

## **Management of Non-Performing Assets of Public Sector Bank in India: Identification, Magnitude, Causation and Resolving**

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### **Abstract:**

*The banking sector in India experienced significant transformation post-independence, notably with the nationalization of major banks in 1969 aimed at enhancing credit to priority sectors. This led to substantial growth, with public sector banks (PSBs) holding 70% of banking resources by 2017. However, the global financial crisis of 2008 led to a sharp increase in Non-Performing Assets (NPAs), where principal and interest on loans are overdue. NPAs in India were classified into substandard, doubtful, and loss assets by the RBI, escalating to 9.3% of total loans by 2017. Factors contributing to NPAs include both macroeconomic conditions like global crises and internal factors such as poor bank management and aggressive credit policies. The paper discusses legal measures such as the Insolvency and Bankruptcy Code 2016, and remedial measures including privatization, governance reforms, and enhancing RBI regulations to resolve NPAs. Further suggestions include improving recovery strategies, staff training, and stricter loan appraisal mechanisms. Effective management of NPAs is crucial for the stability and progress of India's banking system and economy.*

**Keywords:** *Non-Performing Assets (NPAs), Public Sector Banks, Insolvency and Bankruptcy Code, Banking Reforms, Loan Recovery, Credit Appraisal.*

### **Introduction:**

The banking and finance sector was much weak prior to the Independence. During the Great Depression and also world war period these was a spate for bank failure in India. Reserve Bank of India was worried to check the loss to depositors. In 1964 RBI has established a deposit Insurance Corporation to check the losses to the banks. This has given a little stability to banking and financial sector in India. This resulted in the growth of banking and financial sector. But this growth was generating concentration of wealth in the

hands of few industrial houses and banks door for credit were not properly open for the small entrepreneurs for this purpose in 1969 that time prime minster Mrs. Indira Gandhi has nationalized 14 commercial banks and subsequently nationalized 20 banks. And after that there is tremendous growth in banking sector and efforts were made to enhance the disbursement of credit to priority and non-priority sectors.

In the year 1991. Indian Economy was opened for globalization and banks became more cautious in sanctioning loans and advances on account of piling NPAs

(Non-performing Assets) Bank credit in India as a proportion of GDP has increased to 27 percent in 2000 and by 2015 it has increased to 52 percent of GDP. During this period private sector investment has increased from 24 percent to 33 percent of GDP. The public sector banks constitute over 70 percent of banking system and are in a state of crises. The NPAs have piled up and presently stand at 10 percent of total assets and stressed assets stand at 12 percent of total asset of banks.

**Meaning of NPAs:**

An asset is classified as NPA (Non performing asset if due in the form of principal and interest is not paid by the borrower for a period of 90 days. A non performing asset shall be a loan or an advance where –

1. Interest or principal remain overdue for a period of 90 days in respect of term loan.
2. The account of overdraft/cash credit remain out of order for 90 days.
3. A bill purchased or discounted remain overdue for 90 days or more.
4. An advance granted for agricultural purpose remains overdue for payment interest or principal for period of two harvest seasons.
5. Crop loan granted for short duration remain unpaid for installment for period exceeding two harvest seasons.
6. A long-term duration crop loan remains unpaid for once crops seasons.
7. For offer loans any amount remains unpaid for 90 days or more.

8. Other credit facilities if repayment is not made as per terms became non performing.
9. However, RBI suggested that a bank cannot book interest on accrual basis.

**Classification of NPA:**

For the purpose of classification assets are classified on the basis of the strength and on the type of collateral securities into following categories.

- a) Substantial assets – The are assets which remained NPAS a period not less than or equal to 12 months.
- b) Doubtful assets- which is likely to remain NPAS for a period not less than or equal to 12 months.
- c) Loss assets- they are the assets identified by bank auditors or by RBI inspectors as loss asset for which there is no security or there is considerable erosion in the realizable value of security.

**Extent of NPAs in Indian Banking System:**

The NPAS in the Indian Economy stands at Rs. 10.35 Crores. About 85 percent of those NPAS are from loans and advances of public sector banks (2018) for example the NPAS of state bank of India are worth Rs. 2.23 lakhs crores.

The growth of NPAs and return on Assets are shown in following table:

**Table -1**

Year	2008	2010	2012	2014	2016	2017
NPAS as percent of total loans	2.3%	2.5%	2.9%	3.8%	7.5%	9.3%
Return on Assets in percent	1.1%	1.0%	1.1%	0.8%	0.4%	0.4%

The above table shows that during the decade time from 2008 to 2017 the NPAS have grown to 4 times in terms of percentage however the growth in term of values looks exorbitant. The rate of return on the Assets is coming down (became NPAS do not yield any return) resulted in the decrease of profitability of banks.

**Etiology of the rise of NPAs:**

There are two sets of factors leading of rise in NPAs. One is external and another is internal. Among external leading factor is decrease is global commodity prices which resulted in slowing down of exports, while internal factors are intrinsic to the Indian Banking Sector.

Most of NPAS belong to the loans granted in 2000 at this time economy was blooming and business outlook was very positive. At this time large corporate were granted loans for the projects based on extrapolation of their recent growth and performance. With the loans being available more easily than before, corporate, grew highly leveled, implying that most financing was through external borrowing rather than internal promoters' equity. It was well till 2007 but when in 2008 there were global financial crises, the economic growth stagnated, result was decreased in the repayment capacity of these corporate decreased. This contributed what is now knows as India's Twin Balance Sheet problem, where both the banking sector (that gives loan) and corporate sector (that takes and has to repay these loans) have under financial stress.

Moreover, the practice of ever greening of loans doers by the banks to the projects who were under performing were given fresh loan to pay off their interest has

added to the more NPAS. It is unfortunate to tell here that, recently these have been frauds of high magnitude that have also contributes to rising of NPAS. Earlier they were small but now these frauds have been increasing and there have been number of instances of high-profile fraudster being penalized.

**Determinates of NPAS of commercial Banks in India:**

The various factors Causing and determining NPAs are divided into two broad categories macroeconomic determinants, which influence all banks without any distinction and (b) banks specific factors which affect different banks differently.

**a. Macro-Economic Factors** - It was found that the relationship between weakening of macro-environment and failure of banks was positive in US and it was pointed out by brown bridge. But growth of Real GDP (RGDP) and NPA is inverse. Therefore, as slowdown of economic activity results in increase NPAS. Similarly, the inflation and NPAS is found to be inverse. An inflation in economy with heavy import restrictions, would lead to high profits for business enterprises, because of fact that wages and costs of raw material don't rise immediately and consequently there is windfall rise in profit earning would boost loan repayment ability and hence NPA would decrease other macro-economic factors constitute political interference competition among different banks, natural calamities etc. Among these factors political interference is worst in case of Indian Banks. Many businesses corporate get this advantage and the high-level officers were pressurized by politicians either to grant loans without

proper securities or to corporate having doubtful repayment capacity. The competition among the different banks also resulted in capacity and resulted in the piling of NPAS with banks. Moreover, Indians Natural environment is volatile and is exposed to risks of monsoon. This results in fluctuation of agricultural production which results in the losses to agriculturists making their loans defaulted. Other calamities like earthquake, plant diseases etc. also contribute in losses by natural calamities and results in non-repayment of loans.

**b. Bank specific and internal factors:** The bank specific factors include rapid credit growth, poor bank management and aggressive credit policies with eagerness increase market share, results in a growth in bad credit and NPA. This can be attributed to deliberate reformation of lowering of credit standards, reflect a risk-taking behavior on the part of bank management. Moreover, failures to enforce high levels of bank efficiency and aggressiveness to enlarge to share of business results in increasing ratios of NPAS to loans.

Another specific factor is connection between cost efficiency and NPAS found as strong evidence of bad management as a reason for rise in NPAS. Similarly, the banks with larger credit deposit ratios had higher NPAS. It was also found that rapid Credit Growth, bank Size, capital and market power were all directly associated with rising NPAS. Moreover, increase in the operating cost also contribute to increase in NPAS. However, spending more for loan recovery results in reduction of NPAS.

Other internal factors which are also positively associated with the NPAS. They

are first one is appraisal system of utilization and repayment of loan is appraisal story and therefore inefficient on the part of borrowers to utilize the loan in proper way and misdirection of funds leads to rise in NPAs. Secondly the irrational system of sanctioning of loans, leads to sanctioning of bad quality. Of loans which have inherent tendency to poor repayment system, certainly results higher accumulation of NPAS. The third factor, that can be attributed to the increase of NPAS is delegation of power for sanctioning loans to incompetent persons. Where loans are not properly appraised and get results into the NPAS. Fourthly, the improper scrutiny of various information given by the borrower is genesis of the loan becoming a default and result to the rise in NPAS. Fifthly, the pressure of over optimistic targets of credit expansion, results in reckless sanction of loans with risky repayment capacity leads to genesis of NPAS. Sixthly, the non-follow up of recovery also leads to increasing of NPAS. Lastly the banks face the shortage of technical staff for scrutiny of information and pre-sanction verification as well as personal visits to the borrowers to pursue them for recovery of loans.

These two sets of factors operate with combinations and permutations and lead to increase in NPAS of banks

**Measures to solve the problems of growing NPAs:**

The measures that can be taken to resolve and present NPAS are of two categories. Firstly, are regulatory means legal measures and secondly the remedial measures for banks prescribed and regulated by RBI for internal restructuring of stressed assets.

**a. Legal Measures:** It was in the form of enactment of insolvency and Bankruptcy Code 2016 (IBC), which provide 180 days recovery process for insolvent accounts, where borrowers are unable to pay their dues. Under IBC the creditors of these insolvent accounts, pressured over by an insolvency professional decide whether to restructure the loan or to sell the defaulters assets to recover the outstanding amount. If a timely decision is not arrived at, then defaulters' assets are liquidated under IBC. The proceedings under IBC are handled by Debt Recovery Tribunal for personal insolvencies and for corporate insolvencies National Company Law Tribunal (NCLT) adjudicate the matter.

**b. Remedial Measures:** The remedial measures have a very vast scope than legal measures, where, different options are discussed when our banking system was beleaguered with non-performing assets (NPAs). RBI in its financial stability report of Dec. 2017 stated that NPAs stand at 10. Percent of all assets, while stressed assets at 128 percent and related frauds, amount to INR612.6 billion in the last five years. It resulted in failure of integrity and competence of banking system which get plagued with NPAs. Over this issue a round table, seminar was organized in early 2018 at Mumbai where Dy. Governor of RBI, along with representation of bankers, corporate, IMF, Financial Journalist and academics key issues discussed were privatization, improving governance regulatory system and reengineering of banking practices. These issues discussed are summarized below:

**c. Privatization:** - Nationalization of banks, at is was called the "original sin" was considered necessary in 1969 by that time Prime Minister Indira Gandhi was

undertaken as collusion between industry and finance. South Korea was another example where banks are state owned but are disciplined under Chaebols rather than capitulating to political pressure. But in India Public Sector Banks (PSBs) led to a financial deepening in the country, because it has umbilical cord connecting them to politicians and bureaucrats, which in turn stems from ownership structure of PSBs. The Nationalization has led to various inefficiencies in the banks such as (a) weak powered boards (b) Muted incentives to senior management to effect organizational changes (c) Continual bureaucratic madding resulting to systemic risks (d) External vigilance enforcement causing paralyzed decision making and also resulting to frauds and corruption (e) Various opacities, and (f) Distribution in human Resource Management etc. to overcome these insufficiencies the various options for privatizing PSB can be tried as below

- (i) Creating a Holding Company Structure for banks (P.J. Nayak Committee) where government shareholding will be divested below 52 percent and a bank holding company (BHC) to create to monitor bank issued a professional level
- (ii) Creating a sovereign wealth fund where proceed of privatization will be consolidated and shall be managed professionally.
- (iii) Preparing a separate entity which may be government owned and controlled for all agricultural and social sector lending and corporate lending to be privatized.
- (iv) Recapitalization and Governance reforms can enhance the market valuation of PSBs and should lead to a path for privatization.

(v) Single Big Banks: - India may have single big bank mimicking life Insurance Corporation mode for PSBS. But there is possibility of getting it affected by too-big-to-fail syndrome.

(vi) Creating “Bad Bank”- The idea of this bank is where the NPAs of all PSBs may be transferred in it and PSBs balance sheet can be cleared. But this action likely to create more complexities.

Thus, it appears that privatization is not a panacea.

**b) Governance Reforms:**

The reforms those are suggest to improve governance

- i) Nayak Committee suggested that the selection of bank chairperson on should not be controlled by Ministry of Finance, but it has not digested to bureaucrats.
- ii) PSBs should have severe identity and have such a restructuring that they will operate as commercial banks and shall have a coherent business strategy or vision and shall make best use of public money.
- iii) The term of chairperson must be synchronized with the period make them able to implement constructive charges as policy.
- iv) Chairman’s salary package must have incentives with the professional decisions they bring to materialize. This will attract professional talents to banking sector.
- v) Penalize wrongdoer in materialistic way and not the taken or nominal way but to create a deterrence have reformatory influence.

vi) Sharpen the credit appraisal and monitoring to diagnose the defects capital, business purpose and character.

**c) Improvement in RBI governance and regulations:**

The RBI is trying best to Central PSBS. But following improvement are need in its efforts.

- i) The RBI may work on line of bank of England by subsidiarization its prudential regulatory and supervision functions. But the recognition that lost synergies from such separation contributed to global financial crisis demands caution.
- ii) The RBI to be given supervisory capacity to conduct forensic audits and this must be strengthened with human as well as technological resources.
- iii) RBI regulations have permitted bank to “evergreen” credit but in effect it delays the recognition and also the resolution of NPAs. So, RBI regulations must take away incentives of banks to kick the can down the road and “extend and pretend”. Therefore, it is needed to recapitalization of PSBS which is to can be carried out with reforms.

**d) Reengineering of banking systems:**

Our present banking system needs to be reengineering by following measures-

- i) There is need for creation of vibrant secondary market for NPAs is crucial. The lack of transparency in price of the assets is holding this book. The reason is lack of autonomy to PSB and fear of vigilance action.
- ii) The internal and concurrent audit system of banks become old and needs to be strengthened.

- iii) There is need for better market intelligence, fund flow and financial analysis to diagnose willful defaults for banks.
- iv) The maker-checker systems require human intervention and are therefore, prone to capture and corruption. Therefore, to prevent financial frauds there is need for Artificial Intelligence. For this core banking system (CBS) needs to be linked with Financial Technology.
- v) For good quality of financial information, the traditional means like speaking to people in industry, suppliers and customers should be valued and used time to time in combination with artificial intelligence.
- e) **Other Measures:** To solve the problem of non-performing Assets following additional measures can also be suggested.
  - i) There should be regular training programmes on credit and NPAs management for executives.
  - ii) Banks should organize recovery camps to reduce levels of NPAs.
  - iii) Bank officials should organize periodical visits to borrowers' business places.
  - iv) Bank should develop a good quality, Credit Approval and Risk Management Mechanism by improving documentation system. They should sanction the loans with prudential norms to avoid additions to NPAs.
  - v) Banks should develop a monitoring and audit system to the assets which have potential to become NPAs.
  - vi) Banks to take help of Lok Adalats and Debt Recovery Tribunals to decide on NPAs of Rs. 10 lakhs and above.
  - vii) Banks to find out whether loans are used for original purpose they have taken and are not misdirect for their use.
  - viii) There should be a special committee to be constituted to assess NPAs.
  - ix) An appropriate SWOT analysis should be done for enterprises before disbursement of the advances.
  - x) The banking staff to be educated on basis principles of banking i.e. safety, liquidity and profitability. This will enable them to take prudent decisions.
  - xi) Banks should take care that assets pledged or hypothecated are fully insured to safeguard the interest of banks.
  - xii) Banks to organize recovery competitions for their branches. Similarly, to they should reward regular preparers and penalize with defaulters.

### Conclusions:

The strength of the economy is closely related to the reliability of its banking system. The problem of NPAs can be achieved only with appropriate credit appraisal and risk management mechanism. It is very important for the bank to keep the level of NPAs as low as possible. Because NPA is a kind of barrier in the success of a bank which affects its performance. For this purpose, banks in their loan appraisal procedure should pay special attention to macroeconomic forecast made by domestic agencies to maintain stability of banking system. To prevent or minimize adverse impact of NPAs on an economy, banks should strengthen the loan appraisal procedure and recovery measures.

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