

Non-Performing Assets and its Impact on Indian Financial Sector

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Abstract:

Non-Performing Assets are a significant concern for any financial institutions as they can have adverse effects on their financial health and profitability. The presence of high level of NPAs indicates that the bank may face difficulties in recovering the loan amount ultimately resulting in potential losses of the institution. Along with the bank's financial health situation it impacts the country's economy to a large extent. Managing and reducing NPAs is crucial for banks and financial institutions to maintain their financial stability and profitability and to ensure the overall health and stability of financial system.

Key Words – NPA, impact, banks, financial institutions.

Introduction:

A strong financial sector is very important for the economic growth of a country. The commercial banks which form the backbone of the financial sector should be well organized and efficiently managed for the growth dynamics of a growing economy. NPAs is one of the major hindrance in the growth and prospects of any banks and have been a persistent challenge for the Indian Banking Sector impacting its strength, profitability and productivity and its ability to support economic growth. NPAs refer to loans or advances given by banks that have stopped generating revenue for the lender due to borrower's default or nonpayment of interest or principal amount. For any country, the well-being of the banking industry can be firm by inspecting and analyzing the levels of NPAs. Less amount of NPAs shows that the banks have recognized robust credit assessment process with time. On the other hand, an increase or large amount of NPAs result in the decrease in the all-round profitability of the banks.

History of NPAs in Indian Banking Industry

The issue of NPAs in the Indian Banking Industry has a long history, with various factors contributing to its evolution over time.

1. Pre Liberalization Era (Pre 1991)

1. Directed Lending: Prior to economic liberalization in 1991, the Indian banking sector operated under a regulated regime, with directed lending policies.
2. Weak Credit Appraisal and Monitoring: Inadequate credit appraisal and monitoring practices, coupled with political interference and lack of autonomy, led to a relaxed approach in loan sanctioning and recovery.¹

2. Post Liberalization Era (Post 1991)

The main issue of NPAs came into limelight after the publication of the Narasimham Committee report (1991) which showed the position of the Commercial Banks' Health in India. The Committee opined that the classification of assets was not according to the International standard and there was a need to strengthen to make it more stable.²

¹ Parvesh Kumar, Issue of NPA's in Nationalised Banks in India, IRJMST, Vol. 5 Issue 2, [ISSN 2250-1959].

² M.L. TANNA, (*TANNANS BANKING LAW AND PRACTICE IN INDIA*), Lexis Nexis (First Ed.2017)

The committee recommended that the bank strategy of income generation should be purposive and based on the basis of regaining and recovery rather than any other consideration. The committee further suggested that "classification of assets", should be uniform and consistent.³

Categories of NPAs

Non-Performing Assets (NPAs) in India are categorized based on the period of default and the asset classification norms set by the Reserve Bank of India (RBI). The classification categories

for NPAs in India are as follows:

1. **Substandard Assets:** Substandard assets are those where the borrower has defaulted in making payments for more than 90 days and has persisted non performing for a period less than or equal to 12 months. These assets have inherent weaknesses, and if not resolved, they have the potential to deteriorate further. Banks are obligated to make higher mandates for substandard assets.⁴
2. **Doubtful Assets:** Doubtful assets are those where the default has been continuing for more than one year. These assets have a higher degree of risk associated with them, and full recovery is uncertain. All financial institutions are required to make even higher regulations for doubtful assets compared to substandard assets.⁵
3. **Loss Assets:** Loss assets are those where the loss has been recognized by the bank or the internal or external auditors of the bank or by other auditory officers, or the RBI inspectors and the bank has not fully recovered the amount, resulting in a loss to the bank. These assets are considered irrecoverable and banks are mandated to make provisions for the entire outstanding amount.

³ Rajaraman I & Vashishta G , Non-Performing Loans of Indian Public Sector Banks, Economic and Political weekly(2008).

⁴ NATRAJAN PARMESHWARAM, (*INDIAN BANKING*), Asia Law Publication 285-289, (Third Ed. 2017).

Apart from these categories, the RBI also introduced the concept of Special Mention Accounts (SMA) to monitor early warning signs of potential stress.⁷ The SMA classification helps banks identify potential NPAs at an early stage and take necessary actions to prevent further deterioration.

Types of NPA

Gross NPA and Net NPA are two key metrics used to assess the asset quality of a bank.

Gross NPA: Gross NPA refers to the total value of non-performing loans and advances on a bank's books before any provisions or write-offs are made. It represents the total outstanding amount of loans where the borrowers have defaulted on their payment obligations for a specified period. Gross NPA includes all loans that have crossed the defined threshold of non-payment, typically 90 days, after which they are considered non-performing. It encompasses both the principal amount and the accrued interest that remains unpaid. Gross NPA reflects the magnitude of the bank's overall bad loans and the potential risk to its financial health.⁸

Net NPA: Net NPA is a measure that takes into account the provisions made by the bank against its gross NPAs. It is calculated by deducting the provisions (specific, general, and floating) made by the bank for potential loan losses from the gross NPA. Net NPA represents the actual bad loans that remain on the bank's books after accounting for the provisions made towards potential losses. It provides a more realistic picture of the bank's impaired assets and the level of risk it faces.⁹

The calculation for Net NPA is as follows: **Net NPA = Gross NPA - Provisions for Bad Debts**

⁷ Rajeshwari Sengupta and Harsh Varshan "Non-performing assets in India- this time it is different", Economic and Political Weekly, March 2018.

⁸ M.L. TANNA, *TANNANS BANKING LAW AND PRACTICE IN INDIA*, Lexis Nexis, 3rd Edition

Net NPA is considered a more reliable indicator of a bank's asset quality as it reflects the amount that the bank expects to realize from its non-performing loans after making necessary provisions. A lower net NPA ratio indicates better asset quality and reflects the bank's ability to manage and recover from its impaired loans.

Causes of NPA in the Indian Banking Sector:

- a) **Economic Factors:** Economic downturns, industry-specific problems, and structural issues can contribute to NPAs. Factors such as recession, policy changes, fluctuating interest rates, and changes in government regulations can affect borrowers' ability to

repay loans.

- b) Inefficient Credit Assessment and Monitoring: Weak credit appraisal processes, inadequate due diligence, and lax loan monitoring contribute to the rise in NPAs¹⁰. Banks' failure to assess the borrower's creditworthiness, lack of proper documentation, and poor post-disbursement monitoring result in a higher risk of default.
- c) Willful Defaulters and Corporate Governance: Instances of willful default, where borrowers intentionally avoid repaying loans, have plagued the Indian banking sector. Weak corporate governance practices, lack of transparency, and inadequate legal mechanisms to hold defaulters accountable have exacerbated the NPA problem.
- d) External Factors: Many external shocks such as natural disasters or phenomenon outside the control of humans, political instability or chaos, and global economic crises and recession can have a substantial impact on borrowers' repayment capacity, leading to the rise in NPAs.

Consequences of NPA:

- a) Financial Instability: A high level of NPAs weakens the financial health of banks, affecting their profitability, capital adequacy, and overall stability. It reduces banks' ability to lend to productive sectors of the economy, stifling economic growth.
- b) Erosion of Public Confidence: Persistent NPAs erode public confidence in the banking system. Depositors may become apprehensive about the safety of their funds, leading to deposit withdrawals and destabilizing the banking sector further.
- c) Capital Infusion and Government Burden: Banks burdened with NPAs often require capital infusion to maintain their solvency. This places a financial burden on the government, as it may need to recapitalize public sector banks to ensure their continued operations.

- d) Credit Crunch: A high level of NPAs restricts banks' ability to lend, leading to a credit crunch. This negatively impacts businesses, particularly small and medium enterprises (SMEs), which heavily rely on bank credit for their operations and expansion.¹¹

Impact of NPA on the Performance of Banks

1. Erosion of Profitability: NPAs directly affect a bank's profitability. When loans turn into NPAs, the bank stops earning interest income on those assets, leading to a decrease in its net interest income. The bank also incurs additional costs in terms of provisions and write-offs to cover potential losses. These factors can significantly impact the bank's profitability, resulting in lower net profits or even losses.
2. Capital Adequacy Concerns: NPAs reduce a Bank's CAR, which is a measure of its financial strength and ability to absorb potential losses. As NPAs increase, the bank's capital base is eroded, and its CAR decreases. This can lead to regulatory concerns and restrictions on the bank's lending capacity and growth opportunities¹².
3. Liquidity Pressure: Banks with a high proportion of NPAs may face liquidity challenges. Non-performing loans are illiquid assets as they are not generating interest income and cannot be easily sold or converted into cash. This limits the bank's ability to meet deposit withdrawals and fund new loans, potentially leading to a liquidity crunch.

¹⁰ Nelson M.Waweru .et.al. (2009), Global Journal of Finance and Banking Issues, Vol 3, No 3, 2009

¹¹ Rakesh Mohan and Parth Roy, Indian Financial Sector; structure, trends and turns, IMF Working Paper, Jan 2017.

¹² Parvesh Kumar, Issue of NPAs in Nationalised Banks in India (IRJMST), Vol 5 Issue 2[ISSN 2250-1959].

4. **Increased Credit Risk**: NPAs indicate that borrowers are defaulting on their loan repayments, which raises concerns about the bank's credit risk exposure. If a bank has a significant NPA portfolio, it indicates weak credit underwriting standards, inadequate risk management practices, or adverse economic conditions¹³. This can make it more difficult for the bank to attract new customers, raise capital, or access funding at favorable rates.
5. **Reputational Risk**: Persistent high NPAs can harm a bank's reputation and customer confidence. A bank with a reputation for high levels of NPAs may find it challenging to attract new borrowers or retain existing customers. Negative publicity and customer dissatisfaction can lead to a loss of business opportunities and affect the bank's long-term viability.

Early symptoms of recognizing NPAs

Recognizing early symptoms of Non-Performing Assets (NPAs) is crucial for banks to take timely action and prevent further deterioration. Here are some early symptoms that banks can watch out for to identify potential NPAs:

1. **Delayed Payments**: One of the initial signs of a potential NPA is the delay in loan repayments by borrowers. If borrowers consistently miss their payment deadlines or start making irregular payments, it could be an indication of financial stress or cash flow difficulties. Banks should closely monitor the payment behaviour of borrowers to identify any emerging NPA risks.
2. **Deteriorating Financials**: Banks should pay attention to the financial statements and performance of their borrowers. A significant decline in the profitability, cash flow, or liquidity position of a borrower may signal financial distress and a higher probability of default. Banks should conduct regular financial reviews and ratio analysis to identify early warning signs.

3. **Non-Compliance with Loan Covenants**: Loan agreements often include certain conditions or covenants that borrowers must adhere to. Non-compliance with these

¹³ Sandeep Aggarwal, Parul Mittal (2012), Non Performing Asset: Comparative Portion of Public and Private Sector Banks In India", International Journal Of Business and Management Tomorrow, [vol 2 no 1], pp 1-7.

covenants, such as breaching debt service coverage ratios, leverage limits, or collateral maintenance requirements, can indicate a borrower's weakening financial position. Banks should closely monitor loan covenant compliance to identify potential NPAs.

4. **Declining Industry or Sector Performance**: Economic and industry-specific factors can have a significant impact on borrowers' ability to repay loans. Banks should monitor the performance of industries or sectors to which their borrowers belong. Any signs of a slowdown, regulatory changes, or adverse market conditions can increase the risk of loan defaults and potential NPAs.
5. **Adverse Credit Reports or Ratings**: Negative credit reports, credit downgrades, or credit rating agency alerts about a borrower can serve as early indicators of potential NPAs. Banks should regularly review credit reports, ratings, and news updates related to their borrowers to stay informed about any changes in their creditworthiness¹⁴.

Measures to control NPA

Controlling NPAs is vital for banks to maintain financial constancy and increase their overall performance. Here are some key measures that banks can implement to control and manage NPAs effectively:

1. **Strengthening Credit Appraisal and Risk Management**: Banks should enhance their processes to safeguard thorough assessment of borrowers' creditworthiness, repayment ability, and risk profile. This comprises conducting comprehensive due diligence, evaluating cash flow projections, assessing collateral adequacy, and monitoring industry-specific risks. Implementing robust risk management practices can

help prevent potential NPAs.

2. Early Warning Systems: Banks should establish early warning systems to identify borrowers at risk of default. These systems can involve the use of financial ratios, risk models, and credit scoring techniques to detect early signs of financial stress. Early detection allows banks to take timely actions, such as restructuring loans, intensifying monitoring, or initiating recovery measures, to prevent loans from turning into NPAs.

¹⁴ Ramesh K.V and Sudhakar. A , NPA Management in public sector banks, International Journal Of Research in Commerce and Management, Vol 3(11), 2012, pp 44-49, ISSN 0976-2183.

1. Effective Loan Monitoring and Regular Reviews: Regular monitoring of loan accounts is crucial to identify any deterioration in borrower financials or payment behavior. Banks should conduct periodic reviews of borrowers' financial statements, industry trends, and loan compliance to proactively identify potential NPAs. Timely identification enables banks to take necessary corrective actions and mitigate risks¹⁵.
2. Prompt Asset Classification and Provisioning: Banks should adhere to the regulatory guidelines for timely classification of assets as NPAs based on defined criteria. Prompt classification ensures accurate reporting and provisioning for potential loan losses. Adequate provisioning helps banks cover expected credit losses and strengthens their capital adequacy position.
3. Loan Restructuring and Recovery: Restructuring includes modifying the terms or norms of the loan, such as lengthening the repayment period, dipping interest rates, or converting debt into equity¹⁶. This provides relief to borrowers and increases the chances of loan recovery. Banks should also adopt efficient recovery mechanisms, such as debt recovery tribunals, asset reconstruction companies, or negotiated settlements, to recover dues from defaulting borrowers.

By implementing these measures, banks can effectively control and manage NPAs, reduce credit risk exposure, and improve their overall financial performance. Regular monitoring, early intervention, and proactive risk management are key to maintaining a

healthy loan portfolio and minimizing the impact of NPAs.

Judicial pronouncement on NPAs

There have been several significant judicial pronouncements in India related to Non- Performing Assets (NPAs) and their treatment in the banking sector. Here are a few notable judicial pronouncements on NPAs in India:

1. **Dhharani Sugars and Chemicals Limited v. Union of India and Others (2021)**: In this case, the Supreme Court of India upheld the constitutional validity of the RBI's February 12, 2018, circular that mandated banks to initiate insolvency proceedings against borrowers if their loans were classified as NPAs for more than 90 days. The court held that the RBI had the authority to issue such circulars to report the matter of mounting NPAs in the financial or banking system.
2. **Innovative Industries Limited v. ICICI Bank Limited and Others (2017)**: In this case, the Supreme Court clarified that banks can initiate insolvency proceedings against defaulting borrowers even in cases where the borrower challenges the classification of their loan as an NPA. The court held that once a default occurs, the bank has the right to take appropriate action for recovery, including initiating insolvency proceedings.
3. **State Bank of India v. Ramakrishnan and Others (2018)**: In this case, the Supreme Court clarified that the Debts Recovery Tribunal (DRT) has the jurisdiction to adjudicate cases related to NPAs and recovery of outstanding dues. The court held that DRTs are specialized forums for expeditious recovery of NPAs and should be the first forum for resolution before approaching civil courts.
4. **United Bank of India (UBI) v. Satyawati Tondon and Others (2010)**: In this case, the Supreme Court held that a bank can classify a loan as an NPA and initiate recovery proceedings even if there is a dispute or counterclaim by the borrower. The

court emphasized that a mere dispute or counterclaim does not negate the bank's right to classify a loan as an NPA and seek recovery.

Legal framework for NPAs in Indian Banks

The legal framework for Non-Performing Assets (NPAs) in Indian banks encompasses various laws, regulations, and mechanisms that govern the NPAs of different banks and financial institutions. Here are some key components of the legal framework for NPAs in Indian banks:

1. **Reserve Bank of India (RBI) Guidelines**: The RBI plays a significant role in formulating and implementing policies related to NPAs. The RBI issues guidelines and circulars from time to time to regulate asset classification, provisioning, and resolution processes for banks. These guidelines provide a framework for banks to identify and classify NPAs, calculate provisions, and undertake resolution efforts.
2. **Asset Classification and Provisioning Norms**: The RBI mandates specific asset classification norms for banks to ensure accurate and consistent reporting of NPAs. As per RBI guidelines, banks classify assets into various categories such as Substandard, Doubtful, and Loss Assets based on the period of default or other specified criteria¹⁷. All banks are mandated to make provisions against these assets based on their classification, ensuring that potential losses are adequately covered.
3. **Insolvency and Bankruptcy Code (IBC)**: The IBC, enacted in 2016, is a significant legal structure for the determination of stressed assets and NPAs. It provides a time-bound and comprehensive mechanism for the resolution of insolvency cases, aiming to maximize value for creditors and facilitate efficient debt recovery. The IBC empowers creditors, including banks, to initiate insolvency proceedings against defaulters and participate in the resolution process.¹⁸
4. **Debt Recovery Tribunals (DRTs) and Debt Recovery Appellate Tribunals (DRATs)**: DRTs and DRATs are specialized tribunals established under the Recovery of Debts

Due to Banks and Financial Institutions (RDDBFI) Act, 1993. These tribunals provide a forum for banks to recover dues from defaulting borrowers. Banks can file recovery applications with DRTs for the speedy adjudication of causes related to NPAs. Appeals against DRT orders can be filed with the respective DRATs.

5. Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act: The SARFAESI Act, enacted in 2002, empowers banks to enforce the security interest and recover NPAs without court's intervention. Under this act, banks have the power to issue notices or warnings, take control or possession of collateral, and sell the assets to recover dues. The SARFAESI Act provides banks with a quicker and more efficient mechanism for NPA resolution.
6. Debt Recovery Mechanism: Apart from the legal provisions mentioned above, Indian banks also use other debt recovery mechanisms such as One Time Settlement (OTS) schemes, CDR, SDR, and SSA to report NPAs and facilitate their resolution¹⁹

¹⁷ Parvesh Kumar, Issue of NPAs in Nationalised Banks in India (IRJMST), Vol 5 Issue 2 [ISSN 2250-1959]

Recommendation to control NPAs

Controlling Non-Performing Assets (NPAs) requires a comprehensive approach involving various stakeholders, including banks, regulatory authorities, borrowers, and the government. Here are some recommendations to control and manage NPAs effectively:

1. Timely Recognition and Provisioning: Banks should adhere to regulatory guidelines for timely recognition and classification of NPAs. Early identification of problem loans allows banks to take necessary actions promptly, such as provisioning adequately for expected losses. Proper provisioning helps in maintaining the general financial health of the bank and prevents the accumulation of hidden NPAs.
2. Improved Loan Monitoring and Recovery Mechanisms: Banks should establish

robust loan monitoring mechanisms to closely track the performance of borrowers. Early warning systems should be implemented to detect signs of financial distress or default risks. In cases of default, banks should adopt efficient recovery mechanisms, such as debt recovery tribunals, asset reconstruction companies, or negotiated settlements, to recover dues promptly.

3. **Strengthening Legal Framework:** The legal framework for loan recovery and insolvency processes should be further strengthened to expedite resolution and discourage willful defaults. This includes streamlining legal procedures, reducing litigation timelines, and strengthening the enforcement mechanisms. Implementation of the IBC has been a significant step in this direction.
4. **Focus on Financial Literacy and Credit Counselling:** Promoting financial literacy and credit counselling programs can help borrowers understand their financial obligations, improve repayment discipline, and make informed financial decisions. Educating borrowers about responsible borrowing, budgeting, and financial management can reduce the incidence of defaults and NPAs.
5. **Collaboration with Stakeholders:** Banks should collaborate with regulatory authorities, industry associations, and credit rating agencies to gather information, share best practices, and identify potential risks in specific sectors.
6. **Technology Adoption:** Leveraging technology solutions such as data analytics, artificial intelligence, and machine learning can significantly enhance credit risk assessment, loan monitoring, and early warning systems.
7. **Government Support:** The government can play a vital role in controlling NPAs by addressing macroeconomic factors, providing sector-specific policy support, and implementing structural reforms. Measures such as improving infrastructure, addressing governance issues, and promoting ease of doing business can contribute to a conducive business environment and reduce default risks.

Effective control of NPAs requires a proactive and multi-dimensional approach that focuses on risk management, early identification, timely resolution, and regulatory support. By implementing these recommendations, banks can improve their asset quality, strengthen financial stability, and contribute to sustainable economic growth.

Conclusion

Non-Performing Assets (NPAs) pose significant challenges to the Indian banking industry and the overall economy. The increasing level of NPAs has adverse implications for banks' financial health, profitability, and lending capacity. The impact of NPAs on banks is multifaceted. It weakens their balance sheets, erodes profitability, reduces capital adequacy, and increases credit risk. NPAs tie up valuable resources and impede banks' ability to extend credit to new borrowers. Moreover, high provisioning requirements for NPAs strain banks' earnings and capital base, affecting their ability to support economic activities.

The causes of NPAs are diverse, ranging from economic downturns and industry-specific challenges to management inefficiencies and willful defaults. Inadequate credit appraisal, lax monitoring, weak risk management, and legal and regulatory bottlenecks have also contributed

to the NPA problem. Additionally, external factors such as policy changes, industry disruptions, and global economic shocks can exacerbate the NPA situation.

In conclusion, addressing the NPA problem is crucial for the stability and growth of the Indian banking sector. With concerted efforts, proactive risk management, and effective implementation of regulatory measures, the banking sector can control NPAs, improve asset quality, and contribute to a healthier and more resilient financial system.