emphasis that effective judicial mechanism and legal framework could help in recovering stock loans. Similar study is undertaken by Khanna (2012) which explores the trends of NPAs in the Indian banks for a period of five years i.e. 2005 to 2010. The study bifurcates Indian banking sector into three categories namely SBI and its associate banks, private banks and nationalized banks for the purpose of analysis. The analysis concludes that presence of NPAs negatively impacts the net worth and profitability of the banks. The growing level of NPA demands for provisions and reforms in credit managing and issuing loans. The banks should be diligent in sanctioning loans. The purpose of loan, timely disbursement of the amount and proper utilization of funds are the essential pre-requisites for minimizing or preventing new NPAs to accumulate.

Garg (2016) conducts a study to build conceptual framework on the non-performing assets and the role they play in the banking sector. Data collected from annual reports of banks, instructions manual on loans and advances, RBI's report on trend and progress of Banking in India provides that NPA affects the profitability, liquidity of the banks and results in credit loss. Furthermore, it lays down preventive measures to reduce NPAs such as lending to the borrowers who are genuinely in need of loan, timeliness as well as adequacy of response also matters, effective management practices play an important role in tracking the timely repayment loan amount and the borrower. In total, the study projects that proper remedial actions and measures are required to be taken to experience drop in the quantum of NPAs. Another study aims to understand the concept of NPAs and the relationship between NPAs net advances and loans using case study method (Chatterjee, Mukherjee, & Das, 2012). The paper provides that presence of NPA affects capital adequacy level, fund deployment, mobilization policy and credibility of banking system. Public sector banks are burdened with excessive NPA, manpower and governmental equity. Therefore, RBI should take the charge of controlling NPAs by bringing policy reforms. It further appeals that public banks should leave behind the idea of social welfare and focus on improving the status of Indian banking system. Reducing the time gap to declare an asset as non-performing is an attempt to minimize the gap between Indian banking standards and international banking norms which would eventually reduce the level of NPA and improve the asset quality of banks.

Selvarajan & Vadivalagan (2013) states that Indian banks have been trying to integrate with the global banking over the past few years but are not successful due to inherent weaknesses despite great achievements. Banking is viewed as a crucial instrument of economic development especially in developing nations but the problem of NPAs have made banks burdensome for the economy. Non-performing assets increases the credit management cost. NPAs adversely impact the liquidity, profitability, competitiveness of the banks and development of financial institutions. It also affects the psychology of the bankers regarding credit expansion and credit delivery. Banks are required to make provisions for NPAs from their present profits. One of the important parameters to be considered to measure the financial health and performance of the banks is the level of non-performing assets of the banks. NPAs are considered as one of the drivers of financial growth and stability of the banking sector (Kaur & Singh, 2011). While the research carried out by Fotak (2012) provides that government-controlled lenders use different criteria to allocate loan as compared to private lenders. State owned lenders ease out financial constraints by providing credit under weak legal framework or during banking/financial crisis which in turn has negative impact on economic growth.



Research conducted by Srinivas (2013) offers advice to the bankers to curb the increasing problem of NPAs in banking sector. The study concludes that a banker should constantly monitor the activities of the borrower so as to be sure that the sanctioned loan is properly utilised for the purpose for which it was obtained. It is important to have both the informal and formal reports regarding the goodwill of the client. If the customer is already proved as a defaulter, then his/her request for the new loan should be rejected outrightly. While sanctioning loan to the customers the banker should educate them about the consequences of non-repayment of loans. By paying attention to these suggestions, bankers would observe a considerable decline in the level of non-performing assets of the banks. Reddy (2002) in his study describes that measures have been taken to improve several aspects of financial sector in India like prudential norms, barriers to entry, risk-based supervision, reduction in reserve requirements and interest rate deregulation. The study stresses upon the clarity of macroeconomic variables and other systematic issues relevant to the banking structure and the economy. A strong legislative structure, judicial and bureaucratic framework is said to be effective in solving the NPA problem. The paper highlights the experiences of Asian countries in dealing with the problem of NPAs. It further suggests that international experiences with a clarity of local conditions must be referred to construct a tailor-made solution for banks in handling NPAs.

A study undertaken by Jadhav, Gujarathi, & Gawali (2016) aims to understand the management of NPAs at the Bank of Maharashtra Nashik district. Public sector banks are more targeted for study purposes because they occupy a dominant position in our country, India and they usually have more non-performing assets than other private banks. Presence of non-performing assets adversely affect the profitability and financial position of the banks. The prudential as well as provisional norms such as income recognition, asset classification introduced by the central bank has helped in bringing out the true financial health of the Indian banks. The study highlights that the Bank of Maharashtra has a sound credit appraisal mechanism and loan recovery policy in place. A separate department is created to handle credit related deals. Despite these measures, the level of NPA increased considerably from 2011-12 to 2014-15. Non-performing assets of agricultural loan is comparatively higher than other segments hence bank should pay more attention towards the NPAs arising from this sector. Natural calamity like untimely rains is assumed to be the possible reason for the occurrence of NPA in agriculture field. Singh & Makkar (2014) tries to examine the inter-relationship between volatility in stock returns and Indian banking sector crisis. Bankex stock index which acts as a proxy for the stock prices of Indian commercial banks is taken for the purpose of empirical analysis. Bankex index includes major public sector units and private sector banks which are listed on the Bombay stock exchange. The study deals with time series data of closing stock prices which is collected on daily basis from Jan 1, 2004 to Dec 31, 2012. The analysis concludes that there is a significant impact of recession news in the US stock market on the performance of Indian stock market. It is observed that there exists a considerable difference in the stock returns of Indian banks and their volatility between pre as well as post crisis periods.

Numerous studies have been conducted to determine the causes of non-performing assets in the banks. Roy (2014) determines the factors which affect the level of non-performing assets of Indian banks. The study employs panel regression with fixed effect model to examine the impact of bank related as well as country related factors on the level of NPAs for the period starting from 1995-96 to 2011-12. Dependent variable include ratio of net NPA to net advances while the independent variables include one bank level variable i.e. net interest margin and macroeconomic variables namely inflation, real effective exchange rate and GDP growth. Results provide that while the level of NPAs in foreign banks has reduced after global financial crisis it is still increasing after 2008 concluded that the alarming thing is that all the developed and developing countries have already managed to curb the NPA level from the high of 2008-09 at the time of global recession, where it is still rising in India. Analysis reveal that exchange rate fluctuations, GDP growth rate and global volatility have significant impact on the level of NPAs of Indian banking sector. Zafar, Maqbool & Khalid (2013) reveal that the internal factors of the banks are responsible for the poor performance of assets which later on become non-performing assets. It is necessary for the banks to restructure their organization, upgrade techniques which assess credit worthiness of the banks and bring qualitative improvement in the overall managerial as well as technical efficiency and banks themselves are responsible for containing the factors leading to NPAs. Siraj & Pillai (2013) focuses on examining the efficiency of different banks in managing their non-performing assets. Various indicators such as Net NPA, additions to NPA, Gross NPA, provisions towards NPA and reductions to NPA are considered to evaluate the trend of NPA movements in different banks. These variables are further compared with micro-performance indicators of the banks. Overall, the rankings derived from NPA indicators rate NB at the top in the successful management of non-

performing assets followed by SBI associates, foreign banks as well as private sector banks. A study by Rathore, Malpani, & Sharma (2016) also aims to examine the status of non-performing assets (NPAs) of Indian commercial banks up to the year 2015. It identifies that there are several internal as well as external factors which are responsible for rising NPAs in India. Some of the internal factors include diverting funds for expansion or modernization, inefficiency in credit monitoring and management and poor coordination among lenders while external factors include price escalation, natural disaster, exchange rate volatility, recession etc. Findings indicate that lack of proper management has resulted in a positive relationship between net profits, total advances and NPA of a bank which is not a healthy sign. Sluggish domestic growth is also discovered to be one of the reasons for rising NPAs. It further offers several suggestions to control the level of non-performing assets in banks such as making compromise proposals with the borrowers, one-time settlement schemes, filing up a suit against the borrower for non-repayment of loan, seeking help of Lok adalats and debt recovery tribunals.

The research carried out by Narayanan & Surya (2014) highlights the reasons for the assets turning into non-performing assets and remedial actions to be taken to bring down the level of NPAs. It also aims to investigate if there is any difference in the operations of the bank before and after writing off non-performing assets. The study reveals that improper selection of clients for lending loans, poor follow up policies, misappropriation and mismanagement of funds are some of the identified reasons for causing NPAs. These non-performing assets in return reduces the return on investment, fall in interest income and increases the cost of capital. In today's scenario, Banks need to take pro-active measures to control and minimize the occurrence of non-performing assets. Assistance of Finance Ministry and the Reserve Bank of India is required to deal with the problem of NPAs. Das & Dutta (2014) conduct an analysis to discover if there is any sort of difference in the occurrence of non-performing assets in different types of Indian banks for the period of five years i.e. 2008-2013. SBI associate banks and other public banks are considered for the purpose of analysis. Results of ANOVA indicate that there is no significant difference in the occurrence of NPA between various banks. In total, it can be concluded that despite different operations bank experience similar occurrences of non-performing assets. Another significant contribution in the field of banking sector is made by Collins & Wanjau (2011) as the study evaluates the impact of interest rate spread on the NPAs of commercial banks in Kenya. The study is descriptive in nature and uses both quantitative and qualitative techniques to collect data on loan non-performance and interest rate spread of 43 commercial banks in Kenya. It is derived that interest rate spread indirectly determines the cost associated with the loan which eventually affects the performance of assets. The borrowing and lending interest rate spread impacts the performance of the assets as it increases the cost of loans. The research further examines the role of credit risk management policy of banks on interest rate spread and NPAs. It is found that credit risk management policy has a remote impact on the interest rate spread of the banks as interest rates are benchmarked against the linked NPAs and the non-performing loans are attributable to increased cost of loans. At last, the study provides recommendation to the banks that they must assess the credit worthiness of the borrower, the amount of the collateral security offered and charge interest rates accordingly.

## Conclusion

The present paper gives an overview of the existing studies which deal with the most important aspect of banking sector i.e. non-performing assets. A large part of the literature is dedicated towards understanding the conceptual framework of non-performing assets. In other words, NPAs are the assets which no longer generate revenue for the banks. Additionally, studies have discussed the occurrence of NPAs and the factors contributing in the growth of NPAs. Some of the common factors are inefficiency in credit management, offering loans to clients without proper assessment of their credit worthiness or goodwill. These factors lead to the occurrence of NPAs thereby increasing the cost of capital. On the other hand, studies have discovered that the internal factors are not solely responsible for accumulation of NPAs but external factors such as exchange rate volatility and GDP growth rate also have a significant impact on NPAs. It is not possible to have zero NPAs, but attempts should be made by the central bank and respective banks to minimize the level of NPAs. Existence of non-performing assets can affect liquidity, profitability and net worth of the banks. Several remedial and preventive measures have been listed in various studies to prevent NPAs such as post monitoring of loans, credit appraisal mechanism, efficient credit management policy, assessment of credit worthiness of borrowers before lending them money and establishing healthy professional relationships with borrowers to keep a track on the proper utilization of the loan amount. To sum up, NPAs are an important factor which affects growth of the banking sector and eventually hampers economic growth of a country especially the bank-led economies like India. Therefore, it is essential for the

banks to adopt prudential and provisional norms as suggested by central bank from time to time to deal with the problem of NPAs and efforts should be made to prevent the occurrence of non-performing assets.

### Limitation of the Study

The descriptive study offers a summary of existing studies which deals with the issue of non-performing assets in the banking sector. However, an empirical study could be undertaken to know the effects and consequences of the NPAs on the operations and performance of the banks in India.

### Scope for future research

After analyzing the available studies, it is observed that there exists enormous amount of research analyzes the determinants of non-performing assets in Indian banking sector, the reasons for an asset becoming NPA, management of non-performing assets, the impact of non-performing assets on the performance of banks and stated remedial measures to be taken to reduce the level of NPAs. A study could be undertaken to analyze the impact of non-performing assets on the two segments of the Indian banking sector, namely, public sector and private sector banks and make a comparison between them by studying the overall trends in NPAs for the latest time period. In depth study could also be undertaken to analyze the impact of NPAs on the Indian economy, as a whole.

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