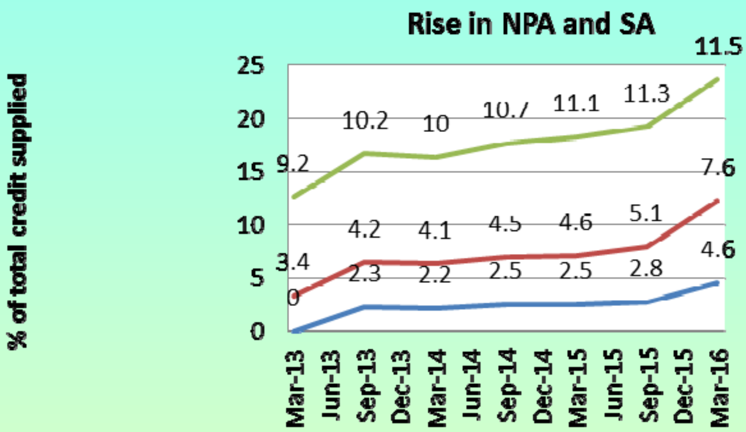
Non-Performing Assets and its implications on Economy

What are Non--performing Assets??

NPA or non-performing assets is defined as a loan wherein payment of interest or installment remains unpaid for more than 90 days. The same applies to investments made in debentures and bonds etc. Once the account is classified as NPA the banker is required to make a provision for the same in its balance sheet. The percentage of provision required to be made defers from account to account based on the asset coverage and also the age of the NPA i.e. the period in which account remained as NPA, etc.



	Mar-13	Sep-13	Mar-14	Sep-14	Mar-15	Sep-15	Mar-16
Stressed assets	9.2	10.2	10	10.7	11.1	11.3	11.5
Gross NPA	3.4	4.2	4.1	4.5	4.6	5.1	7.6
net NPA		2.3	2.2	2.5	2.5	2.8	4.6

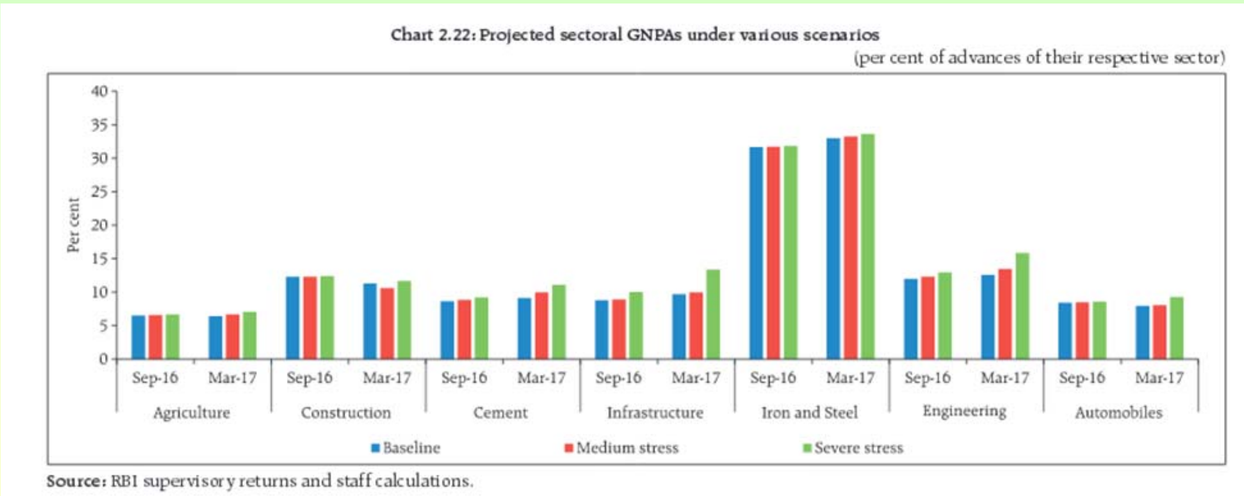
Asset Quality – Evolution of NPAs

Management of asset quality has emerged as one of the major challenges facing banks today as it is the most important factor for the basic viability of the banking system. High level of NPAs not only affects core performance area of the banking system but also raises corporate governance issues. The trends in NPAs since 2007 are furnished below.

NPAs		
Year	Gross NPA (%)	Net NPA (%)
2006-07	2.5	1.0
2007-08	2.3	1.0
2008-09	2.3	1.1
2009-10	2.4	1.1
2010-11	2.4	1.0
2011-12	2.9	1.3
2012-13	3.4	1.4
2013-14	2.2	4.1
2014-15	2.5	4.6
2015-16	4.6	7.6
Source: RBI Reports		

The declining credit growth in the system is an indication for asset deterioration and likely to build up impaired assets further. Asset Quality in terms of performance is a concern as the growth in NPAs rise in quicker pace and has outgrown credit growth.

The Gross NPA ratio of the banks has witnessed sharp increase from 2.90% as on 31st March 2012 to 3.40% as at end of March 2013. Similarly, the Net NPA ratio has gone up from 1.30% to 1.40% during the same period. The sector wise NPA is furnished below:



Among the selected seven sectors, Agriculture, Construction, Iron & Steel and Engineering sectors registered highest NPA compared to other sectors. The low level of NPA under infrastructure sector can be attributed to increased incidence of shifting of infra advances to restructured portfolio. If the present trend is not addressed, this sector is likely to witness higher slippage ratio in the ensuing years.

Effects of NPA:

The increasing NPA levels with various banks have cascading impact on banks viz., Net Interest Margin, return on assets, profitability, dividends disbursed, provision coverage ratio, credit contraction etc., which may decrease the value of all stakeholders including shareholders, depositors, borrowers, employees and public at large. Thus, the increased incidence of NPAs not only affects the performance of the banks but also affect the economy as a whole.

Performance of banks:

The problem of NPAs in the Indian banking system is one of the foremost and the most formidable problems that had impact the entire banking system. There are different effects of NPA on banks and to economy at large.

Profitability:

The banks are required to make provision for NPAs from the profits they make. As a result the higher the NPA, the lesser will the profit of the bank. The survival and growth of the banks crucially depend on the size of the balance sheet as well as the performance of asset since the assets are the major source of income and life-line for the banks. NPAs put detrimental impact on the profitability as banks stop to earn income on one hand and attract higher provisioning compared to standard assets on the other hand. On an average, banks are providing around 25% to 30% additional provision on incremental NPAs which has direct bearing on the profitability of the banks.

In the first six months of FY16, 22 state-owned banks reported losses of Rs. 30, 700 crore. They also wiped off 16.4% of their net worth. The ratio of net non-performing assets (NPAs) of banks to their net worth has decreased despite banks making huge provisions for bad loans in the last two quarters, which led to the heavy losses for these banks. Bad loans across the 40 listed banks in India has increased to Rs. 5.8 trillion as of the end of March 2016 from Rs. 4.38 trillion at the end of December.

Asset (Credit) contraction:

The increased NPAs put pressure on recycling of funds and reduces the ability of banks for lending more and thus results in lesser interest income. It contracts the money stock which may lead to economic slowdown. Poor recycling of funds, leads to contraction in the deployment of credit. NPAs will stop flow of funds for future lending and even make difficult to pay the interest, principal amounts to the depositors and even to meet the day to day expenses of the lending organization.

Liability Management:

In the light of high NPAs, banks try to lower the interest rates on deposits on one hand and tend to obtain higher interest rates on loans to have net interest margin. This increase in cost of borrowing and decrease in returns on investments (on savings) may hamper business as well as economic growth.

Capital Adequacy:

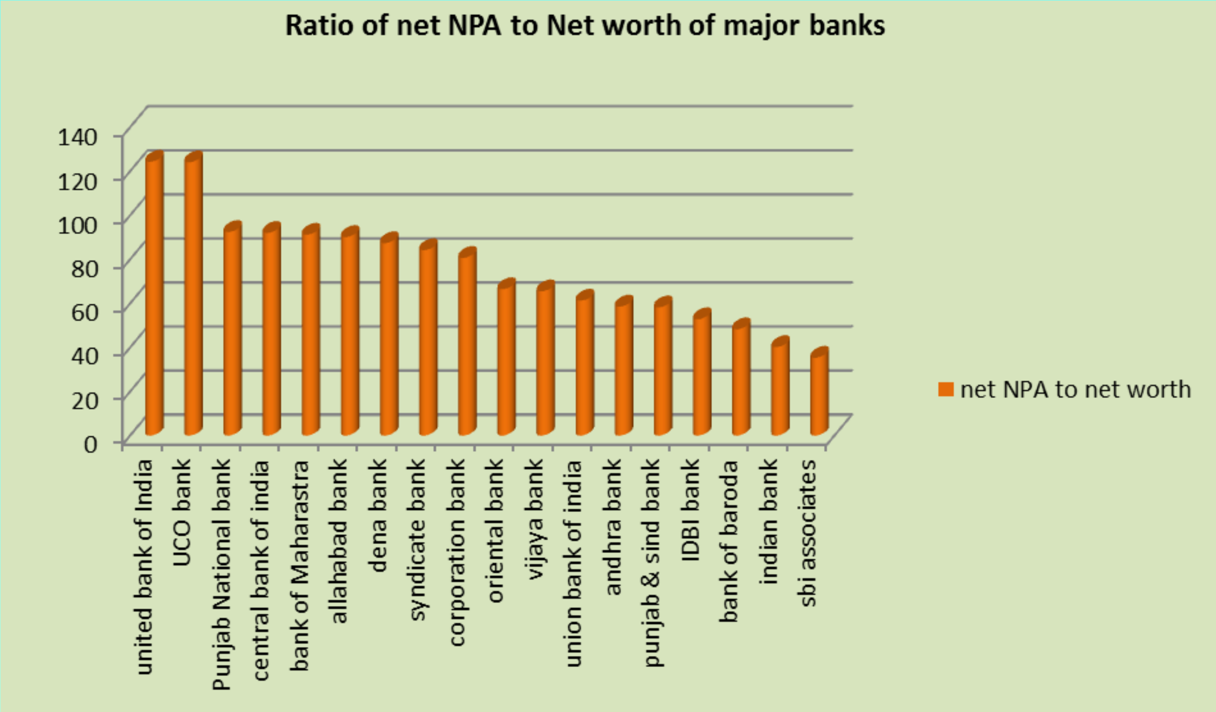
As per norms, banks are required to maintain adequate capital on risk-weighted assets on an ongoing basis. Every increase in NPA level adds to risk weighted assets for which the banks have to increase their capital base. This adds to the cost of lending as raising capital has a price tag ranging from 12% to 18%. The significant surge in bad loans will impact their ability to lend. This is particularly true for public sector banks which have lower levels of capitalization than private banks. This could lead to a decline in the market share of public sector banks. With an increased stressed asset ratio may result in private banks taking over customers where they can. While the profitability of some banks may be impaired in the short run, however the system, once cleaned, will be able to support the economic growth in a sustainable and profitable way.

Shareholders' confidence:

The rise in NPAs hit the confidence of shareholders also. Shareholders are interested to enhance value of their investments through higher dividends and market capitalization. The increased NPA level is likely to have negative impact on the bank business as well as profitability which may lead to less or no return to shareholders eroding value of their investments. Further the RBI guidelines stipulate that banks with Net NPA levels at 5% & above are required to take prior permission from RBI to declare dividend and also stipulate cap on dividend payout. As earnings from banks have fallen, share prices have been plummeted on the exchanges. The NSE's PSU Bank Index has fallen around 14% while the benchmark Nifty has fallen around 8%. A drop in their market valuations would mean that a number of these public sector banks would find it difficult to access the capital market to raise funds by dilution of government stake.

Banks' credibility:

Credibility of banking system is also affected greatly due to higher level NPAs because it shakes the confidence of general public in the soundness of the banking system. The increased NPAs may pose liquidity issues which is likely to lead run on bank by depositors. Many times the bankers do not actually classifying the loans to escape the provisioning. Even in such case the information about financial difficulties in a particular sector, such perception itself is preventing further investment in that sector. The most resounding example for this sort activity happening is in our infrastructure sector. Failure of any major project also dampens the sentiment of the investor.



Effects on industries and economy at large

There are many more companies that should declare NPAs but have not yet been declared NPAs. Those are the companies having operating profits which are much lower than what are needed to cover their interest, which could mean that they are dependent on loans to maintain interest payable. There are reasons for the not so impressive performance of various companies across different industries.

However international experience shows that when this sort of postponement of bad loan recognition happens, the banks lose their ability to fund an economic revival. Examples are Japan after the 1989 crash and Sweden. If banks are laden with bad assets, their ability to lend is crippled as they focus on recovery of loans and may shift focus to compensate for the losses.

Increase in cost of funds to borrowers and its effect on investment

The Lenders earns their profits mainly from the margin between the cost of funds and the return on the landings i.e. difference of interest paid on deposits and interest earned on loans. Once any account goes bad, the interest income on the same will not be there. Therefore the lender has to charge higher interest on the regular accounts to make good that loss. Further, lenders have to pay lesser interests to the depositors. This will lead to increase in the cost of funds to the borrowers of various sectors and thereby reducing investments in the economy. In an economy like India, the domestic savings form a large part of investment needed. The lower rate of interest on deposits in a high inflationary economy will adversely affect the domestic savings and thereby the domestic investment.

Negative impact on industry

The domestic businesses cannot pay higher rates of interest for their borrowings and survive when their global competitors are getting funds very cheap interest rates. Most of the global players are immensely helped by the lower cost their borrowings and are providing cheaper options even in Indian market. This will lead to higher negative balance of trade and also to the destruction of domestic industry resulting in large unemployment and social unrest.

A drain of public fund

The centre announced that its plan to recapitalize 21 public sector banks (PSBs) this July. The budget provision of Rs. 25,000 crore for the financial year 2016-17 has been made for the same. Recapitalization involves providing the bank with new capital, e.g. government agrees to buy new shares. This improves the banks' bank financial status. The NPA's is at 7.6 per cent in proportion to the total advances of the bank which has been the highest over 12 years. The government has recapitalized more than Rs 81,000 crore in the last 15 years for PSBs between 2010 and 2014. In 2015, Rs.11, 200 crore was allocated for the purpose, but the actual capital infusion was Rs. 6,900 crore. This huge chunk of money from exchequer to feed the capital striped banks comes at the cost of forgone public works and spending. This has its own effect on the psychology and economic aspects of citizens.

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