Chapter - II

Non-Performing Assets In Commercial Banks – A Conceptual Frame Work
NON-PERFORMING ASSETS IN COMMERCIAL BANKS - A CONCEPTUAL FRAMEWORK

In this chapter, we have explained and discussed out a various concepts relating to study of Non-Performing Assets, Income Recognition and Prudential Norms, Asset classification, Provisioning norms, Rating of Banks on NPA management, Causes for mounting overdues, Prevention of NPA and Recovery measures, Appraisal of a credit proposal, General Recovery, Compromise Recovery and Legal Action on Recovery.

In common parlance, an asset becomes non-performing if it fails to contribute any income to the owners. An asset including a leased asset becomes non-performing when it ceases to generate income for the bank. Non-Performing Asset means an advance where payment of interest or repayment of instalments of principal or both remains unpaid for a period of more than six months. However with effect from March 2004, default status is given to a borrowed account if dues are not paid for 90 days.

As per the guidelines of Reserve Bank of India, income on loan assets is to be recognised on receipt basis (as against previous accrual basis). As per the RBI norms, a loan is considered to be NPA when borrower defaults on interest and/or principal repayments for two quarters. But from March 2004, a borrower who defaults on loan for one quarter is classified as defaulter and such loan is categorised as Non-performing Asset84(Jeelan Basha,2003). While many countries have tightened norms much earlier, RBI has adopted the system only from the year ending March 31, 2004. Similarly, Financial Institutions treat a credit facility as non-performing asset, if interest is overdue for more than 180 days instead of the present norm of 365 days.

Loans are the major output provided by banks, but they are a risky output, since there is always an ex ante risk for a loan to finally become non-performing. Non-performing loans (NPLs) can be treated as undesirable outputs or costs to a bank which will decrease the bank’s performance.85

The risk from NPLs mainly arises when the external economic environment worsens during economic depressions86 Controlling NPLs is hence very important
for both an individual bank’s overall performance and an economy’s financial environment.

**NPAs in Indian Banks – A Historical Perspective**

The origin of NPAs in Indian Banking Landscape can be broadly discussed in two stages:

a) Pre-liberalization era

b) Post-liberalizing era

**Pre-liberalization era**

In the context of accretion to NPAs in the banking system, the contributory factors during this period were mainly the following:

i. Down swings in agricultural sectors triggered by monsoon vagaries bringing about all round economic and demand recession.

ii. The scale of economy in relation to international standards was compromised leading to high capital cost per unit of production. This was often said to be off-set by lower labour cost.

iii. Sector-wise reservation: Reservation of major sectors for investment by Government of India (GOI) in the public sector structure in post independence days became a necessity due to various reasons including non-availability of private capital. In later years many of these Public Sector Units (PSU) (though might have served their socio-economic objectives); became commercially unviable in the absence of proper growth plan when faced with burgeoning employee cost during their life cycle. Besides, reservation in some of these sectors led to setting-up of uneconomical facilities, improper quality and product pricing (price-quality matrix) despite subsidy given by the GOI.

iv. Controlled interest rate: In the controlled interest rate regime, banks were not at liberty to price the risk premium. This led to cross-subsidization across the risk profile of the loan assets. Although additional collaterals were taken for risky loan assets in the legal system, the banks were not in a position to realize value from these collaterals.

v. Role of Developmental Financial Institutions (DFIs): The DFIs played a predominant role in the growth financing during the pre liberalization era.

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This model became unsustainable as they started facing the difficulty in rising funds. In a way the DFIs in India played the role of Venture Capital (VC) Funding without capturing the possible upside of the model. However due to non-availability of favourable legal environment coupled with various extraneous factors they are often discredited with the failures.

Post-liberalization era

India’s macroeconomic policies were conservative until the early eighties. Accompanied by some liberalization in the form of de-licensing of select industries, permitted change in product mix within the overall capacity (broad banding) and creeping relaxation of imports, during mid-eighties, the Indian economy registered an average growth rate of 5.3 percent per annum (Seventh five year plan). In fact there was a mini industrial boom in the early part of the seventh five year plan (1985-88). However, growing fiscal deficit triggered macroeconomic crisis in 1991.

With the commencement of reform of the Indian economy in 1991, banks were to follow the Basel Committee Capital Accord. Consequently, RBI issued the first set of comprehensive guidelines for Income Recognition and Asset Classification (IRAC) in April 1992. The central bank, with a cautious move, adopted time based provisioning method and averted a near crisis situation based on present value of realizable cash flow upon recognition of NPA.

With a stable political scenario during post reforms period and in the backdrop of hyped up demand projections, endorsed by several leading strategists, the Indian economy once again experienced quick capacity build up during the mid-nineties. However, towards the end of the decade, the mistake was realized as those loan assets started showing signs of impairment. The volume of NPAs in the system came to a peak level requiring focused attention. Banks set up task-forces and special asset management group to deal with the situation in a focused manner. By that time the entire South-East Asian region was reeling under an economic crisis triggered by high level of NPAs in the banking system. Many specialists and experts were by then, seriously raising concerns on possibility of India getting into a crisis ahead.

The net result was that by the mid-nineties, banking industry became risk-averse towards corporate lending activity. Many banks took strong position in the government securities. Propelled by the growth in the retail sector, the banking
sector registered a decent credit growth during subsequent period. In late nineties, during declining interest rate regime the banking sector was sitting on a sizeable capital gain. As such, to tackle the NPA stock problem the banking sector generally adopted ‘provide and hold’ strategy. As a result, net NPAs in the system declined significantly, which was also due to setting up of a self-help mechanism and Corporate Debt Restructuring (CDR) under the aegis of RBI. CDR forum has done a commendable job during the period since its inception in 2002 to restrict the flow of NPAs in the system. The flow of NPAs in the system is as follows:

- 1993 – Assets four quarter past due
- 1994 – Assets three quarter past due
- 1995 – Assets two quarter past due
- 2001 – Past due concept abolished
- 2004 – Assets 90 days overdue norm adopted (M.R. Noronha, 2006)

**Definition of NPAs**

Tim Hindle defines Non-performing Assets in his book 'Pocket Banker' as, A concept in American Bank Accounting in the year 1985, Loans are considered to be non-performing when no interest has been paid on them for at least ninety days. All the interest due (which the banks, until then have reported as having come in) has to be pruned out of their income for the period.

A non-performing asset, in the banking sector may be termed as an asset not contributing to the income of the bank. In other words it is a zero yielding asset.

In India up to the seventies, non-performing assets denoted hard core and sticky accounts only. The Pendharkar Committee, which was constituted by the RBI to look into the system of inspection of commercial banks in India, recommended for the classification of advances into different categories like bad or doubtful debts, suit filed and decreed debts and advances.

From 1985 to 1994, the commercial banks in India adopted 8 types of Health Code system for the loan accounts. They are as follows,

As per RBI guidelines, debt falling under health code 5 to 8 constituted as NPA. In spite of following the above guidelines, the financial position/health of banks as portrayed was far from true and fair. To remove the anomalies that existed in the system, a committee to review the financial system was formed. The committee on Reform of financial system, headed by Narasimham recommended for a proper system of accounting norms on income recognition, asset classification and provisioning for loans and advances, which are fundamental to the preservation of the strength and stability of the banking system. The committee recommended an objective definition of income rather than the subjective one.

Based on the recommendations of Narasimham Committee, RBI issued guidelines to the banks in the year 1998.

Further, based on the recommendations of the Narasimham Committee the RBI has directed that banks should classify the advances into the following categories:

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

The Narasimham committee has remarked that a policy of Income Recognition should be objective and based on the record of recovery rather on any subjective considerations. The International Practice, in respect of non-performing assets, interest is not recognised on accrual basis but it is booked as income only when actually received. The Narasimham committee is of the view that a similar practice should be followed by banks and financial institutions in India and accordingly recommended that interest on non-performing assets should not be booked as income on accrual basis.

As a part of the financial sector reforms process, a prudential system of recognition of income, classification of assets and provisioning were introduced by the RBI from the financial year 1992-93. In terms of the prudential norms, a non-performing asset (NPA) has been defined as a credit facility in respect of which interest remains ‘past due’ for a period of four quarters during the year March 31, 1993, three quarters during the year ending March 31, 1994 and two quarters during the year ending March 31, 1995 and onwards.

In response to certain suggestions regarding practical difficulties faced by some of the banks in implementation of prudential system of income recognition and classification of assets, as also the desirability/need to provide a longer time-frame
for compliance, an informal group was set up by the Reserve Bank of India to look into this aspect. As suggested by the informal group it was decided to give certain relaxation which included inter alia

(i) an amount under any credit facility should be treated 'past due' when it remains outstanding for 30 days beyond the due date, (ii) for treatment as NPA of advances granted for agricultural purposes, where interest payment is on half yearly basis synchronising with harvest, banks should adopt agricultural season as the basis, (iii) net worth of borrower/guarantor need not be taken into account for the purpose of treating an advance as NPA, (iv) negligible salvage value of the security may not be considered while providing for loss assets, (v) the reckoning for 'past due' in the case of project financing shall commence only from the 'due' date for payment, i.e. the date after completion of the moratorium or gestation period, (vi) credit facilities backed by the central and state government guarantees need not be treated as NPA, (vii) the treatment of NPA has to be borrower-wise and (viii) for the purpose of compliance with prudential accounting standards, credit facilities with an outstanding balance of less than Rs.25,000/- aggregate provisioning is required to be made to the extent of 2.5 percent (revised to 5.0 percent from February 4, 1994) of the total outstanding amount.93

The impact of prudential norms could be seen from the working results of the banks. The working results of nationalised banks showed total losses of Rs.3648crores in 1992-93 as against Rs.559crore in 1991-92. In 1992-93, the nationalised banks made total provisions (including provisions for non-performing assets) of Rs.4453crores against that of Rs.1809crores in 1991-92.94

INCOME RECOGNITION AND PRUDENTIAL NORMS

The Reserve Bank has given the following clarifications in the context of the norms laid down for income recognition, provisioning and classification of assets in a circular dated 17 Dec, 1992 addressed to all the Scheduled Commercial Banks (excluding RRBs) regarding past due and NPA.

“Banks are required to consider an amount “past due” when it has remained outstanding for 30 days beyond due date. The reversal of unrealised interest and other charges should be restricted to the amount booked in the accounting year 1991-92 only, and not to any year prior to that. However, for the purpose of
treatment of a credit facility as Non-performing Asset (NPA) as on 31st March 1993, the period for which interest has remained uncollected should be reckoned.

**Agricultural advances**

Advances granted for agricultural purposes where interest payment is on half yearly basis synchronising with harvest, banks should adopt agricultural season as the basis.

**Treatment of loss assets**

The availability of security or net worth of the borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

Negligible salvage value of available security should not be reckoned with, for the purpose of provisioning. If, however, the auditors/RBI inspector are satisfied that a substantial portion of the assets is realisable, the credit facility can be treated as doubtful and provisions must be made in full for the uncovered portion.

**Moratorium and due**

In the case of bank financing given for industrial projects or for agricultural plantations, where moratorium is available for payment of interest, payment of interest becomes “due” only after the moratorium or gestation period is over. Therefore such amount of interest would become “past due” 30 days after the due date for payment of interest, if uncollected and not from the date of debit of interest. For such loans also to become NPA similar logic would apply.

Similarly, in the case of housing loans or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as “past due” from the first quarter onwards.

**ASSET CLASSIFICATION**

On asset classification the Narasimham Committee had opined that for the purpose of provisioning banks and financial institutions should classify their assets by compressing the then prevailing eight health codes into four broad groups viz. standard, sub-standard, doubtful and loss assets. The bifurcation of assets into performing and non-performing for income recognition purpose extends logically as follows:
1. Standard Assets

Standard Assets are Performing Assets. This is not NPA. It does not disclose any problem and does not carry more than normal risk attached to the business.

Non-Performing assets can be classified as: 2. Sub-standard Assets, 3. Doubtful Assets and 4. Loss Assets.

2. Sub-standard Assets

Presently, in case of term loans, a sub-standard is one where instalments of principal are overdue for periods exceeding six months but not exceeding one and half years. When the 4 quarter norm for NPA classification was in vogue, term loans were classified as sub-standard if the instalments were overdue for over one year but less than two years.

3. Doubtful Assets

In the case of term loans, a doubtful asset is one where instalments of principal remained overdue for a period exceeding one and a half years. Earlier, this overdue period was two years under the 4 quarter norms for NPA classification.

4. Loss Assets:

A loss asset is one where loss has been identified by the bank or by the internal or external auditors, but the amount has not been written off, wholly or partly.95

PROVISIONING NORMS FOR CLASSIFICATION OF ASSETS

While arriving at NPA, the following balances are provided:

i. Interest not collected Account (INC)

ii. Interest Suspense Account, if any

iii. Unrealised interest of the previous year.
The provisioning for various types of Assets is done from post-tax profits as shown below:

**Table 2.1**

**Provisioning Norms for Classification of Assets**

<table>
<thead>
<tr>
<th>SL. No.</th>
<th>ASSET CATEGORY</th>
<th>PROVISION (in percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>Standard Assets</td>
<td>Nil</td>
</tr>
<tr>
<td>B.</td>
<td>Sub-standard Assets</td>
<td>10.0</td>
</tr>
<tr>
<td>C.</td>
<td>On secured portion of Doubtful Assets:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>up to 1 year</td>
<td>20.0</td>
</tr>
<tr>
<td></td>
<td>1 year to 3 years</td>
<td>30.0</td>
</tr>
<tr>
<td></td>
<td>Over 3 years</td>
<td>50.0</td>
</tr>
<tr>
<td>D.</td>
<td>Loss Assets and Unsecured portion of Doubtful assets</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: Provisioning on the total outstanding amount

**Causes for Mounting over dues**

Tendency of the banks to lend liberally during the upswings of business cycles with excessive concentration on credit in real estate and equity markets, inadequate preparation for financial liberalization particularly in respect of banking supervision, large scale government involvement in the banking sector and lose control on connected lending, accounting conventions which are not rigorous enough to prevent banks and their borrowers from concealing the true size of the non-performing portfolio, poor credit appraisal system along with lack of proper monitoring of lending portfolio, lack of sincere corporate culture and bad loans made to look good many a time by additional lending to troubled borrowers are some of the causes for growing NPAs.

A major factor contributing to the high level of NPAs has been the inadequate legal frame work for collecting overdue of loans. Although loans are legally collateralised, in practice, the value of the collateral may not commensurate with the loans, and more importantly, timely execution of collateral often remains difficult.
Factors contributing to NPAs

Diversion of funds for expansion, modernization, undertaking new projects and for helping associate concerns are the major factors contributing to NPAs. This is coupled with recessionary trends and failure to tap funds in the capital and debt markets. The factors responsible for NPAs are,

- Business failure, (product, marketing and so on) inefficient management, strained labour relations, inappropriate technology, technical problems, product obsolescence and the like.
- Recession, input/power shortage, price escalation, accidents, natural calamities and the like. Besides, externalization problems in other countries leading to non-payment of overdues.
- Time/cost overrun during project implementation stage.
- Government policies like changes in excise duties, pollution control and so on.
- Wilful default, siphoning off funds, fraud/misappropriation by promoters/directors.
- Deficiencies on the part of banks like delay in releasing of funds and delay in releasing of subsidies by the Government.

It is well known that the bulk of the amount locked up in NPA has been caused due to snags in legal system. The basic security for working capital finance by banks is hypothecation of movable goods. But it is sad that neither Indian Contract Act nor Transfer of Property Act contain any provision for defining hypothecation, rights and obligations of hypothecator and hypothecatee. Now as a consequence of default in payment of banks dues, right to take possession of hypothecated security is not available to banks and in case borrower refuses to give possession of hypothecated security, banks have no right to take forcible possession except through court, even if agreement of hypothecation so provides. There are also instances where the banks find that borrowers have sold the hypothecated goods but neglected to deposit the sale proceeds as part of repayment of loan. But courts normally consider such conduct as a breach of contract and not as a crime. Experience also shows that in the matter of other securities like immovable properties, guarantees, banks do not have any right to enforce the securities on their own and have to obtain recovery from courts. Since suits by banks do not get
priority in courts, it takes a long time to settle the suit and by which time the
securities deteriorate in value and the recovery of it becomes impossible. Another
constraint in recovery of banks dues is the claims of the government revenue dues
and labour dues out of the sale proceeds of the security whenever a bank attempts to
recover its secured loan. In yet another instance while going for sale of securities, in
the form of immovable properties banks have to face problems on account of
restriction imposed by the Urban Land Ceilings Act, 1976, besides obtaining
permission from State Government authorities98.

From the branch manager’s angle, many difficulties are faced in management
of NPAs. Difficulties in keeping a close supervision and effective follow-up system
at branches arise due to increasing routine work load, shortage of staff and lack of
co-operation from borrowers in submitting stock statements, balance sheets and the
like99.

The other factors contributing for NPAs are as follows

- non-payment of the very first instalment in case of term loans;
- Non-submission of stock statements in time.
- Cheques drawn on the account are bouncing
- Credits into the cash credit account are not sufficient to meet the debits in
  the account
- the overdue bills are lying unpaid
- instalments are irregular
- amount paid is not fully covering the principal and interest debited
- no regular operations in the cash credit account
- bank has information that party is not doing the business
- post sanction inspection report speaks of diversion and mis-utilisation of
  funds
- There has been a natural calamity in the borrower’s village100.

The repayment rationale irrespective of the category of borrowers is based
on the assumption that the beneficiary implements the techno economic
terms/conditions of the sanction, makes judicious use of loan, generates incremental
income and repays his/her loan from the surplus so generated.
According to L.C. Mathur, the ideal advance is one which is granted to a reliable customer for an approved purpose in which customer has adequate experience, safe in the knowledge that the money will be used to the advantage and repayment will be made within a reasonable period.

But an ideal advance is rare. There are reasons, internal and external, for rise in NPAs. While internal reasons are within the control of the banks, external ones are beyond control; some of these are given below:

1. Large scale dilution of procedures and practices of lending, loopholes and shortcomings even at the appraisal stage.
   - Improper selection of borrowers, inadequacies of character, capacity and capital at the borrower's level.
   - No time limit for conducting pre-sanction inspection, making discreet enquiry, processing, sanction and release of loans.
   - Deficiencies in appraisal, processing, sanction and release.
   - Inadequate/excess sanction of the limit irrespective of the economic size of the unit.
   - Scattered financing.

2. Unrealistic terms/conditions of the sanction and fixing unrealistic repayment schedule.

3. Deficiencies in documentation.

4. Lack of supervision and follow-up and the resultant diversion of funds, alienation of securities.

5. Political interference in sanctioning of loans and patronage to defaulters.

6. Lack of infrastructural facilities like power, raw-materials, fuel, transportation, marketing and technical support.

7. Nature also causes imbalances in the form of drought, floods, hurricane, winds, earthquakes, cyclonic storm, lightening and the like which spoil the crops and livestock. The functioning of unit goes out of gear. These factors add to the woes of borrowers in meeting their repayment commitments to banks.

8. Lack of inter-bank co-ordination as well as co-operation with financial institutions in exchange of information over list of defaulters.
Wilful Default

A Wilful default is a situation where in the borrower has the capacity to repay but deliberately does not repay the bank loan. This is a peculiar situation for the banks. The borrower earns sufficient income, generates adequate surplus but deliberately defaults in repayment of bank's dues. Some of the glaring examples of wilful default are:

- Utilisation of loan to repay old debts due to the money lenders, friends and relatives.
- Utilisation of loan towards real estate and gold.
- Utilisations of loan towards purchase of consumer durables like car, two wheeler, television, air-conditioner and fridge.
- Utilisation of loan towards marriage of sisters/daughters.
- Utilisation of loan towards professional education of sons/daughters.
- The borrowers in the initial stage of availing loan run the business satisfactorily and repay the instalments timely. They earn the confidence of the bank. But subsequently shift the business to other places without informing the bank.
- Transfer of jobs to the Government employees from the place where they bought the loan based on the salary to another place with the result loan is not deducted from their salary.
- Siphoning off of funds or diversification of loan to other more profitable economic activities and thereby making the original unit on which the loan is availed sick.

The problem of wilful default arises because of the fact that the general atmosphere for recovery of banks' dues has been vitiated by frequent waiver and write-offs. The inculcation of the banking habit including repayment ethics amongst beneficiaries has assumed critical importance in view of the increasing tendency among political parties to use the repayment issue as an instrument of patronage. Large, medium or small borrowers whether in rural or urban centres are made to believe particularly during election time that they can get away with defaults and will receive support for indulging in this misdemeanour.101
Higher NPAs limited the lending capacity of the banks. Periodical reviews on the status of NPAs are also being submitted to their respective top management. To prevent drifting of standard assets into NPAs, periodical dialogue with the borrowers have become more common than before.

Rating of bank performance regarding NPA Management

In recent years a paradox has been observed in NPA management of Indian banks. The criteria of gross NPA as well as net NPA percentages cannot be the only yardsticks for measurement/rating a bank's performance in terms of NPA management. Moreover, the techniques adopted by banks for NPA reduction vary widely and play a significant role in the quality of NPA management of banks. For example, the NPA reduction by maximum compromise and write-off, is significantly different from the NPA reduction by up-gradation. Similarly, the gross NPA to gross advance may be higher in a bank, but its gross NPA to total assets may be lower in comparison to other banks. When RBI has adopted stringent prudential norms for maintaining good health of the banks; it is therefore, necessary that for effective supervision, RBI or Bank Boards should adopt a standardized Rating Model to grade banks/branches with respect to the quality of NPA management being adopted by them. The NPA management rating should be one of the parameters for evaluation of all the public sector banks. The NPA Management Rating Model should be a comprehensive one and it should take care of all aspects of NPA management. Various parameters for rating of NPA management are Gross NPA Ratio, Net NPA Ratio, Provision Ratio, Slippage Ratio, Substandard Asset Ratio, Doubtful Asset Ratio, Loss Asset Ratio, Negotiability Ratio etc.

The performance of a bank/branch on the above parameters is required to be compared with the benchmark standardized by the RBI/Bank Board as well as with the performance of the peer groups or with that of the industry best performers or the banking industry averages. As the NPA management is an ongoing process, the performance of a bank/branch for a particular year has to be compared with that of the previous year to know the improvement/deterioration in the quality of the NPA management strategies adopted by the bank/branch.
Effect of NPAs

The large percentage of NPAs has serious effects on the behaviour of banks at the micro level that may affect the economy. The large percentage of NPAs has deleterious impact on a bank's profit in a number of ways.

A. Profit and Profitability
1. Non-recognition of interest on NPAs, provision requirements for sub-standard, doubtful and loss assets or bad debts, heavy recovery costs, including legal fees and the like affect the profit of the bank drastically.
2. Funds blocked in NPAs could have been deployed in other profitable ventures had there not been such advances.
3. When the bank funds are blocked in NPAs, the bank has to raise funds at high costs to honour the pressing commitments.
4. Branches of Indian banks abroad will have to raise the funds at a higher cost in the international markets due to poor rating from weak capital base. This will affect the profitability of bank branches operating abroad.

B. Other Internal and External Effects including Capital Adequacy Norms
1. Successive reporting of net losses erodes the public image of the banks.
2. The enthusiasm and morality of the employees may get affected.
3. Due to the non-availability of funds the bank may not be in a position to meet the genuine loan requirements of prestigious corporate clients, thereby leading to the shift of such customers to other financial institutions.
4. Further investments in computers and other capital intensive technology become difficult due to the poor financial position of the bank. This may lead to the loss of competitive edge over its competitors.
5. Potential interest income is derecognized. As a result, profit of the banking institution depletes.
6. Depending upon the categorization of NPAs i.e. sub-standard, doubtful or loss assets, the banking institutions will have to make provision against such loans ranging from 10% to 50% or even 100% in case of some assets.
7. In case the banking institution fails to upgrade the NPAs into performing assets, it may be forced to incur legal expenses by going to court or Recovery Tribunals.
8. As a consequence, profit and profitability of the banking institution is depleted and it may face problem of maintaining the required capital adequacy norm, may downgrade the banking institution rating and adversely affect its growth and survival.

**Prevention of NPAs and Recovery Measures**

Identification of early warning signals and taking timely follow-up measures can prevent any advance becoming NPA since it is said that prevention is better than cure.

Although a lot has been said about improving the follow-up and monitoring of advances the situation at the branch level is far from satisfactory. "Bankers need to spend a lot of time in the field, looking after the projects and personally meeting the borrowers. The difficulty today seems to be that the banks are not in a position to motivate their staff who are used to a certain style of credit dispensation". Therefore it is very important to discuss about the Appraisal of a credit Proposal for prevention of NPAs.

There are certain simple but important basic points a banker has to apply his/her mind to, and be alert about, while appraising a credit proposal. We can group them as 5Cs, 6Ms and 7Ps as shown below:

5Cs: Character, Capital, Capacity, Conditions and Collateral;
6Ms: Man(Management), Money, Machine, Material, Market and Men(Workers and Employees)
7Ps: The product, Project, purposes, Place, By people, Policies and Profit.

Therefore undoubtedly, proper appraisal is the best solution for preventing and controlling NPA. Good faith without negligence is also important approach to control the NPA. If one takes at least 50 per cent of the care that one is expected, then to take then 75 per cent of the problems can be avoided for the bank.
RECOVERY MEASURES OF THE BANKS

A) GENERAL RECOVERY MEASURES

1. Personal touch with borrowers

   It is true that nationalization of banks has converted class banking into mass banking and took banking to unknown and unexplored areas. But unfortunately it had the undesirable effect of lack of personal interaction with the borrowers and account holders. This might be due to the heavy workload of bank employees and large number of account holders and borrowers. So, banks have to take measures to regain the lost personal touch with the account holders and borrowers.

2. Professionalism in Credit appraisal

   Credit appraisal is the first and very important step to sanction any loan. It consists of evaluating the viability of the business proposition, mental and physical capabilities of the borrower, market conditions and other related factors. These factors vary from case to case and are in several respects volatile. An untrained bank employee cannot understand the technicalities of the credit appraisal.

3. Common documentation

   The terms and conditions of the undertaking between the creditor and the borrower are very significant as it serves as a record of transactions and also serves the legal purpose. The more precise and clear the documents are, the more certain would be its purport and interpretation given by courts. Unfortunately different banks obtaining same type of securities use different titles and terms making the documentation more complex. Sometimes legal gaps in the documentation add insult to the injury of bankers.

4. Re-phasing of loans:

   Repayment of a term loan depends on income generating capacity of the borrowing concern.

5. Rehabilitation of the potentially viable units

   If a sick unit is potentially viable, necessary efforts should be made to finalize the rehabilitation package without loss of time. Though rehabilitation of sick units is a long drawn procedure, it may be encouraged where units are potentially viable and the management is reliable.
6. Acquisition of sick units by healthy units

Banks should encourage acquisition of sick units by healthy units. If a sick unit is acquired by a healthy unit, the outstanding loan amount of the sick unit may be transferred to the healthy unit thereby banks have the opportunity to recover the loans and advances.

7. Credit Information Bureau

Credit intelligence is one of the casualties in the Indian banking system. For example an individual defaulting on credit payments in the U.S. will be barred from availing credit from any bank as the information is flashed throughout the banking system.106

In India a beginning has recently been made in this regard. The first credit information Bureau started functioning in India in the year 2005. The Bureau shares the information among its members who include banks, financial institutions, non-banking financial institutions and the like. In the year 2005, the Bureau collected information of 55 lakhs account holders. If the Bureau expands its operations to all banks and share relevant information, the non-performing assets can be reduced considerably.107

8. Priority Sector NPAs

Tackling priority sector NPAs by holding recovery camps, Lok Adalats, counselling the borrower are very essential.

9. HRD: Training Intervention

Seminars and regular training programmes on credit and NPA management for all levels of executives are desirable to upgrade the skills necessary to:

a) Improve assets quality
b) Prevent deterioration of assets
c) Limit losses on fuzzy assets and
d) Effect quicker recovery/realization in NPA accounts.108

10. Credit Counseling

An independent person, possessing required qualification and experience, could provide counseling to the borrower, so that the difficulties faced by the borrower can be revealed at an early stage and required suggestions can be given, which includes realignment of facilities. Counseling should not be restricted to very
small borrowers only. The units, which are on growth path to become medium or large, also require counseling. The process of credit counseling could provide a major boost to the business, once it is realized that the bankers take a pragmatic view of the situation, without diluting the required business discipline\textsuperscript{109}.

11. Credit Risk Management

The origin of the problem in burgeoning NPAs lies in the quality of managing credit risk by the bank managers. What is needed is having adequate preventive measures in place namely, fixing pre-sanctioning appraisal responsibility and having an effective post-disbursement supervision. Banks concerned should continuously monitor loans to identify accounts that have the potential to become non-performing. The process of monitoring would be greatly facilitated by the mechanism of credit information companies which shall maintain information on credit takers in the form of a database. The credit rating system of banks helps the credit information company in the assessment purpose\textsuperscript{110}.

B) COMPROMISE RECOVERY

Compromise: Compromise by bank with the borrower would involve

- negotiated settlement
- sacrifices by both sides wherein the bank agrees to accept an amount less than their dues worked out as per credit contract, while the borrower turning out non-profitable, agrees on his part to raise funds either by sale of his/her assets including those charged to the bank or through other sources and repays the bank’s dues.

The basis behind negotiated settlement is bank’s appreciation of the fact that the default is the consequence of factors over which the borrower has no control and he/she has not unduly enriched himself in the process of bank-borrower relationship. While compromises with wilful defaulters can be termed as unethical and an act of misplaced trust, nonetheless on business considerations the banks prefer immediate recovery of such dues rather than going through protracted legal proceedings; in the process, banks also apprehend depletion/evaporation and deterioration of security. Compromises in respect of BIFR cases, are referred as One Time Settlements (OTS). Sometimes, the term OTS is also referred to compromises covering a particular facility/account.
The factors responsible for Compromise

It is logical that when compromise involves sacrifices, it will not be pursued unless both the parties to the settlement perceive latent gains as well in the bargain.

The motivating factors could be:

a. For the Borrower
   i. Settling for a lower payout than the contracted one; scaling down of dues.
   ii. Releasing assets charged to the bank.
   iii. Saving time, energy and expenses on defending the inevitable legal case.
   iv. Keeping avenues of bank finance open for further developmental needs.
   v. Restoring status/position in the market/society; avoiding stigma of being branded as a borrower who is 'litigant type'.

b. For the Bank
   i. NPA is a double edged weapon which affects bank’s profitability due to, interest income not being recognised, and ii) Provisions to be created/made from profits earned. Compromise settlements are encouraged by banks on the following considerations.
   ii. Concept of time value of money, i.e., “a bird in hand is worth two in bush”. The money realised early could be invested/ lent to earn.
   iii. Realisation of securities is difficult. Stock of raw materials and finished goods, machinery have high incidence of depreciation and obsolescence. On taking possession, storage/safety thereof poses a problem and also involves cost for a longer period. Even in cases where court receiver / commissioner is appointed, assets do not get realised fast. Value of mortgaged agricultural land and properties located in rural/ semi-urban areas is difficult to realise and no bidder comes forward when the property is put to auction. This is precisely the reason why many decrees obtained by the banks have merely remained on paper for want of effective execution thereof.
   iv. To maintain the image of ‘development banker’. The principle of natural justice is stretched too far by the defendants. Loopholes in the legal system are thus exploited. Summons is not served for long. Counter-claims are often made against the banks. Courts are saddled with too many cases and the inadequate strength of judges and infrastructure adds to delays. Some
advocates engaged by the banks are also not very effective. Some of the bank’s advocates are overburdened with cases. Further, the follow up of court cases by bank officials is often lax. A sense of indifference is noticed in the follow up of accounts for which legal measures are initiated\textsuperscript{111}.

**ONE-TIME SETTLEMENT AND WRITE-OFFS**

It is recognised that One-Time settlement should form an integral part of strategy for dealing with NPAs. A transparent system has to be put in place for dealing with proposals for one time settlement. While banks had to design procedures best suited to their needs and circumstances, the Board of banks could also consider setting up of advisory bodies comprising eminent professionals from outside including retired persons from judiciary for advising them on matters relating to finalising of one-time settlement. The Finance Minister while moving the Finance Bill 1999-2000 suggested RBI to formulate the guidelines and instruct banks to set up “Settlement Advisory Committees” (SACs) with a view to having compromise proposals settled expeditiously\textsuperscript{112}.

**Lok Adalats and its Action Plan**

Lok Adalats have gained prominence over a period of time as a forum through which the disputes/settlements among the parties are settled through an expeditious compromise settlement by adopting principles of justice, equity, fair play and other legal principles.

In the case of NPA amount is Rs.10lakhs and above there will be sizeable reduction in the level of NPAs cases are settled.

- Depending on the Grouping of amount involved a decision has to be taken to approach the legal services cell attached to the District Court or High Court.
- Once the date is finalised, proper liaison to be kept with court authorities since their full cooperation is required for the success of the Adalat.
- The addresses and other details of the borrowers and guarantors are to be handed over to the court authorities for issue of summons through bailiffs.
- In each branch two officials are to be identified for executing the work in connection with the Lok Adalats. The Branch Manager will coordinate between the court authorities and the officials identified. The officials are to accompany the court bailiffs for issue of notices.
• Print the Agreement of compromise, Form of Decree and Calculation sheets forms and keep them ready.

The branches fill up the calculation sheets and make them available before the reconciliation day for the decision making authorities of the bank to have a proper bargaining. Reconciliation dates and venue must be fixed, the branch official should be present at the venue fixed for negotiation and finalisation of the offer to be documented on the Lok Adalat day. It is essential that the party deposits a reasonable amount of the agreed sum on the Lok Adalat day to make the agreement forceful. On the Lok Adalat day, the agreed cases as above and the other cases coming up for negotiation be finalised and documented. Officials from the Regional Office, who are co-ordinating the Lok Adalat, should collect the details from branches and consolidate them. Branches should be advised to put the compromise proposals and get them approved by regional heads. Regional heads while submitting their sanction should get the proposals sanctioned by higher authorities. The entire processes should be completed within 15 days from the day of the Lok Adalat. The Region/Zone office has to follow-up the court authorities to get the decrees passed by the concerned court for further follow-up113.

C) LEGAL ACTION RECOVERY

**Filing Suits**

Civil suits may be filed against borrowers who are not likely to come forward to a reasonable settlement. Bankers should not feel that their job is over by filing a civil suit. Proper follow-up of the court cases is highly essential. Banks should also revise the list of approved advocates from time to time keeping in view their performance. Advocates who do not perform well should not be given new cases. To the defaulters the bank sends ordinary notice, then Registered and final notice. If he/she fails to respond any of these notices then the banker through the lawyer will take action on filing suits. If a reasonable settlement is possible even after the court cases, compromise may be made with the knowledge of the court114.

**DEBT RECOVERY TRIBUNALS (DRTs) / RECOVERY BY TASK FORCE**

DRT is autonomous in nature. Banks and financial institutions recover dues by way of filing the cases against the defaulted borrower in the DRTs and follow-up their cases115.
‘The Recovery of Debt due to Bank and Financial Institution Ordinance-1993’ (RDBFI Act-1993) was promulgated on 24th June, 1993 and a separate ‘Fast Track Judicial’ system for the cases related to recovery of Banks and Financial Institutions was set up in the form of ‘DRT and DRAT’ in India. After obtaining the consent of parliament and the president, the ordinance was replaced by an Act on 27th August, 1993. In view of compliance of the instruction of the Act, the Central Government has established 29 DRTs and 5 DRATs till 2005 and made various ruling according to the purpose of rules for making the function of DRT/DRATs smoother and faster. At present, cases having suit amount up to Rs.9,99,999/- are filed in Civil Court and for Rs.10 lakhs and above in DRT\textsuperscript{116}.

- The object of the Act is expeditious adjudication and recovery of debts due to Banks and Financial Institutions and to deal with matters connected therewith or incidental thereto.
- The Act will not apply where the amount of debt due to any Bank or Financial Institution or to a Consortium of Banks or Financial Institutions is less than rupees ten lakhs or such other amount being not less than rupees one lakh as the Central Government may, by notification, specify.
- The Act has defined “debt” which means any liability (inclusive of interest) which is alleged as due from any person to a Bank or a Financial Institution or a Consortium of Banks or Financial Institutions during the course of any business activity undertaken by them under any law in cash or otherwise, whether secured or unsecured or payable under a decree or order of a Civil Court or otherwise.
- The Debt Recovery Tribunal (DRT) shall deal with the matter expeditiously and endeavour to dispose off the application finally within six months from the date of receipt of application.
- The Tribunal, subject to the other provisions of the Act and Rules there under can regulate their own procedure and shall not be bound by the procedure laid down by the Civil Procedure Code.
- All recovery suits or other proceedings for recovery of the debt of nature and quantum covered by the Act and pending before any Court immediately before the date of establishment of the Tribunal shall stand transferred to the Tribunal on the date of establishment.
The Appellate Tribunal shall also deal with the appeal as expeditiously as possible and endeavour shall be made to dispose off the appeal within six months. It shall send a copy of the order to the parties to the appeal and to the concerned Tribunal. The appeal by any person indebted to a Bank or Financial Institution shall not be entertained by the Appellate Tribunal unless 75% of the amount of the debt due to the Bank(s) or Financial Institutions has been paid by the person concerned. This requirement of payment may be waived or reduced by the Appellate Tribunal for reasons to be recorded in writing.

Asset Reconstruction Companies

The need for the setting up of an Asset Reconstruction Company for acquiring distressed assets from Banks and FIs with a view to develop market for such assets was being felt, since long. Narasimham Committee I and II and the Verma Committee on restructuring of weak banks have strongly recommended for the setting up of ARCs.

One of the objectives of the SARFAESI Act 2002 is, establishment of an ARC. The ARCs are envisaged to enable the Banks and FIs to sell off/transfer the NPAs. The ARCs are the centralized agencies for resolving bad loans. They are further expected to help the promoting institutions to spruce up the balance sheet by taking bad loans off their books. The ARCs are not peculiar in India. Several countries have tried variants of ARCs to rescue the troubled banks.

The provisions of the Act, cover wide range of activities which include registration and operations of ARCs. Section 7(1) and 7(2) of the Act provides specific guidelines enabling ARC to

- Securitize NPAs.
- Issue security receipts to qualified institutional buyers (QIBs) include, FIs, Insurance Companies, Asset Management Companies making investment on behalf of banks, mutual funds, pension funds, gratuity or provident funds and FIs registered by the SEBI.
- Transfer the acquired assets from the originators to the trust.
- Hold and administer the financial assets for the benefits of the QIBs.

Thus, the accounting aspect relating to transfer of NPAs portfolio to ARCs
should follow relevant Accounting Standard and GAAP. However, recoveries should be recorded only on cash basis. Furthermore, when the ARCs manage to generate enough surpluses through the sale of bad and doubtful loans transferred to them, it will be shared among the sponsors 119.

All ARCs are to be regulated and registered with the RBI. There will be a Central Registry and Central Registrar, to whom details of all individual transactions are to be reported, on an ongoing basis. Further, all the ARCs are required to maintain, on an ongoing basis, a capital Adequacy Ratio of not less than 15% of its Total Risk Weighted Assets.

Corporate Debt Restructuring (CDR)

In spite of best efforts and intentions, sometimes corporates find themselves in financial difficulties because of factors beyond their control and also due to certain internal reasons. For revival of the corporates to come out of the financial difficulties and to ensure safety for the money lent by the Banks and Financial institutions it is necessary to restructure the Debts, but due to delay in the agreement among the Banks and Financial institutions it becomes difficult to restructure the Debt. In view of the said reasons it became necessary to set up a Corporate Debt Restructuring System.

OBJECTIVE OF CDR

- To ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings for the benefit of all concerned.
- To aim at preserving viable Corporate that is affected by certain internal and external factors.
- To minimise the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

The CDR System consists of the CDR Standing Forum and its Core Group; CDR Empowered Group and CDR Cell following three tier structure for the efficient functioning.

The CDR System will also provide an official platform for both creditors and borrowers to amicably and collectively examine policies and guidelines for working out debt restructuring in the interest of all concerned120.

The securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 is an important landmark in Indian banking scenario. With the passage of the Act, the banks and the financial institutions have been quick to initiate action against the defaulters of loans. The banks and the financial institutions are empowered to takeover dead assets of the defaulting borrowers. The act mainly aimed at meeting three important objectives i.e. Securitisation, Asset Reconstruction and Enforcement of the Security Interest.

Securitisation: The Concept

Securitisation is a process through which illiquid assets are packaged, converted into tradable securities and sold to third party investors. Section 5 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 mandates that banks and financial institutions can securitize their financial assets. In the Securitisation process, the lending financial institution is originator and the borrowers are acting as obligators. The originator has to pool homogeneous nature of assets and these are passed to another institution called Special Purpose Vehicle (SPV) or the trust which converts these assets into tradable securities. The SPV splits the package into securities such as pay through certificates, preferred stock certificates and so on.

Definition of Securitisation

Securitization means acquisition of financial assets by any Securitization Company or Reconstruction company from any originator, whether by rating of funds by such Securitisation Company or Reconstruction Company from qualified institutional buyer or by issue of security receipts representing undivided interest in such financial assets.

When the borrower fails to repay the loan amount, then according to RBI guidelines the reconstruction company can take the following measures:

The proper management of business by the borrower, by change in or takeover of the:

a) Management of the business of borrowers.

b) The sale or lease of a part or whole of the business of borrower.

c) Enforcement of security interest in accordance with the provisions of this act,
for settlement of dues payable by the borrower.

d) Taking possessions of secured assets in accordance with the provisions of this act.

Provisions of the Act

1. In the event of default by any borrower, a lender is required to give a notice of 60 days to the borrower, failing which a lender can seize the assets secured to him by the borrower. Lender can take possession of these assets.

2. Take over the management of the assets and appoint any person to carry out the management of the asset. This right has been presently stalled by RBI guidelines.

3. Borrower can approach the DRT to stop the lender’s action by paying 75% of the amount due. However, DRT can waive these requirements at their own discretion.

4. In the cases of there being more than one borrower, lenders in three-fourth of value of NPA must agree to the action.

5. Workmen’s dues have priority over secured creditors.

6. District magistrate/chief metropolitan magistrate (DM/CMM) is the requisite authority to issue seizure orders and DM/CMM can undertake any action to enforce the security interest. Such actions cannot be called into question in any civil court.

7. If the interest of secured creditors is not fully satisfied from the sale of seized assets, DRT may proceed against the borrower in a manner it deems fit.

Classes of assets excluded from the provisions of the Act

- Any security interest created in agricultural land.
- Any Financial Assets,
  - Where amount due is less than 20% of the principal amount and interest amount there on.
  - Loan below Rs.100000.
- Pledge of movable assets within the meaning of section 172 of Indian Contract Act, 1872.
- Any conditional sale/hire purchase/lease or any other contract in which no security interest has been created.
• Security in Air Craft’s/Shipping vessels.
• Unpaid seller rights (Sec 47 of Sale of Goods Act, 1930)
• Properties not liable for attachment (under sec 60 of Civil Procedure Code, 1908)

Given these exclusions, the act will cover only 70% of the NPAs existing at present.

This act provides for very strong creditor rights and hopefully it sends a stronger signal to borrowers and judiciary. However, there are many instances where enforcement of this right has come in conflict with other laws. Since it has implication on the business as a whole, right to disposal can be delayed by courts. It is also possible that asset pledged is inseparable so enforcement of creditor right will be messy.

**Purpose of the Securitisation Act, 2002**

It is a sale and purchase of good quality debts and receivable through Securitisation Company. Securitisation Company can acquire any asset. Assets having good ratings are generally securitised. But financial assets can be acquired for asset reconstruction only for the purpose of realising the financial assistance.

**Impact of Securitisation Act, 2002 on banking**

In the traditional lending process a bank makes loan, maintains it as an asset on its balance sheet, collects principal and interest and monitors whether there is any deterioration in borrowers credit worthiness. This requires a bank to hold the asset till maturity. The funds of the bank are blocked in these loans. To meet its growing fund requirement a bank has to raise additional funds from the market. Securitisation is a way of unlocking these blocked funds. Other than freeing up the blocked assets of banks securitisation can transform banking in other ways as well.

The growth of credit off take has not been matched with the growth in deposits. It means the deposit inflow being less than the credit out flow of banks. The banks selling of government paper has been declining. But beyond certain level banks cannot sell any government securities to generate liquidity. In order to keep giving credit banks either have to increase interest rate or go for securitization, Banks can securitize the loans which they have given out and use the money brought in by this to give more credit. Securitisation can act as a risk management tool because it eliminates the interest risks and provides a hedge against interest risks.
Securitisation helps banks to sell off their bad loans or Non-Performing Assets (NPAs) to Asset Reconstruction Companies (ARCs). ARCs which are typically Government owned act as debt aggregators and are engaged in acquiring bad loans from the banks at a discounted price and they sell them to other investors, thereby freeing the banking system to focus on normal banking activities. A lot of banks have been selling off their NPAs to Asset Reconstruction Company of India Limited (ARCEL) which is the only ARC operating in India. SBI, IDBI and ICICI banks have sold their bad loans to ARCEL.

Blocking of capital in NPAs can reduce the capital adequacy of banks and can be a hindrance to banks to meet the Basel II capital adequacy norms. Thus banks will have two options either to raise more capital or to free capital tied up in NPAs and other loans through securitisation. Under Securitisation risk weighted assets can be converted into low risk weighted assets. It helps to achieve better capital adequacy norms.

Furthermore it offers an excellent source of funds at cheaper rates. It provides more liquidity, quick recycling of funds and the banks need not depend on the market for money at call, and short notice and other sources. The Securitisation has the effect of improving the profitability of banks. Thus, Securitisation is changing the banking business in India.\textsuperscript{125}

In this chapter, we have discussed the concepts relating to study of Non-Performing Assets i.e. Non-performing Assets is defined as an advance where interest and/or instalment of principal remains overdue for a period of more than 90 days. The chapter also focussed on historical perspective of NPAs from pre-liberalisation stage and post-liberalisation stage, 4 types of Asset classification, Provisioning norms for classification of assets as standard, sub-standard, doubtful and loss assets, factors contributing to NPAs. Rating of banks performance regarding NPA management with respect to various ratios as gross NPA ratio, net NPA ratio and so on, Causes for mounting overdues, Prevention of NPAs and Recovery measures for reducing NPAs i.e. appraisal of a credit proposal are discussed. Finally the present chapter also discusses various recovery measures adopted in reducing the NPAs. No doubt, there are number of recovery measures and recovery policies operate in India but their effectiveness finally depends on the involvement of the banks, the branch managers of the banks and the prompt payment of the loan by the both beneficiaries and defaulters.
References


