

Non-performing assets—causes, consequences and cures

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A study on the causes, consequences and cure of large non-performing assets (NPA) in Indian banks. Non linkage of lending with productive investment and recovery with credit-product sale, the author argues, is one of the main causes of large NPAs. Moreover, there is the government directed lending in priority sector leading to NPAs. As a consequence, profitability falls and loan availability shrinks. As a remedy author suggests improved recovery mechanism and improved credit management targeted to NPA minimization.

The initiation of financial sector reforms by the Government of India in the early 1990s has brought wide ranging structural transformations. In this process, among all the constituents of the financial sector, the Indian commercial banks have envisaged the greatest metamorphosis. With the advent of new concepts like income recognition, prudential accounting norms and capital adequacy ratio, etc. it seems that the Indian banking system has been placed in a new platform. These early years of reforms have also seen the entry of new private sector and foreign banks and mushrooming of non-banking financial institutions. Further, the shift of attitude of financial institutions like ICICI, IDBI, IFCI etc., towards the short-term financing has also changed the complexion of Indian banking system. On the wake of these moderation the viability of

scheduled commercial banks and particularly of public sector banks has become very crucial. The growing competition from the internal constituents like private banks and foreign banks and from external side like financial institutions has becoming more tougher these days. Besides; the sluggish economy coupled with poor credit-deposit ratio, the large magnitude of non-performing assets in the balance sheet and lack of automation and professionalisation of public sector banks have been flaring up the situation.

Objectives and methodology

Considering the above changes an attempt has been made to study the causes, consequences and cure of large non-performing assets (NPAs) of Indian commercial banks and particularly of public sector banks. The growing NPAs has been identified as the key factor affecting the profitability and viability of these banks.

The data are collected from secondary sources. The data published by Reserve Bank of India

(RBI) is suitably compiled and analysed for the purpose of study.

Asset quality and NPA

The quality of loan portfolio is very critical for the health of a bank. It is studied through the composition of the portfolio which ranges between "Standard" to "Loss". The main determinants of this quality are the performance record of the clients and the credit recovery mechanism of the bank. Sometimes the target of priority sector lending also allows some amount influence on it. However each and every bank needs a balanced portfolio with adequate and secured return.

In the recent years of structural transformation, quality has become the yardstick of performance in every sector. Thus the Indian scheduled commercial banks, particularly the public sector banks, can not deny the fact that profitability is a function of quality of loan portfolio. In this connection the quantum of non-performing assets has drawn the attentions of concerned bankers as well as of

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The international practice is that an asset is treated as "non-performing" when interest is overdue for at least two quarters. The Narsinham Committee¹ defined NPA as an advance where, as on the balance sheet date

(a) in respect of term loans, interest remains past due for a period of more than 180 days,

(b) in respect of overdraft and cash credits, accounts remain out of order for a period of more than 180 days,

(c) in respect of bills purchased and discounted, the bill remains overdue and unpaid for a period of more than 180 days,

(d) in respect of other accounts, any amount to be received remains past due for a period of more than 180 days.

(An amount is considered past due when it remains outstanding 30 days beyond the due date.) This quantum of NPA as a percentage of advances is one of the critical indicators of the quality of a bank's loan portfolio and hence its overall health². To analyse this the frequency distribution of bank's quantum of NPAs and NPAs as percentage to net advance are presented in table 1 and table 2 respectively.

Table 1 reveals that out of 100 banks 60 of them have less than Rs. 50 crore of NPAs at the lowest rung and 7 of them are in the highest slab of above Rs. 1000 crore category. Although the magnitude of NPAs is dependent on the volume and nature of advance still then the figure of 24 in the above Rs. 200 crore category clearly indicates sorry state of portfolio quality.

1. Report of the Committee on the Financial System, RBI, Nov. 1991, p-55.

2. Report on Trend and Progress of Banking in India, 1996-97, RBI, Dec. 1997, p-13.

Table 1

Frequency Distribution of Net NPAs of Scheduled Commercial Banks for 1996-97					
Net NPAs. (Rs. Cr.)	Public	Private (Old)	Private (New)	Foreign	Total
Less than 50	00	17	08	35	60
50.01-100.00	00	04	01	03	08
100.01-200.00	04	03	00	01	08
200.01-400.00	09	01	00	00	10
400.01-1000.00	07	00	00	00	07
above-1000.00	07	00	00	00	07
Total	27	25	09	39	100

Source : Report on Trend and Progress of Banking in India, RBI, 1996-97.

Table 2

Frequency Distribution of Percentage of Net NPAs to Net Advances of Scheduled commercial Banks for 1996-97					
Net NPA as % of Net Advances	Public	Private (Old)	Private (New)	Foreign	Total
0-4.0	01	04	08	27	40
4.01-8.0	10	15	01	08	34
8.01-12.0	10	06	00	01	17
12.01-16.0	04	00	00	00	04
16.01 and above	02	00	00	03	05
Total	27	25	09	39	100

Source : Report on Trend and Progress of Banking in India, RBI, 1996-97.

Surprisingly, despite all the sops administered to the Indian public sector banks during the last seven years 23 of them are still in this list of 24. Whereas only one old private sector bank is in this category. Similar observations are also made from Table 2. Out of 27 public sector banks only 11 have less than 8 per cent of net NPAs to their net advances and rest are in the above 8 per cent category. Whereas only 6 out of 25 old private sector banks and out of 39 foreign banks are found in this category.

In comparison with the international figure of 4 to 5 per cent net

NPAs to the loan assets with our public sector banks almost all of them cut a sorry figure. Most discouraging fact is that after a decline for consecutive three years (i.e. 1993-94 to 1995-96) the NPAs have again increased in 1996-97 (Table 3) The overall figure as well as the individual category figures have increased both in absolute term and in percentage. It is found from this table that public sector banks still constitute more than 90 per cent of total non-performing assets. However, the growth of NPAs over previous year for public sector banks is the minimum while it has rap-

idly increased for foreign banks. But the large volume of NPAs of public sector banks is affecting the profitability of these banks particularly and the banking sector as a whole.

Causes

One of the reasons for the accumulation of large portfolio of NPAs with banks is that often lending are not linked to productive investment and the recovery of credit is not linked to product sale. The problem is compounded by directed lending where banks are required to extent credit to meet targets stipulated by the Government often disregarding the availability of their loans³. Out of the total Net NPAs of public sector banks for the year 1996-97, the priority sector advances accounted for 47 per cent of the total NPAs and non-priority sector advances for the balance⁴. The contamination of the portfolio of priority sector lending has affected the overall asset quality drastically because of poor performance of borrowers. The borrowers are mainly farmers and small scale industries owners whose financial conditions are generally bad. The volume of bank credit stacked in sick industries is the evidence of this malady. Sometimes it is found that on the advice from BIFR and directions given from the courts the banks have been providing loans to the sick industries. This type of practice has been aggravating the situations.

Besides the faulty lending policy and compulsion from the Government to lend the priority sector

3. Jagirdar, Brinda; "Bank Debt Carve Out—The ARF Option", SBI Monthly Review, Jannum 1998, p. 19.

4. Report on Trend and Progress of Banking in India, 1996-97, RBI, Dec. '97, p.13.

there are many other causes which are responsible for the accumulation of NPAs. Many of these causes are related to faulty credit management like defective credit recovery mechanism, lack of professionalisation in the work force, long time lag between sanctions and disbursements, unscientific repayment schedule and many others. On the otherside the misutilisation of loans by the borrowers, untimely communication to the borrowers regarding their due date, lack of strong legal mechanism, political intervention at local level etc. have also been contributing their chunk to the total stock of NPAs.

Consequences

Contaminated portfolio is definitely a bane for any bank. It puts a severe dent on the profitability of a bank where it is out of proportion. And the present figure of NPAs in the public sector banks is well above the normal level. Thus the consequences envisaged during the past several years are many. Due to the presence of large NPAs it has become difficult for the banks to reduce the lending rate. This ultimately has been affecting the competitiveness of Indian banks. So when a bank does not enjoy the market competitiveness naturally

the credit expansion slump and when it happens the profitability gets a set back. Thus in this way the vicious circle goes on and on.

Another outcome is the reduction in availability of fund for further credit expansion due to the unproductiveness of the existing portfolio. Sometimes it is also found that the presence of large NPAs discourage banks to accept profitable but risky proposal loan from the customers. In other words NPAs also affect the risk taking ability of the banks. On the whole it affects the credibility of the bank and bank faces difficulty in raising fresh capital from the market in case of future need.

Cure

Today, the major drag on the bank's profitability is the high level of NPAs. The earning capacity/profitability of banks is limited by its quantum and thus inversely related to NPAs⁵. Thus reduction of NPAs to a significantly low level can strengthen the profitability position of the banks. In this respect some measures are suggested in the

5. Sastry, J.S.R.; "Recovery Management", IBA Bulletin, Special Issue, January 1996, p. 93.

Table 3

Growth of Net NPAs of Scheduled Commercial Banks							
Category of Banks	NPAs as % of Net Advance		Volume of Net NPAs (Rs. Cr.)		Share in the Total NPAs (as %)		Rate of growth over previous year (%)
	1995-96	1996-97	1995-96	1996-97	1995-96	1996-97	
Public Sector	8.90	9.18	18297.5	20284.7	94.93	90.71	11
Old Private sector	4.51	5.99	793.5	1245.3	4.12	5.57	57
New Private sector	—	2.07	—	161.4	—	0.72	—
Foreign	0.8	2.50	182.9	670.6	0.95	3.00	267
Total	7.83	8.09	19273.9	22362.0	100.00	100.00	16

Source : Report on Trend and Progress of Banking in India, RBI, 1996-97.

following paragraphs.

Improving recovery mechanism and recovery

While the ratio of NPAs to loan assets can be brought down through various measures, the biggest contribution must be through recovery. The recovery should be linked with employees performance appraisal and every bank as well as each branch must choose its own method to attend this task. There is no need of uniform *modus operandi* for all the banks since each and every bank and its branches operates under different circumstances.

Organising recovery camps with the help of local revenue authorities and gram panchayats can also yield results. The borrowers meeting can also be well organised at the panchayat office to save the time of recovery officials to locate or identify the borrowers. The necessity here is the liaising with the various parties at appropriate time.

Strengthening the Debt Recovery Tribunals (DRT) with adequate staff and legal support can be considered as another major area of improvement. The number of pending cases in various Tribunals are the burning evidence of such shortcomings.⁶ The present structure is quite inadequate to handle the pending cases. In many cases borrowers having small loans for recovery which are not coming under DRT, preview are being dealt with civil courts. This type of duality should be avoided as far as practicable. The DRTs should deal with all the types of loans and their geographical coverage should be extended immediately.

6. For details of number of cases pending in various tribunals, see. The Money Manager, Business Standard, April 24, 1997, p-2.

Recognising that weakness in the legal framework has been a major case of delay in recovery of bank loans, a number of measures to enhance the effectiveness of the law to improve debt recovery, including speedy resolution of the large number of pending suits against defaulters need to be introduced.⁷ Not only that the banks should intensify their own recovery performance which should be fundamental to the performance evaluation but recovery of loan should be treated as a strategic area. Till today the major emphasis is given on credit deposit ratio and very few banks have any broad plan of action for recovery. Special recovery cell with committed staff and with extra incentives on the basis of recovery performance should be established.

To improve the quality of lending which has a significant bearing on the recovery of loans, the designing of lending schemes, appraisal technique procedure for disbursement of loans, and monitoring of the end use of credit and recoveries should be based on applied research and frequent exchange of information within and amongst the banks in each region and across the regions.⁸

Improving credit management

The second important area on which improvements can be made is credit management. NPAs are closely linked with credit management. For better credit management it is desirable that banks with high NPAs should keep down their

7. Bhalla, Prof. V. K. : "Restructuring the Indian Financial System" Chartered Secretary, November 1997, p. 1312.

8. Parmar, Dr. T : "Reducing NPAs", IBA Bulletin, May 1995, p. 13.

credit expansion to a level just below that of the system because credit expansion has the propensity to cause hike in NPAs and the bank management has to arrive at the trade off level between the two propositions.⁹

If a bank has a very high NPA it is clear that its credit management team is weak and there is no reason to believe that its incremental lending will not generate NPAs. Thus, there is an imperative need to follow what can be called a damage containment approach by ensuring that weaker units in the financial sector grow slower than stronger units. The Darwinian principle of survival of the fittest needs to be allowed to operate in the financial sector.¹⁰

Providing fresh loans to the would be defaulters by the banks in order to avoid the old loans to be categorised as NPAs has also aggravated the situation. Sometimes it is also marked that banks simply reschedule a loan just before the default takes place and avert the classification. These type of practice by the bankers should be avoided. Rather they should acknowledge spade a spade and try to strategically avoid further accumulation of NPAs.

Even today banks shun risky customers because of the weak mechanism for recovering overdue debt.¹¹ The project appraisal, follow up and monitoring system are still re-

9. Sikdar, Sujit : "Computation of NPA, Income Recognition and Impact On Reporting of Bank Accounts", The Management Accountant, Nov. '97, p. 812.

10. Tarapore, S.S. : "Financial Sector Reform : Retrospect and Prospect", Chartered Secretary, Oct. 1996, p. 1032.

11. Handa, Rajiv : "Debt vs. Equity—India vs. Rest", The Economic Times, Investor Guide, 6.4.1998. p. 8.

main as grey areas. There is a need thus arises for developing on sound Management Information System (MIS) to evolve corrective policy/administrative measures by the top management of the banks. This will help in constant monitoring of NPAs and preventing it from further slippage.

The ARF option

To recycle the funds which are get stacked in bad portfolios the Narsimham Committee on financial sector reform, 1992 had recommended the establishment of Asset Reconstruction Fund (ARF).¹² But the ARF has not found favour for many reasons.¹³ First is the difficulty on the part of a centralised fund i.e. ARF not having wide geographical coverage. Secondly, there is great chance of cropping up of complacency on the parts of the bank to recover the loan in time. And finally Government is not in a position to finance the ARF which requires huge money. The advantage of ARF to banks would have been that their bad and doubtful debts were to be kept off their books though at a price. The banks could have got bonds upto the discounted value of debts with a certainty of income by way of interest.¹⁴ Although there are strong reasons for which ARF should be established but it should be a one time exercise as suggested by the Selvam Committee for NPA which submitted its report recently.¹⁵ The NPAs

of those banks which are committed to productivity and profitability should only be transferred to ARF.

Writing off Debt

As the last resort the non-recoverable bank loans may be written off totally from the books of accounts. But writing off a large volume of NPAs is definitely a herculean task for the banks. It should be done in phased manner and Government should provide tax benefit to such banks. But it is also the moral responsibility of the latter to see that the fresh loan does not turn to NPAs. The tax benefit should only be provided when the bank shows higher productivity in the recovery area. Thus there should be certain broad parameters/guidelines for this step.¹⁶

New initiatives

Even many steps have been taken to control the growing NPAs among Indian banks still the task seems to be remain unfinished. The international figure of 4 to 5 per cent NPAs to loan assets is a distant dream for public sector banks. To lessen the burden the Union Finance Ministry has also suggested a 4 step procedure for recovery of NPA. They include (a) a dialogue with NPA borrowers for negotiated settlement, (b) setting norms for write-off, (c) precloser attachment of assets wherever feasible, and (d) recourse to legal remedy.¹⁷ Further the recent concept of narrow banking suggested by Tarapore Committee is also another step. Banks having large NPAs or weak bank as per this concept should only in-

vest their fund in risk free assets to avoid NPAs.¹⁸ Enlarging the NPAs management scope the second Report of M. Narsimham on financial sector reform has recommended that all loan assets in the doubtful and loss categories should be identified and their realisable value determined. These assets could then be transferred to a reconstruction company. The panel suggests that after the company has been set up, it would issue NPA swap bonds to the banks for the realisable value of the swap bonds to the banks for the realisable value of the assets transferred.¹⁹

Epilogue

It has been observed that a constant effort to enhance bank profitability through upgrading the quality of assets is going on. But, rather than cure prevention is always better. Although the responsibility of reducing and preventing NPAs is solely of the banks the Central Government and State Government should provide moral and social support. Banks should get some amount of operational freedom for lending. The stipulation for priority sector lending can be relaxed on case to case basis. Further, the contaminated portfolio in the priority sector lending should not be taken into account for the calculation of NPAs or some amount of relaxation should be given for such computation. Lastly, banks should take recovery performance as the strategic area for higher profitability as suggested earlier rather than of lukewarm response to all options. □

12. For details modus operandi see the Report, 1991, pp. 61 to 63. The second Report submitted to Govt. in April, 1998 also strongly advocated for ARF.

13. RBI, Annual Report 1992-93, p. 98.

14. Editorial, "Bank's Recovery Position Extremely Grim", *The Banker*, Oct. 1997, p. 7.

15. *The Economic Times*, 5.5.98, p. 1.

16. Taori, K. J. : Management of NPAs—Policies and Perceptives, *SBI Monthly Review*, Feb. 1998, p. 65.

17. *Ibid*, Editorial; *The Banker*.

18. *The Economic Times*, 18/2/98, p. 1.

19. *Financial Express*, 6/5/98, p. 9.