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Non-performing assets and their effect on the Indian economy

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ABSTRACT

Non-performing assets have negatively affected the Indian Economy for several years now. While NPAs have been present for a long time, they sky-rocketed in India during the mid-2000s. The objective of this paper is to explain what NPAs are and show the causes as well as the impact of NPAs in India.

Keywords: *Indian Economy, Banking, Non-Performing Assets*

1. WHAT NON-PERFORMING ASSETS ARE

A non-performing asset (NPA) is the term used by financial institutions to classify loans and advances on which the principal amount is past due and no interest payments have been made for a specific period of time. In general, loans become NPAs when the principal amount has been due for 90 days or more.

1.1 Sub-Classifications for Non-Performing Assets (NPAs)

1. Standard Assets

These are NPAs that have been past due for anywhere from 90 days to 12 months.

2. Sub-Standard Assets

These are NPAs that have been past due for more than 12 months. They have a significantly higher risk level and are usually combined with a borrower that has less than ideal credit

3. Doubtful Debts

These are NPAs that have been past due for at least 18 months. Banks generally have serious doubts that the borrower will ever repay the full loan

4. Loss Assets

These are NPAs with an extended period of non-payment. Banks are forced to accept that the loan will never be repaid, and must record a loss on their balance sheet if a NPA is placed within this class.

1.2 Significance of NPAs

It is important for both the borrower as well as the lender to know the difference between performing and non-performing assets. For the borrower, if the asset is non-performing and interest payments are not made, it negatively affects their credit, growth possibilities, and ability to receive loans in the future.

For the lender, interest earned on loans are their main source of income; therefore, non-performing assets negatively affect their profitability as well as their ability to generate income. More and more NPAs increase the lender's NPA ratio (Net NPA/Loans Given) which reflects the bad quality of loans.

1.3 How NPAs Work

Non-performing assets are listed on the liabilities side of the balance sheet of a bank or other financial institution. After a period of time in which the borrower fails to repay the loan or advance, the lender will force the borrower to sell any assets which are provided as collateral in the debt agreement. If no collateral is provided, the lender might write-off the asset as a bad debt and then sell it at a discount to a collection agency (A collection agency is a company that lenders use to recover funds that are past due or from accounts that are in default).

In most cases, assets are classified as non-performing when loan payments have not been made for 90 days, however, the amount of time may be shorter or longer depending on the terms and conditions of each individual loan. A loan can be classified as a non-performing asset at any point during the term of the loan or at its maturity.

Carrying nonperforming assets place a significant burden on the lender. The nonpayment of interest or principal reduces the lender's cash flow, which disrupts budgets and reduces earnings. The losses faced by a lender due to a NPA is recovered by loan loss provisions which are set aside to cover potential losses. Loan loss provisions reduce the capital available to provide loans to other borrowers. Once the losses from such loans are determined, they are written off against earnings. Carrying a significant amount of NPAs on the balance sheet is an indicator to stakeholders that the financial health of the bank is at risk.

1.4 Examples of NPAs in Real Life

1. Lanco Infratech Ltd.

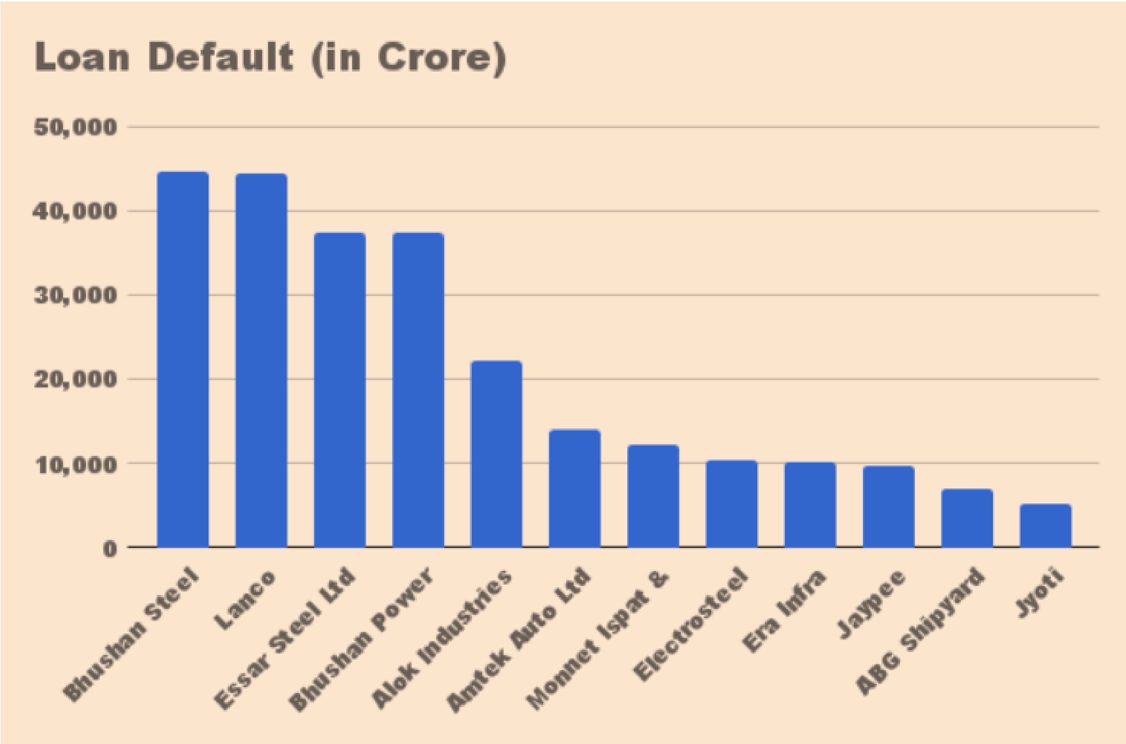
Lanco Infratech has a loan default of Rs 44,364 crore.

2. Essar Steel Ltd.

Essar Ltd has a loan default of Rs 37,284 crore.

3. Bhushan Power and Steel Ltd.

Bhushan Power and Steel has a loan default of Rs 37,248 crore.



2. INTRODUCTION OF NPAs IN INDIA

Non-Performing Assets have been one of the biggest problems which have stood in the way of socio-economic development in India. The levels of NPAs in the banking system are still too high, and while efforts have been made by banks to strengthen the internal risk management policies and setup early warning signs, the problems with NPAs is due to the issue of lack of legal reforms in the country. This area is of utmost importance and should be taken on with full concentration by the government as a system which delays in arriving at an agreeable legal solution is not tenable. The lack of such a system to quickly and efficiently reach a legal solution for a dispute is a major problem in the financial sector as it encourages irresponsible borrowers.

The problem of NPAs is not only prevalent in the Public Sector Banks (PSBs), but in the entire Indian banking system. The NPA problem is further worsened in India as banking institutions derive NPA figures based on percentages against risk assets instead of total earning assets. Banks are expected to continuously perform recovery exercises through various methods adopting newer strategies. Furthermore, borrowers need to be continuously educated about the benefits of using banks rather than local lenders. Defaulters are supposed to be taken care of by banks, however, this becomes a problem when the bank’s write off is affected.

3. CAUSES OF NPAs IN INDIA

Before the financial crisis of 2008 the Indian economy was essentially in a boom phase. This meant that banks, both public and private, gave several loans to corporates in expectations of high returns in the future. With loans being given with such ease, large corporations became highly leveraged which showed that they were financing more through borrowing than by internal equity. While the Indian economy was able to escape the immediate impact of the financial crisis, they faced several problems in the following years. As economic growth slowed down, corporations were unable to pay loans, and both the lender and the borrower now were facing economic instability.

Poor risk management policies, several incidences of fraud, large scale corruption and more in India led to the slowing down of the growth and development of PSBs (Public Sector Banks) in India. This led to a further increase in NPAs. A few companies even showed fake financial statements and projected earnings to receive more and more loans. Banks instead of doing their own analysis, would accept the numbers being showed to them by companies which affected them negatively. An example of this is Kingfisher Airlines which took loans worth Rs. 9000 crore but in 2012 was written off as an NPA by SBI.

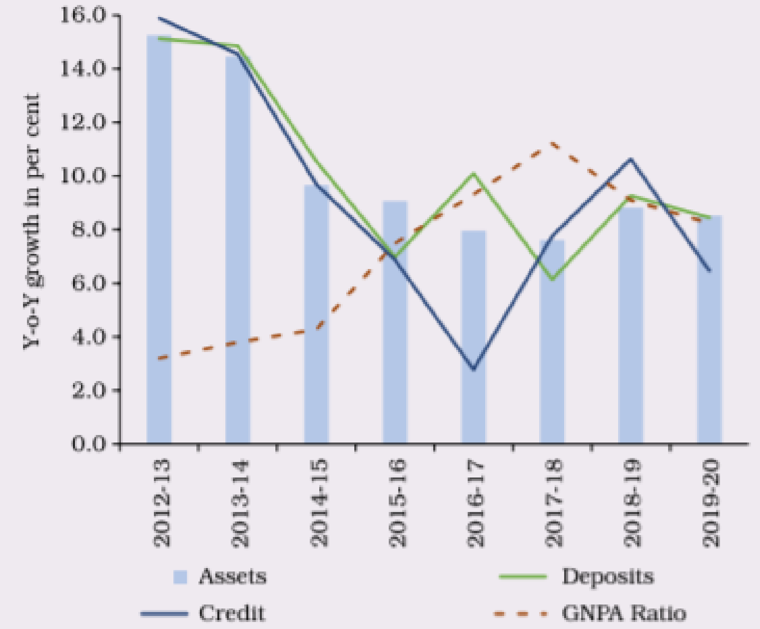
Priority Sector Lending (PSL) which is for loans to agriculture, education, housing sectors is also responsible for a large part of the NPA problem. According to the SBI, education loans constitute 20% of its NPAs.

4. IMPACT OF NPAs IN INDIA

As the NPA ratios of a bank continue to increase, the revenue stream of the bank will become weaker and weaker. It has caused a scarcity of funds in the markets and banks are now unwilling to give loans at times if they are unsure of the recovery of their money. The shareholders of banks have lost money as banks have found it tough to survive with such high NPA ratios. If this continues to happen it will lead to a crisis situation in the market. The interest rates of loans will skyrocket and this will directly impact investors and business owners whom wish to set up infrastructural, industrial and various other projects. All these factors will ultimately affect the Indian economy for the worse, causing inflation due to the higher cost of capital. Furthermore, the credibility of banks as well as the banking system is largely questioned as customers see a rise in NPAs. The general public begin questioning the safety of banks and after a while, begin liquidating their assets. The rise in NPA affects the shareholders' confidence and they may want to declare dividend after seeing a Net NPA level of more than 5%. In the end NPAs have a huge impact on several financial ratios such as Dividend Payout, Net Interest Margin, Profitability, Return on Assets etc. which affects the value of shareholders, depositors, borrowers, employees and the public.

5. FIGURES

Chart IV.1: Select Aggregates of SCBs



Source: Annual accounts of banks and off-site returns (Global Operations)

This graph shows the GNPA Ratio of the different banks in India between 2013 and 2018. You can clearly see an upward trend when it comes to the GNPA ratio of Public Sector Banks and all Scheduled Commercial Banks.

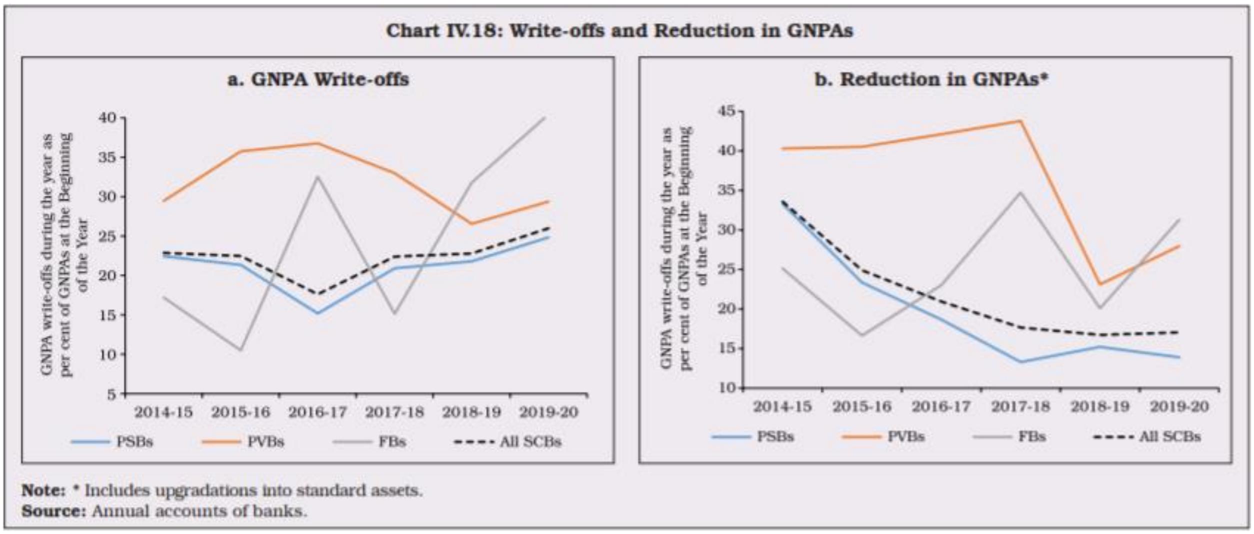
Table IV.12: Classification of Loan Assets by Bank Group

(Amount in ₹ crore)

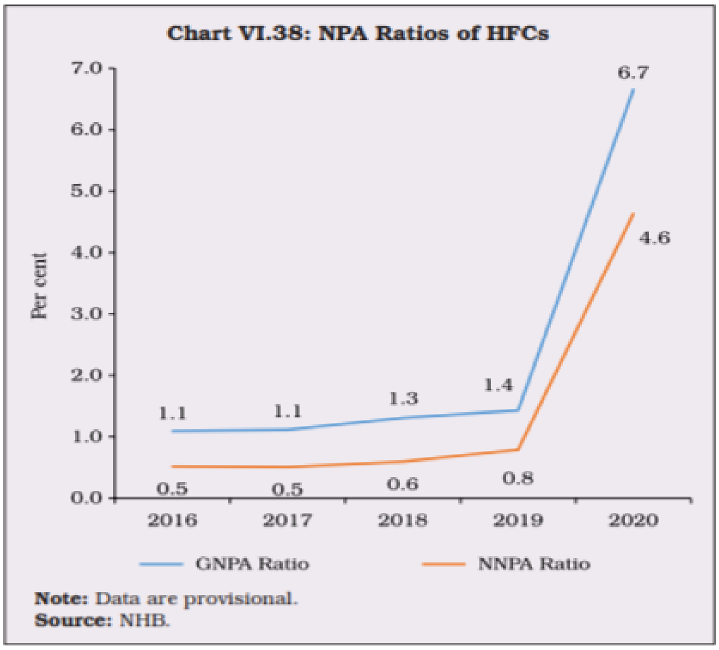
Bank Group	End-March	Standard Assets		Sub-Standard Assets		Doubtful Assets		Loss Assets	
		Amount	Per cent*	Amount	Per cent*	Amount	Per cent*	Amount	Per cent*
PSBs	2019	50,86,874	87.8	1,37,377	2.4	5,06,492	8.7	66,239	1.1
	2020	53,27,903	89.2	1,32,530	2.2	4,04,724	6.8	1,07,163	1.8
PVBs	2019	31,03,581	95.2	42,440	1.3	1,04,696	3.2	9,576	0.3
	2020	34,14,554	94.9	56,588	1.6	92,396	2.6	34,986	1.0
FBs	2019	3,94,638	97.0	3,190	0.8	8,019	2.0	1,034	0.3
	2020	4,25,857	97.7	3,273	0.8	5,775	1.3	1,161	0.3
SFBs**	2019	61,652	98.2	719	1.1	360	0.6	44	0.1
	2020	89,800	98.1	1,023	1.1	648	0.7	39	0.0
All SCBs	2019	86,46,745	90.8	1,83,726	1.9	6,19,567	6.5	76,894	0.8
	2020	92,58,114	91.7	1,93,413	1.9	5,03,543	5.0	1,43,349	1.4

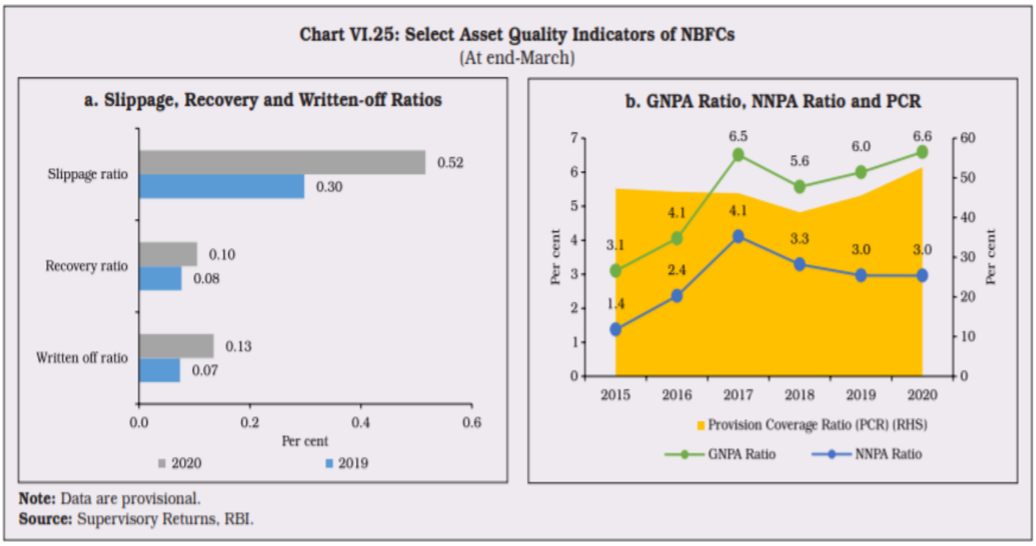
Notes: 1. Constituent items may not add up to the total due to rounding off.
2. *: As per cent to gross advances.
3. **: Refers to scheduled SFBs.
Source: Off-site returns (domestic operations), RBI.

The table above shows the different types of assets within the various banks. There has been an average loss of 1.3% of standard assets of the banks which shows the increase of poor quality assets.



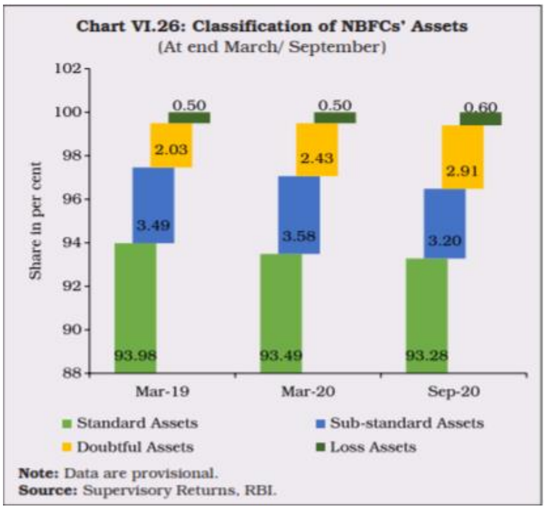
These graphs show the amount of reduction and write-offs of GNPAs in the various banks from 2014 to 2020.



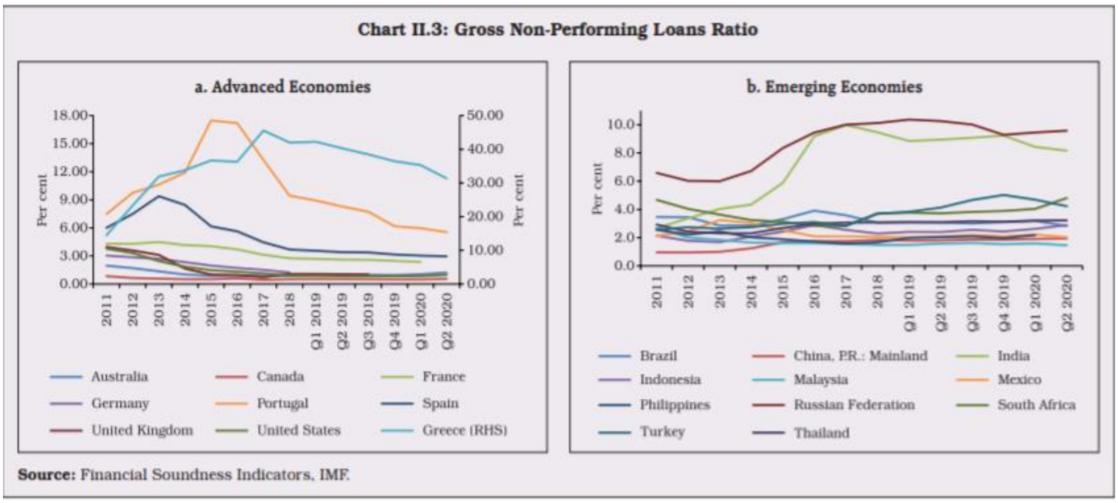


The table above showcases the growing NPA ratios of Housing Finance Companies (HFCs) from 2016-2020. This is a huge problem for all citizens of the country as HFCs deal in home loans, plot loans etc. which when turned into an NPA signify a rising problem of poor real estate within the country.

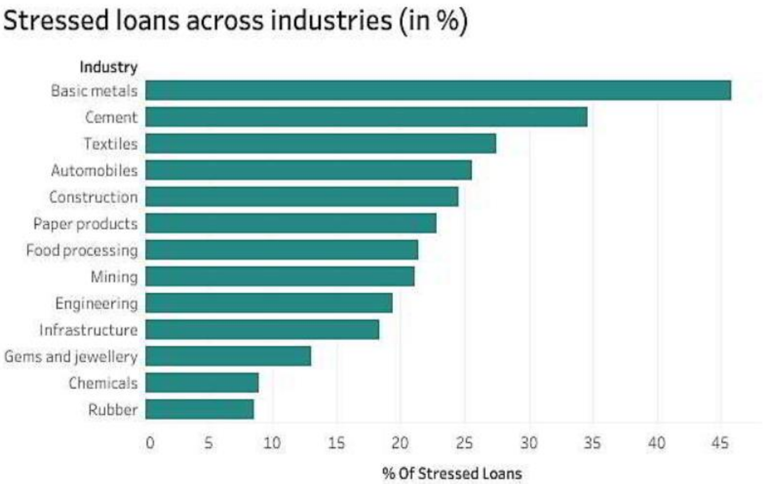
The graphs above display the types of assets as well as the asset quality of Non-Banking Financial Companies. From 2015 to 2020 the increase of the two NPA ratios is worrying as they are rising at an alarming rate.



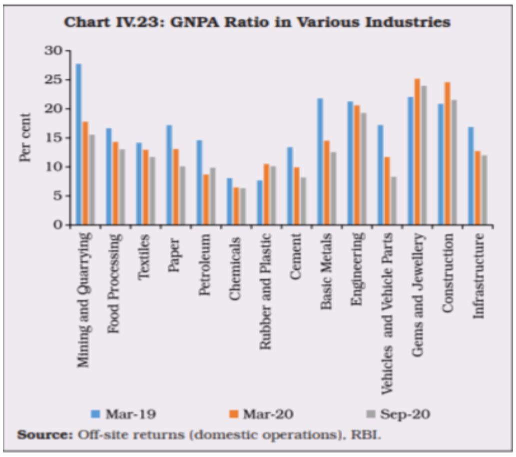
This graph shows the classification of NBFC assets from 2019 to 2020 and we can see a decrease in the percentage of Standard Assets which reflects poorly on asset management.



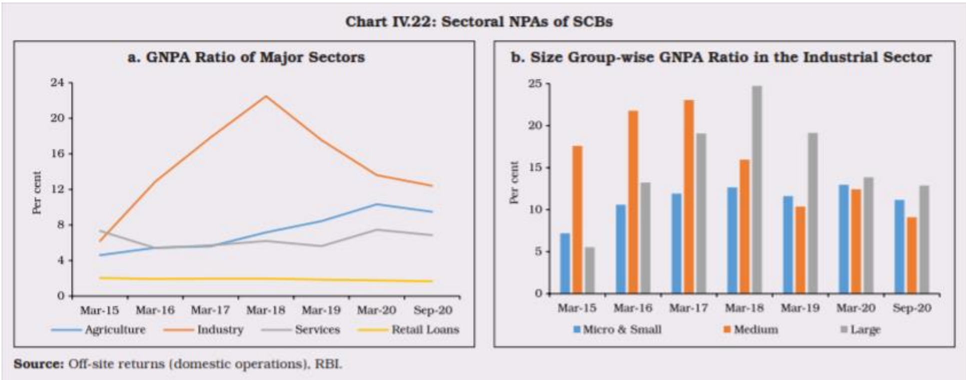
The graph shown above is a comparison between NPA ratios of Emerging and Developed Economies. As we can see India has one of the highest NPA ratios amongst emerging economies however, it is comparatively lower than Developed economies. While this may seem like a positive, the fact is that the government is not being able to protect the economy and banks from NPAs and therefore as we continue growing as an economy our NPAs will continue to rise at an alarmingly high rate.



In this chart we see the high percentages of stressed loans in some of the country's biggest industries. Stressed loans are loans which are on track to be classified as NPAs. Textiles, an industry which is one of the largest employers of women, has 27% of stressed loans which is a terrible sign of progress.



In relation to the previous chart, this graph shows the GNPA ratio in various industries. Over the past 2 years there has been a declining trend which is a good sign.



In the graph and chart shown above we see the GNPA Ratio of major sectors which rose during 2018-2019 but is now slowly reducing. Yet another good sign for the economy.

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