ISSN 2321-2926

# Reforms of NPA in Indian Banking Sector

**M. China Subba Rao**

**Faculty Member, Dept. of Commerce and Management Studies**
**Dr.B.R.Ambedkar University, Srikakulam, Andhra Pradesh**

**Abstract:** The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity. As part of planned development, the macro-economic policy in India moved from fiscal neutrality to fiscal actives Such activism meant large developmental expenditures, much of it to finance long-gestation projects requiring long term finance. The sovereign was also expected to raise funds at fine rates, and understandably at below the market rates for private sector. In order to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, which were unrelated to market conditions. A healthy financial system can help achieve efficient allocation of resources across time and space by reducing inefficiencies arising out of market frictions and other socio-economic factors. NPAs beyond a certain level are indeed cause for concern for everyone involved because credit is essential for economic growth and NPAs affect the smooth flow of credit. Banks raise resources not just on fresh deposits, but also by recycling the funds received from the borrowers. Therefore, the problem of NPAs is not the concern of the lenders alone but is, indeed, a concern for policy makers as well who are involved in putting economic growth on the fast track.

**Keywords***:* NPA, Economic Growth, Financial Performance, Fiscal Policy, Appraisal Mechanisms.

It has been argued by a number of economists that a well-developed financial system enables smooth flow of savings and investments and hence, supports economic growth (see King and Levine, 1993, Goldsmith, 1969). A healthy financial system can help achieve efficient allocation of resources across time and space by reducing inefficiencies arising out of market frictions and other socio-economic factors. Amongst the various desirable characteristics of a well-functioning financial system, the maintenance of a few non-performing assets (NPA) is an important one. NPAs beyond a certain level are indeed cause for concern for everyone involved because credit is essential for economic growth and NPAs affect the smooth flow of credit. Banks raise resources not just on fresh deposits, but also by recycling the funds received from the borrowers. Thus, when a loan becomes non-performing, it affects recycling of credit and credit creation. Apart from this, NPAs affect profitability as well, since higher NPAs require higher provisioning, which means a large part of the profits needs to be kept aside as provision against bad loans. Therefore, the problem of NPAs is not the concern of the lenders alone but is, indeed, a concern for policy makers as well who are involved in putting economic growth on the fast track.

**Objectives of the Study**

The broad objective of the study is to examine the reforms that took place in India and to explore the financial implications of the reforms. Followings are the specific objectives of the study:

1. To review the banking sector reform programs;
2. To compare the financial performance of the banking system in India before and after implementation of the banking sector reforms;
3. To identify different problem areas of the banking sector of in India, which still needed careful restructuring for better performance; and
4. To suggest some policy measures for strengthening the restructuring mechanism.

**Need for Reforms NPAs**

The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity. As part of planned development, the macro-economic policy in India moved from fiscal neutrality to fiscal actives (Reddy2000) Such activism meant large developmental expenditures, much of it to finance long-gestation projects requiring long term finance. The sovereign was also expected to raise funds at fine rates, and understandably at below the market rates for private sector. In order to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, which were unrelated to market conditions. The government securities market, as a result, lost its depth as the concessional rates of interest and maturity period of securities essentially reflected the needs of the issuer (Government) rather than the perception of the market. The provision of fiscal accommodation through ad hoc treasury bills (issued on tap at 4.6 per cent) led to high levels of monetization of fiscal deficit during the major part of the eighties. In order to check the monetary effects of such large-scale monetization, the cash reserve ratio (CRR) was increased frequently to control liquidity.

**Review of literature**

**Ramachandra Reddy** focused their attention on the seriousness of NPAs in public sector banks**.** They argued that with the introduction of international norms of Income Recognition, Asset Classification and Provisioning in the banking Sector, managing NP As has emerged as one of the major challenges facing the Public Sector Banks. They felt that total elimination of NPAs is not possible in the banking business owing to externalities but their incidence can be minimized. To reduce the seriousness of the problem, they suggest that the banks should adopt proper policy for appraisal, supervision and follow-up of advances; special recovery cells may be set-up at regional! zonal levels; Recovery Officers should be appointed at making necessary provisions and contingencies). Seven banks were operating in 'B' category (those banks, which after operating profits have not sufficient funds to provide for the provisions, thereby incurring net losses. And the remaining was placed in the 'e' category (those banks, which were unable to earn significant income to enjoy sufficient operating profits). Apart from studying the profitability of above-mentioned groups of banks, capital adequacy position and other balance sheet trends were also discussed. More over some short-term and long-term strategies for enhancing the Profitability level were suggested.

**Ram Mohan TT(2003)** , in his paper **'Long run performance of public and private sector bank stocks"** , has made an attempt to compare the three categories of banks-Public, Private and Foreign-using Physical quantities of inputs and outputs, and comparing the revenue maximization efficiency of banks during 1992-2000. The findings show that PSBs performed significantly better than private sector banks but not differently from foreign banks. The conclusion points to a convergence in performance between public and private sector banks in the post-reform era, using financial measures of performance.

**Research Methodology**

In Indian, the whole banking industry has been divided into three groups, namely Development Financial Institutions (DFIs), domestic Private Commercial Banks (PCBs), Indian Commercial Banks (ICBs)". The report is based on a critical review of both primary and secondary data. Primary data are used in very limited cases and those are obtained through discussion with the relevant officials, who involve with reforms programs. The main sources of data used in this study are secondary data collected from various publications and annual reports of Indian Banks, annual reports of different commercial banks and statements submitted to Indian Banks. However, the secondary data are carefully scanned prior to using them in the report. In this regard, the secondary data collected from different sources are compared with those of departmental database to complement and enrich the secondary published data in order to arrive at a logical conclusion.

**NPA Norms**

Though the issue of NPA was given more importance after the Narasimham Committee Report (1991 ) highlighted its impact on the financial health of the commercial banks and, subsequently, various asset classification norms were introduced, the concept of classifying bank assets based on its quality began during 1985-86. A critical analysis to monitor credit comprehensively and uniformly was introduced in 1985-86 by the RBI by way of the Health Code System in banks. This system, inter alia, provided information regarding the health of individual advances, the quality of the credit portfolio and the extent of advances causing concern in relation to total advances. It was considered that such information would be of immense use to banks for control purposes. The RBI advised all commercial banks (excluding foreign banks, most of which had similar coding system) on November 7, 1985, to introduce the Health Code System indicating the quality (or health) of individual advances under the following eight categories, with a health code assigned to each borrowable account (source: RBI):

1. Satisfactory - conduct is satisfactory; all terms and conditions are complied with; all accounts are in order and safety of the advance is not in doubt.
2. Irregular- the safety of the advance is not suspected, though there may be occasional irregularities, which may be considered as a short term phenomenon.
3. Sick, viable - advances to units that are sick but viable - under nursing and units for which nursing/revival programmes are taken up.

4. Sick: nonviable/sticky - the irregularities continue to persist and there are no immediate prospects of regularization and the accounts could throw up some of the usual signs of incipient sickness
5. Advances recalled - accounts where the repayment is highly doubtful and nursing is not considered worthwhile and where decision has been taken to recall the advance
6. Suit filed accounts - accounts where legal action or recovery proceedings have been initiated
7. Decreed debts - where decrees (verdict) have been obtained.

**Recovery Mechanism of NPA**

The Government of India felt that the usual recovery measures like issue of notices for enforcement of securities and recovery of dues was a time consuming process. Thus, in order to speed up the recovery of NPAs, the government constituted a committee under the chairmanship of late Shri Tiwari in 1981. The committee examined the ways and means of recovering NPAs and recommended, inter alia, the setting up of 'Special Tribunals' to expedite the recovery process. Later the Narasimham Committee (1991) endorsed this recommendation, and, suggested setting up of the Asset Reconstruction Fund (ARF). It was suggested that the Government of India, if necessary, should establish this fund by special legislation to take over the NPAs from banks and financial institutions at a discount and recover the dues owed by the primary borrowers. Based on the recommendations of the Tiwari and the Narasimham Committees, Debt Recovery Tribunals were established in various parts of the country. An Asset Reconstruction Company was also established. The various measures taken to reduce NPAs include rescheduling and restructuring of banks, corporate debt restructuring and recovery through Lok Adalats, Civil Courts, Debt Recovery Tribunals and compromise settlement. In addition, some legal reforms were introduced to speed up recovery.

**Fiscal Policy and Financial Sector**

There are several channels that link the fiscal and financial sectors and in the Indian context five of them appear significant. These relate to (a) governments' borrowing programmed; (b) guarantees extended by governments; (c) mechanisms such as 'direct debits'; and (d) governments' investments in financial sector. The market borrowing programmed of the central government continued to be relatively large, both in gross and net terms. Since a large part of the borrowing programmed has to be completed in the first half of the fiscal year, in view of seasonality for demand for credit on private account, the monthly average borrowing by centre is around three quarters of a percent of GDP in recent years.

Further, there has been an upward revision in the borrowing programmed of central government during the course of every year, usually, around three quarters of a percent of GDP. It has been possible for RBI as debt manager to complete the borrowing programmed while pursuing its interest rate objectives without jeopardizing external balance, by recourse to several initiatives in terms of institution, instruments, incentives and tactics. At the same time, it has been able for RBI to reduce statutory preemptions in regard to banks to the prescribed minimum of 25% of their net liabilities. The banking system, in which PSBs account for about three quarters of activity, holds majority of the outstanding stock of government securities, and currently their holdings in excess of statutory prescriptions are far in excess of the annual borrowing programmed of the Central and State Governments.

In any case, a large part of outstanding government securities are held by Government owned financial institutions, especially in banking and insurance sectors. RBI has so far been able to successfully reconcile the interests of Government as its debt manager and of banks as regulator and supervisor. In this regard, recognizing the importance of containing interest rate risks and widening the participant profile, RBI has prescribed an Investment Fluctuation Reserve for banks and is pursuing retailing of government securities. While technological, institutional and procedural bottlenecks for retailing are being overcome by RBI, some of the constraints such as tax treatment and relatively high administered interest rates do persist.

**Impact of NPAs on Banking Operations**

The efficiency of a bank is not always reflected only by the size of its balance sheet but also the level of return on its assets. The NPAs do not generate interest income for banks but at the same time banks are required to provide provisions for NPAs from their current profits.

1. The NPAs have destructive impact on the return on assets in the following ways.
2. The interest income of banks reduced it is to be accounted only on receipt basis.
3. The current profits of the banks are eroded because the providing of doubtful debts and writing it off as bad debts and it limits the recycling funds.
4. The capital adequacy ratio is disturbed and cost of capital will go up.
5. The economic value addition (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital.

**Causes responsible for increasing NPAs**

The banking sector has been facing the serious problems of the rising NPAs. In fact PSBs are facing more problems than the private sector banks and foreign banks. The NPAs in PSBs are growing due to external as well as internal factors. One of the main causes of NPAs in the banking sector is the Directed loans system under which commercial banks are required to supply 40% percentage of their credit to priority sectors. Most significant sources of NPAs are directed loans supplied to the “micro sector” are problematic of recoveries especially when some of its units become sick or weak. PSBs 7 percent of net advances were directed to these units

Poverty elevation programs like IRDP, RREP, SUME, SEPUP, JRY, PMRY etc., failed on various grounds in meeting their objectives. The huge amount of loan granted under these schemes was totally unrecoverable by banks due to political manipulation, misuse of funds and non-reliability of target audience of these sections. Loans given by banks are their assets and as the repayments of several of the loans were poor, the quality of these assets was steadily deteriorating. In India the scope for branch expansion in rural and semi urban areas is vast and also necessary. Increasingly, NBFCs operating at such places are coming under regulatory pressure and are likely to abandon their intermediation role. These branches find priority sector financing as the main business available especially in rural/semi-urban centers. Operational restructuring of banks should ensure that NPAs in the priority sectors are reduced, but not priority sector lending. This will remain a priority for the survival of banks. Any decisions about insulating Indian banks from priority sector financing should not be reached until full-scale research is undertaken, taking into account several sources including records of credit guarantee schemes.

**Securitization and SARFAESI Act**

Securitization is a relatively new concept that is taking roots in India of late. It is still in its infancy with only a few market players. Securitization is considered an effective tool for improvement of capital adequacy. It is also seen as a tool for transferring the reinvestment risk, apart from credit risk helping the banks to maintain proper match between assets and liabilities. Securitization can also help in reducing the risk arising out of credit exposure norms and the imbalances of credit exposure, which can help in the maintenance of healthy assets. The SARFAESI Act intends to promote Securitization, pool together NPAs of banks to realize them and make enforcement of Security Interest Transfer.

**Other Legal Reforms**

One of the important factors responsible for the ever-increasing level of NPAs in the Indian banking industry is the weak legal system. According to the Indian legal system is sympathetic towards the borrowers and works against the banks' interest. Despite most of their loans being backed by security, banks are unable to enforce their claims on the collateral when the loans turn non-performing, and therefore, loan recoveries have been insignificant." However, efforts have been made to rectify these problems through the judicial process as well as by enacting laws. In 1999, a standing committee under the aegis of Industrial Development Bank of India (IDBI) was constituted to initiate a co-ordinate approach to the recovery of large NPA accounts and for institutionalizing anarrangementbetween banks and financial institutions for the systematic exchange of information in respect of large borrowers (including defaulters and NPAs). Moreover, as mentioned above, in 2002 the SARFAESI Act was passed and it empowered the creditors to foreclose non-performing loans and the underlying collateral without going through a lengthy judicial or tribunal process (Basu, 2005). All these efforts improved the recovery of NPAs by commercial banks, which in turn has helped in reducing the NPA level. The total worth of NPAs recovered through various channels was around Rs 4,039 core during 2003-04, which increased many fold to Rs 20,578 crore during 2004-05.

**Sector-wise NPAs**

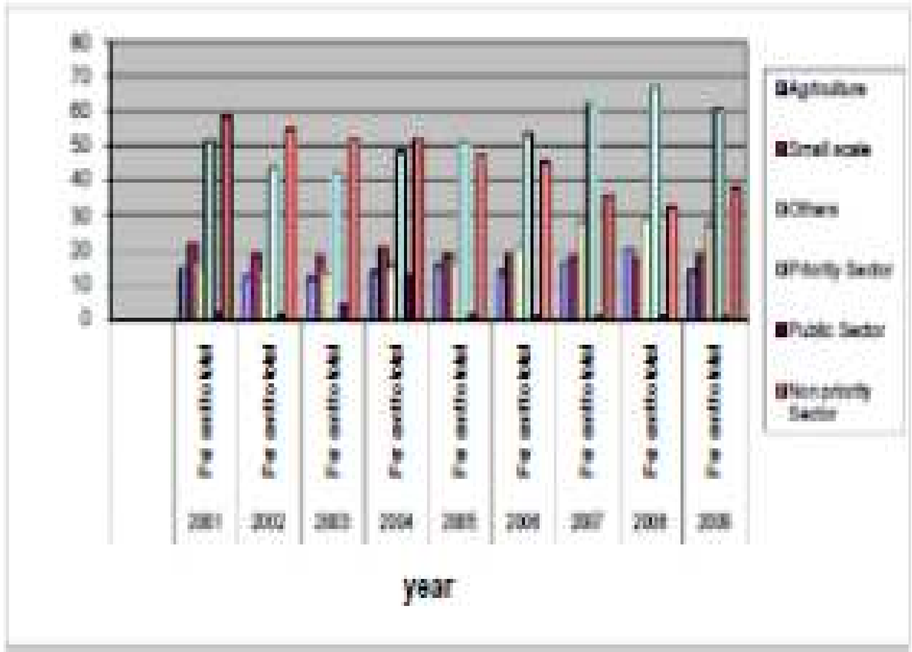
One of the important issues raised in the case of the NPAs of Indian commercial banks is that the credit policy followed by the RBI under the social banking motto of the government led to increase in NPAs.To examine this we first look at the NPAs of the priority sector vis-à-vis non-priority sector loans. Table reveals that the NPA of the priority sector is indeed higher than the NPA of non-priority sector and this trend has been continuing over the year.

**Sector Wise Non Performing Assets of Indian Schedule d Commercial Banks**
**(RsCrore,RealValues)**

| Year | Item | Agriculture | Small Scale | Others | Priority Sector | Public Sector | Non Priority Sector |
|---|---|---|---|---|---|---|---|
| **Bank Group: State Bank and Associates** | | | | | | | |
| 2004 | Amount | 1351 | 1232 | 1272 | 3856 | 119 | 4216 |
| | Per cent to total | 16.5 | 15.0 | 15.5 | 47.1 | 1.5 | 51.5 |
| 2005 | Amount | 1504 | 1175 | 1926 | 4641 | 111 | 5042 |
| | Per cent to total | 15.4 | 12.0 | 19.7 | 47.4 | 1.1 | 51.5 |
| 2006 | Amount | 1750 | 1210 | 2547 | 5508 | 95 | 4420 |
| | Per cent to total | 17.5 | 12.1 | 25.4 | 55.0 | 1.0 | 44.1 |
| 2007 | Amount | 1721 | 982 | 2494 | 5197 | 136 | 3761 |
| | Per cent to total | 18.9 | 10.8 | 27.4 | 57.2 | 1.5 | 41.4 |
| 2008 | Amount | 2248 | 1039 | 2739 | 6026 | 65 | 4212 |
| | Per cent to total | 21.8 | 10.1 | 26.6 | 58.5 | 0.6 | 40.9 |
| 2009 | Amount | 1355 | 1371 | 2992 | 5718 | 120 | 6262 |
| | Per cent to total | 11.2 | 11.3 | 24.7 | 47.3 | 1.0 | 51.8 |
| **Nationalised Banks** | | | | | | | |
| 2004 | Amount | 2561 | 3871 | 2922 | 9026 | 2379 | 9669 |
| | Per cent to total | 13.8 | 20.8 | 15.7 | 48.6 | 12.8 | 52.0 |
| 2005 | Amount | 3294 | 3972 | 3569 | 10834 | 274 | 10120 |
| | Per cent to total | 15.6 | 18.8 | 16.9 | 51.3 | 1.3 | 47.9 |
| 2006 | Amount | 2962 | 4045 | 4482 | 11489 | 164 | 9758 |
| | Per cent to total | 13.8 | 18.9 | 20.9 | 53.7 | 0.8 | 45.6 |
| 2007 | Amount | 2938 | 3202 | 5095 | 11235 | 212 | 6418 |
| | Per cent to total | 16.5 | 17.9 | 28.5 | 62.9 | 1.2 | 35.9 |
| 2008 | Amount | 3349 | 2890 | 4852 | 11091 | 137 | 5376 |
| | Per cent to total | 20.2 | 17.4 | 29.2 | 66.8 | 0.8 | 32.4 |
| 2009 | Amount | 2509 | 3356 | 4878 | 10743 | 201 | 6770 |
| | Per cent to total | 14.2 | 18.9 | 27.5 | 60.6 | 1.1 | 38.2 |
| **Private Banks** | | | | | | | |
| 2004 | Amount | 248 | 681 | 408 | 1338 | 40 | 4204 |
| | Per cent to total | 4.4 | 12.2 | 7.3 | 24.0 | 0.7 | 75.3 |
| 2005 | Amount | 307 | 638 | 497 | 1442 | 28 | 4331 |
| | Per cent to total | 5.3 | 11.0 | 8.6 | 24.9 | 0.5 | 74.7 |
| 2006 | Amount | 391 | 613 | 731 | 1735 | 3 | 4210 |
| | Per cent to total | 6.6 | 10.3 | 12.3 | 29.2 | 0.1 | 70.8 |
| 2007 | Amount | 623 | 467 | 999 | 2089 | 2 | 4601 |
| | Per cent to total | 9.3 | 7.0 | 14.9 | 31.2 | 0.0 | 68.8 |
| 2008 | Amount | 993 | 441 | 880 | 2314 | 0 | 6470 |
| | Per cent to total | 11.3 | 5.0 | 10.0 | 26.3 | - | 73.7 |
| 2009 | Amount | 975 | 454 | 1035 | 2464 | 51 | 8916 |
| | Per cent to total | 8.5 | 4.0 | 9.1 | 21.6 | 0.4 | 78.0 |

Source: Computed by author using RBI data

Figure 2: NPAs from Different Sectors in Nationalised Banks: Percentage to Total




As can be seen from the table, the average share the NPA of non-priority sector in the total NPA is around 50.5 per cent, 53.4 per cent and 74.7 per cent for State Banks Associates, Natiolisation of banks and Private banks respectively in 2005, whereas, the average share of NPA of the priority sector in the total NPA is around 46.2 per cent, 47.9 per cent and 23.9 per cent for Sate Banks Associates, Natioalisation banks and Private banks respectively (in 2005). We also observe that NPA share of the non-priority sector increased, especially for the public sector banks in recent years vis-à-vis their NPAs from the priority sector (see figure for 2009 in Table ). This may partly be due to the loan waiver policy adopted by the government for the priority sector. One can indeed see that NPAs in the agricultural sector show a sharp decline. Another important observation is that the NPA of the priority sector is less in private banks compared to other bank groups. In the case of the sub-category of priority sector, the share of agriculture sector NPA in the total NPA is only around 4.61 per cent for private banks whereas it is around 16 per cent for State banks Associates and 13 per cent for private banks.

While it has been often highlighted in the literature whenever NPA in the priority sector is less than that of the non-priority sector, a point often missed is that the priority sector constitutes about 40 per cent of total lending. Therefore, it is important to examine NPA figures in proportion to the advances made in that particular sector. Computation of sector-wise NPAs indeed reveals that NPA from the SSI sector is much higher than the other sectors. While NPAs from the agricultural sector was about 12.7 per cent in 2002 for the nationalized banks, it was as high as 18.8 per cent for the SSI sector in the same year. For the non-priority sectors together, the NPA as a percentage of total advances declined from about 8 per cent to 4 per cent from 2002 to 2005. This percentage however declined to 6 per cent for the agriculture sector and to 11 per cent for the SSI sector in 2005. Thus, the declining trend is prominently uniform across all sectors.

While the problem of non-recovery of agricultural loans is a well-discussed issue (Bardhan, 1989, Bell and Srinivasan, 1989, Rajeev and Dev, 2007), not many13 studies in India have focused on the non-recovery of loans in the SSI sector (see Gang, 1995 and Rajeev, 2008). The above figures reveal that even though the SSI sector currently has a higher NPA to total advance ratio there is an improvement in recovery rates and NPA from this sector shows a declining trend even in real terms. An important question arises at this juncture. While it is essential to reduce NPA to sustain banks, will such an Endeavour have an adverse effect on the poor, especially poor farmers and small entrepreneurs. The issue assumes importance as this group constitutes more than 60 per cent of the population of India.

**Conclusion**

The NPA is the root cause of the global financial crisis that we observed recently. The world is still trying to recover from the after-effects of the crisis. The problem of NPAs can be achieved only with proper credit assessment and risk management mechanism. In a situation of liquidity overhang, the enthusiasm of the banking system to increase lending may compromise on asset quality, raising concern about their adverse selection and potential danger of addition to the stock of NPAs. It is necessary that the banking system is to be equipped with prudential norms to minimize if not completely to avoid the problem of NPAs. The onus for containing the factors leading to NPAs rests with banks themselves. This will necessitates organizational restructuring, improvement in the managerial efficiency and skill up gradation for proper assessment of credit worthiness. It is better to avoid NPAs at the nascent stage of credit consideration by putting in place of rigorous and appropriate credit appraisal mechanisms. The problem of NPA has received considerable attention after the liberalization of the financial sector in India. Accounting norms have been modified substantially and mechanisms are in place for reduction of bad loans. Our discussions with banks, however, show that such decline is mainly due to the awareness of the problem of bad loans at the bank level (see Rajeev and Mahesh, 2007). It remains true that NPA in the priority sector is still higher than that of the non-priority sector. Within the priority sector, the SSI's performance is the worst. However, even this sector has shown reduction in bad loans over time. In the process of reducing NPAs, will banks shun the poor borrowers? In this context, the self-help group model can be applied to some of the sectors to help the poor access loans and ensure repayment for the banks.

**Refference**

Benson Kunjukunju (2008), Commercial Banks in India: Growth, Challenges and Strategies, New Century Pub., P.342

Lakshmi Narasimhan, S. (1999), "NPAs improve, but need more attention", 24% rise in Banks NPAs in 2nd QR and Capital Adequacy Ratio declines by 2% Points, says Assoc ham.

Bidani S.N., "Managing Non-performing Assets in Banks" "Are non - Performing Assets Gloomy or Greedy from Indian International Journal of Management & Business Studies

Jigar J. Soni. "A Project on Comparative Analysis On Non Performing Assets Of Private and Public Sector Banks" , IBM Ahemadabad.

Report on trend and progress of banking in India 2004-2005.

Rajaraman I, S Bhaoumik and N Bhatia (1999). NPA Variations Across Indian Commercial Banks: Some Findings. Economic and Political Weekly, 34 (3/4): 161-68

Goldsmith, Raymond W (1969). Financial Structure and Development . Yale University Press.

Kunt D A and E Detragiache (1997). The Determinants of Banking Crises: Evidences from Developed and Developing Countries. IMF Staff Papers, 45 (1): 81-109.

Gang, I N (1995). Small Firms in India: A Discussion of Some Issues. In Mookherjee, D (eds), Indian Industry: Policies and Performance. New Delhi: Oxford University Press.

Mor N and B Sharma (2003). Rooting out Non-performing Assets. Paper presented at the 5th annual conference on Money and Finance in the Indian Economy, at IGIDR, Mumbai.

Parera, R. I., Vijai, M. K. and Mahesh, S. (2005). India's Best Banks: The Business Today KPMG survey of the best Banks in India. Business Today, Jan.2, 2005.

Kapil S., Kanwal N. and Nagar, K. N. (2003). Bench Marking Performance of Indian Public Sector Commercial Banks. Indian Journal of Accounting, XXXIV(1), 24-28.

Mittal, R.K. (2001). Performance evaluation of RRBs: A case study of hisar-sirsa-kshetriya gramin bank. The Management Accountant, 36(11), 833-844.

Edisurya, P. and Fang, V. (2001). Financial deregulation and financial perform an a comparative study of Indian banks and selected OECD banks. Journal of Accounting and finance, 15(2), 5-24.