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Non - Performing Assets And Profitability: A Studyof Private Sector Banks In India

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ABSTRACT

Banking system of a nation facilitates financial fine-tuning of the latter's economic activities; an important device for the development and growth of an economy. Indian banking sector although has significantly expanded and improved post liberalization, privatization and globalization (LPG) of Indian economy, yet there are some glitchesimpinging on the smooth sailing of the system. Inparticular,one of the challenging issuesor glitches seems to be prevalent in the contemporary banking sector of India is management of their NPAs (non-performingassets).A high level of NPAs suggests alarge number of credit defaults that besides liquidity, adversely affects the profitability and net worth of a bank.NPAs are like a double-edged sword as it not only halts revenue generation for banks but also undermines capital accruals, leading to a restricted lending capacity of the banks. Moreover, NPAsnot only affect the books of banks and their performance but also adversely impact the economy as a whole.Present study attempts tojudge the impact of NPAs of privatesector banks of India on their profitability. The trend of NPAs in private sector banks has been exploredover the span of 15 years i.e. from 2001 to 2016 to reach the conclusion. The study usesfinancial ratios as a measure of banks' performance and data has beenanalyzed using the Pearson's Coefficient of Correlation and Regression technique through SPSS.

Keywords: Advances, Gross NPAs, Net NPAs,Profitability, Return on Assets

INTRODUCTION

Indian Banking industry is overshadowed by public sector banks since 1969 when Indian government *nationalized* 14 largest commercial banks of the country. Though, soon after liberalizationprivate sector banks emerged significantly. They have grown faster and expanded wellbytaking advantage of the latest technology, contemporary tools and ingenious techniques. As a regulator and supervisor of the Indian banking system, Reserve Bank of India (RBI)bifurcate Indian private sector banks into two sets; old and new. Existence of old private sector banks is marked before nationalization in 1969 but they remainedindependent as they were not significant enough to be nationalized. On the other hand, new private sector banks attained their banking license after liberalization of banking policy in the 1990s.Enormous competition in the banking industry has obligated private banks to serve their clients with superior services. Private Banksface major competition from the public sector banks operating nationwide along with the ones operating across the borders. Therefore, advancement in technology and unparalleled services can enable aprivate sector bank to be distinct frompublic ones.

The primary function of accepting deposits and lendingcredits is common to all banks whereas, what enables a bank to stand out from other banks are its secondary functions which compriseof agency and utility functions. In other words, to have an edge over its competitors, a bank must caterto its customers with a service which other banksmight not afford to. This will enhance the relationship between bank and customer. Over the years it has been held that private sector banks are better in comparison to public sector banks in terms of overall performance. However, the myth of superior performance of the private banks needs to be addressed well.

CONCEPTUAL FRAMEWORK

Non-performing assets(NPAs) as per *Master Circular –Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances* (issued by the RBI),are loans or advances where;

i. Interest and/or installment of principal remain overdue for a period of more than 90 daysin respect of a term loan; or

ii. The account remains 'out of order' in respect of an Overdraft / Cash Credit (OD/CC); or

iii. The bill remains overdue for a period of more than 90 days in the case of bills purchasedand discounted; or

iv. The installment of principal or interest thereon remains overdue for two crop seasonsfor short duration crops and one crop season for long duration crops (in respect of agriculture loan); or

v. The amount of liquidity facility remains outstanding for more than 90 days in respect of securitization transaction undertaken in terms of 'Guidelines on Securitization'issued by Reserve Bank of India on February 1, 2006; or

vi. In respect of derivative transactions, the overdue receivables representing positive markto-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Thus it can be understood that Non-Performing Assets (NPAs) refers to a classification of loans and advances in the books of financial institutions that are in default or scheduled payments of principal or interest are in arrears. A loan or an advance is usually classified as non-performing when loan payments have not been made within a period of 90 days of their maturity as 90 days of non-payment is the standard period of time for classifying any asset as non-performing. However the duration of elapsed time may be shorter or longer depending upon the terms and conditions set forth in each loan.

CATEGORIES OF NPAs

As per the said 'Master Circular'issued by the RBI on July 1,2015,banks are required to classify non-performing assets into the following three categories based on the period for which the asset has remained non-performing:

(1) **Sub-standard Assets**: With effect from 31 March 2005, a substandard asset would bethe one, which has remained non-performing for a period less than or equal to 12 months. Such assets are characterized by the possibility that if deficiencies are not corrected, banks will sustain some loss.

(2) **Doubtful Assets:** With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Accordingly, aloan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard with some additional risk.

(3) **Loss Assets:**A loss asset is one where loss has been identified by the banks'internal or external auditor(s) or the RBI inspection but the amount has not been written off completely. Such an asset is considered uncollectible and is of such a little value that its continuance as a bankable asset is not acceptable although it may have some salvage value.

CONTRIBUTING FACTORS TO NPAs

Some of the factors that contribute towards NPAs of the can be summarized as under:

1. Banks diversify funds for expansion, modernization and at times for helping their associate banks. If this diversification of funds is coupled with recession then banks fail to tap adequate capital from financial markets thereby contributing towards rise in non-performing assets.
2. Use of outdated technology, inappropriate machinery, technical problems, inefficient management, business failures also lead to rise in NPAs.
3. Natural calamities, strained foreign relations, recession in foreign countries can also make assets non-performing.
4. Poor execution of project can lead to time and cost overrun which becomes one of the reasons behind NPAs of banks.
5. Any major change in government's financial policy affect competitiveness and profitability of banks.
6. Inefficient management of banks, delay in releasing funds, subsidies and grants by the government impact the success of banks.
7. Inappropriate and quick analysis of financial credibility of borrowers by banks is a prime reason behind losses of banks. They either fail to recognize early warning signals or cause delay in taking any corrective action for the assets that have become sub-standard or doubtful.
8. Bad economic conditions,rising prices, scarcity of raw material, power shortage cause more number of dues.
9. Banks sometimes grant loan on the basis of instructions of government ignoring their own financial interest as banks are sometimes bound to direct funds towards priority sector.
10. Management disputes, frauds, willful defaults, mismatching of funds,siphoning of funds also lead to rise in the level of non-performing assets.

LITERATURE REVIEW

An attempt has been made here to provide a brief review of the relevant studies.

Reddy(2002)studied how other Asian countries had tackledthe problem of non-performing assets.The country wise analysis was done among People's Republic of China (PRC), Thailand, Japan, Korea and India to identify the differences among causes of NPAs and mechanism to solve the problem.Analysis propounded that in terms of asset quality,financial health of Indian banking system has made evident progress but still there is a need to learn from the foreign experiences so that an effective tailor-made policy for better handling NPAs can be developed for India.

Bodla and Verma (2006)conducted a study titled “Determinants of Profitability of Banks in India: A Multivariate Analysis” in context of public sector banks during the period of 1991-2004.In this study, after conducting step-wise multivariate regression on time-based data it was establishedthat net profit of a public sector bank is significantly affected by non-interest income, operating expenses, provisions and contingencies spread.

Dasand Ghosh (2006)investigated the performance of Indian commercial banking sector during the post-reform period – 1992–2002. Non-parametric Data Envelopment Analysis (DEA) technique was used to evaluate various efficiency estimates of individual banks. Variations in calculated efficiencies was linked to a set of variables, i.e., bank size, ownership, capital adequacy ratio, non-performing loans and management quality. It was witnessed that level of technical efficiency is more in medium-sized public sector banks. A high degree of association was detectedamong efficiency and soundness as determined by banks' capital adequacy ratio. The empirical results revealed that banks withless non-performing loans are precisely efficient.

Vallabh et. al.(2007) studied the NPAs ofpublic, private, and foreign sector banks in India, by using model that comprised of two broad sets of factors. One such factor setwas macroeconomic factors which included GDP growth rate and excise duty and another set used in the model included bankspecific parameters, such as Credit Deposit Ratio (CDR), loan exposure to priority sector, Capital Adequacy Ratio (CAR), and liquidity risk. The results revealed that over the years movement in NPAs is effected by the factors considered in the model. The factors incorporated in the model explained 97.1% and 76.9 % of variations in NPAs of public and private banksrespectively. It was also observed that banks' that lended to priority sector had lesser amount of NPAs.

Malyadri (2011) observed movement of NPAs in public as well as private sector banks during 2004-10using compounded annual growth rate (CAGR) and percentage method. The researcher spotted that NPAs have declined during the period of study leading to a conclusionthat management of NPAs in public and private sector banks have improved over the years.

Balasubramaniam (2012) studied NPAsof selected public sector banks in conjunction with a few private sector banks and established that magnitude of NPAs is high in all banks but appropriate efforts are being initiated by banks to reduce themby means of implementing curative measures like better credit appraisal procedures and effective internal control techniquesalong with the efforts to upgrade asset quality. The study also provided suggestions regarding implementation of Basel III norms in public as well as private sector banks.

Rajput, Gupta and Chauhan (2012) studied magnitude of NPAs in public sector banks and its impact on banks' profitability.Throughthe analysis, authors observed that performance of banks is significantly affected by NPAs as there exists an inverse relationship between profitability measure and NPAs of public sector banks.

Srivastava and Bansal(2012)compared the trend and magnitude of NPAs and advances in public, private and foreign banks using Gross NPAs and Gross Advances for the period of 2007-12.Through this study, it was discovered thatstakeof public sector banks in total advances of the economy is nearly two-thirds.

Kumar (2013)in his study on “A Comparative study of NPAs of Old Private Sector Banks and Foreign Banks”, has established that NPAs have become a matter of concern for old private sector banks and foreign banks in the past several years.

NarulaandSingla (2014) in their study titled “Empirical study on non-performing assets of bank.” assessed the impact of non–performing assets on the profitability with special reference to Punjab National Bank (PNB).Further, relationship between total advances, Net profits, gross NPAsand netNPAswas measured and it wasestablished that there existsa direct relationamongnet profits and NPAs of PNB according to which any increase in profits will also increase NPAs of the bank.

Borse (2016) made an attempt to study the correlation between Net NPA and ROA of 11 major Indian commercial Banks. Among selected sample of commercial banks there were 6 Public sector banks and 5

Private sector banks. Period of study selected was 2010-11 and 2014-15.It was found that NPA increases at a higher rate in public sector banks when compared to private sector banks. In this study a moderate negative correlation between NPA and ROA was witnessed.

Jayakkodi and Rengarajan (2016) attempted to analyze the trend of NPA of selected private and public sector banks. Author also studied the relationship between Gross NPA ratio and ROA of selected banks.Study of period ranged from 2010-2015. The data was analyzedusing various ratios along with correlation analysis. A high degree of negative correlation was found between GNPA ratio with ROA of PNB, BOB, BOI, ICICI and HDFC .Whereas positive correlation was observed between GNPA ratio and ROA of SBI, AXIS and FEDERAL Bank. Major reason identified behind different relationship among GNPA Ratio and ROA of different banks was choice of customers. Through, analysis private sector banks were found to be more efficient than the public sector banks.

The above literature review indicates that the problem of NPAs have been studied over the years to bring insight into its causes, consequences and the probable solution. Although abundance of literature is available on non-performing assets of public sector banks (PSBs), yetquite limited asregards NPAs of private sector banks in India.Thus, present study aims to give insight towards the trend of non-performing assets of private sector banks and also attempts to scrutinize its impact on the profitability of the latter.

OBJECTIVES OF THE STUDY

Objectives of the study are as follows;

1. To analyze and interpret trend of NPAs in 'Private Sector Banks of India'during 2001-16.
2. To scrutinize the impact of Gross NPA Ratio on the profitability (ROA) of private sector banks.
3. To examine the impact of Net NPA Ratio on the profitability (ROA) of private sector banks.

RESEARCH METHODOLOGY

Present study has been conducted in the context of privatesector banks of India. To analyze the trend of NPAs in private sector banks period of study taken is from the year 2001 to16. Robust database of the RBI and various RBI publications,particularly the annual reports on trend and progress of banking in India and statistical tables relating to Indian banks has been used as a source of data for the purpose of empirical analysis.Further,'Correlation Analysis' and 'Regression Technique' has been used to measure the relationship and impact of NPAs on the profitability of Indian private sector banks.

The measure for non-performing assets used in the study are:

Gross NPA to Gross Advances ratio,also referred as 'Gross NPAratio',Net NPA to Net Advances ratioreferred as 'Net NPA ratio'and Return on Assets(ROA) as a measure of profitability of private sector banks. Profitability measure has been used as dependent variable in the study while measures of NPAs has been used as independent variable in the regression model.

Regression Model was formed as below:

$Y= \alpha+\beta.X1+\varepsilon$; $Y= \alpha+\beta.X2+\varepsilon$

Y= ROA

X1=Gross NPA ratio

X2= Net NPA ratio

Here ROA is dependent variable and Gross NPA ratio and Net NPA ratio are independent variable.

HYPOTHESES

The following null hypotheses were formulated and tested for the current study:

H_{01}: There is no relationship betweengrossNPA ratio and return on assets (ROA)of private sector banks operating in India

H_{02}: There is no relationship between netNPA ratio and return on assets(ROA) of private sector banks operating in India.

ANALYSIS AND INTERPRETATION

a) Trend of Gross and Net NPAs in the study period (from 2001-02 to2015-16)

Non-Performing Assets (NPAs) have been defined as loans or advances in respect of which payment of interest or principal or both have remained unpaid as per agreed terms of the loan contract for more than 90 days. The definition of NPAs in theIndia is largely based on the status of loan repayment. NPAs are reported in terms of Gross NPAs and Net NPAs.“Gross NPAs is the amount outstanding in the borrower's account, in books of the bank besides the interest which has been accrued but not debited to the borrowers account” whereas “Net NPAs is the amount of gross NPAs less (1) interest debited to borrowers and not recovered and not recognized as income and kept in interest suspense (2) amount of provisions held in respect of NPAs and (3) amount of claim received and not appropriated”.RBI has directed the banks to compute their gross advances, net advances, gross NPAs and net NPAs as per the above format with effect from September 2009.Due to the requirement of provisioning, NPAsnot only affects banks profitability but also impact banks' ability to strengthen their capital position adversely.Hence, it is anticipated of the banks to maintain high asset quality.

TABLE 1: Gross and Net NPAsof Private Sector Banks

(Amount in INR 100 Crores)

Year	Gross Advances	Gross NPAs	Gross NPA Ratio	Net Advances	Net NPAs	Net NPA Ratio
2001-02	1209.58	116.62	9.64	1164.73	66.76	5.73
2002-03	1460.47	117.82	8.07	1389.51	68.82	4.95
2003-04	1774.19	103.81	5.85	1707.54	48.58	2.85
2004-05	1978.32	87.82	4.44	1913.97	42.12	2.20
2005-06	3176.9	78.11	2.46	3129.62	31.71	1.01
2006-07	4201.45	92.56	2.20	4147.52	40.28	0.97
2007-08	5258.45	129.97	2.47	5184.03	56.47	1.09
2008-09	5850.65	169.26	2.89	5753.28	74.11	1.29
2009-10	6440.7	176.39	2.74	6324.94	65.05	1.03
2010-11	7323.1	181	2.47	7975.33	43	0.54
2011-12	8804.46	183.15	2.08	9664.02	43.35	0.45
2012-13	11591.43	207.63	1.79	11432.48	59.06	0.52
2013-14	13602.53	245.42	1.80	13428.35	88.61	0.66
2014-15	16073.39	341.06	2.12	15842.85	141.28	0.89
2015-16	19726.59	561.85	2.85	19393.09	266.77	1.38

(Source: RBI Publications)

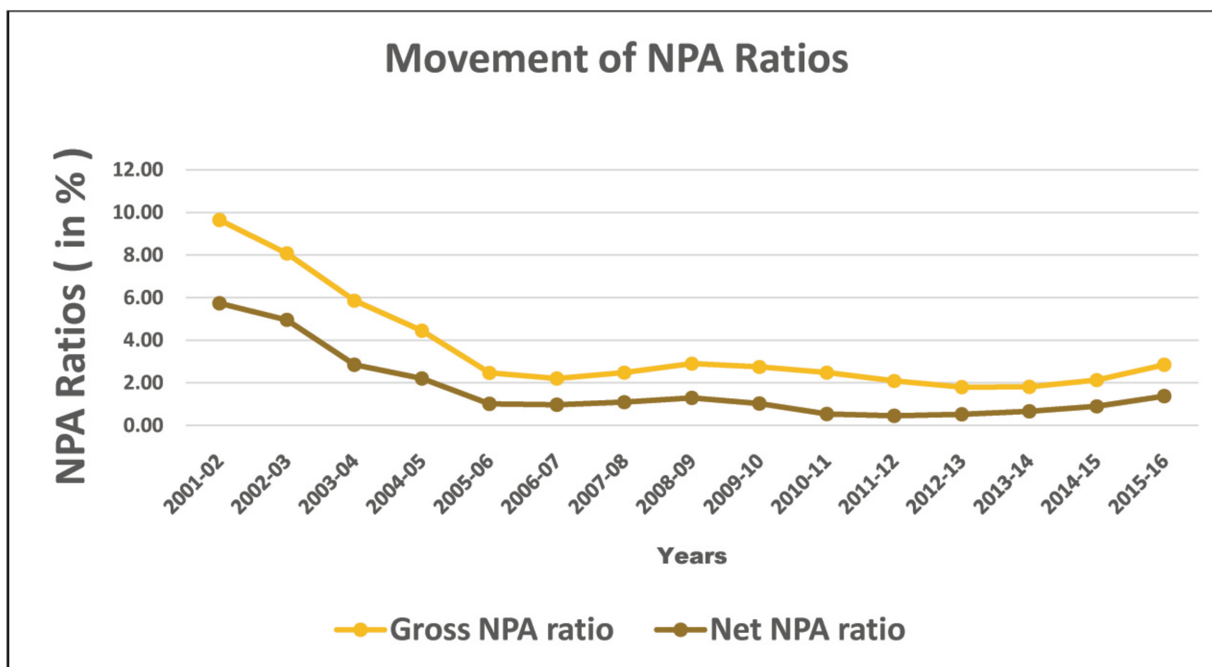

Fig 1: Gross and Net NPA Ratio as % of Gross and Net Advances Respectively

Over the years non-performing assets of Indian private sector banks have declined regularly. As exhibited in Table 1, GrossNPA ratio reduced from 9.64% in 2001-02 to 2.85% in 2015-16, whereas, Net NPA ratio reduced from 5.73% in 2001-02 to 1.38% in 2015-16.

The above analysis shows a diminishing trend inrespect of Gross NPA and Net NPAratio which enable us to conclude that NPAs are declining over the years, which is a strongsign that effectivemeasures are being adopted by the banks to control the risk created by NPAs. Growth of NPAs is a setback for any economy thus it becomes imperative to control them. Non-performing assets distress the liquidity position of the bank and develop a disparity among assets and liability which cause bank to raise resources at a high cost. Rise in NPAs may spill over the banking system which can contract the money supply, and further affect banks liquidity along with profitability.

B) Relationship between NPAs and Profitability of banks

To interpret the relationship between NPAs and profitability of banks Karl Pearson's Coefficient of Correlation has been calculated using three ratios, two out of which are related to NPAs. These ratios are Gross NPA ratio and Net NPA ratio along with ROA (Return on Assets).

Results of Correlation Analysis are as under:

Table 2: Correlation between NPA and ROA for Private Sector Banks (2001 to 2016)

Variables	Correlation
Gross NPA r atio with ROA	-.621
Net NPA r atio with ROA	-.618

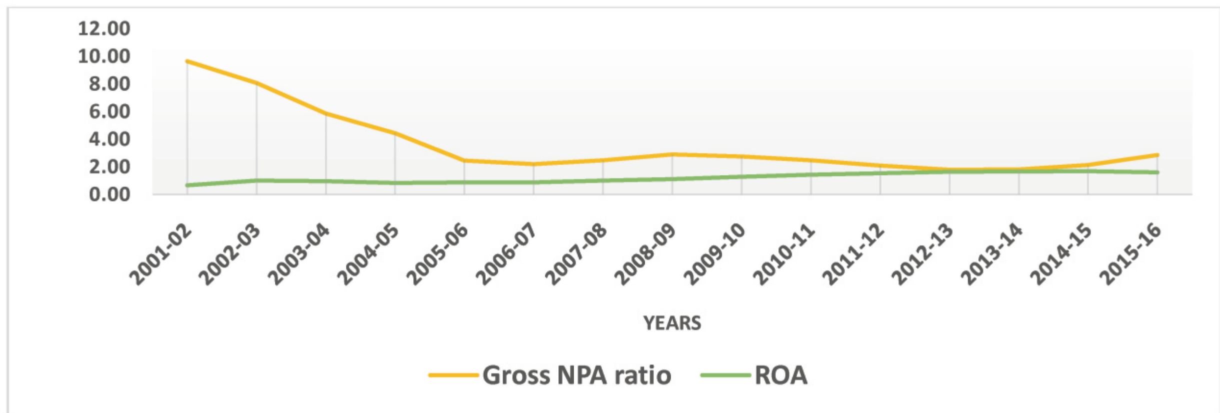

Fig 2: Correlation between Gross NPA Ratio and ROA

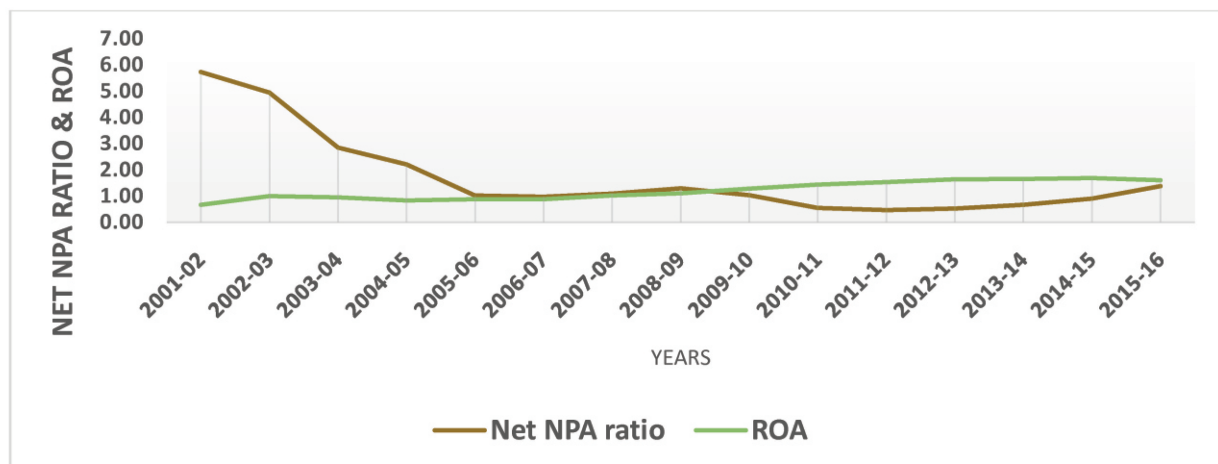

Fig 3: Correlation between Net NPA Ratio and ROA

Interpretation

Analysis of the collected datareveal a high degree of negative correlation between Gross NPA ratioand ROA as well as Net NPA ratio and ROA. An inverse relationship clearly describes that if non-performing assets are contained, profits of banks will increase and vice-a-versa.

Further regression analysis was also performed between these ratios, results of which can be summarized as under:

Table 3: Model Summary: ANOVA (F) Results and Coefficients for Private Sector Banks

Model Dependent variable: Return on Assets	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1.533	.137		11.228	.000
Gross NPA Ratio	-.091	.032	-.621	-2.859	.013
Model Summary	R=.621 , R^2=.386 , F Value = 8.171 at p value = 0.013				

I.V – Gross NPA Ratio, D.V-Return on Assets

Interpretation

The above analysis (Table 3) shows the results of regression analysis between Return on Assets (ROA) and Gross NPA ratio, where the dependent variable is Return on Assets and independent variable is Gross NPA ratio. The value of *R* square is 0.386 which indicates that Gross NPA ratio, explains the 38.6% of total variance in the value of return on assets. Remaining, 61.4% of the total variance in the value of ROA is due to other factors. Accordingly, it can be established that Gross NPA has an impact on the profitability of the Indian private sector banks. The negative sign of regression coefficient i.e. Beta indicates a negative relationship between ROA and Gross NPA ratio. Concluding that the profitability and Gross NPA have an inverse relationship. Any increase in the amount of Gross NPA will cause reduction in the profits of the banks and vice-a-versa.Thus, $H_{01}$is rejected as a significant negative relationship has emerged between Gross NPA ratio and ROA.

Table 4: Model Summary : ANOVA (F) and Coefficients of Private Sector Banks

Model Dependent Variable: Return on Assets	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 **(Constant)**	1.435	.110		13.043	.000
Net NPA Ratio	-.135	.048	-.618	-2.835	.014
Model Summary	R=.618,R^2=.382,F=8.039 at p value = 0.014				

Interpretation

Above analysis (Table 4) shows the results of regression analysis, wherein the dependent variable is ROA and independent variable is Net NPA ratio.The value of *R* square is .382which indicatesthat Net NPA ratio, explains the 38.2% of the total variance in the value of ROA. Remaining, 61.8% of the total variance in the value of ROA is due to other factors.Accordingly, it can be interpreted that Net NPA has anadverse impact on the profitability of the Indian private sector banks. The negative sign of regression coefficient i.e. Beta indicates a negative relationship between ROA and Net NPA ratio, concluding the existence of an inverse relationship among profitability and Net NPA.After correlation and regression analysis it can be established that a significant negative relationship exists amongNet NPA ratio and ROA thus H_{02} also stands rejected.

FINDINGS

On analyzing the trend of NPAs in private sector banks it was observed that non-performing assets has reduced over the years indicating better management practices being adopted by banks. Further, negative relationship was witnessed between both the NPA Ratios (GNPA Ratio & NNPA Ratio) and ROAleading to the rejection of both the null hypotheses which says that there is no relationship between GNPA Ratio,NNPA Ratio and ROA.Existence of negative relationship between NPA Ratios and ROA makes it necessary to adequately manage the NPAs.

CONCLUSION

The present study intended to assess the impact of NPAs on the profitability of the Indian banking industry with special reference to private sector banks. The analysis was conducted for a period of 15 years i.e. from 2001 to 2016.Statistical analysis was done using correlation and regression techniques whereby the hypotheses were tested and it was discovered that significant negative relationship exists between NPAs and ROA. Moreover, a diminishing trend in the ratios of non-performing assets of private sector banks i.e. Gross NPA ratio and Net NPA ratiowas also witnessed. This warrants that the banks should manage the level of NPAsadequately as it can affect the interest of various stakeholders aversely.Notwithstanding non-performing assets are an inevitable burden for banking industry of a nation, they should be contained as they can impact the profitability of banks.Thus, it becomes imperativeto change the curve of NPAs by devising and executing effective monitoring policy, duly supported by legal and regulatory framework of the state to keepthe NPAs under control.Although, achieving completeeradication of NPAs may sound difficult in the banking industry, effective measures can be adopted to lessen the extent of NPAs.

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