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TITLE: ANALYSIS OF UNDERLYING CAUSES FOR NPAS IN INDIAN SCHEDULED COMMERCIAL BANKS

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Abstract - Non-performing assets of banks have become a major concern in India, with an almost regular periodical occurrence of very large value credit defaults / frauds adding to the already humongous levels of NPAs in Banks (especially Public-Sector Banks).They are a direct reflection on the performance of banks. A high level of NPAs affects the profitability, net-worth and liquidity of banks, in addition to posing threat on quality of asset and pushing them to the brink of insolvency. Banks have to make mandatory provisions, which reduces the overall profits and shareholders' value. This problem is not only affecting the banks but also the economy as a whole. Post the revelation of the PNB – Neerav Modi Scam and the Rotomac default, it has now become inescapable for the Government of India to initiate harsh corrective steps to control and reduce the NPAs to improve the financial health of the banking system and the Indian economy.This research paper is an attempt to study what are NPAs, various factors contributing to creation of NPAs andcritically identify causes of consistently rising NPAs and causes for failures of the preventive steps taken by the various agencies.

Keywords: Non-Performing Assets (NPA), Underlying Causes, Scheduled Commercial Banks, Government Policies.

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INTRODUCTION.

As part of the growth strategy, banks are important participants in the financial system of a country. Profitability is a benchmark for measuring performance of banks or any other business enterprise. Increasing levels of NPAs have a direct impact on profitability, as banks cannot legally book income on such accounts, as also they have to make provisions on such assets as per the RBI guidelines. Under such a complex economic scenario, as exists today, the banks face an enormity of risks, which if not controlled in time threaten to push the affected banking organisations to the brink of insolvency. If any advance or credit facilities granted by banks to a borrower become nonperforming, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status, as is happening in the case of the Nirav Modi Group and the Geetanjali Gems owned by Mehul Chowksi.

Non-Performing Asset (NPA)is a term commonly used with reference to poor performance of a financial assets in banking and finance services. When a bank or a finance company is not able to recover the money from its borrower in 90 days, then, that amount which could not be recovered, is treated as an NPA. It represents bad loans, the borrowers of which failed to satisfy their repayment obligations.

Asset Classification Categories of NPAs.

❖ **Standard Assets** Standard assets are the ones in which the bank is regularly receiving interest as well as the principal amount of the loan, from the borrower. The arrears of interest and the principal amount of loan should not exceed 90 days at the end of financial year. If an asset fails to remain a standard asset for a period exceeding 90 days then it needs to be classified as a non-standard asset.

❖ **Non-Standard Assets**. If an asset fails to be in the category of standard assets, that is amount due more than 90 days, then it is an NPA and NPAs are further need to classify in sub categories. Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the reliability of the dues: -

- **Sub-standard Assets** With effect from 31st March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. The features exhibited by substandard assetsare: the current net worth of the borrowers / guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full; and the asset has well-defined credit weaknesses that put to risk the returns and subsequent liquidation of the loan and there is a distinct possibility that the banks will sustain some loss, if such deficiencies are not corrected.

- **Doubtful Assets**A loan classified as doubtful has all the weaknesses inherent in assets that are classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full - on the basis of currently known facts, conditions and values – highly questionable and improbable. With effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months.

- **Loss Assets**An asset which is considered uncollectible and of such little value that its continuation as a bankable asset is unwarranted- although there may be some salvage or recovery value still left. Also, these assets would have been identified as 'loss assets' by the bank or internal or external auditors or the RBI inspection, but the amount would not yet have been written-off completely.

❖ **Restructured Assets**These assets are not NPAs but are accounts for which the banks restructurethe repayment schedule for payment of interests and principle. At times some banks use this procedure to hide their NPAs in the disguise of a restructured Asset.
(Sources:https://rbi.org.in/scripts/NotificationUser.aspx?Id=1313&Mode=0 and https://documents.mx › Documents)

REVIEW OF LITERATURE

Das and Datta (2014) in a study on NPAs of Public Sector Banks in India,found that there was a significant variation between NPAs of the public-sector banks from 2008 to 2013. The objective of the study was to find whether there is any difference in the NPA occurrence between the various banks during the period of the study. They analysed the NNPAs of State Bank of India and its Associate Bank, applied the ANOVA test using the SPSS.

Satpal (2014) in a studycomparison of NPAs in Public and Private sector banks in the new age of technology, found that operating efficiency of banks is adversely affected due to NPAs and NPAs of public sector banks are comparatively higher than those of private sector banks. He highlighted that problem of recovery was more with large borrowers than with small borrowers. He suggested that government should make provisions for faster resolution of pending cases and reduce mandatory lending to priority sectors. The objectives of his study were to study NPA trend of last five years of private and public-sector banks and to make a comparative study of NPAs of public and private sector banks. The research methodology adopted involved use of descriptive research design and analytical study, non-probability convenience method of sampling and use of secondary data of a sample of three public and three private sector banks.

Balasubramaniam (2011) in a study on Non-Performing Assets and Profitability of Commercial Banks in India: Assessment and Emerging Issues concluded that level of NPAs with all banks was high in the period of study (2000-01 to 2009-10) and banks would be expected to bring down their NPAs, by adopting good credit appraisal procedures, effective internal control systems along with efforts to improve asset quality in their balance sheets. He brought out that maintaining profitability is a challenge for commercial banks, especially in a highly competitive era and opening up of banking business to NBFCs and Foreign banks in general, which assumes significance in a period of rising interest rates and operating costs of borrowers in general. Balasubramaniam also brought out that banks would make efforts to mobilise funds in order to comply with provisioning norms and capital adequacy requirements while meeting Basel III standards which will be brought in by RBI shortly. However, the Capital requirements would be large considering the varied structure of banks and financial institutions operating in the economy and their NPA levels. He observed that, the capital market environment currently prevailing in the economy (in 2011) would pose problems for the capital mobilisation by the banks. Finally, he highlighted the emergence of new and private sector banks led by ICICI Bank and HDFC Bank, with their high capital adequacy ratios, enhanced proportion of common equity and better IT and other modern financial skills of the personnel, which are well placed to comply with Basel III norms in general. PSU banks although dominant banks in the Indian financial system may take more time and face challenges in following the Basel III guidelines in the ensuing years.

Krishna(2004) in a study for Non-Performing Assets in Public Sector Banksfound thatbetween the years 1992 to 2002 there has been a marginal decline in the NPAs of the banks and calculated a trend showing a further predicted decline in NPAs over next three years (2002 - 2004) at a marginal rate. The objectives of the study were to understand meaning and nature of NPAs, Examine the causes for NPAs in Public Sector Banks and to project the NPAs in Public Sector Banks over a future period of three years. In the methodology, she explained the NPAs in the Indian context, found that actual NPAs have risen in the period of study, although as a percentage of net advances there was an indication of marginal decline. The causes identified by the researcher were primarily directed lending and social banking to priority sectors. Another reason identified was the large amount of loans granted under various government schemes like IRDP,SUME, SEPUP, RREP, PMRY etc, which became unrecoverable due to failed programmes, manipulation by agencies involved in implementation of these programs and non-reliability of the target audience.

RATIONALE OF THE STUDY

Many researchers have done research on topics related to NPAs. They have studied varying aspects like variation in level of NPAs, impact of periodical fiscal and monetary actions of the government on the level of NPAs, NPAs of Public Sector Banks in specific, causes of NPAs of public sector banks, impact of Demonetization on level of NPAs of banks etc. The earlier research work on the subject needs to be reaffirmed. More importantly, there is a need to carry out a holistic review of NPAs of Scheduled Commercial Banks over a longer period (from 2004to 2017) and critically identify underlying causes for creation of such high level of NPAs and also analyse whether there are gaps in the implementation of regulatory mechanism and Basel Norms.

RESEARCH QUESTION

What are the causes, due to which, the NPA levels of Indian Scheduled Commercial Banks have been growing at uncontrollable rates to unacceptable levels, despite a host of control measures instituted by the regulators?

OBJECTIVE OF THE STUDY

To analyse, in detail, underlying causes for NPAs.

RESEARCH METHODOLOGY

Secondary data has been used for this research. Data has been collected from authenticated websites, newspapers and journals. The critical analysis of data in conjunction with findings of various reports and articles in websites, journals & newspapers along with the comments of financial experts appearing in newspapers in the months of February and March 2018, were studied in a holistic manner to arrive at an independent analysis of the probable underlying causes of deterioration in the asset quality and overall performance of Indian banks.

ANALYSIS OF UNDERLYING CAUSES FOR NPAs IN INDIAN SCHEDULED COMMERCIAL BANKS

A careful and deliberate observation of the ongoing events, of frauds, scams and defaults on loans by large corporates, has exposed few of the many glaring vulnerabilities of the most important element of the Indian Financial system, the ‘Banking Sector’. The state of private sector banks is precarious as they worry about their ability to assess risky investments and provide for bad loans. Most private bank heads, worry about their performance and output and fear for their banks very existence in the intensely competitive and volatile financial market. On the other hand, public sector banks, it is believed, cannot go bust because they are government owned and worry about facing new scams at best. They take their existence for granted and subconsciously are assured of government recapitalization plans for always coming out of troubled waters.

Internal Causes

❖ **Defective Lending Process& Due Diligence**. There are three cardinal principles of bank lending that ideally must be followed by the commercial banks (Principle of Safety, Principle of Liquidity, Principle of Profitability). However, there is a defect in following these principles, by banks, in their internal procedures, causing problems in lending outcomes.A Corporate requires a continuous flow of funds not only for setting up of their business, but also for successful operation as well as regular upgradation / modernisation of the industrial unit(s). These requirements are met through the Governments (both at the Central and State level), who undertake steps like setting up of banks and financial institutions; formulating various policies and schemes, etc. with specific focus towards the promotion and development of small and medium enterprises. Scheduled commercial banks are the major sources of financial assistance to the industrial sector and extend credit support to the firms in the form of loans, advances, discounting bills, project financing, term loans, export finance, etc.

Analysis Although, theoretically the procedure for sanction of corporate loans is very strict if followed by the book, but, unfortunately the actual ground situation is different. As in the case of the now defunct Kingfisher Airlines default in 2012 on a loan of Rs 7500 Crores extended by a consortium of 17 banks led by SBI, or the Neerav Modi / Geetanjali Jewels fraud causing a loss of more than Rs 12,900 Crore to PNB or the Rotomac default of Rs 3500 Crores on loans extended by Bank of Baroda, it is evident that the banks, mostly the public sector banks have been violating the due diligence in the procedures for scrutiny of applications for large value loans by medium and large corporates. This is evident from the rising levels of NPAs especially in the Non-Priority Sectors.Uncontrolled lending without due diligence by corrupt executives of banks is evident after reports surfacing about collusion of unscrupulous personnel.

❖ **Inappropriate Technology** - Due to inappropriate and / or obsoletetechnology and management information systems, banks are not able to take market driven decisions on a real time basis. Proper MIS and financial accounting systems are not implemented in the banks, which leads to poor credit collection, thus leading to NPAs. All branches of banksneed to be computerized and networked, for all aspects of their functioning.

Analysis. In an era when banks and financial institutions around the world are progressing to the BASEL III norms for risk management in banks, it is absolutely shocking to note that Indian Banks are still trying to overcome basic technological weaknesses as poor software architecture, fractured software systems (ill connected or not connected at all) supporting MIS services in the same bank. Here, the case of the fraud committed by Neerav Modi / Geetanjali Jewels towards loans extended by PNB is a glaring example of poor implementation of MIS by banks, in an era, when all banks are moving towards implementation of BASEL III norms for risk management**.** The PNB fraud has daylighted the fatally ill operational management of the banks, suffering from poorly implemented technologies fraught with loopholes which are easily exploited by the cunning and criminally inclined corporates and individuals. The Indian Public as well as Private Sector Banks are, if not equally, but still, to a large extent affected by this technological deficiency, which is inexcusable in today's forward-looking information technology driven era.

❖ **Improper SWOTAnalysis of Prospective Borrowers** - The improper strength, weakness, opportunity and threat analysis is another reason for rise in NPAs. While providing unsecured advances the banks depend more on the honesty, integrity, and financial soundness and assumed credit worthiness of the borrower, which is an invitation to sure shot financial disasters. In the first place, it should be a matter of grave concern for the regulators, when banks start indulging in distributing large amounts of unsecured loans to large corporates.

Analysis. The idea of advancing very large amounts as unsecured loans to corporates, that too without carrying out a proper SWOT analysis of the company, doesn't stand to any logic, even if one views such events, as attempts by banks to take calculated risks to make large profits and also facilitate the industry growth. Therefore, not carrying out SWOT analysis of a prospective borrower, especially a large / medium corporate, are, we can say, well planned events by some corporates in collusion with corrupt bank officials to basically defraud the banks.

❖ **Managerial Deficiencies** -The banks must always select the borrower very carefully and should take tangible assets as security to safe guard its interests. When accepting securities banks should consider the – Marketability, Acceptability, Safety and Transferability. The bankers should follow the principle of diversification of risk (the famous saying - 'Don't place all your eggs in one basket'), i.e. they should not grant advances to only a few big corporate firms or concentrate their assets in few industries or in a few cities.

Analysis. Most banks, barring few exceptions like the HDFC Bank, have thrown caution to the winds when it comes to carefully examining the quality of securities being offered by the prospective borrowers. This is evident from the failure of banks to recover their outstanding dues from large defaulters like Kingfisher Airlines whose attached assets are not even displaying the basic quality of marketability. Similar problems are foreseen in case of the instant events of the PNB losses and the bank of Baroda losses.

❖ **Absence of Regular Industrial Visits** - The irregularities in spot visits also contributes to increase in NPA levels of the banks. Absence of regular visits of bank officials to the customers premiseslowers the instances of collection of interest and outstanding principal amounts on the loan. The NPAs due from wilful defaulters can only be effectively collected by regular visits.

Analysis. There seems to be a definite collusion amongst bank employees and corporate representatives at various levels, because of which bank officials deliberately skip this very important aspect of industrial visits to their clients' sites to inspect and assure themselves of the financial health of the corporate borrowers, their operational efficiency, business performance, collection of the outstanding principal and interest beyond a certain delay period etc. If these procedures are implemented strictly, then automatically assets facing prospects of stress and likelihood of default can be highlighted and early resolution can be worked out.

❖ **Faulty Credit Management** – These are defective appraisal and credit approval mechanisms, defective recovery procedures, defective audit and internal check mechanisms, defective reporting mechanisms and lack of professionalism in the work force.

Analysis. A very unfortunate example is of the NPA created on the books of the Punjab National Bank of an amount of Rs 12,600 Crores, just because of faulty credit management procedures in their Brady Road, Branch Mumbai and also due to faulty regulatory procedures in at the senior management level. An attempt by the banks to hide NPAs by restructuring (upgrading) them wrongfully utilizing various schemes / privileges granted by the regulator (RBI), for restructuring of weak assets through schemes like corporate debt restructuring scheme (CDR), strategic debt restructuring scheme (SDR), and scheme for sustainable structuring of stressed assets (S4A) etc. An instant case is a report by the RBI published in Economic Times, 30 March 2018 edition, highlighting the distressed state of the state run IDBI Bank. The IDBI is also under the prompt corrective action framework of the RBI, having gross NPAs of Rs 50622 Crores at the end of December 2017 and net reported losses of Rs 1542 in the same quarter.

External factors

❖ **Ineffective Recovery Mechanism** - The Government has set up a number of recovery tribunals, which works for recovery of loans and advances, like the Lok Adalats, Debt Recovery Tribunals and the SARFAESI Act (Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002). Due to reasons like negligence, ineffectiveness and lack of proper procedures banks suffer the consequence of non-recovery, thereby reducing their profitability and liquidity.

Analysis. Recovery of dues of NPAs has steadily declined from 22% in FY 2012-13 to 10% in FY 2016-17, of the amount referred to various forums such as DRTs, Lok Adalats and the SARFAESI Act. The big fact here is that the amount referred in 2016-17 was Rs. 2,86,000 Crores while the total Gross NPAs of all scheduled commercial banks in India was Rs. 7,14,900 Crores. This means that by end of the Fiscal 2016-17, the banks facing NPAs had referred only 40% of their NPAs for seeking resolution. **This further points to the following possibilities: -**

▪ **One -** Due to corrupt practices at various levels in banks, assets which must be classified as NPAs do not get highlighted on time or are quietly restructured by wrong utilization of privileges granted to banks by RBI**,** to prevent adverse reflection on their quarterly profit states and to protect of market capitalization.

- **Two –**Poor capability of the structure of banks to handle their designed workload in terms of loans / credit management. Over ambition by banks to increase their loan books by granting very large value loans which are later not monitored for their quality.

- **Three –** Inability of the various recovery mechanisms to handle the humongous levels of NPAs afflicting the banks loan books.

❖ **Wilful Defaults** - There are borrowers who are able to pay back loans but are intentionally withholding payments. Such people and institutions need to be identified, their names and defaults made public, proper measures instituted by banks to ensure timely recovery of credits extended to them as advances and loans and punishments under the Indian Penal Code meted out commensurate to the gravity of the economic crime.

Analysis. Willful defaulting in repayment of loans by corporates, high net worth individuals and people who misuse political connections and positions, is the real cause of concern**.This has been seen as a problem peculiarly afflicting the large corporate organisations in the past five years.** Vijay Mallaya, Chairman King Fisher Airlines and United Breweries, defaulted on very large loans, diverted funds in to his personal accounts abroad and absconded, now labelled as an economic offender and criminal with a non-bailable arrest warrant on his name. Neerav Modi and Mehul Choksi diverted funds taken on loan for their jewellery businesses and absconded from the country, leaving the various agencies in a fix. The Rotomac wilful default of Rs. 2919 Crore reported by Bank of Baroda after declaring it an NPA (The Times of India, February 21, 2018). The government, despite having adequate investigative and policing machinery in place has failed to implement any serious measures to demotivate such wilful defaulters.

❖ **Natural Calamities** - This was also considered as one of the major factors, which was creating alarming rise in NPAs of the PSBs. Every now and then India is hit by major natural calamities / disasters, forcing situations of inability of borrowers (especially farmers) to pay back their loans. Therefore, banks have to per-force make commensurate provisions in order to compensate for such loans, thus reducing their annual profits.

Analysis. As of FY 2016-17, 23% of the Gross NPAs of public sector banks were from the priority sectors, like agriculture, housing, education etc, wherein agriculture is prone to natural calamities, and thus causes uncertainty in returns. However, in past three years the NPAs of the Non-Priority Sector have increased to nearly 75% of the total NPAs of the public-sector Banks. private commercial banks face a similar fate in the composition of NPAs, thus reducing the effect of this factor in contribution to NPAs. Non-Priority Sector lending includes all lending in retail segment, credit cards business, corporate loans to Micro / Small / Medium enterprises and Medium and Large Corporates.

- **Industrial Sickness** - Improper project handling, ineffective management, lack of adequate resources, lack of advance technology, frequently changing Government Policies give rise to industrial sickness. Hence, the banks that finance such sick industries ultimately end up with a low recovery of their loans reducing their profit and liquidity.

Analysis. It is a matter of grave concern that business persons in India are able to hide the poor health of their establishments, portray false profitability and capital adequacy states, fool the banks and keep drawing large sums of money as corporate loans, giving false hopes to the lenders of making handsome returns on investment. Despite multiple overlays of monitoring systems already in existence, the sickness of industries goes unnoticed, which is a surprising fact, demanding a thorough investigation of the efficacy of the regulatory mechanism itself.

- **Lack of Demand**–Most of the times, entrepreneurs in India do not put adequate efforts to predict future demand and start production at a higher than required scale, which results in overstocking and inability to repay the money borrowedfor operating activities. The banks then try to recover the amount by selling of their assets, which is an inefficient method as it usually covers only a minor portion of the advance. The banks then record the non-recovered part as NPAs and have to make provisions for it.

Analysis. Vijay Mallaya started the Kingfisher Airlines, on a very flamboyant note, depicting a new promising phase of luxury flying in Indian aviation history. He, despite being an experienced businessman, failed to see the inappropriateness and the misfit of luxury travel in the Indian context where, the majority consumer of air travel too demands economy. Kingfisher failed miserable due to lack of demand, among other reasons. Similar parities can be drawn for other corporates facing NPA situations.

❖ **Change in Government Policies** - With every new Government at the Centre, the banking sector gets new policies for its operation. Thus, it has to constantly maintain a vigil for changing regulations and policies for the regulation of the rising of NPAs.

Analysis. The tensions prevailing between the government and the RBI are evident from the public dialogue ensuing between them visible for all to read. There are major differences in the understanding of regulatory provisions and control environment, between the Government and the RBI. The Finance Minister, Arun Jaitley has said, that the regulators, RBI, along with the banks managements and the auditors are directly responsible for failure to detect bank frauds (TOI, February 25, 2018). On the other hand, the RBI Governor, Urjit Patel, complained that RBI does not have adequate powers to regulate public sector banks - lack of power to remove directors and management of public sector banks or force a merger. In September 2016, Raghuram Rajan stepped down from the appointment of RBI Governor over differences with the Central government on various issues, which included cleaning up of the loan books of banks. The finance ministry and RBI have not been on the best of terms even after the change of guard at the banking regulator in September 2016 (TOI, March 16, 2018). The RBI ordered an Asset Quality Review (AQR) in FY 2015-16. In the annual financial inspection (AFI), a small sample of loans is inspected to check if asset classification was in line with the loan repayment and if banks have made provisions adequately.But in this exercise, the AQR, the sample size was much bigger and in fact, most of the large borrower accounts were inspected to check if classification was in line with prudential norms. Reports pointed out that a list of close to 200 accounts was identified, which the banks were asked to treat as non-performing.

❖ **Directed Loans System** - Under this system, the scheduled commercial banks are required to give 40% of their credit to priority sectors. Apart from other sectors, significant sources of NPAs are directed loans that are supplied to the micro sector,where problem of recoveries are normal, especially when some of the units become sick or weak.

CONCLUSION

The asset quality of most scheduled commercial banks has deteriorated to unacceptable levels due to poor and negligent regulatory practices.There is a visible disconnect between various arms of the government which needs to be addressed holistically to overcome shameful incidents of misappropriation of public money. There is a very evident confusion between the Government of India (Ministry of Finance) and the Reserve Bank of India, regarding their roles and powers in implementation of regulatory mechanism and penalties over defaulting banks and financial institutions. The present system of processing requests for loans by high net worth individuals / Corporate Houses is fraught with loopholes, which are easily exploited by unscrupulous companies in collusion with corrupt bank officials.The banks have not correctly implemented the relevant information technology tools facilitating the BASEL II / III norms for risk management, thus leading to regulatory failures.

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