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Analyzing the Factors Contributing to Accumulation of NPAs in Public and Private Sector Banks in India

By

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Abstract

"Non-performing Assets (NPAs)" are the grave fear for banking system of India. NPAs show the overall efficiency of banks and affect their profitability and liquidity. Increasing NPAs are serious problem in the banking sector in India. The growth of NPAs directly affects the profitability of banks. It consists of provisions to reduce the overall shareholders' value and profits. NPAs are affecting both banks and economy as a whole. Hence, this study analyses several internal and external factors leading to accumulation of NPAs in Indian banking sector and recommends solutions to deal with this recurring problem.

To fulfil these objectives, this study is based on primary data collected from selected employees in banking sector in India. A self-structured questionnaire was prepared with questions related to internal and external factors of NPA distributed using Google Form through online mode. SPSS Software is used to analyse the data and provide meaningful insights for further studies and policymakers to make necessary changes. NPAs affect the economy by reducing the flow of capital and creating unhealthy environment for the overall financial growth of the country.

Keywords: **"***NPAs, non-performing assets, Indian banking sector, private sector banks, public sector banks, internal factors, external factors***"**

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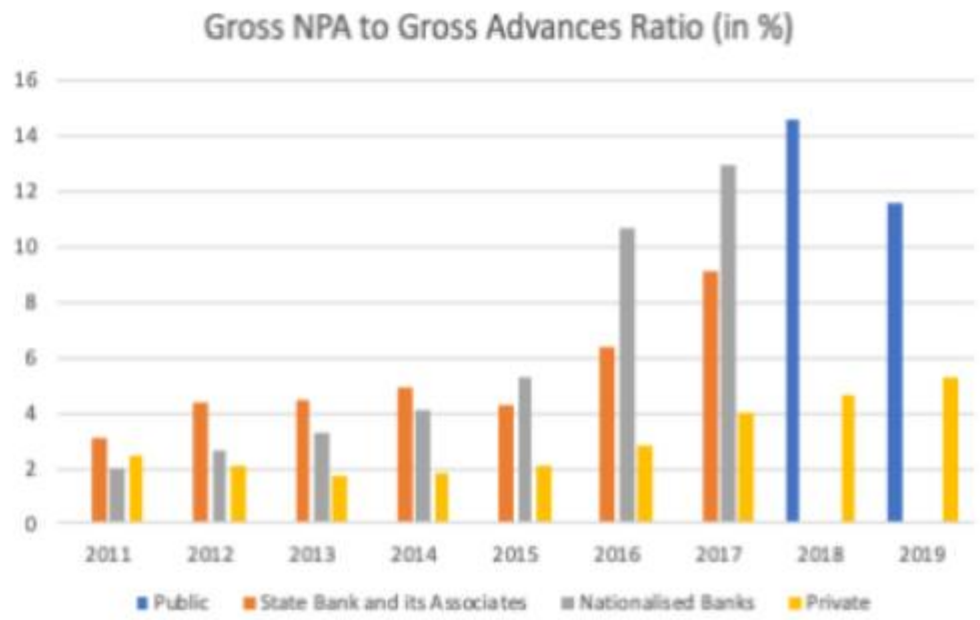
1. Introduction

A country is developed due to its robust financial sector. A sound financial system has a lot of benefits for the country. So, boosting the financial sector has become the need of the hour in India. Cases of bad loans or Non-Performing Assets (NPAs) are increasing which affect the efficiency and performance of banks. Several renowned industrialists like Nirav Modi and Vijay Mallya have scammed the banks several times. These high-profile cases of financial frauds have made common public to lose their faith in banking system in India and raised the question on its regulatory strength. Figure 1 illustrates the rise of NPAs due to "state-owned banks (SOBs) (Jain & Sharma, 2019).

Figure 1 – Growth of NPAs from 2011 to 2019 due to SOBs



Source - Khandelwal & Modi (2019)

It is worth noting that "State Bank and its Associates" and "Nationalized Banks" have been merged in "public sector banks (PSBs)" since 2017. There has been a broad rise in NPAs when considering the gross NPAs as percentage of gross advances (Kaufmann & Kraay, 2019).

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1.1 Background

The financial health of financial sector is a grave concern from economic perspective of any country. There are some disputes on the direction of causality among economic growth and financial development, but it is certain that economy and financial systems of a country are interconnected. With the help of intermediaries, financial sector plays a vital role in promoting transactions, mobilizing funds, and controlling the cost of acquisition of business for economic growth. Loan application is critically analysed by the financial intermediaries and loans are issued to promote good investments. Banks and other financial institutions also allow businesses and people to invest in profitable yet riskier products to diversify their risk over safer customers (Joseph & Prakash, 2014).

Financial security and stability are also important for country's economic growth along with financial growth. Assets become volatile and liquidity is reduced in the economy due to financial instability, which may cause banking crisis. Funds for investment will be lower and public confidence will also be affected by inefficient banking sector. To avoid this kind of scenario, banks reduce credit risk (i.e., due to risk of default) to focus on risk management. Credit risk means possible borrower's default to meet the agreed obligation, as per the "Basel Committee" (Thiagarajan et al., 2011). NPAs are the main reason behind credit risks. A leased asset or other assets turn out to be non-performing when they stop generating any income for the bank.

All in all, it is evident that NPAs are the serious issue that is faced by the whole banking system. First of all, it affects the profitability of banks as they lose the revenue of earning through interests, which is the key source of revenue for banks. Along with losing interest, banks also lose the amount of capital for generating that interest. Every bank has to maintain a specific percentage of assets. However, banks have to control the aggregate lending due to NPAs to maintain their cash flow. Shareholders lose confidence on banks due to reduced profitability by NPAs. The return on the capital reduces for shareholders and their value is also reduced subsequently (Rathore et al., 2016). These types of situations reduce faith in public about the banking system. Hence, public become anxious in depositing their hard-earned money and avoid investing in banks and financial intermediaries, which might cause harmful impact on the economy.

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2. Literature Reviews

Kumar (2017) argues that NPAs have been a headache and painful to the "banking system of India over the past decades. The accumulation of NPAs is one of the serious concerns affecting the efficiency of commercial banks adversely. Quality of portfolio matters a lot for the existence and health of the banks. There are several implications of high NPAs on productivity, profitability, solvency, liquidity, adequacy of capital, and presence of the bank.

Selvarajan & Vadivalagan (2017) found that the growth of lending in Indian banks to private sector is more than the same in public sector. There are slippages in Indian banks when controlling the NPAs in early years. Hence, it is important to focus on management of NPAs for banks and take the right measures to avoid the creation of another NPA, while recovering the existing ones. Timely action is needed for potential growth.

Banks have credit risk management which is responsible for the rise of NPAs, according to Singh (2016). Banks should have proper preventive steps to fix the "pre-sanctioning appraisal" obligation and effective monitoring after disbursement of loan. Banks should constantly track loans to pick accounts which can be non-performing. Banks should have inspection powers to use the loans and loan must be disbursed by the borrowers on the point of purchase to ensure the proper use of deposits". Banks should also have authority of loan recovery from the guarantor.

A lot of mergers have been observed in the name of consolidation in India since 2008. In January 2019, IDBI Bank was privatized (Mint, 2019). Hence, there has been a trend of moving for privatization and increasing consolidation. Only banks are not privatized. The part of government's shares in "Life Insurance Corporation of India (LIC)" was announced to be sold by the BJP government through an "initial public offering (IPO)." These actions are much similar to the act of "Conservative Party led by Margaret Thatcher" which had privatized a lot of public businesses in the year 1979. Instead of privatizing every institution randomly, there is a need to understand the shades of the situation.

Corruption is not common merely in public sector. It might also exist in private sector. The integrity of lending by the bank is affected by higher government intervention and control which may led to corruption (Beck et al., 2006). These incidences are more common in developing nations. According to Kauffman et al. (2007), corruption is correlated negatively with "per capita income" globally. In context of NPA, there are three factors determining the "relation between ownership and NPA ratio - corruption, joint ownership, and civil corruption (Hu et al., 2004)". Hu et al. (2004) also argued that SOBs are more likely to suffer from political influence and lobbying as compared to private banks.

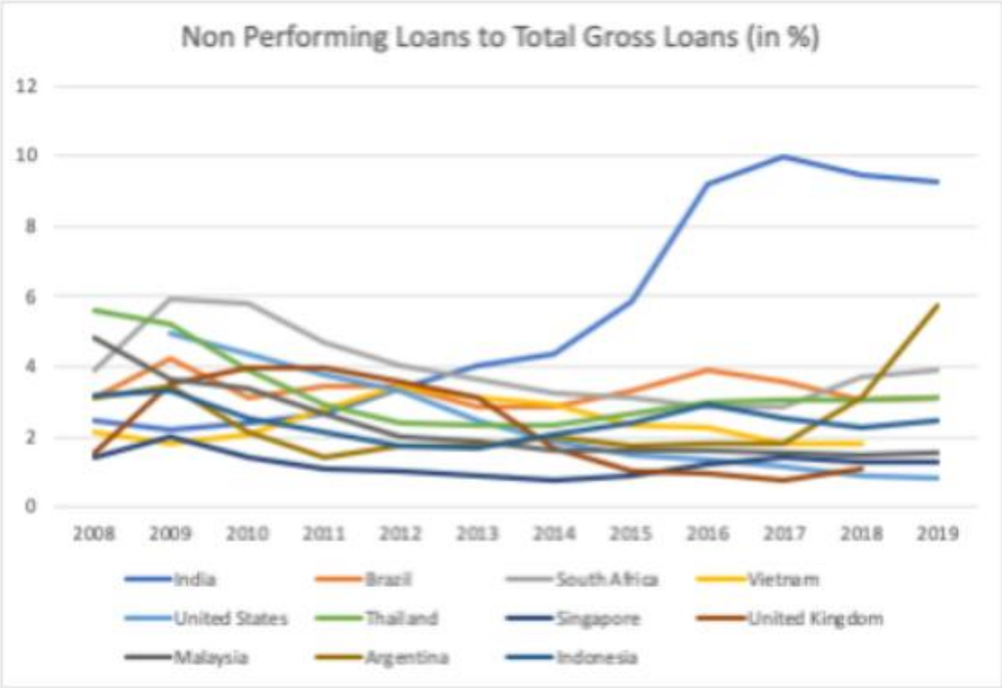
However, it doesn't mean that private banks are totally corruption-free. A lot of high-profile cases have been reported in India related to private bank corruption. These banks may be family-owned in which they lend money to risky business portfolios that are handled by family members. A lot of those cases have been reported like the fraud case in ICICI Bank, which consists of CEO and MD Chanda Kocchar, where huge amount of loans was allegedly provided to a firm promoted by her husband (Tiwary, 2020).

2.1 Research Gap

This study was conducted mainly to get an insight into situation of India about NPAs. India has a higher amount of NPAs as compared to developed countries like the UK and the US, and even some developing countries (Figure 2).

Trajectory of India is dangerously high with over 9% of NPAs for four years in a row since 2015. On the other side, other developing countries in Asia have managed their NPAs very well. It shows that India is most likely facing some NPA crisis with some global internal shocks. Hence, this study will fill this knowledge gap by discussing various internal and external factors contributing to NPAs in India.

Figure 2 – Percentage of NPAs in India and other countries



Source – Khandelwal & Modi (2021)

2.2 Research Question

- What are the "factors responsible for accumulation of NPAs in public and private sector banks in India?"
- What are the solutions to reduce NPAs in Indian banking sector?

2.3 Research Objectives

1. To analyse the "factors responsible for accumulation of NPAs in public and private sector banks in India"
2. To discuss various solutions to reduce NPAs in Indian banking sector

2.4 Hypothesis

H1 – There is a "significant impact of NPAs on profitability of public and private sector banks"

H2 – There is a "correlation between internal and external factors contributing to NPAs in public and private sector banks"

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3. Research Methodology

3.1. Research Design

This study adopts "primary research design to fulfil the objectives mentioned in the above section. In this study, primary data has been collected from employees working in banking sector in India in different positions.

3.2. Study Tools

A self-structured questionnaire was prepared with open-ended questions related to internal and external factors on the basis of 5-Point Likert scale. Google Form has been prepared to be distributed among participants through online mode. Excel Spreadsheet and SPSS Software will be used to interpret and analyse the data.

3.3. Sampling

Random sampling has been used to collect responses from participants. Total 159 responses have been collected using Google Form.

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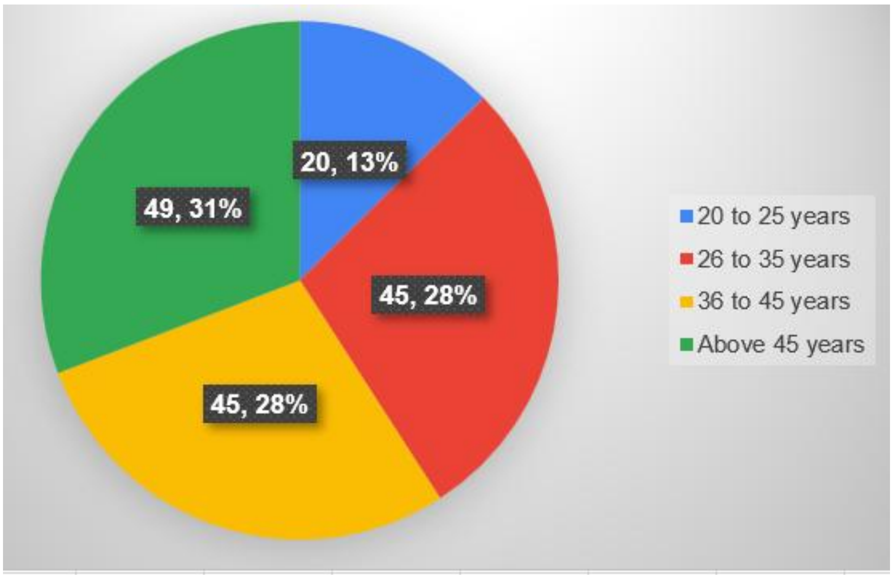
4. Analysis of Study

4.1. Demographics

In this study, 49 (31%) participants are aged above 45 years, 45 (28%) participants are 35 to 46 years old, 45 (28%) participants are 26 to 35 years old, and 20 (13%) participants are 20 to 25 years old (Table 1) (Figure 3).

Table 1 - Age Group					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	20 to 25 years	20	12.6	12.6	12.6
	26 to 35 years	45	28.3	28.3	40.9
	36 to 45 years	45	28.3	28.3	69.2
	Above 45 years	49	30.8	30.8	100.0
	Total	159	100.0	100.0	

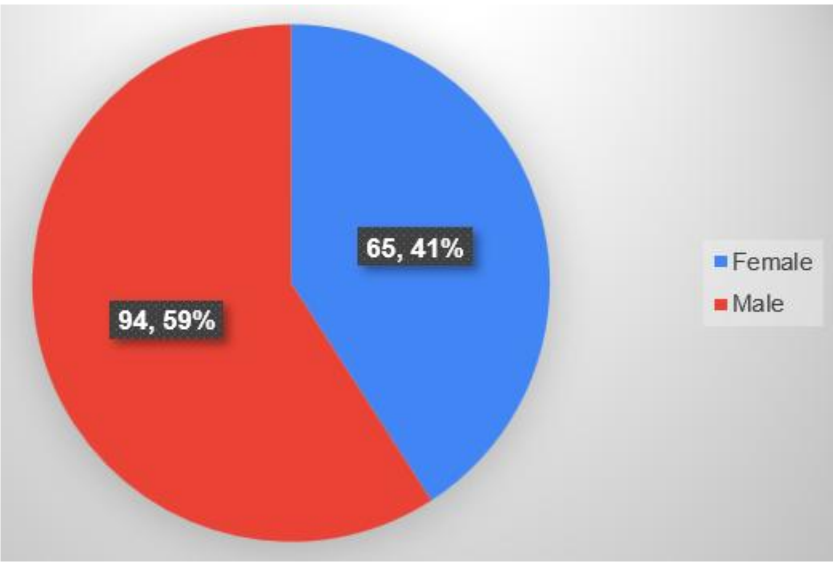
Figure 3 – Age Group of participants



There are 65 (41%) female participants in this survey and 94 (59%) male participants (Table 2) (Figure 4).

Table 2 - Gender					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Female	65	40.9	40.9	40.9
	Male	94	59.1	59.1	100.0
	Total	159	100.0	100.0	

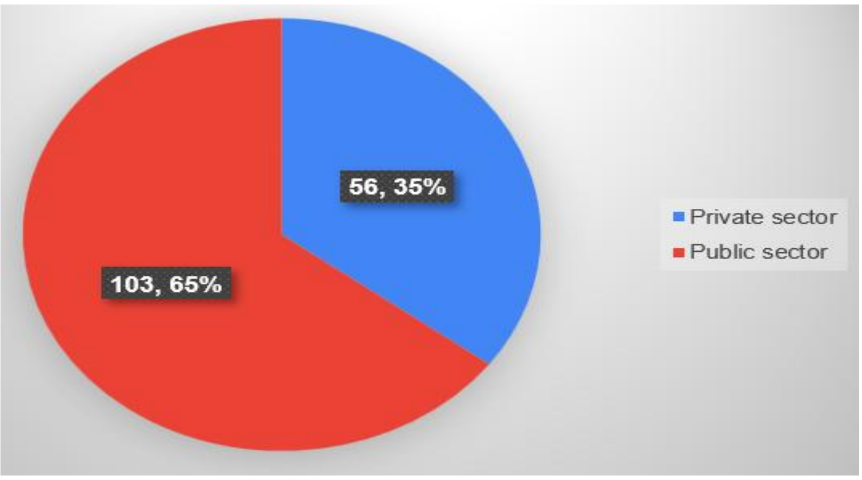
Figure 4 – Gender of the participants



There are 103 (65%) participants who were employed in public sector banks while 56 (35%) participants were employed in private sector banks (Table 3) (Figure 5).

Table 3 - Nature of bank you are employed in					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Private sector	56	35.2	35.2	35.2
	Public sector	103	64.8	64.8	100.0
	Total	159	100.0	100.0	

Figure 5 - Nature of bank



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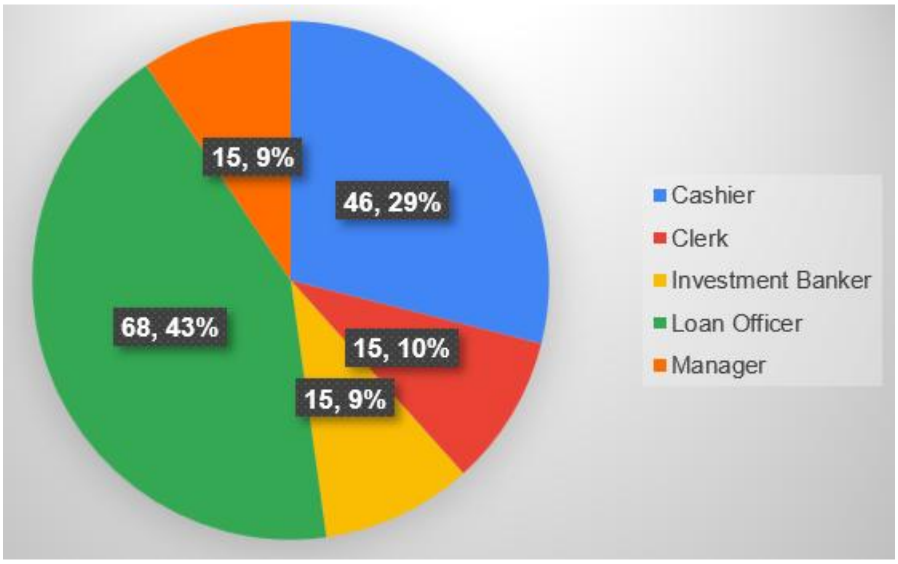
When it comes to job position of employees, 68 (43%) participants are loan officers, 46 (29%) participants are cashiers, 15 (9%) participants are managers, 15 (9%) participants are investment bankers, and 15 (9%) participants are clerk (Table 4) (Figure 6).

Table 4 - Job Position					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Cashier	46	28.9	28.9	28.9
	Clerk	15	9.4	9.4	38.4
	Investment Banker	15	9.4	9.4	47.8
	Loan Officer	68	42.8	42.8	90.6
	Manager	15	9.4	9.4	100.0
	Total	159	100.0	100.0	

Figure 6 – Job position of employees



4.2. Internal Factors

In this study, we have identified 4 internal factors contributing to accumulation of NPAs. It is found that lending process is defective and is based on outdated principles that should be updated. There are 58 (37%) participants who agree and 56 (35%) participants who strongly agree with that, while only 18 (11%) participants disagree, 17 (11%) participants strongly agree, and 10 (6%) participants neither agree nor disagree (Table 5) (Figure 7).

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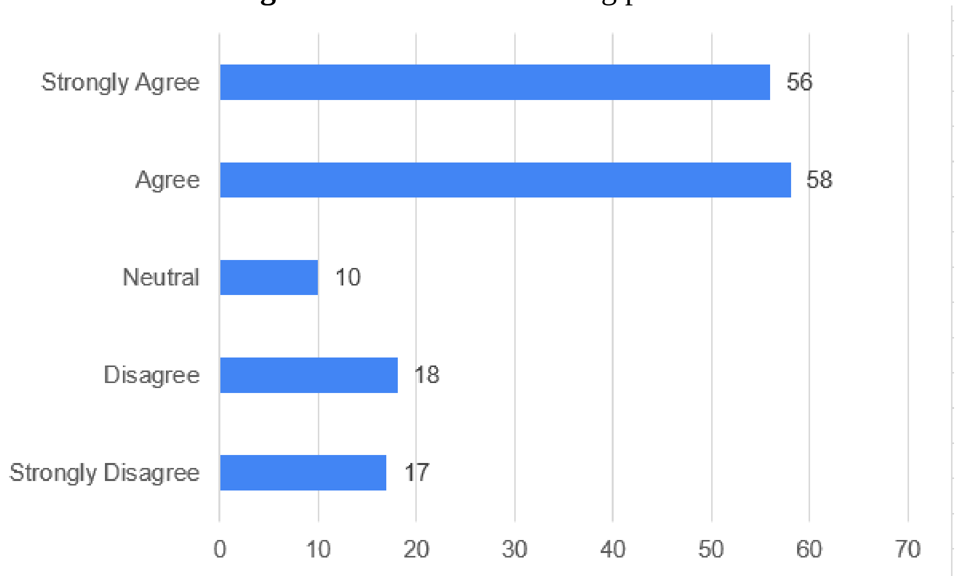
Table 5 - Lending process					
Lending process is based on outdated principles and is defective		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	17	10.7	10.7	10.7
	Disagree	18	11.3	11.3	22.0
	Neutral	10	6.3	6.3	28.3
	Agree	58	36.5	36.5	64.8
	Strongly Agree	56	35.2	35.2	100.0
	Total	159	100.0	100.0	

Figure 7 – Defective Lending process



Due to lack of technological innovation, banks are not able to take market-driven decisions in real-time. Proper financial information system and management information system are not implemented in majority of banks, which causes poor loan correction and NPAs. So, there is a need to computerize all the branches, according to 84% participants who agree and strongly agree (Table 6) (Figure 8).

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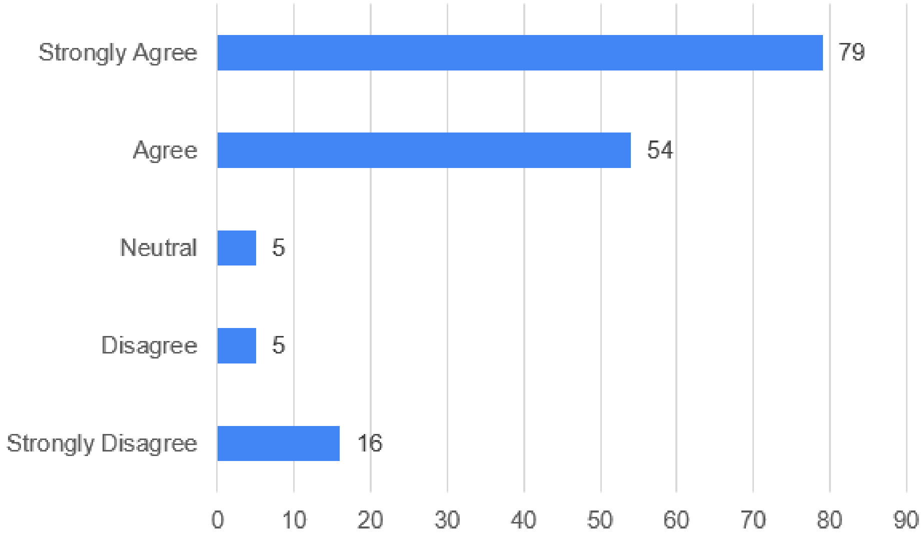
Table 6 – Lack of technological advancement					
Market-driven decisions are not easy to take due to lack of technological innovation		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	16	10.1	10.1	10.1
	Disagree	5	3.1	3.1	13.2
	Neutral	5	3.1	3.1	16.4
	Agree	54	34.0	34.0	50.3
	Strongly Agree	79	49.7	49.7	100.0
	Total	159	100.0	100.0	

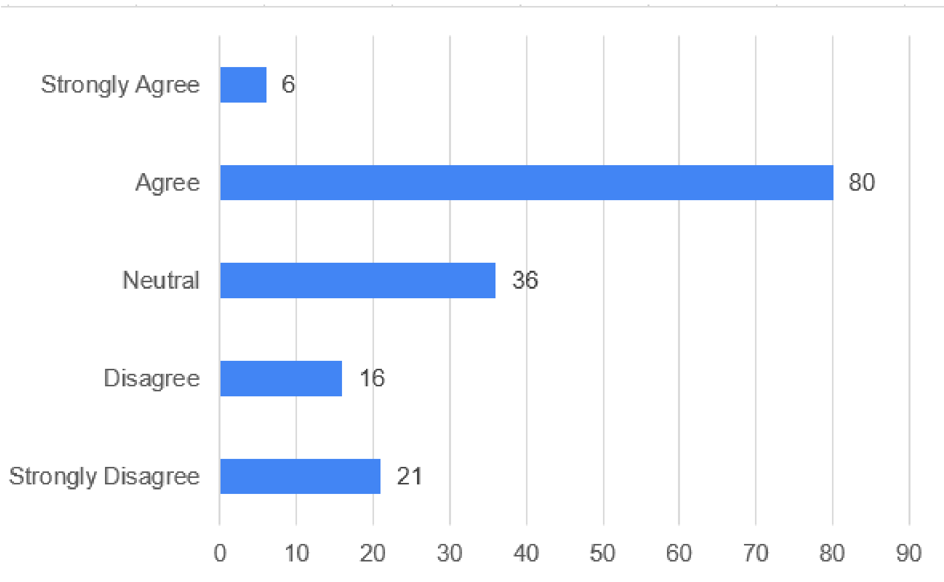
Figure 8 – Lack of technological advancement



There are 80 (50%) participants who agree that NPA has been increased in their bank due to improper "SWOT (Strength, Weakness, Opportunity, Threat)" analysis in their bank. There are 16 (10%) participants who disagree, 21 (13%) participants who strongly disagree, and 36 (23%) participants were not sure. Hence, banks rely more on creditworthiness, soundness, financial integrity, and honesty of the customer when giving unsecured loans.

Table 7 - Improper SWOT Analysis					
NPA has been increased in your bank due to improper SWOT Analysis		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	21	13.2	13.2	13.2
	Disagree	16	10.1	10.1	23.3
	Neutral	36	22.6	22.6	45.9
	Agree	80	50.3	50.3	96.2
	Strongly Agree	6	3.8	3.8	100.0
	Total	159	100.0	100.0	

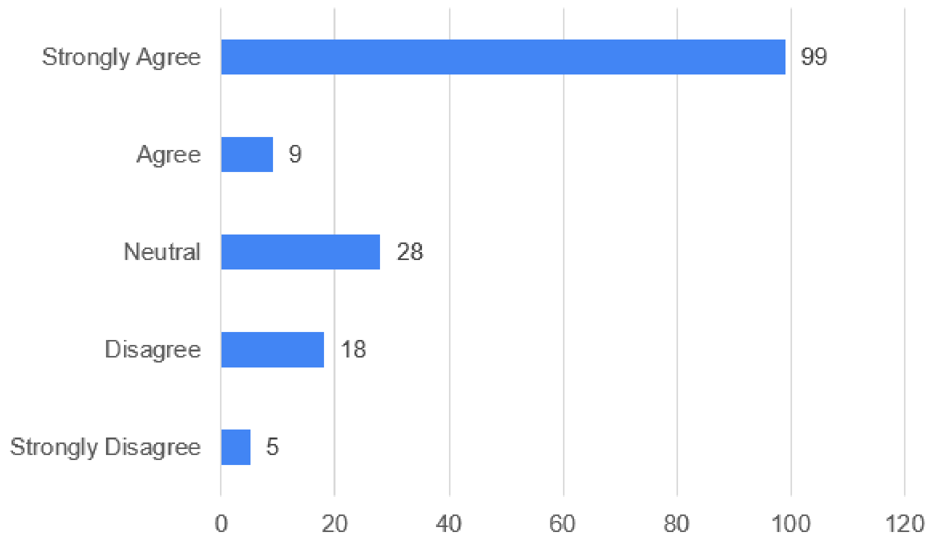
Figure 9 – Improper SWOT Analysis



In this study, 99 (63%) participants strongly agree that credit appraisal system in their bank is very poor, while 28 (18%) participants were not sure, 18 (11%) participants disagree, and 5 (3%) participants strongly disagree. Due to this reason, banks provide loans to those customers who cannot pay their loans back. It should be improved to reduce NPAs.

Table 8 – Poor Credit appraisal system					
Credit appraisal system is very poor in your bank		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	5	3.1	3.1	3.1
	Disagree	18	11.3	11.3	14.5
	Neutral	28	17.6	17.6	32.1
	Agree	9	5.7	5.7	37.7
	Strongly Agree	99	62.3	62.3	100.0
	Total	159	100.0	100.0	

Figure 10 – Poor credit appraisal system



4.3. External Factors

Along with internal factors, there are also external factors responsible for the accumulation of bad debts or NPAs. The government has established a lot of recovery measures but banks still suffer because of negligence and inefficiency of the government in controlling NPAs. There are 42 (26%) participants who agree and 66 (42%) participants who strongly agree (Table 9) (Figure 11).

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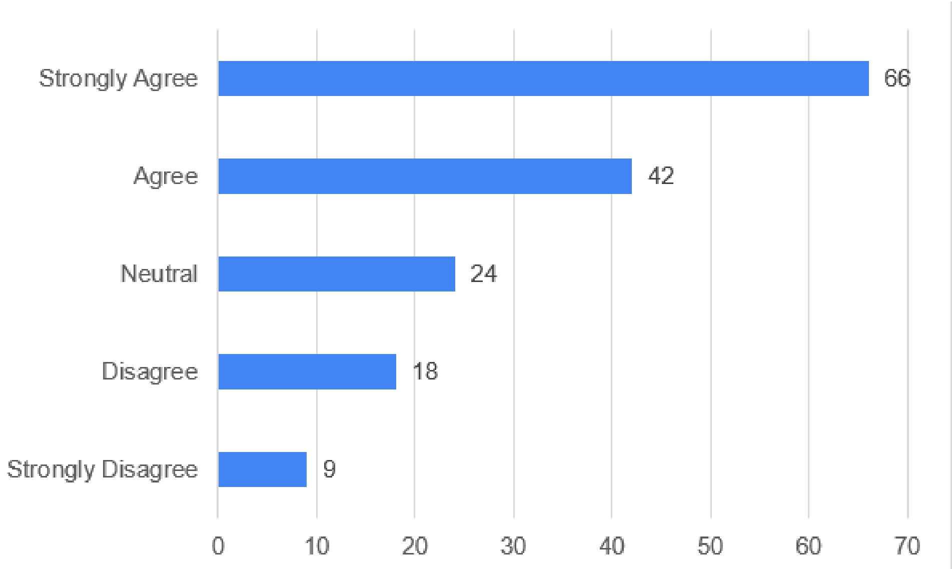
Table 9 - Government's negligence and inefficiency					
Bank suffers the effects of non-recovery due to government's negligence and inefficiency		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	9	5.7	5.7	5.7
	Disagree	18	11.3	11.3	17.0
	Neutral	24	15.1	15.1	32.1
	Agree	42	26.4	26.4	58.5
	Strongly Agree	66	41.5	41.5	100.0
	Total	159	100.0	100.0	

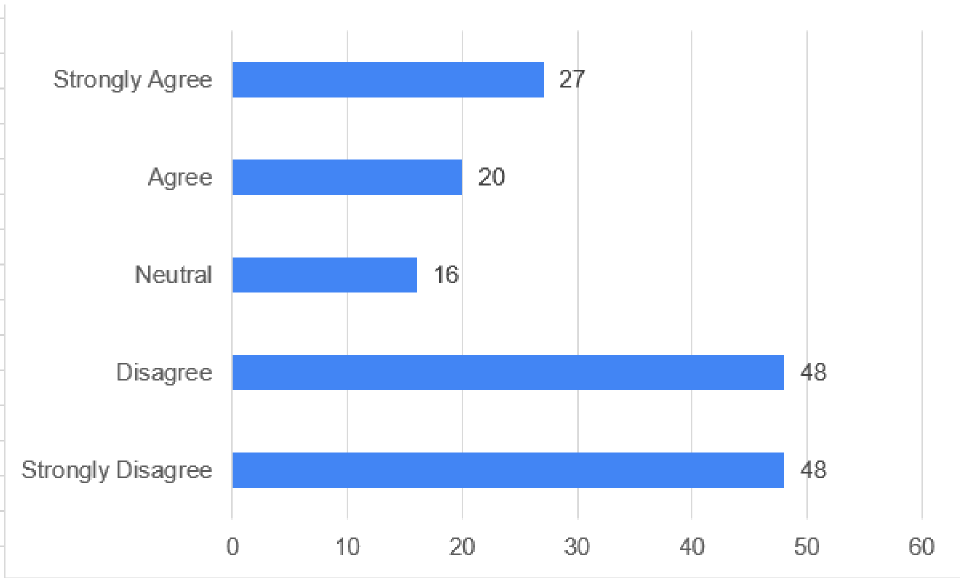
Figure 11 – Government's negligence and inefficiency



There are 48 (30%) participants who disagree and strongly disagree that borrowers are defaulting their loans wilfully even though they can pay their loans back, while only 20 (13%) participants agree, 27 (17%) participants strongly agree, and 16 (10%) participants were not sure (Table 10) (Figure 12). However, banks should still be able to identify these types of borrowers before lending.

Table 10 – Willful default of loans					
Borrowers defaulting the loans willfully even though they can pay their loans back		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	48	30.2	30.2	30.2
	Disagree	48	30.2	30.2	60.4
	Neutral	16	10.1	10.1	70.4
	Agree	20	12.6	12.6	83.0
	Strongly Agree	27	17.0	17.0	100.0
	Total	159	100.0	100.0	

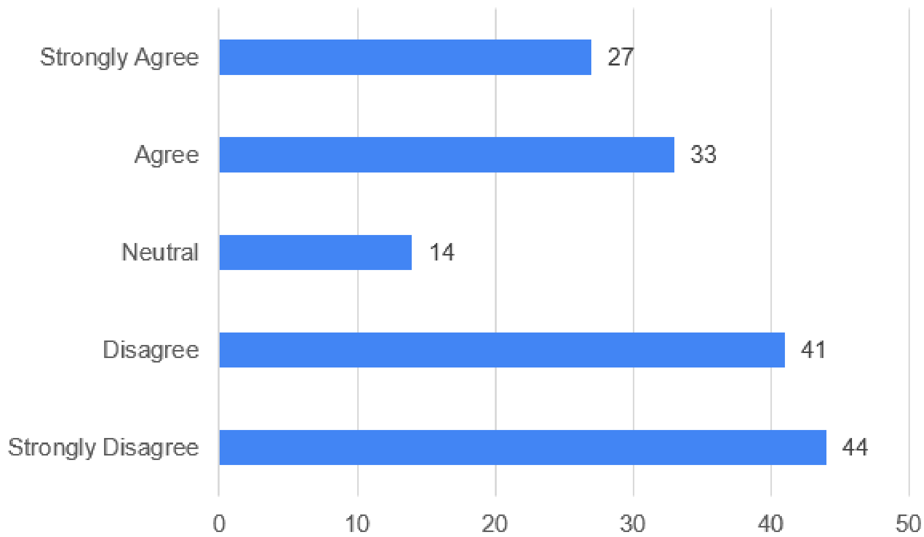
Figure 12 – Wilful default of loans



Natural disasters are another major external factor which creates alarming growth of NPAs of public sector banks. Natural disasters take place in various states every year, making borrowers unable to repay their debts. According to 38% participants, banks need to compensate their loans due to natural disasters and inability of borrowers, while 41 (26%) participants disagree and 44 (28%) participants strongly disagree (Table 11) (Figure 13).

Table 11 – Natural Disasters and Inability of borrowers					
Banks have to compensate their loans because of natural disasters and inability of borrowers		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	44	27.7	27.7	27.7
	Disagree	41	25.8	25.8	53.5
	Neutral	14	8.8	8.8	62.3
	Agree	33	20.8	20.8	83.0
	Strongly Agree	27	17.0	17.0	100.0
	Total	159	100.0	100.0	

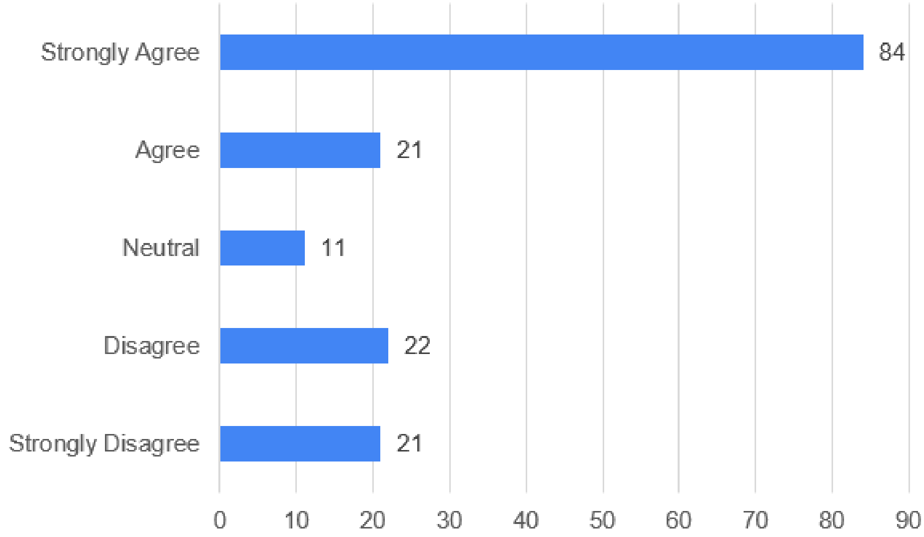
Figure 13 – Natural Disasters and Inability of borrowers



Whenever a new government takes charge, it starts by changing policies for banking sector. So, banks have to deal with changing policies, which leads to a rise in NPAs, according to 53% participants who strongly agree and 13% participants who agree (Table 12) Figure 14).

Table 12 - Constantly changing government policies					
NPAs are rising because of constantly changing government policies		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	21	13.2	13.2	13.2
	Disagree	22	13.8	13.8	27.0
	Neutral	11	6.9	6.9	34.0
	Agree	21	13.2	13.2	47.2
	Strongly Agree	84	52.8	52.8	100.0
	Total	159	100.0	100.0	

Figure 14 – Changing Government Policies



4.4. Hypothesis Testing

In order to solve H1, we have conducted one sample t-test. It is observed that the value of Sig. (2-tailed) is 0.000 which is below the p value, i.e., 0.005. Hence, it is inferred that null hypothesis is rejected and alternate hypothesis is approved, i.e., "there is a significant impact of NPAs on profitability of public and private sector banks".

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Table 13 - One-Sample Test						
	Test Value = 0					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Internal Factors Lending process is based on outdated principles and is defective	35.419	158	.000	3.742	3.53	3.95
Market-driven decisions are not easy to take due to lack of technological innovation	41.406	158	.000	4.101	3.91	4.30
NPA has been increased in your bank due to improper SWOT Analysis	36.318	158	.000	3.214	3.04	3.39
Credit appraisal system is very poor in your bank	42.081	158	.000	4.126	3.93	4.32
External Factors Bank suffers the effects of non-recovery due to government's negligence and inefficiency	39.554	158	.000	3.868	3.67	4.06
Borrowers defaulting the loans willfully even though they can pay their loans back	22.095	158	.000	2.560	2.33	2.79
Banks have to compensate their loans because of natural disasters and inability of borrowers	23.282	158	.000	2.736	2.50	2.97
NPAs are rising because of constantly changing government policies	31.423	158	.000	3.786	3.55	4.02

In order to solve second hypothesis, we have conducted Pearson's Correlation test using SPSS. It is found that there is a "significant correlation between internal and external factors contributing to NPAs in public and private sector banks" at 0.01 level (2-tailed) because the value of significance was 0.005 for both factors (Table 14).

Table 14 - Correlations			
		Internal_Factors	External_Factors
Internal_Factors	Pearson Correlation	1	-.220**
	Sig. (2-tailed)		.005
	N	159	159
External_Factors	Pearson Correlation	-.220**	1
	Sig. (2-tailed)	.005	
	N	159	159
**. Correlation is significant at the 0.01 level (2-tailed).			

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5. Results

Considering the above findings of the study, it is observed that NPAs dearly affect the profitability and efficiency of the banks. Change in customers' sentiments is the most significant impact of NPAs which may affect trustworthiness of banks among investors. Banks can reduce and avoid risks by going for more risk-free investments, which is not conductive for the economic growth of the country." If NPAs are not managed on appropriate basis, they can –

3. Reduce earning potential of assets and affect the returns on investment significantly
4. Increase the cost of capital
5. Increase the mismatch between assets and liabilities
6. Increase the provisioning needs on increasing NPAs and affect the adequacy ratio of capital and profitability of banks
7. Affect the "economic value additions (EVA)" by banks
8. Decline the value of shares even below the book value
9. Make banks unable to face risks

However, there are some suggestions and remedies for the government and policymakers to reduce NPAs in private and public sector banks in India. For example, a loan recovery policy can be prepared to deal with increasing NPAs. Governments can form special loan recovery cells as regional office, zonal headquarters, or head office to identify branches which need recovery. Recovery targets should be fixed and time-bound action should be taken. Proper techniques are also needed to solve the challenge of each non-performing asset. Proper action plan should be made and implemented by the banks. In addition, technological advances are strictly needed to solve internal and external problems related to NPAs in banks, so that they can take the right decisions before lending.

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6. Conclusion

NPAs have always been a serious concern for Indian banks. NPAs are also worse for economies. NPAs lock up the money for productive purposes and they also affect the profitability of banks. The level of NPAs is higher in India than in other countries. It is important to schedule the NPAs to improve the profitability and efficiency. Government has taken a lot of steps to reduce the NPAs. It has caused the decline in NPAs in banking sector of India. However, a lot of things have to be done. Achieving 0% NPA seems to be next to impossible for Indian commercial banks. At least banks can try to compete with international banks to hold their global standard. They can provide loans to trustworthy customers to prevent bad debts.

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