Why Non-Performing Assets are higher in Public Sector Banks: A comparative analysis of NPAs in Private & Public Sector Banks

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Introduction

In the financial world of giving and receiving loans and funds, banks play a vital role in furthering the economic growth and development of a country by acting as a financial intermediary for both the private and public sectors. A healthy economy depends largely on a smooth flowing line of credit as it is an essential feature in reflecting the soundness and profitability of this sector. In the situation where this flow is disrupted, there will be economic fallout as a consequence and there will be adverse effects on income, profitability and overall growth. Non-performing assets, "A loan or advance for which the principal or interest payment remained overdue for a period of 90 days"[1] acts as a threat to this flow. They hamper a bank's ability to lend more and recycle funds due to scarcity which could further influence the overall supply of money in the economy. The Indian economy has a significant NPA issue, roughly 10% of all loans issued are later categorized as an NPA. These NPA's arise due to reasons of fraud, economic slowdown, political turmoil or even financial crises that put stress on the balance sheets, quite similar to what happened in the Global Financial Crisis of 2008.

The Indian banking system escaped the Global Financial Crisis relatively unharmed. However, while the Indian banking system avoided major direct implications of the financial crisis, effects of the same could be observed by the overall drop-off in economic growth. According to the 2008-09 Report on Trend and Progress of Banking in India (RTP), the Indian economy was still vulnerable when it came to the global consequences of the crisis, evident by the consequences of the disintegration of global trade. In order to tackle the grave consequences, the Reserve Bank of India imposed certain financial regulations during and after the crisis. These regulations were imposed with an aim to provide "asset quality" leniency to the banking system especially considering the fact that most Indian firms were experiencing severe liquidity issues at the time. A slight reprieve from loan service obligations was expected to help the banks deal better with the crisis. These relaxations allowed banks to provide forbearance with regards to asset quality classification norms for loans.

[1] "What is Non Performing Assets? Definition of Non Performing Assets, Non Performing Assets Meaning." *The Economic Times*, https://economictimes.indiatimes.com/definition/non-performing-assets.

Trends in India

After the 2008 Global Financial Crisis, the share of NPAs in India's commercial banks significantly rose. Due to this, corporate companies suffered huge losses, resulting in extensive lending to these companies. This was the start of the downward spiral of the ratio of NPAs in the Indian banking system. "RBI's Financial Stability Report (FSR) of 2020 foresaw a surge in the Gross NPA ratio of the banking sector up to 13.5 per cent in September 2021, from 7.5 per cent in September 2020."[2] In public sector banks, this proportion of NPAs went from 2% in 2008 to over 10% in 2018. The COVID-19 pandemic only exacerbated the situation. It has drastically affected the NPAs in private sector banks as well. Private banks like HDFC Bank, ICICI Bank, Axis Bank, Kotak Mahindra Bank and IndusInd Bank have an NPA ratio doubling to about 5%. These top 5 banks control three-fourth of the private banking sector, but due to the loan off-take and a significant decrease in the net loan margins, these ratios are experiencing a huge drop.

Hypothesis

From the trends listed above, it is evident that the Global Financial Crisis had a significant impact on both Public and Private Sector Banks, yet Public Sector Banks took a bigger hit in terms of profitability, asset quality and the proportion of NPAs. Therefore, this paper attempts to explore the premise of why PSBs have higher NPAs than PVBs, and the extent to which this difference in NPA levels exists.

Existing Literature

Multiple studies have been conducted comparing the impact of NPAs on Public and Private sector banks. K. Prasanath Kiran & T.Mary Jones (2016) conducted a study examining the NPAs of the top 5 public sector banks in India from 2005 to 2014. Their results concluded an unprecedented increase in the NPA levels of Public sector banks. Correlation and regression analysis was used for their analysis.

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[2] Rana, Nikita. "NPAs & Covid-19 implications temporary; Indian banking on path to revival: ETILC." The Economics Times, https://economictimes.indiatimes.com/industry/banking/finance/banking/npas-covid-19-implications-temporary-indian-banking-on-path-to-revival-etilc/articleshow/84855165.cms ?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

Abhay Jaiswal, Chanchala Jain (2016), in their study entitled “A Comparative Study of Financial Performance of SBI and ICICI Banks in India” concluded that State Bank of India, a public sector bank, actually has lower non-perfroming loans when compared to ICICI Bank, a private sector bank. Since SBI has a large number of branches, it enables them to cover advances given which contributes in reducing the non-perfroming loans of SBI.
Biswanath Sukul (2017), in his study entitled “Non Performing Assets (NPAs): A Comparative Analysis of Selected Private Sector Banks” noted that NPA levels are significantly increasing in ICICI bank, a private sector bank in India. In his paper, he further stated that proper evaluation of projects and adherence of proper credit appraisal techniques will play an important role in reducing NPA levels.
Pradip Kumar Samanta, Payel Roy (2017), in their study titled “Analysis of Non Performing Assets in Public Sector Banks of India”, explored in there findings, the existence of a high correlation between Gross NPA and Net Profit.
Harani B, Subramanyam Mutyala (2019) suggested in their investigations that the alarming NPA problem in India has to be addressed without impacting the public image of the concerned banks. They further study a sector-wise classification of NPAs and loan assets of public and private sector banks. Their study also examines gross NPAs, gross advance and gross NPAs ratio of public and private sector banks in India. An interesting observation from their paper reveals that non-priority sector loans have worsened NPAs for public sector banks.

Now while there has been considerable research on the NPA problem in India, research on the varying levels of NPAs in different banking sectors hasn’t been comprehensively explored. **This paper adds to existing literature by analysing the comparative trends of NPAs in Public vs Private Sector Banks, while also delving into the aftermath of the GFC on NPA levels and how the ramifications on these sectors still persist. This paper will also analyse possible solutions to curb the NPA problem in the banking sectors.**

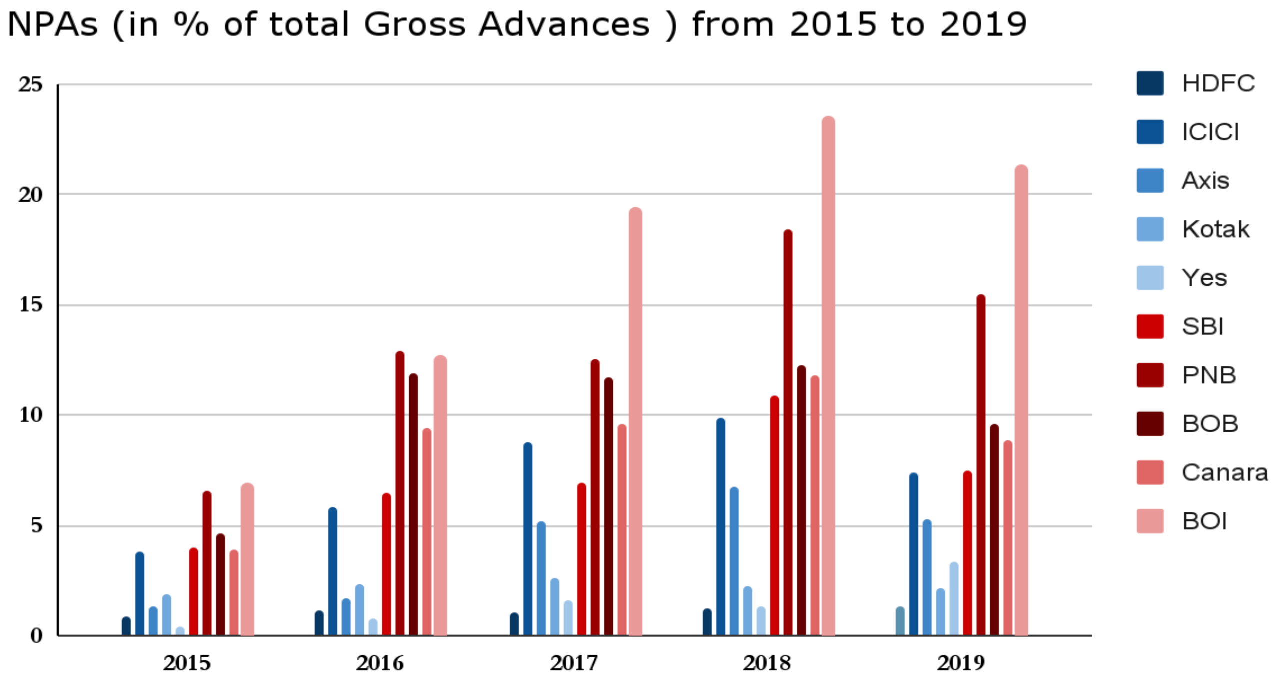
Data and Methodology

In order to conduct a comparative study and analysis, we collect publicly available data from websites of top public and private sector banks. Data was collected from the websites of the following private sector banks – HDFC Bank, ICICI Bank, Axis Bank, Kotak Mahindra Bank, Yes Bank and the following five public sector banks – State Bank of India (SBI), Punjab National Bank (PNB), Bank of Baroda (BOB), Canara Bank and Bank of India (BOI).
The selected banks were the top five banks from each sector as per total assets at the time. The secondary data has been collected from a time period of five years, from FY 2015 to FY 2019. The NPA percentage is calculated using Gross NPAs to Gross Advances.

	Private Sector Banks					Public Sector Banks				
Year	HDFC	ICICI	Axis	Kotak	Yes	SBI	PNB	BOB	Canara	BOI
2019	1.35	7.38	5.31	2.14	3.37	7.53	15.50	9.61	8.83	21.25
2018	1.28	9.90	6.79	2.22	1.33	10.91	18.38	12.26	11.84	23.46
2017	1.04	8.74	5.21	2.59	1.56	6.90	12.53	11.73	9.63	19.32
2016	1.10	5.82	1.71	2.36	0.77	6.50	12.90	11.93	9.40	12.66
2015	0.89	3.78	1.36	1.85	0.42	3.99	6.55	4.64	3.89	6.81
Mean	1.13	7.12	4.08	2.23	1.49	7.17	13.17	10.04	8.72	16.70
Standard Deviation	0.18	2.41	2.41	0.27	1.14	2.49	4.38	3.19	2.93	6.85

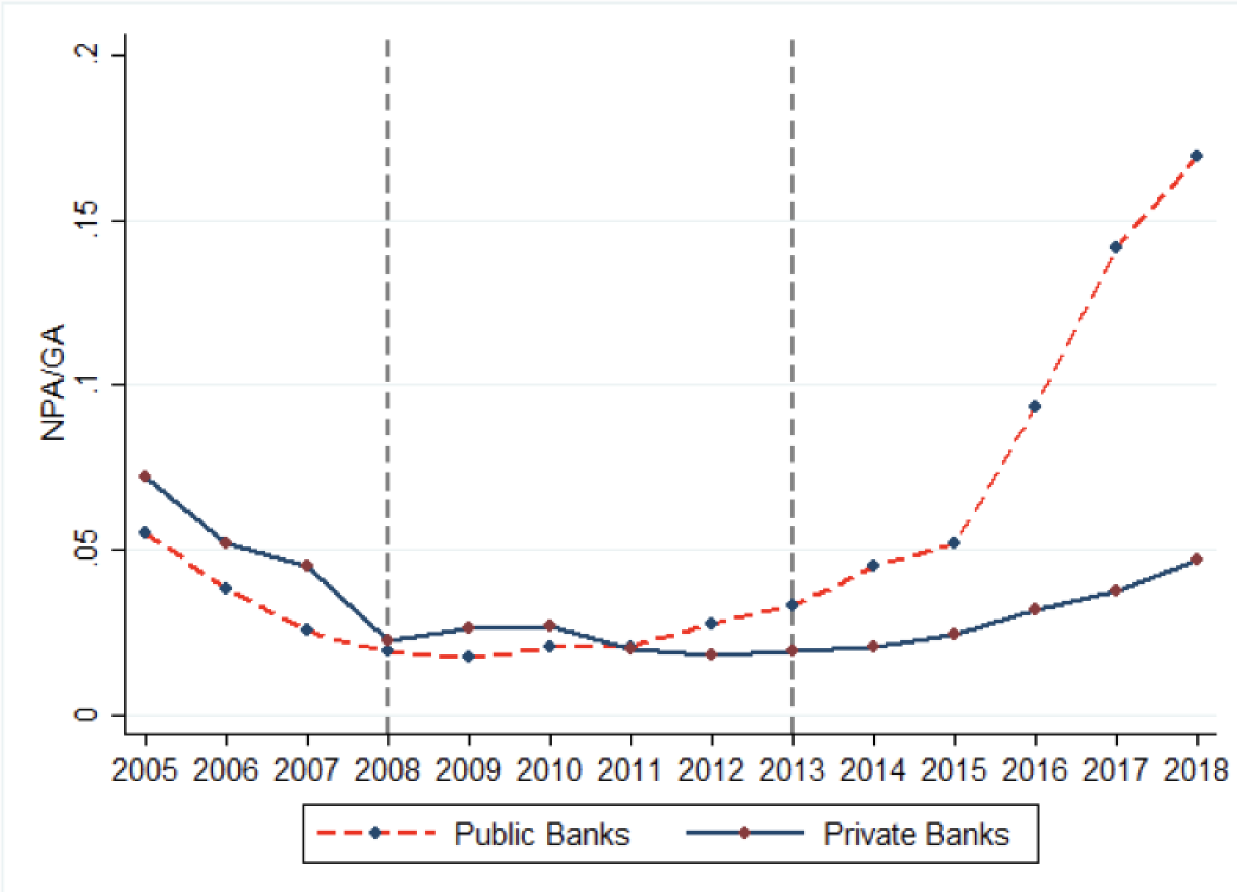
Table 1 – Comparison of the NPAs (in %) of Private Sector Banks and Public Sector Banks for the time period of 5 years – from FY 2015 to FY 2019

Source: HDFC, ICICI, Axis Bank, Kotak, Yes Bank, SBI, PNB, Bank of Baroda, Canara Bank, BOI



Graph 1 – NPAs in percentage of total Gross Advances by bank for Public and Private Sector Banks

The graph shows the NPAs (in percentage of total Gross Advances by banks.) of Private Sector Banks and Public Sector Banks for a period of 5 years – from FY 2015 to FY 2019. It is quite evident that the NPAs of public sector banks considerably exceed those of private sector banks. There are multiple reasons for this stark contrast and the soaring figures for public sector banks. which will be explored further in the paper. From the graph, it can be seen that over the mentioned time period, out of public sector banks, Bank of India has the highest percentage of NPAs in the year 2018 which is 23.46% of its total gross advances. Whereas, amongst private sector banks, the highest percentage of NPAs in terms of the same parameter is 9.90%. Comparing the lowest percentage of NPAs, within public sector banks, SBI's ranks lowest with non-performing assets of 3.99%. Amongst private sector banks, Yes Bank has the least NPAs for the given time period with 0.42 of its total gross advances. We also explore the mean NPAs of each mentioned bank during this period of five years to develop a better understanding. Amongst private sector banks, ICICI Bank has the highest mean percentage with 7.12%. A substantial rise can be seen in the same figure for public sector banks. Bank of India has the highest mean percentage for nonperforming assets over the five years with an elevated figure of 16.70%.



Graph 2 – Nonperfroming loans – Public Sector Banks vs Private Sector Banks.

Source: Link

The graph shows the average level of nonperforming loans in Public and Private sector banks which offers another perspective to understand the conundrum. From 2009, a steady rise in the levels of nonperforming loans for Public sector Banks can be observed as they continue to soar and leapfrog levels set by Private sector Banks. Post 2011, the average level of nonperforming loans for Public sector banks start to aggressively soar, leaving Private sector banks behind and spurring a dangerous NPA crisis which the nation is still struggling to find solutions for.

Impact on Profitability

An efficient credit function plays a significant role in determining the overall profitability and performance of both individual banks and the overall banking system. Credit and Credit Risk Management are two very important functions performed by a bank that are majorly impacted with a rise in the NPA levels. In the past decade, factors such as the nature of ownership, credit management and alarming banking decisions have been playing a significant role in determining NPAs for Public sector banks in particular. The financial crisis of 2008-09 triggered by the subprime mortgage crisis in the United States had adverse effects on financial markets and institutions throughout the globe. The global financial crisis spurred a capital management crisis causing a series of catastrophic events like bank failures, losses, consequential mergers and forced interventions from financial authorities. Bank profitability is inversely proportional to the level of NPAs. As NPAs increase, bank profits go down. There are two primary reasons for this, banks do not receive the payments for the amount that they initially lended but banks are also required to create bigger provisions depending upon the nature of the NPA. Banks have lesser resources to invest which negatively impacts their balance sheets. This reduces inflation and the overall growth of the economy. As a result, the rate of interest on deposits is also reduced by banks which impacts customer belief. NPAs adversely impact cash reserve ratio and the liquidity ratio which reduces shareholders' confidence (Muthumeena 2019). NPAs have a tremendous impact on the overall flow of credit and the financial health of banks.

So why are NPAs higher in PSBs?

PSB's have higher NPA extents and NPA ratios than PVBs because they have implemented progressive credit policies, as well as loans on particular borrowers and businesses, such as major credit exposure levels to a few big enterprises and industries such as infrastructure, power, steel, mining, and telecommunications. In addition, internal factors such as weak internal control techniques, fraud, sizable corruption operating between the branches, a reduced CRAR, and a greater quasi net income especially in comparison to PVBs have significantly impacted the performance of PSBs. The performance of PVBs has been much better across almost all of these dimensions. There are also other factors like hindrance and interference due to political reasons by political parties and corporations.[3]

While there are multiple internal factors that hinder the proper functioning of PSBs, it's the external factors that have left a long-lasting impact on them. One of these external factors includes the demand and trade shocks that the Global Financial Crisis brought with it. As mentioned earlier, the Indian economy was able to avoid the immediate impact of the GFC when it struck the global economy. However, the economy faced turbulence in the following years as the banking system, trade patterns, and the exchange rate bore the brunt of the impact. The reliance of the Indian corporate sector on external funding had an indirect impact on the health of Indian banks, especially on public banking sectors since PVBs do grab a major share of this funding.

The worsening of public sector bank health implied that they didn't have enough capital. Zombie lending fits the likely explanation of the pressure of satisfying additional BASEL-III capital guidelines and slowing credit flows to healthier firms in industries and banks where this kind of lending is prevalent, {Basel III requires at least total capital ratio of 12.9 percent, with a minimal level Tier 1 capital ratio of 10.5 percent of total risk-weighted assets (RWA) and a minimum Tier 2 capital ratio of 2% of RWA) as well as asset quality stress. Zombie lending is essentially defined as lending to otherwise insolvent borrowers that takes up valuable and stymies economic growth. Similar patterns have been observed in Japan and Europe. The dominant view of what drives zombie lending is based majorly on the Japanese experience, and it places banks and government assistance administered through banks at the heart of the problem.

Now, another reason for this significant difference in both the sectors is weak frameworks and absence of bankruptcy laws. Despite having forbearance policies and allowing banks to restructure their debts, issues arise when banks' and firms' incentives to restructure are misaligned with the forbearance regulation's intent. In India's case, it benefited both banks and

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[3] "The Origins of India's NPA Crisis." *Indian Economy*, 8 October 2019, https://indianeconomy.columbia.edu/sites/default/files/content/201904-Chari%20et%20al-NPA%20Crisis.pdf.

firms. This is due to the fact that balance sheets of banks could appear more lucrative than they were by emptying assets that would otherwise have been used for obtaining potential nonpayment by nonperforming loans. As a result, the possibility for arbitrage opportunities was thus built into the provisioning framework, as evidenced by the slight increases in these percentages for the lower asset classifications coupled with the compensation for maintaining an improved asset classification. The RBI's policy of forbearance was prolonged, leading to the formation of a low credit value system in Indian banking.

Proposed Solutions

Over the years, a number of instruments have been adopted by the RBI to deal with the existing problem of NPAs in the banking system, however, these have not been hugely successful. Some of these include sale to asset-reconstruction companies (ARCs), strategic debt restructuring, and refinancing or sustainable structuring of stressed assets.

Asset Reconstruction Companies are companies that work to buy off bad loans from banks and financial institutions and generate profit through the same by successfully recovering the money back. Asset reconstruction companies have the ability to play a major role in the insolvency and turnaround framework of India. Essentially when you give a loan and the loan goes bad, the problem today is that banks will try their best to recover it but that almost always tend to fail so invariably what happens is that the banks will have to provide excess capital which gets stuck cause they aren't able to recover it. One way out of this cycle for Banks and Financial Institutes is to turn to the dedicated funds available in the form of asset reconstruction companies. Since capital is scarce in India there's a big relevance for ARCs in the economy to revive these bad loans and reconstruct them as an attempt to make them viable for future sale.

There is also a rallying cry for the creation of a single 'bad loan' bank, whereby all bad loans will be merged in order to be settled with streamlined outcomes whilst also keeping sectoral challenges and the multitude of lenders in mind. The idea looks impressive on paper, however execution for the same is pretty complicated since creation of bad banks is seen as a very politically sensitive issue which hampers its implementation.

Another potential solution to the rising problem of NPAs in India is for the affected banks to recapitalise as a way to tackle the immediate accumulation of the same. A majority of the Public Sector Banks found in India have balance sheets that reflect large amounts of NPAs. Without adequate capital available to banks to provide loans, there is a disruption to the flow of money in the economy that can fuel an economic crisis. The government injecting capital into these banks works to help them catch a break from the cycle of bad loans, give them time to clean up their sheets and strengthen their credit portfolio. However, recapitalisation works only as a temporary solution. In order for there to be a sustained correction to the problem, there has to be implementation of further reforms and government intervention.[4]

In the context of public sector banks a possible remedy to the problem of NPAs is that of privatisation. The managerial structure of public sector banks along with the influence of political institutions leaves room for a great deal of inefficiencies that further the NPA problem. If these affected banks were to privatise parts of their services, the PSB's are likely to benefit off the expanded ownership. Private sector banks are motivated and incentivised by profits, cutting costs, avoiding losses and inefficiencies and taking risks. This kind of an approach could be essential for Public sector banks if they are aiming to cut down the levels of NPAs in their balance sheets.[5]

Former RBI Governor Mr Raghuram Rajan has also suggested steps emphasising on the need to prevent recurrences which involves improving the quality of the top management and senior boards of Public Sector Banks (where a major chunk of NPAs lie). It is commonly believed that the top management of Public Sector Banks suffers from what is called a talent deficit. This is a result of their hiring approach and resistance to bring in talent from outside the institution. Whether bringing in talent from outside or from within the institution, a proper vetting of the bankers to avoid conflict of interest with the clients while sanctioning the loans is an absolute must.

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[4] Mukhopadhyay, Abhijit. "Finding Innovative Solutions to India's NPA WOES." *ORF*, 13 Aug. 2018, https://www.orfonline.org/research/finding-innovative-solutions-to-indias-npa-woes/.

[5] Roy, Richa, et al. "How to Solve Issue of Rising Non-Performing Assets in Indian Public Sector Banks." *Brookings*, Brookings, 25 Mar. 2019, https://www.brookings.edu/blog/up-front/2018/03/01/how-to-solve-issue-of-rising-non-performing-assets-in-indian-public-sector-banks/.

A change in the conventional hiring/promotion approach in Public Sector Banks might give rise to internal resistance and disputes however it is absolutely essential to prevent recurrences and safeguard lakhs of crores of national assets. Increased scrutiny during sanctioning of these loans can help reduce NPAs, a more efficient and talented senior board can be entrusted with carrying out a proper data analysis and state of the art technology to identify the warning signs early, trends can be observed for the formulation of mechanisms to identify hidden NPAs. Efficient credit assessment and forensic audits to understand the intent of the borrower are key preventive steps which should not be ignored.

Conclusion

Through the paper we explored the dynamics of the financial market and banking sector focusing primarily on the growing problems of NPAs in the Indian economy, while comparing the influence of the same on both the public and private sector of the economy. From the data analysis conducted, we see from the results generated that the public sector has a higher number of NPAs and the reasons behind this is largely attributed to a number of factors both internal and external such as that of poor managerial techniques, lack of incentives, higher levels of fraud etc. We also analysed the impact of the Global Financial Crisis on the Indian economy and the levels of NPAs in the banking sector. Economists have been working to fix the NPA problem in India for a while now. A balance sheet filled with NPAs reflects poorly on the banking sector of that economy and dissuades further investments which could lead to a domino effect of a number of other economic consequences. In order to avoid this, the government and economic advisors have been trying relentlessly to eradicate the accumulating NPAs in the banking sector and clear the twin balance sheet problems of these banks so as to strengthen the credibility of the financial sector of the country.

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