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A STUDY ON NPAS AND ITS EFFECTS ON BANKS' PROFITABILITY

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ABSTRACT

NPA is nothing but old wine in the new bottle. The bad loans which were known as Bad Debts have been renamed as Non-Performing Assets as per the Narsimham Committee recommendations. Previously banks used to write off the bad debts as per their own decisions depending upon the health of the banks. But Narsimham Committee prescribed a standardized norm for the provisioning of NPAs. The present paper examines the reason for the growth of NPAs and what are the preventive measure to be taken to reduce the growth of NPA

Key words: NPA, Non-Performing Assets, bad loan, bad debt.

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1. INTRODUCTION

Market analysts argue that a good financial system provides an easy flow of reserve cash, which will help with financial development. Many economists argue that a good financial system generates good economic growth. This creates credit and ensures an easy credit flow. A sound financial system helps in completing the distribution of assets competently by minimizing problems arising from market downturns etc. In a well-functioning financial system, NPA is one of the key factors. However, when the NPA exceeds a specific level, it becomes a matter of concern. NPA affects the flow of credit, which in turn affects the development and growth of the economy, so proper credit capital flow is necessary. Banks not only enhance assets through new deposits, but also reuse assets they acquire from borrowers. Therefore, when the customer does not return the money, NPA is generated, affecting credit generation and credit reuse. Besides, NPA affects the profits that banks get because they must create larger provisions for bad debts. In this way, the NPA issue is not only a concern for lenders but also a concern for strategic planners who are involved in financial development.

The Narasimham Commission was established in 1991 with the task of analyzing the Indian banking sector and recommending laws and regulations to make it more efficient, competitive, and efficient. Non-performing assets is one of the recommendations of the Narasimham committee. Non-performing assets are the biggest cause of upset in India's banking sector. Earlier, the Narasimham Commission concluded that the main reason for the decline in profitability of commercial banks in India was priority sector lending. The Commission has emphasized that 'priority sector lending' has led to the accumulation of underperforming assets by banks and, therefore, it recommends phasing out. Subsequently, the Narasimham-II Commission also highlighted the need for 'zero' non-performing assets for all Indian banks with an international presence. The 1998 report went on to blame poor credit decisions, usury, and cyclical economic factors among other causes for these banks' underperforming assets to surge to one-time highs. unpleasant way. The Commission recommended setting up an Asset Reconstruction Fund or Asset Reconstruction Company to deal with the bad debts of the banks, allowing them to start over cleanly.

1.1. Identify Non-Performing Assets

An asset becomes NPA if the assets are the following:

- If the interest/principal installment on the Credit is due over ninety days
- If the amount of Overdraft/Cash Credit (OD/CC) is consistently greater than the sanctioned limit for more than ninety days
- If purchased and discounted past due invoices exceed ninety days
- If the interest/principal amortization for agricultural advances is due in two harvests but the term does not exceed two six-month terms based on the advance
- Any receivable that is due more than ninety days in respect of other accounts

1.2. Impact of NPA

NPA is believed to affect the bank of profitability, credit contraction, liability management, shareholders' confidence

Profit is inversely proportional to NPA. As NPA increases, profits decrease because banks do not receive payments. Banks also need to make larger provisions under the NPA category. Usually, these provisions are from 20% to 50%

In term of credit narrowing, the increase in NPA leads to funds that are not easily reused, causing a decrease in the lending capacity of banks. It can cause currency journal jams if NPA contracts cash securities

When NPA increases, bank deposit rates will decrease, and lending rates will increase to maintain net profit margin. This hinders the overall functioning of the financial sector because it will not be easy for customers to get loans. Even if they do get a loan, they may have to pay high interest rates and thus hinder the bank's business and economic growth.

Regarding shareholder confidence, shareholders are generally interested in getting a higher dividend on their investments. However, if banks have a high NPA, their profits will be very small, which means that shareholders can receive very low dividends. In some cases, they may lose their investment. if banks have a net NPA of 5% or more, banks must get RBI approval before declaring a dividend

In terms of public certainty, with the rise of NPAs, the public begins to question the reliability of banks and may express objections. That will cause liquidity problems in the banks as people may not invest or deposit money in the bank.

2. LITERATURE REVIEW

Mishra & Pawaskar (2017) gives an overview of the NPA scenario field. The study investigates the specific impact of NPA on India's banking sector. Research shows that NPA tends to decrease in recent years. From there, the authors suggest ways to restore and reduce NPA. The proposal is that banks must be agile and proactive in choosing customers before deciding to lend.

Mittal et al. (2017) presents the causes of NPA, and their effects analyzed. This study explains the classification of NPA and proposes ways of recovering from NPA through different channels. The authors also suggest that banks should be more proactive and take more stringent measures by looking at a customer's ROI or credit score before making a loan.

Gulati (2018) uses the help of linear regression to explain the impact of gross Non - Performing Assets/gross advances ratio on net profit (total assets %). The t-statistic was used to test the statistical significance and the F-statistic was used to check the fit of the model.

Chellasamy & Prema (2018) offers a study on NPA and profitability. The study examines whether profitability is related to NPA and determines whether banks' profitability is affected by NPA. Research also suggests that NPA cannot be eliminated but it can be controlled

Kavitha et al. (2019) conduct research on the database of commercial banks for ten years. Through ratio analysis and regression analysis, the study shows that NPA and profitability are negatively related to profitability

3. METHODOLOGY

This study was conducted based on audited financial statements published on the websites of 24 commercial banks listed on the Vietnam stock exchange for the period 2017-2020, using OLS regression model with the dependent variable is return on assets (ROA) which represents the performance, and the dependent variable is divided into internal and external factors. Currently, there is no unified model in studying the factors affecting the performance of banks in the world as well as in Vietnam. ROA is widely used by market analysts as a measure of financial performance, as it measures an asset's efficiency in generating income. ROA is a key ratio to assess a bank's profitability because ROA is not distorted by a high equity ratio while return on equity - ROE underestimates the risks of financial leverage. principal, in other words, ROE does not refer to liabilities (Abate, T. W., & Mesfin, E. A. ,2019). The variables that are believed to affect a bank's profitability are bad debt, loan-to-customer deposit ratio, loan-to-total assets ratio, consumer price index and ownership properties. The quantitative analytical research model is presented as follows

$$ROA = \alpha_0 + \beta_1 NPA + \beta_2 \mathrm{LCD} + \beta_3 LTA + \beta_4 CPI + \beta_5 OP$$

Where ROA is return on assets. ROA is a reliable factor used to evaluate the profitability of commercial banks because ROA is not affected by high financial impact. ROA is net profit divided by average total assets.

NPA is Non-Performing Assets. In Vietnam, according to the regulations of the State Bank, non-performing assets are defined as those that are classified into sub-standard debts, doubtful debts and potentially loss of capital. In which, non-performing assets is classified according to two criteria: quantitative and qualitative.

H1: non-performing assets negatively affects banking activities

LCD is the ratio of loans to customer deposits. According to regulations of the State bank, banks and foreign bank branches must maintain the ratio of outstanding loans to total deposits up to 85%. Our assumption is that the loan-to-deposit ratio influences bank performance.

H2: The loan-to-deposit ratio affects the bank's performance

LTA is the loan to total assets ratio. Loans/Total Assets ratio measures total loan balance as a percentage of total assets

H3: Loan/total assets ratio positively affects bank performance.

CPI is Consumer Price Index. CPI is the most used indicator to measure price levels, changes in price levels and can be used to assess inflation.

H4: Inflation has an adverse effect on bank performance.

OP is the ownership properties. Whether a bank is privately owned or owned by the state will have differences in regulations and charters, so the operation of these banks is also affected by this.

H5: Ownership properties affects bank performance.

The hypothesizes are summarized in Figure 1

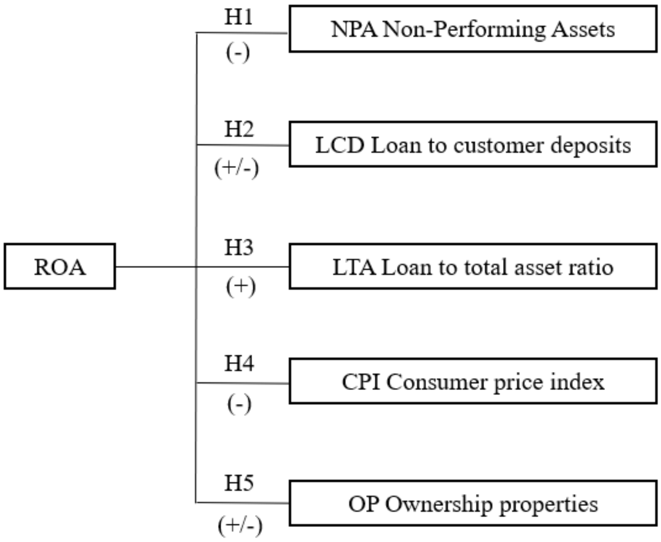

Figure 1: Hypothesis

4. RESULTS

The regression results of the model are presented in the following table

Table 1 Regression result

α	β_1	β_2	β_3	β_4	β_5
-0.14	-0.113***	0.292***	-0.261***	-0.454	-0.043***
R square = 0.676					
Adjust R square = 0.648					
$^{***}p < 0.001$; $^{**}p < 0.01$; $^{*}p < 0.05$					

The study conducted OLS regression analysis, focusing on the relationship between one dependent variable and many independent variables. The model's R square coefficient is 0.676, showing that the selected economic factors explain 67% of the research model. ANOVA test – F test: The independent variables with the value of the t test are all less than 5% significance level, so it can be concluded that these factors act as independent variables with statistical significance in the model

Non-performing assets have a negative effect on bank profitability. Non-performing assets have a negative impact on bank profitability. The failure to recover debts (principal and/or interest and fees) causes the capital of commercial banks to be lost, while these banks still have to pay interest on operating capital, making it difficult for commercial banks to recover. profits fell. If the profit is not enough, the bank must use its own capital to compensate for the loss. This may affect the scale of operation of commercial banks.

On the other hand, the high rate of overdue debt makes the reputation and confidence in the financial potential of the bank degraded, leading to a decrease in the bank's ability to mobilize capital. If it is more serious, it can lead to liquidity risks, push banks to the brink of bankruptcy and threaten the stability of the entire banking system.

The ratio of loans to deposits of customers is directly proportional to ROA which means, the higher this ratio, the higher the bank's performance. In other words, the more banks expand lending and mobilize capital, the larger the difference between loan interest and deposit interest, leading to higher profits.

Loan-to-total assets ratio and ownership properties have a negative impact on bank performance. The higher the loan-to-total assets ratio and ownership properties, the lower the bank profits. The inflation rate (consumer price ratio) is not statistically significant.

5. DISCUSSION AND CONCLUSION

NPA is an important factor that has a negative impact on the financial sector in Vietnam in particular and the world in general. NPA affects the flow of credit capital, which in turn affects the development and growth of the economy. Banks must be proactive and ready to take measures to be able to recover from the NPA.

There are many reasons that lead to the NPA rising. Some are macroeconomic factors like falling exports due to global recession, commodity price cyclical downturn, etc. In the first 9 months of 2020, the world's COVID-19 pandemic was still complicated, seriously affecting all aspects of economic life, making bank depositors who are businesses and people facing difficulties, their revenue decreased, difficult debt repayment. In particular, banks that are financial intermediaries are also affected, which is the cause of the increase in bad debt

Much of today's NPA is from loans made in the mid-2000s when the economy was booming, and business confidence was solid. But as economic growth stalled after the 2008 global financial crisis, the ability of these borrowers to repay their loans declined. This has led to what is known as Vietnam's Balance Sheet problem, where both the banking sector and businesses are reeling from financial stress.

Another reason is computational engineering. In the context of the impact of COVID-19, the economic situation is difficult, the demand for credit is not as high as in previous years, the denominator is smaller, so the relative ratio of bad debts / outstanding loans also increases.

Banks can take various measures to mitigate future NPAs and can manage existing NPAs. We recommend the following measures:

1. The Reserve Bank should revise the existing credit monitoring and appraisal system.
2. Banks need to regularly monitor their customers to make sure they don't redirect their funds
3. All loan accounts must be reviewed periodically.
4. Banks should properly train their staff to correct errors in due diligence and credit monitoring.
5. An appropriate process should be followed prior to granting credit.
6. Before deciding to take a loan, borrowers should reassess their own repayment capacity to what extent, and at the same time make a specific plan for a loan payment schedule to avoid encountering unexpected events that could happen.

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