earlier studies and literature, methodology, sources of data, tools and techniques of analysis and division of chapters.

The second chapter relates to the conceptual frame work of Credit Risk Management with regard to Basel I and Basel II and Management of Non Performing Assets, recommendations of various committees dealing with the problem of Non Performing Assets, prudential norms of RBI and Government for resolution of NPAs.

The third chapter examines the magnitude of Credit deposit ratio, Capital Adequacy Ratio, Credit Risk and Non Performing Assets of SCBs, Sector-wise NPAs and Loan asset quality of different bank groups and recovery of Non Performing Assets by SCBs in India.

The fourth chapter analyses the perceptions of branch managers on the various issues relating to Credit Risk Management on Management of Non Performing Assets at branch level and the recovery of Non Performing Assets by SCBs in India.

The fifth chapter summarizes the major findings of the study and offers suggestions for effective management of credit risk.

CHAPTER -II
A CONCEPTUAL FRAME WORK OF CREDIT RISK MANAGEMENT

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CHAPTER - II
A CONCEPTUAL FRAME WORK OF CREDIT RISK MANAGEMENT

2.1 INTRODUCTION

In this chapter an attempt has been made to highlight the Basel norms with regards to Credit Risk Management in detail and the conceptual frame work of Non-Performing
Assets (NPAs) and the salient features of Prudential relating to management of NPAs. The Strategies adopted by the Central Government and RBI to reduce the level of NPAs have also been discussed in this chapter.

**2.2 SIGNIFICANCE OF RISK MANAGEMENT IN BANKS**

The concept of Credit Risk Management under Basel norms has been discussed in the following paragraphs.

Evolution of risk management in banks is driven by market forces on the one hand and development in banking supervisions on the other, each side operating in a complementary and mutually reinforcing ways.

Rapid pace of change in the banking activities as well as sophistication of technology and increasing exposures to a diverse set of markets, have made management of risk a core function within banks. Simultaneously supervisors also have an obvious interest in promoting strong risk management in banking organizations because a safe and sound banking system is critical to economic growth and stability of financial markets\(^\text{39}\).

**2.2.1 Risk**

The risk, risk management and the importance of credit risk management has been presented in the following paragraph:

Risk is the threat that an event or action will adversely affect an organization’s ability to achieve its objectives and successfully execute its strategies.

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Risk is the probability of the unexpected happening – the probability of suffering loss. Risk can be a potential loss and also can be a potential opportunity. As a bank, normally leverage the potential opportunities by managing the inherent risk.

2.2.2 Risk Management

Risk management is a planned method of dealing with the potential loss or damage. It is an ongoing process of risk appraisal through various methods and tools which continuously take care of the following functions;

- Assess what could go wrong
- Determine which risks are important to deal with
- Implement strategies to deal with those risks

2.2.3 Elements of Sound Risk Management

The key elements of sound risk management are:

- Adoption of comprehensive interest controls.
- Consistent formulation and application of policies and procedures.
- Use of appropriate risk management techniques and reporting.
- Good Corporate Governance that is oversight by the board and senior management.

2.2.4 Advantages of Risk Management in Banks

Main management of sound risk management practices in banks are:

- Competitive advantages by way of lower regulatory capital charge
- Maintaining robust financial health.
- Increasing internal efficiency.
- Helps in effective decisions making.
- Proper pricing of services/products.
- Ensure adequate provisioning.
- Sound reputations and confidence in the market.
- Optimum contributions to stakeholders.

2.3 BASEL

Basel is the name of place in Switzerland. It is also spelt as ‘Bal’ in Spanish language.

2.3.1 Bank for International Settlement (BIS)

BIS stands for Bank for International Settlement. It is an organization which fosters International Monetary and Financial Co-operation and serves as a bank for central banks. It was established in 1930, it is one of world’s oldest international financial organizations. Its head office is in Basel-Switzerland.

2.3.2 Basel Committee on Banking Supervision (BCBS)

BCBS stands for Basel Committee on Banking Supervision, established by the Bank for International Settlement (BIS). It is a committee of the central bank governors of the Group of ten (G-10) countries, constituted at the end of 1947 in the aftermath of serious disturbance in international currency and banking markets (notably the failure of Bank Herstatt in West Germany). The committee is assisted by 30 technical groups and task forces. Its first meeting took place in 1975 and after that it meets regularly three or four times a year and submits guidelines and best practices to the G-10 Central bank governors for endorsement.

2.3.3 G-10 Countries

Originally the G-10 countries constituted of 11 countries. Now its membership has increased to 13 countries. These countries are- Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spains, Sweden, Switzerland, United Kingdom, and United States.
2.3.4 Objectives of BCBS

The important objective of the committee is to close the gaps in internationals supervisory coverage in pursuit of two basic principles:

- No foreign Banking system should escape supervisions.
- Supervision must be adequate for all banks operating internationally.

2.3.5 Basel Accord/Accords

The Basel accord/accords refer to the banking supervision accords namely Basel I and Basel II issued by the Basel Committee on Banking Supervisions (BCBS). They are named after the Swiss town of Basel in which the Committee meets periodically.

2.3.5.1 Basel I Accord

The committee-BCBS, which came into existence in 1974, volunteered to develop a framework for sound banking practices internationally. In 1988 the full set of recommendations was documented and given to the central banks of the countries for implementations to suit their national system. This is called Basel Capital Accord or Basel I Accord. It provided level playing field by stipulating the amount of capital that needs to be maintained by internationally active banks.

2.3.5.2 Contents of Basel I

The 1988 Basel Accord primarily addressed banking in the sense of deposit taking and lending. The main focus was Credit Risk. It described the strength of the Bank as measured by the Capital employed. Accordingly it put a minimum level of capital adequacy (which is reflected by dividing Capital by Credit Risk Weighted Assets) at 8 %. Basel I allocated 4 risk weights i.e. 0 %, 20%, 50%, and 100% to different exposure types, based on the risk perceived on the exposure type under the credit portfolio.

2.3.5.3 Significance of Basel I

For the first time in the international history of banking, there was standard framework for the banks world over to conduct business. The recommendations were
given by BCBS. Basel I provided a set of norms for capital allocation which helped many banks to allocate capital to counter the risks faced by them.

It provided stability in the industry after some of the major bank failures and banking crisis by giving a guideline for the bank to maintain capital in order to counter unforeseen shocks.

It helped to reduce the distortion prevailing in the banking sector and generated a level playing ground for the banks by way of creating clear and uniform framework for all banks world over. This reduced competitive distortion among banks.

Basel I norms stipulated a minimum CRAR of 8% for banks. The regulators/central bank can fix CRAR above 8% to the banks within their jurisdiction, based on local conditions and financial discipline.

2.3.5.4 Advantages of Basel I

Advantages of Basel I can be summarized under;

a) Created clear and uniform guidelines for all banks world over.
b) It strengthened the capital base of the banks world over.
c) Reduced competitive distortion among banks.
d) Stability in the banking sector.

2.3.5.5 Basel I Accord in Indian Context

As a cue to the Basel report some developments took place in India as below:\n
a) Government of India entrusted Narasimham Committee to study the Basel I recommendations for implementations in our country.

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\(^{40}\)Ibid, 19.
b) Narasimham Committee gave its recommendations in Part I and Part II. Part I which can be implemented immediately and Part II after legislative measures for implementation.

c) As an initiative towards Basel I preparedness, part I recommended Implementation of Capital Adequacy norms as per Basel Norms and stipulated Capital Adequacy Ratio(CAR) at 9%.

d) It recommended further, implementation of Income Recognition and Assets Classification/provisions norms which are known as IRAC norms, Transparency in bank balance sheet and profit& loss accounts.

e) Banks were required to follow strict prudential norms with regard to identification of NPAs and making provisions thereof.

f) Classification of Weak banks. A sound banking system by definition presupposes that all the banks, or at least a majority of them within the system are strong and good as viable concerns. However, every system has its own instances of weak links and the banking system is no exception. Hence, Part I recommend criteria for classification of weak banks.

g) Part I also recommended reduction in Statutory Liquidity Ratio(SLR) and Cash Reserve Ratio (CRR), Interest rate on CRR balances, Enlarging priority sector definition, Creation of Asset Reconstruction Funds for bad loans, Creation of Loan Recovery Tribunals, Reconstruction of banks, more licenses to promote private banks, etc.

Most of the recommendations have been since implemented in India.

2.3.6BASEL II ACCORD

Banking has changed dramatically since the Basel I document of 1988. Advances in risk management and the increasing complexity of financial activities/instruments (like options, hybrid securities etc.) prompted international supervisors to review the appropriateness of regulatory capital standards under Basel I. To meet this requirement, the Basel I accord was amended and refined, which came out as the Basel II accord.
2.3.6.1 Objective of Basel II

The major objectives of the Basel II document are as follows:

- Promote safety and soundness in financial system, by way of better risk assessment and capital allocation.
- To align regulatory capital to underlying risk and induce banks to strengthen their risk management capabilities.
- Incentives for enhancing risk management capabilities. Better risk management will be rewarded by way of lesser capital requirement.
- Ensure level playing field for all Banks across the globe. Basel II provides a framework for the banks world over, as a benchmark to global best practices.

2.3.6.2 Applicability of Basel II Norms

In India, as per RBI guidelines, Basel II norms are applicable to Commercial banks including Foreign Banks operating in India (except Local Area Banks and Regional Rural Banks)

2.3.6.3 Pillars under Basel II

The Basel II document is structured into three parts. Each part is called as a pillar. Thus, these three parts constitute three pillars of Basel II.

Pillar1 deals with calculation of Minimum Capital Requirements.
Pillar2 covers the Supervisory Review Process and
Pillar3 covers Market Discipline.

These three pillars are mutually reinforcing in nature.

Pillar1 covers internal responsibility of the Bank to maintain capital
Pillar2 covers the responsibility towards the Regulator, for conducting
review process.

**Pillar3** covers the responsibility of a bank towards various stakeholders by way of disclosures/transparency.

### 2.3.6.4 Types of Risks Covered under Pillar 1 of Basel II

Basel II has gone beyond the scope of Basel I and recognized the risks faced by banks into three broad types namely;

- Credit Risk,
- Market Risk and
- Operational Risk.

### 2.3.6.5 Significance of Pillar 1

The first pillar of Basel II norms aligns the minimum capital requirements more closely to the banks’ actual underlying risks in asset portfolio, under three categories – Credit risk, Market risk and Operational risk.

The minimum capital to risk weighted assets ratio is retained at 8% as suggested under Basel I norms. Reserve bank of India stipulated higher capital to risk weighted assets ratio at 9% for the banks operating in India. A menu of approaches or various methods for computing risk weighted assets are prescribed under pillar 1.

The importance of Pillar 1 is reflected by the fact that the capital acts as a cushion to absorb the losses arising from these risks (namely Credit, Market and Operational) which on the one hand provides financial stability to the Bank and on the other takes care of the reputation of the Bank. If banks have adequate capital to cover the underlying risk they assume, financial stability can be ensured. Hence banks with assets profile carrying higher risk have to maintain a higher level of capital funds.

### 2.3.6.6 Significance of Pillar 2
Pillar 2 of Basel II norms pertains to ‘Supervisory Review”, i.e. the role of the supervisor (i.e. RBI)

Supervisory Reviews are Based on four Key Principles

According to Principle 1, banks should have a system and procedure to assess their capital adequacy relative to their overall risks by formulation of an Internal Capital Adequacy Assessment process. It means that each bank should have capability to perform their capital calculations in transparent and auditable manner. They should also be able to estimate whether the capital that they are setting aside is truly representative of the risk they are exposed to. Credit risk mitigants must be made available to supervisor for review. This gives the supervisor discretion to link capital to the risk profile of the bank.

According to Principle 2, Supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies, their ability to monitor various risks and ensure their compliance with regulatory capital ratios.

According to Principle 3, banks should operate above the minimum regulatory capital ratios and supervisors can require banks to hold capital in excess of the minimum.

According to Principle 4, Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

The Supervisor / Regulator reviews and takes appropriate actions in response to the capital assessments made by the banks. It helps in maintaining benchmark and industry standard on Risk Management in Banks and adequacy of risk management practices or control measures adopted by banks.
2.3.6.7 Significance of Pillar 3

Pillar 3 is about the requirements for “market discipline”.

Under this, banks are required to disclose certain details about their risks, capital and risk management system/techniques, with the aim of bringing transparency and market discipline.

Pillar3 provides a framework to improve the bank’s disclosure standards for information on the scope of application, capital, risk exposure, risk assessment process, capital adequacy etc. The RBI guidelines for implementation of the New Capital Adequacy Framework (April 2007), stipulates following qualitative and quantitative disclosures as a minimum regulatory requirement:

- Scope of application
- Capital structure
- Capital adequacy
- Credit risk- General disclosures
- Credit risk – Portfolios subject to standardized approach
- Credit risk – standardized approach
- Securitization – Standardized approach
- Market risk in Trading Book
- Operational Risk
- Interest rate risk in the banking book

The Banks have to make above mandatory disclosures as at end of March every year along with the annual financial statements, as well as host them on their websites. Banks with capital funds of Rs.100 crores or more should make interim disclosures on the quantitative aspects, on a stand-alone basis, on their respective websites as at the end of September every year.
All banks with capital funds of Rs.500 crores or more, must disclose their Tier I capital, total capital, total required capital, Tier 1 ratio and capital adequacy ratio on a quarterly basis on their respective websites.

2.4 IMPORTANCE OF CREDIT RISK

The importance of Credit Risk has been presented in the following paragraphs:

In the context of Basel II, the Risk that the obligor (borrower or counter party) in respect of particular assets will default in full or in part on the obligations to the bank in relation to that is termed as credit risk.

Credit risk refers to “The risk of loss arising from outright default due to inability or unwillingness of the customer or counter party to meet commitments in relation to lending, trading, hedging, settlement and other financial transaction of the customer of counter party to meet commitments”41.

Credit risk is also defined as the potential that a borrower or counter-party will fail to meet its obligations in accordance with agreed terms.

Credit risk is the probability of loss from a credit transaction.

2.4.1 Forms of Credit Risk

The various forms of credit risk are;

1. Non-repayment of the principal of the loan and/ or the interest on it.
2. Contingent liability like letters of credit or guarantees issued by the bank on behalf of the client and upon crystallization – amount not deposited by the customer.
3. In the case of treasury operations, default by the counter-parties in meeting the obligations. For example, in case of derivatives dealing, on the due date the contract is not settled.
4. In the case of security trading, settlement not taking place when it is due. For example, due to non-availability of funds or due to short selling, on the due date the claim is not settled.
5. In the case of cross-border obligations, any default arising from the flow of foreign exchange due to restrictions imposed on remittances out of the country. For example, the counter party might have made the payment but the country in which the counter party is residing does not allow the settlement\textsuperscript{42}.

2.4.2 Sources of risk of loss under Credit Risk

The risk of loss arises from 3 sources

- Borrowers/ counterparty defaults – Bank loses both the principal and the interest.
- Deterioration in borrowers’ credit quality – bank takes a hit if loan is not repriced for the higher risk.
- Improvement in borrowers’ credit quality- borrower can refinance his loan at a lower rate.

2.4.3 Concept of Non-Performing Assets

\textsuperscript{42} Ibid30.
The Concept of Non-performing Assets (NPAs) has been differently defined by many researches in different Countries. The Concept has come into usage of India of late. The term “Non-Performing assets” is synonymous with “Non-Performing Loans” (NPL) or bad loans or problem loans and as such the terms and used interchangeably.

It is defined by the Securities and Exchange Commission of the United States as “Loans which are contractually past due for 60 days or more as to interest or principal payments and loans the terms of which has been renegotiated to Provide a reduction or deferral of interest or principal"\(^{43}\).

Bhaskar Rao defines non-performing asset as “an asset which does not directly contribute to a bank’s profitability”\(^{44}\).

According to Eitan.A.Aveneyou, Non-performance means a failure to perform an obligation according to the terms of Contract. In the “Dictionary of Finance” he defined non-performing assets as “loans for which no interest is paid for a specific period often ones made to foreign Countries”\(^{45}\).

In American banking parlance, loans are considered as non-performing when no interest has been received on them for at least 90 days. When they cross the critical 90 days threshold (and become non-performing), the loan has to be reported as such in bank’s accounts. All the interest due (which the banks until then have reported as having accrued) has to be pruned out of their income for the period\(^{46}\).

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\(^{46}\) Tim Handle, Economist- “Pocket Banker”, (London: Basil Blackwell publishers Ltd.) p.10.
The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, defines Non-performing Assets (NPAs) as “an asset or account of a borrower, which has been classified by a bank or financial institution as substandard, doubtful or loss asset in accordance with the direction or guidelines relating to assets classification issued by the RBI”\(^{47}\).

From bankers’ point of view, non-performing asset is defined as “an asset which is reflected as such in the books of banks but does not yield any income to the banks because of cassation of activity”\(^{48}\).

### 2.4.4 Main causes of Non-Performing Assets

One of the main causes of NPAs in the banking sector is the directed loans system under which commercial banks are required to supply prescribed percentage of their credit (40 percent) to priority sector\(^{49}\).

Loans to weaker sections of society under state subsidy schemes have led borrowers to expect that like a nonrefundable state subsidy, bank loans need not be repaid. Directed loans supplied to the “micro sector” are problematic of recoveries especially when some of its units become sick or weak.

As the directed credit components of the priority sectors arise from the loan schemes requiring government approval of beneficiaries, banks selection standards with regard to eligible borrowers are being interfered with.


\(^{49}\)http://www.adb.org/documents/books/rising to the challenge/india_bank.pdf
Government subsidy schemes were intended originally to prompt bankers to lend to weaker sectors. But as the directed credit component became partly politicized and bureaucratized, the realization has grown that priority sector bank credit should operate with the required degree of risk management.

Besides directed lending, the reasons that are fundamentally responsible for the problem of non-performing assets are outlined below:

2.4.4.1 The Legal Framework

The RBI considers NPAs in the Indian banking sector as a historic legacy due to lacunae in credit recovery, largely and arising from inadequate legal provisions on foreclosure and bankruptcy, long drawn legal procedures and difficulties in execution of the decree awarded by the court. At the end of March 1998, about 46 percent of NPAs were in respect of suit filed accounts (filed by 27 Public Sector and 6 Private Sector Banks) where the recovery was as low as 4.3 per cent and significant portion of suits have been pending for more than a decade.

2.4.4.2 Political Interference

The Indian banking system has been extensively misused for political reasons in the past. A large part of their bad debts is a legacy of this misuse. In addition, the large-scale loan write-off ordered by political interference promote a culture of indiscipline among borrowers. This adds to the problems of banks already functioning in a hostile legal environment.

2.4.4.3 Competitions and Liberalization

The winds of liberalization have opened up new vistas in the banking industry resulting in the generation of an intensely competitive environment. The banking area has been almost flooded with new entrants including private banks, foreign banks, non-banking finance companies, merchant bankers, chit funds etc.,
Heavy weight foreign banks with huge capital base, latest technology innovative and globally tested products are spreading their wings and wooing away customers from the Indian banks that are steeped in a tradition of inefficiency and lethargy. These banks enjoy a competitive edge in providing services, which are competitively priced and have better quality, wider range of products and specialized services. They are technology driven and have location advantages.

2.4.4.4 Inadequate Risk Management Practices

The banks are exposed to a much greater degree of risk primarily arising out of the potential loss on an asset or a portfolio. For this, the banks have to develop skills to identify, assess and minimize the risk and enhance the returns.

If there is a mismatch between assets and liabilities, the banks may be exposed to interest rate risk, liquidity risk and foreign exchange risk. Narasimham Committee II has also addressed this issue bringing into focus the dangers to liquidity and solvency due to mismatches.

2.4.4.5 Lack of Prudential Norms

Risk management practices can be effective only when financial statements present accurate picture of the level of risk. The income recognition norms being followed by banks prior to 1992-93 involved recognition of income earned on bad debts in their books on accuracy basis. Thus, these financial statements did not reflect the level of bad debts and presented a misleading rosy picture of their health. This allowed the situation to degenerate considerably before it was detected\(^{50}\).

2.4.4.6 Liberalization of Economy / Removal of Restrictions / Reduction of Tariffs

A large number of NPAs borrowers were unable to complete in a competitive market in which lower prices and greater choices were available to consumers. Future, borrowers operating in specific industries have suffered due to political, fiscal and social compulsions, compounding pressures from liberalization.

2.4.4.7 Tax Monitoring of Credit and Failure to Recognize Early Warning Signals

It has been stated that approval of loan proposal is generally thorough and each proposal passes through many levels before approval is granted. However the monitory of complex credit files has not received the attention it needed, which meant that early warning signals were not recognized and standard assets slipped to NPA categories without banks being able to take proactive measures to prevent this. Partly due to this reason, adverse trends in borrowers’ performance were not noted and the position further deteriorated before action was taken.

2.4.4.8 Over Optimistic Promoters

Promoters were often optimistic in setting up large projects and in some cases were not fully above board in their intentions. Screening these issues, often projects were set up with the expectation that part of the funding would be arranged from the capital markets, which were borrowing at the time of the project appraisal. When the capital markets subsequently crashed, the requisite funds could never be raised, promoters often lost interest and lenders were left stand with incomplete/ unviable projects.
2.4.4.9 Funding Mismatch

There are said to be many cases where loans granted for short terms were used to fund long term transactions and had ended as NPAs.

2.4.4.10 High Cost of Funds

Interest rates as high as 20% were not uncommon, coupled with high leveraging and falling demand, borrowers could not continue to service high cost debt.

2.4.4.11 Wilful Defaulters

There are a number of borrowers who have strategically defaulted on their debt obligations realizing that the legal recourse available to creditors is slow in achieving results.

2.4.5 Factors Contributing to NPAs in India

A close scrutiny of the various factors influencing the NPAs level of banks in India would reveal certain concrete circumstances as given below;

- **Industrial Sickness**
  
  Improper project handling, ineffective management, lack of adequate resources, lack of advanced technology, day to day changing government policies have given birth to industrial sickness. Hence the banks that finance those industries ultimately end up with a low recovery of their loans reducing their profit and liquidity.

- **Improper SWOT Analysis**
  
  The improper strength, weakness, opportunity and threat analysis is another reason for rise in NPAs.
• **Poor Credit Approval System**
  
  Poor credit appraisal is another factor for the rise in NPAs. Due to poor credit appraisal, the bank gives advance to those who are not able to repay it back.

• **Absence of Regular Industrial Visit**

  The irregularities in spot visit also results in increase of the NPAs. Absence of regular visit of bank officials to the customer point decreases the collections of interest and principal on the loan.

• **Re-Loading Process**

  Non remittance of recoveries to higher financing agencies and re loading of the same have already affected the smooth operation of the credit cycle. Due to reloading to the defaulters, the NPAs of other Scheduled Commercial Banks are increasing day by day.

  An internal study conducted by RBI shows that in the order of prominence, the following factors contribute to NPAs.  

  2.4.5.1 Internal Factors

  • Diversion of funds for expansion/diversification/modernization.
  • Taking up new projects.
  • Helping/promoting associate concern time/cost overrun during the project implementation stage.
  • Business (Product, Marketing, etc.) failure
  • Inefficiency in management
  • Slackness in credit management and monitoring.
  • In appropriate technology/technical problems.
  • Lack of co-ordination among lenders.

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2.4.5.2 External Factors

- Recession
- Input / power shortage
- Price escalation
- Exchange rate fluctuation
- Accidents and natural calamities, etc.
- Changes in government policies in excise / import duties, pollution control orders, etc.,

2.4.6 Problems due to NPAs

The repercussions of the growing non-performing assets of the banks in India can be summarized as presented below:

1. Owners do not receive a market return on their capital in the worst case, if the bank fails, owners lose their assets. In modern times, this may affect a broad pool of shareholders.
2. Depositors do not receive a market return on saving. In the worst case, if the bank fails, depositors lose their assets or uninsured balances.
3. Banks redistribute losses to other borrowers by charging higher interest rates, lower deposit rates and higher lending rates depress saving and financial market, which hamper economic growth.
4. Non-performing loans epitomize bad investments. They misallocate credit from good projects, which do not receive funding, to failed projects; bad investment ends up in misallocation of capital and by extension, labour and natural resources.
5. Non-performing asset may spill over the banking system and contract the money stock, which may lead to economic contraction. This spillover effect can channelize through liquidity or bank insolvency.
   a) When many borrowers fail to pay interest, banks may experience liquidity shortage. This can jam payment across the country.
   b) Liquidity constraints banks in paying depositors.
c) Under capitalization banks exceeds the bank’s capital base.

2.4.7 EXPERT COMMITTEE RECOMMENDATIONS ON NPAs

With regard to quality-wise classification of loan portfolio and recognition of income of banks and financial institutions, several committees appointed by the Central Government and RBI at different periods have made many recommendations.

The Tandon Committee (1973) recommended slotting of borrower accounts into four Categories as (i) Excellent (ii) Good (iii) Average and (iv) Unsatisfactory or bad and doubtful.

The Basel Committee on Banking Supervision Constituted in 1974 to develop and strengthen supervisory standards and risk management strategies had suggested transparently in asset classification and income recognition norms.

The Chore Committee (1980) also recognized the need for close watch on the quality of the loans portfolio, and this concern is reflected in its emphasis on regular annual review of all borrower accounts with credit limits of over Rs.10 lakhs.

Subsequently, the Pendharkar Committee (1981) recognized the need for classifying advances into different categories to index the overall quality of the assets portfolio and its recommendations were implemented in 1984 with the introduction of Health coding system by the Reserve Bank of India. The guidelines for classification of advances as per the health Code system are detailed in RBI letter DB. OD NO. Fol. BC. 136/C.249-85 dated 07.11.1985. Under the Health code system, banks are required to classify advances under one of the following heads depending upon the nature and seriousness of the irregularity;
TABLE 2.1

HEALTH CODE SYSTEM

<table>
<thead>
<tr>
<th>HEALTH CODE NO</th>
<th>DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Satisfactory</td>
</tr>
<tr>
<td>2</td>
<td>Irregular</td>
</tr>
<tr>
<td>3</td>
<td>Sick, Viable, Under nursing</td>
</tr>
<tr>
<td>4</td>
<td>Sick, Non-viable, Sticky</td>
</tr>
<tr>
<td>5</td>
<td>Advances Recalled</td>
</tr>
<tr>
<td>6</td>
<td>Suit-filed Accounts</td>
</tr>
<tr>
<td>7</td>
<td>Decreed Debts</td>
</tr>
<tr>
<td>8</td>
<td>Bad and Doubtful debts</td>
</tr>
</tbody>
</table>


The Committee on Financial system headed by M. Narasimham the Deputy Governor of the RBI, also called Narasimbam Committee I (1991) recommended the introduction of prudential norms for Income Recognition, Asset classification and Provisioning for the advances of the banks and Financial Institutions in a phased manner so as to move towards greater consistency and transparency in their published accounts. It also recommended that the policy of the income recognition should be objective and based on record of recovery rather than on any subjective considerations. It is the landmark development in the Indian Banking Industry.

Again in 1992, the RBI constituted a working Group under the Chairmanship of Shri S.S. Tarapore, Deputy Governor of the RBI, to examine the various aspects of the prudential norms. Based on the recommendations of the working group, the RBI issued further guidelines/clarification in December 1992.

The Committee on Banking Sector Reforms with Mr. M. Narasimham, also known as Narasimham Committee II, was Constituted by RBI on December 26, 1997 to review the record of implementation of financial sector forms of the Narasimham Committee I
and to suggest remedial measures for strengthening the banking system, covering areas of banking policy, institutional structure and supervisory system and legislative and technological changes\textsuperscript{52}.

The Committee headed by Shri S.S. Tarapore on Capital Account Convertibility (1997) reiterated that “drastic measures should be taken to reduce the level of NPAs”, It went on to suggest that “weak banks” should be converted into “narrow banks” confining them to deploy their resources in investments and if necessary even restricting their liability growth. It emphasized that for strengthening of the financial system, as a part of progressive move towards capital account convertibility, the level of Gross NPAs must be reduced to 5% by March 2000\textsuperscript{53}.

The Committee headed M.S. Verma, former Chairman , State Bank of India(SBI), was set up RBI in February 1999 to identify weak Public Sector Banks , to study the problem of weak banks , to undertake an examination of each weak bank and to identify those which are potentially revisable and to suggest a strategic plan of financial, organizational and operational restricting for weak Public Sector Banks. The Committee has identified three banks namely Indian Bank, UCO Bank and United Bank of India as weak banks as they were in serious trouble because of mounting Nonperforming assets\textsuperscript{54}.

Another expert Committee headed by Mr. T.R. Adhyarujina, a Senior Supreme Court advocate, was appointed by the Government in March 1999 to formulate specific proposals to give effect to the suggestions made by the Narasimham Committee report on banking reforms. The Committee suggested a new legislation for banks and financial

\textsuperscript{52}Report of the Narasimham “Committee on Banking Sector Reforms”, \textit{(Chairman: Shri Narasimham)}, \textit{Reserve Bank of India}, 1997.
\textsuperscript{54}Report of the “Working a group on Restructuring Weak Public Sector Banks”, \textit{(Chairman: M.S.Verma)}, \textit{RBI}, Mumbai, 1999.
institutions to take possessions and sale of securities without the intervention of court in respect of both immovable property and moveable assets and on securitization\textsuperscript{55}.

Over the past one decade, the RBI has modified these norms in several respects and issued circulars from time to time.

2.5 Prudential Norms for Income Recognition, Asset Classification and Provisioning (IRAC) Norms

The major issues arising in the case of non-performing assets are the recognition of income and determination of the quality of the assets followed by adequate provisioning\textsuperscript{56}. In its Annual Report, 1991-92, RBI has stated that “if the balance sheet of a bank is to reflect actual financial health of that bank, there has to be a proper system of recognition of income, classification of assets and provisioning for bad debts on a prudential norm.

Consequently, RBI introduced a new set of prudential norms on income recognition, asset classification, and provisioning known as IRAC norms in the year 1992-93 based on the recommendations of Narasimham Committee- I (Committee on Financial System) with a view to enhance operational efficiency, productivity and with the aim of imparting strength to the banking system as well as ensuring safety and soundness through greater transparency accountability and public credibility.

The prudential norms for Commercial banks recommended by the Narasimham Committee can be broadly classified into four categories:

a. Income recognition.

b. Classification of assets.

c. Provisioning for bad and doubtful debt and


The salient features of the prudential norms are discussed below:

2.5.1 Income Recognition

Income recognition refers to accounting of interest income, commission and other income at branch level for various advances and other services. In May 1989, the RBI had issued another circular no. DBOB.BP. BC. 133/C469-89 dated 26.05.1989 stating that:

- Banks should not take into their income account, interest on loan classified under health code classification 6, 7, 8 from the quarter in which the individual accounts are classified under these categories.
- As regards advances are classified under health code nos. 4 and 5, application of interest will depend on availability of adequate security, at the discretion of the bank taking into account the prospects of reliability of the security,

RBI issued fresh guidelines in respect of recognition of interest as income effective from the financial year 1992-93. In terms of these directives, in those loan accounts which have been identified as non-performing interest recognized based on the record of recovery rather than accrual of interest i.e. interest is not recognized as an income till it is realized; thus, for the purpose of recognition of income, banks are required to classify their loan accounts into two categories:

a) Performing assets (PAs)

b) Non- performing assets (NPAs)

If the asset is “Performing”, income can be recognized even on accrual basis. If the asset is “Non Performing”, interest there on can be recognized only on cash basis i.e. when it is actually realized.

2.5.2 Asset Classification
For the purposes of provisioning, the Narasimham Committee I recommended that bank and financial institution should classify their assets by compressing the eight health codes to form broad groups, viz. standard, substandard, doubtful and loss assets. According to the new prudential norms, the advances are broadly classified into performing and non-performing assets. Performing assets are standard assets and Non performing assets are further classified into substandard, doubtful and loss assets.

**FIGURE 2.1**
CLASSIFICATION OF LOAN ASSETS

- **Performing**
  - **Substandard Assets** (Age <12 months)
  - **Doubtful Assets** (Age >12 months)
  - **Doubtful I Up To One Year**

- **Non - Performing**
  - **Loss Assets** (Not linked to age)
The classification of loan assets into the different categories as in chart 2.1 should be done taking into account the following points.

1. Status of the account – PA/NPA
2. Age of NPA or the period for which the assets have remained performing
3. Reliability of the dues/ degree of well-defined credit risks.

2.5.2.1 Performing Assets – Standard Assets

Performing assets are standard assets which do not disclose any problem and do not carry more than normal risk attached to the business. The performing asset is one, which generates income for the bank. An account is considered to be a standard asset when it is in order or where the over due amount is within a period of 90 days and in respect of direct agricultural advances if the amount overdue is less than 2 harvest seasons but for a period not exceeding 2 half years.

2.5.2.2 Non Performing Assets

Banks are required to classify non-performing assets further into the following three categories based on the period for which the assets has remained non-performing

1. Sub-standard assets
2. Doubtful assets
3. Loss assets
1. Sub-Standard Assets

In respect of loan accounts if any amount is overdue for a period of more than 90 days from the due date, the account should be classified as substandard asset provided it is covered by adequate securities i.e. where erosion in securities is less than 50 percent of the value of securities. Such NPAs account can remain in substandard category for a maximum period of 18 months with effect from 31st March 2005; this period of 18 months is reduced to 12 months. In other words, if an asset is identified as NPAs w.e.f. 31.3.2005 it would become doubtful, if not upgraded to standard category within a period of 12 months from the date it became NPA.

In cases where the loan was granted as a clean or unsecured loan, the account on becoming NPA for the first time should be treated as substandard only. However in case of serious credit impairment or where the realisibility of dues is considered remote, it may be treated as loss asset.

2. Doubtful Assets

The following account should be classified as doubtful assets,

a. An account which has completed 12 months in substandard category and which is covered by security ECGC cover.

b. A non-performing asset where the erosion in securities is more than 50 percent of the value and value of securities available is more than 10 percent of the outstanding liability.

3. Loss Assets

A loss asset is one where the loss has been identified by the bank or internal or external auditor or the RBI inspectors, but the amount has not been written off wholly or partly. In other words, such as asset is considered uncollectible with little salvage or recovery value.
Further if the realizable value of security as assessed by the bank or approved valuer or RBI is less than 10% of the outstanding in the borrowal accounts, such accounts should be classified as loss assets. However, this is applicable only in cases where there is erosion in the value of existing securities and not in the case of accounts where the loan was granted as clean or unsecured.

Types of NPAs
The Non-Performing Assets are of two types;
   a) Gross NPAs and
   b) Net NPAs

a) GROSS NPAs
Gross NPAs are the sum total of all loan assets that are classified as NPAs as per RBI guidelines as on balance sheet date. Gross NPAs reflect the quality of the loans made by banks. It consists of all the non-standard assets like substandard, doubtful and loss assets.

b) NET NPAs
Net NPAs are those type of NPAs in which the banks have deducted the provision regarding NPAs. Net NPAs shows the actual burden of banks. Since in India, bank balance sheet contains a huge amount of NPAs and the process of recovery and write off of loans is very time consuming. The provisions the banks have to make against the NPAs according to the central bank guidelines are quite significant.

The following are deducted from gross NPAs to arrive at net NPAs;
   a) Balance in interest suspense account if applicable.
   b) Deposit Insurance Guarantee Corporation, Export Credit Guarantee Corporation claim received and pending adjustment.
   c) Part payment received and kept in suspense account.
Total provisions held excluding technical write off made at head office and provision of standard assets.

2.5.3 Provisioning for Bad and Doubtful Assets

2.5.3.1 Provision of Standard Assets

Generally, no provision was required for standard assets. However, as per the guidelines of RBI with effect from 31.01.2000, banks one required to make a general provision of a minimum of 0.25 percent on standard assets on the total standard advances portfolio of the bank. At its option, a bank may go for provisioning at a higher percentage. The provision on standard assets should not be reckoned for the purpose of arriving at net NPAs. The required provision for standard assets would be calculated and made at head office.

2.5.3.2 Provision of Substandard Assets

A general provision of 10% on total outstanding should be made without making any allowance for DIGC/ ECGC guarantee cover and securities available. Banks can make additional provision for substandard assets, at their discretion, beyond the normal 10% provision required on such assets.

2.5.3.3 Provision of Doubtful Assets

The quantum of provision in case of doubtful assets depends upon the realizable value of security and the age of doubtfulness of the assets. Provisions required are as stated below:

100 percent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recovery and the realizable value is estimated on a realistic basis.
In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20% - 50% of the secured portion depending upon the period for which an asset has remained doubtful.

The provision requirement for doubtful assets can be summarized in the following Table 2.2

<table>
<thead>
<tr>
<th>Period for which the advance has been considered as doubtful</th>
<th>Provision requirement (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>doubtful up to one year</td>
<td>20 %</td>
</tr>
<tr>
<td>doubtful one to three years</td>
<td>30 %</td>
</tr>
<tr>
<td>Doubtful more than three years</td>
<td>60% with effect from 31\textsuperscript{st} March 2005</td>
</tr>
<tr>
<td>Outstanding stock of NPAs as on 31\textsuperscript{st} March 2004</td>
<td>75% with effect from 31\textsuperscript{st} March 2006</td>
</tr>
<tr>
<td>Advances classified as “doubtful” more than three years on or after 1\textsuperscript{st} April 2004</td>
<td>100% with effective from 31\textsuperscript{st} March 2007</td>
</tr>
</tbody>
</table>

Source: Report on Trends and Progress of Banking in India

Additional provisioning consequent upon the change in the definition of doubtful assets effective from 31\textsuperscript{st} March 2003 has to be made in phases as under:
As on 31st March 2003, 50% of the additional provision requirement on the assets which became doubtful on account of new norms of 18 months for transition from sub-standard assets to doubtful category.

As on 31st March 2002, balance of the provision not made during the previous year, in addition to the provisions needed, as on 31st March.

Banks are permitted to phase the additional provisioning consequent upon the reduction in the transition period from substandard to doubtful asset from 18 to 12 months over a four year period commencing from the year ending 31st March 2005, with a minimum of 20% each year.

2.5.3.4 Provision for Loss Assets

The entire assets should be written off. If the assets are permitted to remain in the books for any reasons, 100 percent of the outstanding should be provided for.

To sum up, provisions are made for NPAs as per the guidelines prescribed by the regularity authorities, subject to minimum provisions as prescribed below by the RBI:

Substandard Assets
1. A general provision of 10%
2. Additional provision of 10% for exposures which are unsecured ab-initio (where realizable value of security is not more than 10 percent ab-initio)

Doubtful Assets
1. Secured portion.
   a) Up to one year – 20%
   b) One to three years – 30%
   c) More than three years – 100%
2. Unsecured portion 100%

**Loss Assets- 100%**

In respect of foreign bank, provisions for non performing advances are made as per the local regulations or as per the norms of RBI, whichever is higher.

The sale of NPAs is accounted as per guidelines prescribed by the RBI, which requires provision to be made for any deficit (where sale price is lower than the net book value), while surplus (where sale price is higher than the net book value) is ignored. Net book value is outstanding as reduced by specific provisions held and ECGC claims received.

For restructured / rescheduled assets, provisions are made in accordance with the guidelines issued by RBI, which requires that the present value of future interest due as per the original loan agreement compared with the present value of the interest expected to be earned under the restricting package be provided in addition to provision for NPAs. The provision for interest sacrifice arising out of the above is reduced from advances.

In addition to the specific provision on NPAs, general provisions are also made for standard assets as per the extent prescribed by the RBI guidelines. The provisions on standard assets are not reckoned for arriving at net NPAs. These provisions are reflected in Schedule 5 of the balance sheet under the head “other liabilities and provisions – others”.

**2.6 MANAGEMENT OF NON-PERFORMING ASSETS**

With the introduction of International norms of Income Recognition, Assets Classification and Provisioning Norms (IRAC norms) in Indian banking sector, the management of NPAs has emerged as one of the major challenges facing the Indian Banks. The success of banking Industry depends mostly upon its ability to maintain the
level of its NPAs at minimum. Therefore, the Credit risk management system to oversee the management of NPAs has assumed a significant and vital role. The effective NPAs management is the top priority for any banking company for its survival.

Generally, the objectives of NPAs management are to make the amount of provision requirements. These objectives can be achieved by adopting the following strategies:

1. Preventing slippage of performing assets into the one of Non Performing Assets.
2. Upgrading non-performing assets into performing assets.
3. Liquidating non-performing assets through effective recovery of bad loans.

2.6.1 Strategies for NPAs Management

The NPAs management strategy has certain objectives. The most important objectives are as follows;

Improving the quality of loan assets with a view to transferring them from non-performing status. As a result of such improvement in quality, income of such assets can be recognized.

Upgrading the status of loan assets with a view to reducing the amount of provisions to be made on such loan assets.

Cleaning the balance sheet loan assets and portion of doubtful assets thereby achieving an improvement in capital adequacy ratio.

2.6.2 Preventive Measures

A study at the behest the Board for Financial Supervision (BFS) was conducted by the Reserve Bank by scanning relevant information/data obtained from a select group of banks, as also by holding discussion with bank officials, who manage NPAs at the policy level as well as those who look after actual recovery, rehabilitation/revival, restructuring of accounts at the implementing level. On the basis of the study, the RBI had suggested a frame work of recommendation for preventing slippage of NPAs accounts from sub-
standard to doubtful/ loss category. The following are some of the recommendations for accounts.

2.6.3 Recognize the Problem Early

Invariably, by the time banks start their efforts to get involved in a revival process; it is too late to retrieve the situation – both in terms of rehabilitation of the project and recovery of banks dues. Identification of weakness in the very beginning (i.e., when the account starts showing first signs of weakness regardless of the fact that it may not have become NPA) is imperative. Assessment of the potential of revival may be done on viability study. Restricting should be attempted where, after an objective assessment of the viability and promoter’s intention (and his stake), banks are convinced of a turnaround within a scheduled timeframe. In respect of totally unviable units as decided by the bank/ consortium, it is better to facilitate winding up/ selling of the business unit early, so as to recover whatever is possible through legal means before the security position becomes worse.

2.6.4 Special Mention Accounts

A system of early recognition with timely and adequate interventions may form the focus of approach in dealing with slippage of NPAs. In this context, RBI had issued guidelines in 2003 where under banks have been advised to introduce a new asset category “Special Mention Accounts”, in between “Standard” and “Sub-standard” categories for their internal monitoring and following up.

2.6.5 Early Alert System

The strategy of management of NPAs may be governed by the circumstances connected to each individual case. Generally, the NPAs is more likely to be resolved in terms of recovery if the company is in operation. For this to be effective there must be a system of identifying the weakness in accounts at an early stage. Banks may put in place
an “early alert” system that captures early warning signals in respect of accounts showing first signs of weakness. This system may be an integral part of the risk management process of the bank. Internationally, there is a similar system of “special mention accounts”. Depending upon the identified weakness, one may go back (rather than with reference to current period) to a prior earlier period in determining the rehabilitation response.

2.6.6 Prompt Corrective Action (PCA)

A scheme of prompt corrective action based on certain triggers had been introduced in December 2002 as a supervisory tool on an experimental basis. The trigger points are Capital Adequacy Ratio (CAR), Net NPAs and Return on Assets (ROA). The scheme is aimed at taking action at an early stage, when banks show incipient sign of weaknesses. For every trigger point, certain structured and mandatory actions have been laid down.

2.7 CAPITAL ADEQUACY NORMS

A system of capital adequacy was implemented on the model suggestion by bank committee on capital convergence. The capital to risk weighted assets ratio (CRAR) is the most widely employed to measure the soundness of a bank. The CRAR of the bank reflects its ability to withstand shocks in the event of adverse developments. The global range for capital adequacy ratio lies between 8.8% to 37.1%. Taking into consideration the substantial off Balance sheet exposures of banks, the Narashimham Committee (1997) had recommended enhancement of CAR from the present stipulation of 8% to 10% by 2002. Endorsing this decision, the union budget 1998-99 announced raising ratio to 9% by March 31, 2000 and to 10% as early as possible thereafter.
Further, according to RBI guidelines banks are eligible to declare dividends without the RBI approval if they have a CAR of at least 11% for the preceding two years and the fiscal year for which they propose to declare dividend\textsuperscript{57}.

2.8 RECOVERY MEASURES

The Central Government and RBI have also taken several steps to reduce the NPAs in the banking system. Some of the important measures for recovery of NPAs are described below;

2.8.1 Compromise Settlement Scheme (CSS)

The broad framework for compromise or negotiated settlement of NPAs advised by RBI in July 1995 continues to be in place. Banks are free to design and implement their own policies for recovery and write-off, incorporating compromise and negotiated settlement with the approval of their boards, particularly for old and unresolved cases falling under the NPA category. The policy framework suggested by RBI provides for setting up an independent Settlement Advisory Committee headed by a retired judge of the high court to scrutinize and recommend compromise proposal.

2.8.2 One-Time Settlement Scheme (OTS)

One-Time Settlement Scheme (OTS) was launched for the first time in May 1999. Specific guidelines were issued to Public Sector Banks (PSBs) for onetime non-discretionary and non-discriminatory settlement of NPAs of small sectors. It was again introduced in July 2000. In May 2003, the time limit for processing of applications received under the revised guidelines for Compromise Settlement of chronic NPAs of PSBs up to Rs 10 crore was extended to December 2003. Based on the requests received for extending the time limit for operation of the guidelines and in consultation with the government of India, the time limit for receiving application was extended up to July 31,

\textsuperscript{57}The Financial Express, 18\textsuperscript{th} May 2005, p.2.
2004. The guidelines are applicable to cases in which the banks have initiated action under the SARFAESI Act 2002 and also cases pending before courts (DRTs), subject to consent decree being obtained from the courts/ DRTs.

2.8.3 Lokadalats

One of the initiatives taken by the DRTs for recovery of NPAs is that DRTs have started holding “Lokadalats”. The concept of Lokadalats was introduced by the Chief Justice of India, Shri.P.N.Bhagwati in the year 1982 as a part of legal aid. By now, it has become a usual feature of the legal system for effecting mediation and conciliation between the parties and to reduce burden on the Courts/ DRTs especially for small loans.\(^{58}\)

As far as recovery of smaller loans is concerned, the Lokadalats have proved a very good agency for quick justice and settlement of dues. With the enactment of Legal Services Authority Act, 1987, Lokadalats were conferred a judicial status and have since emerged as a convenient method for settlement of disputes between banks and small borrowers.

The RBI has issued guidelines to Commercial Banks and Financial Institutions to enable them to make increasing the use of Lokadalats convened by various DRTs/ Debt Recovery Appellate Tribunals (DRATs) for resolving cases involving Rs.10lakhs and above to reduce the stock of NPAs. The government has in August 2004, revised the monetary ceiling of cases referred to Lokadalats organized by Civil Courts. As a result, the scope of the Lokadalats is now expanded to cover both suit filed and non-suit filed cases for recovery of dues in accounts failing in ‘Doubtful’ and ‘Loss’ categories with outstanding balance up to Rs.20lakhs, by way of Compromise Settlement.

\(^{58}\)Kaveri, V.V., “DRTs and Lokadalats”, \textit{Banking Finance}, Vol 18.3(2005)5.
2.8.4 Debt Recovery Tribunals (DRTs)

The recovery of debts due to Banks and Financial Institutions Act, 1993 was enacted on 24\textsuperscript{th} August 1993 to provide for the establishment of Debt Recovery Tribunals (DRTs) for expeditious adjudication and recovery of debts due to Banks and Financial Institutions and the matters connected there with and incidental thereto. At present, there are 29 DRTs set up at major centers in the country with 5 Debt Recovery Appellate Tribunals (DRATs) located in five centers viz. Allahabad, Mumbai, Delhi, Calcutta and Chennai. The Act was amended in the year 2000.

On the recommendation of the Reserve Bank, the Government of India set up a working group under the Chairmanship of Shri. S.N. Aggarwal in July 2004 to review the existing provisions of the said Act and improve the functioning of DRTs. The working group was expected to examine issues and recommend appropriate measures regarding:

1. The need to extend the provisions of the recovery of debt due to Banks and Financial Institution act to cases of less than Rs. 10 lakh.
2. Redistribution of the jurisdictions of the various DRTs.
3. Modification in the existing strength of the DRTs/ Debt Recovery Appellate Tribunals (DRATs).
4. Legal and institutional provisions.

The working group suggested amendments to the Act and Rules framed thereunder. The government has substantially amended the Debts Recovery Tribunals (procedures) Rules, 2003 to facilitate better administration of the act including plural remedies for banks.

2.8.5 Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002

In order to implement the recommendation of the Narasimham Committee on banking sector reforms (April 1998), the Government of India had constituted an expert
committee under the Chairmanship of Shri T.R. Andhyarujina. The committee in its report submitted in February 2000, interalia, proposed a draft securities bill and changes in legal provision relating to enforcement of security interest without the intervention of the court. Subsequently, the ordinance to regulate securities and reconstruction of financial assets and enforcement of security interest was promulgated on June 21, 2002 (subsequently re-promulgated on August 22, 2002) while the Debt Recovery Tribunals will be the usual mechanism for recovery of the debts for unsecured loans; for secured loans, the proposed draft bill confers the power on the banks and financial institutions to take over the securities from the barrowers and sell the same without the intervention of the court. The powers proposed are somewhat similar to the one enjoyed by the State Financial Corporations for recovery of their dues under the State Financial Corporation Act 1951.

The last one decade has seen vigorous attempts on the port of the legislature to enact a law which could effectively curb the menace of ever growing non-performing assets. Discouraged by the result of DRTs in filling the coffers of banks and financial institutions, the government of India enacted Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) w.e.f. 21st day of June 2001. This act lays the emphasis on recovery of the manners, even without the intervention of Courts or Tribunals.

The Security Interest (enforcement) Rules, 2002 has also been notified by securities and recover the dues from the borrowers. The Public sector banks and Financial Institutions have been advised to take action under the act and report compliance to the RBI.

The supreme court in its judgment dated April 8, 2004 in M/s Mardia chemicals has upheld the constitutional validity of the act and its provisions except that section
17(2) by the secured creditor, in case the borrower wants to appeal against the secured creditors notice u/s 13(4) of the act. It has declared section 17(2) as unconstitutional and violative of Article 14 of the constitution of India. In the wake of this judgment, banks have pointed out practical difficulties likely to arise in speeding up the recovery of NPAs. In the union budget 2004-05, the government proposed to amend the relevant provisions of the act to appropriately address the supreme courts concerns regarding a fair deal to borrowers while, at the same time, ensuring that the recovery process is not delayed or hampered. Consequently, the Central government has amended the SARFAESI Act by the promulgation of an ordinance on November 11, 2004 which strengthens the various provisions of the act and paves the way for speedy recovery of banks NPAs.

Releasing the report on ‘Global Non-performing loans 2004’ Efy CEO, Rajiv Memani, said “many of foreign investors like CDC Capital, Standard chartered bank, Merrill Lynch, Morgan Stanley and GE capital are keen to invest in NPAs of Indian banks after the passage of securitization act and setting up of Asset Reconstruction Companies”.

Although the act has no doubt given a lot of leverage to the banks to recover their NPAs, the success share lies only in the proper and forceful enforcement.

**2.8.6 Asset Reconstruction Companies (ARCs)**

From a policy perspective, it becomes imperative that a reduction in NPAs would require both a “stock” (a one – time cleaning of balance sheet) and a “flow” (preventing substantial accretion) solution. Several measure have been taken to address the “flow” problem (viz., lokadalats, Settlement advisors committees) whereas the issue of stock of NPAs has not been adequately addressed towards this end. The Central government budget for 2002-03 announced the setting up of a pilot Asset Reconstruction Company.

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60 Decan Herald, 12th April 2004.
An Asset Reconstruction Company (ARC) is a company specialized in recovery and liquidation of assets. The NPAs can be assigned to ARCs by banks at a discounted price. ARC has the objective of floating bonds and making recovery from the borrowers directly. The need for the setting up of an asset reconstruction company for acquiring distressed assets from banks and financial institution in order to develop market for such assets was being felt, since long. The Narasimham Committee on financial system (1991) has recommended the setting up of Assets Reconstruction Fund (ARF), which will take over the bad debts of bankers from their balances sheets to enable them to start on a clear state. Subsequently, the Narasimham Committee on banking sector reforms (1998) recommended transfer of sick assets of banks to an ARCs further, the Verma Committee on restricting weak public sector banks (1999) has also strongly recommended the setting up of ARCs. Accordingly, an ordinance was promulgated in June 2002 to regulate Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest. The SARFAESI Act has provided an enabling legal frame work for the setting up of securities or Reconstruction Company and the manner of acquisition of financial assets by such companies. The ARC is envisaged to enable the banks and Financial Institutions to sell off/ transfer the NPAs. The sale proceeds of the assets are to be used for payments to the secured creditors for the assets taken over from them. The ARCs or Securities Companies shall be deemed to be lender and the rights of transferor banks and Financial Institutions will vest with them.

As a result of enactment of SARFAESI Act, the first assets reconstruction company called Assets Reconstruction Company of India Limited (ARCIL) was promoted by ICICI bank, State Bank of India and IDBI bank with an authorized capital of Rs.2000crore and initial paid up capital of Rs.1400crores. So far, the RBI has granted certificate of registration to three ARCs including ARCIL.
ASREE (India) Limited has been started recently. In order that ARCs have a sound capital base and a stake in the management of the NPAs acquired, the requirement of owned funds for commencement of business has been stipulated as not less than 15 percent of the assets acquired or Rs.100crores whichever is less.

However, in the survey on status of India banking industry conducted by Federation of India Chamber of Commerce and Industry (FICCI) it was found that absence of secondary market for the trading of secondary receipt issued by ARCs was identified as one of the major problems in Indian model of NPAs management\textsuperscript{62}.

“Several banks having increased NPAs provisioning in the last two years, are now in the process of reducing NPAs portfolios by sale to the ARCs or setting with promoters”, says EFY CEO. Rajiv Memani\textsuperscript{63}.

2.8.7 Corporate Debt Restructuring (CDR)

One of the methods suggested for the reduction of non-performing assets is Corporate Debt Restructuring (CDR). The process is primarily rescheduling the debt portfolio of the borrowing among is creditors to help the borrowers in the revival of projects, reduction in existing debt burden and establishment of new credit lines with implied consumption that the lender would prefer reduction in risk to optimization of returns. The object of the CDR is to ensure a timely and transparent mechanism for restructuring of the corporate debts of viable corporate entities affected by internal and external factors, outside the purview of BIFR, DRT or other legal proceedings, for the benefit of all concerned. It is applicable to standard and sub-standard accounts with potential cases of NPAs getting a priority. The scheme of Corporate Debt Restructuring (CDR) was developed in India based on international experience and detailed guidelines on the same were issued to banks and financial institutions in 2002 for implementation. The scheme was future fine-tuned in February 2003 based on the recommendations made

by a working group under Shri.Vepakamesam. It has three tire structures namely CDR standing forum, CDR empowered group and CDR cell.

2.8.8 Circulation of Information on Defaulters

Periodical circulation of debts of willful defaulters of banks and financial institutions by RBI is also suggested as a measure for reduction of NPAs. Now, RBI has published a list of borrowers (with outstanding aggregate Rs.1crore and above) against whom suits have been filed by banks and financial institution as on 31st march every year.

2.8.9 Credit Information Bureau (CIB)

Banks and lending institutions have a traditional resistance, because of the confidential nature of banker-customer relationship, to share credit information on the client not only between each other but also across the sectors. There has been a widely felt need to establish a Credit Information Bureau (CIB) designed to obtain and share data on borrowers in a systematic manner for sound credit decisions, thereby helping to facilitate avoidance of advance selection. This would also facilitate reduction in NPAs.

The Banking Commission (1972) under the Chairmanship of Shri R.G.Saraiya, recommended setting up of a Credit Information Bureau as a statutory body, which would provide adequate and reliable credit information to banks and other financial institutions.

Considering the growth of financial sector and need for effective mechanism for mitigating credit risk by enhancing the quality of credit decisions, the Reserve Bank of India has constituted a working group under the chairmanship of Shri.N.H.Siddiqui on 30th October 1999, to explore the possibilities of setting up a Credit Information Bureau. Pursuant to acceptance of recommendations of the working group, a draft of the proposed legislature titled “The Credit Information Bureau Regulation Act, 2001” had been prepared by the Reserve Bank of India and the same has been forwarded to the Ministry of Finance (Banking division), Government of India.
Pending the enactment of CIB Regulation Bill, a working group under the Chairmanship of Shri S.R.Iyer was constituted in December 2001 to examine the possibility of the CIB performing the role of collecting and disseminating information on suit-filed accounts and the list of defaulters, presently being reported to RBI by banks and notified institutions. The working group submitted its report in January 2002 and the recommendations which satisfy the existing legal frame work are being implemented by the RBI. Based on the recommendations of the above working group, banks and financial institutions have been directed under section 35A of the Baking Regulation Act, 1949 that they should submit the list of suit-filed accounts of Rs.1crore and above as on March 31,2002 and quarterly updates their of till December 2002 and suit-filed accounts of willful defaulters of Rs.25lakhs and above as at end March, June, September and December 2002 to the RBI as well as to CIBIL for a period of one year till march 31, 2003. Thereafter, the aforesaid information should be submitted to CIBIL only and not to the RBI.

In pursuance of the Central Government Budget proposal 2000-01, Credit Information Bureau (India) Ltd. (CIBIL) was set up in January 2001 by State Bank of India in collaboration with HDFC Ltd., M/S Dun of Bradstreet Information Services (India) Pvt. Ltd., Trans Union International Inc; (as foreign technology partners) with a paid up capital of Rs.25crores, to serve as an effective mechanism for exchange of information between banks and Financial Institutions for curbing growth of NPAs. Dissemination of credit information covering data supplied on suit-filed defaulters in the financial system is being undertaken by Credit Information Bureau of India Limited (CIBIL) w.e.f. March 2003, and the data can be accessed on CIBIL’S website. The RBI has issued instructions to banks and financial institutions on October 1, 2002 and February 10, 2003 respectively, to obtain the consent of all their borrowers for pooling of data for development of a comprehensive credit information system. Further, with a view to strengthening the legal mechanism and facilitate Credit Information Bureau to collect, process and share credit information on borrowers of Banks/ Financial Institutions, a
draft Credit Information Companies Regulation Bill, 2004 covering registration, responsibilities of bureaus, rights and obligations of the credit institutions and safeguarding of privacy rights is under active consideration of the Government.

2.8.10 National Company Law Tribunal (NCLT)

A revised framework of constituting the National Company Law Tribunal (NCLT) and the National Law Appellate Tribunal (NCLT) has been provided for in the Companies Act through the companies (Secondary Amendment) Act, 2002 to replace the Board for Industrial and Financial Reconstruction (BIFR) besides looking at revival and rehabilitation of sick companies and the liquidation process, the NCLT will also handle the work of the Company Law Board.

2.8.11 Write - Off

Write- off is the last resort of NPAs management techniques. The bad debts which are unrecoverable have to be written off from the banks sheet. It is an internal mechanism of the banks to clear up the unproductive assets from the balance sheet, but it, no other way, prevents the banks to recover the dues from the borrowers.

With regard to write off of bad loans by banks, the Supreme Court, in its recent judgment has held that Commercial banks in consultation with the RBI are empowered to write off non-performing assets running to crores. One cannot draw an adverse inference of mismanagement against the bank concerned for doing so.\(^{64}\)

CONCLUSION

In any business, an element of bad debt is inevitable. Banking is a business and therefore, NPAs are inevitable/. In a banking system like that of India, while miracles cannot be expected from banks with different ownership, patterns, cultures and client bases, it could be said that a fair degree of improvement of NPAs can be ensured. The key drives of the banking sector would be competition, consolidation and convergence. Therefore, there is a need to treat reduction of NPAs in banking sector as a national priority item to make strong, resilient and geared up banking system to meet the challenges of globalization.

CHAPTER - III
MANAGEMENT OF NON PERFORMING ASSETS: A COMPONENT OF CREDIT RISK MANAGEMENT

3.1  Introduction
3.2  Credit Deposit Ratio of SCBs groups
3.3  Capital Adequacy Ratio of Bank groups
3.4  Analysis of Gross Advances of Bank groups
3.5  Analysis of Non Performing Assets of Banks in India
3.6  Magnitude of Gross Non Performing Assets of Bank groups
3.7  Analysis of Net Advances of Bank groups
3.8  Magnitude of Net Non Performing Assets of Bank groups
3.9  Evaluation of Loan Assets quality of SCBs
3.10 Magnitude of Loan Assets quality of SCBs
3.11 Sector-wise analysis of NPAs of Banks
3.12 Recovery of Non Performing Assets by SCBs