Impact of NPAs on Bank Profitability: An Empirical Study

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ABSTRACT

NPA is a “termite” for the banking sector. It affects liquidity and profitability of the bank to a great extent; in addition, it also poses a threat to the quality of asset and survival of banks. The post-reform era has changed the whole structure of the banking sector of India. Now, the economy is not confined to the domestic boundary of the country. The core intention of economic reforms in India was to attract foreign investments and create a sound banking system. This chapter provides an empirical approach to the analysis of profitability indicators with a focal point on Non-Performing Assets (NPAs) of commercial banks in the Indian context. The chapter discusses NPA, factors contributing to NPA, magnitude, and consequences. By using an analytical perspective, the chapter observes that NPAs affected significantly the performance of the banks in the present scenario. On the other hand, factors like better credit culture, managing the risk, and business conditions led to lowering of NPAs. The empirical findings using observation method and statistical tools like correlation, regression, and data representation techniques identify that there is a negative relationship between profitability measure and NPAs.

INTRODUCTION

NPA (Non Performing Assets) broadly defined as non-repayment of interest and installment of principal amount (Das & Ghosh, 2006). Amongst the various desirable characteristics of a well-functioning financial system, the maintenance of the Non-performing assets is an important one. NPA after a certain level is indeed a serious concern for the banking system because credit is essential for economic growth and NPA affects the smooth flow of credit. Banks increases their resources not only from the public deposits but also by multiplying the funds received from the...
Impact of NPAs on Bank Profitability

borrowers (Bodla & Verma, 2006). Thus, when a loan turns into NPA, it affects the recycling of credit and credit creation. It also affects the profitability of the banks because then the banks have to create more provisions against bad loans.

In India the definitions of NPAs has changed over time. According to the Narasimham Committee Report (1991), those assets (overdraft/cash credit) for which the interest remains due for a period of four quarters (180 days) should be considered as NPAs. Subsequently, this period was reduced and from March 1995 onwards assets for which interest remains unpaid for a period of 90 days were considered as NPAs. Thus, NPA constitutes an important factor in the banking system as it seriously affects the profitability of the banks.

The NPA can broadly be classified into Gross NPA and Net NPA. Gross NPA reflects the quality of the loans made by banks whereas Net NPA shows the actual burden of banks. The banks and the financial institutions have to take the initiative to reduce NPAs in a time bound strategic approach especially of public sector banks because they dominate the banking industries and also since they have much larger NPAs compared with the private sector banks. This raises a concern in the banking industry because it is generally felt that NPAs reduce the profitability of banks, weaken its financial health and erode its solvency (Karunakar, 2008). For the recovery of NPAs a broad framework has evolved for the management of NPAs under which several options are provided for debt recovery and restructuring. However, with the banking reforms in India and adoption of international banking practices, this issue received due focus. Though the issue has received a considerable attention in the post reform period but the ultimate solution has not yet achieved.

Thus, this research paper focuses on this severe problem and tries to suggest some remedies to overcome it. The paper consists of secondary data which has been collected from different publications such as the Reserve Bank of India publications, the reports published by commercial banks, various issues of the IBA journal etc. The empirical findings using observation method and statistical tools like correlation, regression and data representation techniques identifies that there is a negative relationship between profitability measure and NPAs.

KINDS OF NPAS

1. Gross NPA

Gross NPAs are the sum total of all loan assets that are classified as NPAs as per the RBI guidelines as on Balance Sheet date. It reflects the quality of the loans made by banks. It consists of all the non-standard assets such as sub-standard, doubtful, and loss assets. It can be calculated with the help of following ratio:

\[ \text{Gross NPA ratio} = \frac{\text{Gross NPAs}}{\text{Gross Advances}} \]

2. Net NPA

Net NPAs are those type of NPAs in which the bank deducts 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 by following.

\[ \text{Net NPAs} = \frac{\text{Gross NPAs} - \text{Provisions}}{\text{Gross Advances} - \text{Provisions}} \]