Impact of Non-Performing Assets on the Banking Sector: A Theoretical Framework

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Abstract
The banking industry is a critical factor in any country's financial performance and economic progress but nowadays banking sector faces several problems and issues related to NPAs. NPAs are currently seen as a major issue. The study's goal is to determine the extent of NPAs in the Indian banking system as well as their influence on bank profitability and financial performance. This study found the causes factors (both internal and external), their impact and also recommendations for how to tackle the problem of NPAs because the rising amount of NPAs has a negative influence on bank profitability (including all types of banks).
Keywords: *Non-Performing Assets, Banking Sector*

Introduction

After liberalization, The Indian banking industry changed dramatically. The Reserve Bank of India has nationalized several commercial banks to provide socio-economic services to the Indian people. In terms of financial operations, PSBs have likewise performed well. However, the banking system in India has been frustrated by NPAs. Increased NPAs have a direct impact on bank profitability since banks are not allowed to register income on such accounts and are sometimes forced to make provisions on such assets under RBI standards. Furthermore, as the public's deposits in the banking system grow, the banking industry will be unable to pay for borrowers' defaults since NPAs undermine banks' repayment ability.

Bank Assets and NPA Classification

The following four kinds of bank assets are assigned an NPA rating:

- Standard Assets
- Sub Standard Assets
- Doubtful Assets
- Loss Assets

Standard Assets

Standard assets are ones in which the bank routinely receives interest payments from clients as well as the loan's principal. It is crucial in this case that the principal balance of the loan and the interest arrears do not exceed 90 days following the fiscal year. The designation of an asset as an NPA, which necessitates additional classification into subcategories, occurs when it does not fall into the standard asset category, such as when an amount is unpaid for more than 90 days.

Banks further categorize NPAs into the three categories listed below depending on the duration of the non-performance and the appropriateness of the loan:

- Sub-Standard Assets
- Doubtful Assets
- Loss Assets

Sub-Standard Assets

As of March 31, 2005, a sub-standard asset was one that has been inactive for less than or equal to 12 months.

The current net worth of the borrowers/guarantors or the current market value of the security charged is insufficient to ensure full recovery of the debt owed to the banks.

Doubtful Assets

After March 31, 2005, if an asset remained in the sub-standard category for more than a year, it was classified as doubtful.

Loss Assets

Even if there is some salvage or recovery value, a lost asset has been ruled to be unrecoverable and to be of such low value that its ongoing position as a bankable asset is not justified.

Types of NPA

Gross NPA

Gross NPA refers to the whole balance of the borrower's account without interest that is recorded in the bank books but not credited to the borrower's account.

Net NPA

The Net NPA measure shows how financially stressed banks really are. The safeguards that banks must make against NPAs per RBI standards are crucial since bank balance sheets in India include a high number of NPAs and the technique of retrieving and writing off loans takes a long time. The disparity between gross and net NPA is therefore rather substantial

Review of Literature

NPAs in the banking industry have been the subject of several studies. The researcher made an effort to provide a brief overview of the literature, which was published as research articles and technical papers in journals, periodicals, and websites related to the topic.

Ramu, N (2009). The study found that as prudential regulations became stricter, the banking sector consistently followed and put into practice global prudential principles and accounting procedures. The amount of NPAs in the Urban Cooperative Banking Sector has increased as a result of the tightening of prudential regulations.

Mir and Jegadeeshwaran (2013). NPA and its Causes were the title of the research. They collected secondary information over a five-year period, and they used a range of techniques to evaluate it, including mean, CAGR, ANOVA, and rank. By looking at how banks handled non-performing assets (NPAs), they evaluated banks' performance.

Bhardwaj and Chaudhary (2018). NPAs in commercial banks and their impact on the banking system in India were analyzed. The author gave recommendations for managing and avoiding future NPAs in banks. Ratio and percentage analyses were used to examine the data across fourteen years from 2000 to 2014. The findings of this study revealed that commercial banks' gross and net NPAs have grown, reducing their earning potential and negatively impacting their return on investment.

Panta (2018). The influence of NPAs on bank profitability as well as the banks' macroeconomic indicators of NPAs were evaluated. The data spanned the years 2006 to 2017, and it was assessed using the Herfindahl-Hirschman Index. The profitability of the bank decreases as the number of NPAs increases as a result of declining interest income.

Kumar et al (2018). In order to effectively manage banks, they must evaluate the causes of the rise in NPAs as well as the effects of NPAs on bank profitability. The results of this analysis showed that the main causes include insufficient recovery tribunals, industrial sickness, changes in governmental policies, a subpar credit rating system, and managerial flaws. The author claims that NPAs are reducing bank assets and endangering their ability to maintain a healthy financial position.

Kapoor and Kumar (2019). The research claims that NPAs pose the biggest danger to India's banks. According to a study on the positive impacts of priority sector loans on NPAs, NPAs must be adequately handled to maintain the stable environment of Indian banks. A significant contributor to the NPAs' ongoing rise was shrinking.

Arasu et al (2019). Investigations were done on the root causes of NPAs and how they affect bank profitability. The analysis found no appreciable variances in the NPA by sector and minimal correlation between the Gross NPA and Net Profit of the syndicated bank.

Priyanka et al (2019). Banks believe that the impact of NPAs on profitability is a crucial issue when it comes to debt management and the problem of NPAs in government. To promote greater understanding and mutual confidence, banks should meet with borrowers on a regular basis.

Muthumeena (2019). The profitability of nationalized banks has been analyzed in relation to their NPAs. Additionally threatened is the bank's net worth. The amount of NPAs has a significant influence on how well national banks manage NPAs.

Nachimuthu and Veni (2019). The claim states that, regardless of profitability, liquidity, or competitive working circumstances, the NPA has a major effect on bankers' perceptions of the availability of capital for loan issuance and growth.

NPA Rising Causes

NPAs in the banking industry are increasing as a result of certain internal and external reasons.

External Factors

Willful Defaults

Despite their ability to pay, a group of lenders intentionally failed to do so. They must be traced and appropriate steps must be taken to recover the funds.

Natural Calamities

This is the determining element in the worrisome growth in NPAs in PSBs. Every time significant natural tragedies strike our country; borrowers are unable to repay their loans. As a result, the bank will have to set aside a substantial amount of money to repay such debts.

Industrial Sickness

Poor project management, inadequate management, a lack of sufficient resources, an absence of cutting-edge technology, and often shifting government regulations are the root causes of industrial sickness. As a result, banks that provide financing for certain firms experience poor loan recovery rates, which lower profitability and liquidity.

Absence of Demand

Indian businesspeople started producing their goods since they couldn't forecast the demand for them, which led to hoarding, which made it impossible for them to pay back the loans they took out to finance these operations. The assets of the debtors are sold by the banks in order to recover the loan's whole lump sum value.

Change in Government Policies

Every new government brings new policies for the banking sector. As a result, it must deal with shifting concepts and laws governing the regulation of growing NPAs.

Recession

Global stock markets have plummeted as a result of the recession. Due to a tangled legal system, inadequate infrastructure, a huge fiscal deficit, and less exposure to emerging markets, among other factors, the Indian economy has been severely harmed.

Unreliable Recovery Tribunal

To aid in the recovery of debts and loans, the government has established various recovery tribunals. Due to their carelessness and disregard for their duties, the bank experiences the consequences of non-recovery, which reduces its liquidity and profitability.

Internal Factors

Faulty Credit Procedure

The lender must make sure the venture or business for which a loan is requested is viable and that the borrower is capable of carrying it out effectively. A complete examination of the company's financial accounts will show the genuine status of the enterprise.

Unsuitable Technology

A lack of technology and management information systems prevents market-driven choices from being taken in real time. Poor credit collection, or NPA, is caused by banks' failure to establish adequate management information systems and financial accounting systems.

Analyzing Borrowers Profile

The borrower's personal capital investment should be taken into account by banks. It is recommended that credit information on borrowers be collected from a variety of sources.

Project Feasibility Study

Bankers should assess the project's feasibility before approving any loan. First, the bank should determine whether the borrower's proposal is practical, and only then should loans be granted.

Poor Credit Appraisal System

Poor credit evaluation exacerbates the growth of NPAs. On this premise, the bank makes advances to those who are unable to pay them back. To reduce NPAs, banks should utilize high-quality credit appraisal.

Managerial Deficiencies

Always pick the borrower carefully and demand real assets as collateral for loans so that the bank can safeguard its interests.

Absence of Regular Industrial Visit

The NPAs are also increased by anomalies in project spot visits. Regular visits can be used to recover unpaid NPAs from willful defaulters.

NPA'S Effect on Banks' Operations

NPAs have an effect on the productivity and profitability of banks. NPAs have the most noticeable impact on bankers' emotions, which might prevent loan extensions for beneficial objectives.

The growth of the economy is harmed by banks' preference for more risk-free investments in an effort to prevent and decrease risk. NPAs will become unmanageable if the stage is not quickly reduced:

- NPA refers to money booked in terms of a bad asset as a result of poor customer selection.
- The number of NPAs as well as the amount of profit spent in a project or asset that generates a return serve to curb a bank's prodigality when money becomes sterile.
- NPA can have an impact on both current and future profitability, perhaps leading to the loss of a long-term lucrative opportunity.
- Money is becoming sterile; lower profits result in a lack of cash on hand, forcing the corporation to borrow money for a shorter amount of time, incurring more costs.
- The bank's functioning is being hampered by NPAs.
- Another indirect cost that the bank faces is the time and efforts of management to minimize NPAs.
- Management's time and efforts in dealing with and managing NPA would have been better spent on more profitable operations.
- It has a detrimental impact on the bank's creditworthiness in the market.
- Consumers who make bank deposits may suffer as a result of it losing its goodwill, brand recognition and credit.
- Banks' earning potential of assets is reduced as a result of NPA, which hurts their return on investment (ROI).
- Banks will have to pay a higher cost of capital.
- The asset-to-liability gap will continue to grow.
- Bank profitability and capital adequacy ratios suffer when provisioning needs are raised in response to growing NPAs.
- Since economic value adds (EVA) are calculated by deducting capital expenses from net operating profit, banks' EVA is unimpressive.
- NPAs lower the value of bank shares in the capital market, often down below their book value.
- The ability of a bank to take risks is negatively impacted by NPAs.

Recommendations for Management of NPA’s

- The Reserve Bank of India may make changes to its present credit monitoring and appraisal mechanisms.
- Loan recovery techniques should be improved and strengthened by banks.
- Credit evaluation and post-loan monitoring are critical processes that all public sector banks must prioritize.
- Customers must be followed up with regularly, and the banker's responsibility is to ensure that monies are not diverted. This procedure can be performed regularly.
- Following the approval and disbursement of credit, personal visits should be performed, as well as frequent close monitoring of the accounts of borrowed units.
- Credit monitoring and recovery managers should be enthusiastic about their jobs.
- Regular meetings with branch workers and consideration of their proposals for debt collection.
- Assisting borrowers in strengthening their capitalist skills would help bankers keep track of their cash while also establishing a positive relationship with the borrowers.

- The Reserve Bank of India (RBI) may impose penalties on defaulters, such as disclosing the names of defaulters to the press and public, which will be advantageous to other banks and financial organizations.
- Two choices for remedial action for bankers are a one-time settlement or a compromise settlement.
- The banker ought to reorganize the loans accordingly, considering the borrowers' true hardship, if the delinquencies are caused by circumstances beyond the borrower's control, such as draughts, floods, or other natural catastrophes.
- Before issuing credit, every bank should have a separate independent credit rating agency that determines the borrower's financial capacity.
- For the management of NPAs, an effective committee comprised of financial professionals with extensive experience in this subject can be constituted.

Banks can use professionals to discover and analyze genuine borrowers.

- Credit rating agencies should assess their client's financial situation regularly.
- Clients should have their accounts, including a monthly loan awareness report.
- When there is a risk of mismanagement or diversion of funds, banks should conduct a specific inquiry audit of all financial and business truncations as well as the borrower's books account.
- The bank should assess the borrower companies' SWOT analysis, i.e., how they would respond to environmental threats and opportunities using their strengths and weaknesses, and what their future financial and operational performance prospects would be.
- Because there is a chance that the loan will fall into the NPA category again, the reformation accounts should be closely monitored.
- It doesn't matter if it's a one-time or ongoing task, training is essential for bank employees at the right level. They should address the NPA issue and decide what other steps are necessary to eliminate NPAs.
- Bank loan default should be declared a felony. No financing should be offered to a group that has defaulted on one or more of its projects.
- Banks should keep a close eye on restructured accounts because there's a chance the loans will revert to non-performing assets (NPAs).
- The autonomous settlement procedure should be more rigorous and expeditious, the settlement committee's judgment should be legally binding on both borrowers and lenders, and those who defy the committee's ruling should suffer severe repercussions.

Conclusion

Currently, the banking industry is at a stage of development. Since the 1992 banking sector reforms, limiting NPAs has been a top priority. All banks have been working hard to keep the number of NPAs under control and lessen the pressure on their profits. The magnitude of the problem of performing assets becoming NPAs persisted as a source of concern even after individual banks devised ways to lower NPAs. In contrast to PVSBs, which are consolidating via the use of cutting-edge technology and processes, PSBs, which make up the foundation of the Indian banking system, struggle with having too many employees, NPAs, and government equity. Controlling NPA in a bank is essential since this problem inhibits a bank's success and degrades its performance.

For many years, NPAs have been a serious issue for Indian banks. Not only is there a banking crisis, but there is also a major economic collapse. The amount of money in NPAs directly affects the profitability of the bank because Indian banks primarily rely on interest income from loans. NPA is present at a rather high level in PSBs. Although the government has launched many programs to lower NPAs, much more has to be done to resolve this issue. NPAs at our banks continue to be high when compared to foreign institutions. The management of the bank should quicken the recovery process. Large debtors have the greatest recovery challenges, necessitating the implementation of a strong policy to address this issue. As the priority sector is the major cause of issues, the government should also increase the provisions for the quicker resolution of continuing cases and reduce the number of loans that is necessary. Therefore, addressing the NPA issue would take a lot of effort; otherwise, NPAs will keep eating away at bank earnings, which is bad for the developing Indian economy.

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