A Study on Adoptable Strategies by Banks in India to Bring Down the Rising Percentage of Non Performing Assets

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Abstract

A healthy banking system is essential for any economy striving to achieve growth and remain stable in competitive global business environment. Indian banks are favorable for growth, asset quality and profitability; RBI and Government have made some notable changes in policies and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payment system and integrating regulations of commercial banks. In terms of quality of assets and capital adequacy, these banks have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. PSB need to strengthen institutional skill levels especially in sale and marketing, service operations, risk management and the overall organizational performance ethic & strengthen human capital.

The best indicator for the health of the banking industry in a country is its level of Non-performing assets (NPAs). NPAs are one of the major concerns for banks in India. It reflects the performance of banks. Reduced NPAs generally gives the impression that banks have strengthened their credit appraisal processes over the years and growth in NPAs involves the necessity of provisions, which bring down the overall profitability of banks. The Indian banking sector is facing a serious problem of NPA. The magnitude of NPA is comparatively higher in public sectors banks. To improve the efficiency and profitability of banks the NPA need to be reduced and controlled. This paper deals with understanding the concept of NPAs, its magnitude and major causes for an account becoming non-performing and strategies for managing NPA in Indian banks.

Keywords: *Banking System in India, Commercial Banks, PSB, SCB, NPS.*

Banking Industry in India: Every bank had to earmark a minimum percentage of their loan portfolio to sectors identified as "priority sectors". The manufacturing sector also grew during the 1970s in protected environs and the banking sector was a critical source. The next wave of reforms saw the nationalization of 6 more commercial banks in 1980. Since then the number of scheduled commercial banks increased four-fold and the number of bank branches increased eight-fold. After the second phase of financial sector reforms and liberalization of the sector in the early nineties, the Public Sector Banks (PSBs) found it extremely difficult to compete with the new private sector banks and the foreign banks. The new private sector banks first made their appearance after the guidelines permitting them were issued in January 1993.

As far as the present scenario is concerned the banking industry is in a transition phase. The Public Sector Banks, which are the foundation of the Indian Banking system account for more than 78 per cent of total banking industry assets. Unfortunately they are burdened with excessive Non Performing assets, massive manpower and lack of modern technology.

Norms of NPAs in Banking Industry:

A. BASEL I Norms: The history of the Basel International codes and Standards (BIS) relating to minimum capital adequacy for banks goes back to the developed countries' initiative in 1988 to protect the Organization for Economic Cooperation and Development (OECD) banks from the financial crises common during the 1980s. Basel I norms, were set out in 1988 and accepted over the years by around 100 Central Banks across the globe under what came to be known as the Basel Accord. The original accord, now known as Basel-I, was quite simple and adopted a straight-forward `one size fits all approach' that does not distinguish between the differing risk profiles and risk management standards across banks. The Indian monetary authorities implemented the Basel II by 1999.

The banks were to assess their assets and off-balance-sheet risks taken and incorporate them on their balance-sheet. Basel I norms prescribed a minimum capital adequacy ratio (CRAR) of 8 % for Banks which were signatories to the Basel Accord.

Basel I framework was confined to the prescription of only minimum capital requirements for banks, the Basel II framework expands this approach not only to capture certain additional risks in the minimum capital ratio but also includes two additional areas, Supervisory Review

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Process and Market Discipline through increased disclosure. Thus emerged RBI guidelines on investments and operations risk, paving the way for adoption of what have come to be known as Basel II norms.

B. BASEL II Norms: It is the second accord which focuses on operational risk along with market risk and credit risk. Basel II tries to ensure that the anomalies existed in Basel I are corrected. The process of implementing Basel II norms in India is being carried out in phases. Phase I has been carried out for foreign banks operating in India and Indian banks having operational presence outside India with effect from March 31,2008. In phase II, all other scheduled commercial banks (except Local Area Banks and RRBs) will have to adhere to Basel II guidelines by March 31, 2009. With the deadline of March 31, 2009 for full implementation of Basel II norms fast approaching, banks are looking to maintain a cushion in their respective capital reserves. The minimum capital to risk-weighted asset ratio (CRAR) in India is placed at 9%, one percentage point above the Basel II requirement. All the banks have their Capital to Risk Weighted Assets Ratio (CRAR) above the stipulated requirement of Basel guidelines (8%) and RBI guidelines (9%). As per Basel II norms, Indian banks should maintain tier I capital of at least 6%.

The Government of India has emphasized that public sector banks should maintain CRAR of 12%. For this, it announced measures to re-capitalize most of the public sector banks, as these banks cannot dilute stake further, as the Government is required to maintain a stake of minimum 51% in these banks

Gross NPA and Net NPA: Gross NPA is a advance which is considered irrecoverable, for bank has made provisions, and which is still held in banks' books of account. Net NPA is obtained by deducting items like interest due but not recovered, part payment received and kept in suspense account from Gross NPA. The Reserve Bank of India states that, compared to other Asian countries and the US, the gross non-performing asset figures in India seem more alarming than the net NPA figure. The problem of high gross NPAs is simply one of inheritance. Historically, Indian public sector banks have been poor on credit recovery, mainly because of very little legal provision governing foreclosure and bankruptcy, lengthy legal battles, sticky loans made to government public sector undertakings, loan waivers and priority sector lending. Net NPAs are comparatively better on a global basis because of the stringent provisioning norms prescribed for banks in 1991 by Narasimham Committee. In India, even on security taken against loans, provision has to be created. Further, Indian banks have to make a 100 per cent provision on the amount not covered by the realizable value of securities in case of "doubtful" advance, while in some countries; it is 75 per cent or just 50 per cent.

The ASSOCHAM Study titled "Solvency Analysis of the Indian Banking Sector", reveals that on an average 24 per cent rise in net non performing assets (NPAs) have been registered by 25 public sector and commercial banks during the second quarter of the 2009 as against 2008.

According to the RBI, "Reduction of NPAs in the Indian banking sector should be treated as a national priority item to make the system stronger, resilient and geared to meet the challenges of globalisation. It is necessary that a public debate is started soon on the problem of NPAs and their resolution." Issues and Challenges for Banking Industry: The Indian banking system witnessed a series of reforms over the past few years like the deregulation of interest rates, dilution of the government stake in public sector banks and the increased participation of private sector banks but Indian banks (both public and private) have not able to tap the domestic market also to compete in the global market place. New foreign banks are very enthusiastic to gain in the Indian market.

Non Performing Assets as a major issue and challenge for Banking Industry: Non-performing Assets are threatening the stability and demolishing bank's profitability through a loss of interest income, write-off of the principal loan amount itself. RBI issued guidelines in 1993 based on recommendations of the Narasimham Committee that mandated identification and reduction of NPAs be treated as a 'national priority' because the level of NPA act as an indicator showing the bankers credit risks and efficiency of allocation of resource. The financial reforms in Indian bank industry have helped largely to clean NPA which was around Rs. 52,000 crores in the year 2004. The earning capacity and profitability of the bank are highly affected due to this NPA.

Impact of NPAs on Banking Operations: The efficiency of a bank is not always reflected only by the size of its balance sheet but also the level of return on its assets. The NPAs do not generate interest income for banks but at the same time banks are required to provide provisions for NPAs from their current profits.

1. The NPAs have destructive impact on the return on assets in the following ways.
2. The interest income of banks reduced it is to be accounted only on receipt basis.
3. The current profits of the banks are eroded because the providing of doubtful debts and writing it off as bad debts and it limits the recycling funds.
4. The capital adequacy ratio is disturbed and cost of capital will go up.

5. The economic value addition (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital.

Causes Responsible for Increasing NPAs: The banking sector has been facing the serious problems of the rising NPAs. In fact PSBs are facing more problems than the private sector banks and foreign banks. The NPAs in PSBs are growing due to external as well as internal factors. One of the main causes of NPAs in the banking sector is the Directed loans system under which commercial banks are required to supply 40% percentage of their credit to priority sectors. Most significant sources of NPAs are directed loans supplied to the "micro sector" are problematic of recoveries especially when some of its units become sick or weak. PSBs 7 percent of net advances were directed to these units.

Poverty elevation programs like IRDP, RREP, SUME, SEPUP, JRY, PMRY etc., failed on various grounds in meeting their objectives. The huge amount of loan granted under these schemes was totally unrecoverable by banks due to political manipulation, misuse of funds and non-reliability of target audience of these sections. Loans given by banks are their assets and as the repayments of several of the loans were poor, the quality of these assets was steadily deteriorating.

In India the scope for branch expansion in rural and semi urban areas is vast and also necessary. Increasingly, NBFCs operating at such places are coming under regulatory pressure and are likely to abandon their intermediation role. These branches find priority sector financing as the main business available especially in rural/semi-urban centers. Operational restructuring of banks should ensure that NPAs in the priority sectors are reduced, but not priority sector lending. This will remain a priority for the survival of banks. Any decisions about insulating Indian banks from priority sector financing should not be reached until full-scale research is undertaken, taking into account several sources including records of credit guarantee schemes.

Strategies for Overcoming NPAs:

Various steps have been taken by the government and RBI to recover and reduce NPAs. These strategies are necessary to control NPAs.

1. Preventive management and
2. Curative management

A. Preventive Management: Preventive measures are to prevent the asset from becoming a non performing asset. Banks has to concentrate on the following to minimize the level of NPAs.

1. Early Warning Signals the origin of the flourishing NPAs lies in the quality of managing credit assessment, risk management by the banks concerned. Banks should have adequate preventive measures, fixing presanctioning appraisal responsibility and having an effective post-disbursement supervision. Banks should continuously monitor loans to identify accounts that have potential to become non-performing. It is important in any early warning system, to be sensitive to signals of credit deterioration. It is revealed that the indicators which may trigger early warning system depend not only on default in payment of installment and interest but also other factors such as deterioration in operating and financial performance of the borrower, weakening industry characteristics, regulatory changes, and general economic conditions.

   Financial related warning signals generally emanate from the borrowers' balance sheet, income expenditure statement, statement of cash flows, statement of receivables etc. Following common warning signals are captured by some of the banks having relatively developed EWS.

2. Financial warning signals

- Persistent irregularity in the account
- Default in repayment obligation
- Devolvement of LC/invocation of guarantees
- Deterioration in liquidity/working capital position
- Substantial increase in long term debts in relation to equity
- Declining sales
- Operating losses/net losses
- Rising sales and falling profits
- Disproportionate increase in overheads relative to sales
- Rising level of bad debt losses Operational warning signals
- Low activity level in plant
- Disorderly diversification/frequent changes in plan
- Non-payment of wages/power bills
- Loss of critical customer/s
- Frequent labour problems
- Evidence of aged inventory/large level of inventory

3. Management related warning signals Lack of co-operation from key personnel

- Change in management, ownership, or key personnel

- Desire to take undue risks
- Family disputes
- Poor financial controls
- Fudging of financial statements
- Diversion of funds

4. Banking related signals

- Declining bank balances/declining operations in the account
- Opening of account with other bank
- Return of outward bills/dishonoured cheques
- Sales transactions not routed through the account
- Frequent requests for loan
- Frequent delays in submitting stock statements, financial data, etc. Signals relating to external factors
- Economic recession
- Emergence of new competition
- Emergence of new technology
- Changes in government / regulatory policies
- Natural calamities

5. Know your client' profile (KYC): Most banks in India have a system of preparing `know your client' (KYC) profile/credit report. As a part of `KYC' system, visits are made on clients and their places of business/units. The frequency of such visits depends on the nature and needs of relationship.

6. Watch-list/Special Mention Category: The grading of the bank's risk assets is an important internal control tool. It serves the need of the Management to identify and monitor potential risks of a loan asset. The purpose of identification of potential NPAs is to ensure that appropriate preventive / corrective steps could be initiated by the bank to protect against the loan asset becoming non-performing. Most of the banks have a system to put certain borrowable accounts under watch list or special mention category if performing advances operating under adverse business or economic conditions are exhibiting certain distress signals.

7. Wilful Defaulters: RBI has issued revised guidelines in respect of detection of wilful default and diversion and siphoning of funds. As per these guidelines a wilful default occurs when a borrower defaults in meeting its obligations to the lender when it has capacity to honour the obligations or when funds have been utilized for purposes other than those for which finance was granted. The list of wilful defaulters is required to be submitted to SEBI and RBI to prevent their access to capital markets. Sharing of information of this nature helps banks in their due diligence exercise and helps in avoiding financing unscrupulous elements.

B. Curative Management: The curative measures are designed to maximize recoveries so that banks funds locked up in NPAs are released for recycling. The Central government and RBI have taken steps for controlling incidence of fresh NPAs and creating legal and regulatory environment to facilitate the recovery of existing NPAs of banks. They are:

1. One Time Settlement Schemes

This scheme covers all sectors sub standard assets, doubtful or loss assets as on 31st March 2000. All cases on which the banks have initiated action under the SRFAESI Act and also cases pending before Courts/DRTs/BIFR, subject to consent decree being obtained from the Courts/DRTs/BIFR are covered.

2. Lok Adalats

Lok Adalat institutions help banks to settle disputes involving account in “doubtful” and “loss” category, with outstanding balance of Rs. 5 lakh for compromise settlement under Lok Adalat. Debt recovery tribunals have been empowered to organize Lok Adalat to decide on cases of NPAs of Rs. 10 lakh and above. This mechanism has proved to be quite effective for speedy justice and recovery of small loans. The progress through this channel is expected to pick up in the coming years.

3. Debt Recovery Tribunals (DRTs)

The Debt Recovery Tribunals have been established by the Government of India under an Act of Parliament (Act 51 of 1993) for expeditious adjudication and recovery of debts due to banks and financial institutions. The recovery of debts due to banks and financial institution passed in March 2000 has helped in strengthening the function of DRTs.

4. Securitization and SARFAESI Act

Securitization is a relatively new concept that is taking roots in India of late. It is still in its infancy with only a few market players. Securitization is considered an effective tool for improvement of capital adequacy. It is also seen as a tool for transferring the reinvestment risk, apart from credit risk helping the banks to maintain proper match between assets and liabilities. Securitization can also help in reducing the risk arising out of credit exposure norms and the imbalances of credit exposure, which can help in the maintenance of healthy assets. The SARFAESI Act intends to promote Securitization, pool together NPAs of banks to realize them and make enforcement of Security Interest Transfer.

Asset Reconstruction Company (ARC): This empowerment encouraged the three major players in Indian banking system, namely, State Bank of India (SBI), ICICI Bank Limited (ICICI) and IDBI Bank Limited (IDBI) to come together to set-up the first ARC. Arcil is the first ARC in the country to commence business of resolution of non-performing assets (NPAs) upon acquisition from Indian banks and financial institutions. As the first ARC, Arcil has played a pioneering role in setting standards for the industry in India. The primary objective of Arcil is to expedite recovery of the amounts locked in NPAs of lenders and thereby recycling capital. Arcil thus, provides relief to the banking system by managing NPAs and help them concentrate on core banking activities thereby enhancing shareholders value. Arcil has made successful efforts in funneling investment from both from domestic and international players for funding these acquisitions of distressed assets, followed by showcasing them to prospective buyers. This has initiated creation of a secondary market of distressed assets in the country besides hastening their resolution. The efforts of Arcil would lead the country's distressed debt market to international standards.

Corporate Debt Restructuring (CDR): Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring of the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporate that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

Circulation of Information of Defaulters: The RBI has put in place a system for periodical circulation of details of wilful defaulters of banks and financial institutions. The RBI also publishes a list of borrowers (with outstanding aggregate rupees one crore and above) against whom banks and financial institutions in recovery of funds have filed suits as on 31st March every year. It will serve as a caution list while considering a request for new or additional credit limits from defaulting borrowing units and also from the directors, proprietors and partners of these entities.

Credit Information Bureau: The institutionalization of information sharing arrangement is now possible through the newly formed Credit Information Bureau of India Limited (CIBIL) it was set up in January 2001, by SBI, HDFC, and two foreign technology partners. This will prevent those who take advantage of lack of system of information sharing amongst leading institutions to borrow large amount against same assets and property, which has in no measures contributed to the incremental of NPAs of banks.

Conclusion: The problem of NPAs can be achieved only with proper credit assessment and risk management mechanism. In a situation of liquidity overhang, the enthusiasm of the banking system to increase lending may compromise on asset quality, raising concern about their adverse selection and potential danger of addition to the stock of NPAs. It is necessary that the banking system is to be equipped with prudential norms to minimize if not completely to avoid the problem of NPAs. The onus for containing the factors leading to NPAs rests with banks themselves. This will necessitates organizational restructuring, improvement in the managerial efficiency and skill up gradation for proper assessment of credit worthiness. It is better to avoid NPAs at the nascent stage of credit consideration by putting in place of rigorous and appropriate credit appraisal mechanisms.

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