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Causes for Non-Performing Assets in Public Sector Banks

Kumar Thammanaveni
University College of Commerce and Business Management
OU Campus, Tarnaka, Hyderabad, Telangana- 500007, India.

ABSTRACT

The accumulation of huge non-performing assets in banks has assumed great importance. The depth of the problem of bad debts was first realized only in early 1990s. The magnitude of NPAs in banks and financial institutions is over Rs.1, 50,000 crore.

While gross NPA reflects the quality of the loans made by banks, net NPA shows the actual burden of banks. Now it is increasingly evident that the major defaulters are the big borrowers coming from then on-priority sector. The banks and financial institutions have to take the initiative to reduce NPAs in a time bound strategic approach.

Public sector banks figure prominently in the debate not only because they dominate the banking industries, but also since they have much larger NPAs compared with the private sector banks. This raises a concern in the industry and academia because it is generally felt that NPAs reduce the profitability of a bank, weaken its financial health and erode its solvency.

INTRODUCTION

The Indian has been liberalized and globalize during the last decade or so. It has exposed the Indian financial sector to international competition in fairly significant manner. To cope with the growing competition in the present scenario the Indian banks have embarked on a massive exercise to revamp the system. Despite the overall progress made by the financial system over the years, the operational efficiency of the banking system has been unsatisfactory, characterized by low profitability, high and growing NPAs and relatively low capital base.

NPAs have turned out to be a major stumbling factor affecting the profitability of Indian banks. Before 1992, bank did not disclose the bad debts sustained by them and the provision made by them fearing that it may have an adverse impact. The banks used to take income even on NPAs on accrual basis. This helped them to disclose false profits. Owing to low levels of profitability, the banks owned funds had to be strengthened by repeated intention of additional capital by the government. The introduction of prudential norms to strengthen the banks financial position and enhance transparency is considered as a milestone measure in the financial sector reforms. These prudential norms, which relate to income recognition, asset classification, provisioning for bad and doubtful debt and capital adequacy serve three great purposes.

Definition of 'Non Performing Assets'

Definition: A non performing asset (NPA) “[1]” is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days.

Description: Banks are required to classify NPAs further into Substandard, Doubtful and Loss assets.
1. Substandard assets: Assets which has remained NPA for a period less than or equal to 12 months.
2. Doubtful assets: An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months.
3. Loss assets: As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

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Substandard assets: Assets which has remained NPA for a period less than or equal to 12 months.

Non Performing Assets and its issues

Why in news?

The President has accorded his assent to an ordinance proposed by Cabinet giving more powers to RBI to solve the massive NPA mess.

What is NPA?

- NPA is a loan or advance for which the principal or interest payment remained **overdue for a period of 90 days.**
- Banks are required to classify NPAs further into Substandard, Doubtful and Loss assets.
- **Substandard assets:** Assets which has remained NPA for a period less than or equal to 12 months.
- **Doubtful assets:** An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months.
- **Loss assets:** As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

What is the issue with NPA?

- The total size of the banking sector's NPAs is estimated at over **Rs 6.7 lakh crore,** of which no less than Rs 6 lakh crore is accounted for by state-owned banks or public sector banks (PSB).
- Approximately 16% of loans and advances of banks are **stressed assets (NPA + restructured accounts + write offs).**
- This is higher than BRICS partners except for Russia.
- This is alarming given that capital adequacy ratio threshold for banks are prescribed at 12%.
- Stressed assets for public sector banks are 17% while for private banks, it is 7% and for foreign lenders it is 6%.
- The asset quality of PSU banks is the worst amongst the lot.
- In the boom years, Indian companies took on significant loans to ramp up capacities.
- But while debt galloped, underlying assets did not grow at the same pace.

What does the new ordinance offer?

- An ordinance to amend the Banking Regulation Act of 1949 has been issued.
- The Presidential Ordinance empowers the Reserve Bank of India (RBI) to **enforce expeditious resolution of NPAs of banks.**
- The Union government has now empowered itself to direct the RBI to take necessary steps to initiate the NPA resolution process once a default has been established.
- The earlier provisions of the Banking Regulation Act did not allow the government to direct the RBI to enforce NPA resolution for cases of default.
- On one hand this new provision is an intrusion into central banks sole authority, but on other hand projects the role of the political establishment as a proactive agent in bank NPA resolution.
- NPA resolution under the amended law can take place on specific directives of the Union government.
- The ordinance also links the Bankruptcy code to the Banking regulation act.
- The Ordinance also allows the **RBI to set up oversight committees** for banks with NPAs that remain a matter of concern requiring early resolution.
- This will certainly empower the central bank to enforce a closer supervision of banks with sticky loans.
- The ordinance is likely to give flexibility to banks to resolve bad accounts and give immunity to bankers from taking legal action in future.

What does the ordinance does not offer?

- The ordinance doesn't address basic issue as to why NPAs arise.

- It doesn't provide solutions to challenges faced by banks.
- To ensure NPAs in future remain in control, a tectonic cultural shift and massive IT up-gradation is required.
- The ordinance doesn’t propose making wilful default a criminal offence as publicised.
- Instead of dealing with the issue of external constraints as envisioned by the PJ Nayak committee such as dual regulation by the finance ministry and the RBI, board constitution, etc, the Centre has taken a step back.
- Divesting them of the autonomy to take commercial decisions does little to instil confidence in banks.

Why is there a need for such a move?

- Both the Insolvency and Bankruptcy Code 2016 and the Banks Board Bureau **have done little to improve governance at PSBs.**
- The bank managements were shy of settling deals that would clean up their balance sheet.
- That was because such decisions could also incur the wrath of the investigation and vigilance departments of the government for having entered into, what they would argue were, sweetheart deals.
- At the same time, the bank managements showed no firmness in forcing the borrowers to take haircuts and lose equity in the troubled projects for which the sticky loans were obtained.
- The policy as well as regulatory environment was such that asset reconstruction companies (ARCs) were unable to strike deals on buying sticky loans on which they hoped to make reasonable returns.
- On the other hand, the bank managements were not bold enough to sell the sticky assets to ARCs at such discounts as would make the deal remunerative.
- This called for regulatory reforms that, on the one hand, would have allowed ARCs to be floated by private equity firms that could take the risks.
- And, on the other, would have allowed banks to take the financial hit on such loans in return for a more healthy-looking balance sheet.
- Thus the ordinance is an attempt at tackling the growing problem of the economy’s twin balance-sheet problem (indebted borrowers and NPA-burdened lenders).

Doubtful assets: An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months.

Assets for a bank are the loans it has given and investment made by the bank. Most important assets for banks are loans given by it. Similarly, banks make investment in government securities by purchasing them. Usually, the health as well as the financial condition of a bank is measured through the proportion of bad assets or Non Performing Assets with it.

Simply, NPA indicates the amount of loan that was not returned by the customer. An asset becomes non-performing when it ceases to generate income for the bank.

How assets are classified?

Assets of a bank are classified in terms of its repayment status. Standard assets, substandard assets, doubtful assets and loss assets are classifications of asset quality.

For a bank, classification of assets into different categories should be done taking into account credit weaknesses and the extent of dependence on collateral security for realization of dues.

What is a standard asset?

Standard Asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset should not be an NPA.

What is a substandard asset?

A substandard asset would be one, which has remained NPA for a period less than or equal to 12 months.

What is a doubtful asset?

An asset would be classified as doubtful if it has remained in the substandard category for a period of more than 12 months.

What is a loss asset?

An asset that is an NPA for a period of more than 36 months is treated as a lost asset. Such asset has been identified by the bank or internal or external auditors or by the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible.

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for. This means that full amount of the loss assets should be kept from some other sources like profit of the bank to meet the loss.

The mechanism of Provisioning is done to address the asset quality deterioration for a bank's assets. The worse is the assets' quality; higher will be the provisioning coverage ratio. Banks should make provision against substandard assets, doubtful assets and loss assets in a differential manner.

Loss assets: As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

NON PERFORMING ASSETS ORDINANCE: TO EMPOWER RBI

The Presidential Ordinance legally empowers the **Reserve Bank of India (RBI) "[4]"** to enforce expeditious resolution of **non-performing assets** (NPAs) of banks, an area where recovery has been a painfully slow process.

1. The RBI will be empowered to issue directions to banks to initiate insolvency resolution process in the case of loan default.
2. The Ordinance also allows the RBI to set up oversight committees for banks with NPAs that remain a matter of concern requiring early resolution. This will certainly empower the central bank to enforce a closer supervision of banks with sticky loans.
3. This will provide a big boost to the government's efforts to tackle mounting bad loans. The RBI has been equipped with powers to specify one or more authorities to advise banks for dealing with the problem of non-performing assets (NPAs).

FACTS AND FIGURES NON PERFORMING ASSETS

An asset, including a leased asset, becomes non performing when it ceases to generate income for the bank. A non performing asset (NPA) is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days.

Banks are required to classify NPAs further into Substandard, Doubtful and Loss assets.

1. **Substandard assets**: Assets which has remained NPA for a period less than or equal to 12 months.
2. **Doubtful assets**: An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months.
3. **Loss assets**: As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value.

The Reserve Bank of India is the supreme **monetary and banking** authority in the country. It keeps the cash reserve of all scheduled banks and hence is known as Reserve Bank. It was established on **April 1, 1935** in accordance with the provisions of the Reserve Bank of India Act, 1934. Though originally privately owned, since **nationalization in 1949**, the Reserve Bank is fully owned by the Government of India. Its main function includes; formulate, implements and monitors the

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monetary policy, prescribes broad parameters of banking operations within which the country's banking and financial system functions, Manages the Foreign Exchange Management Act, 1999, Issues and exchanges or destroys currency and coins not fit for circulation, Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker. RBI Governor **URJIT PATEL**.

Article 123 of the Indian Constitution empowers the President to **promulgate ordinances** during the recess of the Parliament. The ordinances are temporary laws having the effect of an act. It is considered one of the important legislative powers of the President, however is subject to limitations like

- ✓ If at any time, except when both houses of parliament are in session, the president is satisfied that circumstances exist which render it necessary for him to take immediate action, he may promulgate such ordinance as the circumstances appear to him to require
- ✓ An ordinance promulgated under this article shall have the same force and effect as an act of parliament, but every such ordinance
- ✓ Shall be laid before both house of parliament and shall cease to operate at the expiration of six weeks from the reassemble of parliament, or, if before the expiration of that period resolutions disapproving it are passed by both houses, upon the passing of the second of those resolutions; and
- ✓ May be withdrawn at any time by the president explanation where the houses of parliament are summoned to reassemble on different dates, the period of six weeks shall be reckoned from the later of those dates for the purposes of this clause.

2.1. OBJECTIVE OF THE STUDY

The general objective of the study was to analyze the NPA level in **commercial banks (1).** However the study was conducted with the following specific objectives.

1. To analyze the NPA level of HDFC bank Limited.
2. To study the recovery procedures of HDFC Bank Limited.
3. To examine how far the bank has been successful in reducing the NPA level.
4. To suggest measures for efficient management of NPAs.
5. To bring out en explorative & descriptive report on "Analysis of NPA in commercial banks, with special reference to HDFC Bank Ltd., Hyderabad."

2.3. TOOLS USED FOR ANALYSIS OF DATA

- ✓ The data collected were analyzed with the help of statistical tools like frequency, percentage and trend analysis.
- ✓ Tables are used to represent the consolidated data.
- ✓ Graphical representation is also used for better comprehension & presentation.

2.4. SCOPE OF THE STUDY

The was conducted in the Head Office of the HDFC Bank limited in Hyderabad. The following are the main scope of the study:

- ❖ Scope of this study is limited to the organization selected ie. HDFC bank.
- ❖ Present a picture of the movement of NPA in HDFC Bank Limited.
- ❖ This study will help to know the drawbacks of the present recovery strategies.
- ❖ This study will help them to think about new innovative recovery strategy.
- ❖ For this purpose I have covered officials of the bank from various departments.
- ❖ Finance Manager of the bank is covered in this study and he is interviewed in presence of the other departmental officials of the bank.

RESEARCH DESIGN

A study on the Management of Non Performing Assets in the HDFC Bank's Loan Portfolio is done at the HDFC

Bank Donimalai Township, Sandur (TQ), Bellary (Dist), Karnataka State.

The type of research used for the collection & analysis of the data is "Historical Research Method".

The main source of data for this study is the past records prepared by the bank. The focus of the study is to determine the non-performing assets of the bank since its inception & to identify the ways in which the performance especially the non-performing assets of the HDFC Bank can be improved.

The data regarding bank history & profile are collected through "Exploratory Research Design" particularly through the study of secondary sources and discussions with individuals.

Primary data:- were collected using Inventory schedule & also through interview, held with the Finance Manager in presence of the other officials of HDFC Bank Ltd.

Secondary data:- were collected from the published annual reports of the HDFC Bank and other sources. Such data collected were analyzed for some kind of a trend and its impact on the profit of the bank.

LIMITATIONS OF THE STUDY:

- The study is mainly based on the secondary data provided by the bank. As such it is subject to the limitations of the secondary data.
- The study is based only on NPAs with respect to loans.
- The study is based on the data given by the officials and reports of the bank. The confidentiality of some facts and figures is a limitation.
- The non-availability of relevant information is one of the limitations.
- The study is done only for the limited past 3 years.

REVIEW OF LITERATURE

Many studies have been conducted by researchers on NPAs in banking Industry. The researcher has made attempts to present a brief review of literature available, which are published in the form of research articles and technical papers published in the journals, magazines and websites in the related area. The review of the literature is used to formulated theorical analysis of Non-performing loans undertaken in the present study. This study is designed for analyzing NPA and its impact on profitability in selected public sector and private sector banks in India.

Amandeep (1991) "(2)" attempted to estimate profit and profitability of Indian Nationalized banks and to study the impact of priority sector lending, credit policies, geographical expansion, industrial sickness, competition, deposit composition , establishment expenses, ancillary income, s[read and burden on bank profitability. For this purpose trend analysis, ratio analysis and regression analysis were used.

Swamy (2001) studied the comparative performance of different bank groups since 1995-96 to 1999-2000 . An attempt was made by researcher to identify factor which could have led to changes in the position of individual banks in terms of their share in the overall banking industry. He analysed the share of rural branches, average branch size , trend in bank's profitability , share of public sector assets , share of wage in expenditure , provision and contingencies, net NPA in net advances , spread , has been calculated . He conducted that in many respects nationalized public sector banks much better than private banks, even they are better than foreign banks.

Rituparna Das (2002) performed a research on Managing the Risk of NPA in the Small Scale industries in India. IN this article the researcher tries to Seek a solution to the problem of NPA in the small Scale industries under the present circumstancesof banking and insurance working together under the same roof. What is stressed in this article is pressing need of the small scale enterprenear for becoming aware and educated in modern business management holding a professional attitude rational decision making and banks have to facilitate that process as a part of the credit policy sold by them.

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COMPANY PROFILE

HDFC "[3]" is India's premier housing finance company and enjoys an impeccable track record in India as well as in international markets. Since its inception in 1977, the Corporation has maintained a consistent and healthy growth in its operations to remain the market leader in mortgages. Its outstanding loan portfolio covers well over a million dwelling units. HDFC has developed significant expertise in retail mortgage loans to different market segments and also has a large corporate client base for its housing related credit facilities. With its experience in the financial markets, a strong market reputation, large shareholder base and unique consumer franchise, HDFC was ideally positioned to promote a bank in the Indian environment.

As on 31st December, 2009 the authorized share capital of the Bank is Rs. 550 crore. The paid-up capital as on said date is Rs. 455,23,65,640/- (45,52,36,564 equity shares of Rs. 11/- each). The HDFC Group holds 23.87 % of the Bank's equity and about 17.94 % of the equity is held by the ADS Depository (in respect of the bank's American Depository Shares (ADS) Issue). 27.46 % of the equity is held by Foreign Institutional Investors (FIIs) and the Bank has about 4,58,683 shareholders.

DATA ANALYSIS

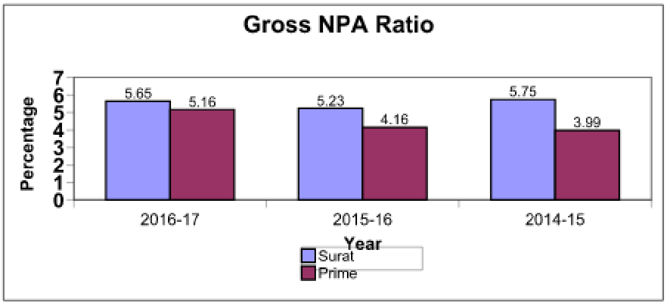
GROSS NPA RATIO

Gross NPA is sum of all the loan assets that are classified as NPA as per the RBI guidelines as on **the balance sheet data "(5)"**. Gross NPA ratio is the ratio of gross NPA to gross advantages of the bank. When it is to be expressed in percentage, it is known as gross NPA percentage.

Gross NPA Ratio = **Gross NPAs** **x 100**

Gross advances

BANK	2016-2017	2015-2016	2014-2015
HDFC.	5.65%	5.23%	5.75%
PRIME	5.16%	4.16%	3.99%



Interpretation:

Above table and chart indicates the quality of credit portfolio of the banks. High gross NPA ration indicates low quality credit portfolio of the bank and vice-versa. We can see from the above two banks gross NPA ratio that is HDFC co-operative bank has stable at 5 to 6% and prime bank ratio has increasing from the last 3 year. It indicates that the quality of credit portfolio of HDFC Bank is lower.

2. NET NPA RATIO:

The net NPA percentage is the ration of NPA to net advances, whereas the net NPA can be simply worked out as the gross NPA minus provisions held for NPA account, and net advances can be simply worked out as the gross advances minus provisions held for the NPA account.

Net NPA Ratio = **Net NPA** **x 100**

Net Advances

Net NPA Ratio = **Net NPA - provisions** **x 100**

Gross advances – provisions

BANK	2016-2017	2015-2016	2014-2015
HDFC .	3.58%	3.67%	4%
PRIME	4.99%	4.33%	3.57%

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Interpretation:

Above table and charts indicates the degree of risk in the portfolio of the bank. High NPA ratio indicates high quantity of the risky assets in the bank for which no provision was made. Above table of two banks are indicates that the net NPA ration of the HDFC bank was higher than prime bank. It saws that HDFC bank consist of risky assets on which no provision has been made. It will become dangerous in the long-term solvency.

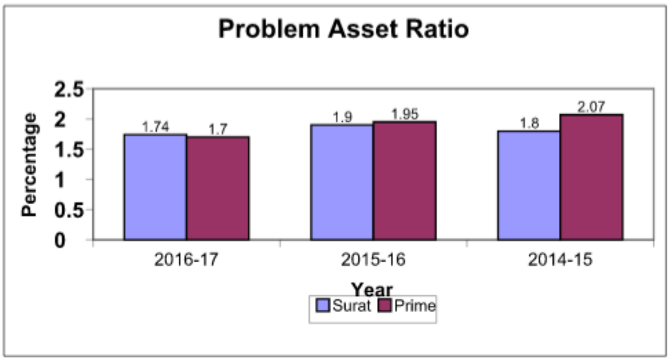
3. PROBLEM ASSET RATIO:

It is the ratio of gross NPA to total assets of the bank.

Problem asset Ratio = Gross NPAs x 100

Total asset

BANK	2016-2017	2015-2016	2014-2015
HDFC .	1.74%	1.90%	1.8%
PRIME	1.70%	1.95%	2.07%



Interpretation:

It has been direct bearing on return of assets as well as liquidity risk management of the bank. High problem assets ratio means high liquid. Above table shows that HDFC bank becomes successful in achieving lower problem asset ratio whereas prime bank have comparatively higher ratio indicates.

FINDIGS

- ✓ From the gross NPA Ratio of the bank in 2015 is 5.75%. Which suddenly decreases in 2016 i.e. 5.23% by 0.52%. It is good for the bank But in increases in 2017 i.e. 5.65% by 0.42%, which is bad for the bank.
- ✓ Gross NPA Ratio i.e. HDFC co-operative bank has stable 5 to 6 % and Prime bank ratio has increases from the last three years. So quality of credit portfolio of HDFC bank is lower.
- ✓ Net NPA Ratio of The HDFC Bank was higher than Prime Bank. It shows that HDFC Bank consist of risky assets. It will become dangerous in the long term solvency.
- ✓ Depositor’s Safety ratio is lower than compare to prime bank in each year. So HDFC bank should improve it.

SUGGESTIONS

- ✓ Identifying reasons for turning of each account of a branch into NPA is the most important factor for upgrading the asset quality, as that would help initiate suitable steps to upgrade the accounts.
- ✓ The bank must focus on recovery form those borrows who have the capacity to repay but are not repaying initiation of coercive action a few such borrows may help.
- ✓ The recovery machinery of the bank has to be streamlined, targets should be fixed for field officers / supervisors not only for recovery in general but also in terms of upgrading number of existing NPAs.

CONCLUSION:

NPA Act is a fine, comprehensive and an extra-ordinary piece of legislation. It is also a reassuring sign of Government’s commitment to reforms. The Act empowers banks to change or take over the management or even take possession of secured assets of the borrowers and sell or lease out the assets. This is for the first time that the banks can take over the immovable assets of the defaulting borrowers without the intervention of the court. They can claim future receivables and supersede the Board of Directors of the defaulting corporate. No court, other than Debt Recovery Tribunal, can entertain any appeal against the action taken by Banks and Financial Institutions under this act.

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