IMPACT OF NON-PERFORMING ASSETS ON THE PROFITABILITY OF BANKS – A SELECTIVE STUDY

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Abstract: *Non-performing Asset is a vital factor in the examination of financial performance of a bank. Non-Performing Asset is the key term for the banking corporations. Non-Performing Assets show the competence of the performance of the banks. Non-Performing Assets means which amount is not received by the bank in return of loans disbursed. Non-Performing Assets affect not only the finance institution but the total financial system. Thus a selective study has been done on public sector banks in India to evaluate the effect of Non-Performing Assets on the profitability of banks. Banks today are not judged only on the basis of number of branches and volume of deposits but also on the basis of standard of assets. NPAs negatively effect on the profitability, liquidity and solvency of the banks. This paper analyses the circumstances of NPAs in selected banks namely State Bank of India (SBI), Bank of India, United Bank of India, Bank of Baroda, Indian Overseas Bank, Punjab National Bank and Central Bank India. It also highlights the policies followed by the banks to tackle the NPAs and suggests a multi-pronged strategy for speedy recovery of NPAs in banking sector. Seven Public Sector Banks has been selected for the study the relation between Gross NPA and Net Profit of seven banks. In this paper is applying the panel regression. The result shows that except for SBI and PNB all the other banks exhibit a negative correlation between their gross Non-Performing Assets and net profits. But SBI and PNB is increased the net profit every year not affected by Gross Non-Performing Assets. Both banks are paying attention towards their NPA to recover their pending loans. The study is based upon secondary data recovered from Report of Progress of banking in India, Websites, Journals and Articles. The scope of the study is limited to analysis of nonperforming assets of public sector banks covering the period of 2007-2016.*

Keywords: *Non-Performing Asset; Net Profit; Doubtful Debts; Correlation; Deposit.*

JEL classification: *G21; C23.*

1. Introduction

With the introduction of financial sector reforms 1991 the faces of Indian Banking sector have extremely changed. The problems arising in the banking sector will affect the Indian economy. When the economy collapsed also affected the banking sector. Function as an intermediary bank is not running normally. The banking sector also has a very important role in the recovery process of the country's economy as a whole. The banking industry has moved step by step from a synchronized environment to a decontrolled market based economy. In 1991-1992 India was adopted the open economy. The beginning of liberalization and globalization in market development there has been tremendous changed in the transitional role of banks in India. The problem of swelling non-performing asset is catching attention

and addition of huge NPA has assumed great importance in terms of risk management. The incidence of non-performing assets (NPAs) is affecting the performance of the credit institutions financially. NPA is a disorder resulting in non-performance of a portion of loan portfolio leading to no recovery or less recovery income to the lender. NPAs represent the quantify “Credit Risk”. Bankers have realized to have effective NPA management on their priority list.
NPA broadly defined as non-repayment of interest and instalment of principal amount (Das & Ghosh, 2006). According to the “Narasimham Committee Report (1991), those assets (overdraft/ cash credit) for which the interest remains due for a period of four quarters (180 days) should be considered as NPAs”. After, this period had reduced and from March 1995 onwards assets for which interest and principle remains unpaid for a period of 90 days were considered as NPAs. Thus, NPA constitutes an important factor in the banking system as it seriously affects the profitability of the banks. The NPA can broadly be classified into Gross NPA and Net NPA. Gross NPA reflects the quality of the loans made by banks whereas Net NPA shows the actual burden of banks.

1.1 Types of NPA

Gross NPA - Gross NPA is an advance which is considered written off, for bank has made provisions, and which is still held in banks' books of account. Gross NPA (non-performing asset) refers to overall quantity of loans that have gone bad debts. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss asset. “Gross NPAs Ratio = Gross NPAs / Gross Advances”
Net NPA - Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. “Net NPAs = Gross NPAs – Provisions / Gross Advances – Provisions”

1.2 Assets Classification

Standard Assets - Standard Asset means which assets are not facing the problem and not more risk towards customer. Such assets are assumed to be performing asset. A general provision of 0.25% has to be provided on global loan portfolio basis.
Sub-standard Assets - An asset would be classified as sub-standard if it remained NPA for a period less than or equal to 12 months. Accordingly a general provision of 10% on outstanding has to be provided on substandard assets.
Doubtful Assets - These are the assets which have remained NPAs for a period exceeding 12 months and which are not considered as a loss advance. As per RBI instruction banks have to facilitate 100% of unsecured amount of the outstanding loan.

1.3 Causes of NPA

Lending Practices of Banks - In 2008 the financial crisis has been happened because of bad lending practices of banks. The banks should strictly follow rules and regulations while lending loans. They should properly follow the credit policy of banks.
Business Risk - The organization may sometimes face problems with its own operational environment which may result in losses for the company.
Environmental Risk - Sometimes there may be environmental problems like cyclones, drought which does not give the required output to the farmers and Agri based businesses.

1.4 Impact of NPA

Liquidity - The Banks are facing the problem of NPAs. They are not recovering which lending money to borrower. Those times money will be blocked. Banks don't have enough cash in hand for short period of time.

Credit loss - Banks lose their goodwill and brand equity in market when there is problem with their NPA that further affect the value of the banks in terms of market credit.

Profitability - NPA not only affects on current profits but also profit of entire financial year.

2. Literature review

According to Reserve Bank of India (RBI) explains the definition of NPAs, "an asset makes non-performing when it stops to generate income for the bank. Recently an asset was measured as non-performing asset (NPA) stand on the concept of 'Past Due'. A non-performing asset was examined as credit in respect of which interest of principal has remained 'past due' for a particular time".

Siraj and Sudarsanan Pillai says that "NPA is a virus affecting banking sector. The study concluded that NPA still remains a major threat and the incremental component explained through additions to NPA poses a great question mark on efficiency of credit risk management of banks in India".

Debarsh and Sukanya Goyal (2012) emphasized "on management of non-performing assets in the perspective of the public sector banks in India under strict asset classification norms, use of latest technological platform based on core banking solution, recovery procedures and other bank specific indicators in the context of stringent regulatory framework of the RBI". In the seminal study on 'credit policy, systems, and culture', Reddy (2004) raised various critical issues pertaining to credit delivery mechanism of the Indian banking sector.

Reddy (2004) critically examined "various issues pertaining to terms of credit of Indian banks. In this context, it was viewed that 'the element of power has no bearing on the illegal activity. A default is not entirely an irrational decision. Rather a defaulter takes into account probabilistic assessment of various costs and benefits of his decision". The problem of NPAs is related to several internal and external factors facing the borrowers (Muniappan, 2002). "The internal factors are diversion of funds for diversification taking up new projects, helping/promoting associate concerns, time/cost overruns during the project implementation stage, business (product, marketing, *etc.*) failure, inefficient management, strained labor relations, inappropriate technology/technical problems, product obsolescence, *etc.,* while external factors are recession, non-payment in other countries, inputs/power shortage, price escalation, accidents and natural calamities".

3. Research Methodology

Aim of the present research paper is to analyze the trends in NPAs in terms of values, gross NPAs and net profit. Several research studies on NPA in Indian banking sector are available, the studies on a closer look validated NPA problem using secondary data. The primary emphasis of this research is focused on analyzing nonperforming assets of public sector banks in India during the period 2007 to 2016.The present study is a descriptive study which tries to establish the relationship between the non-performing assets and net profits. This is selective study. The data for the study has been sourced from Reserve Bank of India (RBI) bulletins, statistical tables relating to banks in India, report on existing and progress of banking in India, issued by the RBI. The study also suggests multi-pronged and diversified strategy for speedy recovery of NPAs in commercial banks in India. The final analysis is done by Correlation and Regression using MS Excel. The paper consists of secondary data which has been collected from different publications such as the Reserve Bank of India publications, the reports published by commercial banks, various issues of the IBA journal etc. The empirical findings using observation method and statistical tools like correlation, regression and data representation techniques identifies that there is a negative relationship between profitability measure and NPAs.

4. Table and Figures

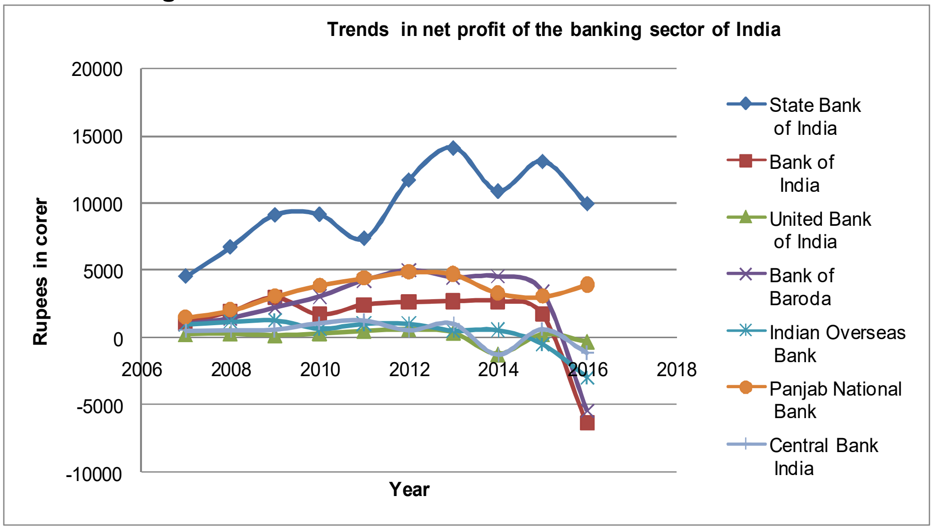

Figure 1: Net profit of Seven Banks for Ten year
Source: Prepared by Author

This is the trend of Net Profit for the different banks for the years 2007 –2016. Almost all the banks have experienced a negative growth in the year 2016.
The gross NPA have been continuously increasing for all he banks for he specified period. As the business operations of the bank increasing the amount of NPAs have also increased.
A remarkable difference in the financial status of the banks was observed in the year 2016. All the banks except SBI and PNB went through a severe loss in the year. The loss percents of the banks- BOI, BOB, IOB, CBI and UBI in the year 2016 as compared to 2015 were 462.32, 258.77, 537.71, 284.30, and 210.14 respectively (Table 1). Among the banks, only SBI and PNB could achieve profit consistently in all the years.

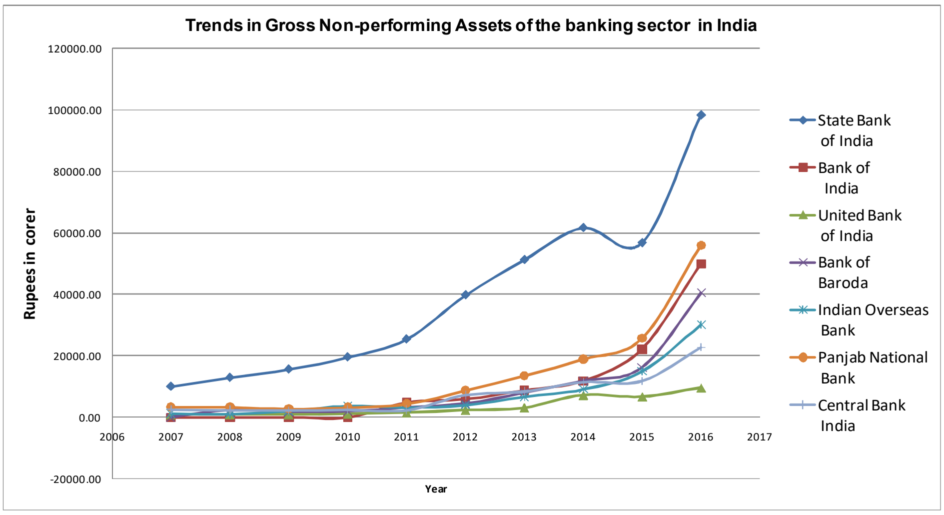

Figure 2: Non-performing assets of seven banks
Source: Prepared by Author

Table 1:

Net Profit (Rupees in corer)							
Year	State Bank of India	Bank of India	United Bank of India	Bank of Baroda	Indian Overseas Bank	Panjab National Bank	Central Bank India
2007	4541.31	1125.95	267.28	1026.46	1008.43	1540.08	498.01
2008	6729.12	1960.28	318.95	1435.52	1202.34	2048.76	550.16
2009	9121.23	3009.41	184.71	2227.20	1325.79	3090.88	571.24
2010	9166.05	1738.56	322.96	3058.33	706.96	3905.36	1058.23
2011	7370.35	2488.71	523.97	4241.68	1072.54	4433.50	1252.41
2012	11707.29	2674.62	632.53	5006.96	1050.13	4884.20	533.04
2013	14104.98	2741.91	391.90	4480.72	567.23	4747.67	1014.96
2014	10891.17	2732.65	-1213.44	4541.08	601.74	3342.58	-1262.84
2015	13101.57	1748.32	255.99	3398.44	-454.33	3061.58	606.45
2016	9950.65	-6334.98	-281.96	-5395.54	-2897.33	3944.40	-1117.67

Source: Financial results of different seven banks of ten years

Table 2:

Gross NPA (Rupees in corer)							
Year	State Bank of India	Bank of India	United Bank of India	Bank of Baroda	Indian Overseas Bank	Panjab National Bank	Central Bank India
2007	9998.00	0.00	744.30	0.00	1120.00	3390.72	2572.00
2008	12837.34	0.00	817.00	2400.69	997.00	3319.30	2350.00
2009	15588.6	0.00	761.00	1842.92	1923.40	2767.46	2316.50
2010	19534.89	0.00	1019.60	1981.38	3611.00	3214.41	2457.90
2011	25326.29	4811.55	1355.78	3152.50	3089.00	4379.39	2394.53
2012	39676.46	5893.97	2176.42	4464.75	3920.00	8719.62	7273.46
2013	51189.39	8765.25	2963.83	7982.58	6607.00	13465.79	8456.18
2014	61605.35	11868.80	7118.01	11875.90	9020.00	18880.06	11500.01
2015	56725.34	22193.24	6552.91	16261.45	14922.00	25694.86	11873.06
2016	98172.80	49879.12	9471.01	40521.04	30048.00	55818.33	22720.88

Source: Financial results of different seven banks of ten years

NPA of the banks went on increasing in all the years but a drastic raise was observed in the year 2016. The percentage raise of NPA of the banks in the year 2016 as compared to 2015 were SBI – 73.07, BOI- 124.75, UBI- 44.53, BOB- 149.18, IOB-101.37, PNB- 117 and CBI- 91.36

Table: 3 Correlation between NPA and Net Profit of the selected banks

Bank	Correlation
State Bank of India	0.591125611
Bank of India	-0.863792026
United Bank of India	-0.654074198
Bank of Baroda	-0.720973007
Indian Overseas Bank	-0.985503809
Panjab National Bank	0.194168193
Central Bank India	-0.73857971

Source: Prepared by author

In Table no 3 is showing that correlation for SBI and PNB are equal to 0.591 and 0.194 respectively. It means that there is a positive relation between Net Profits and NPA. It means that as profits increase NPA also increase. NPA is directly related to Total Advances given by bank and banks main source of income is interest earned by bank. But other banks are negative correlation. NPAs are increasing in every year but net profit decrease.

5. Result

The banks have expressed correlation between Gross NPA and the Net profit. SBI and Punjab National Bank have shown positive correlation, and all the other banks expressed negative correlation. Bank of Baroda increasing the NPA almost 249% as compare with 2015.In this research paper applying the random method of panel regression, the result is:

plm(formula = G.NPA ~ Net.Profit, data = npa_rp, model = "random",

R-Squared: 0.57082

R value is 57% that's why this model is effective model. This model showed that when the NPA is increasing that time net profit decreasing. The independent variables is non-performing asset.

Normally the profitability of the banking sector depends on recovery of loans on time which are disbursed to the different sectors. The performance of banking sector depends on how effectively you manage the non-performing assets. Except SBI and Punjab National Bank all the banks are facing problems with respect to NPAs. It does not indicate that the more NPAs the more profits for SBI but the largest bank of India is able to receive more profits only because of its wide variety of financial services and effective management of NPAs. But if NPAs continue in the same manner then even large banks will also stumble like Lehman Brothers in USA which resulted in International economic crisis.

6. Conclusions

NPAs affect the financial performance of Indian banks as well financial growth of economy. Indian banking system is facing the NPAs problem. Every country's economic growth depends upon their financial system. The financial system mainly comprises banking sector. Especially public sector banks should focus on their NPA Management to grow their profitability. The financial institutions should develop new strategies planning to improve the recovery of loan. Non-performing assets (NPAs) is affecting the performance of financial institutions both financially and psychologically. The non-performing assets have become a major cause of concern. Absorbing the credit management skills has become all the more important for improving the bottom-line of the banking sector. The current NPAs status continues to disturb Indian banking Sector. Several experiments have been tried to reduce NPAs but nothing has hit the mark in tackling NPAs. The Indian banking sector faced a serious problem of NPAs. A high level of NPAs suggests high probability of a large number of credit defaults that affect the profitability and liquidity of banks. Most of the problem related to NPA is faced by public sector banks. To improve the efficiency and profitability, the NPAs have to be scheduled. Strict measures are needed to be taken up to combat these NPAs crises. It is highly impossible to have zero percentage NPAs.

Improvement in recovery management properly functioning of banks depends on time recovery of loan. Banks should develop a new recovery programs for over dues, monitoring accounts, keeping regular contact with borrowers. However, many borrowers are defaulters not because of low income but due to lack of ethics.

Improving the credit Management- Management of credit is essential for proper functioning of banks. Preparation of credit planning, proper credit appraisals, disbursements, post sanction follow-up and need based credit are the some areas of credit management that needs improvement in order to reduce the NPAs. Banks should reduce dependence on interest income- Indian banks are largely dependent on the lending and investment as in comparison to developed countries. Indian banks should look for sources (income) from fee based services and products. Credit Information Bureau India LTD (CIBIL) 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 the year 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.

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