International Journal of Marketing and Management Research
Vol. 6, Issue 10, October 2015, Impact Factor; 4.596 ISSN: (2229-6883)
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An Analysis of NPAs in Priority and Non-Priority Sectors concerning Public Sector Banks in India

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Abstract

An ever-increasing NPA burden on banks, their stressed asset resolution has come under the spotlight of financial policymakers and government agencies. These efforts, coupled with the implementation of Pradhan Mantri Garib Kalyan Yojana (PMGKY) and banking reforms have put some balance on the account of NPAs, the public sector banks (PSBs) are finding themselves unable to manage them efficiently. A focus on credit risk monitoring and customer services may help PSBs reduce their bad loan exposure. Additionally, increasing access to alternative finance channels will allow them to free up their resources for recapitalization. Furthermore, due to the competitive environment and favourable government policies, non-banking financial companies (NBFCs) have taken up most of the under-performing loans from PSBs. Some recent amendments to RBI's supervisory framework suggest that it may start focusing on maintaining market discipline through 'micro-prudential supervision. Thus, these reforms are essential to overcome the rising bad loan problem in India.

Keywords: Non-performing assets, Banking sector, Government schemes, Reserve Bank of India

Introduction

An ever-increasing NPA burden on banks, their stressed asset resolution has come under the spotlight of financial policymakers and government agencies. These efforts, coupled with the implementation of Pradhan Mantri Garib Kalyan Yojana (PMGKY) and banking reforms have put some balance on the account of NPAs, the public sector banks (PSBs) are finding themselves unable to manage them efficiently. Some recent amendments to RBI’s supervisory framework suggest that it may start focusing on maintaining market discipline through ‘micro-prudential supervision. Thus, these reforms are essential to overcome the rising bad loan problem in India. The rationale for NPA elimination strategy on a policy front, one could observe that many states have either already undertaken action or initiated discussions for corrective measures. These include: improving governance; cutting down operational costs; strengthening internal controls; undertaking structural reforms and developing more affordable sources of capital. While all these steps have a place in addressing the NPA problem, However, despite various proposals for improvement, not many changes have been made by PSBs in terms of operating procedures and governance structure. One possible reason for this is that even after initiatives like Ind AS 18 standards were brought in place, there was little or no attempt made by PSBs to comply with these regulations. Also, by trying to change too many systems at once, they risk creating redundancies and a lack of continuity in decision making. It would thus be wise to choose an area where improvement can be implemented gradually and ensure continuity in decision making and process improvements.

Objectives of the study

This paper provides a critical review of NPA analysis from various viewpoints, and suggest policy options to overcome this problem.

Research Methodology

Given the above objective, the present study aims to assess the quantum of Non-Performing Assets (NPAs) in public sector banks in India based on secondary sources. To attain the above objective, data was collected from the various database. The current study is based on descriptive and historical analysis of NPAs in Priority and Non-Priority Sectors concerning Public Sector Banks in India based on secondary sources. A variety of methodological approaches has been used in this study for collecting the data and analyzing it.

Literature review

An increase in non-performing assets (NPAs) has been a challenge for the banking sector. Bank branch closures have increased NPAs. Many other factors contribute to NPAs. An understanding of these factors can help policymakers to avoid another round of financial meltdown. NPA classification has been done based on different time frames and thus there is confusion regarding which are considered as Non-Performing Assets (NPAs) and which are not. Hence, it is necessary to understand whether bank loans classified as NPAs or not based on the specified time frame is correct(Rao & Patel, 2015). Further, we should also understand whether such classification helps to reduce NPAs or not. (Goyal, 2010) try to provide some suggestions based on different parameters for identifying NPA and evaluating their credit quality. In addition, (Khanna, 2012) attempt to find out how effective a monetary policy can be in mitigating NPAs. The suggestion may also help in keeping the flow of credit stable and achieving a higher capital adequacy ratio (CAR) under Basel III guidelines. The impact of branch closures on the level of NPAs has been investigated by (Shabbir & Mujoo, 2014). (Khanna, 2012)fond that closure of bank branches does not lead to any improvement in NPA ratios of public sector banks (PSBs). Therefore, Veerakumar (2012)concluded that even after closing down a large number of branches, there will be no significant change in NPA ratios. Thus, our suggestion may not be very helpful in keeping NPAs low. As mentioned earlier, some other factors such as the inability of PSBs to write off bad loans have also been identified as causes of high NPAs. Further, different economic activities also play a role in creating NPAs. Such factors include export-oriented businesses, inflexible regulatory policies, rural infrastructure sector, non-performing small entrepreneurs, industrial projects and land financing schemes(Veerakumar, 2012). Hence, the identification of various categories of NPAs based on various characteristics is important for addressing them effectively. Overall, (Kaur & Saddy, 2011b) study concluded that while creating NPA categories is a challenging task, there is a need to come up with some alternative models which will enable financial stability and encourage private investment. If NPAs continue to grow at a fast pace, then a financial crisis may arise at some point in time. It is necessary to prevent this scenario from occurring by ensuring appropriate actions at the macro level. To tackle this issue, one needs to develop suitable mechanisms which can provide direction to the financial system and put an end to the boom and bust cycle. There is a need to consider three issues: Examine how well existing instruments such as credit rating agencies and asset quality review (AQR) works Understand how large banking companies are using loan management system Investigate whether private banks could act as supervisors for large public sector banks given the enormous amount of money involved in corporate lending, both lenders and borrowers should understand their exposure better(Kaur & Saddy, 2011b). If companies borrow too much money from banks, they are taking more risk than they would if they only borrowed from their customers. Similarly, lenders should not extend too much credit to borrowers who have less information about their ability to repay loans. Moreover, investors who do not want to buy shares of the same company that borrows too much money from banks may get easily cheated by borrowing more than they can afford(Throve, 2015). Rajender (2009) recommends setting up Credit Rating Agencies (CRAs) for determining risk assessment of NBFCs and Financial Institutions (FIs). Also, since information about a company's assets is readily available in the public domain, CRAs could make better decisions than FIs when assessing the creditworthiness of an NBFC or FI. The failure of one such agency would be harmful to both borrowers and lenders. (Ahmed, 2010) also recommend strengthening the asset quality review (AQR) mechanism by examining: The limits on the number of delinquent accounts allowed for all types of firms; Processes used for calculating the ratio for assessing default probability; Ability of institutions to monitor AQR systems in place; Whether regulatory authorities ensure full disclosure of all material information by reporting entities; Role of legal/administrative infrastructure in implementing AQR system; Institutional structure for enforcing collection process and collecting an outstanding debt; Collateral value taken by institutions to recover bad loans; Credible model for managing recovery process in case of defaults; A legal infrastructure that makes a defaulter eligible for new loans after adequate provisioning for loss recovery. Pandya (2015) analysis has indicated that we have reached a crisis point where most banks are sitting on unproductive capital due to an extremely complex credit chain which allows very few players to play the key role of being the market makers and ultimately end up holding all the key cards in their hands. This complexity also means that many firms with higher risks may have passed as high-quality investments, creating greater instability in the financial system. Thus, an additional set of reforms should be made by strengthening governance and financial regulations so that these problems are tackled before they arise(Krishna, 2008). Such reforms include: Identifying problem areas through independent auditing, enhanced information gathering mechanisms, more structured supervision and ensuring the independence of auditors; Promoting prudent loan making through transparent lending policies and measures such as benchmarking and peer reviews; Streamlining operations through reducing paperwork and allowing companies to develop systems that enable them to provide high-quality products at reasonable costs; Further reducing interconnectivity between credit entities(Rajput et al., 2012).

NPAs in Priority and Non-Priority Sectors concerning Public Sector Banks in India

Apart from fixing some specific issues in individual sectors, banks need to find the root cause of NPA accumulation in the Indian economy. Banks should examine how long their decision-making processes take to complete and whether this leads to unnecessary delays in payments and recovery. For example, lack of checks and balances within departments may result in multiple approval layers which create time lags and costs in recovering funds. This also allows room for human error which results in fraud and increase the chances of asset erosion. Another factor is poor regulatory supervision which creates uncertainty about payment timing and consistency of servicing debt obligations. By analyzing such aspects of bank functioning, it may be possible to determine if certain systemic weaknesses exist which could also affect the credit standards of other lenders. Thus, finding out root causes is important as it will allow for comprehensive reforms in India's banking sector. Moreover, given the significance of the Indian economy to the global economy, its importance cannot be underestimated. The financial system has always been critical to national economic development and any adverse event may lead to its erosion. Banks must realize that failure to do this will ultimately hurt not only themselves but also other stakeholders such as corporates, NBFCs and households. A systemically deep reform can ensure more stability in the banking system by strengthening risk management practices and internal controls. Although these systems are likely to increase compliance costs, banks should consider them an investment for future gain as these investments may eventually bring benefits such as improved capital adequacy ratios, increased market share, reduction in financial crime and increased investor confidence. Since large NPA disbursements during 2008-10 resulted in very high leverage levels, improving corporate governance through appropriate oversight mechanisms could mitigate potential problems that have emerged during the recent NPA disbursement cycle. These new policies will need careful review by both RBI and regulators to avoid inconsistencies with previous experience. Changes in credit culture should be implemented gradually so that small businesses are not adversely affected. Some measures include encouraging cashless transactions, limiting unsecured lending and instituting greater transparency on payment terms. Allowing faster repayment through Debt Recovery Tribunals will also facilitate the timely resolution of bad loans. (Tripathi et al., 2014) find that economic policy considerations make the use of negative rate bonds attractive for a few years but overall, they are an inappropriate instrument for sustainable macroeconomic growth. Given the concerns about rising prices and persistent liquidity shortage, (Dhar & Bakshi, 2015) think it would be preferable to allow the bank to provide temporary interest rate accommodation by rolling over maturing or undrawn excess reserves (UAERs) rather than sell securities at negative rates.To meet their targets of public spending and maintain financial stability, RBI needs to make good use of a number of available instruments such as automatic transfers of funds from surplus accounts of states to specialized government departments or funds; freeing banks from short-term pressures on government borrowings; establishing buffer fund with no time limit; lowering UAER ceilings; conducting information-sharing agreements between regulators; allocating emergency credit lines for key state agencies; authorizing FDIs with international expertise; permitting trading in central bank assets in specific areas such as gold and exchange-traded funds (ETFs); creating infrastructure banks to finance national priority projects and asset management firms for under-developed infrastructure projects. India is facing multiple macroeconomic challenges and needs to attract $6 trillion in foreign direct investment over the next 10 years to address them. External developments such as geopolitical uncertainty, structural reforms in advanced economies, debt market distortions, capital account convertibility concerns and issues related to monetary policy coordination can potentially hinder foreign investment inflows. Uncertainty about external security issues may force FDI inflows to the country to slow down or decline altogether. On the one hand, India's strong fundamentals including strong political institutions, democratic values, market size, urban station`, literacy and entrepreneurial spirit will make India an attractive destination for investors. On the other hand, market participants should not be complacent about these potential disruptions and risks associated with any disturbances in global capital markets. All this requires proactive actions from policymakers and industry players. Government must adopt an active engagement policy with domestic and international investors to convince them that India is ready to engage in more intensive negotiations with potential investors and open up sectors where there is genuine demand from Indian companies. By improving ease of doing business, investing in infrastructural development and building a competitive economy, India can further strengthen its appeal as an investment destination. When viewed through the lens of the quality of the business environment, ease of doing business ranking has been a huge disappointment for India in recent years. To regain ground lost in recent years, India must enhance investor confidence by developing a dynamic economy that can deliver inclusive growth.

NPA crisis is a very serious issue for public sector banks (PSBs) of India. Even though they have played a significant role in building up the Indian economy, their credit activities are generally unprofitable. Public sector banks (PSBs) were initially conceived as an instrument for supporting national infrastructure. During the 1980s, when reforms in India's financial sector began, these banks had high loan growth rates and increasing amounts of NPAs. A detailed study has been made of these PSBs' operations during 1981-2004, covering different periods of economic development and also during the 2001-04 crisis period. These data reveal that there was some reduction in NPA levels during the 1990s, but still, the numbers were too high to justify their full capacity. Since 1991, government intervention has gradually reduced NPAs and strengthened capital adequacy ratio (CAR) levels of PSBs. After accounting for statutory reserve requirements, reserves as a percentage of deposit base have gone up from 7.6% in 2000 to 14.7% in 2005, indicating an improvement in the capital position of PSBs. The following policy options have been suggested: (i) disclosure and monitoring of asset quality indicators; (ii) investment by PSBs in projects for sustainable development; (iii) budgetary support for reducing interest rate volatility; (iv) amalgamation of weak PSBs to strong ones; (v) the raising of private capital through debt restructuring; (vi) supporting healthy competition by allowing healthy internal business practice and setting reasonable interest rates; (vii) streamlining business process through mergers and acquisition; (viii) promotion of new technological means for quick recovery of bad loans; (ix) forming syndicates for participation in riskier lending activities; (x) formation of task forces to evaluate risks associated with market conditions; (xi) drawing good lessons from previous experience and transferring it to other financial institutions; (xii) creation of awareness amongst investors about prudent investing practices; (xiii) linking investor rights with responsible investment principles; (xiv) involvement of regulator to control, manage and mitigate risks associated with unregulated entities. Trends and features of NBFCs the total value of loans disbursed by all non-banking financial companies (NBFCs) rose from Rs 1,77,355 crore in 1995 to Rs 8,27,518 crore in 2010. NBFCs were among the largest contributors to growth in bank credit to the industry. From 9.2% of the overall bank credit to industry in 1994-95, NBFCs contributed 6.9% in 2003-04. The share of the credit granted by NBFCs rose from 2.9% in 1996-97 to 4.2% in 2004-05. While banks focus on commercial viability, NBFCs usually grant loans on favourable covenants such as guarantees from local politicians or state government agencies. It is observed that nearly 40% of all new corporate loan approvals during FY2015-2020 was granted by non-banking financial companies. In comparison, around 30% of bank loans were sanctioned during the same period. However, due to excessive concentration of credit risk by some banks and failure of their ability to screen out borrowers who may default, it has been argued that a large amount of credit flowed to many marginal entrepreneurs who had not undergone necessary checks before borrowing money. Also, these small entrepreneurs could not manage their cash flows efficiently due to a lack of adequate banking system facilities and supervision. Consequently, a large part of this excessive credit supply was misused for the purchase of commodities like real estate and food items which led to unsustainable economic activity and spiralling inflation in India. The Reserve Bank of India has adopted guidelines for promoting the healthy growth of NBFCs in the country. Some features of these guidelines are: (i) gradual increase in leverage ratio for NBFCs over time; (ii) uniform pricing policy across borrowers and maintaining proportionate reserve requirement ratio for different borrower types; (iii) fixed rate pricing based on data obtained from a number of verified agents for retail segment; (iv) regulating over-the-counter issuance of secured credit instruments and thus allowing borrower to calculate cost of funds at least quarterly; (v) differentiating unsecured loans from secured loans by enforcing greater capital requirements for unsecured loans; (vi) demanding full asset disclosure from NBFCs with at least annual turnover of Rs 100 crore; (vii) operating minimum branches across all states and union territories to limit competition among them; (viii) ensure stability of deposits held by NBFCs by imposing daily ceiling on aggregate daily withdrawal from savings accounts; (ix) mandating use of bond market as a back-up funding source for NCLT mechanism; (x) providing collateral free access to rupee funds from bank reserves for timely implementation of micro and small enterprise lending scheme; (xi) demanding reports on institutional arrangements to monitor fund flow; (xii) penalizing N CLT adjudicators who take excessive risk or side with parties against adjudication decisions. These guidelines have not been well received by many stakeholders as it restricts entry of private sector players in the financial services market, it leaves ample scope for vested interests and lenders, banks are asked to change their ways, mandate more transparency, too much government interference, very restrictive approach towards over-the-counter transactions, the only alternative is government funding through LIC. Therefore, RBI should provide maximum flexibility in compliance with the guidelines so that genuine private sector entities could benefit from efficient delivery of financial services. Further, instead of levying some strict penalty or sanctioning reprimand on those who are trying to play safe in meeting regulatory norms, there should be stringent monetary penalization on defaulters to ensure accountability and a clean slate approach. This would incentivize clean operators in the industry. If such action is taken by RBI, the new operators can focus on delivering high-quality service with higher profit margins and therefore help the overall growth of the financial sector. A better understanding of macroeconomic trends can lead to good policy choices. So far, economic conditions were ideal for expansionary policies but not favourable enough for sustaining the boom. To put India on a sustained growth path, two changes need to be brought in immediately. First, given that labour force participation rates are high, skill training needs to be prioritized so that unskilled workers get relevant training so that they can find employment easily and move out of poverty. Second, demand for consumer durables has gone up considerably but most people still prefer buying expensive products which cannot be serviced locally and so long lines form outside showrooms which have low availability of trained manpower and technicians. Given that income levels have been relatively stagnant and the distributional pattern remains inequitable, demand is yet to increase significantly. To this end, skilling needs to be expanded and technology penetration encouraged so that domestic consumption gets an impetus. Sustained high growth will depend on many things including improvement in rural productivity and provision of universal access to infrastructure and public services. We must also think about our huge urban informal population who remain neglected despite all our aspirations for a strong urban economy. Increasing prosperity is possible if rural poverty can be alleviated, modern agriculture practices brought in and infrastructure made available to everyone.All these aspects need to be dealt with at once if we want to grow sustainably. Varun Gaur is with Kothari Infrastructure Management Consultants LLP, India's largest investment management company.

Conclusion

It was found that most of the public sector banks are currently suffering from a huge amount of NPAs. Hence, efforts must be made to decrease the number of NPAs by appropriate financial measures. Further, government policies must be made so that these problems are taken into consideration and thereby all these can be removed at one go. Therefore, more focus should be given to rehabilitating these defaulters by setting up guidelines for quick debt recovery from such cases. Moreover, it must be observed that after the removal of NPA accounts, other asset quality ratios will improve as per industry norms.

There is a widespread view that the banking sector has been able to resist this Indian Crisis of 1998. However, from the analysis presented here, it is suggested that public sector banks have done little better than the private sector banks and as a result has created many problems in their books of accounts. The loans which are classified as bad debts are growing very fast and even these bad debts cannot be removed from the books of these banks without causing great pain to the bank's investors. Several explanations have been advanced for the Crisis, such as inflexibility of PSBs' investment norms, negative response of the government to economic needs, lax lending standards and declining returns on their capital. Also, there is increasing criticism that these banks are playing games with their shareholders by adopting increasingly creative accounting practices to hide their real financial position. If all these arguments are accepted, then one would conclude that Indian PSBs have made very poor financial managers and therefore they need urgent restructuring. These public sector banks must come under full control of the government or be broken up into different companies with strict management control and accountability. This will make sure that they perform well and put them on a sound financial footing so that they can serve the nation better.

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