Shifting Tides: Non-Performing Assets Transitioning from Priority to Non-Priority Sector in India's Banking Sector

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The concept of classifying bank assets based on their quality can be traced back to 1985-86 when the Reserve Bank of India (RBI) introduced the Health Code System in banks. This system was a critical analysis tool to monitor credit comprehensively and uniformly. It provided information on the health of individual advances, the quality of the credit portfolio, and the extent of advances that were causing concern in relation to total advances. The issue of NPA gained more importance after the Narasimham Committee Report (1991) highlighted its impact on commercial banks' financial health, leading to various asset classification norms.
Broadly speaking, Non-Performing Asset (NPA) is defined as an advance, where payment of interest or repayment of installment of principal (in case of term loans disbursed by the commercial banks) or both remain unpaid for a certain period. In India, the definition of NPAs has changed over time. According to the Narasimhan Committee Report (1991), those assets (advances, bills discounted, overdrafts, cash credit, etc.,) for which interest remains due for a period of 180 days should be considered as NPAs. Subsequently, this period was reduced, and from March 1995 onwards, the assets for which the interest has remained unpaid for 90 days are considered as NPAs.

Classification of NPA's

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 realizability of the dues:

Sub-standard Assets

A sub-standard asset was one, which was classified as NPA for a period not exceeding two years. With effect from 31 March 2001, a sub-standard asset is one, which has remained **NPA for a period less than or equal to 18 months**. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well-defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

Doubtful Assets

A doubtful asset was one, which remained NPA for a period exceeding two years. With effect from 31 March 2001, an asset is to be classified as doubtful, if it has remained **NPA for a period exceeding 18 months**. A loan classified as doubtful has all the weaknesses inherent in assets that were 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.

Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection, but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value.

Problems and Causes:

The rising Non-Performing Assets (NPAs) in recent decades have had significant adverse effects on the Indian economy. One of the major problems caused by NPAs is the lowering of profit margins for lenders, such as banks and financial institutions. As NPAs increase, lenders face challenges in recovering the principal and interest on these assets, resulting in reduced profitability and weakened financial health of banks. This can further limit their capacity to lend, leading to a slowdown in credit growth and affecting economic activity.

The stress in the banking sector due to NPAs also results in less money being available to fund other projects. Banks may have to set aside provisions for NPAs, which reduces the funds available for new lending, leading to a negative impact on the larger national economy. This can result in delayed or reduced funding for crucial projects, hampering economic growth and development.

In an effort to maintain profit margins, banks may resort to higher interest rates, which can adversely impact borrowers. Higher borrowing costs can discourage businesses and individuals from taking loans, leading to reduced investments and economic activity. This can also impact the competitiveness of businesses and affect overall economic growth.

NPAs can also lead to a misallocation of funds as resources are redirected from good projects to bad ones in an attempt to recover the NPAs. This can hinder the development of productive sectors of the economy and disrupt the flow of credit to viable projects, leading to suboptimal allocation of resources.

As investments get stuck in NPAs, it may result in unemployment. Projects that are unable to generate returns due to NPAs may be delayed, abandoned, or downsized, resulting in job losses and unemployment. This can have social and economic repercussions, including a negative impact on consumer spending and overall economic growth.

Investors also face risks of not receiving rightful returns due to NPAs. As NPAs erode the profitability of banks and financial institutions, it can affect investor confidence and lead to reduced returns or losses on investments tied to these institutions. This can impact the overall investment climate and affect the attractiveness of the Indian economy for domestic and foreign investors.

The "balance sheet syndrome" is a characteristic of the Indian banking and corporate sector, where both face stressed balance sheets due to the burden of NPAs. This can disrupt the investment-led development process as resources get tied up in resolving NPAs instead of being deployed in productive investments. The burden of NPAs also adds pressure to the already pending cases with the judiciary, further straining the legal system and delaying the resolution of NPAs, leading to prolonged impacts on the banking sector and the economy.

There are several causes of Non-Performing Assets (NPA) as identified by various researchers. Santanu Das (2010) lists market failure, willful defaults, poor follow-up and supervision, non-cooperation from banks, poor legal framework, lack of entrepreneurial skills, and diversion of funds as some of the reasons for NPA.

Zahoor Ahmad and Dr. M. Jegadeeshwaran (2013), in their paper on the comparative study of NPA management of nationalized banks, highlight an improper selection of borrower's activities, weak credit appraisal system, industrial problems, inefficiency in the management of borrowers, slackness in credit management and monitoring, lack of proper follow-up by banks, recession in the market, and natural calamities and other uncertainties as the reasons for NPA.

Ashly Lynn Joseph (2014), in his paper on analyzing the trend of NPA level in private sector banks and public sector banks, identifies various external, internal, and other factors contributing to the formation of NPA. These include diversion of funds for expansion, diversification, modernization, or new projects, diversion of funds for assisting or promoting associate concerns, time or cost overrun during project implementation, business failure due to product or marketing failures, inefficiency in bank management, slackness in credit management and monitoring, inappropriate technology or problems related to modern technology. The external factors include recession in the economy, input or power shortages, price escalation of inputs, exchange rate fluctuations, and changes in government policies. Other factors include liberalization of the economy and the consequent pressures from liberalization, poor monitoring of credits, failure to recognize early warning signals shown by standard assets, the sudden crashing of the capital market and inability to raise adequate funds, mismatching of funds i.e., using loan granted for short-term for long-term transactions, and granting of loans to certain sectors of the economy based on government directives rather than commercial imperatives.

Literature Review

Sambha et al. (2013) conducted research on the problem of Non-Performing Assets (NPAs) in the banking sector in India and found that NPAs were more serious in Public Sector Banks compared to Private Sector Banks. The researchers emphasized that reducing NPAs should be treated as a national priority to strengthen and make the Indian banking system more resilient. They observed that the majority of NPAs came from both priority and non-priority sectors. In the priority sector, Gross NPAs showed a declining trend in 2007 but increased in 2008 and 2011 due to the implementation of a one-time settlement scheme for small and marginal farmers. In the non-priority sector, Gross NPAs showed an increasing trend during the study period.

Suresh Patidar and Ashwini Kataria (2012) conducted a study to analyze priority sector lending by selected public and private sector banks in India. They used statistical tools like regression analysis, ratio analysis, and t-test to assess the impact of priority sector lending on the total NPAs of banks. The authors found that there was a significant impact of priority sector lending on the total NPAs of Public Sector Banks, whereas in the case of Private Sector Banks, there was no significant impact on total NPAs. The results also showed a significant difference in NPAs between SBI & Associates, Old Private Banks, and New Private Banks compared to Nationalized Banks, which was used as the benchmark category.

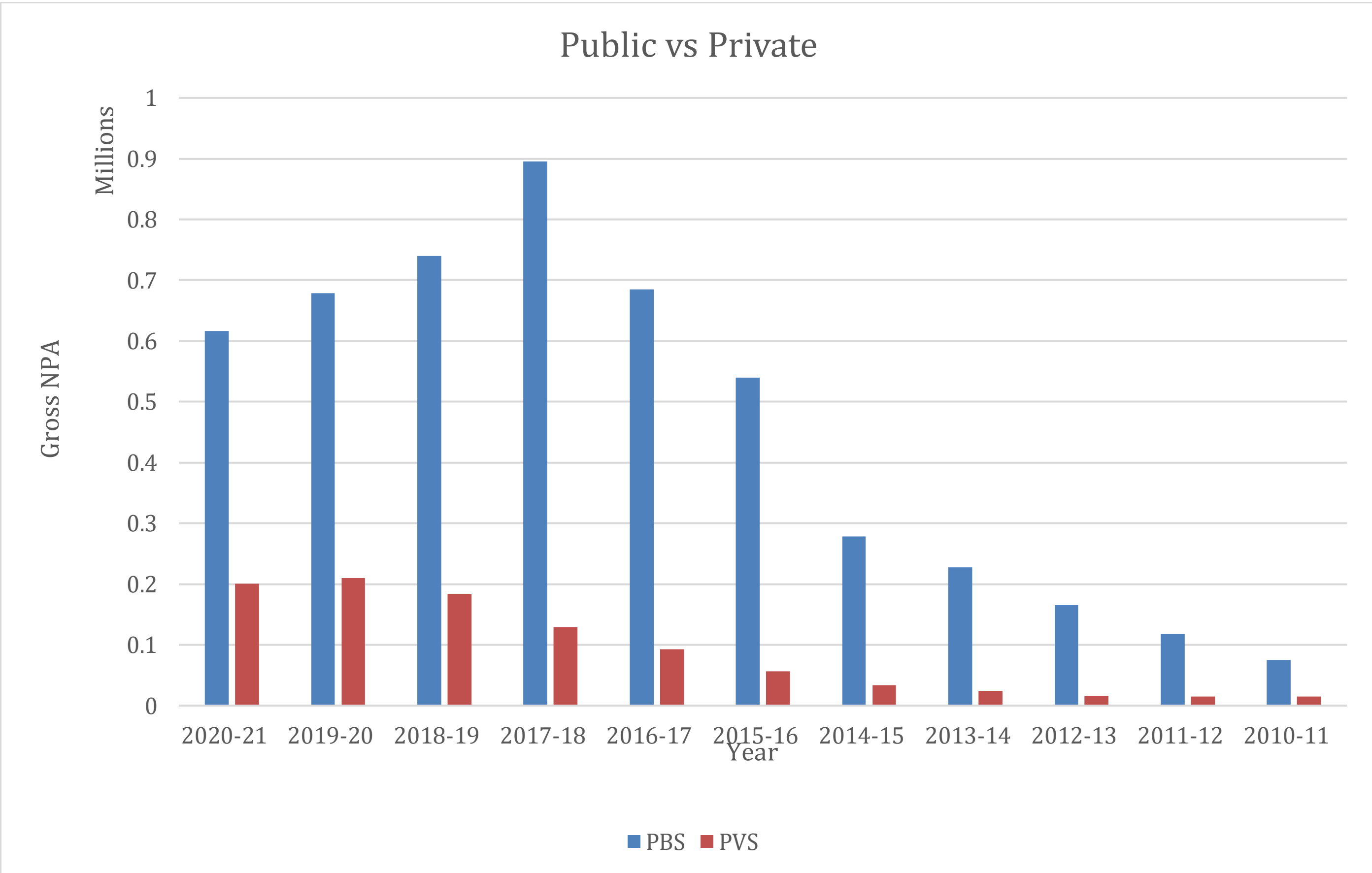
Veerakumar (2012) reviewed the "Non-Performing Assets in Priority Sector: A Threat to Indian Scheduled Commercial Banks." The research study aimed to identify the categories of priority sector advances that contributed to the growth of total priority sector NPAs during a 10-year study period between 2001-02 and 2010-11. The researcher found that the Gross NPAs of Scheduled Commercial Banks had been increasing year after year. The NPAs in the priority sector were higher in public sector banks compared to private and foreign banks. NPAs in the priority sector had a significant impact on total NPAs in Public Sector Banks, whereas in Private Sector Banks, NPAs in the priority sector had no significant impact on total NPAs.

Research Gap:

The studies reviewed in the literature were conducted during the period between 2000 and 2011, and they highlighted the issue of NPAs being concentrated in the priority sector. However, there has been a noticeable shift in the pattern of NPAs post-2011, with an increasing trend observed in the non-priority sector.

Analysis:

The analysis of the total quantum of NPA loans in India reveals a concerning trend, as the majority of NPA loans are concentrated in the public sector. This is evident from the figure below, which highlights the disproportionate burden of NPAs on public sector banks compared to private sector banks.



Data Source: RBI

The contribution of various sources of NPAs to public sector loans has shown an increasing trend since post-2011, with non-priority sector loans accounting for a significant chunk of the total NPA of public sector banks. This is evident from the figure below, which highlights the shifting trend of NPAs from priority sector to non-priority sector loans in the public sector.

Years	NPA	Priority	Non-priority	Proportion of non-priority	Proportion of priorty
2020	616616	236211.8	442105.24	71.7	38.31
2019	678317	197334.5	542206.53	79.93	29.09
2018	739541	187511	708090	95.75	25.36
2017	895601	160941.6	523790.7095	58.48	17.97
2016	684732	125809	414148	60.48	18.37
2015	539956	96611	181598.487	33.63	17.89
2014	278468	79899	147234.8009	52.87	28.69
2013	227264	67276	96030.8093	42.26	29.6
2012	165006	55780	58826.4386	35.65	33.8
2011	117839	40186	34235.4502	29.05	34.1
2010	74664	30496	29113.6647	38.99	40.84

Table 1 : Data Source RBI

By taking a t-statistic of equal variance,

t-Test: Two-Sample Assuming Equal Variances		
	Variable 1	*Variable 2*
Mean	116186.8936	288852.7391
Variance	4903395469	58827496679
Observations	11	11
Pooled Variance	31865446074	
Hypothesized Mean Difference	0	
df	20	
t Stat	-2.268442541	
P(T<=t) one-tail	0.017264036	
t Critical one-tail	1.724718243	
P(T<=t) two-tail	0.034528072	
t Critical two-tail	2.085963447	

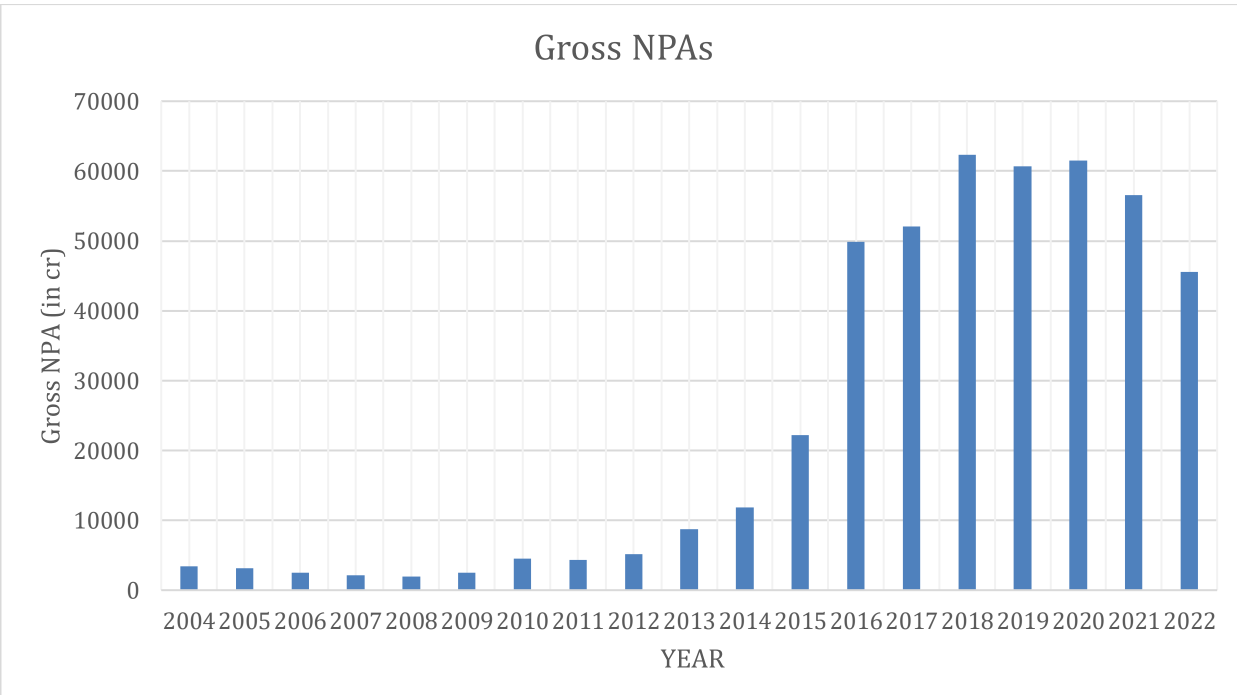
Table 2: t-Test Values

we can see that we obtain a t-statistic of -2.268442541, suggesting that there may be a statistically significant difference in the means between the priority and non-priority categories. With a significance level (alpha) of 0.05, and the calculated p-values of 0.017264036 for a one-tailed test and 0.034528072 for a two-tailed test, both being lower than the significance level, there is evidence to suggest a statistically significant difference between the means of the priority and non-priority categories at the 0.05 significance level. This would indicate that Variable 1 (priority) and Variable 2 (non-priority) may have significantly different mean values. The negative sign indicates that the mean of Variable 1 (priority) is lower than the mean of Variable 2 (non-priority).

This shift from priority and non-priority could be attributed to various factors, such as changes in economic conditions, lending practices, and regulatory policies. The emergence of NPAs in the non-priority sector could pose new challenges to the banking sector in India, requiring a re-evaluation of strategies and measures to manage and mitigate this risk effectively.

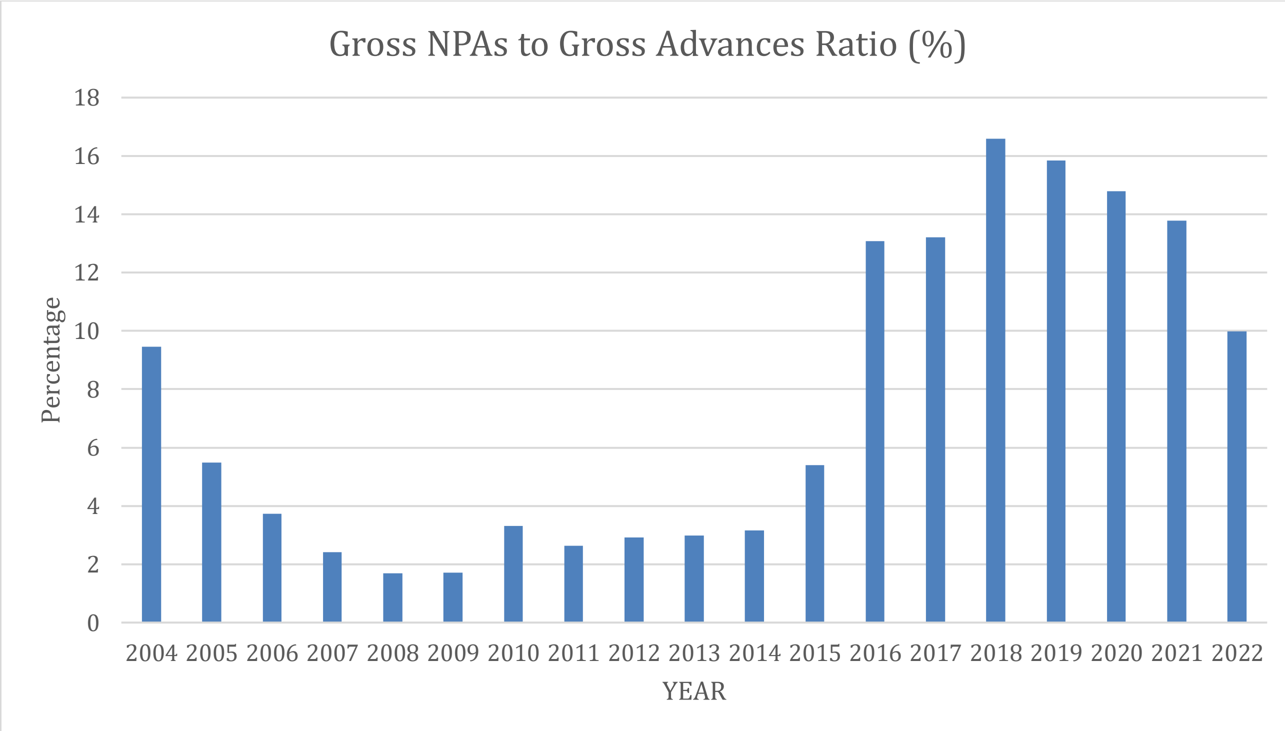
Case Study of Bank of India:

The Gross NPAs of the Bank of India (BOI) have shown an increasing trend from 2004 to 2022, with the peak being observed in 2019 and 2020. This trend closely corresponds to the onset of the COVID-19 pandemic, which may have impacted the financial health of the bank. The increase in NPAs could be attributed to challenges faced by businesses and individuals in repaying loans during the pandemic. Which can be observed from the graph below.



Data Source: RBI

The Gross NPA to Gross Advance Ratio, also known as the NPA ratio, is a key indicator of a bank's asset quality. From the analysis of the NPA ratio of Bank of India (BOI), it is evident that it has been increasing at a similar rate as the Gross NPAs of the bank. This indicates that the proportion of NPAs in relation to the total advances made by BOI has been increasing over the years. This trend may signify a deterioration in the bank's asset quality, as a higher NPA ratio indicates a higher proportion of loans that are not being repaid by borrowers. It may also suggest potential risks and challenges in managing credit risk and loan recovery. It is crucial for BOI to closely monitor and manage its NPA ratio to maintain sound asset quality and financial stability.



Data Source: RBI

Governmental Measures to Reduce NPA in India

The government has implemented a comprehensive 4R's strategy to address the issue of Non-Performing Assets (NPAs) in Public Sector Banks (PSBs). This strategy includes the recognition of NPAs in a transparent manner, resolution and recovery of value from stressed accounts, recapitalization of PSBs, and reforms in the financial ecosystem to ensure a responsible and clean system. Several steps have been taken under this strategy to reduce NPAs in PSBs.

One of the key reforms that have been implemented is a change in credit culture through the Insolvency and Bankruptcy Code (IBC), which has fundamentally altered the creditor-borrower relationship. This has taken away control of defaulting companies from promoters/owners and debars willful defaulters from the resolution process, as well as from raising funds from the market. This has helped in bringing about more accountability and transparency in the resolution of stressed accounts.

Another significant measure taken under the 4R's strategy is the recapitalization of PSBs. Over the last four financial years, PSBs have been recapitalized to the extent of Rs. 3.12 lakh crore, with an infusion of Rs. 2.46 lakh crore by the Government and mobilization of over Rs. 0.66 lakh crore by PSBs themselves. This has enabled PSBs to pursue timely resolution of NPAs and strengthen their capital base to absorb losses.

In addition, key reforms have been instituted in PSBs as part of the PSBs Reforms Agenda. These reforms include changes in loan policies, such as tying up necessary clearances/approvals and linkages before disbursement, scrutiny of group balance-sheet and ring-fencing of cash flows, and non-fund and tail risk appraisal in project financing. The use of third-party data sources for comprehensive due diligence across data sources has also been instituted to mitigate risks related to misrepresentation and fraud. Furthermore, monitoring has been strictly segregated from sanctioning roles in high-value loans, and specialized monitoring agencies combining financial and domain knowledge have been deployed for effective monitoring of loans above Rs. 250 crores.

To ensure timely and better realization in one-time settlements (OTSs), online end-to-end OTS platforms have been set up. These measures collectively aim to improve the resolution and recovery process, enhance transparency, and strengthen the overall credit culture in PSBs. It is important for the government to ensure stringent and tightened implementation of these rules and reforms to reduce NPAs further and promote a responsible and clean banking system in India

Conclusion

In conclusion, addressing the issue of Non-Performing Assets (NPAs) requires a multi-pronged approach that focuses on strengthening the existing framework to prevent their occurrence. This entails robust risk management practices, effective credit assessment and monitoring, timely resolution of stressed accounts, and promoting responsible lending and borrowing behavior. The government, regulators, and banks need to work in tandem to implement and enforce strict rules and regulations to prevent NPAs from arising in the first place.

Key measures such as the comprehensive 4R's strategy of recognition, resolution, recapitalization, and reforms, as well as the implementation of the Insolvency and Bankruptcy Code (IBC), have been important steps towards addressing the issue of NPAs. The recapitalization of Public Sector Banks (PSBs) and reforms in PSBs and the wider financial ecosystem has provided the necessary impetus for the timely resolution of NPAs.

Furthermore, strengthening risk management practices, implementing robust credit assessment and monitoring mechanisms, and promoting responsible lending and borrowing behavior is crucial in preventing NPAs. Proactive credit monitoring, use of third-party data sources for due diligence, and strict segregation of monitoring and sanctioning roles can help in the early detection and mitigation of potential risks.

It is imperative for banks to adopt prudent lending practices, exercise caution while extending credit, and prioritize the quality of assets on their balance sheets. Responsible borrowing behavior, adherence to loan terms and conditions, and timely repayment by borrowers are equally crucial in preventing NPAs.

In conclusion, addressing the issue of NPAs requires a holistic and collaborative approach, involving government, regulators, and banks, to strengthen the existing framework, implement stringent rules and regulations, and promote responsible lending and borrowing behavior. By focusing on prevention, timely resolution, and responsible lending practices, the banking sector can mitigate the risks associated with NPAs and ensure a healthier and more stable financial ecosystem.

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