**PAPER PRESENTED FOR TWO DAY NATIONAL LEVEL CONFENRECE ON**

**“INNOVATION IN THE INDIAN FIANANCIAL SECTOR TOWARDS ECONOMIC GROWTH”**

**THEME: BANKING PRACTICES**

**TITLE OF THE PAPER: NPA’s As an Important Parameter To Evaluate The Performance And Financial Health Of Banks In India.**

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**NPA’s As an Important Parameter To Evaluate The Performance And Financial Health Of Banks In India.**

**Abstract:**

Non-performing assets are what their label says they are. They are assets, usually loans, that aren't earning the lender any income. They aren't producing. While they aren't doing the lender much good to carry them on the company books, writing the loans off as bad debt will look just as bad. So companies hold non-performing assets in the hopes that situation will change for the better or that the company may be able to sell the bad debt to another company. Non-performing assets are problematic for financial institutions since they depend on interest payments for income. Troublesome pressure from the economy can lead to a sharp increase in [non-performing loans](http://en.wikipedia.org/wiki/Non-performing_loan) and often results in massive write-downs.

A strong banking sector is important for flourishing economy. The failure of the banking sector may have an adverse impact on other sectors. Non-performing assets (NPA) are one of the major concerns for banks in India. A loan or lease that is not meeting its stated principal and interest payments is said to be non-performing assets. Banks usually classify as NPA any commercial loans which are more than 90 days overdue, and any consumer loans which are more than 180 days overdue. Most of the rise in NPA is due to problems with commercial loans. A lot of banks and financial institutions in India are dealing with pending cases of these natures for over many years. The banks are lending money to get revenue through interest rates along with principal. But NPA has a bad effect on bank revenue. Non-performing loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. The NPA are considered as an important parameter to judge the performance and financial health of banks. If a bank has high NPA ratio then its performance is considered as weak than that of a bank with lower NPA ratio. It creates a bad effect on good will and equity value of the bank.   
Sometime the banks also hide the actual NPA ratio. These are the challenges the banks are facing regarding the non-performing assets. The reason investors are wary of lenders with too many non-performing assets is that with a reduced cash flow, the company has tighter credit policies. This leads to slower economic growth and economic development because other businesses won't be able to get a loan. With one company this may not be too big of a problem because a company seeking a loan can also find another lender. However, if the problem begins to spread throughout the lending industry, then it will also begin to spread beyond it to other industries as companies find themselves without an option for lender. The SARFAESI Act empowers Banks / Financial Institutions to recover their non-performing assets without the intervention of the Court. The Act provides three alternative methods for recovery of non-performing assets

**Keywords: NPA’s, SARFAESI Act, Securitization, Economy, financial institution.**

**Introduction**

The main business of a banking company is to receive deposits and lend money. Receiving deposit involves no risk, since it is the banker who owes a duty to repay the deposit, whenever it is demanded. On the other hand, lending always involves much risk because there is no certainty of repayment. A banker shall be very cautious in lending, because he is not lending money out of his own capital. A major portion of the money lent comes from the deposits received from the public. These deposits are mostly repayable on demand. Hence, while lending money, a banker should follow a very cautious policy. The risk involved in lending business makes it very important as it involves making prominent decisions. Therefore while sanctioning credit the banker should appraise the project reasonably or else it leads to the non-repayment of loans and advances. Most of the banks today in India are facing the default risk wherein some part of the profit is reserved for covering the non-performing assets.

Non-performing Asset (NPA) has emerged since over a decade as an alarming threat to the banking industry in our country sending distressing signals on the sustainability and endurability of the affected banks. The positive results of the chain of measures affected under banking reforms by the Government of India and RBI in terms of the two Narasimhan Committee Reports in this contemporary period have been neutralized by the ill effects of this surging threat. Despite various correctional steps administered to solve and end this problem, concrete results are eluding. It is a sweeping and all pervasive virus confronted universally on banking and financial institutions. The severity of the problem is however acutely suffered by Nationalized Banks, followed by the SBI group, and the all India Financial Institutions.

**Objectives of the study**

i. To understand the concept of NPAs.

ii. To investigate the impact of NPAs on profitability of the banks.

iii. To analyze the reasons for an asset turning into a non performing assets

iv. To understand the SARFESI Act

1. **Concept of NPAs**

An asset is classified as Non-performing Asset (NPA) if due in the form of principal and interest are not paid by the borrower for a period of 180 days. However with effect from March 2004, default status would be given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by banks to a borrower becomes non-performing, 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.

Though the term NPA connotes a financial asset of a commercial bank, which has stopped earning an expected reasonable return, it is also a reflection of the productivity of the unit, firm, concern, industry and nation where that asset is idling. Viewed with this perspective, the NPA is a result of an environment that prevents it from performing up to expected levels.

THE DEFINITION OF NPAS

The definition of NPAs in Indian context is certainly more liberal with two quarters norm being applied for classification of such assets. The RBI is moving over to one-quarter norm from 2004 onwards.

NPA is defined as a credit facility in respect of which the interest and / or installment of principal has remained ‘past due’ for a specified period of time.

An asset including a leased asset, becomes NPA when it ceases to generate income for the bank

**Why Loan accounts go bad?**

Borrower Side Banker Side

Lack of planning Defective Sanction

Diversion of funds No post-sanction, supervision etc.,

Disputes within Delay in releases

No contribution Directed lending

No modernization Slow decision making process

Improper monitoring

Industrial relations

Natural calamities

**NPA’S CLASSIFICATION:**

NPA have been classified into following four types:-

1. Standard Assets: A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPA in the real sense.

Arrears of interest and the principal of loan does not exceed 90days at the end of financial year.

1. Sub-Standard Assets : All those assets (loans and advances) which are considered as non-performing for a period of 12 months.
2. Doubtful Assets: All those assets which are considered as non-performing for period of more than 12 months.

* Up to 1year 20% provision is made by the banks
* Up to 2year 30% provision is made by the banks
* Up to 3year 100% provision is made by the banks

1. Loss Assets : All those assets which cannot be recovered. These assets are identified by the Central Bank or by the Auditors.

**PROVISIONING NORMS**

🡺 Standard Assets: general provision of a minimum of 0.40% of standard assets

🡺 Sub-Standard Assets: 10% on total outstanding balance, 10% on unsecured exposures identified as Sub standard and 100% for unsecured “doubtful” assets.

🡺 Doubtful Assets: 100% to the extent advance not covered by realizable value of security. In case of secured portion, provision may be made in the range of 20% to 100% depending on the period of asset remaining sub-standard,

🡺 Loss Assets 100% of the outstanding.

**PREVENTING MEASURES FOR NPA:**

* Early recognition of the problem
* Identifying borrowers with genuine intent
* Timeliness and adequacy of response
* Focus on cash flows
* Multiple financing

**TYPES OF NPA**

**GROSS NPA**: Gross NPAs are the sum total of all loan assets that are classified as NPAs as per RBI Guidelines as on Balance Sheet date. Gross NPA reflects the quality of the loans made by banks. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss assets.

It can be calculated with the help of following ratio:

**Gross NPAs Ratio = Gross NPAs / Gross Advances**

**NET NPA**: Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. Net NPA shows the actual burden of banks. Since in India, bank balance sheets contain a huge amount of NPAs and the process of recovery and write off of loans is very time consuming, the banks have to make certain provisions against the NPAs according to the central bank guidelines.

It can be calculated by following:

**Net NPAs = Gross NPAs – Provisions / Gross Advances – Provisions**

1. **Impact of NPA on the operations of banks**

**Profitability**

NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client. Because of the money getting blocked the prodigality of bank decreases not only by the amount of NPA but NPA lead to opportunity cost also as that much of profit invested in some return earning project/asset. So NPA does not affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low ROI (return on investment), which adversely affect current earning of bank.

**Liquidity** Money is getting blocked, decreased profit lead to lack of enough cash at hand which lead to borrowing money for shortest period of time which lead to additional cost to the company. Difficulty in operating the functions of bank is another cause of NPA due to lack of money.

**Involvement of Management** Time and efforts of management is another indirect cost which bank has to bear due to NPA. Time and efforts of management in handling and managing NPA would have diverted to some fruitful activities, which would have given good returns. Now days, banks have special employees to deal and handle NPAs, which is additional cost to the bank.

**Credit Loss** If a bank is facing problem of NPA, then it adversely affects the value of bank in terms of market for credit. It will lose its goodwill and brand image and credit which have negative impact to the people who are putting in their money in the banks (C.S. Balasubramaniam, 2011).

1. **Reasons for an asset turning NPA**

Various Studies have been conducted to analyze the reasons for NPA, what ever may be complete elimination of NPA is impossible.

The reason were generally classified into two

1. Overhand component – due to environmental reasons, business cycle etc

2. Incremental component – due to internal bank management, credit policy, term of credit etc.

There are various reasons either jointly or singly responsible for an asset becoming NPA can be classified as follows:-

**Reasons from the economic side**

1. Political: Mindset regarding paradigm, proactive, fiscal responsible, major portion of NPA arise out of lending to priority sector at the dictates of politicians and bureaucrats.

2. Economic: Growth, distribution, efficient allocation of resource.

3. Social: Acceptability, mobility, education.

4. Technological: Lack of adoption of IT makes data processing difficult.

5. Legal: loan contracts are not enforceable naturally be a tendency to default.

6. Environmental: Liberalization and globalization.

**Reasons from the industry side**

1. Global competition.

2. Cyclical downswing.

3. Sunset industry – industry growing slowly or declining.

4. Frequent changes in regulatory norms.

**Reasons from the borrower side**

1. Misconceived project.

2. Poor governance.

3. Product failure.

4. Bungling management.

5. Diversion of fund.

6. Dormant capital structure.

7. Regulator changes.

**Reasons from the banking side**

1. Parameter set for functioning was deficient.

2. Lack of freedom to choose product and pricing.

3. Unexposed to international marketing methods and products.

4. Wrong lending decision.

5. Lack of Resource and poor training.

6. Lack of system and procedure.

7. Lack of ability to handle assets and liability.

8. Lack of mechanism of credit information dissemination.

9. Lack of an effective judicial system for recovery from defaulters.

10. Collateral based lending to idle assets.

11. Fixing of price and quantum of loans.

12. Lack of effective IT system and MIS.

**Reasons from the loan structuring side**

1. High debt equity ratio.

2. Timing of raising equity.

3. Discrepancy between rate of interest charged and realistic rate of return.

4. Inconsistency between revenue generation and the loan repayment schedule.

5. Lack of binding penal clause and performance guarantees.

6. Rising interest rate.

**Reason from the security side**

There is a tendency among bank and institution to depend excessively on collateral for advancing loans. It is important to presume that if the borrower default in repaying then the security given will be helpful for recovery of loan. Clearly this logic is unacceptable. Emphasis should be on cash generation and a charge on this should be built into the loan contract through some escrow mechanism.

1. **SARFAESI Act**

SARFAESI is effective only for secured loans where bank can enforce the underlying security example: hypothecation, pledge and mortgages. In such cases, court intervention is not necessary, unless the security is invalid or fraudulent. However, if the asset in question is an unsecured asset, the bank would have to move the court to file civil case against the defaulters.

**HOW IT WORKS?**

The SARFAESI Act, 2002 gives powers of "seize and desist" to banks. Banks can give a notice in writing to the defaulting borrower requiring it to discharge its liabilities within 60 days. If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures: Take possession of the security for the loan Sale or lease or assign the right over the security Manage the same or appoint any person to manage the same The SARFAESI Act also provides for the establishment of Asset Reconstruction Companies (ARCs) regulated by RBI to acquire assets from banks and financial institutions. The Act provides for sale of financial assets by banks and financial institutions to asset reconstruction companies (ARCs).

RBI has issued guidelines to banks on the process to be followed for sales of financial assets to ARCs.

**BACKGROUND OF THE ACT**

The previous legislation enacted for recovery of the default loans was Recovery of Debts due to Banks and Financial institutions Act ,1993. This act was passed after the recommendations of the Narsimham Committee - I were submitted to the government. This act had created the forums such as Debt Recovery Tribunals and Debt Recovery Appellate Tribunals for expeditious adjudication of disputes with regard to ever increasing non- recovered dues. However, there were several loopholes in the act and these loopholes were mis-used by the borrowers as well as the lawyers. This led to the government introspect the act and this another committee under Mr. Andhyarujina was appointed to examine banking sector reforms and consideration to changes in the legal system . This committee recommended to enact a new legislation for the establishment of securitisation and reconstruction companies and to empower the banks and financial institutions to take possession of the Non performing assets. Thus, via the Sarfaesi act, for the first time, the secured creditors were empowered to recover their dues without the intervention of the court. However, as soon as the act was passed, its implementation was challenged in the court and this delayed its coming into force for 2 years. In the Mardia Chemicals v. Union of India, the Supreme Court upheld the validity of the SARFAESI act was upheld.

**RIGHTS OF BORROWERS**

The above observations make it clear that the SAFAESI act was able to provide the effective measures to the secured creditors to recover their long standing dues from the Non performing assets, yet the rights of the borrowers could not be ignored, and have been duly incorporated in the law. The borrowers can at any time before the sale is concluded, remit the dues and avoid loosing the security. In case any unhealthy/illegal act is done by the Authorised Officer, he will be liable for penal consequences. The borrowers will be entitled to get compensation for such acts. For redressing the grievances, the borrowers can approach firstly the DRT and thereafter the DRAT in appeal. The limitation period is 45 days and 30 days respectively

**PRE-CONDITIONS**

The Act stipulates four conditions for enforcing the rights by a creditor. The debt is secured The debt has been classified as an NPA by the banks The outstanding dues are one lakh and above and more than 20% of the principal loan amount and interest there on. The security to be enforced is not an Agricultural land.

**METHODS OF RECOVERY**

According to this act, the registration and regulation of securitization companies or reconstruction companies is done by RBI. These companies are authorized to raise funds by issuing security receipts to qualified institutional buyers (QIBs), empowering banks and Fls to take possession of securities given for financial assistance and sell or lease the same to take over management in the event of default. This act makes provisions for two main methods of recovery of the NPAs as follows:

Securitisation: Securitisation is the process of issuing marketable securities backed by a pool of existing assets such as auto or home loans. After an asset is converted into a marketable security, it is sold. A securitization company or reconstruction company may raise funds from only the QIB (Qualified Institutional Buyers) by forming schemes for acquiring financial assets. Asset Reconstruction: Enacting SARFAESI ACT has given birth to the Asset Reconstruction Companies in India. It can be done by either proper management of the business of the borrower, or by taking over it or by selling a part or whole of the business or by rescheduling of payment of debts payable by the borrower enforcement of security interest in accordance with the provisions of this Act. Further, the act provides Exemption from the registration of security receipt. This means that when the securitization company or reconstruction company issues receipts, the holder of the receipts is entitled to undivided interests in the financial assets and there is not need of registration unless and otherwise it is compulsory under the Registration Act 1908. However, the registration of the security receipt is required in the following cases: There is a transfer of receipt The security receipt is creating, declaring, assigning, limiting, extinguishing any right title or interest in a immovable property. Is Mortgaged House exempted? The SARFAESI ACT covers any asset, movable or immovable, given as security whether by way of mortgage, hypothecation or creation of a security interest.

There are some exceptions in the act such as personal belongings. However, only that property given as security can be proceeded under the provisions of SARFAESI ACT. If the property of the borrower is his own mortgaged residential house, it is also NOT exempted from the SARFAESI ACT.

**POWERS OF DEBT RECOVERY TRIBUNAL**

The debt Recovery Tribunals have been empowered to entertain appeals against the misuse of powers given to banks. Any person aggrieved, by any order made by the Debts Recovery Tribunal may go to the Appellate Tribunal within thirty days from the date of receipt of the order of Debts Recovery Tribunal.

**ROLE OF CHIEF METROPOLITAN MAGISTRATE OR DISTRICT MAGISTRATE**

The Chief Metropolitan Magistrate or District Magistrate has been mandated to assist secured creditor in taking possession of secured asset. These officers will make sure that once the creditor has given him in writing that all other formalities of the act have been done, the CMM or DM will take possession of such asset and documents relating thereto; and forward such assets and documents to the secured creditor. Now, here, you have to note that such an act of the CMM or DM can not be called in question in any court or before any authority.

**ROLE OF HIGH COURT:**

The act allows taking the matter to high courts only in some matters related to the implementation of the act in Jammu & Kashmir. However, High Courts have been entertaining writ petitions under article 226 (Power to issue writs) of the constitution of India.

**Economic Survey 2014: Growth of non-performing assets a cause for concern**

NEW DELHI: The four-fold rise in bad loans over the past two years, mainly of public sector banks is a matter of concern and steps are being taken to improve the situation, the Economic Survey said.  
  
"During 2012-13, the deteriorating asset quality of the banking sector emerged as a major concern, with gross NPAs ( non-performing assets) of banks registering a sharp increase...Growth of NPA is a cause for concern," the Survey tabled in Parliament by Finance Minister Arun Jaitley said. ..

The bad loans of public sector banks were at 4.4 per cent in March 2014 compared with 2.09 per cent in 2008-09, it said, adding, the gross NPA increased by almost four times from March 2010 (Rs 59,972 crore) to March 2014 (Rs 2,04,249 crore).  
  
Increase in NPAs of banks is mainly accounted for by switchover to system-based identification of NPAs by PSBs (public sector banks), slowdown of economic growth, and aggressive lending by banks in the past, especially during good times, it said.<b ..

Overall NPAs or bad loans of the banks, including private sector lenders, increased from 2.36 per cent to 3.90 per cent in March 2014. Increase was sharp in case of infrastructure with NPAs rising from 3.23 per cent to 8.22 per cent, it said.

Infrastructure, iron and steel, textiles, aviation and mining are five main sector that are stressed.  
  
"The next wave of infrastructure financing will require a capable bond market."  
  
Despite, asset quality deteriorating, the survey said the capital positions of Indian banks, including that of public sector, remained strong and above the stipulated minimum.  
  
Highlighting challenges and outlook, the Survey said financial markets continue to suffer from illiquidity and a major objective should be to develop bond-currency derivative (BCD) nexus to equity market quality levels.

It said most households are as yet cut off from large parts of the financial system and bank-centric notions of financial inclusion have limited value.

The speed of reforms in the financial sector has not kept pace with financial innovation and the next wave of reforms will be through strengthening the laws, organisations, well designed policy decisions, consistency, and transparency for a globalised India, it said.

On financial inclusion, the Survey said it "is an important priority of the government".  
  
To extend the reach of banking, PSBs opened 7,840 branches in 2013-14 compared to 4,432 in 2012-13, it added.

Going forward, the draft Indian Financial Code of the Financial Sector Legislative Reforms Commission (FSLRC) seeks to address the present weaknesses of the Indian financial system, and meet the requirements of the Indian economy over the coming 30 years

**Conclusion:**

A strong banking sector is important for a flourishing economy. The failure of the banking sector may have an adverse impact on other sectors. NPAs reflect the overall performance of the banks. The NPAs have always been a big worry for the banks in India. The Indian banking sector faced a serious problem of NPAs. . A high level of NPAs suggests high probability of a large number of credit defaults that affect the profitability and liquidity of banks. The extent of NPAs has comparatively higher in public sectors banks. To improve the efficiency and profitability, the NPAs have to be scheduled. Various steps have been taken by government to reduce the NPAs. It is highly impossible to have zero percentage NPAs. But at least Indian banks should take care to ensure that they give loans to creditworthy customers.

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