



## PROBLEM AND PROSPECTS OF NON-PERFORMING ASSETS IN INDIAN BANKS

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### **Abstract**

*The problem of non-performing assets has shaken the entire Indian banking sector. The main reason of high percentage of NPAs is the target-oriented approach, which deteriorates the qualitative aspect of lending. NPAs put detrimental impact on the profitability, capital adequacy ratio and credibility of banks. The paper highlights the most significant factors contributing towards the problem of non-performing assets from the point of view of top bankers from public sector banks in India, some foreign banks and the measures required for management of NPAs like reformulation of banks' credit appraisal techniques, establishment of monitoring department. In this paper, an attempt has been made to find the causes and effects of non-performing assets.*

### **INTRODUCTION**

Banking and financial sector are wheel of fortune and play important role in the development of nation's economy. It is a fact that developed banking and financial system reflects the strength and growth of any economy. In India, the beginning of banking reforms took place with the report of the Committee on the financial system headed by M. Narsimham. In this report, various aspects of Indian banking have been examined and evaluated from different perspectives, domestic as well as international. This reformation brought some challenges before Indian banking. Out of these challenges one most attractive challenge is the continuously growing Non-Performing Assets. The concept of Non Performing Assets was introduced with Income Recognition and Asset Classification Norms (IRAC norms) in the year 1993, which was new for Indian banking industry. A strong banking sector is paramount important for a flourishing economy. The failure of the banking sector may have an adverse impact on other sectors. In the era of globalization Indian banking system is facing challenges of an open economy system with having experience of operation in closed economy. On one side socially protected environment ensured that banks don't require developing sophisticated treasury operations and Asset Liability management skills and on the other hand a combination of directed lending and social banking relegated profitability and competitiveness to the background. The net result was unsustainable NPAs and consequently a higher effective cost of banking services.<sup>1</sup>

The problem of NPAs (bad loans, write-offs and restructured assets) in India is quite fascinating especially in the Indian public sector banks and are result of multiple factors like political nepotism favoritism, mismanagement, willful default, diversion of funds and siphoning off of funds, delay in project completion, asset quality, changes in industrial policy, in addition the volatile interest rate regime which also have important role in it and ultimately multiply the burden on banks. World Bank with holistic view has warned Indian banks and financial institutions on their high NPAs and the future risks of suffering losses if interest rate starts rising.

### **NON PERFORMING ASSETS –CONCEPTUAL FRAMEWORK**

As per Para 2.1 of the RBI's master circular dated 01-07-2005, An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. It is also known as non-productive assets, non-performing loans and constitute integral part of Bank's operations. NPA is an asset or account of borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to asset classification issued by RBI.

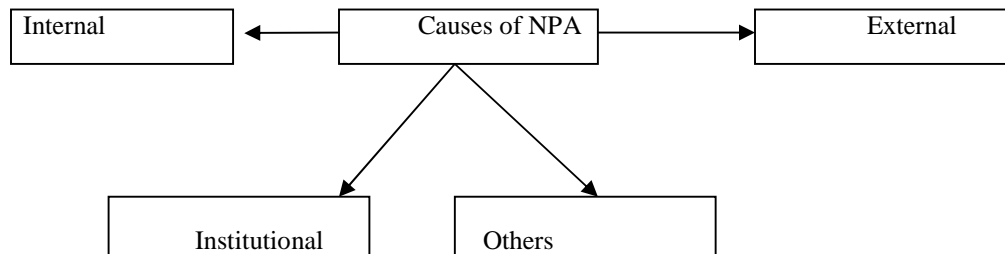
An amount due under any credit facility is treated as 'past due' when it has not been paid within 30 days from the due date. Due to the improvement in the payment and settlement systems, recovery climate, up-gradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, with effect from March 31, 2001.<sup>2</sup>

NPAs are classified into (a) sub-standard, (b) doubtful and (c) loss assets. Banks should be advised to disclose the total provisions held (outstanding) against the NPAs and not only provision made from the current year's profit and loss account. This will give confidence to the shareholders about the magnitude of provisions held against problem accounts. It is also necessary for the banks to give disaggregated data of NPAs such as 'sub-standard', 'doubtful' and 'loss assets', which will

<sup>1</sup> Anurag, "Causes of Non-Performing Assets in Public Sector Banks"

<sup>2</sup> Dr S.M.Tariq Zafar et al, " Nonperforming Assets and Its Impact on Indian Public Sector Banks, International Journal of Marketing, Financial Services & Management Research, Vol.3, No. 2, February (2013).

throw more light on the quality of assets. Growing NPAs amount is not depending upon any one factor; there are various factors, which transform performing assets into non-performing. The following figure shows the four major factors for NPAs.



### IMPACT OF NPAs ON BANKING OPERATIONS IN INDIA

Nonperforming assets of banks are hurdles in economic growth and development of the respective nations and breed multiple challenges for present and future. Every aspect of life, business and other events are judged by their performance and ultimate result. Thus, the size of the banks and its balance sheet is not only the criteria to judge the efficiency, effectiveness and performance but also the level of return on its assets. The NPAs generally do not generate interest income for banks but at the same time they are bound to provide provisions for NPAs from their current profits and are major cause of concern. Further it has following deep impact on the return on assets.

1. The general interest income of banks will decline and will be accounted only on receipt basis.
2. Due to decline in interest income banks profitability get affected adversely because of the providing of doubtful debts and consequent to writing it off as bad debts.
3. Return on investments (ROI) gets reduced more than NPAs.
4. The capital adequacy ratio gets disturbed due to inclusion of NPAs into its calculation.
5. Due to uncertainty in return, high risk and NPAs the cost of capital will go up.
6. Due to NPAs, assets and liability mismatch will increase.

Due to all these above factors the PSBs are over burdened with bulging NPAs which results in declined income and higher provisioning for doubtful debts and further reduce their profit margin. As of today a good percent of Gross NPAs are locked up in 'hard-core' doubtful and loss assets, accumulated over the years.

K.H.Vora observed the many impact of NPAs in his study<sup>3</sup>, like loss of interest income, current profit is reduced, Capital adequacy ratio is also affected as it is directly related to the quality of assets, affects the liquidity position of bank as also recycling of funds due to asset liability mismatch, increases the cost of funds, affects the image of the bank in the public, negatively affected the moral of the staff, adverse effects on the balance sheet and profit.

Generally it is noted that lack of strict prudential norms are not the major problem in India but the legal complexities and time consuming nature of asset disposal proposal, negligence and postponement of existing problem in order to show higher earnings, Manipulation of debtors by using political influence. Indian banks are facing such problems which can be easily observed through the following tables:

**Table.No.-1, BANKS GROUP WISE CLASSIFICATION OF LOAN ASSETS OF SCHEDULED COMMERCIAL BANKS 2006-2011 as on 31 March 2011(Amount in crore)**  
Public Sector Banks

Bank Group / Years	Doubtful assets (amount)	Doubtful (%Share)	Loss Assets (amount)	Loss Assets (%share)	Gross NPAs (amount)	Gross NPAs (%share)	Total Advances
2006	24804	2.3	5180	0.5	41378	3.9	1070872
2007	19944	1.5	4510	0.3	38602	2.8	1373777
2008	19167	1.1	3712	0.2	39749	2.3	1696333
2009	20715	1.0	3803	0.2	44039	2.1	2103763
2010	24685	1.0	4928	0.2	57301	2.3	2519331
2011	31919	1.0	5514	0.2	71047	2.3	3079804

Source: Statistical table relating to banks in India, Page Number 101, 2010-2011

<sup>3</sup> Vora K.H., Management of Non- Performing Assets and Role ARC", Recent Trend in Banking, Mumbai, 2007.

Private Sector Banks

Bank Group / Years	Doubtful assets (amount)	Doubtful (%Share)	Loss Assets (amount)	Loss Assets (%share)	Gross NPAs (amount)	Gross NPAs (%share)	Total Advances
2006	4438	1.5	940	0.3	7774	2.6	303793
2007	3930	1.0	941	0.2	9239	2.4	391869
2008	4452	0.9	1244	0.3	12976	2.7	472345
2009	5017	1.0	1345	0.3	16888	3.2	519655
2010	6542	1.1	2166	0.4	17384	3.0	584591
2011	10735	1.5	2839	0.4	17972	2.5	732310

Source: Statistical table relating to banks in India, Page number 101, 2010-2011

Foreign Banks

Bank Group / Years	Doubtful assets (amount)	Doubtful (%Share)	Loss Assets (amount)	Loss Assets (%share)	Gross NPAs (amount)	Gross NPAs (%share)	Total Advances
2006	698	0.7	446	0.5	2090	2.1	98862
2007	631	0.5	454	0.4	2452	1.9	127867
2008	768	0.5	387	0.2	3118	1.9	162999
2009	1004	0.6	416	0.2	7294	4.3	169714
2010	1441	0.9	757	0.5	7128	4.3	167439
2011	2113	1.1	1087	0.5	5065	2.5	199321

Source: Statistical table relating to banks in India, Page Number 101, 2010-2011

**Table. No. – 2, Composition of Npas of Public Sector Banks  
2002 to 2011as on March 31, 2011  
Nationalized Banks & State Bank of India & its Associates**

(Amount in crore)

Public Sector Banks	Priority Sector (amount)	Priority Sector (%)	Non-priority Sector (amount)	Non-priority Sector (%)	Public Sector (amount)	Public Sector (%)	Total
2002	25150	46.21	28371	52.13	902	1.66	54423
2003	24938	47.23	26781	50.72	1087	2.06	52807
2004	23840	47.54	25698	51.24	610	1.22	50148
2005	23397	49.05	23849	50.00	450	0.94	47696
2006	22374	54.07	18664	45.11	341	0.82	41378
2007	22954	59.46	15158	39.27	490	1.27	38602
2008	25287	63.62	14163	35.63	299	0.75	39749
2009	24318	55.21	19251	43.71	474	1.08	44042
2010	30848	53.83	25929	45.25	524	0.91	57301
2011	41245	58.05	29524	41.56	278	0.39	71047

**MAJOR CAUSES OF NPAs IN INDIAN BANKS**

A lot of practical problems have been found in Indian banks, especially in public sector banks. It is a hard truth that loans are given by them to various industrial houses not on commercial considerations and viability of project but on political considerations, affiliations and associations, without making a thorough study of the facts, actual need of the party concerned, its past records, its managerial skills, the prospects of the business in which it was and is engaged, and so on. Thus, due to these reasons many of the loans become NPAs. In fact most of the depositor's hard earned savings has been frittered away by the banks at the instance of greedy parasites, politicians, while the same depositors are being force to pay through taxes to bridge the losses of the bank which cause deep impact on banks operations and of its market status, further leave a negative impression on the payer of the loan who innocently become victim of political manipulation. Poverty elevation programs like IRDP, RREP, SUME, SEPUP, JRY, PMRY etc., failed in meeting their objectives on several parameters. The huge amount of loan sanctioned under these political schemes became totally unrecoverable by banks due to lack of awareness among the masses about their social rights, misuse of funds and non-reliability of target audience of these sections. Loans given by

banks are their assets and the quality of these assets was steadily deteriorated due to slack proposal evaluation and the poor repayment. Apart from this there are multiple internal and external reasons for an account becoming NPA.

### **Internal Causes**

1. Borrower is a fundamental factor of non-performing assets. The position of a borrower must be carefully studied while sanctioning loan, in the study of a borrower three Cs are used most i.e. Character, Capacity and Capital, some where three Rs. are also used for this purpose i.e., Reliability, Responsibility, Resources.
2. The reliability of a borrower point out his intention to repay the amount advanced. A banker typically avoid bad characters (i.e., dishonest and persons with no integrity) even if collateral security is being offered, as he may, in fact have no title or his title may be defective. However, honesty alone does not constitute character.
3. The responsibility of a borrower refers to his ability to run the intended business in a profitable manner. Because of impersonal relationship that prevails between the banker and the customer, the importance of the two Cs (Capacity and Capital) has increased. 'Capacity' here also refers to the borrower's qualifications and experience in the line of business.
4. The resources of a borrower are most considerable factors while lending money. In the event of the loss, the customer's capital works as the cushion and the loss is saved from being shifted to banker. Normally, a bank does not end more than the capital provided by the customer himself. Of course, in certain cases, e.g., in case of agriculturists or small- scale industrialists, bankers do finance more than their capital.
5. Defective evaluation of project highly contributes in the stock of non-performing assets. A proper appraisal of project can help in knowing as to whether it is viable or not, i.e. whether it will generate enough surplus or not, not only to service the debts but also to help in understanding strengths and weakness of a project for initiating timely corrective action for removal of the impediments, which may otherwise hamper its successful implementation.
6. After sanctioning the loan monitoring is the essential function, to discontinue the transfer of performing assets into non-performing a assts. Post-sanction supervision and follow-up of loan accounts in banks has assumed a lot of significance as it helps in keeping a close watch on their performance and for initiating timely corrective actions. But there is not good monitoring system as such.
7. A bank branch his to wok under the target determined by its head office or regional office. Loan deployment target also specified for a branch by its senior office in the term of amount and time. In such cases, loan managers emphasis on quantity rather than quality, to achieve own pre-determined target of loan disbursement. They sanction advances to non-viable project. After some time such project fail and advances convert in to non-performing. Sometimes borrower finishes false information non-viable project considered as viable project, which directly affects the quality of loan.
8. High volume of transaction also an incidence point of turning a performing assets into non-performing. Dr. C. Rangrajan stated in a conference "Another major anxiety before the banking industry is the high transact cost of carrying non-performing cost in their book" In some branches if is found that manpower allocated improperly. Due to which, number of transactions are over per employee, which affect the evaluation process of loan proposal. In case of agriculture loan proposals they are often in the large number with small amount. In such cases error occurs, made beginning of poor loan quality. On the other side, over transactions increase per transaction cost which adversely affect the profits of banks.
9. Another factor that can contribute to NPAs, the low level of knowledge of bank officers. Untrained staff and lack of expert are most important problem of Indian banking. Lack of expertise in many big public sector banks has been observed due to the constant rotation of duties among the officers and the apparent lack of training in lending principles for the loan officers. Many officers in banks are doing, their daily work without proper knowledge of current rules and regulations prescribed by RBI and Government of India.
10. After final approval and establishment of loan project. Project needed more fund before beginning or after beginning. There, may be many causes of over fund requirement such as market price fluctuations, under estimate of project, natural calamities, etc. In such cases borrowers urgent should be helped from contingency approach to save him from disaster. Thus, contingency approach may be a cause of NPAs in some cases, but in the real practice these cases are rare.
11. Appraisal of viability of a project is an important decisive factor. However, sometimes under valuation and over valuation of a project made viable project, non-viable viable project. An unviable project in any sector may be industrial, trade, services, etc. not only results in waste of capital which could be gainfully used elsewhere but also leads to unemployment having adverse impact on the socio-economic set up of the country. Banks should provide fund only to potentially viable project. The viability of a project is measured by the financial viability, technical viability, economic viability and management competence. These four factors must be deeply assessed before sanctioning the advance to a borrower.

12. Banks provide loans and advances facilities to its customers for several purposes, such loans and advances a customer has to pay in the in the various installments specified between banker and customer. It is, therefore, necessary to fix these installments according to paying capacity of customer. Paying capacity of a borrower depends upon the income generated by the period for which loan has taken and other sources of income. Imbalance between paying capacity and installment structure always turns performing assets in non- performing assets.
13. Psychological biasness of banker is also an incidence point of NPAs. Loan manager in bank is a social being he has some liking, disliking, social relationship, etc. because of them a banker may has psychological biasness towards a particulars borrower.
14. Incidence of NPAs on account of deficiencies on the part of banks such as delay in sanction and disbursement of funds whereby borrowing units starved of funds when needed, and delay in settlement of payment/subsidies by the Government bodies was on the low side in proportion to other factors. Delay sanctioning of loan proposals directly contributes in the stock of NPAs.

### External Causes

1. Misutilization of fund is major cause of turning assets from performing to non-performing assets. Willful defaulters take advantage of government schemes in which low interest rate or rebate in the repayment is allowed. Banks evaluate each and every loan proposal with very deep consideration. Small farmers and self-employee take loan for useful equipments but sale them without opening the packing, and used this money for social expenditure, Bank should monitor loans after sanction and invite report with an interval.
2. Diversion of fund is the core cause of an assets becoming NPAs. If, the unit has defaulted in meeting its payment of interest and repayment of installment of principal to the lender and has not utilized the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
3. Sometimes delay in completion of project becomes a reason of non-performing assets. There are many seasonal and contractual projects as essential to complete in the specific period. Some projects have their expiry date, after the date of expiry they are worthless for anybody. In such cases loan is always blocked and become unproductive Controllable causes are under the control of banker and borrower and must be controlled and uncontrollable causes are out of control of banker and borrower.
4. Disposal of assets is a common contributory factor in the stock of NPAs. It is has been found in many cases that willful defaulters cheat banks through disposal of assets without any intimation to bank. Borrowers dispose two kinds of assets one is borrowed assets, second is mortgage assets with bank. In both situations bank suffer with recovery problem too. Such borrowers diversify funds in other purposes and bank dues become non-performing.
5. A large amount of NPAs in Indian banking contributed by the willful defaulters. A borrower may default from his repayment obligations by his willingness.

### CONCLUSION

In order to control financial cancer RBI should taken numerous effective measures in conjunction with the government and implemented various rules and regulations on assessment and recovery due to which the asset quality of Indian banks should be shown substantial improvement. However, effective implementation of rules and regulations is the potential key to reverse this trend. With improved industrial policy, environment and growing opportunities banks are tactfully and efficiently managing to recover substantial amounts of NPAs.

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