

The Profitability of Banks and Non Performing Assets in India

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INTRODUCTION

The banks play a very crucial role in the process of economic development by providing credit to those sectors of the economy which are not getting adequate credit. These sectors are agriculture, small scale industries, small traders and businessmen, housing and education, professionals, self employed and weaker sections of the society. The banks channelise the funds to these important but neglected sectors for fulfilling the socio economic objectives of development planning.

Banks adopted the role of 'Social Banking' after nationalisation. 'Social Banking' refers to a conscious action of the government to direct adequate funds to socially desirable investments and that is why it is also termed as 'Direct Banking'. Banks are institutions that play the role of intermediaries with the aim of reducing the imbalances in the bargaining capacities that exist between the privileged and under-privileged sections of the society. A subsidised interest rate structure facilitates faster growth of hitherto neglected sectors. These objectives would not be achieved, if we leave this to be solved by the market which is always driven by profit.

There is enough evidence of success stories of social banking in the development history of some developed nations. Korea achieved a high growth rate of more than eight percent during the period 1962 -1984 in which a heavily regulated financial system played an instrumental role. Japan achieved a high annual average growth rate of 9.2 percent in GNP in the period between 1963-72 due to the regulated financial system. The United States too adopted this policy in the 1980s.

Banking sector was not well organised at the time of independence. To reorient the banking system Banking Companies act was passed in 1949. Later on Imperial bank was nationalised and Reserve Bank of India became the Central Bank of the country. This culminated in the beginning of the social control of banks and 14 banks were nationalised in 1969 and 8 banks in 1980. This revolutionised the banking sector and they became the agents of social change and promoters of growth. There was a spurt in deposits and advances of banks as people found the nationalised banks safe. Bank branches reached in under-banked and unbanked areas. Banks were advised to give 33 percent of their credit to priority sectors. This was further revised to 40 percent (Krishnaswami, 1980). As a result priority sectors began to receive a fair share of bank credit. But in order to achieve the objective of 40 percent credit to priority sectors, the banks resorted to indiscriminate lending. There were also regional imbalances in priority sector lending. Gradually, the Indian Banking sector got afflicted by many problems, such as inadequate capital base, too much emphasis on direct credit and central interference in policy matters, no focus on profitability and balance sheet issues and most importantly an increase in Non-Performing Assets (NPAs). This all affected the profitability of banks. India adopted the policy of Liberalisation, Globalisation and Deregulation in 1991 following the world wide trend towards this policy. A committee was set up in 1991 under the chairmanship of M. Narasimham. This committee advised to phase out the concept of Priority Sector Lending, but this was not accepted by the government. Later in its 1998 report, Narasimham committee accepted the importance of Priority Sector Lending, but proposed to slash the net bank credit limit to 10 percent instead of 40 percent. The Bankers panel (Indian Banks' association) suggested to the Narasimham committee to deregulate the interest rate and leave it to banks to fix their own interest rates according to their own situations. The committee also pointed out the problems related to priority sector loans: the banks have to arrange a large number of field staff which increases the operating expenses for small loans and the recovery process of priority sector loans is very slow, and the quality of assets mortgaged is very poor.

In the meantime, many foreign banks too entered the Indian banking sector. Their hands were not tied by RBI regulations. This created the situation of unfair competition for the Indian Banking Sector. On the one hand, the profits of Indian banks were declining due to subsidised priority sector loans and on the other hand, the problem of Non Performing Assets (NPAs) was increasing due to the non repayment of these priority sectors especially agriculture. How long can the banks survive like this? The paper proposes to explore this question.

LITERATURE REVIEW

Bhattacharya (1997) concluded that Social Banking is negatively affecting the profitability of banks.

Sathye M. (2003) also pointed out Priority Sector Lending as the main reason behind low profitability.

Attallah and Cockerill (2004) in their study found that low productivity of banks is mainly due to the rising Non Performing Assets.

Das and Ghosh (2006) revealed that Direct Banking by banks on concessional rates has adversely affected the profitability of banks.

Uppal (2009) also studied the issues related to Priority Sector Lending by commercial banks.

Murthy and Gupta (2012) analysed the impact of non-performing assets in different banking groups and concluded that NPAs were declining at a CAGR of 13% p.a.

Khedekar (2012) examined the causes of NPAs and argued that the level of NPAs indicator reflects the credit risks and efficiency of allocation of bank resources. She concluded that it is necessary to provide provisions to offset possible NPAs as high NPAs reduce the overall profitability of banks.

Vadivalagan and Selvarajan (2012) concluded that NPAs adversely impact the productivity and efficiency and profitability of Indian banks. They suggested carving out an efficient recovery mechanism for keeping NPAs at a low level, in order to maintain the liquidity and profitability.

Objectives:

1. To study the trends of Priority Sector Lending (PSL) by banks in the reform period.
2. To study the quantum and nature of rising NPAs in the Indian Banking Sector.
3. To study how the NPAs have affected the profitability of banks

Hypotheses:

NPAs related to priority sectors have adversely affected the profitability of banks in India.

METHODOLOGY

The study is based on secondary data. Apart from discussing the various concepts related to the topic in hand, the paper also highlights the trends in Priority Sector Lending and NPAs across the Scheduled Commercial Banks (SCBs). The paper tries to measure and evaluate the status and impact of NPA on the profitability of different categories of banks by using various statistical tools, such as regression analysis, Karl Pearson's correlation, growth rates, percentage etc..

Data Analysis: The study has chosen Scheduled Commercial Banks (SCBs) comprising Public Sector Banks (PBSBs), Private Sector Banks (PSBs), State Bank of India and its Associates (SBI & Ass) and Foreign Banks (FBs). The study has taken the reform period, i.e., from 1991 to 2016 to see the effect of Priority Sector Lending (PSL) and NPAs on the profitability of banks.

Data related to different parameters and trends have been taken from various reports of RBI and other organisations. They include Report on currency and Finance, Report on Trend and Progress of Indian Banking by RBI, Various reports by Indian Institute of Banker (IIB), Studies by Indian Banker's Association (IBA), Various studies by Centre for Monitoring Indian Economy (CMIE), Economic Survey by Govt of India, different books, journals and individual studies by scholars. The analysis is being done on a tabular basis. A good time has gone into calculation of growth rates, ratios and other statistical measures.

Conceptual Framework:

Profitability is the product of productivity and price recovery. Profit in general terms can be defined as Total Revenue - Total Cost which includes imputed costs also. Modern theory defines profit as return on capital, as a reward for bearing uncertainty of business and for dynamic change and innovation. In the banking industry, profit is defined as the difference between total earnings from all earning assets and total expenditure on managing the entire assets portfolio or as the ratio of net profits to working funds.

Advances: Banks use the deposits for advancing loans and making investments. Loans and advances go mainly to industries, service sector and also to priority sector.

Banks earn good income from industries and service sector, but priority sector loans fetch lower returns due to concessional rates of interest, high cost of formalities and non repayment of loans. This also led to the problem of Non Performing Assets (NPAs) that seriously affect the profitability of banks.

Assets: Liquid assets or the money at short notice which are governed by Statutory Liquidity Requirements (SLR) and Cash Reserve Ratio (CRR) issued by RBI also adversely affect profitability of banks.

Priority Sectors: These include sectors like agriculture and allied activities, small scale industries, retail traders and other business businessmen, professionals and self employed, village and cottage industries, weaker section like small and marginal farmers, artisans and marginal farmers, landless labourers and share-croppers, export credit, education, housing, social infrastructure, renewable energy, Scheduled Castes and Scheduled Tribes and target groups under Integrated Rural Development Programme and Differential Rate of Interest Scheme.

Non Performing Assets: NPAs are defined as loans that are in jeopardy of default once the borrower fails to pay the interest and/ or instalment of the principal amount for 90 days or more. Such loans are termed as Non Performing Assets. NPAs pose a serious liquidity problem for the banks and affect profitability of banks.

Classification of NPAs:

<u>Categories of Loan Asset</u>	<u>Provisioning Requirements</u>
Standard Asset:	Assets that generate income and do not show any sign of illness.
Sub standard Assets:	Assets that have remained an NPA for a period of 12 months or less.
Doubtful Assets:	An doubtful asset will be called Doubtful if it is Not performing for more than 12 months. the subordinate category for a period of months (i) Doubtful 1: NPA for a period of 12 to 24 months (ii) Doubtful 2: NPA for a period of 24 to 36 months (ii) Doubtful 3: NPA for over 36 months
Loss Assets:	These assets are loans that need to be fully written off

Return on Equity: It is defined as the amount of net income as a percentage of shareholders equity or the profit generated with the money shareholders have invested.

$$ROE = \text{Net Income} / \text{Shareholders Equity}$$

Return on Assets: It is calculated by dividing annual earnings of a company by its total assets and is an indicator of the profitability of a company relative to its assets. It is also called 'Return on Investments'.

Period of Study: The period of study has been taken from 2004 to 2016. A post reform period would throw significant light on the chosen topic of study.

DATA ANALYSIS

The Indian banking system plays an important role in the development of the country. Nationalisation of commercial banks brought them in line with socio economic objectives of development planning and banks were directed to increase the credit assistance to the neglected sectors or the 'Priority Sectors' of the economy. This brought changes in the pattern of credit flow. There was rapid expansion in the rural branch network. The 'Directed Credit' policy included a very important dimension of allocating credit to priority sectors at concessional rates and lending to priority sectors became an essential component of lending by commercial banks.

(A) Priority Sector Lending, Classification of Assets, NPAs, NPAs as a Percentage of Advances of Scheduled Commercial Banks, Trends in NPAs:

Table: 1 - Distribution of Total Advances to Priority Sectors (Rs Cr)

Year	Amount	Percentage
2005	215.36	45.22
2006	222.36	53.75

2007	225.19	57.96
2008	248.74	61.48
2009	242.01	53.75
2010	304.96	50.89
2011	401.86	53.82
2012	557.8	47.57
2013	672.16	40.9
2014	798.99	35.16
2015	966.11	34.69
2016	1258.09	23.3

Source: RBI- Database on Indian Economy

It is evident from the above table that advances to priority sectors remained high with 45.22, 53.75 and 57.96 percent from the year 2005 to 2008 in comparison to non priority sector advances. But post 2008, priority sector advances took a downward trend. The reason may lie in the global depression and high rates of growth expectations in non -priority sectors.

Table- 2 presents different categories of loan assets as a percentage of Total Advances to NPAs. The positive impact of implementation of Narasimham Committee recommendations regarding banking reforms are reflected in a continuous decline in NPAs from 2004 to 2007. They were in fact at the lowest in 2008. But, NPAs have started rising after this.

Table: 2 - Categories of Loan Advances (NPAs As percentage of Loan Advances)

Year	Standard Assets	Sub-Standard Assets	Doubtful Assets	Loss Assets	Total NPAs
2004	92.80	2.33	4.02	0.85	7.19
2005	95.01	1.18	3.12	0.62	4.91
2006	96.52	1.00	2.03	0.45	3.48
2007	97.34	1.05	1.29	0.31	2.66
2008	97.61	1.12	1.04	0.23	2.39
2009	97.55	1.29	0.96	0.20	2.45
2010	97.49	1.26	1.00	0.24	2.51
2011	97.64	1.00	1.12	0.24	2.36
2012	97.06	1.45	1.28	0.21	2.94
2013	96.58	1.59	1.63	0.21	3.42

Source: RBI- Report on Trends and Progress of Banking in India.

The Sub-standard assets showed a similar pattern - declining till 2008 but rising in later years, which is a worrisome development and if continues like this, can pose a pressure on the health of the banking sector. There is a satisfactory trend in Loss Assets as they showed continuous decline and stabilises in the years 2012 and 2013. .

Table:- 3 below lists the gross and net NPAs of all scheduled commercial banks. An analysis of the above Table: 3 indicates that the Gross NPAs of SCBs in value terms

Table: 3 - Gross and Net NPA of all Scheduled Commercial Banks (in Rs Billion: as a Percentage of Gross and Net Advances)

Year	Scheduled Commercial Banks Gross NPAs		Scheduled Commercial Banks Net NPAs	
	In Rs Billion	As % of Gr. Advances	In Rs Billion	As % of Net Advances
2004	647.86	7.7	296.92	4.0
2005	583.00	6.3	243.96	2.8
2006	518.0	4.4	217.54	2.0
2007	504.86	3.7	185.43	1.2
2008	564.35	3.5	201.01	1.0
2009	846.98	2.4	247.30	1.0
2010	979.22	2.3	315.64	1.1
2011	1423.00	2.5	387.23	1.1
2012	1429.00	3.1	417.00	1.1
2013	1940.00	3.6	649.0	1.4

Source: Report on Trends and Progress of Banking in India, Various Years.

have declined from Rs 647.86 billion in 2004 to Rs 504.86 billion in 2007, but this value started rising from 2008 and touched almost fourfold in 2013. Gross NPAs as percentage to Gross Advances also declined till 2010 from 7.7% to 2.25%, but started rising from 2011 to 2013, which is a warning sign for the Indian banking sector. Similarly, Net NPA too declined till 2008 and started to increase after 2008. This figure increased threefold in 2013. Net NPAs to Net Advances declined till 2008 and remained stable in later years.

(B) Impact of Non Performing Assets on the Profitability of Banks:

In order to analyse the impact of NPAs on the profitability of banks, the ratios of GNPA to Gross Advances, GNPA to Total Assets, NNPA to Net Advances and NNPA to Total Assets have been taken and then the impact of NPAs has been taken on Return on Assets (ROA) and Return on Equity (ROE).

Table: 4- Impact of NPA on Profitability of Banks

Year	GNPA to Gross Advances	GNPA to Total Assets	NNPA to Net Advances	NNPA to Total Assets	ROA	ROE
2005	6.3	2.5	2.8	0.9	0.8	13.8
2006	4.4	1.8	2.0	0.7	0.8	12.7
2007	3.7	1.5	1.2	0.6	0.9	13.2
2008	3.5	1.3	1.0	0.6	1.0	12.5
2009	2.4	1.3	1.0	0.6	1.13	15.44
2010	2.3	1.4	1.1	0.6	1.05	14.31
2011	2.5	1.4	1.1	0.6	1.1	14.96

2012	3.1	1.7	1.1	0.8	1.08	14.6
2013	3.6	2.0	1.4	1.0	1.04	13.84
2014	3.8	2.4	2.1	1.3	0.81	10.69
2015	4.3	2.7	2.4	1.5	0.81	10.42
2016	7.5	4.7	4.4	2.7	0.4	3.58
Correlation				Correlation of ROA on NNPA to Net advances = 0.881		
				Correlation of ROE on NNPA to Net advances = 0.956		

Source: RBI - Database of Indian Economy

The Correlation between ROA on NNPA to Net Advances is 0.881 which shows that there is a significant correlation between NNPA and ROA.

The Correlation between ROE on NNPA to Net Advances is 0.956 which shows that there is a high degree of positive correlation between NNPA and ROE.

CONCLUSION

It is clear from the above analysis that out of the four classifications of assets, Standard Assets are declining and the amount and percentage of other three categories of assets (NPAs) are rising since 2008 which is an alarming sign for the banking sector. A study of the relationship between NNPA to total advances with ROA & ROE shows that NNPA directly affects both ROA & ROE and has a high degree of positive correlation with the two. ROA and ROE both are efficiency and profitability indicators of banks. A high degree of positive Correlation of both the indicators with NNPA calls for immediate attention from the government and RBI.

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