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Why Non-Performing Assets Are More in Public Sector Banks in India?

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Abstract

The paper identifies why there are more non-performing assets (NPAs) in the public sector banks (PSBs) than those in the private sector banks (PVSBs). It evaluates and reviews the policies and practices of scheduled commercial banks (SCBs) in terms of NPA management. It studies the causes of NPAs, such as ownership structure, credit terms, conditions and covenants, nature of loans, kind of borrowers, bank management practices and business cycles. The study suggests that PSBs have adopted liberal and loose credit policies, and have concentrated loans on borrowers and sectors, *i.e.*, huge credit exposures to a few large corporate borrowers and to a few sectors. It also finds that PSBs are subject to weak and mild regulatory and supervisory impacts on their operations and functions as these are owned by the Government of India. The managements of PSBs are indifferent to the success and performance of PSBs as there are no incentives or penalties for their performance and nonperformance. It is suggested that the PSBs should develop both the skills and practices towards credit and credit risk management. The government has to introduce flexible compensation package and incentives to the managements of PSBs linked to the performance so that it will improve profitability and reduce NPAs. The Reserve Bank of India's regulation and supervision should be ownership neutral.

Keywords

Credit Risk Management, Public Sector Banks, Non-Performing Assets

1. Introduction

The profitability and performance of banking institutions depend upon the efficient credit function of banks. Credit and credit risk managements are important functions of the bank. The nature of ownership, credit management or style of management or principles and practices of baking business are influencing and determining the NPAs in scheduled commercial banks (SCB) in general and public sector banks (PSB) in particular. The core business of a bank is to manage different risks and to provide a return to shareholders in line with the risk profile of the bank. The global financial meltdown triggered during 2008-09 by the subprime mortgage crisis of United States and its adverse effects on financial markets and participants in the financial industry. The global financial crisis has created capital management crises and problems in most of the financial institutions and banks. The crisis turned out to be a major financial crisis in 2009 with a series of bank failures, mergers, losses and unprecedented interventions of financial authorities in providing liquidity in the system and announced nationalization of major institutions. Risk management in banking industry has became an important issue since the 2009 global financial crisis (Joel) [1].

Overview of Indian Banking Industry

The present Indian banking structure comprises 84 scheduled commercial banks (SCBs) consisting of 21 public sector banks (PSBs), 20 private sector banks (PVBs) and 43 foreign banks (FBs). These banks account for 98 per cent of the banking business in India [2]. In the post reforms era, the Indian banking experienced tremendous growth in deposits mobilization, sanctions of loans and overall banking business. Commercial bank credit as percent of GDP picked up steadily from 24 per cent in 2001 to 55 percent by 2017 [2]. The ratio of bank deposits also grew from 44 per cent to 68 per cent during the same period. Most of the banks in public and private sectors are listed on the stock exchanges and are actively trading at the stock exchanges. The performance and strength of the banking structure improved perceptibly during last three decades. It supported commerce, industry, trade, and personal segments of the economy by providing different types of banking products. The Indian economy and banking industry had changed drastically since introduction of financial reforms in 1990s. Based on recommendations of Narasimham Committee Report, 1991 [3]. Reserve Bank of India (RBI) introduced several reforms such as reduction of reserve requirements, deregulation of interest rates, introduction of prudential norms, strengthening of bank supervision and improving the competitiveness of the system by allowing entry of private banks. The second Narasimham Committee Report, 1998 [4] laid emphasis on two aspects of banking regulation, viz., capital adequacy and asset classification and resolution of NPAs. The RBI has taken various measures for early identification of asset quality problems, timely restructuring of debt and recovery of loans. The RBI also introduced Basel III norms of minimum capital requirements to improve the overall health of the banking industry. The soundness of the system was evident from the way it withstood the financial crises of 1997-98 and 2008-09, even the banking systems in many developed countries across the world were adversely affected [5]. Financial soundness of the Indian banking system can be considered as one of the best banking systems in the world [6]. Four subsidiaries of the State Bank of India such as State Bank of Bikaner & Jaipur, State Bank of Travancore, State Bank of Patiala, State Bank of Hyderabad and the new government bank Bharatiya Mahila Bank Ltd. (BMB) have been merged with the State Bank of India (SBI) during 2016-17.

2. Literature Review

Jarrow [7] presents a new methodology for estimating risk ratings (RRs) and probability of defaults (PDs). Muniappan [8] concludes that the problem of NPAs is related to several internal and external factors confronting the borrowers The internal factors are diversion of funds for expansion, diversification and, taking up new projects. Bagchi and Ghosh [9] (2003), conclude that proper credit risk architecture, policies and framework of credit risk management, credit rating system, monitoring and control contributes in success of credit risk management. Ranjan and Dhal [10] analyzed the effect of terms of credit, bank specific variables and macroeconomic shocks on NPA of banks. The study identifies that the maturity of credit, better credit culture, and favorable macroeconomic and business conditions can lead to lowering NPAs. Das and Ghosh [11] find that collateral might also play a role in influencing bad loans. In a growth phase, rapid increases in asset prices will increase the availability of pled gable funds, willingness of banks to increase lending. If the recessionary tendencies gather momentum, the decline in asset values leads to an overall lowering in collateral values as well, leading to an overall declining credit standards, and creates NPAs. Bodla and Richa [12] their study reveals that irrespective of sector and size of bank, the risk management framework of banks in India are on the right track and are based on the RBI's guidelines. Misra and Dhal [13] in their study examined the pro-cyclical movement of NPA in PSBs. The authors conclude that the terms of credit such as 1) interest rate, 2) maturity, 3) collateral and 4) bank specific variables have a significant effect on the banks' NPAs in the presence of macroeconomic shocks. Das and Ghosh [14] investigate that to the extent bank size acted as a proxy for diversification, it seemed likely that bigger banks could exhibit higher stability. However, results indicate negative impact of banks size on banking stability index on large banks had higher credit risk. Thiagarajan *et al.* [15] find a negative correlation between bank size and non-performing asset as banks with more assets had more resources for developing proto cots and training of credit officers. The differences in ownership and legal dispensation create challenges for the recognition and resolution of banking crises (Sengupta and Vardhan) [16].

Non-Performing Assets in Indian Banks

There are about Rs.10.0 lakh crore of advances and loans had been recognized as non-performing assets (NPAs) on total commercial credit of Rs.54.0 lakh crore as at the end of March 2018 [17]. It is estimated that there are about Rs.3.00 lakh crore of undeclared and undisclosed non-performing assets in the books of banks by March 2018. Credit risk is inherent in the business of banking. Banking institutions do financial intermediation by undertaking asset liability transformation, size transformation, maturity transformation and risk transformation. As a result of these four transformations, banking business is nothing but risky business. The risks such as credit risk, market risk (interest rate, liquidity, foreign exchange risk, and equity price risk) and operational risks generate stressed assets, NPAs and losses to banks. Credit risk is major source of NPA. Poor and weak credit management of banks will lead to more credit risk management. Inefficient and defective credit risk management policies and practices lead to crystallization of more NPAs in banks. The global financial crisis demonstrated the shortcomings of the framework for effective credit and financial crisis management. Banks may have an opportunity with increasing demand for loans during economic expansion, but restrain supply during recession to avoid possible losses caused by economic downturn. During economic expansion and growth, banks augment their capital base through retained earnings, and increased participation in the domestic and international capital market; and during the periods of contraction, (down turn or recession) raising capital would be difficult because of high cost of funds and less supply capital funds. The RBI directed SCBs to initiate insolvency and bankruptcy proceedings against major defaulters and borrowers which account for about 20 per cent of all bad loans of the system.

In view of these developments and not many studies were carried out on the subject in the Indian context, the present study is undertaken. To undertake the study, information and data relating to the performance and NPAs of all the SCB has been collected from secondary sources for the period 2013 to 2018. The scope of this paper is to investigate NPAs in different categories of banks such as SCBs, PSBs and PVBs in India. The rest of the paper is organized as follows. Section 2 reviews the literature; Section 3 provides analyses of performance, and NPAs of SCBs. The last section summarizes results, and provides policy recommendations.

3. Analysis of Banks' Performance and Non-Performing Assets of Banks

Table 1 provides profitability ratios of (ROA and ROE) of SCBs, PSBs and PVSBs for the period from 2013 through 2018. Profitability of scheduled commercial banks (SCBs) declined continuously from 2013. The return on equity (RoE) of SCBs fell down from 13.8 per cent in March 2013 to negative (1.9) per cent in March 2018. The return on equity (RoE) of PSBs declined down from 11.0 per cent March 2013 to negative (−13.6) per cent in March 2018, whereas the return on equity (RoE) of PVSBs declined down from 15.0 per cent March 2013 to 11.1 per cent in March 2018. The return on assets (RoA) of SCBs fell down from one per cent in March 2013 to 0.3 per cent in March 2018. The return on assets (RoA) of PSBs declined down from 0.7 per cent March 2013 to negative (0.9) per cent in March 2018, whereas the return on assets (RoA) of

PVSBs declined down from 1.8 per cent March 2013 to 1.3 per cent in March 2018. Profitability ratios such as RoE and RoA of SCBs and PSBs turned negative during 2017-18. There are several problem areas and issues resulting in low profitability of PSBs viz., higher loan loss provisions, increasing operating costs and declining interest incomes and other revenues. Table 2 presents the CRARs of SCBs, PSBs and PVSBs for the period 2013 to 2018. The capital to risk weighted assets ratio (CRAR) of SCBs has declined from 14.5 per cent in 2013 to 13.8 per cent in March 2018. The CRAR of PSBs fell from 12.8 per cent in 2013 to 11.7 per cent in 2018, whereas the CRAR of PVSBs fell nominally from 16.5 per cent in 2013 to 16.4 per cent in 2018.

Table 3 presents the GNPAs of SCBs, PSBs and PVSBs for the period 2013 to 2018. PSB's gross non-performing advances (GNPA) ratio rose from 10.2 per cent in March 2015 to 11.6 per cent in March 2018. The credit risk in the banking sector continued as the gross non-performing advances (GNPA) and net non-performing advances (NNPA) ratios have increased continuously from 2013. The gross non-performing advances (GNPA) to total advances of the SCBs increased continuously from 8.0 per cent in March 2013 to 11.6 per cent in March 2018. The gross non-performing advances (GNPA) to total advances of the PSBs increased continuously from 10.5 per cent to 15.6 per cent during the same period, whereas, the gross non-performing advances (GNPA) to total advances of the PVSBs remained constant with minor variation between 4.0 per cent to 5.1 per cent during the same period. The GNPA ratio in the industrial sector of the SCBs rose from 12 per cent in March 2013 to 25.8 per cent in March 2018 whereas stressed advances ratio increased from 15.0 per cent to 24.8 per cent in 2018. PSBs had the maximum exposure to industrial sectors such as infrastructure, road sector, steel, power and telecom and also had the highest GNPA. It means that PSBs had undertaken the riskier lending by adopting loose and liberal credit policies and practices as compared to PVSBs and FBs. This implies that the riskiness of credit allocation is not only influenced by macroeconomic factors but also by unique factors related to banks such as credit policies, type of customer/borrower, nature and size of loan, banks' management approach and nature and type of regulation.

Table 1. Performance of banks.

	Return on Assets (RoA) %			Return on Equity (RoE) %		
Year	PSBs	PVSBs	SCBs	PSBs	PVSBs	SCBs
2013	0.7	1.8	1.0	11.0	15.0	13.8
2014	0.5	1.5	0.8	7.0	14.0	9.5
2015	0.4	1.8	0.8	6.0	14.1	9.3
2016	−0.3	1.6	0.3	−4.0	13.2	3.5
2017	−0.2	1.5	0.4	−2.4	12.9	4.3
2018	−0.9	1.3	0.3	−13.6	11.1	−1.9

Source: RBI's, Financial Stability Report (FSR), 2017 and 2018 [17] [18].

Table 2. CRAR of banks [17] [18].

Year	PSBs	PVSBs	SCBs
2013	12.8	16.5	14.5
2014	11.5	16.0	13.4
2015	11.0	15.0	13.1
2016	11.5	14.5	13.0
2017	12.2	15.4	13.6
2018	11.7	16.4	13.8

Source: RBI's FSR, 2017 and 2018 [17] [18].

Table 3. GNPAs of banks.

Year	PSBs	PVSBs	SCBs
2013	10.5	4.0	8.0
2014	11.0	4.0	9.5
2015	13.0	5.0	10.3
2016	10.0	5.1	10.2
2017	12.5	4.5	11.0
2018	15.6	4.0	11.6

Source: RBI's FSR, 2017 and 2018 [17] [18].

4. Conclusions and Policy Recommendations

The study concludes that PSBs have adopted liberal and loose credit policies, and have highly concentrated loans on certain borrowers and specific sectors, *i.e.*, huge credit exposures to a few large corporate borrowers and to a few sectors such as infrastructures, powers, steels, mining, and telecoms. PSBs are inefficient in managing their credit and credit portfolio since evidence shows that they have more NPAs than their counterparts. The study suggests that managements among the PSBs have been inefficient and weak in their performance. The trend of NPAs in public in the last five years in relation to the total advances has increased. The extents of NPAs and NPAs ratios are significantly higher in PSBs than PVSBs. The study highlights that the primary causes of higher NPAs in PSBs are their liberal credit policies and loose terms and conditions of loans, deficiencies in the credit sanctions, and disbursements of loans. The study also suggests that PSBs are subject to weak and mild regulatory environments and impacts compared with the PVSBs as the RBI is not neutral to the ownership structure of banks. The RBI is not in position to regulate and control PSBs effectively and efficiently compared with PVSBs and FBs. The managements of PSBs are indifferent and inefficient to the performance of PSBs as there are no incentives or penalties for their responsibilities, accountabilities and performances.

It is suggested that the PSBs should develop necessary skills across all the levels and all their products and services. The government has to introduce flexible compensation packages and incentives to the top and senior managements of PSBs so that they will improve profitability of the PSBs and curtail the NPAs. The RBI's regulation should be ownership neutral. All banking regulatory powers of the RBI and its approaches in regulatory policies shall be neutral to bank ownership (Vishwanathan) [19]. The level playing field between PSBs and PVSBs is the need of hours.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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