

Non-Performing Assets in Public Sector and Private Sector Banks: A Comparative Study

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Abstract

“When the lifeline of nation is itself in ICU, state of economy is not in good health.” Well-performing banking industry is core of a healthy functioning economy; it facilitates the flow of funds in the economy and ensures financial resources are allocated efficiently towards promoting economic development and growth. It is well known that banks play an important role in maintaining the economic lifeline of the country. For instance, banks allocate funds from savers to borrowers and provide specialized financial services. These services help in maintaining cash reserve in the country. The modern Indian banking system, started in the 19th century, supports the world’s fastest-growing large economy but is grappling with challenges that test its strength and resilience. The primary problem that banks in India face today is of non-performing assets (NPAs). An NPA account is a loan asset, which has ceased to generate any income for the bank whether in the form of interest or principal repayment. Different categories of NPAs are classified according to various timeframes given and several other criteria. Rate of higher NPA is a signal of warning not only for banks but also for the country, because firstly the shareholders of the bank are adversely affected by the NPAs of the bank, depositors get affected because the bank starts charging higher rates to compensate for NPA losses. Further, liquidity problems may ensue when the quantum of NPA in books of accounts of the bank starts rising. Recently, in this year the Nirav Modi scam was exposed which had huge impact on the credibility as well as profitability of the banking sector. When the issue regarding NPA is being raised, it is observed that public sector banks have much higher NPA compared to the private sector banks. Recent data on NPAs shows that 21 public sector banks saw their bad loans pile grow by Rs. 1.19 lakh crore to Rs. 8.97 lakh crore in the March 2018 quarter, while that of 18 private banks surged by Rs. 19,446 crores to Rs.1.28 lakh crore in the March 2018 quarter from Rs. 1.09 lakh crore in the December 2017 quarter. It can be observed that there is much parity, when comparison is made in the quantum of NPA of both types of banks. There are different reasons for such inequality in numbers, primary one of them being priority-sector lending. Banks are required to pay some percent of loans to priority sectors such as agriculture, MSMEs and other small-scale industries. However, these sectors do not share the reputation of paying loans back on time. Hence, due to various other factors involved, the loans given to such sectors become non-performing assets for a bank. Other reasons for higher NPAs and suggestions to reduce them are provided in the subsequent parts of the paper. The paper, which primarily deals with the issue of NPAs, attempts to make a comparison between NPAs in public sector banks and NPAs in private sector banks. To give a theoretical background for the paper and to understand the concept of NPAs, in the first chapter of the paper, banking and history of Indian banking industry, challenges facing the banks and types of banks have been explained. In the second chapter of the paper, concept of NPAs has been introduced, their classification, reasons and suggestions to reduce have been elucidated. In the third chapter, data showing comparison between NPAs of public-sector and private-sector banks has been shown. In the fourth chapter, suggestions to reduce the parity and redefine the structure of the banking system are dealt with. Finally, the sixth and the last chapter deals with conclusion and opinion of the authors.

Keywords: NPA, Public Sector Banks, Reserve Bank, Comparison, banking system, loan asset

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INTRODUCTION

Banking in India is said to have originated in the 18th century. The first bank was established

in the year 1770 in the name of *Bank of Hindustan*; however, this bank got liquidated in the year 1829-32. Then the *General Bank of*

India was established in the year 1786, which came to an end in 1791. In our country, the banking phase can be divided into two phases: firstly, pre-independence phase which covers the period from 1786 to 1947 and secondly the post-independence phase, which covers the period from 1947 till now. The post-independence phase can further be classified into various categories, firstly from 1947 to 1991 and secondly from 1991 till today.

The pre-independence phase had witnessed many banks; it had almost 600 banks at that time. The origin of banking system can be traced with the foundation of Bank of Hindustan in Calcutta in the year 1770. Thereafter many banks came such as General bank of India which came in 1786 and Oudh commercial bank in the year 1881; this was the first commercial bank in India, which came to an end in 1958. Despite these banks, which failed after some time, there are some banks which were established in pre-independence phase and are still operating. Some of those banks are, Allahabad Bank which was established in 1854; Punjab National Bank established in 1894, its headquarter was in Lahore at that time. Then we have Bank of India established in 1906, Bank of Baroda established in 1908 and Central Bank of India which was established in the year 1911 [1]. Three presidency banks were established under the East India Company which were namely Bank of Bengal (1806), Bank of Bombay (1840), Bank of Madras (1843), which were merged in a single entity in the year 1921 which came to be known as Imperial Bank of India. This imperial bank of India was later renamed and converted to State Bank of India in the year 1955 [2]. A committee was set up in the year 1926, known as Hilton Young Commission, which recommended for constitution of Reserve bank of India as an apex bank. Based on this recommendation, RBI was constituted in the year 1935.

The main characteristic of this phase is the nationalization of various banks. Prior to this, banking sector primarily focused on the urban parts of the nation and the rural parts were neglected. The government to eradicate the problem of disparity and to ensure economic

planning came up with the tool of nationalization. On 1st January 1949, the Reserve Bank of India was nationalized. Then fourteen commercial banks were nationalized under the leadership of the Prime Minister Smt. Indira Gandhi in the year 1969. Then in the year 1980, six more banks were nationalized. The regional rural banks were constituted on the recommendation of Narasimham Committee on 2nd October 1975.

Even after nationalization, various sectors of the economy were still untouched and not covered by these banks; therefore, in 1991 the Narasimham Committee gave the recommendation for allowing private sector players in the economy. Accordingly, RBI gave licenses to ten private sectors banks. Some of these private players are ICICI, HDFC, AXIS Bank, INDUSIND bank and DCB. In 1998, the Narasimham Committee again recommended for more such players and as a result we have Kotak Mahindra Bank and Yes Bank [3].

Types of banks prevailing in India are:

- Organized and unorganized banks: Those banks which do not fall under the control of the Reserve Bank of India are called unorganized banks. Indigenous banks are one such example for an unorganized bank. On the other hand, those banks which are regulated and controlled by the Reserve bank of India are called organized banks.
- Central bank: In every country there exists an apex bank which regulates the other banks in the nation and supervises them. It acts as the bank of the banks and lends money to them whenever needed. In India we have Reserve Bank of India as the central bank [4].
- Commercial banks: These are the banks, which accept deposits from the general public and lend money to traders, farmers, firms, general public, etc. Through the process of accepting deposits and lending money these banks create credit in the economy [5].
- Cooperative banks: These are the banks which are established under the provisions of Cooperative Societies Act. Originally the prime objective of these banks was to

provide loan to the farmers at a very low interest rate.

- Regional rural banks (RRBs): These banks were established to meet the needs of weaker section of the economy which are not covered by various other banks.
- Foreign banks: We have many foreign banks in India like the Citi Bank, the Hong Kong and Shanghai Bank, and the Bank of America which are actively participating in the economy of our country through banking system [6].

To explain NPA in greater detail, one must understand different kinds of challenges facing the banks:

Large over dues– This is one of the major challenges and problems faced by the banks. The banks must provide loans to various sectors of the economy and excess of granting such loans leads to a misbalance situation in the banks. This negatively affects the working of the bank and may prove fatal for the banks in the long run.

Accumulation of NPAs –The piling up of large numbers of NPAs in the banks shows the negative image towards its functioning. This largely affects the capital adequacy ratio of the bank. The banks are still lacking the proper machinery and the method to effectively deal with these NPAs. These are considered as bad loans. As per a survey, India's accumulation of these kinds of loans is greater than the gross domestic product of at least 137 countries [7].

Cyber threats – With the advancement of technology and digital banking and net banking schemes in our country, we are witnessing increase in the number of cyber-crimes day by day. This issue is becoming a pain in the neck for every bank and financial institution.

Bank frauds – In recent past, our country has suffered from various instances of banking frauds which are now increasing day by day. The banks are still not able to find out a proper solution for this, as increase in number of such frauds shows that our banking system has failed to provide a proper remedy in this regard.

Political hindrance – Due to the effect of nationalization, banks must suffer because of the hindrance caused by various political factors. This affects the smooth functioning of the banks and ultimately the economy. Nationalized banks often face lots of difficulties due to various political pressures and political interference in the working of banks. Political pressure adversely affects the selection of suitable personnel in the management of the bank, which affects the policy of granting of loans [8].

CONCEPT, REASONS, AND CLASSIFICATION OF NPAS

NPA is defined as a loan asset, which has ceased to generate any income for a bank whether in the form of interest or principal repayment. Simply stating, assets which generate income are performing assets while those which do not are termed as non-performing assets. There can be various examples of loans, which if not paid within the specified timeframe, turn out to be NPA – overdraft, cash credits, agricultural advances, overdue bills, expected payments overdue, loans, etc. [9].

An NPA account is not merely responsible for reducing the profitability of a bank, but it also leads to increase in the carrying costs, the direct consequence of which is excess and inevitable attention by the management. It is pertinent to note that a high level of NPA is as well responsible for lowering down the bank's net worth as banks are then put under strain to maintain a required level of capital adequacy ratio [10]. When it comes to the lack of an adequate profit level, banks ultimately go for their internal financial strength to fulfil the norms, thereby slowly eroding the net worth.

Generally, the time period for classifying an asset as an NPA is 90 days of the non-payment of interest or the principal. For example, if a company that has borrowed 1 lakh as loan from a bank and interest payment to be made is 3000 per month, and it fails to pay the same within a span of 3 months, i.e., 90 days. This would entitle the bank to classify such a debt as an NPA. Moreover, a loan can also be categorized as NPA if the party makes all the

interest payments but is unable to pay the principal amount in its entirety at the end.

There are a lot of ways in which an NPA may impact a bank or any other financial institution. To name a few are – adverse effect on the profitability, contraction of assets, management of liability, lowering the capital adequacy, dwindling of the shareholder's confidence, losing the public confidence, etc. These are only some of the harmful effects an NPA may bring with itself for a bank, other than many [11].

There cannot be any sole reason for NPA as a lot of reasons may contribute in its development. Though, to list down a few reasons:

- Lack of follow up measures
- No proper monitoring
- Alteration in economic policies
- Terrible auditing practices
- Short of coordination amongst the banks
- Corruption by the bank officials by favorably granting loans

The presence of NPA may cause a threefold loss to a bank. Firstly, the non-payment of interest or the principal reduces the cash flow of the bank, which would decrease earnings. Secondly, loan loss reduces the capital to provide for further loans. Thirdly, once the actual losses are known, they are then written off against the actual earnings [12].

Assets that pay the principal and interests on time are very well classified as performing assets or standard assets. Non-performing assets that do not pay the interest or principle on time are further classified into three categories based on the time frame [13]. Post-liberalization in 1991, the government appointed various committees to review the functioning of the Indian banking sector and recommend policy changes to make the banks more healthy, competitive and efficient. This classification was not done earlier but post the Narsimham committee 1993 when it was suggested to classify non-performing assets so that they can be treated as per the classification [14].

They are classified as:

1. Substandard assets—A substandard asset has remained as an NPA for more than 12

months at a time. If they are not corrected and handled at this very level, it would become very difficult to do so if they enter into another category. Thus, substandard assets are very crucial and decide the feasibility of the converting back of NPA as performing asset. Bank must maintain 15% as its reserves.

2. Doubtful assets—An asset which remains as a substandard one for a period of more than 12 months is known as a doubtful asset. Added to a substandard asset, the primary characteristic of a doubtful asset is that it makes the refund and the credibility of the asset a very highly doubtful and questionable issue.
3. Loss assets—An asset that is an NPA for a period of more than 36 months is treated as a lost asset [15]. A loss asset is one on which loss has been identified by the internal auditors of the bank and external auditors of the RBI. They have been recognized as uncollectible and of very little value. Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for. This means that full amount of the loss assets should be kept from some other sources like profit of the bank to meet the loss.

Further, in this chapter of the paper, the authors will provide recent examples that have been in the news and have been troubling the banking industry with the NPA issues.

THE NIRAV MODI SAGA IN CONTEXT OF NPAS

To understand how the scam that has been in the news, one must understand how the buyer's credit and letter of credit works in practice.

Buyer's credit is a tool to acquire capital goods and services, a loan facility given to importer so that importer can perform financial transactions. Buyer's credit facility takes on the one hand a bank that can give guarantee, and on the other that the export facility provider. Bank will pay the exporter on due date based on invoice of material imported and same will be collected from the importer. Buyer's credit is a complex system which involves many cross-border litigation and multi-party agreements, hence usually

credibility of exporter to be seen and generally banks grant it to only large-scale borrowers [16]. On the other hand, CBS is a back-end system that processes daily banking transactions, that includes posting updates to accounts and other financial records [17]. It is a centralized form of software, primary function of which is alerting banks over warning of distress and financial scams [18]. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) provides a network that enables financial institutions worldwide to send and receive information about financial transactions in a safe environment. Nostro account is the record of the bank whose money is on deposit at another bank, who are used for settlements of trade and foreign exchange transactions [19].

Nirav Modi is a luxury diamond jewelry designer, who is the founder and creative director of the Nirav Modi chain of diamond jewelry retail stores, and is the Chairman of Firestar International, which has stores in key markets across the globe [20]. Nirav Modi through his three firms, Diamond R US, Solar Exports, and Stellar Diamonds, wants to import diamonds to design high-end collection. Therefore, he approaches the Punjab National Bank and asks for a Letter of Undertaking (LOU) [21].

Normally, the branch officials would request the firm to furnish 100% cash margin for issuing the LOU for raising the buyer's credit, however in this case, no security was asked for. Entries in respect of the Letter of Undertaking were not recorded properly in the CBS of the bank. Colluding officials sent SWIFT messages from one of PNB's Mumbai branches, offering unauthorized LOUs. The messages were sent by the officials without proper documents and permission from competent authorities [22]. By virtue of the RBI guidelines, the import of the items should not exceed 90 days, but in this case, it was exceeded and rolled over repeatedly [23]. According to reports, the LOUs were rolled over again and again, and money was not demanded from Nirav Modi. By rolling over the credit, he paid over money of previous LOUs by subsequent LOUs. The scam went on for 7 years and in the year 2017 alone, 151 such LOUs were signed [24].

On the basis of the complaint filed by PNB with the CBI on January 28, the fraudulent issuance of Letters of Undertakings (LOUs) was detected by the Central Bureau of Investigation. On basis of further inquiry made, the bank officials discovered that two of its employees had fraudulently issued LOUs in the past without following prescribed procedures and approvals. The employees had then transmitted SWIFT instructions to the overseas branches of Indian banks for raising buyer's credit without making entries in the banking system to avoid detection. The complaint further said that the funds so raised for the payment of the import bills had not been utilized for that required goals in almost all the cases. It was observed in the inquiry that five of the SWIFT messages were issued to Allahabad Bank in Hong Kong and three to Axis Bank in Hong Kong.

Due to the scam, the PNB which in previous quarter had posted a profit of 340 crores went down to loss of 940 crores in the next quarter. According to a source in the bank, the loss is to the tune of 11,000 crores. After the scam details were made public, the stock of the bank went down 10%. PNB's gross NPAs rose to 18.26% of advances as on June 30, 2018 as against 13.66% in the same quarter a year ago. Net NPAs rose to 10.58% against 8.67%. By the second quarter of this fiscal (2017-18), the bad loans of the PSBs had reached Rs. 7.34 lakh crore (compared with the Rs. 1.03 lakh crore of the private sector banks [25]).

DATA OF NPAS IN PUBLIC AND PRIVATE SECTOR BANKS

The details of gross advances, gross non-performing assets and gross non-performing assets ratio of public sector banks and the private sector banks are as in Table 1.

Table 1: Comparing the GNPA in Public and Private Sector Banks.

Public Sector Banks (Rs. in crore)			
	Gross Advances	GNPA	GNPA Ratio
FY 2014	45,90,458	2,16,739	4.72%
FY 2015	49,17,228	2,67,065	5.43%
FY 2016	51,04,915	5,02,068	9.83%
Private Sector Banks (Rs. in crore)			
	Gross Advances	GNPA	GNPA Ratio
FY 2014	12,10,661	22,738	1.88
FY 2015	14,37,338	31,576	2.20
FY 2016	17,91,681	48,380	2.70

SUGGESTIONS TO REDUCE NPAS IN PSBS

As on 31st March 2018, the NPAs in the Indian banks stood at around Rs. 10 lakhs crore. This was a sharp rise of Rs. 3.13 lakh crore as compared to the past year.

Though, this is not only a responsibility of the banks to seek ways to reduce NPAs, but by those lenders who seek to take loans from these banks. Moreover, RBI has to play a major role in the whole process, alongside the Indian government. The bank officials have to do the most by not letting assets get into the category of doubtful and loss assets. There can be various steps that can be taken by a bank to reduce the non-performing assets. There are several points to be taken care of, which are discussed below:

- **A Conservative Approach:** Banks need to be very cautious while lending to people. Though, this does not mean that they need to lend less, but rather more cautiously by verifying everything. Advances provided by banks need to be done pre-sanctioning evaluation and post disbursement control so that NPA can decrease [26]. Good management is needed on the side of banks to decrease the level of NPA. Though this might be a little problematic for the borrower at times, but as a long-term measure, this would hold certainly good. They need to follow a conservative approach for loan disbursement, particularly in cases where the repayment tenure is stretched over a long period of time [27].
- **Loan Restructuring:** Banks need to necessarily ensure that all the interest payments, EMIs, and the principal amount are paid well on time without any delay. Even a small delay needs to be monitored very meticulously. They must not wait for so long that the loan reaches the last category of NPA and thus becomes almost impossible to recover.
- **Innovative Means:** There is an immediate need to use advanced tools where banks can have detailed insights on customer behavior, and their repaying capacity to make effective lending decisions. They must also find aids to contact borrowers for recovering loan instalments in case of

failure and take legal action whenever required [28].

- **SARFAESI:** The Securitisation and Restructuring of Financial Assets and Enforcement of Security Interest Act 2002 empowers banks and financial institutions to recover debts without the intervention of courts, it being an executory process rather than an adjudicatory one. The act provides for securitization of assets, reconstruction and enforcement of security interest, thus making it easier for banks. Bank can sell the NPA to asset reconstruction companies for cash, they can appoint a manager to manage the stock on which security is created and take the possession of the property on which security is created.
- **Lok Adalats:** Banks can approach Lok Adalats for recovery of small loans that are below 5 Lakh. This is a very swift process and easier for banks as well.
- **Compromise Settlement:** To avoid the litigation process, banks should go for the settlement scheme [29]. It is a scheme which provides a simple mechanism for recovery of NPA. It is applied to advances below Rs. 10 crores [30]. It involves certain sacrifices on the part of the banks on the principle of “a bird in hand is worth two in the bush”.
- **Recovery Camps:** As a matter of fact, bank personnel approach the loan defaulters so that they pay at a place and time convenient to the bank as well as the defaulters. These are more suited to small loans [31]. Generally, the bank manager along with the officials reaches out to each defaulter’s house to draw out a settlement between the bank and the defaulter. This way, the bank compromises with the defaulter and receives a lesser amount as compared to the whole loan amount.
- **One-Time Settlement Scheme:** Lately, the Government of India in collaboration with the Reserve Bank of India has been announcing one-time settlement schemes, which are attractive and feasible for both the contracting parties.

CONCLUSION

With regard to data shown and statistics reflected, it can be said that NPAs are draining the capital of the banks and weakening their

financial strength. It is quite evident that the banks and financial institutions should be more proactive to adopt a pragmatic and structured non-performing assets management policy where prevention of NPAs receives priority. When comparison is made with the private sector-banks, public-sector banks have higher level of NPAs. It is not wrong to say that public sector banks are the life-line for rural and middle-class sector of the country. Banks perform an invaluable service by encouraging savings among the people, and mostly poor people of the nation rely on public sector banks.

It is rightly said above that when the lifeline of the nation is itself in ICU, state of economy is not in good health. High extent of NPAs in Indian banks is a reflection of the bad economic indicator of the country. It has become essential to reduce the extent of NPAs to improve the financial health of the banking system. The banks should boost the recovery mechanism and make attempt to reduce the extent of the same. The problem of recovery is not only with small borrowers but also with large borrowers and a strict policy should be followed for solving this problem. The government ought to make legal provisions to accommodate efficient dispute resolution mechanism and should attempt to reduce the mandatory lending to priority sector as this is the major problem creating area. The issue of NPAs should have been nipped in the bud; however, still efforts can be made to reduce it and later elimination of the same.

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