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# "Impact of NPAs upon Profitability of State Bank of India- A critical review"

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*Banking sector is one of the leading indicators of a nation and represents one of the most important components of a nation's capital. In a same manner loan represents the one of the important components of a bank's total assets, which generates income for the bank. Timely recovery of the lone is important for the performance of the banks. A loan whose interest or principle has been overdue for over 90 days become NPAs and treated as bad loan. These bad loans are not able to generate income for the bank which affects the profitability of the bank. Therefore, the non-performing loans ratio is a critical tool to measure a bank's performance. The main function of a bank is to accept deposit which is liability of a bank and provide loan generates income for the bank. The quality of loan assets is the most important factor for the basic viability of the banking system. Lower level of the non performing assets helps the bank in consolidating their position and gives credence to efficiency of the management. The bank not only evaluate the creditworthiness of the borrower at the time of processing of loan but the close monitoring of the borrower regularly will help the banks to reduce the level of NPA. In the era of globalization where whole world is treated as the domestic market, the Indian banks are not able to compete due to certain inherent weakness. The purpose of study is to investigate whether there is a significant relationship between non- performing assets and the performance of bank.*

**Keywords**: Indicators, Non-performing assets, Creditworthiness.

## Introduction:

Banks are the important segment in Indian Financial System. The banking systems directly or indirectly affect the economic development of the nation. An efficient banking system helps the nation's economic development. Various categories of stakeholders of the Society use the banks for their different requirements. Banks are financial intermediaries between the depositors and the borrowers. Apart from accepting deposits and lending money, banks in today's changed global business environment offer many more value added services to their clients. The Reserve Bank of India as the Central Bank of the country plays different roles like the regulator, supervisor and facilitator of the Indian Banking System. A strong banking sector is important for the development of economy. The banking industry has undergone a sea change after the first phase of economic liberalization in 1991 and hence credit management. The primary

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function of banks is to lend money as loans to various sectors such as agriculture, industry, personal loans, housing loans etc., but at present the banks have become very cautious in providing loans. The reason is increasing amount of nonperforming assets (NPAs) and nowadays these are one of the major concerns for banks in India. NPAs affect the performance of banks. A high level of NPAs suggests high probability of a large number of credit defaults that affect the profitability and net-worth of banks and also erodes the value of the asset. The NPA growth involves the necessity of provisions, which reduces the overall profits and shareholders' value. The quality of assets/ loans portfolio held by banks is a critical indicator of health of the banking/financial system. It mirrors the level of credit risk and efficiency in the allocation of bank funds.

The concept of NPAs is not new for the India, Reserve Bank of India introduced a critical analysis for a comprehensive and uniform credit and monitoring by way of the Health Code System, in banks, which provided information regarding health of individual advances in 1985 – 86. It was considered that such information would be of immense use to banks management for control purpose. Reserve Bank of India advises all commercial banks on 7th November, 1987 to introduce the health classification indicating the quality of individual advances in the eight categories with Health Code assigned to each borrower account.

The concept of NPA came into existence with the recommendation of the Narasimaham committee in the year 1992-1993. As per committee recommendation, NPA is defined as a loan asset which has stopped to generate any income for a bank whether in the form of interest repayment or principal repayment. In order to adopt international practices and to ensure more transparency, it was decided to adopt the 90 days overdue norms for identification of NPAs.

**Meaning of NPA**

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. A 'non-performing asset' (NPA) was defined as a credit facility in respect of which the interest and/ or installment of principal has remained 'past due' for a specified period of time. The specified period was reduced in a phased manner as under:

**Year ending March 31 Specified periods**

| | |
|---|---|
| 1993 | four quarters |
| 1994 | three quarters |
| 1995 | onwards two quarters |

An amount due under any credit facility is treated as "past due" when it has not been paid within 30 days from the due date. Due to the improvements in the payment and settlement systems, recovery climate, up gradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, effective from March 31, 2001.

**Categories of NPAs:**

Banks are required to classify non-performing assets further in the following three categories based on the period for which the assets has remained non-performing and the reliability of the dues. Further the NPAs can be categorised into –

a. Sub-standard Assets

b. Doubtful Assets

c. Loss Assets

**Sub Standard Assets:**

Assets classified as NPA are classified as Sub Standard Assets for a period not exceeding 12 months.

**Doubtful Assets:**

An asset which has remained NPA for a period exceeding 12 months and realization of dues in full is highly improbable.

**Loss Assets:** A loan account will be classified as Loss Asset if:

- NPA not supported by any security or DICGC/ECGC cover
- Asset identified by the bank or its internal or external auditors of RBI inspectors.

**TYPES OF NPAs**

NPAs are broadly divided into:

a) Gross NPAs, and

b) Net NPAs

**a) Gross NPAs:** Gross NPAs are the sum total of all loan assets that are classified as NPAs as per RBI guidelines as on Balance Sheet date. Gross NPA reflects the quality of the loans made by banks. It consists of all the non standard assets like as sub-standard, doubtful and loss assets.

It can be calculated with the help of following ratio:

Gross NPAs Ratio = Gross NPAs / Gross Advances

**b) Net NPAs**: Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. Net NPA shows the actual burden of banks. Since in India, bank balance sheets contain a huge amount of NPAs and the process of recovery and write off of loans is very time consuming, the provisions the banks have to make against the NPAs according to the central bank guidelines, are quite significant. That is why the difference between gross and net NPA is quite high.

It can be calculated as:

Net NPAs = Gross NPAs – Provisions / Gross Advances – Provisions

**CAPITAL ADEQUACY NORMS (CAR):**

Along with profitability and safety, banks also give importance to Solvency. Solvency refers to the situation where assets are equal to or more than liabilities. A bank should select its assets in such a way that the shareholders and depositors' interest are protected.

**Prudential Norms**

The norms which are to be followed while investing funds are called "**Prudential Norms**." They are formulated to protect the interests of the shareholders and depositors. Prudential Norms are generally prescribed and implemented by the central bank of the country. Commercial Banks have to follow these norms to protect the interests of the customers.

For international banks, prudential norms were prescribed by the **Bank for International Settlements** popularly known as **BIS**. The BIS appointed a **Basle Committee** on Banking Supervision in 1988.

**Basel Committee**

Basel committee appointed by BIS formulated rules and regulation for effective supervision of the central banks. For this it also prescribed international norms to be followed by the central banks. This committee prescribed **Capital Adequacy Norms** in order to protect the interests of the customers.

**Definition of Capital Adequacy Ratio**

Capital Adequacy Ratio (CAR) is defined as the ratio of bank's capital to its risk assets. Capital Adequacy Ratio (CAR) is also known as Capital to Risk (Weighted) Assets Ratio (CRAR).

**India and Capital Adequacy Norms**

The Government of India (GOI) appointed the Narasimham Committee in 1991 to suggest reforms in the financial sector. In the year 1992-93 the Narasimhan Committee submitted its first report and recommended that all the banks are required to have a minimum capital of 8% to the risk weighted assets of the banks. The ratio is known as **Capital to Risk Assets Ratio (CRAR)**. All the 27 Public Sector Banks in India (except UCO and Indian Bank) had achieved the Capital Adequacy Norm of 8% by March 1997.

The Second Report of Narasimham Committee was submitted in the year 1998-99. It recommended that the CRAR to be raised to 10% in a phased manner. It recommended an intermediate minimum target of 9% to be achieved by the year 2000 and 10% by 2002.

**Review of Literature:**

1. The Reserve Bank of India has also conducted a study to ascertain the contributing factors for the high level of NPAs in the banks covering 800 top NPA accounts in 33 banks (RBI Bulletin, July 1999). The study has found that the proportion of problem loans in case of Indian banking sector always been very high. The problem loans of these banks, in fact, formed 17.91 percent of their gross advances as on March 31, 1989. This proportion did not include the amounts locked up in sick industrial units. Hence, the proportion of problem loans indeed was higher. However, the NPAs of Indian Banks declined to 17.44 percent as on March 31, 1997 after introduction of prudential norms. In case of many of the banks, the decline in ratio of NPAs was mainly due to proportionately much higher rise in advances and a lower level of NPAs accretion after 1992. The study also revealed that the major factors contributing to loans becoming NPAs include diversion of funds for expansion, diversification, modernization, undertaking new projects and for helping associate concerns. This is coupled with recessionary trend and failure to tap funds in the capital and debt markets, business failure (product, marketing, etc.), inefficient management , strained labour relations, inappropriate technology/technical problems, product obsolescence, recession input/power shortage, price escalation, accidents, natural calamities, Government policies like changes in excise duties, pollution control orders, etc. The RBI report concluded that reduction of

NPAs in banking sector should be treated as a national priority issue to make the Indian banking system stronger, resilient and geared to meet the challenges of globalization.

2. **Toor N.S. (1997)** explained the concept of NPAs and management of NPAs from bankers' point of view and explains the strategy to be followed in handling borrowing accounts right from pre-sanction stage till recovery of the loan. The book is a practical guide for the practicing bankers and serves as a ready reckoner. However, this book does not contain any statistical data of NPAs.
3. **Dr. C.H. Rajesham and Dr. K. Rajendra (June 2007)** studied the management of nonperforming assets in Indian scheduled commercial banks. The results of these studies were unfavorable of nonperforming assets in banks. Both the authors found that stringent measures are required at the levels of RBI, banks and judiciary to control the NPA problem. Further, they found NPAs have negative impact on banks.
4. **Veerakumar, K. (2012)** The Indian banking sector has been facing serious problems of raising Non-Performing Assets (NPAs). Like a canker worm, NPAs have been eating the banking industries from within, since nationalization of banks in 1969. NPAs have choked off quantum of credit, restriction the recycling of funds and leads to asset-liability mismatches. It also affected profitability, liquidity and solvency position of the Indian banking sector.
5. **Vohra and Dhamu (2012)** em**pha**tically point out that the NPAs gave a direct impact on profitability, liquidity and equity of the banks. The author observes that NPA of Indian banks are relatively very high by global standards. Thus, they recommend restricting of lending operations only to secured advances with adequate collateral securities. They also list a few command reasons for an asset turning NPA, considering economy, industry, borrower and lender sides separately.
6. BUSINESS STANDARD REPORT (2016) says that NPA provisioning drowns banks profits. Their study concludes a steep rise in provisions for bad loans has made a heavy dent in the bottom-line of banks.

## STATEMENT OF THE PROBLEM:

The main function of a bank is to serve the people by providing loans and advances to needy people for their productive use, even for the growth of industry and the economy. Interest Income is the main source of a bank if the borrowers are not able to repay the amount to the banks regularly as per the due dates; it is affecting the performance of the banks. As per the new banking regulation if the borrower not paid the principle and interest amount within 30 days it is to be considered as Non-Performing Assets.

During observation of various studies on Non- performing assets and the financial statements. A question arises that, what is the level of NPA in Commercial banks? What are the reasons for the assets becoming Non- Performing assets and what is its impact on performance of a bank. There are so many factors which define the performance of the banks such as satisfaction of the consumer, satisfaction level of the employees; increase in the market value of the share etc. In this research article NPAs is taken as the measure of profitability of the bank.

## Objective of study:

1. To understand the concept of Non-performing assets (NPAs).

2. To understand the impact of NPAs on the profitability.
3. To study the nature and causes of NPAs.
4. To assess the growth and magnitude of NPAs in State Bank of India.

**Research Methodology:**

**Data Collection:**

The research is based on secondary data obtained from the published financial reports and statements of the bank. The supplement data generated from IBA Bulletin, RBI data bank are be taken into consideration.

**Period of Study:**

The present research is based on the analysis of NPAs with various references of accounting and accounting information of 10 years, from 2005- 2006 to 2014-2015.

**Mode of Analysis:**

As numerical and secondary data is used, quantitative approach is employed to find out the findings of the research. To observe variability in the data statistical analysis are used. This involves the process of analyses of the data that has been collected. The descriptive study is used for the purpose of study.

**Research Model:**

Correlation analysis was carried out to test the impact of NPA on the profitability.

**Hypotheses of study:**

To justify the research title following null hypotheses were formulated by the researcher-

$H_{01:}$ There is no significant relationship between Net Profit and Gross NPAs.

$H_{02:}$ There is no significant relationship between Net Profit and Net NPAs.

**Analysis of Data:**

**Hypothesis - 1**

$H_{0:}$ There is no significant relationship between Net Profit and Gross NPAs.

$H_{1:}$ There is significant relationship between Profit and Gross NPAs.

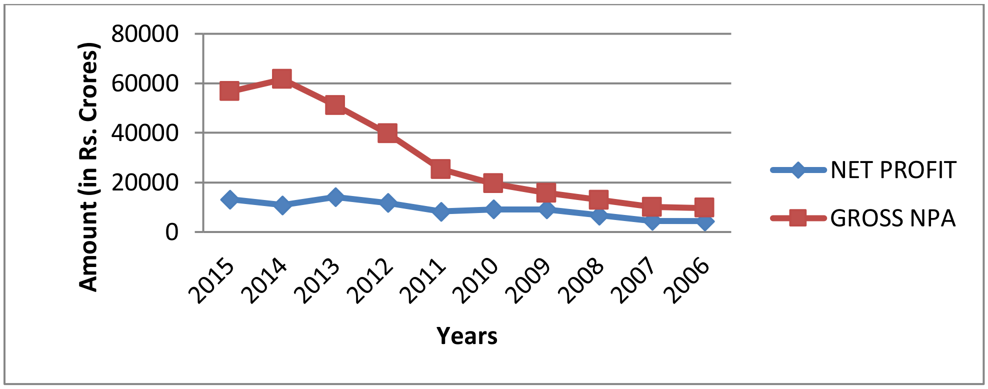
**Table No. 1- Data of NET PROFIT & Gross NPAs for 10 Years of State Bank of India.**

**(Rs. Cr.)**

| Years | NET PROFIT | GROSS NPAs |
|---|---|---|
| 2015 | 13101.57 | 56725.34 |
| 2014 | 10891.17 | 61605.35 |
| 2013 | 14104.98 | 51189.39 |
| 2012 | 11707.29 | 39676.46 |
| 2011 | 7370.35 | 25326.29 |
| 2010 | 9166.05 | 19534.89 |

| | | |
|---|---|---|
| 2009 | 9121.23 | 15588.6 |
| 2008 | 6729.12 | 12837.34 |
| 2007 | 4541.31 | 9998.22 |
| 2006 | 4406.67 | 9628.14 |

Source:- www.sbi.co.in




Graph on the basis of above data

OX axis - Years

OY axis – Amount of Gross NPAs and Net Profit Rs. in Crores

**Descriptive Statistics**

| | Mean | Standard Deviation | N |
|---|---|---|---|
| NP | 9.2034E3 | 3334.91054 | 10 |
| GNPA | 3.0223E4 | 20276.77918 | 10 |

**Correlations**

| | | NP | GNPA |
|---|---|---|---|
| NP | Pearson Correlation | 1 | .863** |
| | Sig. (2-tailed) | | .001 |
| | N | 10 | 10 |
| GNPA | Pearson Correlation | .863** | 1 |
| | Sig. (2-tailed) | .001 | |
| | N | 10 | 10 |

**. Correlation is significant at the 0.01 level (2-tailed).

As there is a significant relation between the Net Profit and Gross NPAs. So, Null hypothesis is rejected.

**Hypothesis - 2**

$H_{0:}$ There is no significant relation between Net Profit and Net NPAs.

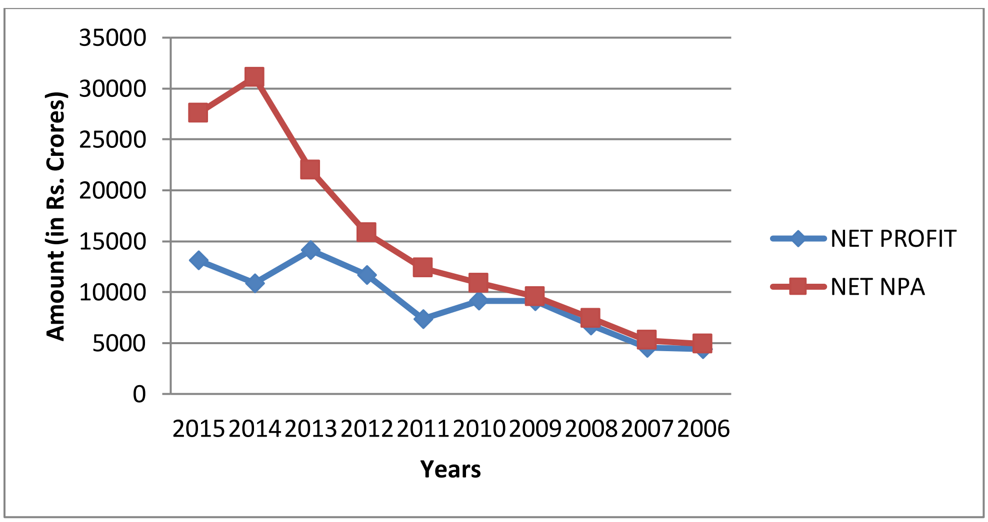
$H_{2:}$ There is significant relation between Net Profit and Net NPAs.

**Table No. 2 - Data of NET PROFIT & NET NPAs for 10 Years of State Bank of India**

**(Rs. Cr.)**

| Years | NET PROFIT | NET NPAs |
|---|---|---|
| 2015 | 13101.57 | 27590.58 |
| 2014 | 10891.17 | 31096.07 |
| 2013 | 14104.98 | 21956.48 |
| 2012 | 11707.29 | 15818.85 |
| 2011 | 7370.35 | 12346.89 |
| 2010 | 9166.05 | 10870.17 |
| 2009 | 9121.23 | 9552 |
| 2008 | 6729.12 | 7424.34 |
| 2007 | 4541.31 | 5257.72 |
| 2006 | 4406.67 | 4911.41 |

Source: www.sbi.co.in




Graph on the basis of above data

OX axis - Years

OY axis – Amount of Net NPAs and Net Profit Rs. in Crores.

**Descriptive Statistics**

| | Mean | Std. Deviation | N |
|---|---|---|---|

| | | | |
|---|---|---|---|
| NP | 9.2034E3 | 3334.91054 | 10 |
| NNPA | 1.4682E4 | 9270.73301 | 10 |

**Correlations**

| | | NP | NNPA |
|---|---|---|---|
| NP | Pearson Correlation | 1 | .820** |
| | Sig. (2-tailed) | | .004 |
| | N | 10 | 10 |
| NNPA | Pearson Correlation | .820** | 1 |
| | Sig. (2-tailed) | .004 | |
| | N | 10 | 10 |

**. Correlation is significant at the 0.01 level (2-tailed).

As there is a significant relation between the Net Profit and Net NPAs. So, Null hypothesis is rejected.

**<u>Conclusion:</u>**

NPAs reflect the overall performance of the banks. Due to inherent function of banks the NPAs have always been a big problem for the banks in India. Currently Indian banking sector faced a serious problem of NPAs due to provisioning of NPAs in the balance sheet which not only reduce the profit of the bank but also reduce the market value of the bank. A bank which is in profit in the previous year, besides the increase in the area of operation and customer base they incurred huge loss due to provisioning of NPA in the balance sheet. A high level of NPAs suggests high probability of a large number of credit defaults that affect the profitability and liquidity of banks. The extent of NPAs has comparatively higher in public sectors banks in comparison to private banks. To improve the efficiency and profitability of the banks, NPAs should have to be controlled and reduced. Various steps have been taken by government and banks to reduce the level of NPAs. It is highly impossible to have zero percentage NPAs. But at least Indian banks should take care to ensure that they give loans to creditworthy customers.

**<u>Suggestions:</u>**

As it is next to impossible to reduce the level of NPA at Zero level. But this is high time to take strict action against the defaulter. There are certain measures which should be taken care to reduce the level of NPAs. They are-

1. As while sanctioning the loan the bank employees access the creditworthiness of the borrower. The question is - are they really trained to access the creditworthiness of the borrower? Proper training should be provided to these employees.
2. Generally the creditworthiness is accessed at the time of sanctioning of loan; it should not be, the assessment should be done on continuous basis.

3. Midterm review of the borrowal accounts at regular interval, so that corrective measures can be taken immediately.
4. It is the time to decide the accountability of the employee who is involved in the loan processing system. The bank should define the responsibility and accountability of the employee while finalizing the loan. These are the steps which can really change the present scenario.

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