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Impact of Non-Performing Assets on Financial Health of Banks

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Abstract:- The banking sector is a crucial financial service industry that supports development plans by channelling funds for productive purposes, facilitating the flow of funds from surplus to deficit units, and aiding in the implementation of government financial and economic policies. Banks fulfil social objectives through priority sector lending, extensive branch networks, and employment generation. Maintaining asset quality and profitability is essential for the survival and growth of banks. However, a significant challenge faced by the banking sector is the prevalence of Non-Performing Assets (NPAs). The Reserve Bank of India defines an NPA as "an asset, including a leased asset, that ceases to generate income for the bank." Major causes of NPAs include wilful default, misuse of borrowed funds, and inadequate pre-loan inquiries. As of June 30, 2018, the Gross NPA of Indian banks was ₹10.03 lakh crores, with Public Sector Banks accounting for 88.74% of this total. The top five Public Sector Banks—SBI, PNB, IDBI, BOI, and BOB—make up 46.67% of the Gross NPAs. Private Sector Banks hold 11.26% of the total Gross NPAs, with leading banks being ICICI, AXIS, and HDFC. The primary aim of this paper is to examine the causes and effects of NPAs in the banking sector.

***Keywords**:- Non-Performing Assets, Banking Sector, NPA, Banks Health, Finance, Banks Profitability.*

I. INTRODUCTION

Non-Performing Assets (NPAs) represent a significant challenge to the banking sector, adversely affecting its financial health and stability. NPAs are loans or advances that cease to generate income for the bank, typically due to the borrower's failure to meet repayment obligations. The prevalence of NPAs undermines the core functions of banks, such as channelling funds for productive purposes, facilitating financial intermediation, and supporting economic policies.

The impact of NPAs on banks is multifaceted. High levels of NPAs lead to reduced profitability, as banks must allocate substantial provisions for bad loans. This, in turn, affects their liquidity and ability to extend new credit, thereby stunting economic growth. Moreover, the erosion of asset quality and financial performance can diminish investor confidence and destabilize the banking system.

II. OBJECTIVE OF THE STUDY

To explore the causes and effects of NPAs on the financial health of banks. To analyze the underlying factors contributing to NPAs and their repercussions on banks' operations and performance. To explore the effective risk management system for NPAs. To identify strategies for managing Non-performing assets.

A. Meaning of Non-Performing assets

NPA expands to Non-Performing assets (NPA). Reserve Bank of India defines Non-Performing Assets in India as any advance or loan that is overdue for more than 90 days. "An asset becomes Non-Performing when it ceases to generate income for the bank," said RBI in a circular form 2007. To be more attuned to international practises, RBI implemented the 90 days overdue norm for identifying NPAs has been made applicable from the year ended March 31, 2004. Depending on how long the assets have been an NPA, there are different types of Non-Performing assets as well.

B. Types of Non-Performing Assets (NPA)

Different types of Non-Performing assets depend on how long they remain in the NPA category.

- Sub-Standard Assets: An asset is classified as a sub-standard asset if it remains as an NPA for a period less than or equal to 12 months.
- Doubtful Assets: An asset is classified as a doubtful asset if it remains as an NPA for more than 12 months.
- Loss Assets: An asset is considered a loss asset when it is "uncollectible" or has such little value that its continuance as a bankable asset is not suggested. However, some recovery value may be left in it as the asset has not been written off wholly or in parts.

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III. REVIEW OF LITERATURE

Prashanth K Reddy, this research paper "A Comparative Study of Non-Performing Assets in India in the Global Context – Similarities and Dissimilarities, Remedial Measures," emphasizes the importance of understanding macroeconomic variables and systemic issues related to banks and the economy for addressing NPAs. The paper highlights the critical need for a robust legal and legislative framework.

Dr. Sonia Narula and Monika Singla (2014), This research paper "Empirical Study on Non-Performing Assets of Banks," found that mismanagement in banks leads to a positive relationship between Total Advances, Net Profits, and NPAs, which is detrimental. Due to NPAs, banks lack the funds to provide loans to new customers.

Neha Rani (2014), This research paper "Analysis of Non-Performing Assets of Public Sector Banks," revealed that the share of nationalized banks in priority sector NPAs was higher in 2008 but has been decreasing since then. While the amount of NPAs for both categories of banks is increasing, their percentage share in total NPAs has been declining continuously since 2010.

Abhani Dhara K (2017), This paper explores the relationship between Non-Performing Assets (NPAs) and profitability in the banking sector, highlighting how NPAs indicate a bank's efficiency. The study focuses on five private sector banks, analysing data from 2013 to 2017 using descriptive research tools and t-tests to examine the impact of NPAs on profitability. Despite efforts to recover loans, NPAs have significantly increased, presenting a major challenge for banks. The findings confirm a strong negative impact of NPAs on bank profitability and suggest that while eliminating NPAs may not be feasible, effective management and preventive measures can significantly reduce their ratio and improve bank performance.

Agarwala & Agarwala (2019), This study analyses the significance of NPAs as indicators of the banking sector's health, focusing on the growth patterns of different banks from 2010 to 2017. It investigates the contributions of individual banks, including private sector banks, nationalized banks, and the State Bank of India (SBI) and its associates, to the NPA levels within the industry. The study uses secondary data collected from annual reports of the banks and employs the geometric mean to calculate the mean growth rate of gross NPAs for each bank. The findings indicate that private sector banks generally exhibit lower NPA growth rates compared to nationalized banks and SBI associates, suggesting more effective management of poor loans. Conversely, nationalized banks and SBI associates struggle with high NPA growth due to ineffective handling of poor loans. This research provides valuable insights into the banking sector post-financial crisis and offers useful information for investors concerned about bank profitability and prospects.

A. Causes for NPAS on Financial Health of Bank

The Indian banking system, transitioning from a closed economy to an open one, faces various challenges, including the high incidence of Non-Performing Assets (NPAs). A significant contributing factor to NPAs is the directed lending system mandating commercial banks to allocate a prescribed percentage (40%) of their credit to priority sectors. Presently, approximately 7% of Gross NPAs consist of 'hard-core' doubtful and loss assets that have accumulated over time.

- Economic Slowdown: Reduced economic activity results in decreased revenue and higher default rates.
- Poor Lending Practices: Insufficient due diligence, pressure to meet lending targets, and political interference can result in poorly assessed loans.
- Fraudulent Activities: Misappropriation of funds and fraudulent practices by borrowers lead to non-repayment.
- Sector-Specific Issues: Industries such as infrastructure encounter prolonged gestation periods and regulatory obstacles, contributing to default scenarios.
- Project Delays: Cost overruns and project completion delays add financial strain to borrowers.

B. Priority Sector

Priority sector refers to those sectors which the Government of India and the Reserve Bank of India consider as important for the development of the basic needs of the country. They are assigned priority over other sectors. The banks are mandated to encourage the growth of such sectors with adequate and timely credit.

C. Effects of NPAS on Financial Health of Bank

Carrying non-performing assets, also referred to as non-performing loans, on the balance sheet places three distinct burdens on lenders. The non-payment of interest or principal reduces cash flow for the lender, which can disrupt budgets and decrease earnings. Loan loss provisions, which are set aside to cover potential losses, reduce the capital available to provide subsequent loans. Once the actual losses from defaulted loans are determined, they are written off against earnings.

The following are the some of the major problems faced by banks due to NPA's:

- Effect of Profitability of Banks: The profitability of banks is adversely affected by NPAs, as they do not generate income, leading to a reduction in the net interest income. As NPAs increase, the net income of banks decreases.
- Increase in Provisions for Banks: The RBI has established prudential norms for income recognition and asset classification for Indian banks and financial institutions to ensure proper provisioning and transparency in their published accounts. According to these norms, banks must make provisions for Non-Performing Assets (NPAs).

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- Liquidity Position: NPAs affect the liquidity position of banks, causing a mismatch between assets and liabilities and forcing banks to raise resources at higher costs. Increased NPAs can lead to liquidity issues, potentially resulting in a bank run by depositors.
- Effect on MSMEs: The focus on disbursing loans primarily to large-scale firms has made banks reluctant to issue loans to small-scale industries. Consequently, MSMEs suffer from a lack of funding from banks and are forced to borrow from other sources, which increases their cost of capital.
- Shareholders' Confidence: Shareholders typically seek to enhance the value of their investments through higher dividends and market capitalization, which is achievable only when the bank posts significant profits from improved business operations. However, increased NPA levels can adversely impact the bank's business and profitability, leading to reduced returns for shareholders and, in some cases, eroding the value of their investments.
- Burden to Government: As the majority shareholder in public sector banks, the government must provide equity capital if these banks are struggling. With the rise in NPAs, public sector banks face increased financial difficulties, necessitating additional capital support from the government.
- Higher Cost of Capital: This situation leads to an increased cost of capital, as banks must allocate more funds to ensure smooth operations. To generate income and cover expenses, banks are likely to raise interest rates.
- Declining Productivity: Loans issued by banks are considered assets. However, since NPAs do not generate income for the bank, there is a decrease in overall income, resulting in reduced productivity of the bank's assets.
- Asset Contraction (Credit): Rising NPAs create pressure on fund recycling and diminish the banks' capacity to lend more, consequently reducing interest income. This contraction in assets tightens the money stock, potentially leading to an economic slowdown.
- Public Confidence: The credibility of the banking system is significantly impacted by higher levels of NPAs, as it undermines the confidence of the general public in the stability of the banking system.
- Ultimate Burden on Society: The impact will ultimately be felt by consumers, who will need to allocate more funds to cover higher interest payments. This situation can lead to lower economic growth and higher inflation due to the increased cost of capital.

D. Factors Contributing To Non Performing Assets

Non-performing assets (NPAs) are loans or advances that have stopped generating income for a lender. Several factors contribute to the emergence and growth of NPAs, which can impact the financial stability of banks.

The factors for NPA are classified as Internal Factors and External Factors.

➢ *Internal Factors:*

- Defective lending process: The principle of safety dictates that the borrower should have the capability to repay the loan. Hence, bankers must exercise utmost diligence to verify the soundness of the enterprise or business seeking the loan, ensuring the borrower is competent to manage it successfully and possesses integrity and good character.
- Inappropriate technology: Inadequate technology and management information systems prevent banks from making real-time, market-driven decisions. Therefore, it is crucial to upgrade all branches of banks to align with the current scenario
- Improper SWOT analysis: Poor SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis is another factor contributing to the increase in NPAs. Therefore, banks should thoroughly assess the profitability, viability, and long-term sustainability of projects before providing financing.
- Poor credit appraisal system: Poor credit appraisal leads banks to extend loans to borrowers who are unable to repay them, thereby increasing the bank's NPAs. Therefore, it is essential for the bank to maintain a robust credit appraisal system.
- Managerial deficiencies: Bankers should meticulously choose borrowers and secure tangible assets as collateral to protect their interests. Additionally, they should adhere to the principle of risk diversification, ensuring they do not concentrate loans solely on a few large firms, industries, or cities.
- Absence of regular follow up: Irregular spot visits contribute to increased NPAs, as the absence of regular visits by bank officials to customer locations decreases the timely collection of interest and principal on loans.

➢ *External Factors:*

- Ineffective recovery tribunal: The government has established a number of recovery tribunals to handle the recovery of loans and advances. However, due to their carelessness and ineffectiveness, banks suffer from non-recovery, which in turn reduces their profitability and liquidity
- Wilful Defaults: - Indian Public Sector Banks are the most severely impacted by these defaults, which represent failures in repayment obligations. For example, Kingfisher Airlines Ltd. is one of many wilful defaulters, along with Beta, Napthol, Winsome Diamonds & Jewellery Ltd., Rank Industries Ltd., and XL Energy Ltd.
- Natural calamities: This is a significant factor contributing to the alarming increase in NPAs of the PSBs. Our farmers largely depend on rainfall for their crops, and due to irregular rainfall, they often fail to achieve the desired production levels, making them unable to repay their loans. Consequently, banks must set aside large provisions to cover these unpaid loans

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- Industrial Sickness: Inappropriate project handling, ineffective management, inadequate resources, outdated technology, and frequent changes in government policies lead to industrial sickness. As a result, banks that finance these industries experience low loan recovery, which reduces their profitability and liquidity.
- Lack of Demand: Indian entrepreneurs often struggle to accurately predict demand for their products, leading to overproduction and an inability to repay borrowed funds. Consequently, banks must classify these unpaid loans as NPAs and make provisions for them.

E. Repercussions on Banks' Operations and Performance

- Reduced Profitability: Non-performing assets (NPAs) create a drag on bank profitability. They lock up valuable capital that could be used for new loans, thereby reducing potential interest income. Additionally, banks are required to allocate provisions from their profits to cover potential losses on NPAs, further squeezing their bottom line.
- Increased Credit Risk: A significant level of NPAs signals a higher credit risk for the bank. This perception from other lenders translates into stricter borrowing terms and potentially higher interest rates in the interbank market, making it more expensive for the bank to access necessary funds.
- Decreased Lending Capacity: Banks with a burden of NPAs may be forced to slam the brakes on lending to comply with capital adequacy requirements. This curbs economic activity by limiting the availability of credit for businesses and consumers to invest, grow, and spend.
- Reputational Damage: A ballooning level of NPAs can erode public trust in a bank's financial health. This damaged reputation makes it harder to attract new customers and convince existing ones to keep their money with the bank.
- Reduced Shareholder Value: Non-performing assets act as a deadweight on a bank's profitability. This translates to lower earnings, which can trigger a sell-off by investors and a subsequent drop in the bank's stock price. As a result, shareholders see a reduction in the value of their investment.

F. Effective Risk Management

- Identify and Assess Risks: The first step in implementing effective risk management systems for non-performing assets (NPAs) is to identify and assess the potential risks associated with these assets. This involves conducting a thorough analysis of the borrower's financial situation, collateral value, and market conditions. For example, a bank may assess the risk of default by evaluating the borrower's credit history, income stability, and debt-to-income ratio. Accurately identifying and assessing these risks enables banks to develop appropriate strategies to mitigate them.
- Diversify NPA Portfolio: Diversification is a key strategy in risk management. Banks should aim to diversify their NPA portfolio by investing in a variety of asset classes and sectors. By spreading the risk across different types of NPAs, such as loans for real estate, small businesses, and consumer credit, banks can reduce their exposure to any single sector or industry. For instance, if a bank has a significant portion of its NPAs in the real estate sector and there is a downturn in the housing market, the bank's overall portfolio will be less impacted if it also has NPAs from other sectors.
- Implement Robust Credit Monitoring Systems: To effectively manage NPAs, banks need to establish robust credit monitoring systems. These systems should enable banks to track borrower performance and identify early warning signs of potential default. For example, banks can set up automated alerts for missed payments, changes in credit scores, or significant shifts in a borrower's financial behavior. By promptly identifying and addressing these warning signs, banks can take proactive measures to mitigate the risks associated with NPAs.
- Regular Portfolio Reviews: Conducting regular portfolio reviews is essential for effective risk management. Banks should periodically analyze their NPA portfolio to identify trends, assess the impact of external factors, and evaluate the effectiveness of their risk mitigation strategies. For instance, a bank may notice a higher default rate among NPAs related to a particular industry. This information can prompt the bank to adjust its lending criteria or tighten its risk assessment process for similar NPAs in the future.

G. Impact of Non-Performing Assets on Banks Financial Performance

- Reduced Income: NPAs fail to generate interest income, directly impacting the bank's profitability. Since interest income is a primary revenue source for banks, the loss of this income from non-performing loans significantly affects their financial performance.
- Higher Provisions: Banks need to allocate provisions to cover potential losses from NPAs, which reduces their net income. These provisions are expenses that directly impact the profit and loss statement.
- Erosion of Capital: As NPAs increase, the bank's capital is diminished due to the need to write off bad loans. This weakens the bank's capital adequacy ratio (CAR), which measures a bank's capital relative to its risk-weighted assets.
- Increased Risk Weight: NPAs raise the risk-weighted assets of the bank, necessitating more capital to maintain the same CAR. This can result in the need for banks to raise additional capital.
- Cash Flow Strain: NPAs reduce cash inflows from loan repayments, straining the bank's liquidity and potentially impacting its ability to meet short-term obligations.

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- Sale of Assets: To manage liquidity, banks might need to sell assets, sometimes at a loss, which can further weaken their financial position.
- Increased Costs: Managing NPAs demands additional resources for recovery efforts, legal processes, and monitoring. These higher operational costs can strain the bank's financial performance.
- Diversion of Focus: Excessive NPAs can shift management's attention from core banking activities to managing and recovering bad loans, negatively impacting overall operational efficiency.
- Stock Price Impact: Elevated levels of NPAs can adversely affect investor confidence, resulting in a decrease in the bank's stock price. This can complicate and increase the cost of capital-raising efforts for the bank.
- Credit Rating Impact: NPAs can influence the bank's credit rating, potentially raising its borrowing costs and diminishing its ability to secure funding.
- Regulatory Scrutiny: Elevated NPAs draw increased attention from regulators, potentially resulting in fines and more stringent compliance demands. This escalation can raise compliance costs and operational burdens.
- Stress Tests: Banks with elevated NPAs may face more rigorous stress tests from regulators, potentially uncovering additional capital deficiencies that necessitate corrective actions.
- Balance Sheet Impact: NPAs undermine the bank's overall financial health by diminishing the quality of assets on the balance sheet. This can initiate a negative feedback loop, where declining asset quality contributes to additional financial distress
- Long-term Viability: Sustained high levels of NPAs have the potential to endanger the long-term viability of a bank, possibly resulting in insolvency if not effectively managed.

H. Strategies for Managing Non-Performing Assets

- Asset Reconstruction Companies (ARCs): Banks can sell their NPAs to ARCs, which specialize in recovering bad loans. ARCs purchase NPAs at a discounted price and attempt to recover the debts through various means, including restructuring the loans.
- Corporate Debt Restructuring (CDR): CDR involves restructuring the debt of financially distressed yet potentially viable companies. It provides borrowers with a second chance by extending the repayment period, reducing interest rates, or converting part of the debt into equity.
- Strategic Debt Restructuring (SDR): Under SDR, lenders can convert a portion of the loan into equity, gaining majority ownership in the borrowing company. This enables banks to implement necessary management changes to turn the company around.
- SARFAESI Act, 2002: The SARFAESI Act allows banks and financial institutions to auction properties (commercial or residential) when borrowers fail to repay their loans, providing a faster recovery mechanism compared to traditional litigation.
- Insolvency and Bankruptcy Code (IBC), 2016: The IBC offers a time-bound process for resolving insolvency in companies and individuals. It consolidates existing laws related to insolvency and bankruptcy to ensure a smoother resolution process, overseen by the National Company Law Tribunal (NCLT).
- One-Time Settlement (OTS): OTS schemes enable borrowers to settle their outstanding debts by paying a lump sum amount, usually less than the total due, providing a quicker resolution for both banks and borrowers.
- Lok Adalats: Lok Adalats are a form of alternative dispute resolution where cases pending in courts or at pre-litigation stages are settled amicably. Organized by the National Legal Services Authority, they are effective for resolving smaller NPAs.
- Joint Lenders' Forum (JLF): The JLF mechanism helps coordinate efforts among multiple banks when a borrower has loans from different lenders. It involves joint discussions and collective decisions to restructure loans.
- Mission Indradhanush: Launched by the Indian government, this mission aims to revamp public sector banks through measures that improve efficiency, accountability, and address NPAs.
- RBI's Prompt Corrective Action (PCA): The PCA framework imposes restrictions on banks with high NPAs and low capital to risk-weighted assets ratio (CRAR), mandating corrective actions to restore their financial health.
- Debt Recovery Tribunals (DRTs): DRTs offer a faster and more efficient mechanism for banks to recover debts, empowered to order the recovery of debts from borrowers.
- Bank-led Resolution Approach (BLRA): Banks proactively address NPAs by forming committees to oversee and implement recovery plans, emphasizing proactive management and internal resolutions.

IV. CONCLUSION

Non-Performing Assets (NPAs) have consistently posed a significant challenge for Indian banks, impacting not just the banking sector but the overall economy as well. The funds locked in NPAs directly affect the profitability of banks, which rely heavily on interest income from loans. High levels of NPAs have a cascading impact on critical financial ratios such as Net Interest Margin, Return on Assets, Profitability, Dividend Payout, Provision Coverage Ratio, and Credit Contraction. This can erode value for all stakeholders, including shareholders, depositors, borrowers, employees, and the public at large.

Although the government has taken various steps to reduce NPAs, much more needs to be done to address this issue. The NPA levels of Indian banks remain high compared to foreign banks, and achieving zero NPAs is unrealistic. Banks need to be more proactive in selecting clients and customers when sanctioning loans, and bank management should accelerate the recovery process. The

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primary recovery issue lies with large borrowers, necessitating strict policies for resolution. Additionally, the government should introduce more provisions for the faster settlement of pending cases and consider reducing mandatory lending to the priority sector, which is a major contributor to the NPA problem.

Addressing the NPA issue requires serious and concerted efforts. Without these efforts, NPAs will continue to undermine the profitability of banks, which is detrimental to the growth of the Indian economy.

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