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A study on the impact of Securitization Act on Gross and Net NPA Ratio of Indian Commercial Banks

Dr.N.L.VIJAYA

M.Com., Ph.D., Assistant Professor, Department of Commerce & Management, Government College for Women, Kolar – 563101, Karnataka

***Abstract*:-Banks are important segment in Indian financial system. An efficient banking system helps the nation's economic development. After nationalization of banks, they expanded and extended the credit to all the sectors including priority sector. The social concern of the commercial banks in India resulted in mounting of non-performing affecting the liquidity and the profitability of Indian commercial banks. This paper aims at studying Asset classification by banks, NPAs, factors contributing to NPAs, effects of NPAs, Measures to tackle the non-performing assets and Impact of SARFAESI Act on reduction of Gross and Net NPA ratios of Indian Commercial banks.**

***Key words*: NPAs, GNPA ratio, NNPA ratio, SARFAESI ACT, Default.**

INTRODUCTION

Banking system which constitutes the core of the financial sector plays a vital role in transmitting monetary policy impulses to the economic system. As the important role that banking sector played in the economy was that of providing financial support for preferred sectors which would lead to development of the country. However, because of inefficient lending practices, combined with poor monitoring, corruption, and a host of other factors, the Indian banking sector became saddled with huge folios of non-performing loans and there has been extensive discussion on the accumulation of "huge" non-performing assets on the balance sheet of Indian banks, more specifically public sector banks. This rises concern in the industry and academia because it is generally felt that non-performing assets reduces the profitability of a bank, weaken its financial health and erode its solvency. In order to clean up its banking system, the Indian government has embarked upon major regulatory reform in the last decade. It has passed Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI) and amendment Act 2004 and allowed Banks and Financial institutions to securitize its non-performing assets.

ASSET CLASSIFICATION

The loans given by the Banks are classified into performing and non-performing assets on the following basis:

1. Performing Assets: Performing or standard assets are the assets which do not disclose any problem and which do not carry more than the normal risk attached to the business. Performing asset is one which generates income for the bank.
2. Non-Performing Assets: An asset is to be treated as non-performing asset when it ceases to generate income for the Bank. An asset may be treated as Non-Performing Asset (NPA), if interest and /or installment of Principal remain overdue for a period exceeding 90 days earlier it was 180 days. (Modified to 90 days w.e.f. Mar, 2004). If any advance or credit facilities granted by a bank to a borrower become non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status. Banks and FIs should not take into their Income account, the interest accrued on such NPAs, unless it is actually received/recovered NPAs are further classified into:

- Substandard Assets: Loans which are non-performing for a period not exceeding two years, where the current net-worth of the borrower or the current market value of the security, against which the loan is taken, is not enough to ensure full recovery of the debt.
- Doubtful Assets: Loans which have remained non-performing for a period exceeding two years and which are not classified as loss assets by the management, or the internal/external auditor appointed by RBI.

- Loss Assets: Assets where loss has been identified by the internal/external auditor of the bank or the RBI, but the amount has not been written-off wholly or partly. These assets are considered unrecoverable and are of little value to the lending institution.

Evaluation of NPA definition in India
1993-Assets four quarter past due
1994-Assets three quarter past due
1995-Assets two quarter past due
2001-Past due concept abolished
2004-Assets 90 days overdue norm adopted

Factors contributing to NPA

- Poor Credit discipline
- Inadequate Credit & Risk Management
- Diversion of funds by promoters
- Funding of non-viable projects
- In the early 1990s PSBs started suffering from acute capital inadequacy and lower/ negative profitability. The parameters set for their functioning did not project the paramount need for these corporate goals.
- The banks had little freedom to price products, cater products to chosen segments or invest funds in their best interest
- Since 1970s, the SCBs functioned as units cut off from international banking and unable to participate in the structural transformations and new types of lending products.
- Audit and control functions were not independent and thus unable to correct the effect of serious flaws in policies and directions
- Banks were not sufficiently developed in terms of skills and expertise to regulate the humongous growth in credit and manage the diverse risks that emerged in the process
- Inadequate mechanism to gather and disseminate credit information amongst commercial banks
- Effective recovery from defaulting and overdue borrowers was hampered on account of sizeable overhang component arising from infirmities in the existing process of debt recovery, inadequate legal provisions on foreclosure and bankruptcy and difficulties in the execution of court decrees.
- Direct and pre-approved natures of loans sanctioned under sponsored programs.
- Frequent changes in Government policies.
- Willful default.
- Technology obsolescence.
- Industrial sickness and labour problems.
- Political compulsion and corruption.
- Lack of legal reforms.

Effects of Non-performing Assets:

- They erode current profits through provisioning requirements
- They result in reduced interest income
- They require higher provisioning requirements affecting profits and accretion to capital funds and capacity to increase good quality risk assets in future,
- They limit recycling of funds, set in asset-liability mismatches, etc
- High cost of funds due to NPAs
- Impact on banks scrips on Stock Exchanges
- Excessive focus on credit risk management

Measures to tackle the non-performing assets:

1. Compromise settlement schemes
2. Lok Adalats:
3. Debt Recovery Tribunal(DRT):
4. Proceedings under the Code of Civil Procedure
5. Board for Industrial & Financial Reconstruction (BIFR):
6. Corporate Debt Restructuring(CDR):
7. Sale of NPA to Asset Reconstruction company (ARC)/ Securitization company (SC) under Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SRFAESI)

SARFAESI Act

The Act has been made effective from 21st June 2002, the date on which the first Securitization and Reconstruction of Financial Assets and Enforcement of Security interest ordinance, 2002 was promulgated. The Act has provided an enabling legal framework for setting up of Securitization or Reconstruction Company and the manner of acquisition of financial assets by such companies. This Act has been enacted to help banks and financial institutions to tackle the NPAs problem.

Securitization: It is the process of conversion of homogeneous existing illiquid assets or future cash flows into marketable securities. In other words, securitization deals with the conversion of assets which are not marketable into marketable ones. In other words taking possession of secured assets by the bank (originator) and sell them without the intervention of the court.

Procedure followed under SARFAESI Act:

1. Banker should identify Non-performing assets to be securitized.
2. NPAs must be above Rupees one lakh.
3. These assets must be secured by mortgage, hypothecation and not pledge.
4. NPAs must not be against agricultural land.
5. Authorised officer must appointed by the bank as rule 2(a) of Enforcement of security interest rules, 2002.
6. Bank will issue 60 days notice as per the provisions of section 12(2) of the Act to the default borrower.
7. If the borrower does not respond even after serving the notice, Banker will take possession of the property (or) the management of the organization.
8. Property acquired will be sold to outsiders so as to secure maximum price.
9. Balance outstanding is settled either through a case with Debt Recovery Tribunal or other competent court.
10. If any surplus is left after clearing NPA, it is to be refunded to the borrower.

Limitations of SARFEASI Act:

1. Securitization Act does not applicable to agricultural land and loans below Rupees one lakh.
2. The process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitization commercially unviable in states that still have a high stamp duty.
3. Once management is taken over, who takes of the statutory duties like sales tax, excise duty, income tax etc., of the defaulting company is not addressed in the Act.
4. Only secured assets are covered under this Act.
5. Valuation of assets is another concern.
6. Financial costs are involved in disposal of distressed assets.

REVIEW OF LITERATURE

1. Nesrine ben salah and Hassouna fedhila (2012) investigated the impact of securitization on risk behavior and banking stability. Based on a sample of 174 US commercial banks from 2001 to 2008, they found that a greater recourse to securitization is associated with deterioration in the quality of American banks' loan portfolios and an increase of the credit risk in their balance sheets. They also observed a positive and significant impact of securitization on banking stability. They think that this paradox is due to the fact that different classes of securitized assets lead to heterogeneous effects on American banks' stabilities. Particularly, their results show that mortgage securitization has a positive and significant impact on banking stability, providing thus a support to the implicit recourse hypothesis. Inversely, non-mortgage securitization has a negative effect on banking stability because of the reduction of banks' monitoring incentives related to this particular form of securitization.

2. Alper Kara, David Marques-Ibanez and Steven Ongena (2012) pointed out the effect of securitization activity on banks' lending standards using evidence from pricing behavior on the syndicated loan market. They found that banks more active at originating asset-backed securities are also more aggressive on their loan pricing practices. This suggests that securitization activity lead to laxer credit standards. Macroeconomic factors also play a large role explaining the impact of securitization activity on bank lending standards: banks more active in the securitization markets loosened more aggressively their lending standards in the run up to the recent financial crisis but also tightened more strongly during the crisis period.

OBJECTIVE

1. To study the Non-performing Assets of select banks.
2. To analyze the impact of securitization on Gross and Net NPA Ratios of select banks.

SCOPE OF THE STUDY

The scope of the study is confined to study the impact of Securitization Act on Gross and Net NPA ratios of select public sector banks only. Using judgment sampling, 10 public sector banks were selected for the purpose of the study having their branches across the country. viz., Allahabad Bank, Bank of Maharashtra, Central Bank of India, Corporation Bank, Dena bank, Oriental bank of Commerce, Punjab National bank, State Bank of India, State bank of Mysore, Syndicate Bank.

METHODOLOGY

Present study is based on secondary data
14 years Gross NPA and Net NPA ratios were collected from RBI-Report on trend and progress of banking in India (www.rbi.org.in), these ratios are divided into two groups, Group- I Ratios before securitization Act and Group- II Ratios after securitization Act. Mean and standard deviation were calculated separately for each group and t-test technique is applied to know the results on the impact if securitization Act in reduction of these ratios.

SOURCES OF SECONDARY DATA

journals, Research papers, Magazines, Annual reports of banks, RBI reports & websites, Various bank website and Extract of NPAs provided by the banks.

ANALYSIS AND INTERPRETATION OF DATA

Table-1: Gross NPA ratios of select banks before Securitization Act (group- I)

Sl.No.	Name of the bank	1997	1998	1999	2000	2001	2002
1	Allahabad Bank	23.93	23.18	20.09	19.07	17.66	16.94
2	Bank of Maharashtra	20.67	17.39	15.97	12.65	12.35	10.44
3	Central Bank of India	25.00	20.47	17.41	16.63	16.06	14.70
4	Corporation Bank	9.92	7.60	5.66	5.39	5.40	5.19
5	Dena bank.	15.10	13.73	12.37	18.17	25.31	24.11
6	Oriental bk of Commerce	7.36	6.16	6.30	5.54	5.21	6.57
7	Punjab National bank	16.31	14.50	14.12	13.19	11.71	11.38
8	State Bank of India	16.02	14.14	15.56	14.25	12.93	11.95
9	State bank of Mysore	16.92	17.47	16.96	13.89	12.83	12.07
10	Syndicate Bank	19.32	15.31	10.72	7.74	7.87	8.38

Source: RBI-Report on trend and progress of banking in India

Table-2: Gross NPA ratios of select banks after Securitization Act (Group-II)

Sl.No	Name of the bank	2003	2004	2005	2006	2007	2008	2009	2010
1	Allahabad bank	13.65	8.66	5.8	3.9	2.6	2.0	1.8	1.71
2	Bank of Maharashtra	9.55	7.7	7.0	5.5	3.5	2.6	2.3	3.0
3	Central bank of India	13.06	12.55	9.5	6.9	4.8	3.2	2.7	2.1
4	Corporation bank	5.27	5.03	3.4	2.6	2.1	1.5	1.1	1.0
5	Dena bank	17.86	14.82	9.7	6.4	4.1	2.4	2.1	1.81
6	Oriental bk of commerce	6.94	5.87	9.1	6.0	3.2	2.3	1.5	1.6
7	Punjab National Bank	11.58	9.35	6.0	4.1	3.5	2.7	1.8	1.73
8	State bank of India	9.34	7.75	6.0	3.6	2.9	3.0	2.8	3.09
9	State bank of Mysore	10.14	7.76	4.6	3.3	2.3	1.7	1.4	2.02
10	Syndicate bank	8.34	7.33	5.2	4.0	3.0	2.7	1.9	2.2

Graph- 1: Gross NPA ratios of select banks before and after Securitization Act.

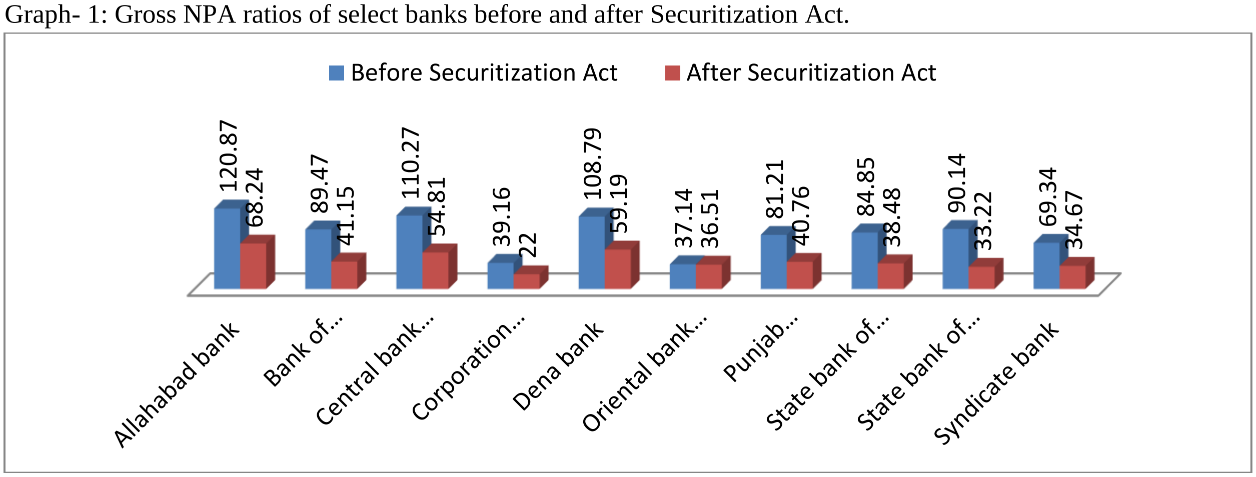

Table- 1, 2 and Graph-1 exhibit Gross NPA ratios of select banks. Where 14years Gross NPA ratios were collected and these were classified into two groups, group-I ratios before securitization Act i.e. from financial year 1997 to 2002 (6years) and group-II ratios after securitization Act i.e. from financial year 2003 to 2010 (8years). As compared to sum of Gross NPA ratios of before securitization Act (group-I), the sum of Gross NPA ratios of after securitization period (group-II) has been considerably decreased as shown below.

Sl.No	Name of the bank	Before securitization Act	After securitization Act
1.	Allahabad bank	120.87	68.24
2.	Bank of Maharashtra	89.47	41.15
3.	Central bank of India	110.27	54.81
4.	Corporation bank	39.16	22.00
5.	Dena bank	108.79	59.19
6.	Oriental bank of commerce	37.14	36.51
7.	Punjab National bank	81.21	40.76
8.	State bank of India	84.85	38.48
9.	State bank of Mysore	90.14	33.22
10.	Syndicate bank	69.34	34.67

Table-3: Net NPA ratios of select banks before Securitization Act (group- I)

Sl.No.	Name of the bank	1997	1998	1999	2000	2001	2002
1	Allahabad Bank	14.84	15.09	12.54	12.17	11.21	10.55
2	Bank of Maharashtra	9.66	8.66	8.72	6.97	7.41	5.81
3	Central Bank of India	14.40	12.21	9.79	9.84	9.72	7.98
4	Corporation Bank	3.63	2.93	1.98	1.91	1.98	2.31
5	Dena bank.	9.38	8.28	7.67	13.81	18.29	16.31
6	Oriental bk of Commerce	5.64	4.50	4.50	3.61	3.59	3.21
7	Punjab National bank	10.38	9.57	8.96	8.52	6.69	5.27
8	State Bank of India	7.30	6.07	7.18	6.41	6.03	5.64
9	State bank of Mysore	10.96	10.75	10.55	8.12	7.88	7.36
10	Syndicate Bank	7.53	5.78	3.93	3.17	4.07	4.53

Table-4: Net NPA ratios of select banks after Securitization Act (Group-II)

Sl.No	Name of the bank	2003	2004	2005	2006	2007	2008	2009	2010
1	Allahabad bank	7.07	2.37	1.3	0.8	1.1	0.8	0.7	0.66
2	Bank of Maharashtra	4.83	2.46	2.2	2.0	1.2	0.9	0.8	1.64
3	Central bank of India	6.74	5.57	3.0	2.6	1.7	1.5	1.2	1.0
4	Corporation bank	1.65	1.8	1.1	0.6	0.5	0.3	0.3	0.2
5	Dena bank	11.82	9.4	5.2	3.0	2.0	0.9	1.1	1.21
6	Oriental bk of commerce	1.44	0	1.3	0.5	0.5	1.0	0.7	0.87
7	Punjab National Bank	3.8	0.95	0.2	0.3	0.8	0.6	0.2	0.1
8	State bank of India	4.49	3.45	2.7	1.9	1.6	1.8	1.8	1.72
9	State bank of Mysore	5.19	2.96	0.9	0.7	0.5	0.4	0.5	1.02
10	Syndicate bank	4.29	2.58	1.6	0.9	0.8	1.0	0.8	0.70

Graph-2: Net NPA ratios of select banks before and after securitization Act

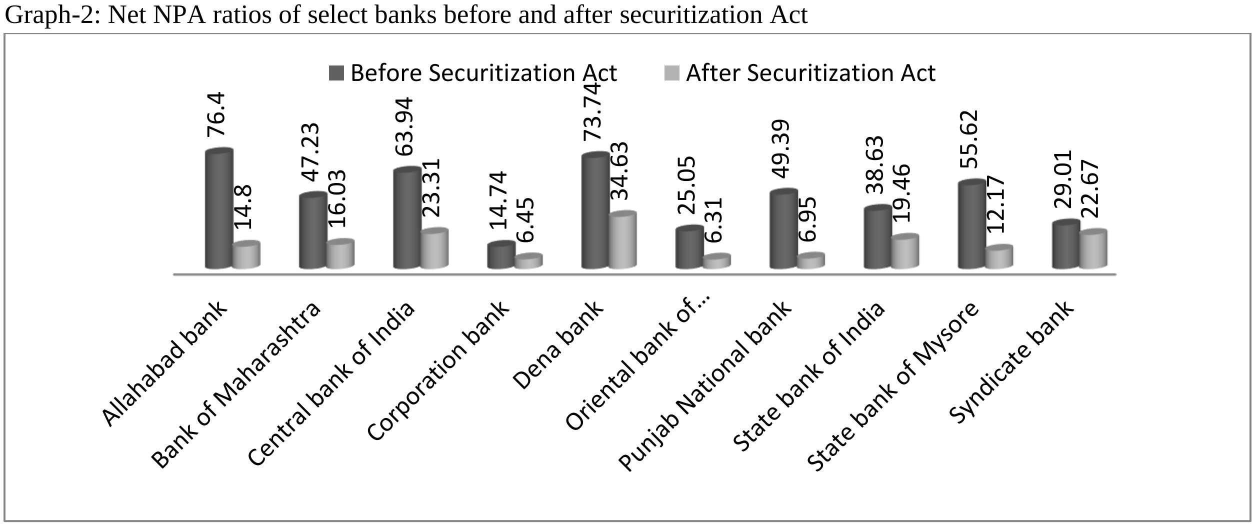

Table- 3, 4 and Graph-2 shows that Net NPA ratios of select banks. Where 14years Gross NPA ratios were collected and these were classified into two groups, group-I ratios before securitization Act i.e. from financial year 1997 to 2002 (6years) and group-II ratios after securitization Act i.e. from financial year 2003 to 2010 (8years). The sum of these individual groups shows that there is considerable decrease in these ratios after enactment of securitization Act as compared to the sum of these ratios before enactment of securitization Act which is mentioned as under.

Sl.No	Name of the bank	Before securitization Act	After securitization Act
1.	Allahabad bank	76.40	14.08
2.	Bank of Maharashtra	47.23	16.03
3.	Central bank of India	63.94	23.31
4.	Corporation bank	14.74	6.45
5.	Dena bank	73.74	34.63
6.	Oriental bank of commerce	25.05	6.31
7.	Punjab National bank	49.39	6.95
8.	State bank of India	38.63	19.46
9.	State bank of Mysore	55.62	12.17
10.	Syndicate bank	29.01	22.67

Table-5: t-test for Gross NPA Ratios of select banks

Sl. No.	Name of the banks	Before Securitization Act		After Securitization Act		t-Test value	P-value	Result
		Mean	Std.Dev	Mean	Std.Dev			
1.	Allahabad bank	20.1450	2.86857	5.0175	4.23857	7.511	.001	VHS
2.	Bank of Maharashtra	14.9117	3.79720	5.1438	2.70917	5.639	.001	VHS
3.	Central bank of India	18.3783	3.77149	6.8513	4.39787	5.145	.001	VHS
4.	Corporation bank	6.8513	4.39787	2.7500	1.68030	3.954	.002	VHS
5.	Dena bank	18.1317	5.45954	7.3988	6.16425	3.379	.005	VHS
6.	Oriental bk of Commerce	6.1900	.76278	4.5638	2.80683	1.369	.196	NSS
7.	Punjab National bank	13.5350	1.84758	5.0950	3.63376	5.174	.001	VHS
8.	State bank of India	14.1417	1.53773	4.8100	2.56257	7.874	.001	VHS
9.	State bank of Mysore	15.0383	2.36450	4.1525	3.19288	7.006	.001	VHS
10.	Syndicate bank	11.5567	4.76039	4.3338	2.41464	3.732	.003	VHS

Source: Secondary data

To evaluate the impact of Securitization Act on the gross NPA ratios of select banks, t-test technique has been applied. The results of all the banks were highly statistically significant except for Oriental bank of commerce. Though the result for Oriental bank of Commerce is not statistically significant, there is considerable decrease in Gross NPA ratio of the bank after enactment of securitization Act.

Table-6: t-test for Net NPA Ratios of select banks

Sl. no	Name of the banks	Before Securitization Act		After Securitization Act		t-Test value	P-value	Result
		Mean	Std.Dev	Mean	Std.Dev			
1	Allahabad bank	12.7333	1.86730	1.8500	2.18198	9.798	.001	VHS
2	Bank of Maharashtra	7.8717	1.40113	2.0163	1.28330	8.130	.001	VHS
3	Central bank of India	10.6567	2.27532	2.9138	2.13384	6.535	.001	VHS
4	Corporation bank	2.4567	.68928	.8063	.63270	4.652	.001	VHS
5	Dena bank	12.2900	4.48025	4.3288	4.16948	3.427	.005	VHS
6	Oriental bk of commerce	4.1750	.88884	.7888	.46805	9.275	.001	VHS
7	Punjab National bank	8.2317	1.90622	.8688	1.22385	8.823	.001	VHS
8	State bank of India	6.4383	.66829	2.4325	1.04366	8.184	.001	VHS
9	State bank of Mysore	9.2700	1.64849	1.5213	1.69809	8.553	.001	VHS
10	Syndicate bank	4.8350	1.57642	2.8338	3.40083	1.328	.209	NSS

Source: Secondary data

To analyze the impact of Securitization Act on the net NPA ratios of select banks, t-test technique has been applied and the results of all the banks were highly statistically significant except Syndicate bank. Though the result of Syndicate bank is not statistically significant, there is considerable decrease in Net NPA ratio of the bank after enactment of securitization Act.

FINDING

1. After implementation of securitization Act there is considerable decrease in the Gross NPA ratios and Net NPA ratios of all the selected banks.
2. The income from the non-performing assets cannot be recognized except to the extent of actual recovery. Both these have a negative impact on the profitability of banks.
3. The main reasons for an account becoming a non-performing asset are diversion of funds, improper credit appraisal and willful default followed by cost ineffective legal measures and difficulty in the execution of decrees.
4. Before the enactment of the Securitisation Act the banker had limited options for recovery which consisted of having an intensive follow-up and interaction with the borrower and initiating legal actions either through courts or Debt recovery tribunals.
5. The provisions of the Securitization Act enabled banks;
   - To Release long-term assets
   - Manage problem of liquidity
   - Manage Asset-Liability mismatches and
   - Improve recovery

     These could be achieved by exercising powers to take possession of Secured assets, sell them and reduce NPAs by adopting measures for recovery under Securitization Act.
6. Establishment of an Asset Reconstruction Company/Securitization Company under Securitization Act for acquiring distressed assets from banks with a view to develop market for such assets helped the banks to transfer their risk to such companies.
7. However, recently the Supreme Court in the case of Mardia chemicals has struck down the clause in the act that allows the borrower to seek legal redress only upon paying 75% of the claimed amount to the lending bank as unconstitutional.
8. This Supreme Court decision is viewed as a threat to the effective implementation of the act by the banking community as it enables borrowers to make appeals on flimsy grounds without depositing any amount with the lender bank.

CONCLUSION

As money deposited in the banks get blocked in loans and advances having adverse effect on money supply and developmental activities of the economy, enactment of the Securitization Act was seen as a panacea to the entire problem of NPAs. Though there are many flaws, weaknesses and limitations which the defaulters may exploit to the full extent, overall the Act has boosted banks' health. First, it has empowered the banks with additional powers for recovery and facilitated the reduction of Gross and Net NPA ratios and secondly, it has helped, only in a miniscule way, in development of a stronger debt market which is necessary to provide the "spare tire" for the economy. As such it can be concluded that implementation of securitization Act has significant impact on reduction of these NPA ratios.

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