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Non-Performing Assets: Reasons, Consequences and Corrective Actions

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Abstract: This study examined the reasons of rising Non-Performing Assets (NPAs) and investigated the consequences of inflating NPAs on the bank performance of Indian Banks. It also analyzed how the corrective actions initiated by government helped in controlling the rising NPAs. It also analyzed how the NPAs were recovered through various recovery channels in Indian Scheduled Commercial Banks. It also examined the restructuring of NPAs in Public Sector Banks, Private Sector Banks and Foreign Banks of India. The period of the research is 2012-13 to 2016-17. Time series analysis was employed. The findings confirmed that profitability of banks decreased and financial growth of the country was hindered with rising NPAs. It was also confirmed that SARFAESI Act was the more effective NPA recovery channel than Lok Adalats and DRTs in Indian Scheduled Commercial Banks. It was also found that restructuring of NPAs was highest in Public Sector Banks and lowest in Foreign Banks of India.

Keywords: *Corporate Debt Restructuring, Debt Recovery Tribunals (DRTs), Lok Adalats, Non-Performing Assets (NPAs), Restructuring, SARFAESI Act, Strategic Debt Restructuring*

I. INTRODUCTION

From the time of the inception of Global Financial Crisis 2007-08 due to the spillover effect of U.S. Subprime Crisis in 2007, the economic performance of all the major emerging economies of the world including Indian economy retarded (Ghosh & Chandrasekhar, 2009; Kshetri, 2011; Sharma, 2009). This crisis also adversely impacted banking performance of major Global economies including that of Indian Banks and even resulted in banking crisis in some economies (Shukla, 2014). This confirms that there is a strong relation of macroeconomic environment and banking sector performance. Banking performance can be assessed in terms of bank asset value and return on assets which are indicator of financial health of banks. Thus when there are adverse macroeconomic

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conditions in the country, the bank asset quality of loan portfolio strongly degrade which lowers the profitability of banks. The bank asset quality of loan portfolio can be measured in terms of level of NPAs. The unfavorable macroeconomic conditions cause rise in non-performing assets which can even cause insolvency and ultimately collapsing of banks (Demirguc-Kunt, 1989; Whalen, 1991). The defaulting of loans leading to emergence of Non-Performing Assets can be also caused by bank-specific variables (Abid, Ouertani, & Zouari-Ghorbel, 2014; Chaibi & Ftiti, 2015; Dhar & Bakshi, 2015; Dimitrios, Helen, & Mike, 2016; Louzis, Vouldis, & Metaxas, 2012). Thus both bank-specific and macroeconomic variables results in defaulting of loans and increasing the bank credit risk. Bank specific variables are in the control of the banking authorities and hence their impact on bank asset quality can be managed. The macroeconomic conditions are beyond the control of banking authorities and thus need special attention.

Increasing NPAs not only adversely impact the banks' net profit and liquidity and also decelerate the economic growth of the nation. As per RBI (2015), "A non performing asset (NPA) is a loan or an advance where interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan…..An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank." Banks also have to make provisions to recover the losses due to defaulting of loans. Hence banks' profitability gets impacted by rising NPAs in the form of provisioning for defaulted loans and loss of interest income on loans. Banks and their regulatory bodies must take preventive measures to control occurrence of NPAs. They should make effective regulatory framework and credit risk management system to manage the bad loans.

This paper examines the reasons behind inflating NPAs especially in the context of Indian Banks. This study also discusses the consequences of rising NPAs on the profitability of the Indian Banks and economic growth of the nation. This study also focuses on the role of corrective actions in management of increasing NPAs in Indian Banks. It also examines how the NPAs were recovered through various recovery channels in Indian Scheduled Commercial Banks. It also examines the restructuring of NPAs in Public Sector Banks, Private Sector Banks and Foreign Banks of India. The period of study is 2012-13 to 2016-17. Secondary data analysis was done using time series method.

The remaining discussions in the paper are as follows. Section 2 gives the literature review. Section 3 gives the methodology. Section 4 presents the results. Section 5 gives the conclusion.

II. LITERATURE REVIEW

The literature review is discussed in two parts in Indian context. First part summarizes the researches on reasons behind escalating NPAs and second part summarizes the literature on consequences of inflating NPAs in Indian Banks.

1. Reasons behind Rising NPAs

This section summarizes some specific reasons behind rising NPAs which are identified especially in Indian context and had caused escalation in NPAs especially in Indian Banks.

Some researchers concluded that weak and inefficient Indian banks in terms of profitability and capital ratios disguised their actual amount of Gross Non-Performing Assets in the period after 1999 in order to increase their profit margin and capital adequacy ratios (Chipalkatti & Rishi, 2007). This understating of actual magnitude of Gross NPAs by the banks became the major cause of rise in NPAs in the Indian Banks. This finding was also supported by Raghuram Rajan, the former RBI chief who also stated that cronyism, over-

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positiveness due to favourable outcome of Public Private Partnership in 2007, decline in GDP after Global Financial Crisis 2007 and deflection of funds along with frauds which were not checked effectively by RBI plus Indian Banks led to the escalation of NPAs (Aiyer, 2018, September 26).

Some researchers stated that capital adequacy ratio (CAR) negatively impacted the bank asset quality where less capitalized Indian Banks were more prone to loan default, had higher number of NPAs and lesser productivity (Das & Ghosh, 2004). Similarly Vallabh, Bhatia, and Mishra (2007) concluded that capital adequacy ratio has negative effect on bad loans of Private Banks but positive impact on bad debts of Indian Public Sector Banks. They also found that as the lending to priority sector grows in volume, the NPAs reduces in Indian Banks and excise duty rates have affirmative effect on bad loans. In the similar line Rajaraman and Vasishtha (2002) concluded that bad loans of Indian Public Sector Banks have bivariate association with the operating efficiency factors like operating profit and capital adequacy. Dhar and Bakshi (2015) stated that sensitive sector lending, net interest margin and CAR impact the level of NPAs in the Indian Banks. Ghosh (2005) concluded that corporate leverage has a positive impact on NPAs and bad debts in Indian Banks increases when there is elevation in corporate leverage.

2. Consequences of Inflating NPAs

This section summarizes the literature related to consequences of escalating NPAs especially in Indian Banks.

Inflating NPAs decreases both profitability and liquidity in Indian Banks (Balasubramaniam, 2012). Rajaraman, Bhaumik, and Bhatia (1999) also confirmed that rising NPAs reduces overall profitability of banks as they have to maintain provision coverage and stop receiving interest income.

There are various recent reports, editorials and newspaper articles which discuss the impact of inflating NPAs on the profitability of Indian Banks. Some such reports and articles with respect to Indian Private Sector Banks are discussed as follows. Quoting the “Axis Bank net falls 16%, net NPAs rise” (2017), the net profitability of Axis Bank declined by 16% to 1306 crore in the first quarter end of 2017-18 due to escalation in net NPAs. The article “Axis Bank posts first loss as NPAs rise” (2018) stated that net loss suffered by Axis Bank was Rs. 2189 crore in the last quarter end of 2017-18 because of huge rise in provisions for bad loans to recover losses. But Yes Bank performed better with a fall in NPA percent. As per the report “YES Bank Q4 net profit climbs 29%” (2018), YES Bank experienced a net profit growth of 29% to Rs. 1,179.4 crore due to decline in NPA percent in the last quarter end 2017-18. Similarly one report “ICICI Bank net slides 56%, NPAs decline” (2018) recapitulated that ICICI experienced a net profit of 909 crore and decline in NPA percent to 3.65 % in the second quarter end in 2018-19 due to less provisions for bad loans and more income.

Some more such reports and newspaper articles with respect to Indian Public Sector Banks are discussed as follows. Quoting the “Canara Bank net profit plummets 61%: Vijaya Bank’s profit in Q3 drops 65%” (2018), the net profit of Canara Bank in the third quarter ended in 2017 declined by 60.9% amounting to 125.75 crore due to enormous rise in provisioning for bad loans. Similarly the net profit of Vijaya Bank in the third quarter ended in 2017 declined by 65.45% to Rs. 79.56 crore because of higher provisioning for bad loans. Similarly as per the write-up “Unending pain: On SBI’s Q3 loss” (2018), India’s largest Public Sector Bank State Bank of India experienced a net loss of 2416 crore in the quarter ended in December 2017 for huge increase in provision for NPAs. In the same line the report “NPAs push Bank of India to Rs. 2,341 cr.

loss" (2018) stated that Bank of India had a net loss of Rs. 2,341.23 crore in the quarter ended in December 2017 for increase in provision for NPAs. Similarly as per the editorial "IOB loss widens as bad loans provision climbs" (2018), Indian Overseas Bank experienced a net loss of Rs. 971 crore in the third quarter end of 2017-18 because of higher provisioning for bad loans. Some Indian Public Sector Banks even came under the PCA Framework due to high NPA level. Quoting the "RBI Triggers Corrective Action on Banks over NPA Worries" (2017), RBI levied certain restrictive actions under PCA Framework 2017 on some banks like Bank of India, Corporation Bank, IDBI Bank, Central Bank of India, Dena Bank, UCO Bank, Oriental Bank of Commerce, Indian Overseas Bank, United Bank of India and Bank of Maharashtra in 2017 for abrupt increase in NPA and capital erosion. The editorial "RBI bars Dena Bank from fresh lending" (2018) stated that RBI prohibited Dena Bank from fresh lending of credit and recruiting of employees as per the PCA Framework because of high amount of NPAs.

Some more reports and articles with respect to Indian Public Sector Banks' performance are as follows. The article "Union Bank registers ₹2,583 crore loss in Q4" (2018) summarized that the net loss suffered by Union Bank was 2583 crore in the last quarter end of 2017-18 because of rise in NPAs. Similarly the article "Andhra Bank posts quarterly loss of ₹2,536 cr." (2018) discussed that net loss suffered by Andhra Bank was 2536 crore in the last quarter end of 2017-18 because of higher provisioning for NPAs. In the same line the report "Andhra Bank still on a strong wicket: GM" (2018) synopsized that Andhra Bank also suffered loss in profitability due to large scale provisioning. Similarly as per the report "KVB Q1 profit falls 69% on provisioning" (2018), the net profit of Karur Vysya Bank declined by 69% to 45.91 crore in the first quarter end in 2018-19 because of huge provisioning. In the same line the article "PNB posts Rs. 940 cr. loss on higher provisioning" (2018) stated that PNB had a net loss of 940 crore first quarter end in 2018-19 on account of huge provisioning. Similarly the editorial "Indian Bank net falls 44% on higher provisioning" (2018) summarized that the net profit of Indian Bank in the first quarter end of 2018-19 declined by 44% at Rs. 209.31 crore due to huge provisions done for bad debts.

III. METHODOLOGY

The sample consists of all Scheduled Commercial Banks in Indian Banking System. The time period of study is 2012-13 to 2016-17. Secondary data analysis was done using time series method. The study used secondary data which comprises of NPAs of Indian Scheduled Commercial Banks that are recovered via different channels such as Lok Adalats, DRTs and SARFAESI Act within the sampled time period. Secondary data also comprises of total restructured loans of all categories of Indian Scheduled Commercial Banks. The annual data is analyzed which is collected from the database of RBI. The time series method is applied to examine the sampled data where the data is collected on one or more variables over a period of time and its trend is analyzed (Brooks, 2008).

IV. RESULTS

The corrective actions taken by RBI to manage and control the escalating NPAs comprises of restructuring of loans and formation of various recovery channels such as Lok Adalats, DRTs and SARFAESI Act.

As per RBI (2018), "Restructuring is an act in which a lender, for economic or legal reasons relating to the borrower's financial difficulty, grants concessions to the borrower." It include revision of terms and conditions of loans which covers modification in repayable sum, repayment period, interest rate, instalments, improving current credit limits, permitting extra credit facility etc. Restructuring of debt can be of two types which are

Strategic Debt Restructuring and Corporate Debt Restructuring (RBI, 2015).

Different recovery channels to recover NPAs are Lok Adalats, DRTs and SARFAESI Act. Lok Adalats are coordinated by NALSA that is National Legal Services Authority by means of other Legal Services Organizations. Lok Adalat is an optional dispute redressal method where the pending cases or disputes of the court of law are resolved or compromised cordially (NALSA, 2018). DRTs known as Debt Recovery Tribunals were initiated by the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and their objective is to speed up judgement or resolution for debt recovery due to banks (Debts Recovery Tribunals and Appellate Tribunals, 2018). SARFAESI Act stands for Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 which permits acquisition as well as sale of fiscal assets such as residential or commercial properties from banks to Securitisation and Reconstruction Company to recover loan (RBI, 2015).

Figure 1 gives NPAs of Indian Scheduled Commercial Banks recovered via different channels (Database on Indian Economy, 2018).

Figure 1: Bad Loans of Indian Scheduled Commercial Banks Recovered via Different Channels (Amount in ` Billion)

Year	Sr No.	Recovery Channel	Lok Adalats	DRTs	SARFAESI Act	Total
2012-13	1	No. of cases referred	840691	13408	190537	1044636
	2	Amount involved	66	310	681	1057
	3	Amount recovered*	4	44	185	233
	4	3 as per cent of 2	6	14	27	22
2013-14	1	No. of cases referred	1636957	28258	194,707#	1859922
	2	Amount involved	232	553	953	1738
	3	Amount recovered*	14	53	253	320
	4	3 as per cent of 2	6	10	27	18
2014-15	1	No. of cases referred	2958313	22004	175355	3155672
	2	Amount involved	310	604	1568	2482
	3	Amount recovered*	10	42	256	308
	4	3 as per cent of 2	3	7	16	12
2015-16	1	No. of cases referred	4456634	24537	173582	4654753
	2	Amount involved	720	693	801	2214
	3	Amount recovered*	32	64	132	228
	4	3 as per cent of 2	4	9	17	10
2016-17	1	No. of cases referred	2152895	28902	80076	2261873
	2	Amount involved	1058	671	1131	2860
	3	Amount recovered*	38	164	78	280
	4	3 as per cent of 2	4	24	7	10

Source: Database on Indian Economy: RBI's Data Warehouse

1. Analysis of NPAs of Indian Scheduled Commercial Banks Recovered via Different Recovery Channels

Analysis of NPAs of Indian Scheduled Commercial Banks recovered by different recovery channels is given below.

Figure 2 as shown below gives the analysis of the NPAs of Indian Scheduled Commercial Banks recovered via Lok Adalats.

Figure 2: NPAs of Indian Scheduled Commercial Banks Recovered via Lok Adalats

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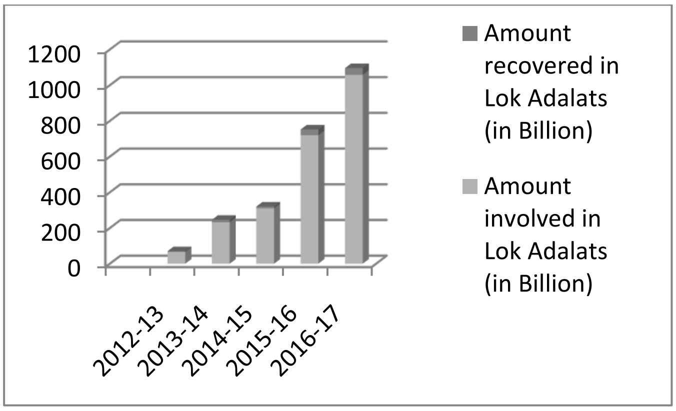
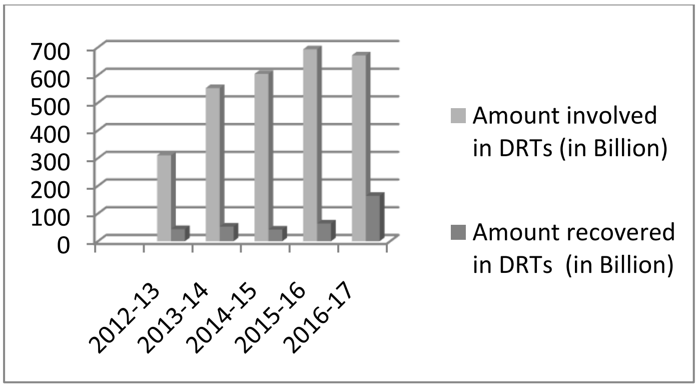


Source: Database on Indian Economy: RBI's Data Warehouse

From the Figure 2 which gives the analysis of the NPAs of Indian Scheduled Commercial Banks recovered via Lok Adalats, it can be seen that amount recovered out of amount involved is 4 billion out of 66 billion in 2012-13, 14 billion out of 232 billion in 2013-14, 10 billion out of 310 billion in 2014-15, 32 billion out of 720 billion in 2015-16 and 38 billion out of 1058 billion in 2016-17. Hence it can be concluded that Recovery of NPAs through Lok Adalats is maximum in 2016-17 and minimum in 2012-13.

Figure 3 as shown below gives the analysis of the NPAs of Scheduled Commercial Banks recovered through DRTs.

Figure 3: NPAs of Indian Scheduled Commercial Banks recovered via DRTs

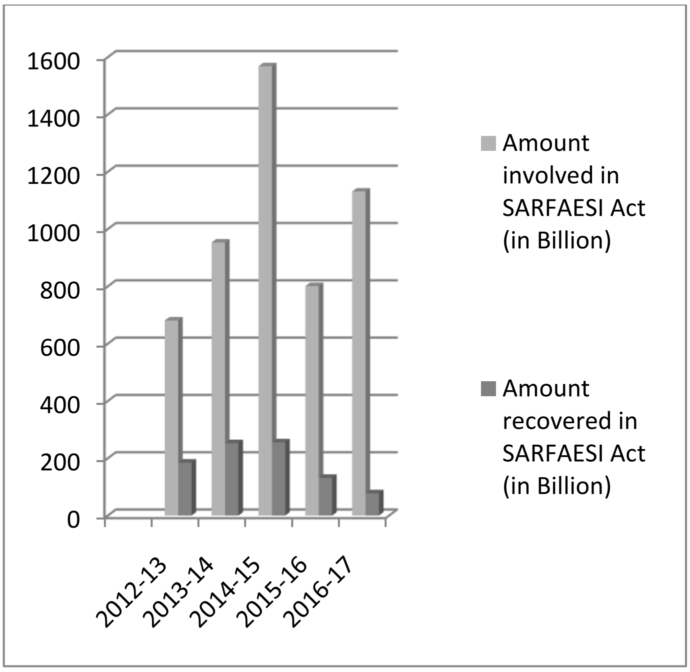


Source: Database on Indian Economy: RBI's Data Warehouse

From the Figure 3 which gives the analysis of the NPAs of Scheduled Commercial Banks recovered through DRTs, it can be seen that amount recovered out of amount involved is 44 billion out of 310 billion in 2012-13, 53 billion out of 553 billion in 2013-14, 42 billion out of 604 billion in 2014-15, 64 billion out of 693 billion in 2015-16 and 164 billion out of 671 billion in 2016-17. Hence it can be concluded that recovery of NPAs through DRTs is maximum in 2016-17 and minimum in 2014-15.

Figure 4 as shown below gives the analysis of the NPAs of Indian Scheduled Commercial Banks recovered via SARFAESI Act.

Figure 4: NPAs of Indian Scheduled Commercial Banks Recovered via SARFAESI Act



Source: Database on Indian Economy: RBI's Data Warehouse

From the Figure 4 which gives the analysis of the NPAs of Indian Scheduled Commercial Banks recovered via SARFAESI Act, it can be seen that amount recovered out of amount involved is 223 billion out of 1057 billion in 2012-13, 320 billion out of 1738 billion in 2013-14, 308 billion out of 2482 billion in 2014-15, 228 billion out of 2214 billion in 2015-16 and 280 billion out of 2860

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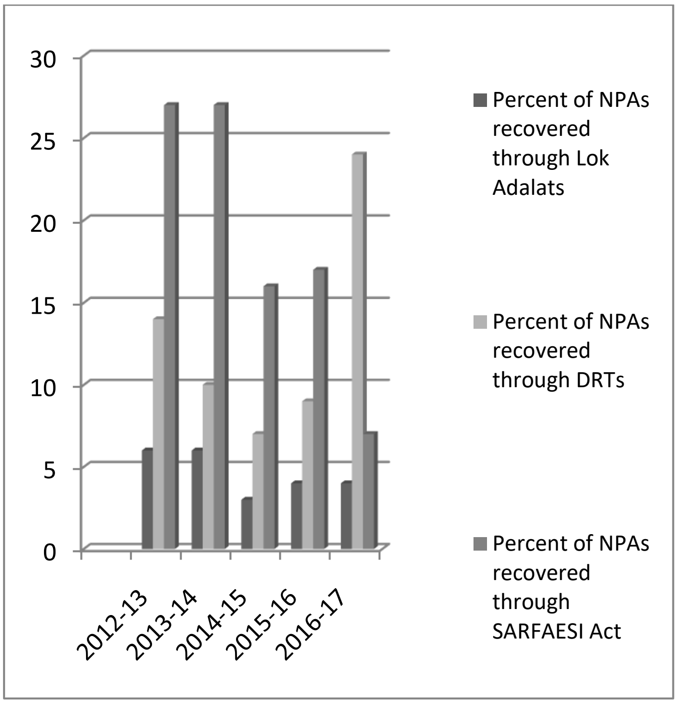
billion in 2016-17. Hence it can be concluded that recovery of NPAs through SARFAESI Act is maximum in 2014-15 and minimum in 2016-17.

Figure 5 as shown below gives the comparative analysis of recovery of NPAs in Scheduled Commercial Banks through different recovery channels.

Figure 5: Comparative Analysis of Recovery of NPAs in Scheduled Commercial Banks



Source: Database on Indian Economy: RBI's Data Warehouse

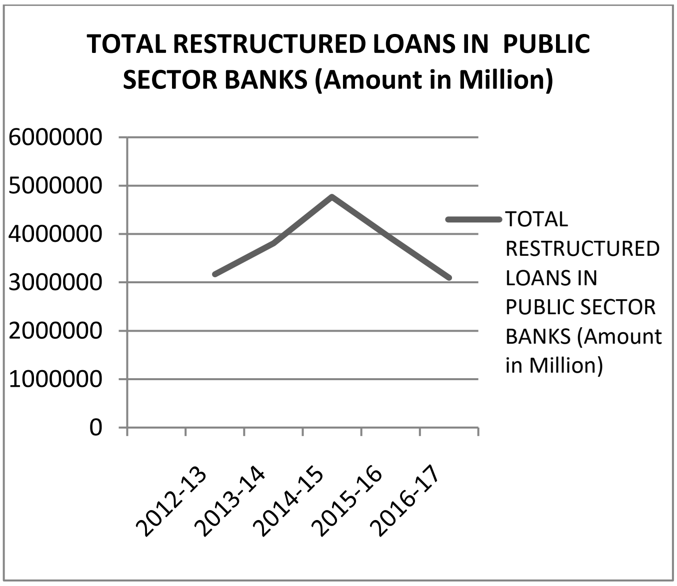
From the Figure 5 which gives the comparative analysis of recovery of NPAs in Scheduled Commercial Banks, it can be observed that in 2012-13 recovery of NPAs is highest through SARFAESI Act which is 27 percent and minimum through Lok Adalats which is 6 percent. In 2013-14 recovery of NPAs is highest through SARFAESI Act which is 27 percent and minimum through Lok Adalats which is 6 percent. In 2014-15 recovery of NPAs is highest through SARFAESI Act which is 16 percent and minimum through Lok Adalats which is 3 percent. In 2015-16 recovery of NPAs is highest through SARFAESI Act which is 17 percent and minimum through Lok Adalats which is 4 percent. In 2016-17 recovery of NPAs is highest through DRTs which is 24 percent and minimum through Lok Adalats which is 4 percent. Hence it can be concluded that in all the years except 2016-17, maximum recovery of NPAs is done through SARFAESI Act and this recovery channel is the most effective than other channels. Also in all the years that is across the sampled time period minimum recovery of NPAs is done through Lok Adalats and this recovery channel is the least effective than other channels.

2. Analysis of Total Restructured Loans in all categories of Indian Scheduled Commercial Banks

Analysis of total restructured loans in all categories of Indian Scheduled Commercial Banks which are Private Sector Banks, Public Sector Banks and Foreign Banks is given as below (Database on Indian Economy, 2018).

Figure 6 as shown below gives the total restructured loans in Public Sector Banks.

Figure 6: Total Restructured Loans in Public Sector Banks

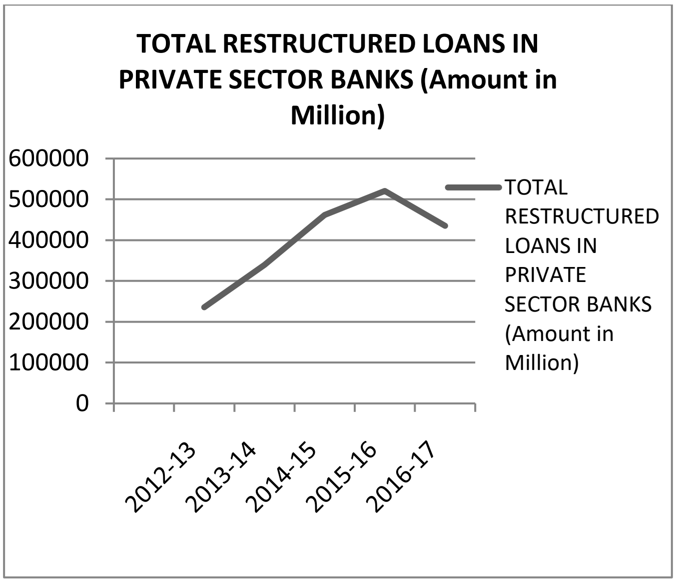


Source: Database on Indian Economy: RBI's Data Warehouse

Figure 6 shows the total restructured loans in Public Sector Banks from 2012-13 to 2016-17 which shows that total restructured loans are 3170623 million in 2012-13, 3807448 million in 2013-14, 4768528 million in 2014-15, 3920753 million in 2015-16 and 3096740 million in 2016-17. It can be concluded that restructuring of loans is highest in 2014-15 and lowest in 2016-17.

Figure 7 as shown below gives the total restructured loans in Private Sector Banks.

Figure 7: Total Restructured Loans in Private Sector Banks

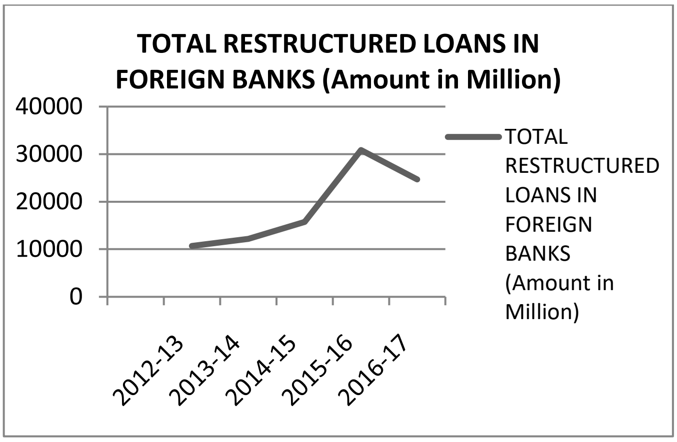


Source: Database on Indian Economy: RBI's Data Warehouse

Figure 7 shows the total restructured loans in Private Sector Banks from 2012-13 to 2016-17 which shows that total restructured loans are 235536 million in 2012-13, 339613 million in 2013-14, 461794 million in 2014-15, 520574 million in 2015-16 and 434842 million in 2016-17. It can be concluded that restructuring of loans is highest in 2015-16 and lowest in 2012-13.

Figure 8 as shown below gives the total restructured loans in Foreign Banks

Figure 8: Total restructured loans in Foreign Banks



Source: Database on Indian Economy: RBI's Data Warehouse

Figure 8 shows the total restructured loans in Foreign Banks from 2012-13 to 2016-17 which shows that total restructured loans are 10693 million in 2012-13, 12216 million in 2013-14, 15770 million in 2014-15, 30864 million in 2015-16 and 24698 million in 2016-17. It can be concluded that restructuring of loans is highest in 2015-16 and lowest in 2012-13.

V. CONCLUSION

On investigating the reasons behind inflating NPAs in the Indian Banks, this study concluded that understating of actual magnitude of Gross NPAs by the Indian banks, capital adequacy ratio, lending to priority and sensitive sectors, deflection of funds, wilful defaulters, bad management practices, elevation in corporate leverage, cronyism, business collapse and frauds became the major causes of rise in NPAs in the Indian Banks. It was also found that inflating NPAs not only negatively affected the profitability and solvency of Indian Banks but also hampered the economic growth of the nation. On examining the recovery of NPAs of Indian Scheduled Commercial Banks through various recovery channels, it can be concluded that SARFAESI Act was more effective than other recovery channels like DRTs and Lok Adalats. The results also confirmed that restructuring of loans

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was lowest in Foreign Banks and highest in Public Sector Banks of India as Public Sector Banks had comparatively higher amount of NPAs than Private Sector Banks and Foreign Banks of India.

The bank-specific variables responsible for the rise in bad loans could be controlled and managed by the RBI and Indian Banks. The macroeconomic variables causing deterioration in loan quality and escalation in the Non-Performing Assets could be identified and controlled by the Government by implementing effective policies. Recently Government of India formulated and implemented some very effective policies for regulating the functioning of RBI and to resolve the issue of escalating bad loans in Indian Banks. Government of India recapitalized Indian Public Sector Banks by 2.1 trillion in October, 2017 through recapitalization bonds and budgetary assistance because they had higher amount of bad loans than Foreign and Private Sector Banks of India. The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017 was also announced by the Government of India for modification for Insolvency and Bankruptcy Code 2016 and reinforcement of the insolvency resolution plan. The Indian Government also passed the Banking Regulation (Amendment) Ordinance 2017 and Banking Regulation (Amendment) Bill 2017 which gave additional powers to the RBI for issuing directions to Indian banks for initiating insolvency proceedings under Insolvency and Bankruptcy Code 2016 to recover bad loans and solve the problem of rising NPA. Prompt Corrective Action Framework was also revised by RBI that made it compulsory for the Indian Banks to keep their Net NPA Ratio less than 6 percent so that they remain outside the PCA Framework and are saved from corrective actions such as restriction on dividend distribution, branch expansion, management compensation, increasing provision coverage and raising capital level. The Indian Government implemented these policies to manage and control the rising NPAs in the Indian Banks.

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