4.1 Introduction

The economic development of a country is accelerated by the efficient flow and allocation of financial resources, from surplus units to deficit units. The financial intermediation is necessary to shift funds for development activities. Many empirical studies have emphasized the importance of financial service sector development for the overall development of the economy (Koivu, 2002; Levine, 1997; Amaral and Quintin, 2007). Beck, T (2005), observed that financial sector development fosters economic growth and reduces poverty by widening and broadening the access to finance and allocating the society’s savings more efficiently. The health of the financial sector is a matter of policy concern especially in developing countries where the failure of financial intermediation can critically disrupt the development process. Commercial banks are major constituents in the financial service sector. NPA poses a serious threat to the efficiency of the banking sector in allocating funds for development purposes. Rapid increase in NPA during the
last two decades resulted in the collapse of many banking institutions across the world. The significance of the NPA in banking sector crisis is stated in various national and international studies and expert committee reports (Narasimham Committee 1991, Verma Committee, 1998).

The transition from pre-liberalization period to post-liberalization period is characterized with a deviation from regulated to deregulated banking, not only in India but as well in various other transition economies including Turkey (Denizer, C. Dinc, M and Tarimcilar, M. 2000), Malaysia (Yee, C and Tan, E. 2009), etc. To mitigate the challenges of new world order and to improve the banking sector, many reformatory measures have been introduced in Indian banking sector since 1991. Levine et al (1999) pointed out that the legal and accounting reforms that strengthened creditor rights, contract enforcement and accounting practices enhanced the financial development and accelerated the economic growth.

4.2. Theoretical Perspective

Lending is one of the principal functions of banks. Lending always carries a risk, usually known as credit risk, arises out of the inability of the borrower to satisfy their obligations to the financial institutions. The problem of bad loans (explained in banking terms as NPA) existed right from the days of Goldsmith banking in 17th Century England, where many Goldsmiths’ failed because they could not fulfill their obligations due to non recovery of their loan amounts. The economic crises of many nations that were dominated by the banks in their financial structure began from the bad loans of banks.

According to Reserve Bank of India, an asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. In other words, NPA refers to a debt obligation where the borrower has not paid
any previously agreed upon interest and principal repayments to the designated lender for an extended period of time.

A ‘non-performing asset’ (NPA) is defined as a credit facility in respect of which the interest and/or installment of principal has remained ‘past due’ for a specified period of time. The specified period was reduced in a phased manner as under:

<table>
<thead>
<tr>
<th>Year ending March 31</th>
<th>Specified Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>Four Quarters</td>
</tr>
<tr>
<td>1994</td>
<td>Three Quarters</td>
</tr>
<tr>
<td><em>1995 onwards</em></td>
<td>Two Quarters</td>
</tr>
</tbody>
</table>

With a view to move towards international best practices and to ensure greater transparency, it has been decided to adopt the ‘90 days’ overdue’ norm for identification of NPA, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) is a loan or an advance where:

i) Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii) The account remains ‘out of order’, for a period of more than 90 days in respect of an Overdraft/Cash Credit (OD/CC),

iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv) Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and

v) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

(Source: RBI/2012-13/64 UBD.BPD.(PCB) MC No.3 /09.14.000/2012-13)
If any advance or credit facilities granted by banks 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.

The Narasimham Committee (1991) identified NPA as one of the major causes/effects of the malfunctioning of banking institutions. The regulatory measures prior to 1990 which are often mentioned as “financial repression” (Roland, C. 2006) in nature resulted in lack of transparency and accountability and resulted in a rising burden of NPA (Reddy, 2002). The financial liberalization literature stressed that the removal of repressionist policies allowed the banking sector to better perform its functions of mobilizing savings and allocating capital what ultimately results in higher growth rates (Levine, 1997).

4.3. Classification of Loan Accounts

The assets (loans) are classified into;

(i) Standard Assets
(ii) Sub-standard Assets
(iii) Doubtful Assets
(iv) Loss Assets

The RBI guidelines direct commercial banks to classify the loan account into various categories taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realization of dues.

4.3.1. Standard Assets

Standard Asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business.
4.3.2. Sub-standard Assets

(i) With effect from March 31, 2005 an asset is classified as substandard if it remained NPA for a period less than or equal to 12 months. In such case, the current net worth of the borrowers/ guarantors 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 assets have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks sustain some loss, if deficiencies are not corrected.

(ii) An asset where the terms of the loan agreement regarding interest and principal have been re-negotiated or rescheduled after commencement of production is classified as substandard and remain in such category for at least 12 months of satisfactory performance under the re-negotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of the above mentioned conditions.

4.3.3. Doubtful Assets

An asset is classified as doubtful, if it had remained NPA for more than 12 months. A loan classified as doubtful has all the weaknesses inherent as that classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, is highly questionable and improbable.

4.3.4. Loss Assets

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

In respect of accounts where there are potential threats to recovery on account of erosion in the value of the security and existence of other factors such as, frauds committed by borrowers, it is not prudent for the banks to classify them first as sub-standard and then as doubtful after the expiry of 12 months from the date the account has become NPA. Such accounts are straight away classified as doubtful asset or loss asset as appropriate, irrespective of the period for which it has remained as NPA.

4.4. Provisioning Norms for accounts classified as NPA

RBI has directed banks to provide provisions in respect of NPA accounts on the basis of classification of assets into substandard, doubtful and loss assets. RBI states that the provisioning should be made taking into account the time lag between an account becoming doubtful of recovery, the realization of the security and the erosion over time in the value of security charged to the bank. The minimum amount of provision required to be made against a loan asset is different for different type of asset as follows;

4.4.1. Standard Asset

At present, no provision is required. However, banks are directed to provision a minimum of 0.25 percent against standard assets from the financial year ended 31st March 2000 onwards. In this regard, RBI clarified that;

a) The general provision of 0.25 percent on standard assets is made on the global loan portfolio basis and not on domestic advances alone;
b) The provisions towards standard assets need not be netted from gross advances but shown separately as “contingent provisions against standard assets” under “other liabilities and provisions-others” in Schedule V of the balance sheet; and c) Provisions for standard assets should not be reckoned for arriving at the net NPA.

4.4.2. Substandard Asset

A general provision of 10 percent of the total outstanding is required without making any further allowance for DICGC/ECGC guarantee cover and securities available against such advances.

4.4.3. Doubtful Assets

a) A 100 percent is required of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse. The realizable value is estimated on a realistic basis.

b) With regard to the secured portion, provision is made at the rates ranging from 20 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful:

4.4.4. Loss Assets

a) The entire assets is written off after obtaining necessary approval from the competent authority and as per the provisions of the Co-operative Societies Act/Rules. If the assets are permitted to remain on the books for any reason, 100 percent of the outstanding should be provided for.
b) In respect of an asset identified as a loss asset, full provision at 100 percent should be made if the expected salvage value of the security is negligible.

The calculation of provision requirements can be determined by the following formula;

\[
\text{Total provision} = [B-S (100-P)/100]*(1-C/100)
\]

where;

- B Balance outstanding in NPA accounts.
- S Realizable value of the security available.
- P Percentage of provision required for the secured portion depending upon the age of doubtfulness of the account.
- C Percentage of DICGC/ECGC cover available on total outstanding balance. Where limit for DICGC/ECGC cover is fixed, it should be converted into a percentage.

4.5. Incidence of NPA

NPA is considered as a major reason for bank failures (Estrella et al, 2000; Chijoriga MM, 2000; Ahmed et al, 2007). Santoni, A et al (2010) observed based on bank failures in US that the “real” component resulting from exposure to a high loans/assets ratio, combined with a heavy accumulation of NPA, is the main factor of ‘vulnerability’: 90% of the banks that failed in the U.S. in 2009 had a high level of NPA (over 4.7%). In India, enormous presence of NPA led to bank failures. Some banks exit to destiny (Ex: United Western Bank), while some other banks merged (Ex. Lord Krishna Bank) with other banks, since affected by high levels of NPA. Heffernan S (2000) pointed out that a firm is said to have failed if it is insolvent, that is, has a negative net worth. A bank is
deemed to have ‘failed’ if it is liquidated, merged with a healthy bank under government supervision, or rescued with state financial support.

Various reasons are cited for an account becoming NPA. In general, an asset becomes NPA when the borrower fails to repay the interest and/or principal on agreed terms. The reasons for NPA are classified differently; into the system and situational causes, (Istrate et al 2007) into overhang component and incremental component, (Poongavanam, S. 2000; Kumar, BS. 2005) into internal and external factors, (Misra and Dhal. 2010; Muniappan. 2002) into random and non-random factors, (Biswas and Deb, 2005) based on its effects (Islam, et al. 2005) into bank-specific business and institutional environment factors, (Boudriga et al, 2009) and into macro-economic (systematic) and debt and bank specific factors. (Louzis et al, 2012). The reasons classified into internal factors and external factors are more common in literatures.

Reddy, PK (2002) has listed the reasons for NPA into; (1) the legal impediments and time consuming nature of the asset disposal process, (2) the manipulation by the debtors and (3) the political tool - Directed Credit to SSI and Rural sectors. Shuklal, J and Bajpai, G (2010) classified the reasons for NPA into two components (1) the overhang component that is due to environmental reasons, business cycle etc. (2) the incremental component which is due to internal bank management, credit policy, terms of credit etc.

Biswas, PK and Deb, AT (2005) classified the reasons for NPA into random and non-random component. The random component which is stochastic in nature arises from the risk that the business confronts. These risks are translated into NPA through default. The nonrandom component arises when a loan is not paid even when it is possible for the borrower to repay it – a case of willful default.
Espinoza, R and Prasad, A (2010) emphasized that financial system shocks emanates from firm specific factors (idiosyncratic shocks) and from macroeconomic imbalances (systemic shocks). Fainstein, G (2011) classified reasons for NPA into macroeconomic, banking sector and also microeconomic level variables. Gopalakrishnan, TV (2005) has classified the factors into political, economic, social and technological reasons. The economic causes are further classified in internal and external causes.

Further, Collins, NJ and Wanjau, K (2011) explained a direct relationship between interest rate and NPA. The interest rate spread affects the performance of loan portfolio as it increases the cost of loans charged to the borrowers. Sergio (1996) observed that an increase in risks of loan assets is rooted in the banks lending policy adducing to relative unselective and inadequate assessment of sectoral prospects. Giovanniz and Grimardx (2002) found that the bank specific indicators such as asset growth, the ratio of net worth to net assets, the ratio of operating costs of assets, exposure to personal loans and institutional characteristics such as credit growth, reserve adequacy and monetary expansion are major reasons for NPA of banks.

Muniappan, G (2002) classified the causes of NPA into several internal and external factors confronting the borrowers. The internal factors are diversion of funds for expansion/ diversification/modernization, taking up new projects, helping/promoting associate concerns, time/cost overruns during the project implementation stage, business (product, marketing, etc.) failure, inefficient management, strained labor relations, inappropriate technology/ technical problems, product obsolescence, etc., while external factors are recession, non-payment in other countries, inputs/power shortage, price escalation, accidents and natural calamities.
Raul, R.K and Ahmed, J.U (2005) observed that the banks since nationalization have diverted their attention from “class banking” to “mass banking” with little emphasis on profit element. But many problems cropped up such as inter-regional inequality in banks’ operations, non-recovery of loans, willful default, political interference, deterioration of customer services, red-tapism, neglect in the supervision of end use of credit, declining efficiency and profitability. All these factors adversely affected the quality of loan portfolio, thereby resulted in NPA.

Bhole, LM and Mahakud, J (2009) has noted that the high level of NPA in India is attributed to the following factors: (a) Diversion of funds, (b) Demand Recession, (c) Industrial Sickness, (d) Improper and Inadequate credit appraisal, (e) Poor post-loan supervision and follow-up, (f) Political compulsions and corruption, (g) The slow and inefficient legal system, (h) Moral degradation and the ethical deficit which afflict social fiber and value system, (i) The inefficient management, strained labor relations, product obsolescence etc, of the borrowing entity, (j) Time/Cost overrun during the project implementation stage, (k) Adverse changes in government policies such as excise duties, pollution control orders, and so on.

4.5.1. Internal factors

Diversion of funds is reported as a major reason for the NPA. Funds are diverted for purposes other than for its original purpose. Jain, V (2007) listed this as a major cause for NPA and observed that the diversion of funds occurs mostly for expansion, diversification/modernization/new projects of business or for promoting associate concerns. Bankers in a workshop conducted by Orissa Industries Federation (2002) have blamed diversion of funds as the major factor creating industrial sickness, thereby NPA. Even though various measures were
initiated to assure the utilization of funds for the purpose it is granted, the problem still persists and contribute to the generation of NPA in Indian banking sector.

The other major culprits for higher levels of NPA are willful default, mismanagement and lack of planning. Public money obtained from banks has been systematically siphoned away from the industries. Pandey and Kaur (2012) observed that the willful default is non-payment of dues despite having adequate cash flow and net worth, Signs of siphoning of funds by the borrower, falsification of records, disposal of securities without bank’s approval, fraudulent practices etc., point out a default situation. Islam, MS et al (2005) noted the presence of willful default as a major reason for the NPA. Researches on NPA including Moni, M and Misra, S (2009) and Pathak, B.V (2009) also indicated the significance of willful default towards the incidence of NPA and stated the requirements for stringent legal measures like SARFAESI Act to mitigate the effects. In India, according to Reserve Bank of India (RBI) guidelines, a willful defaulter is a person or entity that has “defaulted in meeting its payment/repayment obligations to the lender even when it has the capacity to honor the said obligations”. Any entity that has not utilized the money borrowed for the specific purpose for which it was raised from the lender and diverted it to other use is also a willful defaulter. Besides, an entity that has siphoned off funds, or has removed the fixed assets or property given by it for the purpose of securing a term loan without the knowledge of the lender, can be classified as a willful defaulter. RBI and banks initiated various measures to curtail the willful default in the banking sector.

The RBI, in consultation with the Central Government, constituted a Working Group on Willful Defaulters (WGWD) with Shri Kohli as Chairman.
Based on their recommendations, a default would be deemed to have occurred if any of the following events is noted;

a) The unit has defaulted in meetings is payment/repayment obligations to the lender even when it has the capacity to honor such obligations.

b) The unit has defaulted in meeting its payment/repayment obligations to the lender and has not utilized the finance from the lender for the specific purposes for which finance was availed, diverting the funds instead to other purposes, and

c) Banks and FIs are required to form a committee of higher functionaries headed by the executive director for classification of accounts as willful defaulters and create the redressal mechanism in the form of a committee headed by the Chairman and Managing Director for giving a hearing to the borrowers who have grievances on their classification as ‘willful defaulters’. It has been pointed out that redressal of grievances after the event is not fair in view of the damage to the reputation that cannot be easily reversed. Therefore, an opportunity is provided to the defaulter to be heard before being declared as such.

Anup Roy, A and Rebello, J (2011) mentioned that according to RBI’s norms, promoters of firms where banks and financial institutions have identified instances of funds being diverted, misrepresentation, falsification of accounts and fraudulent transactions are barred from institutional finance from banks and financial institutions for floating new ventures for five years. The Financial Express (2008) on Indian banking system shared the banker’s view that a significant rise in default cases has led to a surge in the level of NPA in the banking sector. It was mentioned that the legal system to manage NPA is
not only archaic but also ambiguous and needs to reform to bring down NPA in the banking sector.

Misra, BM and Dhal, S (2010) explained that apart from the business cycle, the terms of credit variables play an important role with statistically significant effects on the banks' NPA in the presence of bank size induced risk preferences and macroeconomic shocks. The changes in the cost of credit in terms of higher interest rate induce rise in the NPA. As well, factors like maturity of credit, better credit culture and favorable macroeconomic and business conditions lead to lowering of the NPA. The business cycle has differential implications adducing to differential response of borrowers and lenders.

Studies have indicated the significance of credit culture assessed through lending standards, collaterals, etc in generating NPA of banks. McGoven (1993) observed that relaxed credit standards, unguaranteed credits etc cause NPA. Borbora (2007) indicated that a major cause for NPA is fixation of unrealistic repayment schedule. Repayment schedule may be fixed taking into account gestation or moratorium period, harvesting season, income generation, surplus available etc. If the repayment schedule is defective both with reference to quantum of installment and the period of recovery, assets have a tendency to become NPA. Ahmed JU (2010) cited the following reasons for an increase in NPA of commercial banks. It includes (1) Poor credit appraisal system, (2) Lack of vision/foresightedness while sanctioning/reviewing or enhancing credit limits, (3) Lack of proper monitoring, (4) Reckless advances to achieve budgetary targets, (5) Lack of sincere corporate culture, (6) Inadequate legal provisions on foreclosure and bankruptcy, (7) Change in economic policies/environment at macro level, (8) Non-transparent accounting policy.
and poor auditing practices, (9) Lack of coordination between banks and their customers, and (10) Directed/Schematic lending to certain sectors.

Reddy, CS and Kalavathi, V (2004) quoted the comments of RBI study group on causes for NPA. It includes (1) diversion of funds, mostly for expansion/diversification of business or for promoting associate concern, (2) factors internal to business like product/marketing failure, inefficient management, inappropriate technology, labor unrest etc, (3) changes in macro environment like recession, infrastructural bottlenecks etc., (4) time/cost over runs during project implementation, (5) changes in government policies (6) deficiencies like delay in release of sanctioned funds by banks. Bloem and Gorter (2001) explained that the major cause for NPA is ‘wrong economic decisions’ by individuals and plain bad luck (inclement weather, unexpected price changes for certain products etc).

Rehman (2000) pointed out that that bank managers tend to be more influenced by the social structure of borrowers on the assumption that affluent citizens are likely to be more creditworthy and hence can be relied upon to repay their loans.

Some of the important reasons for NPA, mentioned in various literatures are summarized below;

a) Willful defaults, siphoning of funds, fraud, disputes, management disputes, mismanagement, misappropriation of funds etc.,

b) Lack of proper pre-appraisal and follow up.

c) Improper selection of borrowers/activities.

d) Inadequate working capital leading to operational issues. Under financing/untimely financing.
e) Delay in completing the project.

f) Non-compliance of sanction terms and conditions.

g) Poor debt management by the borrower, leading to financial crisis.

h) Excess capacities created on non-economic costs.

i) Inability of the corporate to raise capital through the issue of equity or other debt instrument from capital markets.

j) Business failures.

k) Failures to identify problems in advance.

l) Diversion of funds for expansion\modernization\setting up new projects\ helping or promoting sister concerns.

m) Deficiencies on the part of the banks viz. In credit appraisal, monitoring and follow-ups, delay in the settlement of payments\ subsidiaries by government bodies etc.,

n) Time involved in the legal process and realization of securities.

These are the major internal factors leading to poor asset quality and non performing assets.

4.5.2. External factors

The external factors indicate factors beyond the control of the borrower, created by economic, political, legal, technological and social systems existing in the country. The major external factors cited in various researches include;

1) Sluggish legal system -

   a) Long legal tangles

   b) Changes that had taken place in labor laws

   c) Lack of sincere effort.
2) Scarcity of raw material, power and other resources.

3) Industrial recession.

4) Shortage of raw material, raw material\input price escalation, power shortage, industrial recession, excess capacity, natural calamities like floods, accidents.

5) Failures, non payment over dues in other countries, recession in other countries, externalization problems, adverse exchange rates etc.

6) Government policies like excise duty changes, Import duty changes etc.,

In addition to the above studies have mentioned other external factors that includes; (a) the failure in planning and organizing (mismanagement, lack of proper planning, (b) failure to bring required capital, (c) poor credit allocation, (d) heavy borrowing, too ambitious project, (e) cost escalations (unwanted expenses, imbalances of inventories, improper working capital management, diversion of funds) and (f) poor product management (lack of proper planning, dependence of single customers, poor quality management).

4.6. Management of NPA

In its annual report (2010) RBI noted that “management of NPA remains an area of concern, particularly, due to the likelihood of deterioration of the quality of restructured advances”. Murinde, V and Yaseen, H (2004) on management of NPA made it clear that the traditional approaches to bank regulation is not conducive for management of NPA. These approaches emphasized the view that the existence of capital adequacy regulation plays a crucial role in the long-term financing and solvency position of banks, especially in helping the banks to avoid bankruptcies and their negative externalities on the financial system. In general, capital or net worth serves as a buffer against losses
and hence failure. Rather than accommodating measures to combat the NPA issues, the traditional measures tried to protect the interests of deposits through maintaining adequate capital in liquid form. This has impacted the availability of funds for productive purpose, since banks were not able to lend it but are required to keep the fund as reserves.

Management of NPA is essential for bank’s survival and growth. Credit risk is inherent in banking. It should be controlled through prudent risk management mechanisms, credit appraisal and follow-up. RBI has noted an improvement in NPA management process (annual report 2005-06), since banks in India have been able to contain their NPA to just two percent to their net advances in spite of adopting 90 days delinquency norms. The reasons put forward for this efficiency includes (1) The use of treasury by banks. (2) Recovery management measures significantly strengthened the lenders ability to enforce its right to collateral under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. (3) The corporate debt restructuring (CDR) system has also emerged as a time bound and transparent mechanism for arriving at a consensual financial arrangement between the creditor and the borrower. (4) The Credit Information Companies Act 2005 enables sharing of credit information which helps in reducing transactional costs of banks in extending credit to small and medium borrowers which again translates into lower NPA.

Measures to mitigate credit risk normally comprise clearly defined policies that express the bank’s credit risk management philosophy and the parameters within which credit risk is to be controlled. Ideally a starting point for improving the prudential efficiency of monitoring of the banking system in the region must involve the identification of credit crunch.
Strengthening the financial systems has been one of the central issues facing emerging markets and developing economies. This is because of the fact that a sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks. Borbora, RR (2007) emphasized that the essential components of sound NPA management are i) quick identification of NPA, ii) their containment at a minimum level and iii) ensuring minimum impact of NPA on the financials. Panta, R (2007) noted that all kinds of lending involves three stages where discretion needs to be exercised (a) Evaluation and assessment of the proposal (b) Timely monitoring and evaluation and (c) Proper assessment of exit decision and modality.

Many authors have noted the importance to apply reasoning while exercising lending activity. Panta, R (2007) mentioned that mostly banks apply rule based approach that precludes reasonable application of mind. Evaluation of project idea and the management is something that most of the banks are least equipped for. This has lead to the bank acting too liberal on all projects insisting on collaterals without taking into consideration any other competencies of the project and the entrepreneur’s capability. Further constant monitoring of major economic indicators which bears direct impact on the business is a must.

To manage NPA effectively, both proactive and curative measures are required. Proactive measures implies efficient loan appraisal and its management, while curative measures focus on realizing NPA accounts using minimum possible efforts. At the pre-disbursement stage, appraisal techniques of bank need to be sharpened. All technical, economic, commercial, organizational and financial aspects of the project need to be assessed realistically. Bankers should satisfy themselves that the project is technically feasible with reference to
technical know how, scale of production etc. The project should be commercially feasible and all background linkages by way of availability of raw materials at competitive rates and that all forward linkages by way of assured market are available. It should be ensured that the various assumptions mentioned in project report are realistic/achievable. Some projects are born sick because of unrealistic planning, inadequate appraisal and faulty implementation.

As the initiative to sanction or reject the project proposal is with the banker, the banker can exercise his judgment judiciously. The banker should at the pre-sanction stage not only appraise the project but also the promoter – the promoter’s character and capacity. It is said that it is more prudent to sanction a 'B' class project with an 'A' class entrepreneur than vice-versa. The banker has to ensure that the borrower complies with all the terms of sanction before disbursement. At the post-disbursement stage, bankers should ensure that the advance does not become and NPA by proper follow-up and supervision to ensure both assets creation and asset utilization. Bankers can do either off-site surveillance or on site inspection to detect whether the unit / project is likely to become NPA. Instead of waiting for the mandatory period before classifying an asset as NPA, the banker should look for early warning signals of NPA.

NPA Management measures can be broadly classified into (1) Non-legal measures, and (2) Legal measures. The various measures under this two head are detailed below;

4.6.1. Non – Legal measures

1) Preparation of ‘know-your client’ profile.
2) Reminder system
3) Seasonal/ Area based recovery drive
4) Follow up of Potential NPA
5) Review of NPA account
6) Preparation of village wise/Area wise list
7) Visit to Borrower’s business premise/Residence
8) Allotment of NPA account to staff
9) Recovery camps/Settlement camp
10) Road shows
11) Appointment of professional Recovery Agents.
12) Rehabilitation of sick units
13) Corporate debt Restructuring
14) Lok adalat/lok nayalaya
15) Circulation of list of defaulters
16) Recalling of advances
17) Recovery through Recovery Branches
18) Up gradation of NPA
19) Cash Recovery
20) Recovery through compromise cases
21) Revival of failed compromise cases
22) Recovery of written-off cases
23) Restructuring/Rescheduling
24) Sale of financial Assets (Asset Reconstruction companies)
25) Write-off
26) Credit Rating System
27) Identification of watch-list/special category accounts
4.6.2. Legal Measures

1) Recovery through Judicial process (Filing of suit)
2) Execution of decreed cases
3) Debt Recovery Tribunals (DRT)
4) Securitization and Reconstruction of Financial assets and Enforceability of security interest Act 2002 (SARFAESI)
5) Other legal measures

Financial system liberalization need not bring operational efficiency. It calls for efficient and effective regulatory and non-regulatory measures to mitigate the challenges posed by globalization and financial sector liberalization. Hsiao et al (2010) observed that the banking system in many developing countries exhibited poor performance after liberalization. As rightly pointed by Bossone and Promisel (2010), financial sector reforms require not only setting rules, articulating standards, approving legislation and creating new institutions, but also a change in behavior of financial institutions. Thus NPA management requires a change in behavior of bankers towards loan portfolio in addition to the vast number of proactive and reactive measures to manage NPA.

4.7. Implications of NPA Accounts

Sethi, J and Bhatia, N (2007) on the implications of NPA accounts mentioned that Banks cannot credit income to their profit and loss account to the debit of loan account unless recovery thereof takes place. Interest or other charges already debited but not recovered have to be provided for and provision on the amount of NPA also to be made. All the loan accounts of the borrower would be treated as NPA, if one account is NPA. Many authors emphasized the straddling impact of NPA and stressed its impact on loan growth. A higher NPA force banks to invest in risk-free investments, thus
directly affect the flow of funds for productive purpose. (Tracey and Leon, 2011; Heid and Kruger, 2011 and O"Brien, 1992)

Bloem and Goter (2001) remarked that issues relating to NPA affect all sectors (in particular if parallel issues with defaulting trade credit is also considered). The most serious impact, however, is on the financial institutions, which tend to own large portfolios, indirectly; the customers of these financial intermediaries are also implicated; deposit holders, shareholders and so forth. Add to this, NPA is not only affecting the banks and its intermediaries, it has an impact on the development of the nation as well. For a bank, NPA means unsettled loan, for which they have to incur financial losses. The cost for recovering NPA is a loss for the bank.

Karunakar, M et al (2008) explained that NPA results in deleterious impact on the return on assets. It happens in the following ways;

a) The interest income of banks will fall and it is to be accounted only on receipt basis.

b) Banks profitability is affected adversely because of the provision for doubtful debts and consequent write off as bad debts.

c) Return on Investment (ROI) is reduced.

d) The capital adequacy ratio is disturbed as NPAS are entering into the calculation.

e) The cost of capital will go up.

f) The assets and liability mismatch will widen.

g) The economic value additions (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital, and

h) It limits recycling of the funds.
To sum up, the following are major implications on an NPA accounts.

1.) The NPA is the result of failure to repay principal and/or interest as per agreed terms between the bank and the client. Failure to receive interest will affect the profitability of the bank. Failure to receive the principal affects the availability of funds for further lending.

2.) Interest income cannot be booked on the loan declared as an NPA, and hence profit is affected. In addition, provisioning against assets creates further losses. Thus, financial institutions have a tendency to rollover non-performing loans. The borrower is given more loans to pay interest on past loans and repay whatever amount is possible.

3.) Banks redistribute losses to other borrowers by charging higher interest rates. Lower deposit rates and higher lending rates repress savings and financial markets, which hampers economic growth.

4.) Non performing loans represent bad investments. NPA misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital and, by extension, labor and natural resources. The economy performs below its production potential.

5.) Non performing loans may spill over the banking system and contract the money stock, which may lead to economic contraction.

These spillover effects can channel through illiquidity or bank insolvency;

(a) When many borrowers fail to pay interest, banks may experience liquidity shortages. These shortages can jam payments across the country.
(b) Illiquidity constraints bank in paying depositors.

(c) Undercapitalized banks exceed the banks' capital base.

4.8. Conclusion

The non-performing assets have a direct impact on the profitability, productivity, liquidity and equity of banks and finally influence the outlook of the banks towards credit delivery and credit expansion. Many factors contributed to increase in NPA. Since 1991, many measures were initiated to improve the credit management process and recovery of NPA accounts. NPA being an important parameter for assessing financial performance of banks, should be managed in order to improve the quality of the asset portfolio of banks. The financial crisis that erupted worldwide have impacted the quality of asset portfolio and resulted higher NPA. The increase in NPA since 2007-08 is an area of concern for regulatory authorities and commercial banks. It hence requires a detailed analysis of NPA in the post millennium period to assess the trend in the movement of NPA and a critical evaluation based on expert feedback to critically analyze whether the NPA management is effective in Indian scheduled commercial banks.

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