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A Study on Impact of Bad Loans on Performance of Banks

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Abstract: *The major functions of a bank are accepting deposits and lending loans, the former involve no risk, as the banker owes to repay deposit with interest. And latter is highly risky, as there is no certainty of repayment by the borrowers which would give rise to non-performing assets (NPAs) which are also called bad loans. In India, bad loans are the major indicators which explain about the health and profitability of the banks. Bad loans (NPAs) are those which do not generate the expected income i.e., commission, interest or other dues for more than 90 days.*

In addition to non- generation of income, these NPAs force the banks to make necessary provisions for repayment of deposits. NPAs not only impact the profitability but also have an adverse affect on the economy. Management of these bad loans is gaining importance as they reduce the net-worth of banks. The core factors due to which the NPAs are growing are lack of effective supervision of accounts related to loans, insufficient collateral guarantee provided and also willful default by borrowers.

The volume of bad loans is higher in the public sector banks when compared to private sector banks. In order to increase bank's profitability and efficiency, there is a need to control these bad loans which is done through selling of NPAs by banks to Asset Restructuring Companies (ARCs) who are specialized agencies in recovering loans.

This study aims at understanding NPAs, their classification, and reasons for increasing NPAs, steps taken by RBI to trim the NPAs and suggestions to improve the recovery process.

Key terms: *Asset Restructuring Companies, collateral guarantee, Non-performing assets, net-worth of banks.*

I. Introduction

There is no exaggeration in saying that a well-developed financial system is the fuel to run the economy as it promotes savings and investments. After the reforms of financial sector and the first phase of economic liberalization in 1991, the banking industry has gained a wide importance, which has become the foundation for economic development. In India, the banking system consists of commercial and cooperative banks, of which 90 percent of assets are held by commercial banks. Apart from them there are few foreign banks and regional rural banks which form a part of Indian banking system.

Prior to 1991, the asset quality was not a prime concern as it was not related to the primary objectives (accepting deposits and lending loans). But it has become important as banks focused on performance objectives like diversification, employment generation, development of rural areas etc. In the recent times, banks have become more cautious in extending advances and loans, the reason being increasing bad loans or non-performing assets.

II. Literature Review

Chatterjee C., Mukherjee J. and Das (2012) in their study on Management of non-performing assets - a current scenario they have concluded that there is a need for banks to find out the purposes for which the loan is borrowed. Vohra and Dhamu (2012) pointed out that the profitability and equity of the banks are affected by NPAs. The authors observe that NPA of Indian banks are comparatively high by international standards. Therefore they recommended restrictive lending operations only to borrowers who provide adequate collateral guarantee..Rai (2012) in her study on Study on performance of NPAs of Indian commercial banks found out that as there is legal mechanism to safeguard the real interest of banks, big corporate companies continuously default.Kaur K. and Singh B. (2011) in their study on Non-performing assets of public and private sector banks (a comparative study) have said that the important parameter to judge the performance of banks is NPAs and also the growth of banking sector in a country is determined by the level of NPAs.

Mitra & Ravi (2008). The main objective of this paper was to estimate and compare efficiency of the banking sector in India. The analysis aimed at evaluating whether the banking sector fulfills its function of intermediation to compete with the global entities. Identifying priority area for different banks to improve their performance is necessary, in which loan recovery procedures also play a major role.

III. Non-Performing Asset- Concept

A non-performing asset is defined as that asset which ceases to generate income. It is that credit facility, the interest or principal, with its respect is due over a specified period of time. If a borrower makes a default in making payments against the interest or principal for 90 days, such loan is said to be a non-performing asset. To ensure greater transparency, '90 days' overdue' norm has been adopted for identifying an NPA, from the financial year ending 31 march, 2004. Accordingly, an NPA is a loan or an advance, where- In respect of a term loan, interest and/or installment of principal remain overdue for a period of more than 91 days.In respect of overdraft/cash credit (OD/CC), the account stays out of order for a time period which exceeds 90 days.In case of bills purchased and discounted, bill remains overdue for a period exceeding 90 days. In case of an advance granted for agricultural purposes, interest or principal remains overdue for two harvest seasons.In case of cash credit facility, stocks are not submitted for 3 consecutive quarters.

Classification Of Npas:

An asset which has remained an NPA for a time period not more than 12 months is a sub-standard asset. An asset which has remained an NPA for a time period exceeding 12 months is a doubtful asset. If a bank, external or internal auditor identifies a loss, the amount of which has not been written-off either wholly or partially, it is called as a loss asset.

Repercussions Of Npas:

The repercussions of NPAs on banks are that the repayment of deposits along with the interest is not assured and also shareholders of banks are adversely affected. Management efforts and time are indirect costs which the banks have to bear due to increasing bad loans. NPAs not only affect the current profits but also future profits which may lead to loss of beneficial opportunities because funds are used for unproductive projects which will lead to failure of useful and productive projects due to lack of sufficient funds. Inability to recover and realize bad loans decreases the net profit as well as the lending capacity, making them risk averse. Non-repayment by existing borrowers prevents the banks from lending to new borrowers, this slows down the credit recycling which leads to lowering the deposit interest rates and raising the lending rates that discourage the genuine borrowers .Domestic business cannot survive since, global competitors lend at lower rates which leads to negative balance of trade, unemployment and social unrest.

Causes Responsible For Bad Loans:

The causes for NPAs can be classified into external and internal factors.

Table.1 Factors Responsible For Non-Performing Assets

EXTERNAL FACTORS	INTERNAL FACTORS
Due to carelessness and ineffectiveness in the working of recovery tribunals established by government, banks suffer from consequences of non-recovery.	Defective lending process.
Entrepreneurs start production without having enough knowledge about their products' demand making them unable to pay back the loans	Due to lack of technology and inappropriate management information system, real time decisions cannot be taken which leads to poor credit collection.
Natural calamities are the factors, which are leading to NPAs of PSBs.	Poor credit appraisal system.[1]
Ineffective management, lack of technology etc produce industrial sickness. Banks that finance those industries end up with a low recovery.	Lack of sufficient collateral security provided by the borrowers.[2]
Willful defaults by the borrowers. [3]	Lack of regular visits of bank officials to the customers' place decreases collection of amount of loan.
Inability of banks to cope with the changing principles and policies for the regulation of raising NPAs leads to future NPAs.	Because of managerial deficiencies, decisions relating to extension of credit to genuine borrowers are not made.

IV. Objectives of the study:

To study the concept of NPAs, their classification and causes.
To study the impact of bad loans on the performance of the banks.
To understand the recovery procedure of NPAs.

To analyze and interpret NPA related ratios for aggregates of public and private sector banks.
To make suggestions to avoid future NPAs and also manage the existing ones.

V. Methodology:

Analysis and interpretation is done on the data from the year 2014 to 2017 to make a comparison between public sector banks and private sector banks.
Population: Indian banking industry is considered for the study wherein data related to NPAs of public and private sector banks is used.
Research design: Descriptive research design is used.
Data collection: Secondary data collected from RBI website and review of literature is used in the paper.
Time period: Past three year's aggregate data is used for comparison.

VI. Analysis And Interpretation

The non-performing assets of the banking system of India have increased in the recent past. The gross NPAs to gross advances and net NPAs to net advances of public sector banks have increased from 4.46 per cent to 5.09 per cent and 2.92 per cent to 5.75 per cent in financial years 2014-15 and 2015-16 respectively. The lowest gross NPAs to gross advances are maintained by the private sector banks at 2.16 per cent in FY15. When compared with the private sector banks, the Public sector banks are more stressed.
8.1. Movement of gross non-performing assets of banks:
Table.2

Gross non-performing assets of banks: movements over 3 years

BANK NAMES	Q4 FY15	Q4 FY16	Q4 FY17
Vijaya bank	2.78	6.64	6.59
Indian bank	4.40	6.66	7.47
Syndicate bank	3.13	6.70	8.50
Canara bank	3.89	9.40	9.63
Punjab and sind bank	4.76	6.48	10.45
Union bank	4.96	8.70	11.17
Andhra bank	5.31	8.39	12.25
PNB	6.55	12.90	12.53
OBC	5.18	9.57	13.73
Dena bank	5.45	9.98	16.27
Bank of Maharashtra	6.33	9.34	16.93
UCO bank	6.76	15.43	17.12
Central bank	6.09	11.95	17.81

Sources: Reserve Bank of India website.

From table.3, we can see an increase in the gross non-performing assets of the banks from the past 3 years on an average.

According to the ratings of CARE (credit analysis and research limited), the gross non-performing assets ratio has been increasing continuously from the year 2015. The NPA ratio has increased to almost 12 per cent in the fourth quarter of 2017 from 5.12 percent in 2015.

Chart.1 Gross NPA (%)

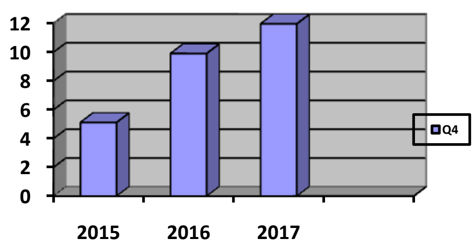

Table.3 Gross NPA (%)

YY	FY15	FY16	FY17
Q4	5.12	9.91	11.97

Sources: Ace Equity

8.2 Current NPA position:

Table.4 NPA POSITION

YEAR	NPAs (in crores)	NPA ratio
March 2016	5,71,841	7.69
March 2017	7,11,312	9.06
June 2017	8,29,338	10.21

Source: Ace Equity

Table.4 shows that the NPA ratio of banks in India has increased from 7.69 per cent in March 2016 to 10.21 per cent in June 2017 which is the highest in the previous six quarters.

VII. Recovery Of Npas Through Asset Restructuring Companies (Arcs):

Banks sell their NPAs to ARCs in a bid to recover the dues and get their stressed balance sheet recovered. Most of the NPA's sale to ARCs is based on 15:85 rules wherein ARCs give 15% of the net asset value in cash and the remaining by issue of security receipts. Sale of NPAs to ARCs have reduced from about Rs.50000 crore in 2013-14 and 2014-15 to Rs.15,000 crore in 2016-17. The reason behind this is RBI demanding a higher down payment. Currently there are about 21 ARCs with an aggregate capital of Rs.4000 crore.

Various other initiatives have been taken by RBI to subside the effects of NPAs on economy. Loan classification, SDR (strategic debt restructuring) and S4A (scheme for sustainable structuring of stressed assets) are a part of such initiatives

VIII. Findings:

The gross NPAs to gross advances and net NPAs to net advances of by public sector banks have increased from 4.46 per cent to 5.09 per cent and 2.92 per cent to 5.75 per cent in financial years 2014-15 and 2015-16 respectively. The lowest gross NPAs to gross advances are maintained by the private sector banks at 2.16 per cent in FY15.The NPA ratio of banks in India has increased from 7.69 per cent in March 2016 to 10.21 per cent in June 2017.

Sale of NPAs to ARCs have reduced from about Rs.50000 crore in 2013-14 and 2014-15 to Rs.15,000 crore in 2016-17.

IX. Suggestions For Recovery Of Npas:

Loan recovery methods must be strengthened.

Revision of existing credit appraisal system to be done to lend to genuine borrowers.

Actions against the borrowers must be initiated. Resorting to curative measures such as one time settlements will improve the recovery procedure.

After sanctioning the loans, personal visits must be made and also regular follow-up with the customers must be ensured. [4]

Insolvency and bankruptcy code should be amended.

X. Conclusion

The increasing NPAs are not only a matter of concern to banks but also to the whole economy. From the findings, it is clear that when compared to the private sector banks, public sector banks are more affected. Though various measures have been taken by the government, there is still a need for lot to be done to stop the raising NPAs. The NPA levels of Indian banks are more when compared to the foreign banks [5]. Although bringing NPAs to zero is not possible, all possible steps are to be taken to speed up the recovery procedure. Pending cases relating to NPAs are to be solved in order to recover the past NPAs and measures must be taken for preventing future NPAs as they adversely affect the profitability of banks which in turn hinders the growth of the economy. Once the balance sheets of banks are cleaned up, the profitability will increase and banks will be able to support the economic growth in a sustainable way.

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