Are increase in NPAs of Indian Banks-Structural or Cyclical phenomenon?

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In the current economic scenario the rise in Non Performing Assets (NPAs) of Indian Banks is an alarming situation for India Inc.-"Growth Story". This study is an attempt to understand the relationship between increases in NPAs of Indian Banks to Structural or Cyclical phenomenon. Post 1990, Indian Banking sector implemented some of the major financial reforms. During this period, Indian Banks also adopted guidelines issued by Basel Committee in order to ensure compliance with global standard for risk management.

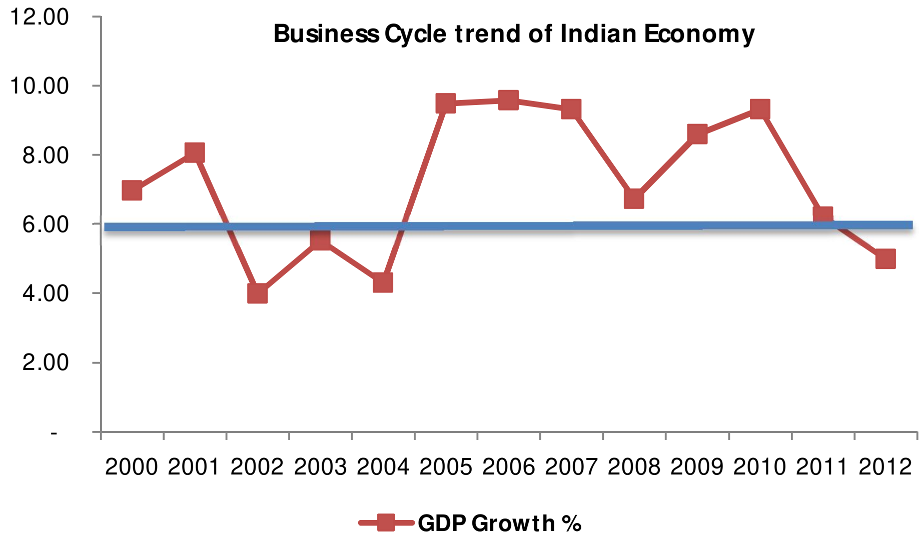
NPAs percentage of all Scheduled Commercials Banks (SCB) of India declined from 12.8% in 2000 to 2.9% in 2012.Though there have been significant improvement in NPAs % of SCB over the time period of (2000..-2012); however it is on higher side as compared to its counterparts –Argentina and China (which has NPAs % of 1.5 and 0.9 respectively in 2012).There are many studies that suggests NPAs are closely linked to macroeconomics factors such as slowdown in economy, low rate of saving, recession in industrial production, reduction in per capita income levels and most importantly the inflation levels in the economy. Although it becomes apparent from the above figures that in percentage terms the NPAs have shown a decline, during the said period, but in absolute terms the total amount of NPAs have shown a significant increase during the concerned period.

In the Indian context, the problem of NPAs is related to several internal and external factors confronting the borrowers (Muniappan, 2002). The internal factors are diversion of funds for expansion, diversification and modernisation, taking up the new projects, helping/promoting associate concerns, time/cost overruns during the project implementation stage, business (product, marketing, etc.) failure, inefficient management, strained labour relations, inappropriate technology/technical problems, product obsolescence, etc., while the external factors are recession, non-payment in other countries, inputs/power shortage, price escalation, accidents and natural calamities. There are some studies which indicated that the improper banking policy followed by Indian Banks has been mainly responsible for the increase in the NPAs. A study by Reddy (2004) emphasises that considerable view should be given to bank's lending credit policy, specific to credit delivery mechanism. India's credit system was based on the three pillars in the past- fixing of prices of credit or interest rate as well as quantum of credit linked with the purpose; insisting on collateral; and prescribing the end-use of credit. Interest rate prescription and fixing quantum has been significantly reduced in the recent period. However, the study highlighted the issues in security-based or collateralised lending, which needs careful examination in the context of growing services sector. Also, it advised better linkage between formal and informal sector could be achieved by pushing the supply of credit in the formal sector following a supply leading approach to reduce the price or interest rate. The study conducted by Mohan (2004) on public sector banks on their assets quality in 1990 with higher interest rate spread, but were earning lower rates of return with higher operational cost due to mismatch in their overall asset-liability position. Since deposit liabilities of banks often tend to be of relatively shorter maturity, long-term lending could induce the problem of asset-liability mismatches. The maturity profile of commercial bank deposits shows that less than one fifth is of a tenor of more than three years. On the asset side, nearly 40 per cent has already been invested in assets of over three year maturity. Banks also have some capacity to invest in longer term assets, but this capacity will remain highly limited until the fiscal deficit remains as high as it is and the

Government demand for investment in long dated bonds remains high. Some enhancement of their capacity to invest in infrastructure, industry and agriculture in longer gestation projects can be achieved by allowing a limited recourse to longer term bond issues. In another study, Mohan (2003) observed that lending rates of banks have not come down as much as deposit rates and interest rates on Government bonds. While banks have reduced their prime lending rates (PLRs) to some extent and are also extending sub-PLR loans, effective lending rates continue to remain high. This development has adverse systemic implications, especially in a country like India where interest cost as a proportion of sales of corporates are much higher as compared to many emerging economies. Poongavanam .S (2011) study suggested in India, larger NPAs can be attributed to lending to priority sector at the diktats of politicians and bureaucrats, slow legal system, ineffective debt restructuring system and business cycle.

From cross-country perspective, a study conducted by Sergio (1996) for NPAs in Italy has found that inappropriate bank's lending policy in term relatively unselective and inadequate assessment of sectoral prospects, which has led to increase in the riskiness of loan assets as well as Business cycle could be possibly a primary reason for bank's NPAs. The study emphasised that increase in bad debts as a consequence of recession alone is not empirically demonstrated. In the study undertaken for US banks, McGoven (1993) has advocated that "character" has historically been a paramount factor of credit and a major determinant in the decision to lend money. US banks have suffered losses through relaxed lending standards, unguaranteed credits, the influence of the 1980s culture, and the borrowers' perceptions. Kent and D'Arcy (2000) examined the cyclical lending behaviour of Australian Banks and concluded that on top of the business cycle banks will appear to be relatively healthy; non-performing loans are low and profits are high, reflecting the fact that even the riskiest of borrowers tend to benefit from buoyant economic conditions. While banks' lending portfolios will experience risk tends to be realized during the contractionary phase of the business cycle. At this time, banks' NPAs increase, profits decline and substantial losses to capital may become apparent. Jimenez and Saurina (2003) used logit model for analysing the determinants of the probability of default (PD) of bank loans in terms of variables such as collateral, type of lender and bank-borrower relationship while controlling for the other explanatory variables such as size of loan, category of the borrower, maturity structure of loans and currency composition of loans. Their empirical results suggested that collateralised loans had a higher PD, loans granted by savings banks were riskier and a close bank-borrower relationship had a positive effect on the willingness to take more risk. At the same time, size of bank loan had a negative effect on default while maturity term of loans, i.e., short-term loans of less than 1-year maturity had a significant positive effect on default.

The concept of Business Cycle is conventionally defined as the periodic phases of prosperity, recession, depression and recovery of economics activity. It is evaluated in term of percentage of GDP growth around a predetermined mean GDP, which is used as yardstick of comparison. Apart from % GDP growth this study also considers the Index of Industrial Production (IIP) as a supporting variable included in evaluating the business cycle.



Source: RBI

Empirical Analysis:

This paper consider three variables namely: NPAs as percentage of Total Advances, GDP growth, IIP

Year	NPAs as % of total Advance	GDP Growth %	IIP %
2000	12.79	6.97	12.2
2001	11.45	8.06	5.0
2002	10.42	3.99	2.7
2003	9.06	5.52	5.7
2004	7.19	4.30	7.0
2005	4.91	9.48	8.1
2006	3.48	9.57	8.2
2007	2.65	9.32	11.6
2008	2.39	6.72	8.5
2009	2.45	8.59	2.8
2010	2.51	9.32	10.5
2011	2.36	6.21	8.2
2012	2.94	4.99	2.9

(Sources: RBI, Ministry of Finance)

This Study computes pair-wise correlation between NPAs as % of Total Advances with GDP growth and NPAs as of % of Total Advances with IIP. These two correlations are respectively -0.1 and -0.01. The above results indicate weak relationship NPAs as % of Total Advances with respect to GDP growth and IIP. This trend establishes that the impact of cyclical forces on behaviour of NPAs of Indian Banks is less significant. Hence, it would be prudent to analyse the structural factors which are inherent in the Indian Economy to study their impact on behaviour of NPAs.

Structural Factors:

IMF in its recent report states that India is faced with structural issues in the light of low growth, high inflation and high current-account deficit. Though the government's recent fiscal consolidation has provided some space for RBI to ease its monetary policy to support growth in the economy. It will enable RBI with necessary support but not sufficient enough to put the economy back on the track. Structural issues in India are related to both supply factors – which include supply and labour- market bottlenecks, poor infrastructure and underutilized capacity and domestic policy factors- such as policy uncertainty and regulatory obstacles. The pace of reforms such as prompt clearance for stalled infrastructure projects, reduction in fiscal deficit and enhancing the overall productivity in the industrial sector accompanied with Governance concern and delay in approvals continue to weigh on business confidence. Thus, it is difficult to sustain the level of investments required to revive the economy.

Conclusion:

The result of this study has shown that behaviour of NPAs in the Indian Banks is largely impacted by the endemic structural factors rather than the cyclical factors. It is apparent that Indian Economy is passing through downswing phase of the business cycle. Certain bold measures for financial reforms were stated by the government in 2011 which cannot be implemented because over two complete sessions of parliament were wasted in 2011 & 2012 due to political disturbance. This has adversely affected domestic and foreign investments in India. Nevertheless, there are some positive signals with respect to the government's recent reform measures, improving external demand, and a better monsoon season are likely to boost economic activity. However, the pace is likely to remain gradual until the result of coming elections as uncertain policies fail to address the core structural problems. Perhaps, urgently addressing these problems will go a long way in resolving the issue of increasing NPAs in the Indian banks.

About the Author

Dr. Poonam Bisht is double master in commerce M.com (University of Mumbai) and finance holding MS (Finance) with CFA Charter from ICFAI. She was conferred a Ph.D degree in Economics from University of Mumbai in 2012 for her thesis tittle: “Basel II norms and Indian Banking Sector: Some Issues”. She has over seven year experience in financial sector from some of leading Corporates.