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A study of profitability, reconciliation and non-performing advances of public sector banks in India

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Abstract
The need for reform or changes in the banking sector had become necessary as the financial sector, almost over the world, had changed almost unrecognizably during the 1980s. Technology – computerization and telecommunication – was a major factor that contributed to these. An important outcome of these changes was the emergence of more integrated global financial markets in the major developed economies. In the background of flexible exchange rates and convertibility that had already emerged during the 1970s. The financial flows that were generated were started with the appearance of euro-currency further changed the financial scenarios almost everywhere. The non-banking financial institutions played a major role in these changes. The effect was to blur the distinction between banks and the non-banking institutions as well as between traditional categories used within banks for internal control and management. Conventional banking functions were taken over progressively by the non-banking institutions and banks entered new areas activities that were conventionally considered out of bounds for them. In short, there was more competition at one end and more risky operations at the other. Deregulation was associated with these developments. Greater risks of the new regulation of the financial system. The emphasis that was put on transparency in financial statements and on capital adequacy of the banks is the result of these development.

Keywords: Profitability, reconciliation, performing advances

Introduction
The Indian financial system could not remain insulated from these changes. An added factor was the poor financial performance of Indian banks during the eighties. The lack of transparency in the financial statements of the banks had made it difficult, if not impossible, to draw firm conclusions about their performance. Many of these facets of banking had receive attention before the reforms in their present form were launched in 1991. The Ghosh Committee had gone into several balance sheet aspects in 1985. Other issues regarding the monetary system has been analyzed by the Chakravarty Committee (1985) and the Vaghul Group (1987). The Narasimaham Committee (1991) gave wide ranging and comprehensive recommendations for financial sector reform. These recommendations have provided the basis for several changes initiated by the RBI.

The measures initiated since 1991 in what is termed the first phase of reforms related to four major inter-related aspects. These are: (i) monetary policy changes with respect to reserve requirements (SLR and CRR), interest rate (level and structure) and the exchange rate mechanism; (ii) adoption of internationally accepted practices and norms relating to income recognition provisioning and capital adequacy; (iii) organizational and structural changes aimed at introducing greater autonomy in the management of public sector bank, greater competition among the banks and, above all, greater efficiency an better performance in the industry. Permitting entry of private sector banks, both Indian and foreign, in the banking market, generally, an in specific areas from which they were earlier excluded is part of these policy changes; and (iv) strengthening supervision and surveillance over banking operations in a deregulated environment. This became crucial, not only as a result of the securities scam episode of 1992 but also as a result of structural changes in financial markets (for example, growth of non-banking institutions and use of open market operations for monetary and credit controls).

Policy reforms that have implemented during the last 15 years cover a very wide range of policies.

These include monetary policy and monetary control measures ranging from CRR/SLR changes to de-regulation of interest rates. At the same time, fulfilling the difficult task of managing inflation along with supporting investment for growth without sacrificing a relatively secure positions of balance of payments continued to remain major monetary policy concerns. Changes in internal debt management policies have included introduction of a ceiling on adhoc treasury bills and introduction of new instruments like the floating rate bonds. Internationally accepted banking norms have now become acceptable to the banks and bank supervision has been strengthened. The capital market and the external sector policies have also undergone several operational changes aimed at instituting a more liberal environment.

The results achieved so far have, until now, also appeared quite satisfactory if they are to be judged by the level of foreign exchange reserves, exchange rate movements, institutional innovations and above all, from the point of view of containing the rate of inflation. However, in 1996 performance of the economy is a cause for all round concern. Inflation rate is going up, the exchange reserves are less strong, the rupee has been under pressure several times during the year, interest rates have been high in the system, the capital market is weak and industrial growth has definitely slackened, if the earlier successes were attributed to policy changes. Do the problems now indicated policy failure? This is just one of the questions that arise in the policy context. An analysis of each of these issues should form a separate subject for a presentation like the present one. We have not touched upon any of these issues. Available date and information is inadequate for a firm conclusion on them and the issues are bound to be debated for a long time to come.

Our presentation today is concerned with the last three aspects of the above changes. Operational aspects of banking in particular situations are more important in these areas than the general theoretical propositions. Let me also state at the outset that the unfinished agenda of reforms, even as per the Narasimham Committee recommendations, is substantial. Some of the aspects of the unfinished agenda particularly those related to organizational changes are equally important, and, at the same time more complex than changes introduced so far. The changes introduced so far have been implemented, by and large, through mandatory changes in the rules of the game, Changes that are required now are concerned with (a) the structure and organization of banking operations, including those related to rural banking, and (b) with supervisory and regulatory function. They are concerned with management and internal control structures and require in effect a change in the 'banking culture' and modes of operation which can become effective only through, a change in the mindset of people working in the banking sector.

Profitability and performance

It is well known that Indian banking laws permitted banks to conceal the real status of their financial health. The introduction of new statutory formats for financial reporting (i.e. balance sheet and profit and loss statement) in 1992 was the first step in the reform process. New prudential norms required banks classify loans into sub-standard, doubtful and loss categories on the basis of length of time for which an account remains irregular. We may note here that the Indian norm applied so far is softer than the international norm under which an irregularity of 90 days is sufficient for the loan to be classified as irregular. In our case, an irregularity of more than two quarters results in the loan to be classified as sub-standard. The level of provisioning for each category was also mandated. To enable comparability among banks, uniformity in accounting policies was also attempted. These changes provided an opportunity to banks to clean up their balance sheets. Further, apart from disclosure of nonperforming assets, income recognition and capital adequacy, the scope of transparency has been extended to bank's housekeeping aspects such as balancing of books, reconciliation an clearing of old outstanding entries. All of these are part of the Memorandum of Understanding (MOU) agreed between the bank the RBI.

As a result, nationalized banks as a whole showed huge losses amounting to Rs. 8354 crore during two years following the reforms *viz.* 1992-93 and 1993-94. For the public sector banks losses amounted to a somewhat smaller total of Rs. 7717 crore on account of the profits of Rs. 637 crore of the State Bank of India group. Only six banks out of twenty nationalized banks were able to show profits in both the years. This happened largely because banks were required to make large provisions for their irregular advances which they had not been doing before the introduction of the new norms. In 1994-95 the net profit of nationalized and public sector banks was Rs. 269 crore and Rs. 1,116 crore respectively, When provisioning requirements were completed the losses turned into profits but without any material change in banking operations. For those who analyze the performance of the banks in terms of profitability ratios and other financial indicators, the problem is to understand and explain what really is happening. The issue is whether a qualitative change in the working of the banks as is evident in the profit shown by them in 1994-95 an din 1995-96 has occurred or not. If profits do not reflect a qualitative change in operations, they may be an illusion. Further, they may not be sustainable over time. This becomes relevant in the context of the financial results for the year 1995-96 when the net profit of Rs. 2,219 crore of the profit making banks was set off by losses of Rs. 2,592 crore of other loss making banks. It is certainly baffling to find that a Bank which showed the highest losses lst year has become a Bank with the largest profit a year later (1995-96). Only one bank *viz.* Indian Bank reported a massive loss of Rs. 1,336 crore, after showing a net profit of Rs. 14 crore in the previous year. The entire net worth of this bank-capital and reserve-has been wiped out. Among other things yet to be fully unraveled, the negative outcome is apparently the result of not recognizing irregular accounts in time for making the required provisions. This would then imply that just as the profits do not tell the whole story about bank performance, the losses also do not depict the real picture except possibly, that large provisions for irregular accounts as well as for depreciation on Government securities as a result of increase in the yield to maturity (YTM) from 13 percent to 14 percent had to be made during 1995-96.

Norms of disclosure as well as accounting practices prior to reforms had permitted banks to conceal the real worth of assets i.e. the investment and advances portfolios. The Government, in turn, was not particularly bothered about bank profits per se, as it was preempting, at the margin, more than 60 percent of bank resources through the CRR

and SLR route. As is well known, CRR requires banks to hold a portion of their deposits in the form of cash deposits with RBI. The SLR requires banks to invest a portion of their net demand and time liabilities in approved government securities which, until two years ago, used to carry lower than market interest/yield rates. While CRR is a text book recommended and widely practiced instrument of monetary management the world over, mandatory stipulations regarding government securities are not so widespread even though, banks invest in government securities as part of prudent management of their asset portfolio mainly for liquidity consideration. This trend in pre-empting the bulk of the additions to bank resources by the government was linked to financing of government deficits through borrowing from the RBI. Therefore, prudent macro-economic management necessitated that this route of financing government deficits plugged in phased manner. This was done by lowering the SLR/CRR requirements. This, in turn, helped banks to widen the spread between interest earned and the cost of deposit.

The first factor that explains the improved balance sheet performance is the injection of more than Rs. 11,000 crore, into the equity of public sector banks-a major part of it by issue of no marketable recapitalization bonds. This enabled them to earn income without any cost. Therefore, in the macro perspective, the higher earnings are unrelated to bank performance to the extent of interest earned on the bonds.

The second method adopted by the banks to improve asset quality has been through compromise and settlements involving write off or waiver or sacrifice. This has attracted considerable adverse comment from many quarters on the reasoning that it favours the defaulters against the honest borrower. On the other hand, it is also seen as a substitute for lengthy and expensive legal procedures of recovery of non-performing loans. In fact, compromise and settlement may often be the only way of getting back some amount for further recycling.

At the same time, the practices of many bank borrowers in the matter of fund mobilization and utilization are questionable. Diversion of funds to other group companies and utilization for ends other than those for which the money was borrowed is a common feature. While defaulting in one account, the same borrower manages to get more funds in the name of another firm from the same bank or from another bank. The second firm may be part of the same corporate group of promoters. The concept of corporate group lending raises difficult legal and operational problems. The secrecy and confidentiality of the relationship between a bank and its client further add to the problems. Whatever be the reasons and howsoever difficult the solution, the end result is not conducive for financial discipline.

The loan writ off by the public sector banks have been of two types. One is the actual write off where the loan is written off the books. Since provisions were generally made at earlier dates against such loans, the result of the operation is positive on the balance sheet as the provisions can be written back to income or adjusted against new provisions that are required. The non performing advances or the NPAs are taken off the loan portfolio, provisions are not losses. They are a cushion against expected losses. The extent that loans become regular and/or recoveries are made, provisions can give a positive outcome in future. If on the other hand, adequate provisions were not made earlier, then this operation result in a loss for the bank. Banks which had a management culture of making adequate provisions in the past have been able to show higher profits as a result of compromise settlements. On the other hand, it appears that some banks, even now, get away with inadequate provisions. This raises the question of why banks are able to apply the same norm different without being taken to task either by the RBI or by the statutory auditors.

The second type of write off is a technical write off where the account is taken off the books, but efforts to recover continue. This is an in house exercise undertaken at the corporate level and is part of tax planning and financial management. It does not affect operations at the branch level as the branches do not even know which accounts are technically written off. The Lok Sabha was informed that of the Rs. 4,631 crore write off during the period 1991-92 to 1993-94, 36 percent were actual write offs and the remaining were technical/ prudential write offs. The latter were made mostly by the profit earning banks. These distinctions are often lost sight of when general criticisms about banking practices in the matter are sometimes made. It would come as a surprise that a profitable banks that showed the maximum technical write off during 1992-93 and 1993-94.

The third factor that explains the balance sheet performance is the change in accounting norms which have been referred to earlier. These gave losses one year and profits the year after. The results for 1995-96 are more confusing. The changes in accounting norms have made comparability between banks easier, but the changes have neither been uniformly, nor, fully adopted.

Reconciliation of accounts

A factor that needs to be recognized is the reconciliation of accounts is still incomplete and there are large arrears in this respect. Given this situation, the statutory audit of the bank loses its credibility. The balance sheet has to be read along with the notes in fine print which simply state in almost every bank's balance sheet that impact of un-reconciled entries on the profit and loss account is unascertainable. Arrears in reconciliation of a large number of entries for several years cannot be understood or defended. The total amount involved in these entries is also substantial. In this context the point has been raised in many quarters that the statutory auditors of banks must be made to follow uniform practices with respect to the notes to the balance sheet as well. Often the notes in fine print tell the real picture better than the balance sheet itself. The Institute of Chartered Accountants of India has yet to come forward to lay down sound audit and accounting standards for bank audit and there is a long way to go before we reach a situation in which the statutory auditors can be used by the depositors or shareholders for certifying that the accounts give a true picture when in fact it does not do so. A recent example of this in the international context is the case of Bank of Credit and Commerce International. (BCCI).

Non-performing advances

The strength of a bank depends on the quality of its loan portfolio. The quality of the loan portfolio of the banks had deteriorated over time. This was not evident in the financial reports for the reason that accrued interest was booked an income even though it was not received. This not only led to concealment of the true picture regarding loan quality but it

also reduced the recycling of funds and the profitability of bank operations.

The quality of the loan portfolio depends basically upon the lending decisions taken by bank managers. These decisions suffered on account of several factors, of which external and political pressure that were brought to bear upon bank management were probably the most important. These pressures were not limited to loan sanctioning alone, but also to toleration of defaults beyond the limits of commercial prudence. The legal framework for recovery of loans involving lengthy litigations and inordinate delays contributed to slow loan recoveries. Urban land cannot be pledged due to ceiling restrictions and loans against buildings are discouraged. Guarantees of individuals are often difficult to invoke either due to legal hurdles or due to laxity on the part of bank managements at different levels. Pledged securities also, cannot be easily liquidated.

Therefore the important thing to see is the steps taken to improve the quality of the advances portfolio. As on March 31, 1994 the non performing advances (NPAs) of the public sector banks were estimated at a little less than Rs. 40,000 crore. This was 23.6 percent of gross credit. By March 1995, the level has further come down to about 16.8 percent of total advances. The number of banks with a non-performing asset (NPA) portfolio level of 25 percent of more has come down to 10 out to 27 in 1995 compared to 15 in 1993. Furthermore, the additions to NPAs of the nationalized banks were less than the recoveries made by about Rs. 200 crore. We may also note that and NPA is defined as a credit facility where the interest or principal or both, becomes past due, i.e. where the dues remain outstanding for 30 days beyond the due date. An asset is to be treated as NPA if it remains ‘past during for a period of four quarters in the year ending March 1993, three quarters in the year ending March 1994 and two quarters in the year ending March 1996 onwards.

There are two aspects which need to be considered with regard to this trend. The first relates to the application of the NPA criterion. There are indications that the criterion is not uniformly applied by all banks. There is also lack of transparency in this respect. It is not certain whether the system of reporting has fully stabilized as reported figures of individual banks often show results that cannot be fully explained in terms of application of the given norms.

The second aspect relates to the manner in which the reduction has been brought about. The method largely used by most banks has been to negotiate compromise settlement, provide waivers and write off the balance. According to the data provided in the Lok Sabha, in three years between 1991-92 and 1993-94 Rs. 4,631 crore were written off and the rest of it was technical write-off for tax purposes. In 1994-95 the reduction in NPAs was Rs. 670 crore of which only 51 percent was through actual recoveries. The rest was the result of write offs (25 percent) and up-gradation (24 percent).

The process of write-off and sacrifices had the potential of becoming another scam in the financial sector. However, the process has somewhat halted in 1995-96 because of the adverse publicity and comment that it generated. The practice of write-offs and fives erodes financial discipline and encourages willful default. It induces even discipline borrowers to default. As a result, several malpractices in the utilization of funds have become more frequent now than they were before in particular extensive diversion and siphoning of bank funds on a fairly large scale has become a common feature, about which banks in general have failed to take any action.

The real issue is how to improve credit quality. This requires several steps at different levels. The first is to review the credit appraisal system within the banks to ascertain whether they are adequate to meet the challenges or not. For such a system to exist within the bank, analysis of data is essential. While each bank may have rich experience or taking decisions much of it remains an undocumented part of operations unfortunately, the research and analysis wings of banks are nor among their stronger units. Computerization of data could have helped but it does not appear to be used for this purpose. Economists, by and large, are not familiar with several operational aspects and banks are mostly concerned with operational performance and have little time for economic analysis issues.

Secondly, adequate recovery procedures are necessary for improving credit quality. As of now, public sector banks do not have the powers that the state financial corporations or even the co-operative banks, have in the matter or recovery of dues. In fact, a bank manager has less powers in this regard than a tehsildar in the village. The Government of India have set up debt recovery tribunals, but they have had very little impact so far. In fact, some have not yet started functioning as even the minimum required office space has not been procured.

Lastly, quality of the loan portfolio depends upon the internal management banks. Risk management is an area where the skills of bank personnel need further strengthening. Staff morale is also a significant factor in so far as a low staff morale reduces the willingness to take even the normal risks associated with business decisions.

This brings us to another aspect of banking operations which is under considerable strain. This is the aspect of personnel and human resource management. There can be no denying the fact that for a bank the most important asset is its human resources- the officers and employees. The size of the above force in the sector grew enormously after nationalization. Impact of these operation on the balance sheet of the banks could not have been positive even though expansion particularly of the rural network has indeed been quite phenomenal. However, the problems in human resource management are the result of this expansion. Public sector operation on such a vast scale, in-enably led to regulatory systems of personnel management that have hampered the autonomy of individual banks. It has also led to centralized negotiating frameworks between the banks and its staff. The soft state and the soft budget constraints have together taken away the force of commercial consideration from banking operations Bank employees have become an important to emolument packages from time to time. The trouble is not with the package itself, which is quite favorable when compared to other with the private sector. The real trouble is with the outcome, which is that performance. Efficiency and profitability have very little influence on what is given. Once accepted at the centralized level, there is complete socialism in this respect within the sector. Everyone gets the benefit irrespective of any efficiency consideration. Bank managements, in turn, have no autonomy and very little say in the matter of recruitment and personnel policies.

Conclusion

All these are determined either by the Ministry of Finance or as a result of negotiated settlements at the industry/sector level. The centralization also affects some aspects of banking policy (e.g. interest rate structure) in which banks are asked to be autonomous and take individual decisions. Questions that have to be sorted out now are questions of autonomy of management's vis-à-vis the Ministry of Finance or vis-à-vis the Indian Banks Association or the centralized staff associations. Autonomy will require that each bank be allowed flexibility and autonomy subject only to broad guidelines regarding all these matters. Is the government ready for this? The organizational challenge before the public sector banking system is the real challenge as it is the hardest to tackle within the given political framework.

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