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CHAPTER- 2
NON-PERFORMING ASSETS- AN OVERVIEW

2.1 Introduction to Risk

William James says, “It is only by risking our persons (entrepreneurs) from one hour to another that we live at all”. Any new business is exposed to risk. The businessmen may succeed or they may fail. Risk taking implies assuming the responsibility for loss that may occur due to unforeseen events of the future. Risk taking is the specific function of businessmen. He visualizes new opportunities in taking the risks.

In simple words, ‘risk’ is the condition of not knowing the outcome of any activity or any decision. It is the state that exists when the probability of success is less than 100%. If the decision is the wrong one, the businessman may lose money, time, reputation or other important assets. A ‘risk’ is any event that could prevent the project realizing the expectations of stake holders. Risk generally means that the problem and the alternative solutions fall somewhere between the extremes of being certain and being ambiguous. ¹

The term “Risk” is derived from an Italian term “Risicare”, which means “To dare”. In this sense risk is a choice rather than a fate. The further analysis of the term risk says that it is not something to be faced but it is a set of opportunities open to choice. In modern sense, risk is generally interpreted as “The Danger or Loss”. The term risk is associated with loss that is expected to be incurred due to happening or non-happening of certain events or activities. Various experts have tried to define the term ‘risk’. Some of them say that risk is a measureable uncertainty where as the others say that risk is the ambiguous situation where the outcome of an action or decision is not certain. Some other experts have considered ‘risk’ as the chance of loss or injury. The modern experts believe that the risk is the variability of outcomes or returns.

In this age of high-risk, it is important to manage the risk. Risk management is actually the management of uncertainty, risk, equivocality and error. All these are the drivers of unexpected outcomes. The following diagram shows that the uncertainty

¹ Sudha, G.S. (2007), Dynamics of Business Entrepreneurship, RBSA Publishers, Jaipur, pp. 62
arises because of lack of information. As the information increases, the uncertainty decreases. Lack of knowledge leads to risk. Risk can be reduced by increasing the knowledge. Equivocality is the result of lack of judgment. If a decision maker has more capacity of taking judgments, the equivocality reduces. Error is the result of lack of care. If more care is taken in any activity, the chances of error reduce.²

Chart 2.1

Chart Showing Drivers of Unexpected Outcomes

² Goyal, Anoop (2008), Risk Management in Indian Banks, Ritu Publications, Jaipur, pp. 101
2.2 Introduction to Risk in Banking

Risk is all pervasive. Everybody is exposed to some kind of risks in routine life. The degree of risk may vary from person to person. Banking sector is not an exception to it. In conducting banking business, banks and financial institutions assume risk. They assume the risk in terms of return on their investments. There is a possibility of risk of loss of profitability. This loss can be categorized into two i.e. expected losses and unexpected losses. Expected losses are those that the banks know with reasonable certainty and are reserved for in some manner. Unexpected losses are those that occur due to some unforeseen event. Besides this, banking sector faces various risks such as financial and non-financial risks viz. credit risk, interest risk, foreign exchange rate risk, liquidity risk, equity price risk, commodity price risk, legal risk, regulatory risk, reputation risk, operational risk and many more. These risks are highly interdependent events that affect the bank or financial institutions. For controlling the risk in banking and financial sector, an effective risk management system has to be implemented. Generally, a banking business itself is a business of taking risk. A banking business has to face various types of risks, which can be classified as follows:

Table – 2.1
A Table Showing Possible Risks Facing a Bank

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<th>Type of Risk</th>
<th>Possible Risk Events</th>
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<td>Procurement: Alternative Source Identification, Quality of Parts, Stock Exchanges, Supplier Profile</td>
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<td>Currency: Non-Convertible of Currency, Economic Factors, Transaction Risk, Translation Risk, Mismatches, Volatility</td>
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<td>Interest Rates: Basis Risk, Parallel Yield Curve Shifts, Twists in Yield Curve, Incorrect Day Count Basis</td>
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### 2.3 Classification of Risk in Banking

Risks manifest themselves in many ways and the risk in banking are a result of many diverse activities, executed from many locations and by numerous people. The volatile nature of the bank’s operating environment will aggravate the effect of these risks. Based on the origin and their nature, risk can be classified in to following categories:

- **2.3.1 Liquidity Risk**
- **2.3.2 Interest Rate Risk**
- **2.3.3 Market Risk**
- **2.3.4 Default or Credit Risk**
- **2.3.5 Operational Risk**

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*Goyal, Anoop (2008)*, Risk Management in Indian Banks, Ritu Publications, Jaipur, p. 112
Chart 2.2
A Chart Showing Classification of Risks in Banking

2.3.1
LIQUIDITY RISK
- FUNDING RISK
- TIME RISK
- CALL RISK

2.3.2
INTEREST RATE RISK
- GAP/MISMATCH RISK
- YIELD CURVE RISK
- BASIC RISK
- EMBEDDED OPTION RISK
- RE-INVESTMENT RIKS

2.3.3
MARKET RISK
- FOREX RISK
- MARKET LIQUIDITY RISK

2.3.4
CREDIT RISK
- COUNTER PARTY RISK
- COUNTER RISK

2.3.5
OPERATIONAL RISK
- TRANSACTION RISK
- COMPLIANCE RISK
- STRATEGIC RISK
- REPUTATION RISK
2.3.1 Liquidity Risk
This risk arises from funding of long-term assets by short term liabilities, thereby making the liabilities subject to rollover or refinancing risk. The liquidity risk is defined as the inability to obtain funds to meet cash flow obligations. Liquidity risk is very crucial for the banks because the financing capacity of the banks depends upon liquidity. If the liquidity is low, the banks cannot fulfill the demands of loans. So, the banks must try to reduce this liquidity risk. The liquidity risk can take following dimensions.

2.3.1.1 Funding Risk:
This risk arises from the pre-mature or unanticipated withdrawal of the deposits. Generally pre-mature or unanticipated withdrawals take place when there is rumor about creditworthiness of the bank. Because of pre-mature withdrawal of the deposits, the bank is put into tight corner and it cannot finance new projects or it cannot give loan to other parties.

2.3.1.2 Time Risk:
This risk arises from non-receipt of expected inflows of funds. Generally this risk arises when the performing assets turn into non-performing assets. When the bank has estimated the expected inflows of fund, it has planned out to give loans or to invest such funds elsewhere, but when this inflow does not arise, the planning of banks is failed.

2.3.1.3 Call Risk:
This risk arises when a bank has no enough funds to give advances to a profitable business or project. When the bank itself is facing the financial crunch, it cannot give loans to even a profitable business. In this situation, the bank looses a good opportunity to earn profit.

2.3.2 Interest Rate Risk
Interest risk refers to potential impact of net interest income or net interest margin or market value of equity caused by unexpected changes in market interest rates. Interest rate risk arises because of the exposure of a bank’s financial conditions to adverse movements in interest rates. When there is unanticipated change in the
market interest rate, the bank has also to change the interest rates for its loans and advances. In such situation, the bank may lose some amount of interest.

2.3.2.1 Gap or Mismatch Risk:
This risk arises when the bank receives a deposit for long term and pays high rate of interest. Out of this received deposit, it gives loan for short term and receives low rate of interest. The difference between interest received and interest paid is termed as gap or mismatch risk.
For example, a bank receives deposit maturing in two years at 10% interest and out of this deposit it gives loan for 3 months at 8% interest. The mismatch between these two interest rates is known as gap or mismatch risk.

2.3.2.2 Yield Curve Risk:
In a floating interest rate scenario, banks may price their assets and liabilities based on different benchmarks, i.e. Treasury Bill’s Yield, FD Rates, Call Money rates, LIBOR etc. In case the banks use two different instruments maturing at different time horizons for pricing their assets and liabilities, any non-parallel movements in yield curves would affect the net interest income. The movements in yield curve are rather frequent. Thus, banks should evaluate the movement in yield curves and the impact of that on the portfolio values and income.

2.3.2.3 Basic Risk:
When there is a difference between interest rate of different assets and interest rate of different liabilities, such difference creates basic risk.
For example, in a rising interest rate scenario, interest rate of assets may rise in different magnitude from the interest rate of corresponding liability. This creates variation in net interest income. Such risk is termed as basic risk.

2.3.2.4 Embedded Option Risk:
In a volatile market, significant changes in market interest rates become the source of risk to banks profitability by encouraging pre-payment of cash
credit, demand loans, term loans and exercise of call/put options on bonds/debentures or pre-mature withdrawal of termed deposits before their stated maturities. The embedded option risk arises because of faster and higher changes in interest rates. The result is reduction of projected cash flow and income for the bank.

2.3.2.5 Reinvestment Risk:
Uncertainty with regard to interest rates at which at future cash flows could be reinvested is called reinvestment risk. Market rate of interest moves in different directions and it creates variations in net interest income. Such variation causes reinvestment risk.

2.3.3 Market Risk
Such risk arises due to adverse deviations of the market-to-market value of the trading portfolio. This risk arises due to adverse movements in the level or volatility of the market prices of the interest rate instruments, equities, commodities and currencies. The market risk is also known as price risk. The market risk/price risk takes the following forms.

2.3.3.1 FOREX Risk:
This risk arises because of adverse movements in exchange rates. Generally bank faces such risks when it has made investment abroad. At the time of investment the rate of foreign exchange may be higher and they may turn downward at the time of maturity of such investment. This creates loss in return. Such risk is known as FOREX risk.

2.3.3.2 Market Liquidity Risk:
When the bank has made large scale investment in marketable securities, it desires to generate good return out of this investment. But there are chances that the rate of interest at the time of investment may be higher which turns downward at the time of withdrawal. Such difference in the value of investment is known as market liquidity risk.
2.3.4 Default or Credit Risk
This risk is created because of the failure of bank borrowers to meet their obligations in accordance with agreed terms. Generally when the borrowers make default in the payment of their obligations, such risk arises. Default or credit risk generates the non-performing assets in the banks. Such risk is the most dangerous for the banks. Default or credit risk manifests following dimensions.

2.3.4.1 Counter Party Risk:
This risk is related to non-performance of the trading partners due to counter party’s refusal or inability to perform.

2.3.4.2 Country Risk:
This type of risk arises where the non-performance of a borrower or counter party is due to constraints or restrictions imposed by the country of borrower’s domicile. Such risk arises because of external constraints which are not within the control of either the bank or the borrower.

2.3.5 Operational Risk
Operational risk arises due to inadequate or failed internal system. Lack of staff, lack of internal management, lack of system etc. causes such risk. Such risk includes transaction risk, compliance risk, strategic risk and reputation risk.

2.3.5.1 Transaction Risk:
Transaction risk arises from fraud, failed business processes and inability to maintain the business continuity and to manage information.

2.3.5.2 Compliance Risk:
This risk arises because of non-performance of legal or regulatory formality. The non-performance of such formalities creates loss of reputation. When the bank breaks applicable laws, regulations, codes of conduct or standards of good practice, such risk arises. Such risk is also known as integrity risk.
2.3.5.3 **Strategic Risk:**
This risk arises from wring business decisions, improper implementation of decisions or irresponsiveness to industry changes. When the bank cannot make its strategic goals compatible to the changes in industry or market, it has to face the loss of some good business opportunities. The loss of such good business opportunities is known as strategic risk.

2.3.5.4 **Reputation Risk:**
When the bank has to face litigation because of non compliance with some laws or regulations, its reputation is down cast. Because of the loss of reputation, the banks may lose some good projects or business opportunities. Such loss is termed as reputation risk.

2.4 **Introduction to Non-Performing Assets**
Assets mean valuable resources or properties owned by an organization. The organization utilized this assets in an efficient manner to their full capacity to attain the main goals of the organization i.e. income yield, improving productivity and profitability.

Optimizing the performance of assets is the most important part of overall asset management. In order to assess the performance of any organization, the efficiency of its assets should be analysed. The focus has shifted from nearly an asset management to asset-liability management (ALM) in order to achieve the optimum efficiency of the organization.

For the banking sector, efficient management of its assets is of principal importance because banks are the custodians of public funds and they lend other people’s money. To protect the interest of the public as well as the banks itself, deliberate efforts are needed for efficient asset management. If the assets and liabilities of the banks are not managed in well manner, it can cause a serious problem for bank as well as for the society as a whole. In order to increase profitability of the banks, serious efforts are required for managing the assets and liabilities of the banks. If the assets are not managed in an appropriate manner, they turned to non-performing state. Such assets are generally termed as ‘Non-Performing Assets’. In the field of bank, non-performing assets include non-performing cash and bank balances, non-performing loans and advances,
interest on which is not realizable.\textsuperscript{5} If the amount of such non-performing assets increases, it can cause serious problem for the bank. In the current age most of the banks are facing the problem of non-performing assets. It has become a serious concern for the bankers. The alarming situation of non-performing assets is an issue of concern not only to the bank management but also to the authorities regulating the working of the banks and to the policy makers at the national level.\textsuperscript{6} The figures published by ‘CARE’ shows that the problem of non-performing assets has been a burning issue for the entire banking sector. Moreover, it has been observed that the non-performing assets in public sector banks are higher than that of private sector banks and foreign banks working in India. ‘CARE’ has supported this argument in its research report. As per their survey the overall Gross NPAs of the banks as on 31\textsuperscript{st} March, 2011 stood at Rs.91,410 crore, of which Rs.74,615 crore was on the books of public sector banks, which is approximately 81.63\% of the total NPAs this is really an alarming situation of non-performing assets in banking sector.

2.5 Emergence of the term ‘Non-Performing Assets’ (NPA)

In human life, sickness, bankruptcy and death are not welcome, but they do occur. So is the case with industrial or agricultural units, which fall sick, go into liquidation and die much against the wishes of all concerned. Realities cannot be escaped; it is necessary to face them. In the context of NPA’s, the situation is no different.\textsuperscript{7}

In the current age the term ‘non-performing assets’ is the highly discussed issue in the banking and financial sector. All the management thinkers, policy makers and strategists are discussing this issue on a high scale. But actually the non-performing asset is not a new concept. It was in existence in olden days also without having a proper coinage of the term. A non-performing asset in the banking sector was termed as an asset not contributing to the income of the bank. In other words it is a ‘zero-yielding asset’. The zero-yielding assets include surplus cash and banker’s balance held over the norms, amount lying in suspense account, investments in shares or debentures of companies not

\textsuperscript{5} Bhagavat, T.K.K. (1990), paper titled “Management of Non-Performing Assets in Banks”, p. 351
\textsuperscript{6} Singh, Kanahaiya (1990), paper titled “Management of Non-Performing Assets”, pp. 386-387
\textsuperscript{7} Godse, V.T. (1990), paper titled “Management of Non-Performing Assets”, p. 373
yielding any dividend or interest, advances where interest is not realized and even the principal amount is difficult to recover.\textsuperscript{8}

In Indian banking sector also the concept of NPA is not new. In olden days the assets were classified into eight categories as follows:

a) Satisfactory  
b) Irregular  
c) Sick-viable under nursing  
d) Sick-non-viable/sticky  
e) Advances recalled  
f) Suit filed accounts  
g) Decreed debts  
h) Debts classified by the banks as bad/doubtful

Out of these eight categories last four categories were deemed to be non-performing loans. It is interesting to note that this classification was left to the discretion of each bank and there was no objective attempt to segregate bad-loans from good loans.\textsuperscript{9}

In the year 1991, The Narasimham Committee on Financial Sector Reforms (CFSR) and in the year 1998, The Narasimham Committee on Banking Sector Reforms (CBSR) focused on this zero- yielding assets. The committee created various norms for the zero-yielding assets and the new term “Non-Performing Assets” was coined by the committee. The term “Non-Performing Assets” is now widely used in the banking sector. It has become a burning issue of the modern age of the banking industry.

The term non-performing assets can be defined both in the wider and the narrow sense. While in the narrower sense, it includes only non-earning credit portfolio, in the wider sense it may include also the volume of unutilized cash balances and unutilized or underutilized physical assets like building and premises. In the wider sense it may also include non-performing human resources-a large volume of work force not effectively utilized.\textsuperscript{10} This is the generalized definition of the non-performing assets but the present research is focused on the norms developed by RBI on the basis of recommendations given by The Narasimham Committee.

\textsuperscript{8} Ahuja, P.L. (1990), paper titled “Management of Non-Performing Assets”, p. 413
\textsuperscript{9} Krishna Murthy, G. (2007), paper titled “Control of NPAs in Commercial Banks”, p. 83
\textsuperscript{10} Gupta, M. (1990), paper titled “Management of Non-Performing assets: Some Issue”, p. 409
In order to quantify NPA problem, The Narasimham Committee, 1991 made it mandatory on the part of the banks to publish annually the magnitude of NPAs. According to The Narasimham Committee, 1991 NPAs are those categories of assets (advances, bills discounted, overdraft, cash credits etc...) for which any amount remains due for a period of 180 days.\(^{11}\)

### 2.6 Meaning and Definition of NPAs

A non-performing asset, in a narrow sense, may be defined as an asset which does not directly contribute to the corporate profits or yield any positive returns. This may be appropriate when applied to loans and advances. However, there are other assets such as cash balances held which are certainly require for business operations but do not yield any direct return. Although banks cannot completely do away with such non-performing assets from their books, they have to manage to keep them at a minimum possible level to maximize profits.\(^ {12}\) The term non-performing asset has been defined by several experts, SARFAESI Act and RBI on the basis of recommendation of Narasimham Committee.

1) Mohan, B. and Rajesh, K. defined “A non-performing asset is one which does not generate income for the bank. In other words an advance account which ceases to yield income in a non-performing asset.”\(^ {13}\)

2) Lakshman, U.N defined NPA as “an advance where payment of interest or repayment of installment on principal (in case of term loans) or both remain unpaid for a period of 2 quarters or more and if they have become “past due”. An amount under any of the credit facilities is to be treated as past due when it remains unpaid for 30 days beyond due date”.\(^ {14}\)

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\(^ {13}\) Mohan, B. and Rajesh, K. (2007), paper titled “Management of non-performing assets in institutional agencies”, p. 9

3) Reddy, C.S. and Kalavathi, V. defined NPA as “an asset which ceases to yield income for the bank and that any income accrued from such asset shall not be treated as income until it is actually realized”.\textsuperscript{15}

4) SARFEASI Act, 2002 defined NPA as “an asset or account of borrower, which has been classified by a bank or financial institutions as sub-standard, doubtful or loss assets in accordance with the direction issued the Reserve Bank of India”.

5) As per RBI guidelines advances are classified into performing and non-performing advances (NPAs). NPAs are further classified into sub-standard, doubtful and loss assets based on the criteria stipulated by RBI.

\textit{An asset, including a leased asset, becomes nonperforming when it ceases to generate income for the Bank.}

An NPA is a loan or an advance where:

- Interest and/or installment of principal remains overdue for a period of more than 90 days in respect of a term loan.
- The account remains "out-of-order" in respect of an Overdraft or Cash Credit (OD/CC).
- The bill remains overdue for a period of more than 90 days in case of bills purchased and discounted.
- A loan granted for short duration crops will be treated as an NPA if the installments of principal or interest thereon remain overdue for two crop seasons.
- A loan granted for long duration crops will be treated as an NPA if the installments of principal or interest thereon remain overdue for one crop season.

The Bank classifies an account as an NPA only if the interest imposed during any quarter is not fully repaid within 90 days from the end of the relevant quarter. This is a key to the stability of the banking sector. There should be no hesitation in stating that Indian banks have done a remarkable job in containment of non-performing loans (NPL) considering the overhang issues and overall difficult environment.

\textsuperscript{15} Reddy, C.S. and Kalavathi, V (2007), paper titled “Non-Performing Assets in Banks-Causes and Remedies”, p. 60
In fact, recovery management is also linked to the banks’ interest margins. The cost and recovery management supported by enabling legal framework hold the key to future health and competitiveness of the banks. No doubt, improving recovery-management in India is an area requiring expeditious and effective actions in legal, institutional and judicial processes.

In 2001 the norms of recognizing the NPA were somewhat liberal but in 2004 the RBI revised the norms and made them stricter. Below given is the comparative presentation of RBI guidelines for NPAs recognition.

Table 2.2
RBI Guidelines for NPAs Recognition

<table>
<thead>
<tr>
<th>Loans &amp; Advances</th>
<th>Guidelines applicable from 31-3-2001</th>
<th>Guidelines applicable from 31-3-2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan interest and/or installment remain over due for more than</td>
<td>180 days</td>
<td>90 days</td>
</tr>
<tr>
<td>Overdraft/credit account</td>
<td>Remains out of order</td>
<td>Remains out of order</td>
</tr>
<tr>
<td>Bill purchased and discounted remains over due for more than</td>
<td>180 days</td>
<td>90 days</td>
</tr>
<tr>
<td>Agricultural loan interest and/or installments remains over due for</td>
<td>Two harvest seasons but not exceeding two and half years</td>
<td>Two harvest seasons but not exceeding two and half years</td>
</tr>
<tr>
<td>Other accounts-any amount to be received remains over due for more than</td>
<td>180 days</td>
<td>90 days</td>
</tr>
</tbody>
</table>
2.7 Classification of Non-Performing Assets

For the evaluation of bank performance, it is important to identify the quality of assets of the bank. In the light of Narasimham Committee recommendations, the Reserve Bank of India has redefined the non-performing assets and advised all commercial banks in public sector, old and new private sector banks, development banks and the co-operative banks, to classify their advances into four broad categories i.e. Standard, Sub-standard, Doubtful and Loss assets. The standard assets are treated as performing assets and the remaining three categories are treated as non-performing assets.

With reference to master circular No. DBOD. No. BP. BC. 17/21.04.048/2009-10 dated July 1, 2009 banks are required to classify nonperforming assets further into the following three categories based on the period for which the asset has remained nonperforming and the realisability of the dues:

2.7.1 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 jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

2.7.2 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.

2.7.3 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.
2. Sector wise classification of NPAs:

As per the guidelines of RBI, the NPAs in banks of India may be classified in to two categories, such are:

- Priority sector NPAs, further it may classify in to agriculture sector, small scale industries (now it is broadly covered as MSME sector), and others.
- Non-priority sector NPAs, further it may classify in to public sector and others.

The reality of NPAs in public sector banks is shown in the following table. For better understanding, public sector banks are categorized in to nationalized banks and SBI and its associates.

<table>
<thead>
<tr>
<th>Year</th>
<th>Nationalized Banks</th>
<th>SBI and its’ Associates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Priority sector</td>
<td>Non-priority sector</td>
</tr>
<tr>
<td>As on 31st March</td>
<td>[Rs. in Crores]</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>16,886</td>
<td>18,402</td>
</tr>
<tr>
<td>2004</td>
<td>16,705</td>
<td>17,895</td>
</tr>
<tr>
<td>2005</td>
<td>16,381</td>
<td>16,225</td>
</tr>
<tr>
<td>2006</td>
<td>15,124</td>
<td>12,845</td>
</tr>
<tr>
<td>2007</td>
<td>15,779</td>
<td>9,965</td>
</tr>
<tr>
<td>2008</td>
<td>16,385</td>
<td>7,941</td>
</tr>
<tr>
<td>2009</td>
<td>15,871</td>
<td>10,001</td>
</tr>
<tr>
<td>2010</td>
<td>19,908</td>
<td>15,283</td>
</tr>
<tr>
<td>2011</td>
<td>25,678</td>
<td>16,957</td>
</tr>
<tr>
<td>2012</td>
<td>32,290</td>
<td>33,487</td>
</tr>
</tbody>
</table>

Source: RBI Website (http://www.rbi.org.in/scripts/PublicationsView.aspx?id=14693)
2.9 Reasons for Growing NPAs

The banking sector all over the world is facing the problem of mounting NPAs. The rate of growth of NPAs is such a high that it has become the matter of concern for the bankers. The bankers are investigating the reasons for such high growth rate of NPAs. Following are some of the reasons for the high growth rate of NPAs.

2.9.1 Inability and unwillingness of the borrower to pay:

Sometimes the borrower takes the loan from the bank in a large amount but they are unable to repay the same or sometimes they are unwilling to repay the amount. Such amount is not realized back by the bank and as a result the NPA is created. Sometimes willful defaults, frauds and misappropriations of accounts by the borrowers also results in NPA.

2.9.2 Mismanagement and diversion of funds:

Because of the mismanagement of the fund or because of diversion of the investment, the fund is invested in low interest securities or the securities that don’t pay any interest. Such kind of investment creates the NPA.

2.9.3 Failure of the activity:

When the borrower has taken the loan for any specific business activity and that very activity fails, the borrower is unable to repay the loan. This creates NPA in the bank.

2.9.4 Recessionary market trend:

Because of the effect of economic cycles, the profits of the firm decreases. In the situation of recession, the firm is not able to generate enough revenue and it is unable to repay the borrowed fund. When the recession becomes very stiff, it results into the bankruptcy of the firms, which results into NPAs for the banks. Recently such situation was faced in America when the Lehman Bros. filed the bankruptcy; it created NPA in several banks over there from which the Lehman Bros. had taken the loan.
2.9.5 **Improper selection of borrowers/activities:**
Sometimes the banker makes the mistake in the selection of borrower or the business activity. When the less creditworthy borrower is selected by the bank, the amount given as a loan does not realize back and the NPA results.

2.9.6 **Selection of borrower under influence:**
For the banks RBI has issued guidelines for sanctioning the loans. Banks have to compulsorily follow these guidelines but sometimes the banks have to act under the political pressure and relativism. The banks sanction the loans to such less creditworthy borrowers. The amounts of such loans are not recovered and consequently the NPA is created. Generally such cases happen more in co-operative banks.

2.9.7 **Lack of proper pre-appraisal and follow-up:**
According to RBI guidelines, the banks must appraise the project report before sanctioning the loan to any borrower. But sometimes the banks do not perform proper appraisal of the project reports. Without such pre-appraisal, the loan is sanctioned. In addition to it, proper follow-up is also not taken by the bank. In such situation the bank does not get the installments regularly and sometimes such loan is converted into NPA.

2.9.8 **Non-compliance of sanction terms and conditions:**
The banks must follow the terms and conditions provided by the RBI for sanctioning the loan. In some cases, the banks do not comply with this terms and conditions and they sanction the loan. In such cases, there are chances of NPAs.

2.9.9 **Inadequate/excess sanction of the loan:**
While sanctioning the loan, the bank must consider the economic size of the unit to which the loan is to be sanctioned. In some cases, bank does not consider the economic size of the unit and sanction the loan. If the amount sanctioned is inadequate for the business, the business will face the financial crunch and it will not survive for longer. It will result into NPAs for the bank. On the other hand if the excessive amount is sanctioned as a loan to the smaller unit, it will not be able
to utilize the fund effectively. It will not be able to generate enough cash flow to repay the amount of loan and ultimately it will result into NPAs.

2.9.10 Unrealistic repayment schedule:
The schedule for the repayment of the loan should be prepared after considering two main things i.e. the amount of loan and the repayment capacity of the borrower. Sometimes the bank makes the mistakes in preparing the repayment schedule for some borrowers. It creates overburden on such borrowers and they are unable to repay the amount according to the prescribed schedule. They face the financial crisis and ultimately turn to liquidation.

2.9.11 Lack of inter-bank co-ordination:
When there is lack of inter-bank co-ordination as well as lack of co-operation with financial institutions, there is no exchange of information of the solvency of the borrowers. Because of this the borrowers make default in more than one bank. As a result one borrower becomes the cause of NPA in many banks.

2.9.12 Factors Internal to the business:
The business of the borrowers fails due to certain internal factors such as inefficient management, inefficient marketing, inappropriate technology, labour unrest, etc. When the business of the borrower fails, he is not able to repay the borrowed amount. This creates NPAs in the banks.

2.9.13 Highly Ambitious Projects:
The borrowers take the loans for establishing the projects. They over-estimate the return on Investment on such projects. And because of that they prepare the tight re-payment schedule for the loans taken by them. In reality the project does not generate that much return and the borrower is not capable to repay the loan. This results into NPAs in the banks.

2.9.14 Unhealthy Competition:
Sometimes the businessmen enter into cut throat competition. When they enter into price base competition, they suffer a loss. Because of such loss they are not capable to repay the amount of loan. This results into NPAs in Banks.
2.9.14 Cost overruns during the project implementation:
Because of inflationary trends the cost project increases over and above the estimation of the cost of project before starting it. The loan taken by the businessmen is not enough for such project. The project experiences financial crisis and it is not able to repay the loans. This creates NPAs in the banks.

2.9.15 No fear of legal action under the present complex legal system:
In India, when a borrower makes the default in the repayment of the loan, legal actions are taken against him. But the legal procedure is too much complex. The procedure runs for year long and judgments are delayed. Such kind of legal system does not create any fear in the mind of borrower and they are not hesitant to make the default in the repayment of the loans. They willingly create the default. It results into NPAs in the banks.

2.9.16 Government policy for financing priority sector:
For making growth and development of the Indian economy and to maintain the regional and sectoral balance, the government has selected some priority sector. According to the government policy, public sector banks have to give loans to this priority sector at a low rate of interest and sometimes loans are subsidized. This is the direct loss to the bank. In addition to it, these priority sectors do not work efficiently and hence are not capable to repay the loans. This creates NPAs in public sector banks. As per the RBI guidelines, the NPAs are classified into two categories viz. priority sector and non-priority sector. This is enough evidence that RBI itself accepts that there are more chances of NPAs in priority sector.
2.10 Suggestions for Reducing Non-Performing Assets

The non-performing asset is like termite which eats the whole financial system. If this termite is not controlled, it will be dangerous for the financial system. The government has taken several policy decisions and has prepared several strategies to control the high rate of NPAs in the banking sector. But these steps have not created desired effect on the rate of NPAs. Here are some suggestions for reducing non-performing assets. If these suggestions are implemented effectively, they will be helpful for reducing NPAs with immediate effect.

2.10.1 Proper selection of borrower/activity:
When the borrower/activity is wrongly selected, it definitely results into NPAs. To reduce this danger, the banks should take enough care in selection of the borrower/activity. For this the bank should perform an in-depth investigation about the creditworthiness of the borrower. The bank must collect as much information as possible. After making thorough analysis of this information, the bank should take the decision whether to sanction the loan or not.

2.10.2 Regular post-sanction follow up:
Generally it happens that after sanctioning the loan, banks do not take any follow up of the borrower. Lack of regular follow up makes the borrower careless in the repayment of loans. And it results into default. To remove this danger, the bank must take regular follow up of the borrower after sanctioning the loan. Follow up taken at a regular interval will keep the borrower alert and the chances of default will be reduced. Reporting to the top level management of the bank about the repayment schedule of the borrower should be done regularly.

2.10.3 Establishment of a recovery cell:
The efforts made by the banks to recover the amount of loan are not enough. In this situation the amounts of NPAs are continuously rising. The bank should form a special recovery cell to recover the outstanding amount of loan. This recovery cell is responsible to recover the outstanding loans. For this, the recovery cell is empowered to take necessary steps to recover the outstanding loans.
2.10.4 **Publishing the name of defaulters in local news papers:**

This can be an effective step for recovering the outstanding loans from the defaulters. The banks should publish the names of such defaulters in the local newspapers with outstanding amounts. This will affect the dignity of such defaulter and there are chances that they may repay the amount of loan. This will be a helpful step for other banks also. By considering the names of defaulters, other banks would not sanction loans to such defaulter.

2.10.5 **Set up a group of auctioneers:**

Generally the assets that are kept as security are auctioned to recover the amount of default. But there are no bidders to purchase such moveable or immovable property due to the fear of the defaulters. Because of this the bank can not realize the full amount of default. In such case the bank should assign such case to a special group of auctioneer that will find out an appropriate bidder so that the full amount of default can be realized by selling the securitized property held with the bank.

2.10.6 **Constant touch with persons trading with the borrower:**

To know about the creditworthiness of the borrower and to obtain market report in regard to his trade dealings and solvency, the bank should keep a touch with the persons trading with the borrower. By this the bank can take immediate steps as and when some negative information about the borrower is received from the market.

2.10.7 **Setting up of credit investigation and information agency:**

The banks should establish an agency which is assigned the duty to investigate about the creditworthiness of the borrowers. The information obtained by such agency should be easily accessible by all the bankers. This will be helpful in the selection of borrowers. Before sanctioning the loan, such agency should be contacted to obtain the information about the creditworthiness of the borrowers. This will reduce the chances of wrong selection of borrower.
2.10.8 Legislative changes:
The government should pass some legislation in the direction of effective recovery of outstanding loans. By passing the legislation, recovery tribunals, recovery cell, lok-adalatas etc. should be given more authority and they should be made autonomous institutions. If they have more power to recover the outstanding loans, they can take immediate and effective steps for the recovery. This kind of institutions will be helpful for the banks to make the legal recovery of outstanding loans.

2.10.9 Interest discounts for prompt repayments:
To reduce the NPAs, the bank should start some schemes under which the defaulters are given a special interest discount if they make the prompt repayment of the outstanding amount. This step may be helpful to recover the outstanding amount from those defaulters who have sense of market credit.

2.10.10 Asset Reconstruction Fund:
The NPAs of weak banks may be transferred to state owned asset reconstruction fund (ARF), managed by an independent private sector firms. The ARF will buy the NPAs from the weak banks at a price it decides. Its objective will be to make profits out of deals. It is just like business buying impaired loans, recovering them and in the process, making profits.17

2.10.11 Pro-active steps by banks:
To reduce the chances of NPAs, banks should be pro-active in recognizing sickness and then going to the courts for obtaining relief, before the borrower could take the shelter of BIFR proceedings. The lending bank should initiate action as soon as the total loss crosses half of the net worth. Banks should not wait till they wipe out the entire net worth.

2.10.12 Delegation of more power to branch manager:

The branch managers do not have more powers to undertake strict recovery of loans. Because of this, though it is possible branch manager cannot do anything due to lack of power. If the branch managers are assigned more power, they can perform strict recovery of such loan and the chances of NPAs would reduce. The branch manager should given the power to take over or realize securities charged to them for the recovery of loans without going to courts. This provision will reduce court cases and the recovery will be quick.
2.11 Non-Performing Assets Recovery Mechanism

Reduction in NPAs is the most important task for the banks. It is the burning issue for the RBI as well as the Government of India to control the NPAs. The government of India has taken certain steps for reducing NPAs of the Indian banking sector. For this, the government has established a recovery mechanism that involves the following steps.

2.11.1 Sending reminders and visiting the borrower’s business premises/residence:

The banks should take continuous follow – up for collecting the advances. The bank should adopt the policy of “the older the advances, the tighter the follow – up. The bank should send reminders to the borrowers on a periodical basis or the bank should visit the premises of the business or the residence of the borrowers. The bank should make it a point that the reminders are sent on time and without fail. Frequent visits should be taken in the case of hardcore borrowers. The visit should not be only the formality but it should bring some quality results.¹⁸

2.11.2 Recovery camps:

In case of agricultural advances and advances given to seasonal businesses, recovery camps should be organize during the peak season of the business or during the harvest season in agriculture. In the recovery camp the banks can recover maximum advances by offering some discount or certain other relaxations. Such recovery camp should be properly planned to ensure maximum advantage. It is advisable to take the help of outsiders such as local panchayat officials, regional bank managers and similar other person. Such camps should be widely publicized to ensure maximum recovery of loans.

2.11.3 Redesigning unpaid loan installments:

The bank should make an effort to redesign the loan repayment schedule for those borrowers who are unable to repay the loans. The banks can reduce the amount of installment and can extend the time for repayment of the loan. This will convince the borrowers that they can repay the loan. The banks need to be sympathetic to the sincere borrowers.

2.11.4 One-time settlement/Compromise scheme:
The bank can start compromise schemes or one-time settlement schemes for the recovery of loans. The RBI in consultation with the government of India has issued the guidelines for such one-time settlement/compromise scheme for the dues of commercial banks up to Rs. 10,00,000.19

2.11.5 Rehabilitation of sick units:
The banks should identify sick units in SSI as well as in medium and large scale industry. The banks should introduce rehabilitation package for such sick units according to RBI guidelines. While introducing such rehabilitation package, the bank should keep in mind that the causes of sickness should be genuine and the project should be viable in terms of debt-service coverage ratio.

2.11.6 Filing of civil suits or legal actions for recovery:
Where the compromise proposals given by the banks are not accepted by the borrowers, it is better for the banks to file the civil suits instead of waiting for the long time. The bank should start immediate actions against such borrowers because there are chances of their willful default.20

2.11.7 Asset Reconstruction Companies (ARC):
The Committee on Banking Sector Reforms (CBSR) Report suggest remedies to recover the NPAs as well their subsequent transfer as asset through Asset Reconstruction Companies. The most effective way of removing NPAs from the books of the weak banks would be to move these out to a separate agency which will buy the loans and make it own efforts for their recovery. The ARC’s efforts are profit oriented and its aim is to recover from the acquired assets more than the price paid for it. These companies are to be registered with the RBI with a minimum capital base of Rs.2,00,00,000.21

2.11.8 Lok adalats:

Lok adalats are voluntary agencies created by state governments to assist in matters of loan compromise. Lok adalats work out an acceptable compromise and issue a recovery certificate which shortens the period of obtaining a court decree. The government should make an effort to give wide publicity to the scheme, besides educating the bankers and borrowers about Lok adalats.

Lok adalats have been set up for the recovery of dues in accounts falling in the doubtful and loss categories with outstanding balance up to Rs.5,00,000 by way of compromise settlements. Government has recently revised the monetary ceiling of cases to be referred to Lok adalats organized by civil courts from Rs.5,00,000 to Rs.20,00,000. RBI has issued guidelines to commercial banks advising them to make use of Lok adalats. 22

2.11.9 SARFAESI Act:

SARFAESI is the preferred route for finding solution to NPA. There was no legal provision for facilitating securitization of financial asset of the bank and financial institutions or power to take possession of securities and sell them. This resulted in slow recovery of defaulting loan and mounting levels of NPA of bank and financial institutions and a need was felt for keeping pace with changing commercial practice and financial sector reforms. Keeping with this, an enabling legislative and regulatory framework was put in place with the enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The primary objective of the act is reduction of NPA levels of banks or financial institutions and unlocking value from distressed asset in the banking and financial system. 23

2.11.10 Debt Recovery Tribunal (DRT):

The government of India passed the recovery of Debts due to Banks and Financial Institutions (amendment) Act, 2000. This act has helped in strengthening the functioning of DRTs. Provisions for placement of more than

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one recovery officer, power to attach defendant’s property or asset before judgment, penal provision for disobedience of tribunal’s order or for breach of any terms has provided necessary strength to DRTs.

2.11.11 Corporate Debt Restructuring (CDR):
Corporate Debt Restructuring mechanism has been introduced in the year 2001. The aim is to provide a timely and transparent system for restructuring of the corporate debt of Rs.20,00,00,000 and above with the banks and financial institutions. The CDR process enables the companies to restructure their dues and reduce the incidence of fresh NPAs. It reforms the loan servicing obligation of the borrower and gives some concession in the interest rate.

2.11.12 Revenue Recovery Act:
On the basis of recommendations of Talwar Committee, a simplified procedure for recovery of commercial banks’ dues has been introduced. The recommendations of the committee have been accepted by most of the states but the results in terms of recovery are not encouraging.

2.11.13 Settlement of claim with Deposit Insurance and Credit Guarantee Corporation of India (DICGC):
Bank should submit their proposals for outstanding loans with DICGC for settlement of their claims and reduce their NPAs. DICGC will recover the outstanding loans on behalf of the banks.
2.12 Prudential Norms

It is the primary responsibility of the bank management and the statutory auditors to make adequate provisions for any loss in the value of loan assets, investment or other assets. The RBI has furnished prudential guidelines to the bank management and the statutory auditors in order to help them take decision in regard to make adequate and necessary provisions.

According to these prudential guidelines, assets are classified into four categories viz. loss assets, doubtful assets, sub-standard assets and standard assets. RBI has prescribed following provisioning norms for all such categories of assets.

2.12.1 Loss assets:

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

2.12.2 Doubtful assets:

For the doubtful assets, RBI has prescribed to make provisions according to the period for which the advance has remained in ‘doubtful’ category. According to this guideline, 25% provision is required if advance has remained doubtful for up to 1 year. 40% provision is required if advance has remained doubtful for 1 to 3 years. 100% provision is required if advance has remained doubtful for more than 3 years.

2.12.3 Sub-standard assets:

A general provision of 15% on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.

‘The unsecured exposure’ which is identified as ‘sub-standard’ would require an additional provision of 10% i.e. total 25% of the outstanding balance. Infrastructure accounts will attract a provisioning of 20% instead of 25%. The provisioning requirement for unsecured ‘doubtful’ asset is 100%.

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2.12.4 Standard assets:

Direct advances to Agricultural and Small and Micro Enterprises (SMEs) sectors will attract the provision of 0.25%.
Advances to Commercial Real Estate (CRE) Sector will attract the provision of 1%.
Housing Loans will attract the provision of advances as indicated in Para 5.9.13 and 5.9.14 of the RBI circular dated 1st July, 2011, which are as follows:

2.12.5 Provisioning for housing loans at teaser rates (Para 5.9.13):  
It has been observed that some banks are following the practice of sanctioning housing loans at teaser rates i.e. at comparatively lower rates of interest in the first few years, after which rates are reset at higher rates. This practice raises concern as some borrowers may find it difficult to service the loans once the normal interest rate, which is higher than the rate applicable in the initial years, becomes effective. It has been also observed that many banks at the time of initial loan appraisal, do not take into account the repaying capacity of the borrower at normal lending rates. Therefore, in view of the higher risk associated with such loans, the standard asset provisioning on the outstanding amount has been increased from 0.40 per cent to 2.00 per cent with immediate effect. The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain ‘standard’.

2.12.5 Restructured Advances (Para 5.9.14):
- Restructured accounts classified as standard advances will attract a provision of 2% in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2 per cent for the period covering moratorium and two years; and
- Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2 per cent in the first year from the date of up-gradation
- All other Loans and Advances not included above will attract the provision of 0.40%.
- Medium enterprises will attract provision of 0.40%.
References:
- Goyal, Anoop (2008), Risk Management in Indian Banks, Ritu Publications, Jaipur
- Mathur, B.L. (2005), Management of Non-Performing Assets, Wide Vision, Jaipur