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THE PROBLEM OF RISING NON- PERFORMING ASSETS IN BANKING SECTOR IN INDIA: COMPARATIVE ANALYSIS OF PUBLIC AND PRIVATE SECTOR BANKS

Dr. Raj Kumar Mittal*

Ms. Deeksha Suneja**

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Abstract

The growth of the economy depends upon the efficiency and stability of the banking sector. The most important factor which measures the health of the banking industry is the size of NPAs. Non-Performing assets have direct impact on the financial performance of banks i.e. their profitability. It denotes the efficiency with which a bank is optimizing its total resources and therefore, serving an index to the degree of asset utilization and managerial effectiveness.NPAs affects the profitability of the banks in terms of rising cost of capital, increasing risk perception thereby affecting liquidity position of banks.This paper attempts to first examine the level of NPAs in the banking sector in India and then analyze the causes for increasing NPAs. In the final part of the paper,measures which banks can take to reduce their NPAs have been suggested. The study also compares the performance of the public sector banks with the private sector banks.The secondary data collected from different sources has been used in the study. The study shows that the magnitude of NPAs is increasing in public sector banks as compared to the private sector banks. Therefore banks need to effectively control their NPAs in order to increase their profitability and efficiency.

***University School of Management Studies, Guru Gobind Singh Indraprastha University, New Delhi**

**** Jagannath International Management School, New Delhi**

1. Introduction

The banking system is the heart of the financial system. The major function of the financial system is themobilisation of the public savings and its allocation in different sectors of the economy as an investment. The conversion of financial savings in to investment is known as the process of capital formation in the economy.How this process of financial intermediation (i.e. collecting scattered savings and using it in to productive purposive) is carried out shall reflect the efficiency of the financial institutions and their role in socio-economic transformation of the nation.

The Narasimham Committee (1991) on “Financial System Reforms” introduced the concept of non-performing assets.The status on non-performing assets constitutethe best indicator of judging the health of the banking industry. The problem of NPAs is linked with the lending procedure of banks as these are an inevitable burden on the banks.A bank gives out money upfront and earns income over a time on the promise of a borrower to repay. When loans are not repaid, the bank loses both its income stream, as well as its capital. Lending is always accompanied by the credit risk arising out of the borrower’s default in repaying the money[*].The major problem today faced by all the commercial banks is the increasing risk of non-performing assets, which poses challenge to their ultimate survival.

The NPAs have been classified under four categories:

(i) **Standard Assets**: A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPAs in the real sense.

(ii) **Sub-standard Assets**: All those assets which are considered as non-performing for a period of 12 months.

(iii) **Doubtful Assets**: Those assets which are considered as non-performing for period of more than 12 months.

(iv) **Loss Assets**: All those assets which cannot be recovered.

These assets are identified by the Central Bank or by the auditors.

[*]HarpreetKaur and Pasricha J.S.(2004) “Management of NPAs in Public Sector Banks”, The Indian Journal of Commerce, Vol.57, No.2, p.14.

As compared to private sector banks, public sector banks have shown a better performance as far as financial operations are concerned. The biggest problem however, in case of public sector banks is the increasing level of non-performing assets year after year. NPAs hurts the profitability of the banks as it results in non-recovery of loan installments along with the interest amount due to which banks have to use more owned funds by way of increased capital and also in the form of reserves and surplus to provide a cushion for the loss due to loan.

The efficiency of the banks is also reflected by the level of return on its assets which is deteriorated by the presence of NPAs in the balance sheet of the banks. Therefore, this paper examines the issue of NPAs in the context of scheduled commercialbanks in both public and private sector. One of the drivers of growth and financial stability is the level of NPAs in the banking sector.

In the year 1992, the Government of India introduced a number of reforms to deal with the problem of growing NPAs in banking sector. The major steps includes; introduction of Debt Recovery Tribunals, Securitization Act 2002, LokAdalats, Compromise Settlement Scheme and introduction of Credit Information Bureau. The below data shows the amount of NPAs recovered through various channels during the year 2015-16.

Table1: Recovery of NPAs through different channels

Recovery Channels	**LokAdalats**	**DRT's**	**SARFAESI Act**	**Total**
No. of cases referred	4456634	24537	173582	4654753
Amount involved (in Rs.billion)	720	693	801	2214
Amount recovered (in Rs. billion)	32	64	132	228

In the year 2015-16, 10.3 percent of the total amount referred to for recovery is recovered though all the recovery channels. The above table shows that recovery through LokAdalats is 4.4% while it was 9.2% through DRT's as compared to 16.5% from SARFAESI Act.

Undoubtedly, strong banking sector is important for a flourishing economy. Various studies have been conducted in the past to address the issue of NPA's in the Indian bankingindustry. A brief review of the different studies is given below:

Bhavani Prasad, G. and Veena, V.D (2011)in their paper titled "NPAs in Indian banking sector: trends and issues," found that public sector banks accounted for 78 percent of NPAs and is the main reason for their falling revenues.

The RBI has also conducted a study to examine the factors contributing to the growth of NPA's. The study covered 800 top NPAs accounts in 33 banks (RBI Bulletin, July 1999). The study showed that the proportion of problem loans in the banks has always been very high which was at 17.91% of their gross advances on 31stMarch,1989. After the introduction of prudential norms it came down to 17.44% as on 31st March,1999. The study also showed that the major factors which result in NPA's includes ; diversion of funds for modernization, expansion, diversification, undertaking new projects etc.The report concluded that the reduction in non-performing assets in the banking sector should be taken as a nation's priority to make the banking sector stronger.

KaminiRai(2012), in her study on "Performance of NPAs in Indian Commercial Banks" has examined the main reasons for increasing NPA's in banks in India.She pointed out that the target-oriented approach, which results in ineffective supervision of loan accounts, lack of managerial and technical expertise on part of the borrowers which ultimately deteriorates the qualitative aspect of lending by banks, are the main reasons for the increasing NPAs in banks.
Mario Castelino (2005) in "Managing Non-Performing Assets" stated that in the recent past the NPAs of the corporate sector have come down drastically, where as there is a concern over increase in NPAs in the retail sector and increasing issue of frauds in mortgage loans.

Murali and Krishna (2006) observed that there has been a spurt in the lending activity of banks, in the recent past. This is due to two factors, viz. availability of huge surplus funds with the banks and the losses suffered by the banks in investment and treasury activities. While credit growth is needed for survival, it is imperative to ensure that the credit growth does not result in non-performing advances later. For this, banks have to resort to effective pre-disbursement as well as post-disbursement monitoring. The authors concluded that negligence in monitoring a loan was less excusable than an error at the appraisal stage.

Kumar (2006) in his research book titled, "Banking Sector Efficiency in Globalized Economy," highlighted that the performance of the banks both in the public and private sectors has become more market driven with growing emphasis on better performance. Author has examinedthe broad structure of banking system in India, analyzed the overall efficiency of the system in terms of financial parameters into two components: technical efficiency and allocation efficiency. He concluded that the much-publicized fact that public sector banks are inefficient is based on a piecemeal analysis in the form of a simple, static, partial and isolated ratios having some hidden and often misconceived assumptions about the structure. The study concluded that there is an urgent need of the time to go in for this kind of system wide analysis to explore the intricacies of the complex system.

Bhatia (2007) in his research paper entitled, “Non-performingassets of Indian public, private and foreign sectorbanks: An empiricalassessment”, explored theapplication of an empirical approach to the analysis of NPAs. The NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. This paper attempts to find out the fundamental factors which impact the level of NPAs of banks in India . A framework consisting of two types of factors, viz., macroeconomic and bank-specific parameters, is developed and the behavior of NPAs of the three categories of banks has beenanalysed.

Siraj and Pillai (2011) investigated the performance of Indian scheduled commercialbanks (SCBs) before and after the global financial crisis (2007-2009). The study wasconducted using data available for the period from 1999-2000 to 2010-2011. It wasfound that from year 2007-2008 to year 2010-2011 the provisions and contingencies that included provisions towards NPAs grewconsiderably for all bank groups. Thefresh additions to NPAs grew at a higher rate after the global financial crisis. The mostaffected bank groups were foreign banks and nationalised banks.

Financial crises leadto higher NPAs and force banks to invest in less risky investment portfolios.Consequently, a reduction in the CDR was observed after 2007 across all bank groups except at the State Bank of India and its associated banks.

Ali Shingjergji (2013) in "The impact of macro-economicvariables on the non – performingloansin the Albanian Banking System (2005 – 2012)" examined the impact of main macroeconomic variables on the non performing loans'. This study is motivated by the hypothesis that macroeconomic variables have an effect on the non- performing loans. The paper examined the relationship between non -performing loans and variables like GDP, inflation rate, exchange rate, and base interest rate by using a simple regression model. In fact the level of non - performing loans in the Albanian banking system reachedup to 23.1 percent of the total loans. The study concluded that there is a positive relationship between the base interest rate of four quarters lag and NPLs ratio in time.

Asha Singh (2013) in "Performance of Non-Performing Assets in Indian commercialbanks" observed that the NPAs of the public sector banks are increasing year by year. On the contrary, the non-performing assets of private sector banks have been decreasing regularly year by year except in some years. Generally reduction in NPAs shows that banks have strengthened their credit appraisal processes over the years and increased in NPAs shows the necessity of provisions, which brings down the overall profitability of banks.

Gerlach, S., Peng, W.&Shu, C. (2005) in "Macroeconomic conditions and banking performance in Hong Kong SAR: A panel data study" concluded that NPAs ratio increases with number of bankruptcies and nominal interest rate but decreases with inflation (CPI and property prices) and economic growth.

The existing studies generally focused on analyzing NPAs till the end of the year 2015. This paper attempts to examine the trend in NPAs from the year 2005 till 2016 which primarily focused on analyzing the growth rate in non-performing assets in public sector and private sector banks. The paper also attempts to identify possible causes which drive loans to become bad along with its impact on the future performance of banks. The study also providesuggestions banks can take to minimize the problem.

2. Research Method

The study is primarily analytical and descriptive based on secondary data collected from RBI publications, journals, reports and websites of public and private sector banks in India. The time period covered for the study is from 2005 to 2016.

To analyse the growth in NPAs among public sector banks and private sector banks, different statistical tools like figures, bar graphs have been used. Compound annual growth rate(CAGR) has been calculated to identify the percentage increase in NPAs over the selected period under study.

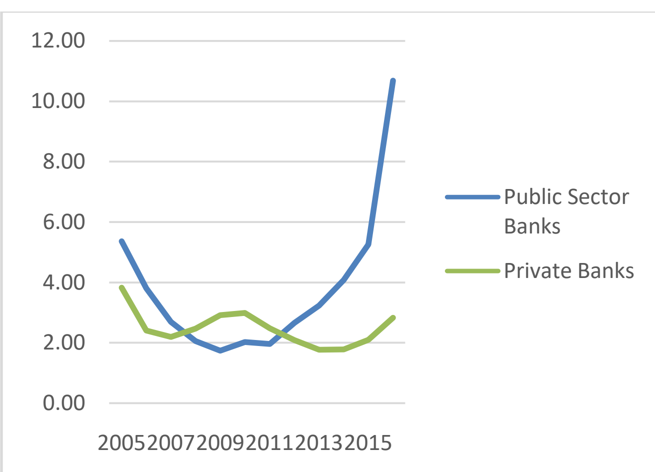
The specific objectives of the present study are:

1. To find out the quantum of NPAs in public sector and private sector banks in India.
2. Toanalyze the impact of NPAs on banks' performance.
3. To analyze the reasons for mounting NPAs in banks in India.
4. To suggest ways to reduce the level of NPAs in banks in India.

3. Results and Analysis

3.1 The figure 1 shows the Gross NPAs to Gross Advances Ratio of public and privatesectorbanks during the year 2005 – 2016.

Figure 1: Gross NPAs to Gross Advances Ratio of Public and Private Sector Banks



(Source: Database on Indian Economy, Reserve Bank of India, 2005-2016)

The above graph shows the trend of Gross NPAs to Gross Advances Ratio of public and private sector banks for the period of 10 years starting from 2005 to 2016. The x-axis represent the years, whereas y-axis represent the ratio. We can observe here that the Gross NPAs to Gross Advances Ratio of public sector banks is showing a downward trend from year 2005 till 2008 but since the year 2009 it has started increasing. One of the reasons is the global financial turmoil of 2008. Private sector banks havealso shown almost the same trend but we can see that the trend is considerably increasing for public sector banks.

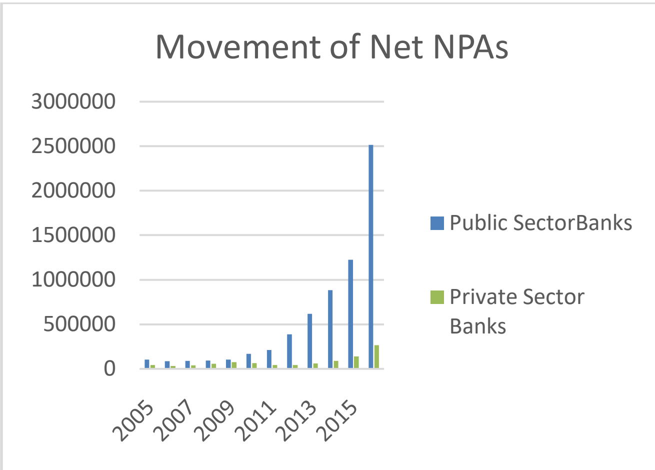
Table 2: Gross NPAs to gross advances ratio of public and private sector banks
(Amount in Rs. Crores)

Year	Public Sector Banks	Private Banks
2005	5.36	3.83
2006	3.81	2.41
2007	2.69	2.19
2008	2.06	2.47
2009	1.75	2.92
2010	2.03	2.99
2011	1.97	2.48
2012	2.67	2.09
2013	3.24	1.77
2014	4.09	1.78
2015	5.26	2.1
2016	10.69	2.83

From Table 2, it can beseen that there is a compound annual increase of 6 percent in gross NPAs to gross advances ratio of public sector banks but with respect to private sector banks, there is a negative increase of 3 percent which means that the ratio of gross NPAs to gross advances have improved considerably over the years.

The following figure represents the movement of Net NPAs of public and private sectorbanks for the time period under study.

Figure 2:Movement of Net NPAs of Public Sector and Private Sector Banks



(Source: Database on Indian Economy, Reserve Bank of India, 2005-2016)

We can observe here that the net non- performing assets of both public and private sector banks are increasing over the years but as there is a huge difference between the quantum of NPAs between them. The share of public sector banks in NPAs is considerably far more compared to private sector banks.

Table 3: Rising NPAs in public and private sector banks in India.
(Amount in Rs. Crores)

Year	**Public Sector Banks**	**Private Sector Banks**
2005	105407	42116
2006	84934	31703
2007	89657	40282
2008	93275	56469
2009	102863	74120
2010	168131	65060
2011	212640	44322

2012	389686	44012
2013	618509	59944
2014	885464	88615
2015	1226734	141283
2016	2514814	266774

From Table 3, as shown in , it is found that CAGR in NPAs for public sector banks is 33 percent as compared to 18 percent for private sector banks which shows a mounting increase over the period under study.

Table 4: Classification of Loan Assets of Public Sector Banks

(Amount in Rs. Crores)

Year	**Standard Advances**		**Sub-Standard Advances**		**Doubtful Advances**		**Loss Advances**	
	Amount	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
2005	8379	94.6	110	1.2	308	3.5	59	0.7
2006	10926	96.4	113	1.0	246	2.2	55	0.5
2007	14262	97.4	143	1.0	198	1.4	48	0.3
2008	17786	97.8	173	1.0	192	1.1	40	0.2
2009	22378	98.0	203	0.9	206	0.9	41	0.2
2010	26735	97.8	288	1.1	254	0.9	58	0.2
2011	32718	97.8	350	1.1	332	1.0	65	0.2
2012	38255	97.0	623	1.6	490	1.2	60	0.2
2013	43957	96.4	815	1.8	761	1.7	68	0.2
2014	49887	95.6	958	1.8	1216	2.3	99	0.2
2015	53382	95.0	1054	1.9	1630	2.9	100	0.2
2016	52875	90.7	2005	3.4	3232	5.5	163	0.3

(Source: Database on Indian Economy, Reserve Bank of India, 2005-2016)

The above table shows the classification of loan assets of publicsectorbanks. Over the years, there is a fluctuation of NPAs among the banks. Standard advances and doubtful advances have shown both increasing and decreasing trend. Sub-standard advances are gradually increasing over the years. Loss advances are more of constant during the period under study.

Table 5: Classification of Loan Assets of Private Sector Banks

(Amount in Rs. Crores)

Year	Standard Advances		Sub-Standard Advances		Doubtful Advances		Loss Advances	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
2005	2172	96.1	22	1.0	56	2.5	9	0.4
2006	3099	97.6	24	0.8	44	1.4	9	0.3
2007	4109	97.8	44	1.0	39	0.9	9	0.2
2008	5129	97.5	73	1.4	45	0.9	12	0.2
2009	5681	97.1	106	1.8	50	0.9	13	0.2
2010	6265	97.3	89	1.4	66	1.0	22	0.3
2011	7936	97.8	45	0.6	108	1.3	29	0.4
2012	9629	98.1	52	0.5	104	1.1	29	0.3
2013	11384	98.2	64	0.6	112	1.0	32	0.3
2014	13371	98.2	86	0.6	114	0.8	42	0.3
2015	15750	97.9	108	0.7	176	1.1	52	0.3
2016	19184	97.2	186	0.9	311	1.6	62	0.3

(Source: Database on Indian Economy, Reserve Bank of India, 2005-2016)

The above table shows the classification of loan assets of privatesectorbanks. There has been a constant rise in standard advances over the years except for the years 2015 and 2016 when can see a decline. There is a fluctuation in sub-standard advances and doubtful advances over the years. After year 2011, loss advances remained constant over the years.

As compared to private sector banks, public sector banks have more sub-standard and doubtful advances but the standard advances of private sector banks remains high against public sector banks which shows a better performance of private sector banks.

3.2 Causes for NPAs

A robust banking sector is the backbone of the economy, therefore to improve the health of the banking system we must look into account all the likely causes which can hinder its smooth performance. No doubt, NPAs are a menace to the efficient working of the overall banking industry. In order to reduce the problem of NPAs that banks can work efficiently, we must first be aware of all the reasons which cause problem of bad loans.The causes are divided into three categories, one related with respect to the internal functioning of banks, second are the causes accountable to borrowers. It has been observed that the large borrowers are the biggest defaulters in the bank. The top 30 NPAs of PSBs were found to account for 40.2 percent of their GNPAs[2]Apart from these, there are some macro-economic causes which affect the whole industry and cause changes in NPAs.

Table6: Causes for rising NPAs in banks in India

Causes accountable to banks	**Causes accountable to borrower**	**Other causes**
Poor credit appraisal mechanism	Longer gestation time	Fast changing technology
Wrong selection of borrowers	Mis-management of funds	Political warfare
Lack of trained staff	Wrong selection of projects	Taxation laws
Inflexible attitude	Diversion of funds	Credit policies
No delegation of authority	Lack of quality control	Government policies
Lack of proper follow-up by the banks	Rising expenses	Increase in factor cost
Weakpost- credit appraisal system	Poor choice of location	Changes in consumer tastes and preferences
Inefficient management of lending facilities	Inadequate attention to research and development	Recession in the market

3.3 Impact of NPAs on banks

NPAs directly affect the profitability of the banks. Below mentioned are the ways through which banks profitability is affected:

(i) **Liquidity position:**NPAs affects the liquidity position of the banks, thereby creating a mis-match between assets and liability and force the banks to raise resources at high cost.

(ii) **Undermine bank's image:** High level of NPAs shadows the image of banks both in domestic and global markets. This ultimately leads to lower profitability.

(iii) **Effect on funding:** Increasing level of NPAs in banks results in scarcity of funds in the Indian capital market as there will be only few banking institutions who will lend money.

(iv) **Higher cost of capital:** It shall result in increasing the cost of capital as banks will now have to keep aside more funds for the smooth working of its operations.

(v) **High risk:** NPAs will affect the risk-bearing capacity of the banks.

(vi) **Effect on income:** NPAs will reduce the net interest income of the banks as interest is not charged to these accounts.

(vii) **Declining productivity:** It will also cost in terms of time, money and manpower which will ultimately results in declining profitability, since the staff is primarily engaged with preparing papers for filing law cases to recover principal amount and interest rather than devoting time for planningmobilization of funds.

(viii) **Effect on ROI and profitability:** It reduces the earning capacity of the assets thereby negatively affect the ROI.All NPAs need to be prudentially provided for which shall have a direct impact on the profitability of the banks.

(ix) **Ultimate burden on society:** It will ultimately affect the consumers who now will have to fetch out more money for paying higher interest.

3.4 Suggestions to reduce NPAs in banks

(i) Revision of existing credit appraisal and monitoring systems by RBI

(ii) Regular follow-up of customers by the banks to ensure that there is no diversion of funds.

(iii) Review of all loan accounts at fixed interval.

(iv) Proper training to bank employees and staff to overcome the weakness of credit appraisal and credit monitoring.

(v) Banks may resort to one-time settlement scheme or compromise settlement scheme. Recovery through Debt Recovery Tribunals and LokAdalats are other ways. Banks these days are resorting to SARFAESIAct for the management of NPAs.

(vi) Establishing a rigorous screening process before granting credit.

(vii) The bank should rephrase or reschedule the account for reasons that are beyond the borrower' control.

4. Conclusion

Non-performing assets have always been a problem for the Indian bankingsector as it is having a direct impact on the profitability of the banks. The failure of the banking sector may have an adverse impact on other sectors. Thus, there is a need to ensure that the banks take proper steps to resolve it, thereby ensuring fair and efficient recovery of loans so that banking sector continue to function without stress. The study reveals that the extent of NPAs is comparatively more in public sector banks as compared to private sector banks. The government is taking many steps to reduce the problem of NPAs but banks should also have to be more proactive to adopt a structured NPAs policy to prevent the non-performing assets and should follow stringent measures for its recovery. Bankers should also consider the ROI on a proposed project and provide loans to customers who have better credit worthiness as prevention is always better than cure.

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