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Understanding Impact of Non-Performing Assets on Indian Banks: A Review of Studies

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ABSTRACT:

The ongoing rise of non-performing assets has become a significant concern for all parties involved in the Indian banking sector. The bank's profitability is under pressure due to rising interest costs and non-performing asset levels brought on by consistent fund requirements and an increasing defaulter rate. The study's goals are to assess the performance of the Indian banking sector regarding the accumulation of nonperforming assets (NPAs), pinpoint the reasons behind the rise in NPAs in Indian banks, and suggest the essential steps for a considerable reduction in NPA. The research report included secondary data that was downloaded from multiple websites and included in several research studies that were published in reputable national and international journals. Apart from these, various reports available in the numerous domains are also considered as the source of key information inputs. The paper will try to give a glimpse of the literature on NPA management after considering the guidelines of the various committees on banking supervision to manage the defaulter risk. The focus of the research work is to identify the scope and direction in line with factors responsible for NPA and what key financial statements need to be observed to arrive at a conclusion regarding the issue of NPAs.

Keywords: NPAs, Indian Banks, Microeconomic Variables, Macroeconomic Variables

Introduction:

Non-performing assets are the key factor in determining a bank's efficacy and financial health. They affect the banks' operational productivity, which in turn affects the banks' proficiency, profitability, liquidity, and solvency positions. The analysis looks at the various factors that affect banks' non-performing assets (NPA) worldwide. The investigation also includes the work completed by various analysts in relation to NPA, accepted standards, and strategies for reducing NPA while assisting the banks in finding a solution to the growing problem of non-performing assets. Sums of Non-Performing Assets have become a significant risk for the Indian banking industry. Banks act as middlemen to direct domestic savings funds toward profitable ventures to hasten the growth of the country.

Banks are regarded as a key business component because they generate resources through advances. It will be difficult for banks to fulfill their obligations to investors and depositors if they are unable to comprehend these advantages. Due to the nature of advances—which are an indebted source of well-being and growing profitability for banks—bank management is concerned. The assessment of resource quality includes the estimation of risk management, control, and write-offs for banks. "Potential default of a borrower to meet the commitment as per the concurred term" is how the Basel Committee on Banking Supervision defines and recognizes risk. The success of banking is evaluated based on the type and amount of advantage it receives from outside sources.

According to the RBI's 2021 Financial Stability Report, SCBs' gross non-performing asset (GNPA) ratio may rise from 7.48 percent in March 2021 to 9.80 percent by March 2022 under the baseline scenario and 11.22 percent under a severe stress scenario. However, SCBs have sufficient capital at both the aggregate and individual levels, even under stress. The ongoing increase in non-performing assets (NPAs) negatively impacts bank profitability. The banking sector's capital-to-risk-weighted assets ratio (CRAR) has increased slightly and is now above the Basel III level. However, challenges remain if the issue is not addressed.

Problem Definition

Even while banks prioritize lending to the most vulnerable sectors of the economy, maintaining resource quality and productivity is essential to the banks' existence and growth. It has been determined to implement the "90 days" overdue" criterion for NPA designation in accordance with committee recommendations to progress toward best banking practices and to provide greater transparency in the system. According to RBI regulations, a loan or advance made by the bank that has not received payment for principal installments or interest for more than 90 days is considered a non-performing asset (NPA). If an account for a term loan stays inactive for longer than ninety days, the bank considers it a dead investment. An Overdraft/Cash Credit (OD/CC), is concerning when a bill is past due or unpaid for longer than ninety days. For bills that the banks have bought and discounted, interest and/or principal payments are past due for two harvest seasons, but not for longer than two and a half years. If an advance is given for agricultural purposes, any outstanding balances are past due for longer than ninety days with regard to other accounts.

The following three categories: substandard assets, bad & doubtful assets, and loss-incurring assets must be used by banks to categorize non-performing assets, depending on how long the asset has remained non-performing or not paid interest or written off the agreed amount. The research paper attempts to analyze the various NPA management points of view as well as important factors of financial statements demonstrating the sound financial standing of Indian banks.

Review of Literature :

The study of Non-Performing Assets and its impact has always been an interesting topic for scholars, but the recent banking crisis has reignited interest in the subject. Both industrialized and emerging countries have experienced various shocks and instabilities during their growth process, which is reflected in the lower quality of their bank loans, namely non-performing assets. An increase in NPLs has the potential to destabilize the banking industry, affecting balance sheets and general financial stability (Park and Shin, 2021; Das and Uppal, 2021).

Axis Bank has more debt than Bank of Baroda as of 2013–2017, according to a study that compares the nonperforming assets (NPAs) of the two banks. When Net NPAs and Net Profit of both banks were analyzed, it was also discovered that Net NPAs and Net Profit of Bank of Baroda had a negative correlation, meaning that lower debt levels and an increase in Net NPAs had a negative impact on Net Profit, whereas Net NPAs and Net Profit of Axis Bank had a positive correlation, indicating higher debt levels with higher bank income. When the NPAs of the two banks were compared, it was found that Bank of Baroda was experiencing a negative correlation whereas Axis Bank was exhibiting a positive correlation. The adage "Prevention is better than cure" applies here, thus quick corrective action and timely steps should be made to control it (Gadhia, 2018).

The study examined the relationship between net profits, total advances, and gross and net non-performing assets (NPA) at Punjab National Bank as well as the impact of these assets on the bank's profitability. The Punjab National Bank's annual reports covering the six-year period from 2006–07 to 2011–12 were examined for the study. The study revealed that a positive correlation exists between PNB's Net Profits and NPA. According to (Nurula and Singla,2014), there was apparent and implied bank mismanagement, which led to an increase in non-performing assets.

The notion of non-performing assets was used in a different study by the researchers titled "Unearthing the Epidemic of Non-Performing Assets: A Study of Public and Private Sector Banks," which examined how public and private sector banks classified their loan and financing assets. The analysis looked into and found that private sector banks were doing better than public sector banks in terms of the decline in the non-performing assets (NPAs) ratio. It also found that the public sector banks' NPAs needed to be checked for the Indian banking system to become more efficient over time (Arora and Ostwal, 2014).

Restructuring the low-quality assets and financing patterns that contributed to a high percentage of nonperforming assets would be a significant task for Indian banks, according to the report. Large banks would benefit from the rules due to their experience in risk management, portfolio diversification, and expertise minimization. According to (Mehta and Malhotra,2014), the banks must also create new, advanced computerized technologies to cut down on data analysis costs and eliminate the majority of historical data.

The identification of India's commercial banks' non-performing assets was emphasized by the researcher. The numerous common causes that turn advances or assets into non-performing assets were observed and supported in this study, which also offered helpful recommendations on solutions to address the issue at hand. (Srinivas,2013) noted that the study also focused on how closely commercial banks adhered to the goal of an effective recovery management system. This article aimed to uncover and provide methods of interpreting the credit/defaulter risk resulting from current bank non-performing assets (NPAs). It also offered insight into the evolving dynamics of NPA in the risk framework of certain Indian commercial banks.

Subsequent investigations revealed the significant actions and procedural execution undertaken by prominent Indian commercial banks, both in the public and private sectors, with the aim of retrieving loans and advances that are classified as non-performing assets (NPAs). The Indian Banks Association's (IBA) yearly reports on the performance of commercial banks in the public and private sectors served as the foundation for the study's research. Additionally, the study for the year ending in March 2012 was the topic of commercial banks' annual reports, and it found that the best way to address the issue of non-performing assets (NPAs) is through appropriate credit assessment, competency evaluation, and risk management mechanisms within the banking system (Sikdar and Makkad, 2013).

According to the study, the Indian banking industry is undergoing a fast transition, and because of their modest size, private sector banks from the older generation will likely face numerous difficulties. While the corporate control system of small private sector banks has improved, the rise in gross nonperforming assets is a cause for worry. The housing and retail credit sectors are two of the credit categories that are most likely to see an increase in NPAs. In some instances, aggressive private sector banks have been forcing them to accept house financing with no minimum margins at all. Up until recently, banks were making a fortune on houses since floating interest rates were generally heading higher. The repayments will undoubtedly be impacted now that a huge number of IT employees are on benches and the banks are pursuing them with pink slips, forcing the banks to increase the provisions on their balance sheets. The other connected segments that can see a drop in revenue include hotels and transportation. Banks that are heavily exposed to these markets may see a slow increase in non-performing assets (NPAs) (Thingalaya, 2013).

The operational performance of State Bank of India and Canara Bank of India, two public sector banks, was assessed in the research during the years 2007–12. Gross non-performing assets (NPAs) of SBI were found to be greater than those of the Central Bank of India (Vasantbhai, 2013). The study conducted by the researchers revealed that there is no noteworthy distinction in the Scheduled Commercial Banks (SCB) in India's net profit to asset, net profit to deposits, net profit to net worth, net profit to advances, NPA to assets, and spread income to assets ratios. It was noted that the ratios of non-interest income to total income advances to non-interest income, and interest income to total income all differ significantly. There exists no significant difference in the growth rates of income, expenditure, and profits of SCBs in India (Selvakumar and Nagalakshmi, 2012).

For seven years, another study looked at the nonperforming assets (NPA) of Indian public and private sector banks that serve possibly poorer demographics. The Reports on Trends and Progress of the Indian Banking Sector were the source of the secondary data analysis. According to (Chaudhary and Singh's, 2012) assessment, public sector banks have outperformed private sector banks in recovering non-performing assets (NPA) during the 2004–10 period when statistical tools like percentages and compound annual growth rate were used.

The researchers provided an empirical and descriptive study titled "Unearthing the Epidemic of Non-Performing Assets regarding Public Sector Banks in India" that illustrated the scope, size, and direction of public sector banks in the country. It was shown that the diverse NPA proportion was declining, which is a sign of a minor improvement in asset quality. According to the study's findings, non-performing assets (NPA) are a crucial metric for evaluating a bank's profitability, liquidity, and operational economies of scale. Banks must also act quickly to prevent the depreciation of their high-performing assets (Hosmani and Hudagi, 2011).

An attempt was made to define and explain the concept of non-performing assets (NPAs), as well as the major factors that contribute to their increase, the reasons behind their high levels, the size of NPAs, and their impact on Indian banking operations, in the research paper that followed, titled "A Comparative Study of Non-Performing Assets of Public and Private Sector Banks." In addition to the public and private sector banks' capital-to-risk weightage assets ratio, topics covered included credit and defaulter risk management, NPA threat mitigation, and other related topics (Kaur, 2010).

Afterwards, the researchers conducted a study on non-performing asset (NPA) management with a focus on Karnataka Central Cooperative Bank Ltd. They expounded on the conceptual data surrounding NPA, computed a few ratios related to NPA, and employed the trend projection method to forecast the bank's yearly progress. Among their conclusions were the bank's significant NPA decrease as well as some recommendations for lowering NPA and guaranteeing returns (Monteiro and Ananthan, 2007).

Objectives

The objectives of the paper are:

1. To study NPA, various types of NPA, and its causes
2. To analyze and suggest methods for reducing non-performing assets (NPAs).

Discussion

Studies aimed at ensuring that international best practices for repayment standards are followed have shown that adopting a 90-day overdue term will lower net present value (NPA) and have an impact on collection within the allotted timeframe. Additionally, the study made the following deductions and brought them to light:

- Interest and/or installment of principal remain overdue for more than 91 days in respect of a term loan,
- The account remains out of order for more than 90 days, in respect of an Overdraft/Cash, Credit (OD/CC),
- The bill remains overdue for more than 90 days in the case of bills purchased and discounted,
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two and half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for more than 90 days in respect of other accounts.
- Non-submission of Stock Statements for 3 Continuous Quarters in case of Cash Credit Facility.
- No active transactions in the account (Cash Credit/Over Draft/EPC/PCFC) for more than 91 days.

Depending on how long the asset has been non-performing and how reliable the payments are, non-performing assets can be further divided into the following three categories:

1. Assets below par/ Sub-standard assets: An asset that has been labeled and justified as non-performing for a duration of little more than a year is considered substandard.

2. Dubious/ Doubtful Assets: An asset that has remained non-performing for more than a year is considered dubious.

3. Loss Assets: These are assets where loss has been noted and recognized by central bank inspectors, internal or external auditors, or banks. However, the money has not been fully or partially recovered and written off.

Reasons for Occurrence of NPAs

NPAs are defined as bad loans or instances of principal and interest repayment default. when a borrower can't afford to fulfill financial commitments, like missing a loan installment, NPAs are created. The following factors may result in these loans:

- Wilful Defaults: When a borrower is not paying his debts to the lender however borrower is able to pay their due obligation.
- Misuse of funds: Sometimes borrowers take out loans for different purposes, but in reality, they use the money for other purposes, such as taking out loans for a longer period than intended, which prevents them from earning enough money to pay back the loans on time.
- Loss Projected on components (due to environmental reasons, natural calamities, business cycle, Disease Occurrence, etc.)
- Industrial Crisis: This external factor has an impact on the nation's bank non-performing assets (NPAs). Industries have occasionally experienced performance issues. For example, the real estate sector has had problems over the past five years, and bank financing for real estate has defaulted, A banking crisis (as happened in South Asia and Japan) .
- Incremental component (due to internal bank management, like credit policy, terms of credit, etc.)
- Lenient Lending Standards: One of the main causes of the rise in non-performing assets (NPAs) is the banks' own lethargy. It is also a result of the banking industry's fierce competition and aggressive funding for expansion. Bad lending practices/ Usual banking operations.

Problems Caused by NPAs :

NPAs have a negative effect on the country's economy in addition to appearing poorly in a bank's account books. Among the consequences of NPAs are the following:

- In addition to frequently losing uninsured savings, depositors do not receive fair returns. Banks could start imposing greater fees on some goods' interest rates to make up for losses from non-performing loans
- Bad loans indicate that money is being diverted from worthwhile initiatives to unfavorable ones, which has a negative impact on bank shareholders. As a result, the economy suffers from the loss of worthwhile enterprises and the failure of poor investments.
- Liquidity issues may arise if the bank does not receive interest or loan repayment payments.

Determinants of NPAs

The rise of nonperforming loans is directly impacted by several factors. These variables can be categorized into two groups for ease of understanding: macroeconomic factors and microeconomic elements.

Micro Economic Factors influencing NPAs

The banking sector's unique features and policy choices, notably regarding efficiency and risk management, are projected to impact the evolution of NPLs. In the literature in terms of microeconomic determinants, generally, the variables such as asset size, capital adequacy, asset quality, liquidity, deposit, and income expenditure structure are considered. Previous research has highlighted bank-specific variables such as size, inefficiency, quality of management, leverage, ownership, and profitability (Zribi and Boujelbene, 2011; Podpiera and Weil, 2008; Ahmad and Ariff, 2007). According to (Kwan and Eisenbis,1997), moral hazard, ownership structure, and regulatory measures are the primary influences on bank risk-taking behavior.

Macro Economic Factors influencing NPAs

The empirical data generally points to a close relationship between bank problem loans and economic activity; in other words, macroeconomic variables like declines in overall economic activity are always at the root of financial crises. Businesses and consumers cut back on cash inflows (wages, sales) when growth slows or even reverses, making it more difficult for them to repay the loans. NPLs are influenced by macroeconomic volatility, which reflects a country's undiversified economy (Fofack, 2005). According to (De Bock and Demyanets, 2012), a country's lending rate and unemployment rate have a positive influence on NPLs, while GDP has a negative impact (Erdas & Ezanoglu, 2022; Huljak et al., 2022;).

According to (Jimenez and Saurina,2006), banks predict that in the event of a recession, enterprises and consumers will face a shortage of cash, which could lead to delays in meeting their financial obligations. In these situations, they are more likely to implement strict lending policies (credit crunch), which exacerbates businesses' and consumers' liquidity issues. The pace of economic activity continues to slow compounding the problem loan difficulty.

Financial liberalization proponents contend that negative real rates of interest imposed by a financially repressive system restrict savings and investment (Ghatak, 1981; Fry, 1988). High real interest rates appear to have the potential to increase borrowers' cost of capital and make it more difficult for them to make timely loan repayments in the banking industry. This would imply that greater real interest rates would lead to an increase in non-performing loans; hence, a positive coefficient is anticipated for this variable.

Financial Impact of NPA

The numerous studies concentrated on the variable impact and evolving relationship of NPA on ratios and financial statements. Financial statements accurately reflect a bank's financial health and welfare. Any changes in non-performing assets will be reflected in the company's financial accounts. Research suggests that banks' aggressive credit lending policies are primarily responsible for the rise in non-performing assets on their balance sheets (Mcgoven, 1993). Other studies analyzed the net worth, liabilities, assets, income, expenses, profitability, and efficiency of various banking firms. The study found that public sector banks performed poorly compared to international and private sector banks across all criteria. The researcher proposed that commercial banks be redefined in such a way that there is an alignment between the business profitability and social duty of public sector banks (Sreedhran,1996). (Thiagarajan, S. and Ramachandran, A., 2011) analyzed defaulter risk in the Indian banking sector from 2001 to 2010 utilizing financial data and important credit risk measures. It was understood that ratio analysis resulted in a gradual decrease in the ratio of non-performing assets to total loans for both public and private sector banks between 2001 and 2010. Their findings confirm that while chosen ratios move similarly, sector-wise comparisons reveal considerable variances among bank groupings. Thus, financial statements are accurate forecasters of financial health, and all NPA decisions are based on the bank's ratios, profit and loss account, and balance sheet.

Conclusion :

According to the survey, one of the most essential and critical issues for banks to manage and control is non-performing assets (NPA). The rising number of nonperforming assets (NPAs) is a setback for banks, and they may be at a disadvantage if a robust recovery framework is not built and recovery efforts are not implemented. To address the impact of non-performing assets (NPAs) on banks and the economy, an effective recovery system is necessary to reduce rising defaulter rates. Reduce interest collection time and ensure creditworthiness and financial stability. Banks should adopt a tight mechanism for dealing with defaulters to ensure payment is made as promised. Interest rates should also be regulated to ensure that banks do not lose interest repayments. Financial statements and records must be thoroughly analyzed in order to maintain track of NPAs and manage them to a minimum. The ratios namely cash-deposit ratio, credit-deposit ratio, net interest margin, profit per employee, return on assets, and the ratio of return on equity represent the liquidity, efficiency, solvency, and profitability of the Indian commercial banks represent the state of the Indian commercial banks. Hence decisions can be framed easily to ensure the smooth functioning of the banks. NPAs are like viruses that wreak havoc on the banking industry's growth. It also impacts liquidity and profitability by threatening asset quality and bank survival. PSBs are susceptible to greater asset quality implications because they are the primary lenders to critical and sluggish industries such as power and agriculture, which suffer significant losses during the economic downturn. To handle non-performing assets (NPAs), banks should establish robust recovery mechanisms to avoid losses. Financial indicators are important predictors of financial health, and a continuous appraisal and feedback mechanism should be built.

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