Nonperforming Assets & Its Impact on Net Profit

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ABSTRACT

Banking Industry plays a very important role in economic development of a country through extending credit to various deficit sectors and earn income in the form of interest on advance and other incomes like commission, consultancy fee etc. But the credit creation activity creates credit risk to the bank which results in nonperforming assets. The current study has been undertaken to study nonperforming assets of SBI, one of the biggest lender in India which has approx twenty percent share in loan market. NPA is one of the important parameter in analysing the performance of bank as it reduces the profit margin and increases the carrying cost of such nonperforming assets in the form of provision for doubtful debts and bad debts. The motive of study on SBI is to assess the NPA of the bank and to make a comparison between total advances, nonperforming assets and net profit. Here the data has been analysed using comparison table and Pearson correlation coefficient used to check relationship between net profit and net nonperforming assets. When data of total advance, nonperforming assets and net profit has been studied, it reveals mismanagement on the side of SBI. While analysing the impact of net nonperforming assets on net profit of the bank for last nine years, conclusion has been derived that a positive correlation between two which simply means as profit increases, NPA also increases. It is because of poor NPA management on the side of bank.

Keywords-- NPA, Net Non Performing Assets, Gross Non Performing Assets, SBI, Net Profit, Mismanagement.

I. INTRODUCTION

In any economy banking industry has its own importance in fund mobilization and growth and development. Banks is an institution which accepts deposits from surplus generating groups and mobilizes these deposits to deficit group in the economy, who can use these funds for production and capital formation. So through credit creation banks contributes in economic development.

The main source of earning to a bank is interest receipts from advance given to borrowers in different forms of loan. Banks advanced different loans in expectation of interest income and repayment of principals within a specified period or due date as per contractual obligations between client and banks. When payment of interest and repayment of loan is made by the borrower when it becomes due, is called performing assets or standard assets but the advance amount which fails to meet obligations of payment of interest and repayment of principal on due date is called nonperforming assets. Nonperforming assets (NPA) is one of the serious concern and problem for Indian banks specially PSU banks in India.

NPA is the indicator of level of risk and asset quality of a bank. A high level of NPA reflects high credit defaults that affect the profitability and net worth of bank. A growing NPA year by year involves reduction of incomes from the assets of bank.

In India NPA level of banks has reached to alarming level and this is seen high in public sector banks due to priority sector lending. A high NPA also show the mismanagement of assets by the management and fail to recover the loan from defaulters. Today main problem faced by public sector bank is huge NPA in their portfolio.

State Bank of India, well known for the biggest lender in India, has very high level of nonperforming assets in its portfolio. Though largest PSU bank of India and with efficient management, SBI facing serious problem of nonperforming assets and its amount of default is much higher than any other banks in India. This study mainly aims to compare the total advance, net profit and non performing assets and to test whether any significant correlation exist between this increasing net profit with nonperforming assets.

II. NON-PERFORMING ASSETS (NPAS) – CONCEPTS

A nonperforming asset (NPA) is a loan or an advance where:

i. Instalment of loan or advance and/or periodical interest remains overdue for more than 90 days in respect of term and condition of loan.

ii. The overdraft/cash credit bank account of client is out of order for a period more than 90days.

iii. In case of bill purchase or discounted, it remains overdue for a period more than 90 days.
iv. In case of loan for short duration crops, the instalments of principal and /or interest on principal remain due for two crop seasons.

v. In case of long duration crops, the principal or / and interest thereon is remain due for one crop season.

vi. The amount of liquidity remains outstanding for more than 90 days in case of securitisation transaction undertaken in terms of guidelines on securitisation.

Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter. Any amount due to the bank under any credit facility is „overdue” if it is not paid on the due date fixed by the bank.

III. CLASSIFICATION OF ASSETS

Banks are generally classified their NPA into the three categories depends on the time for which these assets are nonperforming and their realised ability;

i. Substandard Assets

Substandard Assets

With effect from 31 March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

ii. Doubtful Assets

Doubtful Assets

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

iii. Loss Assets

Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

IV. TYPES OF NPA

Gross NPA: 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 is advance which is considered irrecoverable, for bank has made provisions, and which is still held in banks’ books of account Gross NPA reflects the quality of the loans made by Banks. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss assets. It can be calculated with the help of following ratio:

\[
\text{Gross NPAs Ratio} = \frac{\text{Gross NPAs}}{\text{Gross Advances}}
\]

Net NPA: 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 RBI guidelines, are quite significant. That is why the difference between gross and net NPA is quite high. It can be calculated by,

\[
\text{Net NPAs} = \text{Gross NPAs} – \text{Provisions}.
\]

V. COST OF NONPERFORMING ASSETS

Non Performing Assets affect the profitability, liquidity and competitive functioning of banks and developmental financial institutions and finally the psychology of the bankers in respect of their disposition towards credit delivery and credit expansion. Non Performing assets cause high cost for the bank, as these assets do not improve Profits, Capital adequacy, Reduction of other costs and Capital market perception.

VI. COMPANY PROFILE

State Bank of India (SBI) is an Indian multinational, public sector banking and financial services company. It is a government-owned corporation with its headquarters in Mumbai, Maharashtra. As of 2014-15, it has more than 14000 branches, including 191 foreign offices spread across 36 countries, making it the largest banking and financial services company in India by wealth. The bank traces its ancestry to British India, through the Imperial Bank of India, to the founding, in 1806, of the Bank of Calcutta, making it the oldest commercial bank in the Indian Subcontinent. Bank of Madras merged into the other two “presidency banks” in British India, Bank of Calcutta and Bank of Bombay, to form the Imperial Bank of India, which in turn became the State Bank of India. Government of India owned the Imperial Bank of India in 1955, with Reserve Bank of India (India’s Central Bank) taking a 60% stake, and renamed it the State Bank of India. In 2008, the government took over the stake held by the Reserve Bank of India.

SBI now has five associate banks, down from the eight that it originally acquired in 1959. All use the State Bank of India logo, which is a blue circle, and all use the “State Bank of” name, followed by the regional headquarters’ name:

- State Bank of Mysore (SBM) (founded 1913)
- State Bank of Patiala (SBP) (founded 1917)
VII. OBJECTIVES OF THE STUDY

1. To compare Net Profit, Total Advances, Gross NPA (GNPA) & Net NPA (NNPA).
2. To study the correlation between Net Profit & NNPA.

VIII. HYPOTHESIS OF THE STUDY

\[ H_0 = \text{There is no significant difference between Net Profit and NNPA of State Bank of India during the study period.} \]
\[ H_A = \text{There is significant difference between Net Profit and NNPA of State Bank of India during the study period.} \]

IX. METHODOLOGY OF STUDY

The study is based on secondary data from annual report of State Bank of India. Data exclusively taken from the financial report for nine years period, i.e., from 2007-08 to 2015-16. Data are tabulated as per requirement of the research. A comparison has been made among trends of total advance, net profit, gross and net nonperforming assets.

Karl Pearson’s Correlation Coefficient has been used to check the nature and degree of correlation between net profit and net nonperforming assets. Finally, Student’s “t” test has been used to test the significance of the correlation.

Management of Non Performing Assets in SBI;

State Bank of Hyderabad (SBH) (founded 1941)
State Bank of Travancore (SBT) (founded 1945)
State Bank of Bikaner & Jaipur (SBBJ) (founded 1963)

The State Bank of India and all its associate banks are identified by the same blue keyhole logo. There has been a proposal to merge all the associate banks into SBI to create a “mega bank” and streamline the group’s operations.

SBI has been ranked 260th in the Fortune Global 500 rankings of the world’s biggest corporations for the year 2015. It has a market share among Indian commercial banks of about 20% in deposits and loans.

Apart from its five associate banks, SBI also has the following non-banking subsidiaries:
- SBI Capital Markets Ltd
- SBI Funds Management Pvt Ltd
- SBI Factors & Commercial Services Pvt Ltd
- SBI Cards & Payments Services Pvt Ltd.
  (SBICPSL)
- SBI DFHI Ltd
- SBI Life Insurance Company Limited
- SBI General Insurance.

Interpretation

If we minutely study the above comparative statement, it shows that total advance or business of the bank increases continuously in previous nine years. This indicates demand of bank’s loan and advance in the market and marketing efficiency of its employees. However, with increase in total lending, Gross NPA and Net NPA of the bank also increase. Total Advance, GNPA and NNPA all three are showing similar linear positive trend during study period but net profits of the bank did not follow them and showing a fluctuating trend. The increase in NPA may be due to the following reasons:

i. Improper selection of borrower by SBI
ii. Weak credit appraisal system of the bank
iii. Inefficient management of borrowers account and lack of proper follow up.
iv. Slackness in credit management and monitoring.
v. Recession in the market.

The main source of income for any bank is income from interest on advance or lending. Here in case of SBI, during the study period net profit did not follow the trend of total advance and certainly this is due to increasing trend of nonperforming assets of SBI. The NPA of the bank is making double impact on the profits of SBI. First, NPA of the bank reduces the interest income of SBI, as NPA doesn’t generate any interest income and second, every banks are required to provide provisions for NPA from current year profit, which further reduce the current year’s profits.

The NPA has deleterious effect on return on assets and its profitability is affected because of providing doubtful debt and writing it off as bad debts. As a result return on equity and return on assets falls and cost of capital go up. Overall impact is seen in the form of assets-liabilities mismatch.
Correlation coefficient between Net NPA and Net Profit of SBI:

Correlation coefficient measures the degree to which two variables are related. Here to check the degree of linear relationship between net profit (X) and net NPA (Y), Pearson’s correlation coefficient has been used.

Statement showing necessary calculations

\[
\begin{align*}
\Sigma x &= 32474.51;  \Sigma y = 125643.34;  \Sigma xy = 552918810.8;  \\
\Sigma x^2 &= 161512841.1;  \Sigma y^2 = 3630194832 \\
\end{align*}
\]

Correlation coefficient \( r \) between net profit (X) and Net NPA (Y);

\[
\begin{align*}
\rho_{xy} &= \frac{n\Sigma xy - (\Sigma x)(\Sigma y)}{\sqrt{n\Sigma x^2 - (\Sigma x)^2} \sqrt{n\Sigma y^2 - (\Sigma y)^2}} \\
\end{align*}
\]

\[
\begin{align*}
\rho_{xy} &= 0.34 \\
\end{align*}
\]

Interpretation

There is a positive correlation coefficient exists between net profit and net NPA of the bank. This simply means with increase in profit, net NPA of the bank will also increase and vice versa. The main source of income for a bank is interest on advance. If any part of this advance if not paid by the client is termed as non-performing assets and this shows mismanagement and inefficiency of bank in disburse and recovery of advance. The figure \( r = (0.34) \) shows that there is a positive correlation exist and the bank must take steps to control the nonperforming assets through its different policies.

As NPA is directly related with advance given to bank’s clients, the bank must take proper steps and improve credit appraisal methods in order to reduce the bad debts. NPA has direct affect on assets and liquidity of a bank. So it should be control through different policies and measures of bank.

Test of significance using Student’s “t” test;

\[
t = \frac{r \sqrt{n-2}}{\sqrt{1-r^2}}
\]

Where “n”= 9; \( r_{xy} = \text{Pearson’s correlation coefficient} = 0.34 \)

d.f. = (n-2)=(9-2)=7

The computed value of “t”= 0.96

Table value of “t” at 5% level of significance & degree of freedom at 7 is, 1.90.

As computed value of “t” is lower than table value, null hypothesis is accepted. Thus it signifies that there is no significant difference between net profit and net NPA of the bank.

X. FINDINGS

- Gross NPA & Net NPA of the bank is increases every year with increase in total advance during study period. This indicates poor NPA management policy of the bank.
- Total advance showing increasing trend but net profit of the bank showing a fluctuating trend. This is due to increasing NPA.
- Positive correlation exists between net profit and net NPA due to wrong credit management policy of the bank. This must be reduce to improve profit.

XI. RECOMMENDATION

The bank needs to follow strict policy towards pre sanction credit evaluation of the clients and post disbursement control to control increasing NPA. The decline of NPA is necessary to improve the profits of SBI.

XII. LIMITATION OF THE STUDY

The research is based only on secondary data. The required data has been collected from annual report of the bank from 2007 to 2016. Final conclusion has been drawn only on the basis of collected data for previous nine years.

XIII. CONCLUSIONS

The study has been showing the nonperforming assets of SBI, one of the biggest lender in India which has approx twenty percent share in loan market. NPA is one of the important parameter in analysing the performance of bank as it reduces the profit margin and increases the carrying cost of such nonperforming assets in the form of provision for doubtful debts and bad debts. The motive of study on SBI is to assess the NPA of the bank and to make a comparison between total advances, nonperforming assets and net profit.

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