Impact of Non-Performing Assets on Bank Profitability and Economic Growth

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Abstract

An important factor in determining a country's economic growth is its financial system. Through a range of services, a strong financial system raises a nation's standard of life and promotes economic progress. The banking industry plays a crucial role in the Indian financial system by providing services that aid in the nation's development goals. One of the bank's main responsibilities is to transfer savings to borrowers for beneficial uses. Banks provide social services by creating jobs and engaging in priority lending. Nevertheless, lending money to debtors has grown to be a significant problem. Increasing one's asset base does not always translate into more profitability. Banks are currently grappling with the issue of borrowers not repaying the principal and interest. Interest and advance nonpayment has had a major impact on the banks' operating effectiveness and profitability. Due to their critical role in the expansion of the banking industry and the economy at large, banks must preserve the quality of their assets and guarantee stability in their profitability. As a result, the study's goal is to gain a solid conceptual knowledge of non-performing assets. It does this by thoroughly examining the problem of non-performing assets in the banking industry using previous research. A theoretical foundation for upcoming research on non-performing assets in the banking industry is established by this work.

Keywords: economic growth, financial system, banking industry, non-performing assets (NPAs), asset quality, profitability, loan repayment, credit management, economic stability, Indian banking sector

Introduction

A strong financial system provides a range of services that boost economic expansion and raise a nation's standard of life. To support both local and international trade, these services include clearing and settlement procedures, as well as the collection and distribution of cash between depositors and borrowers (Bollard, Hunt, & Hodgetts, 2011). Banks are experts at assessing borrowers' creditworthiness and keeping a close eye on their activities to guarantee loan repayment on schedule. The difference between the interest rates that banks charge borrowers and pay depositors is the marginal spread that rewards banks for their services.

In addition to carrying out its most important and traditional function, which is lending and borrowing, banks now also serve a variety of other purposes and provide a range of financial products. Banks provide a wide range of services, including acting as the government's agent, selling mutual fund products and insurance policies, accepting bills of exchange, selling and buying securities, providing letters of credit, acting as an underwriter, referee, dealing in foreign exchange, remitting money, merchant banking, and more.

Between savers and borrowers, banks serve as a middleman. Accepting money from people who have extra and lending it to people who need it is the main purpose of all banks. While there is no danger involved in accepting money from savers, lending money to borrowers carries some risk due to the possibility of non-repayment. These days, banks are more cautious when making loans because of the rising amount of non-performing assets, or NPAs (Narula & Singla, 2014). Concern should be raised about the growing amount of non-performing assets since it has an impact on banks' ability to operate. The growing number of non-performing assets (NPAs) is a concern for developing nations like India, which are predominantly bank-led. In addition to impeding bank operations and profitability, the presence of non-performing assets has a negative effect on economic growth. Finding the causes of non-performing assets and creating appropriate strategies to reduce them are therefore crucial.

Concept of non-performing assets

A bank's books contain a variety of assets, including cash on hand, investments, balances with various other banks, financing and advances, fixed assets, and much more. Only loans, advances, and investments are included in the definition of non-performing assets. A performing asset is one that produces the anticipated amount of revenue while revealing no extraordinary risk, even in the face of typical commercial risk. A non-performing asset is one that stops producing income in the form of fees, interest, or commission to the owner. When principal repayment or interest payments are not made for at least two quarters after they are due, the advance is considered a non-performing asset, or NPA (Selvarajan & Vadivalagan, 2013).

Put differently, non-performing assets are referred to the banks as non-performing loans. It is an advance from a bank that has interest or instalments that are not paid on time. Banks view loans and advances as assets since they create a steady flow of cash flows from principal repayment and interest. Banks often make money from interest income because they charge greater interest rates on loans and advances than they guarantee to pay depositors on their deposits. The difference between the interest that banks charge borrowers and the interest that depositors agree to pay is what they make. Advances that are not paid within 90 days of the due date are categorized as non-performing assets. On the other hand, advances that are not paid within a short period of time after the due date are referred to as past due. The banks are concerned about the concerning increase in non-performing assets. Therefore, it is necessary to address the problem and find ways to stop non-performing assets from happening.

Thus, the current study refers to previous research in order to thoroughly examine the problem of non-performing assets in the banking industry. The study's main goal is to have a solid conceptual knowledge of the subject of non-performing assets. Additionally, it seeks to shed light on the causes of non-performing assets, how banks contribute to the problem of non-performing assets, how the existence of NPAs may affect banks' ability to operate, and, lastly, how to reduce the issue of non-performing assets. Descriptive in nature, the study heavily draws from previous research on non-performing assets to achieve the aforementioned goals. The study helps to develop a theoretical framework for future empirical research on how NPAs affect banks' operational efficiency, how the central bank's prudential and provisional rules affect the state of non-performing assets in the banking industry, which is one of the topics covered in this paper.

Examining Current Research

The occurrence of assets that are not performing in the banking industry is the subject of a large number of studies. They look into how banks handle these assets and the causes of their existence. A few of the research (Reddy, 2002; Malyadri & Sirisha, 2011; Collins & Wanjau, 2011; Srinivas, 2013) are thoroughly reviewed. In their study, Malyadri & Sirisha (2011) look at the evolution of non-performing assets in public and private sector banks that belong to India's weaker segments during a seven-year period (2004–10). The quality of the assets of both kinds of banks has increased in recent years, according to the data analysis taken from the Report on Trends and Progress of Banking in India. Public sector banks have outpaced private banks in terms of penetration in comparison to weaker sectors during the course of the study period. A notable decline in the NPA ratio indicates that both public and private sector banks are managing their non-performing assets (NPAs) better. It also emphasizes how regulatory authorities' actions, such prudential standards and provisioning, have forced banks to keep an eye on their operations and reduce non-performing assets (NPAs) in order to strengthen the Indian financial system as a whole.

The goal of another study by Balasubramaniam (2011) is to investigate the patterns of non-performing assets (NPAs) in the Indian banking system. Despite high rates of interest and operational expenses, the Indian banking industry has shown ongoing progress in terms of profitability and performance. Higher credit growth, return on equity, and greater return on assets all show the increased performance. It also implies that improved credit evaluation procedures and efficient internal control systems can lower a larger level of non-performing assets. In order to meet Basel III standards and capital adequacy criteria and provisioning standards, banks would have to raise money.

Singh (2016) conducts research to investigate the state of non-performing investments in the banking sector of India. According to the trend research, public sector banks have more non-performing assets (NPAs) than private sector banks. NPAs in the Indian banking industry remain greater than in international banks, even after a number of reforms have been implemented. It claims that while non-performing assets (NPAs) have an effect on banks' profitability, having zero NPAs is not achievable. As a result, banks had to enhance their debt recovery systems. For quick loan recovery, credit evaluation and post-monitoring are necessary. One effective strategy to monitor the debtors is to cultivate positive relationships with them by offering them business advise. The study finds that large borrowers have a greater trouble with loan recovery than do small borrowers. Therefore, the RBI ought to try to update the current credit appraisal changes.

The development of a conceptual comprehension of non-performing assets is another goal of Mishra & Pawaskar (2017). The report offers strategies for promptly recovering loans and explains the sectoral distribution of non-performing assets (NPAs) in the Indian banking system. The results of a four-year ratio analysis (2011–12 to 2015–16) indicate an increasing tendency in the amount of non-performing assets. According to the study, banks should exercise caution when choosing which consumers to extend credit to because loan recovery is crucial to the expansion of both the banking industry and the overall economy. It also highlights how recovering stock loans may be aided by an efficient legal system and judicial system.

Khanna (2012) conducted a similar analysis that examines the patterns of non-performing assets (NPAs) in Indian banks during a five-year period (2005–10). For analytical purposes, the study divides the Indian banking industry into three groups: private banks, nationalized banks, and SBI and its affiliate banks. According to the report, banks' profitability and net value are adversely affected by the existence of non-performing assets (NPAs). Provisions and reforms in loan issuance and credit management are required due to the rising number of non-performing assets (NPAs). When approving loans, the banks ought to exercise caution. In order to minimize or prevent the accumulation of new non-performing assets (NPAs), it is imperative that the loan's purpose, the amount disbursed on time, and the funds be used appropriately.

A study on non-performing investments and their function in the banking industry is carried out by Garg (2016). NPAs have an impact on banks' profitability and liquidity and lead to credit loss, according to data gathered from bank annual reports, loan and advance instruction manuals, and the RBI's Report on Trends and Progress of Banking in India. Additionally, it establishes preventive measures to lower non-performing assets (NPAs), including lending to borrowers who actually need loans, prompt and sufficient responses, and efficient management procedures to guarantee loan amounts are repaid on time.

Using a case study approach, Chatterjee, Mukherjee, and Das (2012) investigate the connection between loans, net advances, and non-performing assets. The study offers proof that the existence of non-performing assets (NPAs) has an impact on the banking system's reputation, money deployment, mobilisation policy, and capital adequacy levels. Excessive non-performing assets (NPAs), workforce, and government equity stress public sector banks. Therefore, by enacting legislative changes, the RBI should assume responsibility for managing non-performing assets.

According to Selvarajan & Vadivalagan (2013), Indian banks have been attempting to integrate with international banking in recent years, but their attempts have failed because of innate flaws. Banks are now a burden on the economy due to the NPA issue, which has a negative impact on liquidity, economic viability and competitiveness. Bankers' attitudes on extending and delivering credit are also impacted by non-performing assets (NPAs).

According to research by Srinivas (2013), bankers should reduce the growing issue of non-performing assets. Emphasis is placed on keeping an eye on borrowers' behavior and informing them of the repercussions of non-repayment. It is possible to see a decrease in NPAs by implementing these procedures.

Last but not least, research like that done by Reddy (2002) and Jadhav, Gujarathi, and Gawali (2016) highlights how important judicial frameworks and reforms are to successfully managing non-performing assets.

The reasons for the banks' non-performing assets have been the subject of numerous investigations. Roy (2014) identifies the variables influencing Indian banks' non-performing asset levels. The study uses panel regression using a model with fixed effects to investigate how country-related and bank-related factors affect the amount of non-performing assets (NPAs) from 1995–1996 to 2011–2012. The net NPA to net advances ratio is one of the dependent factors, whereas the macroeconomic variables—inflation, real effective rate of exchange, and GDP growth—and one bank-level variable—net interest margin—are the independent variables. The findings show that although the amount of non-performing assets (NPAs) in foreign banks decreased following the global financial crisis, it continued to rise after 2008. It is concerning that all developed and developing nations have already succeeded in reducing the NPA level from its peak during the global recession in 2008–2009, while it continues to rise in India. Analysis shows that the amount of non-performing assets (NPAs) in the Indian banking industry is significantly impacted by changes in the currency rate, the growth of the GDP rate, and global volatility.

According to Zafar, Maqbool, and Khalid (2013), the internal issues of the banks are to blame for the assets' subpar performance, which ultimately results in them being non-performing assets. Organizational restructuring, improvements to methods for evaluating the banks' creditworthiness, and a qualitative boost to overall management and technological efficiency are all required. Controlling the causes of non-performing assets (NPAs) is the responsibility of the banks themselves. Siraj & Pillai (2013) concentrate on analyzing how well various banks handle their non-performing assets. To assess the trajectory of NPA movements in various banks, a number of indicators are taken into consideration, including Net NPA, additions to NPA, Gross NPA, provisions towards NPA, and reductions to NPA. These characteristics are further contrasted with the banks' micro-performance metrics. According to the rankings based on NPA indicators, NB is ranked first overall for managing non-performing assets successfully, followed by SBI affiliates, foreign banks, and private sector banks.

Another study by Rathore, Malpani, and Sharma (2016) looks at Indian commercial banks' non-performing assets (NPAs) as of 2015. It cites a number of external and internal causes that contribute to India's escalating non-performing assets (NPAs). Price increases, natural catastrophes, currency rate volatility, recession, and other external events are examples of internal issues, such as rerouting money for growth or modernization, ineffective monitoring of credit and management, and a lack of coordination among lenders. The results show that poor management has led to a positive correlation between a bank's net earnings, total advances, and non-performing assets (NPA), which is not a good indicator. It is also shown that one of the causes of the rising NPAs is slow domestic growth. It also makes a number of recommendations for reducing the amount of non-performing assets in banks, including negotiating compromises with borrowers, one-time settlement plans, suing the borrower for non-payment of loans, and enlisting the aid of debt recovery tribunals and Lok Adalats.

The study conducted by Narayanan and Surya (2014) identifies the causes of assets becoming non-performing assets and the corrective measures that should be implemented to lower the amount of non-performing assets. It also seeks to determine whether the bank's operations before and after writing down non-performing assets differ in any way. According to the report, some of the factors that have been linked to non-performing assets (NPAs) include bad follow-up procedures, misappropriation, poor fund management, and wrong client selection for providing loans. In consequence, these non-performing assets raise the cost of capital, decrease interest revenue, and lower return on investment. Banks must act proactively in the current environment to manage and reduce the amount of non-performing assets. To address the issue of non-performing assets (NPAs), the Reserve Bank of India and the Finance Ministry must provide assistance.

In order to determine whether non-performing assets in various Indian bank types differ in any way during a five-year period (2008–2013), Das & Dutta (2014) conduct an analysis. For analysis purposes, SBI affiliate banks and other public banks are taken into account. The ANOVA results show that the incidence of non-performing assets (NPA) does not significantly differ amongst banks. Overall, it can be said that banks encounter non-performing assets in a similar way, even though their activities differ.

Collins & Wanjau (2011) make another important contribution to the banking industry by assessing the effect of interest rate spread on Kenyan commercial banks' non-performing assets (NPAs). The study is descriptive in nature and gathers information on loan failure to perform and interest rate spread for 43 Kenyan commercial banks using both quantitative and qualitative methods. It is concluded that the interest rate spread indirectly establishes the loan's cost, which ultimately influences asset performance. Because it raises loan costs, the difference between lending and borrowing interest rates affects asset performance. The study also looks at how banks' credit risk management policies affect interest rate spreads and non-performing assets. Since interest rates are measured against the associated non-performing assets (NPAs) and non-performing loans are a result of higher loan costs, it is discovered that credit risk management policies have a remote effect on the banks' interest rate spread. The study concludes by advising banks to evaluate the borrower's creditworthiness, the quantity of collateral security given, and adjust interest rates accordingly.

Conclusion

The current paper provides a summary of the research that has been done on non-performing assets, the most significant topic in the banking industry. Understanding the theoretical framework of assets that are not performing takes up a significant portion of the literature. Stated differently, non-performing assets (NPAs) are assets that no longer bring in money for the banks. Studies have also examined the prevalence of non-performing assets (NPAs) and the factors that contribute to their growth. Ineffective credit management and providing loans to customers without doing a thorough evaluation of their credibility or goodwill are a couple of the frequent causes. These elements raise the cost of capital by causing non-performing assets (NPAs) to occur.

However, research has shown that external factors like GDP growth rate and currency rate volatility also have a big influence on non-performing assets (NPAs), therefore internal factors aren't the only ones that cause them to accumulate. Although it is impossible to have zero non-performing assets (NPAs), the central bank and individual banks should make an effort to reduce the amount of NPAs. The presence of non-performing assets may have an impact on banks' net worth, profitability, and liquidity. Numerous studies have identified a number of corrective and preventive measures to stop non-performing assets (NPAs). These include post-monitoring loans, credit appraisal mechanisms, effective credit management policies, evaluating borrowers' creditworthiness prior to making loans, and developing positive working relationships with borrowers to monitor the appropriate use of the loan amount.

In conclusion, non-performing assets (NPAs) have a significant impact on the expansion of the banking industry, which ultimately impedes a nation's economic growth, particularly in bank-led countries like India. Therefore, in order to address the issue of non-performing assets (NPAs), it is imperative that banks implement prudential and provisional norms as periodically recommended by the central bank. Additionally, measures should be taken to prevent the development of non-performing assets.

Study Limitations

The descriptive study provides an overview of previous research on the problem of assets that are not performing in the banking industry. To learn more about the impacts and ramifications of non-performing assets (NPAs) on the performance and operations of Indian banks, an empirical investigation could be conducted.

Future Research Scope

The determinants of non-performing investments in the Indian banking sector, the reasons why an asset becomes non-performing, the management of assets that are not performing, the impact of not performing assets on bank performance, and the remedial measures to be taken to reduce the level of NPAs are all the subject of a vast amount of research, according to an analysis of the studies that are currently available. By examining the general trends in non-performing assets during the most recent time period, research might be conducted to compare the effects of not performing assets on the public and private sectors of the Indian banking industry. The effects of non-performing assets (NPAs) on the Indian economy at large should also be thoroughly examined.

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