Chapter – 4
Theoretical Framework of Study

4.1 Introduction:

Banking reforms have changed the face of the Banking Industry making it more competitive and market oriented. On the one hand regulations on interest rates, manner of determining the credit capacity of borrowers and investment of funds have been made flexible and on the other hand regulations regarding disclosure of Non-Performing Assets and provisioning norms have been made more stringent. While the Banking sector has been thrown open to competition, existing banks have been given the necessary leeway to compete, though not recklessly. This fourth chapter is devoted to the Prudential Norms introduced in the Banking Sector after adoption of New Economic Policy in 1991. The concept of Non-Performing Assets and Provisioning in Norms are discussed as per RBI guidelines.

4.2 Stages of Development in Indian Banking

The history of Banking in India can be for the purpose of present study be divided into three stages:

1. Foundation Phase
2. Expansion Phase
3. Reform Phase
These phases need be discussed with a view to analyse the concept of Non-Performing Assets which is closely related with the third reform phase.

1. Foundation Phase

This phase is related with the period from 1947-1969. This is the stage from the obtaining of freedom to Nationalization of Banks. India adopted a socialistic pattern of society in the Constitution of India under the Directive Principles of State Policy. Yet it was under the impact of British Colonial Rule. In those initial days, the need of the hour was to reorganize and to consolidate the prevailing banking network keeping in view the requirements of the economy. The first step taken to that end was the enactment of the Banking Companies Act, 1949 followed by rapid industrial finance. Role played by banks was instrumental behind industrialization with the impetus given to both heavy and Small Scale Industries. Subsequently, after the adoption of social control, banks started taking steps in extending credit to agriculture and small borrowers. Finally, on July 19, 1969, 14 banks were Nationalised with a view to extending credit to all segments of the economy and also to mitigate regional imbalances. Thus, the period regulated growth from 1950 till bank nationalization witnessed a number of far-reaching changes in the banking system.
2. Expansion Phase

This phase is related with the period from 1970 to 1984. The motto of bank nationalization was to make banking services reach the masses that can be attributed as ‘first banking revolution’. Commercial banks acted as a vital instrument for this purpose by way of rapid branch expansion, deposits mobilization and credit creation. A series of measures had been taken since then. Introduction of Lead Bank Scheme and District Credit Plans, setting up of Regional Rural Banks in 1975 etc., were important for penetrating into the rural areas. Alongside, the agenda of geographical expansion in the form of branch expansion continued. During 1970 to 1980 the branch expansion was 12.0% per annum and during 1980-90 it was around 8.8% per annum. Resource of the banking system grew significantly. Banks were deploying these funds both in credit and investments. During 1970 to 1980, net profit grew annually by 14.7% and during 1980-90 the annual growth was 11.7%.

3. Reform Phase

This phase is related with the period from 1991 onwards. Indian banking system has been subject to widespread structural reforms initiated since June 1991. This phase can be regarded as ‘Second Banking Revolution’. Reform Measures such as introduction of new accounting and prudential norms, liberalization measures etc. are heading towards a truly competitive and well-structured banking system resilient from an international perspective. These
have spurred the dynamics of Indian Banking Sector in all the fields. The annual growth of branch expansion during 1990-2000 was 1.1%. The population served per branch was 15000 as at March end 2000. During 1990-2000, the annual average growth rates of deposits and credit were 16.1% and 18.8% respectively. During 1990s, the growth of investments was 20.0% as compared to 16.0% during 1985-90 and 18.8% during 1980-85. The net profit of the banking system grew by more than 13 times during 1990 to 2000. It increased from Rs. 555.33 crores as at March end 1990 to Rs. 7306.36 crores as at March end 2000.


4.3 Financial Sector Reforms and New Economic Policy

India adopted New Economic Policy after its entry into GATT. The policy of Globalization, Liberalization and Privatization was adopted by India in 1991. This was a shift over from the socialistic pattern to the capitalistic pattern. This new era of free economy posed various challenges in front of Indian economic system including banking.

The challenges facing the Indian banking system stem from significant and far-reaching changes that have taken place in India during the last few years. The economic liberalisation measures introduced by the Indian Government coupled with trends towards globalisation have substantially
altered the banking turf. Entry for foreign banks has been rendered easier, new private banks have been permitted to set up operations and a larger number are reportedly still in the licensing queue. Non-banking finance companies have emerged to take away certain businesses that were traditionally being handled by commercial banks. This has widened the choice of financial institutions, markets and instruments for a large group of customers, corporate and personal, who no longer require the intermediating function of commercial banks.

Globalisation and economic liberalisation have also brought in their wake deregulation of the Indian banking system. Interest rates on deposits and advances have been partially deregulated. While the recommendations of the Committee on Financial Sector Reforms (Narasimham Committee) have not been fully implemented, some liberalisation has taken place in SLR requirements. In so far as priority sector lending is concerned, while the stipulated target of 40 per cent of net bank credit still remains, the cross-subsidisation of the priority sector has been substantially reduced through a mechanism of market-determined interest rates, save in respect of credits below a small cut-off point, i.e. very small credits. Regulation provides protection but is generally not friendly to efficiency.

The phenomenal growth and development of the banking system over the two decades prior to the reforms, rendered the system unwieldy. In addition, the constraints, external and internal to the banking system gave rise
to several problems such as low operational efficiency, inadequate capital base, high level of non-performing assets, low profitability, unhealthy balance sheets and unsatisfactory customer service. In short, the very viability of the banking system came in for scrutiny and the need for such a scrutiny became imperative with the introduction of economic reforms. It hardly needs emphasis that a liberalised economy will be ill-served if the banking system remains highly sheltered or regulated, just as the banking system cannot become viable or sustainable in the long run, unless it adequately responds to the needs of the market-oriented economy. Thus there was enough justification for putting in place banking reforms in the wake of economic reforms.

The broad directions of the financial reforms initiated are:

1. Improvement in the overall monetary policy framework
2. Strengthening the financial institutions
3. Gradual integration of the domestic financial system into the global economy.

Within these broad goals of policy, banking reforms have the specific task of achieving:

(a) A suitable modification in the policy framework within which banks operate
(b) Improvement in the financial health and competitive capabilities of banks
(c) Building financial infrastructure relating to supervision, audit and technology

(d) Upgradation of the level of managerial competence and the quality of human resources.

The banking reforms based on these specific tasks may be said to have two aspects: (i) macro level policy changes and (ii) micro-level policy reforms. The macro-level policy changes aim at removing the external constraints on the banking system as a whole and thus create a proper climate in which the banks could function in tune with liberalisation. Micro-level reforms, on the other hand, are concerned with the specifics of the banking system and also of individual banks in order to overcome the internal constraints on the functioning of banks. It must be recognised that in terms of the overall impact on the banking system, external and internal constraints are inter-related, though for convenience these may be treated separately. These two approaches, i.e. macro- and micro-aspects, facilitate proper sequencing, timing and also the pace of reforms.

A number of measures were taken to relax the external constraints which form the macro-level policy changes. There was the need for reduction in the pre-emption of bank resources in the form of cash reserve ratio and statutory liquidity ratio. Similarly, the plethora of lending rates (for different slabs) and rates on deposits forming the administered structure of interest rates needed to be simplified and rationalised. The directed credit programmes
were also to be reduced over a period. The need for strong supervision to ensure sound banking became imperative. The overall credit policy changes were also required in respect of credit to government, refinance facilities available to banks and in credit delivery systems.

As for the internal constraints impinging on the functioning of the banks, a number of steps were taken to improve the financial health of the banks. "Prudential norms (i.e. income recognition, asset classification and capital adequacy) were introduced with a view to ensure transparency and to reflect true financial health and at the same time act as tools for financial discipline. The major task was to improve the financial performance of banks through improving profitability and reducing non-performing assets through better recovery. In order to facilitate this, debt recovery tribunals have also been set up. Measures for strengthening banking institutions included re-capitalisation of banks, improving the quality of the loan portfolios, creation of a climate for greater competition and strengthening the supervision process. In order to tone up the management, Memorandums of Understanding (Molls) were signed between the banks and the RBI. The objectives of these Moles are to ensure certain performance obligations and commitments.

The progress of reforms has been very encouraging in the last four years of reform. The proportion of resources pre-empted has been brought down. For instance, Statutory Liquidity Ratio (SLR), which was 37.4 per cent in March 1992 came down to 28 per cent by March 1996. Similarly, the Cash Reserve
Ratio has also been brought down to 12 per cent though it could be used flexibly, being one of the important instruments of monetary control. Interest rate structures underwent substantial changes both on the deposit and advances side. The process of rationalisation of rates began in 1990 when the number of lending rates were reduced to six. After recent changes, there are only two lending rates and only one maximum rate on deposits up to one year.

A shift in the credit delivery system from cash credit to loan system is also effected. As far as the directed credit programmes are concerned, though the intention is to reduce them over time, these will have to continue for some time for socio-economic reasons. Measures for the institutional strengthening of banks in general and public sector banks in particular have also been taken. The introduction of capital adequacy ratio accompanied by re-capitalisation is an important measure. Since 1992, government contributed Rs 12,500 crore towards the capital of public sector banks. A good element of competition has been introduced into the banking system by permitting the entry of private sector banks both Indian and foreign. By way of a mechanism for monitoring compliance of prudential norms and directives of Reserve Bank of India and to widen the area of supervision the Board for Financial Supervision has been set up.

The available working results of the banking system suggest that the response of the banks to the reforms has been positive and encouraging. The banks have been adjusting very well in the new scenario though somewhat
gradually. The indicators which are available for the reform period so far may be briefly referred to. There has been a considerable reduction in the quantum of non-performing assets; these formed 23 per cent of the loan assets in 1992-93 and by March 1995 it came down to 19 per cent. As per cent to total advances non-performing assets was 26 per cent in March 1994, 20 per cent in 1995 and is placed at 16 per cent by March 1996. Second, there has been extreme caution in credit extension in order to improve the quality of the loan assets and also to keep down the level of non-performing assets. Third, there has been considerable progress in regard to the attainment of prescribed capital adequacy ratios. By March 1995, 13 out of the 27 public sector banks reported a capital adequacy ratio of 8 per cent. Of the remaining, 11 public sector banks have a capital adequacy ratio of 4 per cent and the remaining three banks have less than 4 per cent. All foreign banks and 19 out of the 34 private sector banks reported a capital adequacy ratio of 8 per cent and more. Since 1992, government has infused funds by way of re-capitalisation an amount of Rs 12,500 crore towards the capital of public sector banks. Six more public sector banks have been identified for capital infusion in 1995-96. Fourth, banks are now free to determine their own prime lending rates which have now replaced the minimum lending rates. Fifth, there has been a rise in the number of profit making public sector banks. In terms of earnings and profitability 19 nationalised banks earned a net profit of Rs 269.33 crore in 1994-95 against a net loss of Rs 4705 crore in 1993-94. By and large, banks are expected to show
much better results in 1995—96. This turnaround in the balance-sheet position of the public sector banks reflects the process of cleaning up initiated and also the resilience of the banks, though they encountered problems in the early stages in coping with the new accounting norms. Lastly, a more qualitative aspect is the change in the mind-set in the banks towards a better work culture and towards the realisation that banks are commercial bodies and they must be viable and healthy.

The progress of the banking system should be viewed against the background of the all round progress of the Indian economy under the impact of the reforms so well delineated by Dr Shankar Acharya in his special address at the conference. It is clear that the banking system is rising to the occasion and has been operating in conjunction with the growth and stability of our economy.

However, a number of problems, risks and challenges are emerging as a result of the implementation of the reforms. The banks, particularly the public sector banks, will have to ready themselves to face them in several areas such as competition, efficiency, delivery of products and services, risk management, technology and development of human resources. This process of change calls for a determination on the part of banks to overcome the present weaknesses, enhance the existing strengths and to re-orient the huge banking base towards specific problems so as to make the system conform to international standards.
With the introduction of new income accounting system mainly, asset classifications, income recognition and provisioning during 1992-93, transparency has been injected into banks’ accounting system. Though depressed in profitability, many banks have exceeded the minimum stipulated capital adequacy norms. Traditional banking has gradually yielded to sophistication in credit management. Investment decisions need to be based on full information and assessment of various types of risks.

The new capital adequacy norms which are based on three pillars approach viz. minimum capital requirements, supervisory review and market discipline, when implemented, are expected to be tighter than the existing norms. They are also expected to use internal assessment of credit ratings in respect of their credit exposures. The new methods of measuring market risk, such as, the value-at-risk and pre-commitment approaches, which are rapidly gaining importance in recent years, should complement the risk weighted capital adequacy ratios. Sophisticated tools are to be employed for an appropriate evaluation of risks. Banks will have to devote greater attention to risk management systems and to the competence of risk appraisal and management personnel.

To improve the capital adequacy standards of public sector banks, the Government has so far contributed an aggregate amount of Rs. 204 billion for recapitalization. The new BIS paper has serious implications for the public sector banks as the new capital norms could involve injecting fresh capital into
the banking system. Banks have been encouraged to raise capital through public issues and to raise subordinated debt for their Tier-II capital. Banks have also been allowed to write-off accumulated losses, so as to have higher earnings per share in its public issues.

**Major Changes of the Reform Era**

The Government of India initiated the process of economic reforms in 1991. A Committee headed by Shri Narsimhan, former RBI Governor was set up to make recommendations on financial sector reforms. As the Banking system formed the most dominant segment of the financial system accounting for 80% of the funds flowing through it, the reforms were crucial to the banking industry. The major changes brought about in banking in recent years are as under:

- Introduction of Prudential Norms for Income Recognition, Asset Classification and Provisioning, in the line with International standards.
- Introduction of Capital adequacy Norms in line with International standards.
- Progressive reduction in SLR and CRR.
- Progressive deregulation of administered interest rates and moving towards market determined rates.
- Restoration of Bank Rate as a reference rate.
• Operational flexibility granted by withdrawal of Consortium Lending. MPBF Norms, ceiling on Term Lending.

4.4 Income Recognition, Asset Classification and Provisioning

The gradual process of introducing structural reforms in the banking sector was a unique experiment undertaken with the key objective of strengthening the banking sector balance sheets and governance frameworks in a non-disruptive manner while managing the given political-economy considerations. The reforms were carefully sequenced in terms of instruments and objectives. Thus, introduced early in the reform cycle, followed by interest rate deregulation and gradually lowering of statutory preemptions. The more complex aspects of legal and accounting measures were ushered in subsequently. More recently, the regulatory framework has also focused on ensuring good governance through 'fit and proper' owners, directors and senior managers of the banks.

The most important factors that must be consider with reference to the study of Non-Performing Assets are the recent norms of Income Recognition, Asset Classification and provisioning. The researcher has presented an analytic study of these concepts in the following order:

1. Asset Classification
2. Income Recognition
3. Provisioning
These concepts are closely related with the management of Non-Performing Assets in any bank and Marathwada Gramin Bank is not an exception to this. Before the researcher turns to the explanation of these concepts it is necessary to explain the division of Banks into two groups Tier-I bank and Tier-II these concepts are explained here with reference to annxure-IV of the Master Circular of Reserve Bank of India.

**Tier – I Banks :**

i) Unit banks i.e. banks having a single branch Head Office and banks with deposits below Rs.100 crore, whose branches are located in a single district.

ii) Banks with deposits below Rs.100 crore having branches in more than one district, provided the branches are in contiguous districts and deposits and advances of branches in one district separately constitute at least 95% of the total deposits and advances respectively of the bank.

iii) Banks with deposits below Rs.100 crore, whose branches were originally in a single district but subsequently, became multi-district due to reorganization of the district.

The deposit base of Rs. 100 crore for the above will be determined on the basis of average of the fortnightly Net Demand and Time Liabilities in the financial year concerned.
**Tier – II Banks**: Bank which is not a Tier I bank.

The norms of Income Recognition, Asset Classification and Provisioning are separate for Tier-I and Tier-II Banks. The general objectives of introducing the Prudential Norms of Recognition, Asset Classification and Provisioning can be briefly stated as follows:

1. In order to reflect a bank’s actual financial health in its balance sheet and as per the recommendations made by the Committee on Financial System (Chairman Shri. M. Narasimham), the Reserve Bank has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the primary (urban) co-operative banks.

2. Broadly, the policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks has to be done on the basis of objective criteria, which would ensure a uniform and consistent application of the norms. The provisioning should be made on the basis of the classification of assets into different categories.

3. The requirements of the State Co-operative Societies Acts and / or rules made there under or other statutory enactments may continue to be followed, if they are more stringent than those prescribed hereby.

4. With the introduction of prudential norms, the Health Code based system for classification of advances has ceased to be a subject of
supervisory interest. As such, all related reporting requirements, etc. also ceased to be a supervisory requirement, but could be continued in the banks entirely at their discretion and the management policy, if felt necessary.

**Asset Classification:**

Having discussed the concept of classification of Banks in Tier-I and Tier-II groups and having seen the general objectives of adoption of prudential norms it would not be out of place to discuss the definitions of asset groups as described in the RBI guidelines.

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. Such an asset should not be an NPA.
2. Sub-standard Assets

(i) With effect from March 31, 2005 an asset would be classified as substandard if it remained NPA for a period less than or equal to 12 months. In such cases, 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 will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will 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, should be classified as sub-standard and should 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 this condition.

3. Doubtful Assets

With effect from March 31, 2005, an asset is required to be classified as doubtful, if it has remained NPA for more than 12 months. ' For Tier I banks, the 12-month period of classification of a substandard asset in doubtful category will be effective from April 1, 2009. As in the case of sub-standard assets, rescheduling does not entitle the bank to upgrade the quality of an advance
automatically. A loan classified as doubtful has all the weaknesses inherent as that 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.

Consequent to change in asset classification norms w.e.f. March 31, 2005 banks are permitted to phase the consequent additional provisioning over a five year period commencing from the year ended March 31, 2005, with a minimum of 10 % of the required provision in each of the first two years and the balance in equal instalments over the subsequent three years.

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.

Basic Considerations for classification of assets into the above categories are as follows:

(i) Broadly speaking, classification of assets into above categories should be done taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation of dues.
In respect of accounts where there are potential threats to recovery on account of erosion in the value of security and existence of other factors such as, frauds committed by borrowers, it will not be prudent for the banks to classify them first as sub-standard and then as doubtful after expiry of 12 months from the date the account has become NPA. Such accounts should be straight away classified as doubtful asset or loss asset, as appropriate, irrespective of the period for which it has remained as NPA.

It is necessary to introduce an internal control system for every bank for classification of assets. Marathwada Gramin Bank is not an exception to this.

(i) Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. The banks may fix a minimum cut-off point to decide what would constitute a high value account depending upon their respective business levels. The cut-off point should be valid for the entire accounting year.

(ii) Responsibility and validation levels for ensuring proper asset classification may be fixed by the bank.

(iii) The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines.

(iv) RBI would continue to identify the divergences arising due to non-compliance, for fixing accountability. Where there is wilful non-compliance by
the official responsible for classification and is well documented, RBI would initiate deterrent action including imposition of monetary penalties.

**The Concept of Advances Past Due**

It is necessary for classification of a loans and advances of a bank as NPA it must first become overdue or past due. Unless the account becomes overdue or past due it is not possible to treat the same as NPA.

An asset becomes non-performing when it ceases to generate income for the bank. Earlier an asset was considered as non-performing asset (NPA) based on the concept of 'Past Due'. A 'non performing asset' (NPA) was defined as credit in respect of which interest and/ or installment of principal has remained 'past due' for a specific period of time. The specific period was reduced in a phased manner as under:

<table>
<thead>
<tr>
<th>Year ended March, 31</th>
<th>Specific period</th>
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<tbody>
<tr>
<td>1993</td>
<td>4,quarters</td>
</tr>
<tr>
<td>1994</td>
<td>3 quarters</td>
</tr>
<tr>
<td>1995</td>
<td>2 quarters</td>
</tr>
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An amount is considered as past due, when it remains outstanding for 30 days beyond the due date. However, with effect from March 31, 2001 the 'past due' concept has been dispensed with and the period is reckoned from the due date of payment.
With a view to moving towards international best practices and to ensure greater transparency, '90 days' overdue norms for identification of NPAs have been made applicable from the year ended March 31, 2004. As such, save and except certain relaxations mentioned at para 2.1.3 and 2.1.4 below, with effect from March 31, 2004, a non-performing asset shall be 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) In the case of direct agricultural advances as listed in Annex 1, the overdue norm specified at para 2.1.5 would be applicable. In respect of agricultural loans, other than those specified in Annex 1, identification of NPAs would be done on the same basis as non-agricultural advances.

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

   Any amount due to the bank under any credit facility, if not paid by the due date fixed by the bank becomes overdue.

   "An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power."
In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order''.

**Norms for Classification of NPA**

An account can be classified as NPA depending upon the nature of account.

**Tier I Banks** (for definition please see annex 4) have been permitted to classify loan accounts including gold loans and small loan upto Rs 1 lakh as NPAs based on 180 days delinquency norm instead of the extant 90 days norm. This relaxation will be in force upto March 31, 2009. For the above category of banks, an account would be classified as Non Performing Asset if the:

**Non-Agricultural Advances**

The RBI guidelines for Non-Agricultural advances for treatment as NPA for different type of accounts are as follows:

i) **Term Loan**: A Term Loan can be treated as NPA in case Interest and/or installment of principal remain overdue for a period of more than 180 days in respect of a Term Loan.

ii) **Cash Credit / Over Draft**: A Cash Credit can be treated as NPA in case The account remains 'Out of order' for a period of more than 180 days, in respect of an Overdraft/Cash Credit (OD/CC).
iii) **Bills Purchased**: The Bills Purchased Account can be treated as NPA in case the bill remains overdue for a period of more than 180 days, in the case of bills purchased and discounted.

iv) **All Other Advances**: All other advances can be treated as NPA in case any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

The relaxations are given for the explicit purpose of enabling the RRBs concerned to transit to the 90 day NPA norm in the year 2009-10 by building up adequate provisions and strengthening their appraisal, disbursement and post disbursement procedures.

**Tier II banks** (all other which are not Tier I banks) shall classify their loan accounts as NPA as per 90 day norm as hitherto.

**Agricultural Advances**:

The norms of classification of NPA for agricultural advances particularly in case of Crop Loans are as follows:

i) With effect from September 30, 2004 the following revised norms are applicable to all direct agricultural advances (Annex 1):

   a. A loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for two crop seasons.
b. A loan granted for long duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season.

ii) For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

iii) The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each state.

iv) Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him. In respect of agricultural loans, other than those specified in the Annex 1 and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances which, at present, is the 90 days delinquency norm.

v) Banks should ensure that while granting loans and advances, realistic repayment schedules are fixed on the basis of cash flows / fluidity with the borrowers.

Record of Recovery
It is necessary for the banks to keep a record of recovery in case of every account only on the basis of which it is possible to decide whether an account is NPA or not.

i) The treatment of an asset as NPA should be based on the record of recovery. Banks should not treat an advance as NPA merely due to existence of some deficiencies which are of temporary in nature such as non-availability of adequate drawing power, balance outstanding exceeding the limit, non-submission of stock statements and the non-renewal of the limits on the due date, etc. Where there is a threat of loss, or the recoverability of the advances is in doubt, the asset should be treated as NPA.

A credit facility should be treated as NPA as per norms given in paragraph above. However, where the accounts of the borrowers have been regularised by repayment of overdue amounts through genuine sources (not by sanction of additional facilities or transfer of funds between accounts), the accounts need not be treated as NPAs. In such cases, it should, however, be ensured that the accounts remain in order subsequently and a solitary credit entry made in an account on or before the balance sheet date which extinguishes the overdue amount of interest or installment of principal is not reckoned as the sole criteria for treatment the account as a standard asset.

**Treatment of NPAs - Borrower-wise and not Facility-wise**
It is necessary to understand that the classification of NPA should be based on borrowerwise classification and not facilitywise classification. That is to say if a borrower is having more than 1 facilities, and one of these facilities becomes NPA all other facilities will be treated as NPA.

i) In respect of a borrower having more than one facility with a bank, all the facilities granted by the bank will have to be treated as NPA and not the particular facility or part thereof which has become irregular.

ii) However, in respect of consortium advances or financing under multiple banking arrangements, each bank may classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances.

Some Special Considerations

It is also necessary to keep in mind some special considerations while classification of accounts in the NPA category.

Housing Loan to Staff

In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/ advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.

Credit facilities Guaranteed by Central /State Government
(i) The credit facilities backed by guarantee of the Central Government though overdue should not be treated as NPA.

(ii) This exemption from classification of government guaranteed advances as NPA is not for the purpose of recognition of income.

(iii) From the year ended March 31, 2006, State Government guaranteed advance and investment in State Government guaranteed securities would attract asset classification and provisioning norms, if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days irrespective of the fact whether the guarantee have been invoked or not.

**Project Financing**

In the case of bank finance given for industrial projects where moratorium is available for payment of interest, payment of interest becomes due only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

**Other Advances**

(i) Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and Life policies need not be treated as NPAs although interest thereon may not have been paid for more than 90 days provided adequate margin is available in the accounts.
(ii) Primary (urban) co-operative banks should fix monthly/quarterly installments for repayment of gold loans for non-agricultural purposes taking into account the pattern of income generation and repayment capacity of the borrowers and such gold loan accounts may be treated as NPAs if installments of principal and/or interest thereon are overdue for more than 90 days.

(iii) As regards gold loans granted for agricultural purposes, interest is required to be charged as per Supreme Court judgement at yearly intervals and payment should coincide with the harvesting of crops. Accordingly, such advances will be treated as NPA only if installments of principal and/or interest become overdue after due date.

The Identification of assets as NPAs should be done on an ongoing basis. The system should ensure that identification of NPAs is done on an ongoing basis and doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per prescribed norms. Banks should also make provisions for NPAs as at the end of each calendar quarter i.e. as at the end of March/ June/ September/ December, so that the income and expenditure account for the respective quarters as well as the P&L account and balance sheet for the year end reflects the provision made for NPAs.

Income Recognition
The most important change that was introduced after acceptance of Prudential Norms of Income Recognition, Asset Classification and Provisioning was switchover from the Accounting Principle of Accrual to the Accounting Principle of Realization. Before application of this principle banks used to recognize interest income to the credit of P&L A/c whenever it became due irrespective of the fact whether it is recovered in money form or not. After application of the new principle banks can take into account interest income to the credit of P&L A/c only the interest is actually received.

**Income Recognition - Policy**

i) The policy of income recognition has to be objective and based on the record of recovery. Income from non-performing assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, banks should not take to income account interest on non-performing assets on accrual basis.

ii) However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

iii) Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.
iv) If Government guaranteed advances become 'overdue' and thereby NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Reversal of Income on Accounts Becoming NPAs

i) If any advance including bills purchased and discounted becomes NPA as at the close of any year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

ii) If interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to same borrower that have been accrued should ceased to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

iii) Banks undertaking equipment leasing should follow prudential accounting standards. Lease rentals comprises two elements - a finance charge (i.e. interest charge) and a charge towards recovery of the cost of the asset. The interest component alone should be taken to income account. Such income taken to income account, before the asset became NPA, and remained unrealised should be reversed or provided for in the current accounting period.
Booking of Income on Investments in Shares & Bonds

i) As a prudent practice and in order to bring about uniform accounting practice among banks for booking of income on units of UTI and equity of All India Financial Institutions, such income should be booked on cash basis and not on accrual basis.

ii) However, in respect of income from Government securities/bonds of public sector undertakings and All India Financial Institutions, where interest rates on the instruments are predetermined, income may be booked on accrual basis, provided interest is serviced regularly and is not in arrears.

Partial Recovery of NPAs

Interest realised on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/additional credit facilities sanctioned to the borrower concerned.

Interest Application

i) In case of NPAs where interest has not been received for 90 days or more, as a prudential norm, there is no use in debiting the said account by interest accrued in subsequent quarters and taking this accrued interest amount as income of the bank as the said interest is not being received. It is simultaneously desirable to show such accrued interest separately or park in a separate account so that
interest receivable on such NPA account is computed and shown as such, though not accounted as income of the bank for the period.

ii) The interest accrued in respect of performing assets may be taken to income account as the interest is reasonably expected to be received. However, if interest is not actually received for any reason in these cases and the account is to be treated as an NPA at the close of the subsequent year as per the guidelines, then the amount of interest so taken to income in the corresponding previous year should be reversed or should be provided for in full.

iii) With a view to ensuring uniformity in accounting the accrued interest in respect of both the performing and non-performing assets, the following guidelines may be adopted notwithstanding the existing provisions in the respective State Co-operative Societies Act:

a. Interest accrued in respect of non-performing advances should not be debited to borrowal accounts but shown separately under 'Interest Receivable Account' on the 'Property and Assets' side of the balance sheet and corresponding amount shown under 'Overdue Interest Reserve Account' on the 'Capital and Liabilities' side of the balance sheet.

b. In respect of borrowal accounts, which are treated as performing assets, accrued interest can alternatively be debited to the borrowal account and credited to Interest account and taken to
income account. In case the accrued interest in respect of the borrowal account is not actually realised and the account has become NPA as at the close of subsequent year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for.

c. The illustrative accounting entries to be passed in respect of accrued interest on both the performing and non-performing advances are indicated in the Annex 3.

iv) In the above context, it may be clarified that overdue interest reserve is not created out of the real or earned income received by the bank and as such, the amounts held in the Overdue Interest Reserve Account can not be regarded as 'reserve' or a part of the owned funds of the banks. It will also be observed that the Balance Sheet format prescribed under the Third Schedule to the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies) specifically requires the banks to show 'Overdue Interest Reserve' as a distinct item on the 'Capital and Liabilities' side vide item 8 thereof.

4.5 Provisioning Norms

Norms for Provisioning on Loans & Advances

1. In conformity with the prudential norms, provisions should be made on the non-performing assets on the basis of classification of assets into prescribed categories as detailed in paragraph 3 above.
2. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against loss assets, doubtful assets and sub-standard assets as below:

Standard Assets
(a) From the year ended March 31, 2000, the banks should make a general provision of a minimum of 0.25 per cent on standard assets.

(b) However, Tier II banks (unit banks and banks having multiple branches within a single district with deposit of Rs 100 crore and above and all other UCBs operating in more than one district) will be subjected to higher provisioning norms on standard asset as under:

i. The general provisioning requirement for 'standard advances' shall be 0.40 per cent from the present level of 0.25 percent. However, direct advances to agricultural and SME sectors which are standard assets, would attract a uniform provisioning requirement of 0.25 per cent of the funded outstanding on a portfolio basis, as hitherto.

ii. For personal loans, loans and advances qualifying as capital market exposures and commercial real estate loans, loans and advances to systemically important NBFCs-ND provisioning requirement would be 2.0 %. Salary Earners'
banks in Tier II may provide for standard assets in respect of personal loans at the rate of 0.4 percent.

(c) The provisions towards "standard assets" need not be netted from gross advances but shown separately as "Contingent Provision against Standard Assets" under "Other Funds and Reserves" (item.2 (viii) of Capital and Liabilities) in the Balance Sheet.

(d) In case banks are already maintaining excess provision than what is required/prescribed by Statutory Auditor/RBI Inspection for impaired credits under Bad and Doubtful Debt Reserve, additional provision required for Standard Assets may be segregated from Bad and Doubtful Debt Reserve and the same may be parked under the head "Contingent Provisions against Standard Assets" with the approval of their Board of Directors. Shortfall if any, on this account may be made good in the normal course.

(e) The above contingent provision will be eligible for inclusion in Tier-II capital.

There is no objection if the banks create bad and doubtful debts reserve beyond the specified limits on their own or if provided in the respective State Co-operative Societies Acts.

Substandard Assets

A general provision of 10 per cent on total outstanding should be made without making any allowance for DICGC/ECGC guarantee cover and securities available.

Doubtful Assets

(a) Provision should be for 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse should be made and the realisable value is estimated on a realistic basis.

Loss Assets

(a) The entire assets should be 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 in the books for any reason, 100 per cent of the outstanding should be provided for.

(b) In respect of an asset identified as a loss asset, full provision at 100 per cent should be made if the expected salvage value of the security is negligible.
### Tier-I

<table>
<thead>
<tr>
<th>Period for which the advance has remained in 'doubtful' category</th>
<th>Provision requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to one year</td>
<td>• 20 per cent</td>
</tr>
<tr>
<td>One to three years</td>
<td>• 30 per cent</td>
</tr>
<tr>
<td>More than three years (D-III)</td>
<td>• 50 per cent.</td>
</tr>
<tr>
<td>(i) outstanding stock of NPAs as on March 31,2010</td>
<td>• 60 per cent with effect from March 31, 2011</td>
</tr>
<tr>
<td>(ii) Advances classified as ‘doubtful for more than three years’ on or after April 2010.</td>
<td>• 75 per cent with effect from March 31, 2012</td>
</tr>
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<td></td>
<td>• 100 per cent with effect from March 31, 2013</td>
</tr>
</tbody>
</table>
## Tier-II

<table>
<thead>
<tr>
<th>Period for which the advance has remained in 'doubtful' category</th>
<th>Provision requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to one year</td>
<td>• 20 per cent</td>
</tr>
<tr>
<td>One to three years</td>
<td>• 30 per cent</td>
</tr>
<tr>
<td>More than three years (D-III)</td>
<td></td>
</tr>
<tr>
<td>(i) Outstanding stock of NPAs as on March 31, 2007</td>
<td>• 60 per cent with effect from March 31, 2008</td>
</tr>
<tr>
<td></td>
<td>• 75 per cent with effect from March 31, 2009</td>
</tr>
<tr>
<td></td>
<td>• 100 per cent with effect from March 31, 2010</td>
</tr>
<tr>
<td></td>
<td>• 100 percent</td>
</tr>
<tr>
<td>(ii) Advances classified as ‘doubtful for more than three years’ on or after April 2007.</td>
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</tbody>
</table>

The second report of Narsimhan Committee has strongly urged that the banks should strive to reach an average level of net NPA level of below 5 percent by 2000 and below 3 percent by 2002. The banking system is very far from this goal, though a few of the enterprising banks have already reached this level. It is not generally known the NPA norms in India are more stringent than
elsewhere. The Reserve Bank of India has conceded, in its Report on Trend and Progress of Banking in India. Serious efforts should be made by the Marathwada Gramin Bank for training of the staff in understanding the RBI concepts and its applications in the practical banking.

Thus, in this chapter the researcher has analyzed the concept of Prudential Norms of Income Recognition, Asset Classification and Provisioning. The Concept of NPA is closely related with these norms which were introduced after the New Economic Policy in 1990. Management of NPA depends upon understanding of these norms. The NPA level thus decided further determines the income level and quality of assets of a bank. These norms are also applicable to all Gramin Banks.
Notes & References:


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