

## Non-performing Assets in Indian Banking Sector: Current Trends and Causes

*Rameeza Rafi<sup>1</sup>, Ravinder Kumar<sup>2</sup>*

### ABSTRACT

In an emerging economy like India, the banking system's sound health is imperious for financial stability and the overall development of the economy. A well-developed financial system enables a smooth flow of savings and investments and hence supports economic growth (King & Levine, 1993). NPA undesirably is a critical indicator of the financial health of banks. NPAs in the Indian banking sector has soared up to an extent that operating earnings had been besieged by provisioning, after the asset quality review (AQR) mechanism initiated by RBI in 2015. A clear picture of the problem of the Twin balance sheet of the banks (bad loan burdened banks and over-leveraged companies) came to light only after the AQR. The present paper attempts to review the major causes of NPA among Indian banks. It has been observed that the NPA was greater in the priority sector after the post-liberalization period and most of the NPA account holders today are industrialists.

The main purpose of this study is to identify and diagnose the major causes of NPAs, besides studying the Indian Banking Sector's current trend of NPAs. The existing literature has been reviewed thoroughly for the present study. Moreover, the causes of NPA in other economies are also reviewed. The Economic Surveys and trend and progress reports of Banking in India have been thoroughly reviewed to analyze the NPAs trend in recent years. As the NPA increased abruptly after 2011 when the NPA of other economies were stable, it mandates to revisit the causes of NPA which led to such sudden hike, which in turn will provide ease in

---

<sup>1</sup> Research Scholar, Department of Commerce and Business Studies, Jamia Millia Islamia, New Delhi, India. Email: rameezarafii009@yahoo.com

<sup>2</sup> Professor, Department of Commerce and Business Studies, Jamia Millia Islamia, New Delhi, India. Email: rkumar4@jmi.ac.in

managing NPA. The study doesn't cover the significance and degree of impact of different causes on NPA.

---

**Keywords: Asset Quality Review Mechanism, Non-Performing Assets, Scheduled Commercial Banks, Indian Banking Sector**

---

## INTRODUCTION

The Banking system of any country exists to accelerate its economic growth and development. However, the alarming levels of NPA in the Indian Banking system have become a major hurdle on this behalf. The literature accords that asset quality is an important determinant of the health of the banking system. NPAs affect the operational efficiency of banks and that affects their profitability, liquidity and solvency (Micheal et al., 2006). Moreover, NPAs also create a vicious cycle of effects on sustainability and growth of the banking system and could lead to bank failures if not managed properly (Chijoriga, 2000). A sudden hike in NPA in recent years has become a major concern for banks as NPA erodes the profitability and productivity of banks. Banks deposit growth rates, as well as credit, have been deteriorating since 2013. Normally NPA soars in the time of economic crisis, leading to bankruptcies. But nothing such happen in the Indian economy moreover the GDP was also growing at a fast pace. Compared to other economies of the world, the Indian Banking sector has seen an increase in NPA at a very high pace while the NPA of other economies is operating at a stable rate. The NPAs current trends are not considered pleasing for the wellbeing of the Indian banking sector.

India's NPA level is the highest except for Russia in emerging economies. In major emerging economies, NPL ratios are low, revealing improving macroeconomic performance that helped in improving asset quality stress. But India along with Russia had high NPL ratios in 2017 with further deteriorating in 2018 (Reserve Bank of India, 2018). The first reason revealed for the sudden hike in NPA in the Indian banking sector is Asset Quality Review (AQR) implemented by RBI in March 2015 but as the GNPA reaches 9 percent to gross advances in 2016, it became clear that mandated adjustments were also factor at work along with AQR.

India along with other countries did follow the standard path of loosening credit norms in times of boom, leading to companies following over leverage policy. Even though companies' balance sheets suffered from the crisis but it did not impact the growth of the economy, as it followed with strong aggregate demand.

In other words, India's TBS problem is called 'Balance Sheet Syndrome with Indian Characteristics' by recent economic surveys. To overcome the problem of over-leverage, banks gave time to corporate to heal their wounds, in a hope that if the projects were given time they will prove their viability. Moreover, highly leveraged companies got bank financing to survive. The belief was that NPA need to be limited only in nominal terms, and they will simply shrink, and as the economy was growing at a faster pace, the NPA importance will simply fade away. Everything seems right by mid-2015, as the EBIT of companies was stable, but after that, it starts diminishing, they had to continuously borrow to carry on their operations and after AQR the real picture of the evergreen balance sheet came to light. The paper in the further sections discusses the causes of NPA and its current trend.

## **LITERATURE REVIEW**

Reddy (2002) attempts to make a comparison of causes and strategies of handling NPA in India and other Asian countries. It has been examined that Legal impediments, manipulation by the debtors and political tools are some of the causes of NPA in India. While moral hazards, inefficient legal enforcement mechanisms, political and social implications, real estate boom and bust, crony capitalism, lack of effective monitoring, increase in interest rate, bankruptcy laws favoring borrowers were found to be major causes of NPA in other Asian countries.

Rajan and Dhal (2003) analyzed that in the presence of size of banks and macro-economic shocks non-performing assets have been significantly affected by credit variables. Impact on NPA is different by altered measures of bank size. In terms of assets, bank size gives a negative impact on NPA but capital has a positive and significant effect on gross NPAs changes in the cost of credit and increasing higher hit rate can result in increased NPAs and better credit culture will help in reducing NPA.

Mukherjee (2003) made some policy conclusions of NPA. The worldwide experience suggests that the countries mostly adopted the strategy of decentralized restructuring and forming asset management companies. It has been observed the asset management companies are less effective in developing countries. The debt transfer to asset management companies is much lower than the profitability of success. So, the decentralized creditor-led strategy should be adopted in India.

Gopalakrishnan (2005) propounded political, economic, social and technological causes of NPA. It has been observed that improper credit appraisal, and lack of follow-up after issue of loan and supervision, recessionary pressures, modification in policies of government and funds diversion for other purposes than the one for which it is issued are the major causes of NPA.

Ghosh (2005) investigated the link between corporate leverage and NPA. The study finds that the quality of the asset gets impacted by the leverage ratio usually with the lag of one year. It is also been confirmed that the financial condition of the corporate sector helps in predicting a bank's asset quality. Asset quality of banks also got worsens, due to the rapid expansion of lending, and the capital position of banks gets affected in return.

Swamy (2012) examines the impact on non-performing assets of macroeconomic and endogenous factors and it is found that there is no significant impact of GDP growth rate on NPA. whereas estimated per capita income and coefficient of assets have negative significance on NPA's, which is an indicator of better risk management by large banks and gives them lower ROA. CDR and cost of funds are also negatively correlated with NPA. The ownership style is also affecting NPA, private and foreign banks managed NPA efficiently.

Messai and Jouini (2013) studied non-performing assets as the macro determinants in 85 banks of Greece, Italy and Spain. And through the application of panel data, they concluded that the GDP growth rate, ROI of credit institutions is negatively related to non-performing assets. Positive relation has been found out between the unemployment rate and real interest rate and impaired loans. Therefore, banks should take into consideration the profitability of the real economy when extending loans.

Memdani, Dubey and Suresh (2017) studied the major reasons responsible for high NPA's and examined the various measures adopted in India to tackle the problem of high NPA's. The various causes found responsible for high NPA's are high interest, the directional credit policy of the government, bank's failure to recognize early warnings signals. NPA's are impacting the profitability of the banks on a large scale. NPA's are also affecting the liquidity of banks and the capital adequacy ratio is also getting adversely affected. The banks also get lower credit ratings due to which depositors are reluctant to deposit in banks.

Samantaraya (2016) highlighted diverse issues related to rolling NPAs in banks and it has been observed that current NPA are due to excessive credit growth

in the past. Capital adequacy, current economic conditions, and the overall efficiency of banks also affect NPA. The PSBs are more prone to higher NPAs, which could be related to corporate governance mechanisms. The appointments of top executives are influenced by political economy concerns and affect the long sanctioning and disbursal process.

Bhaskaran et al. (2016) compared the NPAs of over ten years, from 2004 to 2013 of the Indian public and private sector. Through regression analysis, it has been revealed that the public sector bank's net NPAs to net advances have varied more than private sector banks. Private banks are more successful in reducing NPA than public sector banks. The advances in Public sector banks are not much affected by NPAs and for private sector banks, most of the advances are recovered before converting to NPA.

Goyal and Verma (2018) investigated the real reason for slow credit growth, among aggregate demand and NPA. The results favor demand as the major constraint. It has also been revealed that AQR affected credit growth but not Gross NPA. Apart from reducing credit growth, low demand also increases NPA. So apart from structural reform to reduce NPA, for the revival of credit growth, recovery of demand is necessary

Through the above literature review, it has been revealed that the major share of NPA after the 1990 crisis was with the priority sector as banks were bound to 40 percent of total credit to the priority sector. In comparison, the major share today of NPA is with the Industrial sector. Several other reasons for high NPA have been explored are in the later section.

## **OBJECTIVES OF THE STUDY**

- To understand the recent trends of NPAs.
- To investigate the causes of escalating NPAs.

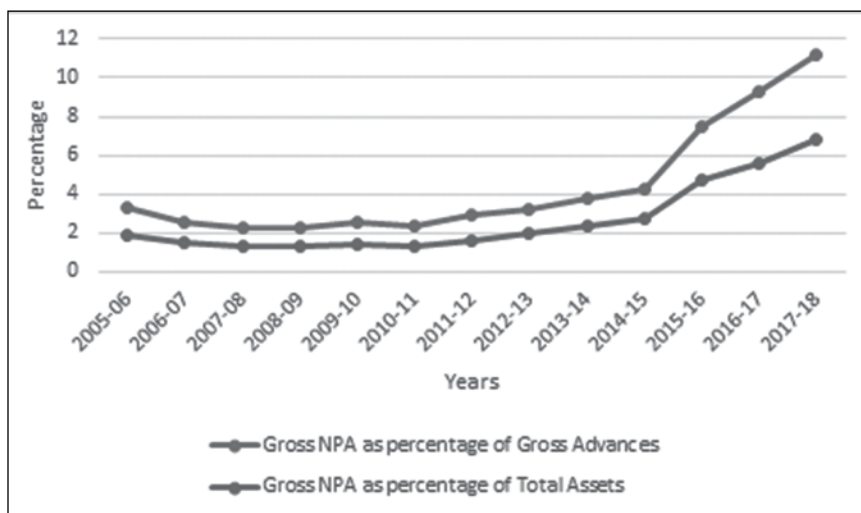
## **CURRENT TRENDS OF NPA IN THE INDIAN BANKING SECTOR**

The banking sector provides stability to the economy and confidence to investors. Looking at the current trend of NPA, the investors responded by fleeing public sector bank shares, and HDFC bank was valued as much as 24 public sector banks. The NPA of scheduled commercial banks was declining initially in the period covered for the study. Although strict norms for recognition of NPA were adopted from March 2004, still NPA declined in the succeeding years after the

adoption of new norms, Gross NPA as a percentage of Gross Advances as well as Net NPA (GNPA minus provisions) as a percentage of Net Advances declined. The downfall continues till March 2011, even the financial crisis of 2008, doesn't increase the NPA. It starts increasing after 2011, from 2.9 percent in March 2011 to 3.2 percent in March 2012 for Gross NPA as a percentage of Gross Advances. Net NPA as a percentage of net Advances increased from 1 percent in March 2011, to 1.3 percent in March 2012. Still, the situation was in the control, but the real state of balance sheets of banks came after AQR. Within the span of two years after implementing AQR, the Gross NPA became almost double as it was before AQR. The Gross NPA as a percentage of Gross Advances reached 11.2 percent in March 2018 and Net NPA as a percentage of net advances also increased after 2011 and reached 6 percent in 2018.

Gross NPA as a percentage of Total Assets was also initially decreasing till 2011 except the year 2009-10, where it increased by 0.1 percent. It starts increasing as Gross NPA increased in 2011 and after implementing AQR, it became almost double in just one year. It was 2.7 in March 2015 and it reached 4.7 in March 2016. It reached 6.8 in March 2018. Net NPA as a percentage of total assets was stable before 2011 at 0.6 percent but it starts increasing after 2011 as net NPA increased. At the time of AQR, it was 1.5 percent and it also became almost double and reached 2.7 percent. And it continued to increase and reached 3.4 percent.

**Figure 1: Gross NPA of Scheduled Commercial Banks**



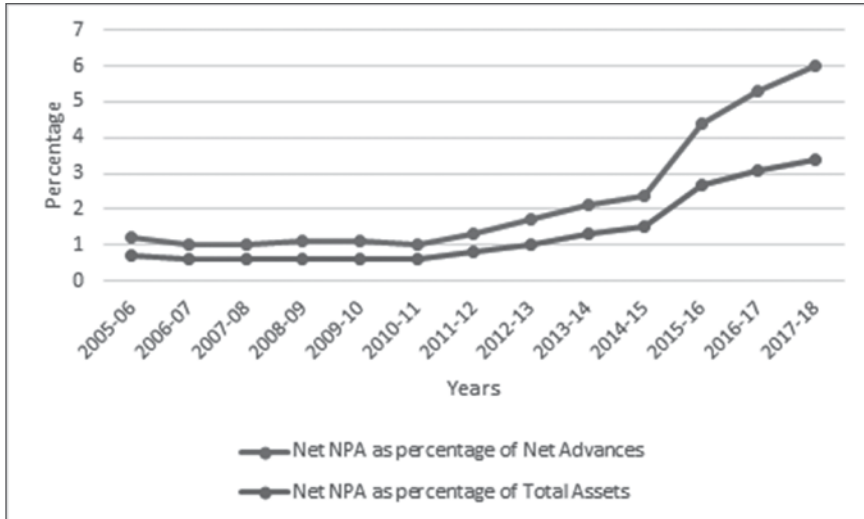
Year	Gross NPA of SCB	Gross NPA as percentage of Gross Advances	Gross NPA as percentage of Total Assets
2005-06	517.53	3.3	1.9
2006-07	505.17	2.5	1.5
2007-08	566.06	2.3	1.3
2008-09	699.54	2.3	1.3
2009-10	817.18	2.5	1.4
2010-11	939.97	2.4	1.3
2011-12	1369.68	2.9	1.6
2012-13	1927.69	3.2	2
2013-14	2630.15	3.8	2.4
2014-15	3229.16	4.3	2.7
2015-16	6116.07	7.5	4.7
2016-17	7902.68	9.3	5.6
2017-18	10397	11.2	6.8

Source: Reserve Bank of India (2018)

Year	Net NPA of SCB	Net NPA as percentage of Net Advances	Net NPA as percentage of Total Assets
2005-06	185.43	1.2	0.7
2006-07	202.8	1	0.6
2007-08	247.3	1	0.6
2008-09	315.64	1.1	0.6
2009-10	391.27	1.1	0.6
2010-11	417.99	1	0.6
2011-12	652.05	1.3	0.8
2012-13	986.93	1.7	1
2013-14	1426.56	2.1	1.3
2014-15	1758.41	2.4	1.5
2015-16	3498.14	4.4	2.7
2016-17	4330.1	5.3	3.1
2017-18	5207	6	3.4

Source: Reserve Bank of India

**Figure 2: Net NPA of Scheduled Commercial Banks**



## **MAJOR CAUSES OF NPA**

A flourishing Banking sector is an utmost need for the growth of an economy. NPA is a well-known hurdle for the growth of the banking sector for decades. The asset quality review mechanism implemented by RBI in 2015 brings out a clear picture of banks' balance sheets. To show higher-earning banks were continuously postponing the problem of NPA. The major reasons cited by Raghuram Ranjan, the ex-governor of RBI, are overall slow-down in the economy, improper monitoring and laxity in credit risk appraisal, delays in approvals for projects implementation, corruption, willful defaults, insistent lending during the boom period. He also pointed out the Banker's optimism and overconfidence as a major factor contributing to NPA. The bankers possibly did less due alertness for some of these loans and left doing self-sufficient scrutiny and relied on SBI Caps and IDBI to process the required analysis. The outsourcing of analysis results in the possibility of undue influence. Also according to K. C. Chakrabarty, ex-deputy governor of RBI, NPAs are a result of non-performing administration and everybody including central and state government is responsible for it.

Some of the major causes of NPA observed from the previous studies are listed below:



1. **Extensive Lending to Corporates:** Indian economy was in a boom phase between 2000 and 2008, and the public sector banks lend extensively to corporate. However, due to slowdown in the global economy the profits of the corporate diminished, volatility in prices and shortage of raw material, the ban in mining projects, environmental permits delay for power, iron and steel sector. All this led to an inability on part of corporate to pay back loans and it turn out to be the main cause of NPA in banks.
2. **Inadequate contingency planning:** Banks do not make adequate contingency planning for mitigating project risk. They do not take into account eventualities like highway projects, failure in the land acquisition process.
3. **Higher interest rate:** NPA increases as the interest rate in the market increases. The change in cost of credit, i.e. higher interest rate results in increased NPA (Misra & Dhal, 2010).
4. **Lack of Corporate Judiciousness:** Lack of corporate judiciousness is considered an important cause of NPA. Corporate gets involved in over-leverage, with no equity and all debt. Higher growth obsession leads to higher capacity by corporate, and unrelated diversification, and they are unable to pay back later, leading to more NPA (Mundra, 2016).
5. **Willful Defaulters:** A lot of cases came to light after AQR who willfully defaulted payments, Vijay Mallya who defaulted about to Rs. 9,000 crore of 17 banks, Nirav Modi and Mehul Choksi who defaulted about Rs.14,000 crore to Punjab National Bank.
6. **Weak Appraisal System:** The credit appraisal system of banks is very weak, they do not investigate deeply the credit history of the borrowers. As corporate takes a loan from more than one bank and default on their part results loss to all the banks.
7. **Lack of Follow-up:** After granting loans and no proper monitoring after loan disbursement, which results in diversion of funds to other projects and not used for the one for which it is granted. As over and over again observed by RBI Inspectors, one of the highest up causes for NPAs is improper follow-up by the credit management staff.
8. **Political Pressure:** Banks face a lot of political pressure for sanctioning of loans of big industrialists without proper credit appraisal and it results in o NPA in later years. The problem of NPAs is not mainly because of lack of strict prudential norms, but due to legal impediments and time-consuming nature of asset disposal process, postponement of the problem by the banks

to show higher returns and manipulation by the debtors using political influence (Reddy, 2002).

9. **High Credit Growth Targets:** Banks management set high targets for credit growth which lead to a mad rush for granting loans. NPA growth follows credit growth with a lag. The asset quality can get compromised during periods of high credit growth and this can result in NPA's in later years. The rise in NPA in the post-crisis period is a result of high credit growth in the pre-crisis period. (Shashidhar M .Lokare, 2014)
10. **Projects Delays:** Project delays for which loan was granted. The cost of the project overruns the estimated cost and it leads to default in payment making their account NPA.
11. **Low Income:** GDP is the sign of reduction where defaults are unavoidable due to low income (Kumar et al., 2018).
12. **Mismanaged Loan Facility:** The companies with the major problem of inadequate profitability and over-leverage were extended loan facilities mostly by public sector banks.
13. **Relaxed Lending Norms:** One of the main reasons for NPA is relaxed lending norms, the credit rating and financial status are not analyzed properly of big corporate and also banks sell their unsecured loans which are attributed to the level of NPA.
14. **Lack of Bankruptcy Code:** The legal system in India is very sluggish and there was no proper bankruptcy code till 2016, which made it difficult for banks to recover loans from large corporate and non-corporate.
15. **Blind Faith on Superiors:** The bankers blindly follow the instructions of superiors to appease them as to get promotions and issue loans to corporate with weak credit history.
16. **Poor Auditing Practices and Non-Transparent Accounting Policy:** The NPA was restructured again and again and the banks were reluctant to show the actual position of the balance sheet which led to building up huge NPA.
17. **Improper Coordination between Banks and their Customers:** The policies and procedures are not well versed with the customers and huge NPA build-up due to problems of coordination among customers and banks.
18. **Direct Lending Towards Certain Sectors:** Although it has been found that a large number of NPA belongs to large corporate, priority sectors also share a portion of NPA. The priority sector continues to enjoy a major portion of bank credit despite NPA, and they do not pay back the loan as they think the

government will exempt it.

19. **Changes in Government Policies:** Changes in environmental policies and economic policies at the macro level in the economy led to not getting permits for the industries for which loan was assigned and it led to increase NPA.
20. **Lack of Managerial Efficiencies:** The banker should perform proper SWOT analysis before selecting the borrower and to safeguard its interest, they should take tangible assets as security. While accepting securities the marketability, acceptability, safety, transferability of assets should be considered.
21. **Re-loaning Process:** Credit cycle smooth operation gets affected by re-issuing loans to already defaulting large corporate. Due to re-loaning to the defaulters, the NPAs increased more day by day.
22. **Shortage of Demand:** Indian entrepreneurs are not able to predict the appropriate demand for their product and start production which ultimately heaps up their product, thus they are unable to pay back the loan amount they borrowed from banks to operate these activities. The banks were able to recover the amount by selling their assets, which covers a minimum level. The non-recovered part becomes NPA and banks have to make provision for it.
23. **Natural Calamities:** Natural calamities are very common in India, now and then we face some natural calamities and thus the borrowers are unable to pay back their loans. The main source of irrigation of our farmers is rainfall, due to uneven rainfall and drought, the desired production level is not achieved by the farmers and thus they are not able to repay the loans.
24. **The Inability of Corporate to Raise Equity:** The promoters are sometimes unable to bring in their portion of equity or through public issues due to the market turning lukewarm, and in case of failed projects, their accounts become NPA.
25. **Highly Leveraged Borrowers:** Many corporate depends more on borrowed capital than equity, and become highly leveraged. In case of not having sufficient profits, they are unable to repay the loan and it turns to NPA.
26. **Lack of Credit Information Sharing:** lack of proper credit information system amid financial institutions led to the grant of advances to defaulters or to the one with weak credit history, which later on results in NPA.
27. **Price Escalation:** The inflation or increase in prices of raw material led to

increased cost of projects and inability on part of corporate to pay back the advances granted to them.

28. **De-licensing:** The abolition of license raj and hooting up of competition in the liberalized Indian economy also resulted in increased NPA.
29. **Industrial Sickness:** Unsuitable handling of projects, absence of improved technology, regularly changing policies of Government, absence of sufficient resources led to industrial sickness. Hence, the banks reduce their liquidity and profits by providing finance to those industries.
30. **Other Factors:** Some external and internal factors like shortage of raw material, floods, accidents, incompetent management, Recession, exchange rate fluctuations, change in government policies, have all contributed to NPA.

## CONCLUSION

The escalating NPA of the banking sector in India has become a hurdle in the credit growth of the economy, impacting the overall economic growth and development. Analysis carried on in this paper about GNPA and NNPA shows that the overall NPA position of all the banks is deteriorating over the years since 2011. A lot of factors have been identified for increasing NPA after 2011, but the major reason identified is extensive lending in the boom period between 2000-2008, and later on giving the corporate sufficient time to show results, which all led up to increased NPA. Also, lack of proper insolvency code till IBC 2016, political pressure, lack of follow up on the part of banks, re-loaning process, lack of managerial efficiencies are contributing to NPA. Moreover, banks were also reluctant to show the real position of assets, the real picture came after AQR was implemented by RBI. NPA increased at an alarming rate after that. A lot of measures are now being taken up by the Government including introducing 'The Insolvency and Bankruptcy Code, 2016' for the speedy recovery of loans. It is being suggested in the literature that government needs to follow the centralized approach for restructuring the non-performing assets. Also, recognition and strong action on the resolution will mitigate the destructive impact of the crisis.

## REFERENCES

Bhaskaran, R., Bhalla, L., Sarin, V., Kaur, S., Rahman, A., Singh, G., ... & Verma, P. (2016). Non-performing assets of public and private sector banks in India-a comparative study. *International Journal of Services and Operations Management*, 25(2), 155-172.

- Chijoriga, M. M. (2000). The interrelationship between bank failure and political interventions in Tanzania in the pre-liberalization period. *African Journal of Finance and Management*, 9(1), 14-30.
- Ghosh, S. (2005). Does leverage influence banks' non-performing loans? Evidence from India. *Applied Economics Letters*, 12(15), 913-918.
- Gopalakrishnan, T. V. (2005). *Management of Non Performing Advances*. Mumbai: , Indian Institute of Banking and Finance.
- Goyal, A., & Verma, A. (2018). Slowdown in bank credit growth: Aggregate demand or bank non-performing assets? *Margin: The Journal of Applied Economic Research*, 12(3), 257-275.
- Kumar, N., Shrivastava, A., Singh, D. P., & Kumar, P. (2018). Determinants of Financial Stress of Indian Banks: Hierarchical Bayesian Panel Data Modelling. *South Asia Economic Journal*, 19(2), 210-228.
- Kumar, S. (2014). Non-Performing Assets: An Indian Perspective. *International Journal of Academic Research in Economics and Management Sciences*, 3(2), 175.
- Memdani, L., Dubey, S., & Suresh, K. G. (2017). Factors Affecting Non-performing Loans/Assets in the Public Sector Banks of India. *The Empirical Economics Letters*, 16(9), 919-927
- Messai, A. S., & Jouini, F. (2013). Micro and macro determinants of non-performing loans. *International journal of economics and financial issues*, 3(4), 852-860.
- Michael, J. N., Vasanthi, G., & Selvaraju, R. (2006). Effect of non-performing assets on operational efficiency of central co-operative banks. *Indian Economic Panorama*, 16(3), 33-39.
- Misra, B. M., & Dhal, S. (2010). Pro-cyclical management of banks' non-performing loans by the Indian public sector banks. *BIS Asian Research Papers*, 1-23.
- Mukherjee, P. (2003). Dealing with NPAs: lessons from international experiences. *Money and Finance*, 12(12), 14-9.
- Mundra, S. S. (2016). Asset quality challenges in India: Diagnosis and prognosis. *Deputy Governor of RBI at the Edelweiss Credit Conclave, Mumbai*.
- Rajan, R., & Dhal, S. C. (2003). Non-performing loans and terms of credit of public sector banks in India: An empirical assessment. *Reserve Bank of India Occasional Papers*, 24(3), 81-121.
- Reddy, P. K. (2002). A comparative study of Non-Performing Assets in India in the Global context-similarities and dissimilarities, remedial measures.
- Reserve Bank of India. (2018). Report on Trend and Progress of Banking in India 2017-18. Retrieved from [https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/ORTP2018\\_FE9E97E7AF7024A4B94321734CD76DD4F.PDF](https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/ORTP2018_FE9E97E7AF7024A4B94321734CD76DD4F.PDF)

Samantaraya, A. (2016). Procyclical credit growth and bank NPAs. *Economic and Political Weekly*, 51(12), 112-119.

Swamy, V. (2012). Impact of Macroeconomic and Endogenous Factors on Non-Performing Bank Assets. *International Journal of Banking and Finance*, 9(1), 27-47.