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## Non Performing Assets - A Drag On Banking Sector

**Dr. Ramprakash O. Panchariya<sup>1</sup>**  
Assistant Professor, DMS, BDCE,  
Sevagram – India

**Prof. C. A. Sarode<sup>2</sup>**  
Research Guide  
India

*Abstract: The biggest ever challenge that the banking industry now faces is management of Non-performing Assets (NPAs). The magnitude of NPA has a direct impact on banks profitability, liquidity & equity. "NPA is an important parameter in the analysis of financial performance of banks". This study has attempted to identify the effects of NPA on public sector commercial banks operating in Wardha District. The study uses primary data collected from banker of public sector commercial banks operating in Wardha District. The study reveals that the selected banks are facing the problem of NPAs and the magnitude of NPA has a high impact on banks profitability, liquidity and productivity hence it can be stated that NPA is a drag on banking sector.*

*Keywords: Banking Industry and NPAs.*

### I. Introduction

To start with, performance in terms of profitability is a benchmark for any business enterprise including the banking industry. Extension of credit is one of the major activities of banks and financial institution. Credit represents the bulk of the bank and financial institution's asset portfolio. However, increasing NPAs have a direct impact on banks profitability as legally banks are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets as per the central Bank guidelines. Also, with increasing deposits made by the public in the banking system, the banking industry cannot afford defaults by borrowers since NPAs affects the repayment capacity of banks. Further, central Bank successfully creates excess liquidity in the system through various rate cuts and banks fail to utilize this benefit to its advantage due to the fear of burgeoning non-performing assets. Thus it is imperative to determine the effects of NPAs on the banks.

#### 1.1 MEANING OF NPA

Reserve Bank of India (RBI) defines NPA as: An asset, including a leased asset, becomes nonperforming when it ceases to generate income for the bank. A 'non-performing asset' (NPA) is 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 (90 days, March 31, 2004 onwards).

#### 1.2 EFFECTS OF NPA

**1) Effect on Profitability:** NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client. Because of the money getting blocked the productivity of bank decreases not only by the amount of NPA but NPA lead to opportunity cost also as that much of profit invested in some return earning project/asset. So NPA doesn't affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low ROI (Return on Investment), which adversely affect current earning of bank.

**2) Effect on Liquidity:** Money is getting blocked, decreased profit lead to lack of enough cash at hand which lead to borrowing money for shortest period of time which lead to additional cost to the company. Difficulty in operating the functions of bank is another cause of NPA due to lack of money. Routine payments and dues.

- 3) Effect on Interest Rate:** Due to high NPAs, banks are charging high rate of interest on the good borrowers to compensate the interest loss in the NPA accounts.
- 4) Effect on Capital Adequacy Ratio:** As NPAs do not earn any income and reduce the profits by way of provisioning, they adversely affect Capital Adequacy Ratio (CAR).
- 5) Effect on Rating:** As per the recommendations of Padmanabhan Committee the banks are to rated on a five point scale of A to E widely on the lines of International CAMELS rating model. NPA has directly or indirectly effect on the three factors such as C (Capital Adequacy), A (Asset Quality) and E (Earnings) of the above rating model. Regulatory and credit rating agencies abroad are also not comfortable with the high level of NPAs of Indian Banks.
- 6) Effect on Productivity:** The productivity of the banks having high, NPAs would be low as the branch staff who could have been utilized for business mobilization would primarily be engaged in management of NPAs. It is one of the factors for low productivity of some banks having high NPAs.
- 7) Effect on Business Mobilization:** The presence of high NPAs would reduce the average yield on funds deployed. In order to earn profits the bankers would be in search of low cost deposits and they have to face a lot of difficulty in mobilizing, maintaining and serving such deposits in today's competitive environment. In case, the banks are not able to mobilize low cost deposits, then to remain in profit, they have to find the avenues of investment/ advances where the earning is high and funds are safe. But here again, there is lot of competition among the banks for such avenues. The banks with high NPAs are thus in vicious circle.
- 8) Effect on Recycling of Funds:** Recycling of fund is severely affected due to high NPAs in the banks. The banks are being deprived of utilizing the funds blocked in NPAs in highly productive avenues.
- 9)Effect on Image of the Bank:** The high NPAs in the balance sheet of a bank shows a poor picture of the bank as it indicates inefficiency and ineffectiveness in the credit management of the bank.
- 10)Credit/Goodwill losses:** Bank is facing problem of NPA then it adversely affect the value of bank in terms of market credit. It will lose its goodwill and brand image and credit which have negative impact to the people who are putting their money in the banks.

## II. Review of Literature

In the banking literature, the effects of non-performing assets have been revisited in several theoretical and empirical studies. A synoptic review of the relevant literature on the effects of NPAs issues examined by different researchers is presented as follows:

**Mahipal Singh Yadav (2011)** in his article "Impact of Non Performing Assets on Profitability and Productivity of Public Sector Banks in India" has stated that Banks directly or indirectly affect economic development because of their many facets. During colonial rule in India, banks were geographically confined to urban areas and provided credit particularly business and trading class and were restructured into nationalized banks during post –independence period to achieve broader economic objectives and registered an overall impressive achievement. Despite of this, the question has been raised time and again on myriad restriction of nationalised banks which merely fulfills social agenda of the government and increased non-performing assets.

**Poongavanam. S. (2011)** stated in his article Non-Performing Assets: Issues, Causes and remedial Solution concluded that the banking industry has undergone a major change after the first phase of economic liberalization; hence the importance credit management has emerged. In recent time banks are very cautious in extending loan, because of mounting NPA. This article highlights the reasons for an assets becoming NPA and remedial measures to be taken. Due to various steps taken by the

Government of India NPA levels were reduced to considerable level. (Nearly 2.7% of the loans on the balance sheet of bank, from 8.8%) So it is an indication for the bankers with bad loan in their portfolio to take appropriate actions immediately.

**Ms. RajniSaluja and Dr. RoshanLal (2010)** in their paper has stated the burgeoning NPAs in banking Industry is a matter of deep concern. It is just not a problem for banks but also proves fatal to the economic growth of the country. PSBs are under severe pressures of NPAs as compared to its counterparts that private and foreign banks. NPAs reduce the profitability of banks, weaken its financial health and erode its solvency. In this study an attempt has been made to compare the performance of public and private sector banks and in foreign banks in India with special reference to their NPAs.

**Mr. M. Karunakar, Mrs. K.Vasuki and Mr. S. Saravanan (2008)** in their article has tried to highlight various aspects of NPA like Factor contributing NPA, Magnitude and Consequences, Recovery methods, Capital adequacy ratio. The factors contributing to NPA, the magnitude of NPA, reasons for high NPA and their impact on Indian banking operations. Besides capital to risk weightage assets ratio of public sector banks, management of credit risk and measures to control the menace of NPAs are also discussed. The lasting solution to the problem of NPAs can be achieved only with proper credit assessment and risk management mechanism. It is better to avoid NPAs at the market stage of credit consolidation by putting in place of rigorous and appropriate credit appraisal mechanisms.

**Dr. Justin Nelson Michael, Dr. G. Vasanthi and Dr. R. Selvaraju (2003)** in their research have stated financial health of co-operative banks is reflected by their operational efficiency. Among other factors, Non-performing Assets (NPA) in the loan portfolio affects the operational efficiency which in turn influences profitability, liquidity and solvency position of co-operative banks. They have to maintain and increase viability by generation of more products in order to meet capital adequacy norms and make provision against NPA. A crisis in liquidity occurs when the funds deployed by the banks get locked up as NPAs, which reduce the profitability and liquidity, indirectly affect the solvency position of the banks. Now it is high time for co-operative banks to monitor NPAs to strengthen their operational efficiency.

### III. Research Methodology

#### 3.1 Objectives of the Study:

The objective of the study is to identify the effects of NPA on public sector commercial banks operating in Wardha District.

#### 3.2 Hypothesis:

H<sub>0</sub>: The level of effect of NPAs on bank is less than or equal to low.

H<sub>1</sub>: The level of effect of NPAs on bank is more than or equal to medium.

**3.3 Sample and Sample Size:** This refers to number of respondents to be selected from the population to constitute a sample. The sample consists of 50 respondents from banks operating in Wardha District. The sample includes representation from public sector commercial banks. Banks and the branches were chosen using convenience sampling method. The study area is limited to Wardha District only.

#### 3.4 Data Collection Technique:

Primary data is obtained by Questionnaire Method. The data collection tool is structured questionnaire. The questionnaires were filled up in front of the researcher. The respondents were asked to rate the level of influence of the various factors given in the questionnaires on a 5-point scale where "0" refers to nil, "1" refers to low, "2" refers to medium, "3" refers to high and "4" refers to very high.

**3.5 Statistical Tools:** Statistical tools are the mathematical techniques used to facilitate the analysis and interpretation of numerical data. "Statistical Analysis is one particular language, which describes the data and makes possible to talk about the relations and the difference of the variables." Following statistical tools have been used in this study.

1. Mean
2. Z-test

#### IV. Data Analysis and Interpretation

The process of data analysis as a step of scientific method constitutes the basis of every research through which all activities related to research are controlled and guided from its beginning to its end. Statistical analysis is performed for analysis of collected data.

**Table No. 1: Level of effect of NPAs on Bank**

Sr. No.	Effect of NPAs on	Mean	Hypothesized Mean = X*	Z test (One -tailed)	P Value	Result (H <sub>0</sub> )
<b>i.</b>	Profitability	<b>3.32</b>	<b>1</b>	<b>27.95</b>	<b>0.00</b>	<b>Rejected</b>
<b>ii.</b>	Liquidity	<b>2.66</b>	<b>1</b>	<b>14.26</b>	<b>0.00</b>	<b>Rejected</b>
iii.	Interest Rate	1.10	1	0.73	0.23	Accepted
<b>iv.</b>	Capital Adequacy Ratio	<b>2.34</b>	<b>1</b>	<b>10.09</b>	<b>0.00</b>	<b>Rejected</b>
v.	Rating	1.18	1	1.46	0.07	Accepted
<b>vi.</b>	Productivity	<b>2.52</b>	<b>1</b>	<b>11.83</b>	<b>0.00</b>	<b>Rejected</b>
vii.	Business Mobilization	1.16	1	1.34	0.09	Accepted
<b>viii.</b>	Recycling of Funds	<b>2.38</b>	<b>1</b>	<b>10.57</b>	<b>0.00</b>	<b>Rejected</b>
ix.	Image of the Bank	1.18	1	1.22	0.11	Accepted
x.	Credit/Goodwill losses	1.14	1	1.15	0.12	Accepted

\* 0 - Nil, 1 – Low

Amongst the effects of NPAs it can be seen from above table that five factors have been identified to be having more than low effect of NPAs as their p-value is 0.00 which is less than 0.05. These are:

- Profitability
- Liquidity
- Capital Adequacy Ratio
- Productivity
- Recycling of Funds

**Z value and Mean:** Since Z value and mean amongst the identified factors having more than low effect of NPAs is highest for “Profitability” i.e. (Z = 27.95, Mean = 3.32), “Liquidity” i.e. (Z = 14.26, Mean = 2.66) and “Liquidity” i.e. (Z = 11.83, Mean = 2.52) as compared to Z value and mean of other factors hence it is identified that NPAs highly affects banks profitability, liquidity and productivity.

#### V. Conclusion

Findings from data analysis indicate that the magnitude of NPA has a high impact on banks profitability, liquidity and productivity hence it can be stated that NPA is a drag on banking sector.

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