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Crash to Banking Sectors Vis-à-Vis NPA

Dr. Sangeeta Gupta*
Dilip Gupta**

Introduction

The worst part of our country is perhaps it is developing. Probably it is the reason that still after 70 years of independence, a larger portion of the country is not served with Banking. It may be due to various reasons such as unavailability of resources, non development of rural areas, inadequacy of efficient work force, illiteracy, unawareness about banking and last but not the least and most important Factor avoidance of rural area development by Government. First let's have an intro of banking structure in our country. Presently, there are four types of banking institutions in India. These are:

- Commercial banks that includes Public Sector Banks and Private Banks.
- Regional rural banks
- Co-operative banks
- Development banks or 'term-lending institution'

RBI acts as the Central Bank of the country.

Major functions in which Banks Engages primarily are two viz. Accepting deposits from and advancing the money to public. Advancing is the major source of Income followed by income from Investment made out of deposits. Income is

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* Associate Professor, Department of ABST, Faculty of Commerce, University of Rajasthan, Jaipur, Rajasthan, India.

** Research Scholar, Department of ABST, Faculty of Commerce, University of Rajasthan, Jaipur, Rajasthan, India.

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necessary part of banks operations as bank need this for meeting expenses and pays interest credits to their deposit holders. Banks use to plan their finds (Deposits) in such manner that the portfolio of investment is optimized to earn income sufficient to meet expenses, Pay interest, to create fund for further extension of banks branch and some profit naturally. If the process would have been working in such dream manner as planned, probably banks would extended their operation I rural areas too. Unfortunately it is not so. The Big issue to banks now a day is losses to bank which is occurring due to NPA. A strong banking in country is a pillar to strong economy in the country.

The gross NPA of SBI alone had swollen from Rs. 51189 crores to Rs. 98172 crores during the five years from March 2013 to March 2017, as per the SBI's annual reports. Another Public Bank named Punjab national Banks has same position. There NPA has swollen from Rs. 13,465 crores to Rs. 55,370 crores during the five years from March 2013 to March 2017, as per the their annual reports. The position of other banks is same and not better rather worst to it. Through this article we tried to find out the structure of Banks Advance process and its Loopholes and the suggestion to reduce the Heavy NPA's.

NPA - Meaning

The non performing Asset means when a loan is not repaid by borrower even after its due date. In simple words default in repayment of loan is the cause of becoming NPA. Borrower may do default in repayment due to various reasons such as non availability of funds or unwillingness to repay or fraud. If the credit facility remains outstanding for considerable time (i.e. after due date) then it turns into NPA. Banks and financial institutions mainly depend upon the interest income they earn from advances. If a borrower defaults in repayment not only principal amount delayed also the interest income discontinues.

Generally the account becomes NPA when payment remains overdue for more than 90 days. However to follow best international practice the NPA determination is now based two different concepts. One concept is past due and the other one out of order. Former is based on the phenomena that if a credit facility such as term loan is not paid even after 90 days from due date than such credit facility becomes NPA. However some short term exemptions available such as short term deficiencies or non maintenance of stock etc. in such cases account is not treated as NPA. Latter one is when account becomes NPA if an account or credit facility such as cash credit or overdraft or bill discounting remains out of order for continuous period of 90 days. There is another concept prevailing which is exclusively for Agriculture advances. Under this case account becomes NPA if a short term credit facility not repaid after 2 crop seasons and a long term credit facility if not repaid after 1 crop season.

To ensure more transparency, it has been decided to adopt the '90 days' overdue' for NPA determination, from 31 march, 2004. From 31 March 2004 and onwards, a non-performing asset (NPA) is a credit facility where

Type of Loan	**Overdue period required to convert the Debt into NPA**
Term Loan	Interest and/or principal remain overdue for a period of more than 90 days
Overdraft/Cash Credit	Remains 'out of order' for a period of more than 90 days i.e. either no credit to the Account (in case of overdraft) or interest is not sufficient to cover interest debited or Outstanding balance exceeds the sanctioned limit (in case of Cash Credit) for continuous period of 90 days.
Bills purchased and discounted	Bill remains overdue for a period of more than 90 days
Agricultural Advances	• For short duration Crops: Interest and/or principal remains overdue for two harvest seasons or crop season • For long duration Crops: overdue Period is one harvest or crop season **Note:** Long Duration Crops means where crop season is longer then 1 year. A crop which is not a long duration Crop is a short duration Crop.
Securitisation Transaction	Amount of Liquidity Facility remains outstanding for more than 90 days
Derivative Transaction	Overdue receivables representing positive mark to market value of a derivative contract remains unpaid for a period of 90 days from the specified date for payment.
Cash Credit	• 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 90 days
Any other	Any amount to be received, remains overdue for a period of more than 90 days

Banking system in India developed over a long period of time. It took around 150 years to come at this stage. In the very earlier stage of banking, it hasn't grown at very high pace as economic liberalization was not there. When economic liberalization has started taking place in the country banking sector has also started developing. As part of economic liberalization Indian Banking patter has seen many drastic transformations. And to encompass it we adopted best international practices. One of such them was to allow outside banks (that is privates sector and foreign entities) in Banking industry to provide more flexibility, financial autonomy and faster mobilization of funds.

Banking system need a lot of concentration on the efficient management of funds, to ensure removal of obstacles of rotation of funds. The major reason of such obstacles which is fund in many researches and studies, is utilization of funds for purpose other than that for which loan is originally obtained. For example borrower who took foe purchase or construction of his house used the funds for meeting his family needs. Since loan has not been used by him for specified purpose hence the repayment becomes more difficult. It results than accumulation of overdue outstanding balance and leads to poor recovery and poor performance. So the concept of NPA helps banks or NBFCs or financial institutions to gear up the recovery of their dues on timely and accelerated manner. Practice of Misuse of finds is not only with individual borrower, it also persist with corporate borrower specially in priority sector lending.

Here lacking is also on the part of banks such weak administration of priority sector advances and fault in the identification of right type of customers as beneficiaries under the priority sector lending. (**Funk, R., Ives, M. and Dennis, M. 2007).** Another lacking point is weakness in supervision of use of fund post disbursement.

Reason of Higher NPA in Banks

The banking is opposite the severe harms of the increasing NPAs. However the problem of NPAs is found more drastic in PSU banks compare to private banks and other banks such as foreign banks. The NPAs in PSU Banks are increasing due to various reasons which may include outside as well as inside factors.

- **External Factors**

  Followings are the main external factors:

  - **Ineffective Recovery Tribunal:** The Government has established various Tribunals and recovery agencies that recover or help in recovering the sum due. But the carelessness on their part as well no proper response to Banks, these tribunals are useless and a failure not totally but almost totally. **(Naidu and Naidu, 2014)**
  - **Willful Defaults:** There are many people or called a group of types of borrowers who has enough finds to repay but no intention to repay. As they found easy to do fraud with banks money and enjoy. Such people must be identified and money shall be recovered from them with penalty.
  - **Natural Calamities:** This is one of the biggest reason or alarm increase in NPA's in PSU Banks. Various times India is hit by various major calamities which makes borrower unable to pay debts back. Accordingly Banks need to make a large amount of provision in order to fill the gap of such damages which subsequently reduces their profit. The major drawback of our country's agriculture is it is totally based dependent on Rain fall and

due to irregularity in rain farmers do not get the level of desired production and hence not repaying their loans.

- **Industrial Sickness**: Inefficient project handling, improper management, lack of adequate resources and technology, changes in govt. Policies produces industrial sickness. **(Shastri, 2017)** this all results inappropriate recovery and ends up with reduction in profit of banks and sometimes loss as banks do not even recover their principle amount.
- **Lack of Demand:** In India another big concern and factor is that industrialist are not able to predict their demand properly and hence it piles up their production which further lead to non recovery of loan. Banks and Financial institution sell their assets to recover the loan but the asset does not help as value of it is not enough to pay the loan.
- **Change on Govt. Policies:** With every new govt. banking sector gets new policies for its operation, so it has to cope with the changing principles and policies for the regulation of the rising of NPAs. **(Nair, 2013)** For example, the fallout of handloom sector is continuing as most of the weavers Co-operative societies have become defunct largely due to withdrawal of state patronage. The rehabilitation plan worked out by the Central government to renew the handloom sector has not yet been implemented, so the over dues due to the handloom sectors are becoming NPAs.

- **Internal Factors**

  Followings are the main internal factors of NPA in banks:

  - **Defective Lending Process:** The Banks or Financial institutions advances based on 3 basic principles of advancing which includes Safety, Liquidity and Profitability. Principle of safety means the borrower must be in a position to repay the loan (including Principle and Interest). The repayment of loan depends upon various factors such as capacity to repay, willingness to repay, success of business etc. Willingness to pay depends upon borrower’s character, reputation etc. simultaneously Borrower shall have proper liquidity measures to repay the loan in those circumstances in which he is not able to run his business properly or to earn sufficient amount to repay the loan. Considering all these, lender must take utmost care to ensure that enterprise or business for which he is taking loan is a sound business and borrower is competent to run it successfully. He must also be a person of integrity and good character.
  - **Inappropriate Development in Technology**: Due to Lack of Inappropriate technology and MIS, decision which is market driven on real time basis cannot be taken. In India in Banks specially in PSU Banks a Proper system of MIS and financial accounting is not established in the

banks, and hence which results poor credit collection. To come out from the situation proper computerization and management techniques shall be adopted. **(Gopalakrishnan, 2014)**

- **Improper SWOT Analysis:** Another big reason of NPA is lacking in SWOT analysis i.e. a weak analysis of strength, weakness, opportunity and threat. Sometime bank advances unsecured loan, in that case bank depends upon more on Honesty, integrity and Financial Soundness of borrower including his market reputation. To analyze all above banks should consider investment in capital made by the borrower, collect information from other bankers, his trade inquiry, and his credit performance as evaluated by credit rating agencies. Audited Financials can be another source which shows a true mirror image of the business. Also examine purpose of loan and shall grant loan only for productive purpose only.
- **Poor Credit Appraisal System:** A wrong credit appraisal gives rise to NPA. How? Due poor credit appraisal bank gives Loan to those who are not able to pay and recovery of the same becomes difficult or rather impossible. Hence proper credit appraisal is a very basic need to reduce NPA's.
- **Managerial Deficiencies:** Have you ever given consideration to Asset or its value kept as security for repayment of Loan? This a question which a banker shall ask to himself before sanctioning loan to anyone. Because the only source of recovery after default by the borrower is the asset kept for guarantee. Hence banker should select a borrower very carefully and should accept only tangible assets as security or guarantee. At the same time he shall also consider that such security is marketable, acceptable, safe and transferable. The ensure further that no risk pertains, Banker shall not give all amount to one person or firm or group of companies or concentrate in one particular region or city. In such case If one big customer meets misfortune or certain traders or industries affected adversely, the overall position of the bank will not be affected.
- **No Regular Industrial Visit:** Since bank officials (especially PSU Bank officials) do not concentrate on post disbursement activities, one of them is industrial visit or visit to clients place. It increases the risk of collection of dues (both Principle and Interest). By proper visit to client place banker may ensure two things

  ¼ Loan is utilized for the purpose for which it is taken, or

  ¼ Position of recovery

NPAs can be collected by regular visits. Lacking of this led to ever increasing NPA and over the period of time it has mounted to a huge amount. Without visiting and finding out actual figures, banks has shown their position wrongly or window dressed. The quantum of NPA has been calculated and shown at different figures due to unavailability of proper data, statistics and methods. For a large number of years, the banks have been taking credit in its books, on basis of accrued interest income, even for the sum of periodic interest that was not really paid by the borrower. This was done by raising debit in suspense account and crediting amount equivalent to the periodic interest in the loan account of the borrower.

Impact of NPA on Banking Operations

A Bank is not deemed to be profitable when the size of its balance sheet is large rather it depends upon return on its assets. A NPA is a loss to banks in terms that it do not give any income to banks, at the same time banks need to make provision for the same which curtail their profit. The NPA curtails profit of the bank in following ways:

- The Interest Income will get decrease and will be than record only on receipt basis.
- Since banks need to provide for doubtful debts, profitability is affected adversely.
- Return on investments (ROI) will decrease.
- Because of entry of NPA, Capital Adequacy ratio will disturb.
- The cost of capital will go up.
- Mismatch between Asset and liability will widen.

The Size of NPA over last many years has increased due to NPA, but no doubt simultaneous steps taken by regulatory authorities have reduced Gross NPA. To ensure long-term profitability, banks shall manage NPA effectively by adopting the following techniques:

- Ensuring that loans are not concentrated in one customer.
- Improvement in the quality of credit monitoring system by allocating special credit manager or customer relationship manager.
- Raising the share of non- fund income by increasing service product offering by better use of technology.
- Reducing operating expenses by upgrading the banking technology.
- Monitoring early warning signals and taking immediate appropriate action.
- Adopting credit rating system to identify measure and monitor the credit rate of individual proposal.

- Putting certain borrow able accounts which exhibit certain distress signals under watch list and paying a close and special attention so that they may not become an NPA.
- Reducing the impact of operational risks by measure them and mitigating insuring them.
- Knowing a clients profile thoroughly and preparing a credit report by paying frequent visit to the client and his business unit.
- Appraising credit proposals professionally and insisting on timely delivery of credit.

Remedies Available for NPA

After having proper credit management in terms of appraising and Monitoring of Loan assets, NPA do occur. In such cases, some of remedial measures will help to deal with NPA problem. Such remedial actions can be broadly divided into:

- **Non- Legal Remedies**

Non- legal remedies may be compromise, mergers and take-over. The goods pledged or hypothecated may be sold without courts intervention. The debts can be assigned in favour of an agency which may come forward to collect debts for a service charge.

- **Legal Remedies**

The RBI has suggested lenders to start or initiate legal measures including criminal action. Some of the important legal measures available are:

- Filing of civil suits for debt recovery or for security enforcement.
- Filing of suits under State Recovery Act for the recovery of debts. Referring cases to Lokadalats constituted under the Legal Services Authorities Act, 1987 which help in resolving disputes between the parties by conciliation, mediation, compromise, or amicable settlement. Here it shall be noted that Every verdict of the Lokadalat is equivalent of decree of a civil court.
- Recovering Large Loans via DRM (i.e. Debt Recovery Mechanism) including Corporate Debt Restructuring, one time settlement scheme, have shown good results.
- Proceeding against the default borrower under SARFAESI Act, 2002which came into effect on June 21, 2002. Under the Act, Lender is allowed to take possession of secured assets of borrower after issue of demand notice, If dues not paid in 60 days from date of such notice. The interference by the court is not required in this case. The provisions of this Act are applicable to unsecured loans or loans below Rs. 1,00,000 or

loans due is less than 20% of the principal amount and interest thereon. Recently on April 8, 2004 the Supreme Court has upheld the validity of the Securitization Act by giving one major relief to the borrower- litigant. The earlier provision that the borrower will have to deposit 75% of the disputed amount before appealing has been scrapped. With the implementation of the SRFAESI Act, many lenders have commenced their recovery action against recalcitrant debtors. Since the Supreme Court has upheld the constitutional validity of the Act, it will go a long way in managing NPA successfully. This Act also provides the formal legal basis for setting up Asset Reconstruction Companies (ARCs) in India.

Recommendations of the Narsimham Committee

Banks and financial institutions shall be allowed a period of 3 years for implementing the above recommendations. It means the banks or Financial Institutions following system of accrual for accounting shall not record income on NPA. (Karunakar and Saravanan, 2010). An asset would be considered nonperforming if interest on such assets remains past due for a period exceeding 180 days at the balance sheet date. The committee further recommends that banks and financial norms in a phased manner beginning with that current year. Provisioning / Asset Management: For the purpose of provisioning, the Committee recommends that, using the health code classification which is already in vogue in banks and financial institutions, the assets should be classified into four categories namely, Standard, Sub- standard, Doubtful and Loss Assets. The provision shall be made against Non Performing Assets as follows:

Loss Assets

Should be written off or 100% provision should be made for the amount outstanding.

Doubtful Assets

- Full provision to the extent of the unsecured portion should be made. The R.V. of the security available should be determined on realistic basis.
- In regard to the secured portion, no provision needs to be made towards the guaranteed portion by DICGC (Deposit Insurance And Credit Guarantee Corporation) or ECGC (Export Credit Guarantee Corporation). over & above guaranteed portion should be provided for as per the period for which asset has remained doubtful:

Period for which Advance has been considered as doubtful	% of Provision
Up to 1 years	25*
More than 1 year and up to 3 years	40*
More than 3 years	100

Sub-standard Assets

A provision of 15%* on total outstanding and an additional provision of 10% is required to be made on 'unsecured exposure'.

Standard Assets

- Direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25%.
- Advances to Commercial Real Estate (CRE) Sector at 1%.
- Housing loans extended at teaser rates.
- All other loans and advances not included in (a) (b) and (c) above at 0.40%.

According to committee a period of 4 years shall be given to Banks and Financial Institutions to comply with above provision requirements. However movement towards above requirement need not to implement immediately rather it shall be done in a phase manner beginning with current year. But Provision in respect of doubtful assets should be made or provided in shortest possible time. The committee believes that's Financial Statements of Banks and Financial institutions shall be made transparent and disclosure shall be made in line with international Accounting Standards. The RBI may give some relaxation in terms of time for implementation of such standards as it consider appropriate for transitional period until the norms are fully implemented. Recommendation of committee also includes the criteria recommended for non-performing assets and provisioning requirements should be given due recognition by the tax authorities.

For this purpose, committee also suggests the guidelines to be issued by RBI under Section 43D of the Income Tax Act should be in line with our recommendations for determination of nonperforming assets. Also, the specific provisions made by the banks and institutions in line with our recommendations should be made permissible deductions under the Income Tax Act. The Committee further suggests that in regard to general provisions, instead of deductions under Section 36 (1) (VIII) being restricted to 5% of total income and 2% of the aggregate average advances by rural branches, it should be restricted to 0.5% of the aggregate average non-agricultural advance and 2% of the aggregate average advances by rural branches. This exemption should also be available to banks having operations outside India in respect of their Indian assets, in addition to the deductions available under Section 36 (1)(viii).

Some Measures for Prevention of NPA

Followings are the main preventive measures for NPA:

- **Detection of Problem at Early Stage:** Banks starts their recovery process too late. By the time they start their efforts to recover the amount of loan it become too late to retrieve the situation for recovery as well as rehabilitation.

- **Finding out Genuine Borrowers:** The Front office desk officer who deals with client first plays a vital role in identifying quickly that customer who are genuine and intended to pay with seriousness of their dues. Now days it's a big challenge bankers confronting. Front desk officials shall be intelligent enough to identify promoter's sincerity and capability to achieve their objective. An objective assessment in this regard is appreciable. Based on such objective assessment banks should decide quickly as soon as possible whether it will be worthwhile to sanction additional finance. "Special Investigation" In this regard banks may consider having of all financial transaction or business transaction, books of account in order to ascertain real factors that contributed to sickness of the borrower. Banks could maintain a panel of experts having expertise in techno economic evaluation of project financing. (Gopalakrishnan, 2014)
- **Timeliness & Adequacy of Response:** Longer the delay in response, grater the injury to the account and the asset. Time is a crucial element in any restructuring or rehabilitation activity. The sanction of fresh loan as well as extension of further facility of loan shall be based on response of techno economic study and promoter's commitment.
- **Cash Flow Consideration**: While financing the banks considers only the fund flow picture which a conventional system of analysis is and do not yield a correct picture and shows a misleading picture. Hence for credit appraisal at both time i.e. fresh sanction or on rehabilitation cash flow shall also be considered to find out a correct picture.
- **Management Effectiveness:** Generally it is presumed that lack of finance causes financial sickness and that leads NPA. However that is a reason no doubt but another factor which plays again a vital role is inefficiency of management of borrower to handle adverse business circumstances. It affects a borrowable unit very adversely and becomes reason of his misfortune. Quality of management shall also be examined only after basic viability of enterprise. it will be useful to have consultant appointed as early as possible to examine this aspect. (Jayasree and Radhika, 2011)

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