CHAPTER 5

MANAGEMENT OF NON-PERFORMING ASSETS AND IMPLICATIONS

Banking sector plays an indispensable role in economic development of a country through mobilization of savings and deployment of funds to the productive sectors. Bank lending is very crucial for it makes it possible, the financing of agricultural, industrial and commercial activities of the country. It is an established fact that a fragile banking system can, not only hamper the development of a particular economy but also it can deepen the real economic crisis and impose heavy social costs. So the health of the banking system should be one of the primary concerns of the government of each country.

Banks play a very useful and dynamic role in the economic life of every modern state: They are important constituents of the money market and their demand deposits serve as money in the modern community. The operations of commercial banks record the economic pulse of economy of almost all countries big or small, rich or poor, socialist or capitalist and they are faced with the problem of regional disparities in economic development. Economic development is primarily linked with financial institutions and commercial banks become prime movers of the economic development because of their unique function of credit creation. In modern economy, bankers are to be considered not merely as “dealers in money” but more realistically the “leaders in development”. Similarly, banks are not just the storehouses of the country's wealth but are the reservoirs of resources necessary for economic development.

Banks are the purveyors of money and credit to the factors of production in every country and thus help in the acceleration of growth. Banks are also called

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custodians of public money. Money and credit provide the pivot around which all our economic activities cluster. Banks are the pivots of modern commerce; industrial innovations and business expansions become possible through finance provided by banks. Finance is the life blood of every country. It helps in capital formation and capital accumulation, which is very much necessary for building infrastructure, and setting up of basic and key industries, which are essential for long-term development.

The Banking sector is an indispensable financial service sector supporting development plans through channelizing funds for productive purpose. Commercial Banks mainly contribute to:

- Develop both internal and external trade of a country by providing loans to retailers and wholesalers for their inventory and facilitating movement of goods from one place to another or between the countries.
- Capital formation to accelerate the tempo of economic development by managing the rate of saving. The development of the industrial sector by providing short-term, medium-term and long-term loans to industry, to secure labour and other factors of production.
- Develop employment generating activities by providing loans for the education of youngsters in pursuing higher learning in engineering, medical and other vocational institutions.
- Develop rural economy by providing credit facilities at cheaper rate to the large agricultural sector and also other sectors of the rural economy by extending their branches into the rural areas.
- Facilitate the Government motive and force for economic development, by providing / arranging finance to the government through various methods like direct credit to the Government various Government undertakings and through subscribing public debt and investing money in various Government securities. The economic

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6 Vishist A.K., “Public Sector Banks in India”, H.K. Publishers and Distributors; Delhi, 1991, p.4
development of the country is possible by following the monetary policy of the central bank (Ministry of Finance through the Reserve Bank of India).

Hence, banking is the essential industry, which not only caters to the development of trade, commerce and industry, but also helps in removing many obstacles in the way of economic development. Commercial banks are oldest, biggest and fastest growing financial intermediaries in India. Commercial banking in India is a unique system, the like of which exists nowhere in the world. The truth of this statement becomes clear as one studies the philosophy and approaches that have contributed to the evolution of the banking policy, programmes and operations in India\textsuperscript{8}.

Capital is the chief factor of modern production and entrepreneurs are unable to help without adequate funds. Therefore, only banks can help them. Banks mobilize the dormant capital of the country for productive purposes. Commercial banks play an important role in mobilizing the savings of economically surplus units, which are widely scattered. The savings of economically surplus units, when pooled together in commercial banks, result in a large reservoir of social capital. The commercial banks become a source of capital which is in short supply in a developing economy like India\textsuperscript{9}. It will be equally true to state that without the development of sound commercial banking, underdeveloped countries cannot hope to join the rank of advanced countries\textsuperscript{10}. Commercial banking increases its significance in an underdeveloped country like India, as it has resorted to economic planning.

An increasing rate of savings is essential for the increasing requirements of productive use or can be invested in bank-deposits; Government securities, capital formation for a developing country. The savings can be put to direct equities, bonds, etc. Unfortunately, in under-developed countries savings are very low because their incomes are very low and or financial institutions are inadequate. Further, rural people who belong to higher income groups, their saving potential is high. Such income earners tend to hold


\textsuperscript{9} Agrawal B.P. “Commercial Banking in India”, Classical Publishing Company, New Delhi, 1981, p.252

\textsuperscript{10} Jhingar M.L., “Money Banking and International Trade”, Konark Publications, New Delhi, 1985, p.252
their savings mainly in currency and to some extent in jewellery, in land or in the form of 
loans and advances given to unorganized market. Often they do so because of such 
factors as their ignorance of the availability of different types of financial assets in which 
can hold their savings\textsuperscript{11}.

It is here that commercial banks can play a pivotal role as intermediaries by 
bridging the gap between savings and investments. They mobilize the idle and dormant 
capital of the community, through branch expansion in unbanked and under banked areas 
and by introducing a variety of deposit schemes to suit the needs of individual depositors 
and make it available to various productive purposes. Economic development depends 
upon the diversion of economic resources from consumption to capital formation\textsuperscript{12}. Thus, 
a higher rate of savings and investment can help in accelerating the rate of capital 
formation in a developing economy.

The economic progress of a nation and development of banking is invariably 
interrelated. The Banking sector is an indispensable financial service sector supporting 
development plans through channelizing funds for productive purpose, intermediating 
flow of funds from surplus to deficit units and supporting financial and economic policies 
of government. The stability of banking hence is a pre-requisite for economic 
development and resilience against financial crisis.

5.1 THE NON PERFORMING ASSETS (NPAs)

A major threat of banking sector is prevalence of Non-Performing Assets 
(NPAs). The Non-Performing Assets (NPAs) problem is one of the foremost and the 
most formidable problems that have shaken the entire banking industry in India like an 
earthquake. Like a cancer worm, it has been eating the banking system from within, since 
long. It has grown like a cancer and has infected every limb of the banking system. Like 
y any other business, success of banking is assessed based on profit and quality of asset it 
possesses. Even though bank serves social objective through its priority sector lending, 
mass branch networks and employment generation, maintaining asset quality and 
profitability is critical for banks survival and growth.

\textsuperscript{11} Report of the Banking Commission, 1972, pp. 85-86
\textsuperscript{12} Agrawal B.P., Op. Cit., p-2
The accumulation of huge non-performing assets in bank has assumed great importance. The debt of the problem of bad debts was first realized only in early 1990s. NPAs represent bad loans, the borrowers of which failed to satisfy their repayment obligations. NPA is a virus affecting banking sector. It affects liquidity and profitability, in addition posing threat on quality of asset and survival of banks. Hence, this has been considered to be the most challenging problem facing the banking and financial sectors.

5.2 MEANING AND DEFINITION OF NON PERFORMING ASSETS (NPAs)

5.2.1 MEANING OF NPAs

A performing asset is an advance which generates income to the bank by way of interest and other charges. A non-performing asset in the banking sector may be referred to an asset not contributing to the income of the bank or which does not generate income for the bank. In other words, an advance account, which ceases to yield income, is a non-performing asset. If the customers do not repay principal amount and interest for a certain period of time then such loans become Non-performing assets (NPA). Thus non-performing assets are basically non-performing loans. Banks are not allowed to book any income from NPAs. They have to make provision for NPAs or keep money aside in case they cannot collect from the borrower, which affects profitability adversely.

5.2.2 DEFINITION OF NPAS

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. A ‘Non-Performing Asset’ (NPA) was defined as a credit facility in respect of which the interest and/or installment of principal has remained ‘past due’ or a specified period of time. The specified period was reduced in a phased manner as under:

With effect from March, 1993 – Four Quarters

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With effect from March, 1994 – Three Quarters
With effect from March, 1995 – Two Quarters
With effect from March, 2001 – 180 days
With effect from March, 2004 – 90 days

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

- Interest and/or installment of principal remains overdue for a period of more than 90 days in respect of term loan.
- The account remains ‘out of order’ for a period of more than 90 days, in respect of an overdraft/cash credit (OD/CC).
- The bills remain overdue for a period of more than 90 days in the case of bills purchased and discounted.
- Interest and/or installment of principal remains overdue for two harvest seasons for a period not exceeding two half years in the case of an advance granted for agricultural purposes and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Various committees and financial institutions, legislations interpreted NPAs in different ways to define NPA in respective terms.

**Definition as per Narasimham Committee**

The problem of NPA was first brought into focus by the Narasimham Committee on financial system (1991), set up with the initiation of liberalization process in the country. The Committee placed emphasis on identifying problem loans of banks and making provisions for such loan and so instituted proper definition of NPAs. Apart from identification of bad assets the Committee also suggested some ways to deal with them. Further, Narasimham Committee clearly defined that an asset may be treated as Non-performing Asset (NPA), if interest or installments of principal or both remain
unpaid for a period of more than 180 days. However, with effect from March 2004, default status is given to a borrower account if dues not paid for a period of 90 days.\(^\text{16}\)

**Definition according to Prudential Norms**

According to the prudential norms, an asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. A non-performing asset was defined as a credit facility in respect of which interest remained ‘past due’ for a period of four quarters in the year ending March 31, 1993, three quarters during the year ending March 31, 1994 and two quarters during the year ending March 1995 and onwards\(^\text{17}\).

**Definition as per RBI Guidelines**

RBI guidelines defined that NPAs consist of substandard assets, doubtful assets and loan assets. Any asset usually turns as NPA when it fails to yield income during a certain period. As a result, doubtful assets find their way from substandard assets after 18 months in Indian context (against 12 months under the international norms of NPAs.) If it is found irrecoverable, then it migrates to loss assets category.

**Definition according to SARFAESI Act, 2002**

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 defined Non-Performing Assets as an asset or account of a borrower, which has been classified by a bank or financial institution as substandard, doubtful or loss assets in accordance with the direction or guidelines relating to asset classification issued by the RBI.

5.2.3 **CONCEPTUAL FRAMEWORK OF NPAs**\(^\text{18}\) The basis for defining a credit, as NPA will vary depending on the nature of the loan account “such as term loan account, running account (cash credit and overdraft), bill account (bills purchased and discounted), etc.

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\(^{16}\) (1998). Banking Sector Reforms-Recommendations of Nararsimham Committee-Second Report, RBI


Term Loan

A term loan account is to be treated as NPA, if on the balance sheet, interest or loan installment remains overdue for a period of four quarters during the year ending 31\textsuperscript{st} March 1993 (or) three quarters during the year ending 31\textsuperscript{st} March 1994 (or) more than 180 days during the year ending 31\textsuperscript{st} March 1995-2003 and more than 90 days during the year ending 31\textsuperscript{st} March 2004 onwards.

Due Date

Due date is the ultimate date fixed or stipulated in the loan sanction letter for repayment of loan installment or interest. In all term loans, at the time of original sanction and at the time of rescheduling, a repayment schedule is stipulated indicating the due date for payment of interest and installment with or without any moratorium period. The periodicity of instalment repayment may be monthly, quarterly, half yearly or yearly, beyond the moratorium period, where provided.

Cash Credit (CC)/Overdraft (OD)

A cash credit or overdraft account is treated as NPA if the account is not out of order for two quarters or more on the date of balance sheet. Before an account is treated as out of order, it should be identified as irregular. An account is treated as irregular under the following situations: (i) If the balance outstanding remains continuously in excess of the sanctioned limit/drawing power; (ii) Even if the debit balance is within the sanctioned limit/drawing power, if there is no credit continuously for six months as on the date of balance sheet. (iii) The credit are not enough to cover if the interest debited during the same period of six months even if the balance outstanding in the account including interest debited is within the limit sanctioned/drawing power.

After an account is identified as irregular for six months basing on the above three criteria, it will be treated as out of order. A CC/OD account is treated as NPA if it continues to be out of order for a further period of six months.

Bills Purchased/Discounted

Bills which remain overdue and are unpaid for a period of two quarters or more from the due date will be treated as NPA on the date of balance sheet.

Agricultural Advances
Installment/interest which remains unpaid after past due for two harvest seasons or two half years shall be treated as NPA.

**Other Facilities**

Any other credit facility not specified above will be treated as NPA if interest or installment remains past due for two quarters or more, as on the date of balance sheet.

**Identification of NPAs**

The fresh NPA can be identified under credit monitoring system (CMS) as on last Friday or every quarter for reviewing purpose. Charging of interest in first three quarters till the annual closing date, if on the annual closing date i.e., 31st March, the account continues to be NPA, the interest applied during the year, but not realized, should be reversed by debiting ‘interest account’ and crediting ‘interest not collected account’.

**5.3 PRUDENTIAL ACCOUNTING NORMS**

Prior to the financial sector reforms in the year 1992-93, banks used to debit interest to the loan account on accrual basis and recognized the same as income even in accounts with poor record of recovery. Recognizing income on accrual basis in accounts where the realization is in doubt is not a prudential practice. As per the recommendation of the Narsimham Committee, as stated earlier, the Reserve Bank of India introduced prudential accounting norms applicable from the financial year 1992-93; interest is not to be debited on the accrual basis but on the cash basis. The prudential accounting norms are based on the NPA concept, N for No income, P for provisioning and A for asset classification. The prudential accounting norms comprise of the following: (1) Income Recognition; (2) Asset Classification and (3) Provisioning Norms.

**5.3.1 INCOME RECOGNITION**

For the purpose of income recognition, banks are required to classify their loan account into two categories: (a) Performing Assets [PA] (b) Non-performing Assets [NPA]

If the asset is ‘Performing’, income is recognized on an accrual basis. If the asset is ‘Non-Performing’, interest thereon is to be recognized only on cash basis, i.e., when it is actually realized. Banks may book dividend income on shares of corporate bodies on accrual basis, provided dividends on the shares have been declared in the Annual General Meetings and the owners’ right to receive the payment is established.
Hence if dividend is not declared before finalizing the accounts, it cannot be taken to income account. In respect of income from Government securities and bonds and debenture of corporate bodies where interest rates are predetermined, income could be booked on accrual basis, provided interest is serviced regularly and is not in arrears.

As per the RBI guidelines, applicable from 1992-93 onwards, once a loan account is identified as NPA, the bank should do the following:

- Not to charge/debit interest to the account on accrual basis.
- To charge interest to the account only when it’s actually received.
- To reverse the amount of interest already charged on accrual basis in the accounting period to the extent it remains un-recovered on the date of the classification it as NPA. If any performing asset of the previous period has become NPA in the current period, all interest income relating to that NPA credited to the Profit and Loss Account of the previous period, to the extent unrealized interest. The unrealized interest is to be transferred from income account to interest suspense account, where maintained, or credited to party’s account. This applies to unrealized interest on Government guaranteed accounts too.
- Other items of income such as fees, commission, locker rent, etc. are transaction-oriented and hence may be recognized as income only on realization. If income such as fees, commission, etc. is booked, on accrual basis, in the case of an account that has turned NPA, the same should be reversed.
- In case of NPA where interest income has ceased to accrue, the fees, commission and similar receipts should neither be debited to the account nor credited as income and even if credited, should be reversed or provided for to the extent to which it is uncollected.
- Any amount recovered even partially towards interest in case of an account can be recognized as income, provided such credits in the account towards interest are not out of fresh/additional facilities sanctioned.
- In case of rescheduling or negotiation of loan, the fees, interest, commission, etc., should be recognized on accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit. Thus the income would be recognized on accrual basis from the date of rescheduling, as in a fresh account.
5.3.2 ASSET CLASSIFICATION

Loan assets of the banks are broadly classified as performing asset (Standard asset) and non-performing assets. The non-performing asset (NPA) is further classified into (a) Substandard, (b) doubtful and (c) Loss assets.

Fig. 5.1 Classifications of Assets

- **Standard Assets**: A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPA in the real sense. So, no special provisions are required for Standard Assets.

- **Sub-Standard Assets**: All those assets (loans and advances) which are considered as non-performing for a period not exceeding two years. However, with effect from March 31, 2001 an asset may remain in substandard category for 18 months. This period has further been reduced to 12 months with effect from 31st March, 2005.

- **Doubtful Assets**: All those assets which are considered as non-performing for period of more than two years are called as doubtful assets from 31st March 2001. The period has been reduced to 18 months and further to 12 months with effect from 31st March, 2005.

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- **Loss Assets**: All those assets which cannot be recovered are called as Loss Assets. These assets can be identified by the Central Bank Inspectors or by the Bank Auditors. 100 percent provision for the amount outstanding must be made\(^2^0\).

### 5.3.3 Provisioning

Based on the asset classification banks are required to make provision against the NPAs at 100% for loss assets; 100% percent of the unsecured portion plus 20% to 50% of the secured portion, depending on the period for which the account has remained in doubtful category; and 10% etc. Banks have constituted Recovery Cells, Recovery Branches, and NPA Management Departments and fix recovery targets\(^2^1\).

Policies evolved and steps taken in this regard are critically examined during the annual on-site inspection of banks. The off-site returns also provide RBI an insight into the quality of credit portfolio and quarterly intervals. Introduction of prudential norms on income recognition, asset classification and provisioning during 1992-93 and other steps initiated apart from bringing in transparency in the loan portfolio of the banking industry have significantly contributed towards improvement of the pre-sanction appraisal and post-sanction supervision which is reflected in lowering of the levels of fresh accretion of non-performing advances of banks after 1992.

### 5.4 Types of NPAs

NPAs are broadly divided into two types: Gross NPAs and Net NPAs

#### 5.4.1 Gross NPA

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 NPA reflects the quality of the loans made by banks. It consists of all the non standard assets like as sub-standard, doubtful and loss assets. It can be calculated with the help of following ratio:

\[
\text{Gross NPAs Ratio} = \left(\frac{\text{Gross NPAs}}{\text{Gross Advances}}\right) \times 100
\]


\(^{21}\) Raj Kalpana and Uma Kalpana, “On going development in banking and financial sector”, Academic Foundation, Delhi, 2000, p.164 &165
5.4.2 NET NPA

Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. Net NPA shows the actual burden of banks. Since in India, bank balance sheets contain 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. That is why the difference between gross and net NPA is quite high. It can be calculated with the help of following ratio:

\[
\text{Net NPAs} = \left( \frac{\text{Gross NPAs} - \text{Provisions}}{\text{Gross Advances} - \text{Provisions}} \right) \times 100
\]

The Reserve Bank of India states that, compared to other Asian countries and the US, the gross non-performing asset figures in India seem more alarming than the net NPA figure. The problem of high gross NPAs is simply one of inheritance. Historically, Indian public sector banks have been poor on credit recovery, mainly because of very little legal provision governing foreclosure and bankruptcy, lengthy legal battles, sticky loans made to government public sector undertakings, loan waivers and priority sector lending. Net NPAs are comparatively better on a global basis because of the stringent provisioning norms prescribed for banks in 1991 by Narasimham Committee.

**Table 5.1**

<table>
<thead>
<tr>
<th>YEAR</th>
<th>GROSS NPAs (in per cent)</th>
<th>NET NPAs (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001-02</td>
<td>11.1</td>
<td>5.8</td>
</tr>
<tr>
<td>2002-03</td>
<td>9.4</td>
<td>4.5</td>
</tr>
<tr>
<td>2003-04</td>
<td>7.8</td>
<td>3.0</td>
</tr>
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<td>2004-05</td>
<td>5.5</td>
<td>2.0</td>
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<td>2005-06</td>
<td>3.6</td>
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<tr>
<td>2006-07</td>
<td>2.7</td>
<td>1.1</td>
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<td>2007-08</td>
<td>2.2</td>
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<td>3.3</td>
<td>1.5</td>
</tr>
<tr>
<td>2012-13</td>
<td>3.6</td>
<td>2.0</td>
</tr>
</tbody>
</table>

*Source: RBI, Report on Trend and Progress of Banking in India, Relevant Issues*
Table 5.1 depicts the movement of NPA Ratios (per cent) spread over period from the year 2001-02 to 2012-13. The position of Gross NPAs was 11.1 percent in 2001-02, which continuously declined to 3.6 percent in 2012-13. Similarly, net NPA also experienced declining trend from 5.8 percent to 2.0 percent over the same period. Further, the declining progress in NPA position of public sector banks was due to preventive and curative measures adopted by RBI.

5.5 GUIDELINES FOR THE CLASSIFICATION OF ASSETS

Broadly speaking, classification of assets into above categories should be done taking into account the degree of well-defined weakness and the extent of time lag of dues.

- Banks should establish appropriate internal system to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. The banks should fix a minimum cut-off point to decide what would constitute a high value account depending upon their business levels. Responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per guidelines.

- Accounts with temporary deficiencies: The Classification of an asset as NPA should be based on record of recovery. Banks should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of limits on the due date, etc. In the matter of classification of accounts with such deficiencies bank may follow the following guidelines:

- Banks should ensure that the drawing in the working capital accounts are covered by adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived as based on the stock statement, which is current. However, considering the difficulties of large borrowers, stock statement relied upon the banks for determining drawing power should not be older than the three months. The outstanding in the account based on the drawing power
calculated from the stock statement older than three months, would be deemed as irregular. A working capital account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or borrowers’ financial position is satisfactory. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/review of credit limits is already on and would be completed soon. In any case, delay beyond three months is not considered desirable as a general discipline. Hence, accounts where the regular/ad hoc credit limits have not been reviewed/ renewed within 90 days from the due date/date of ad hoc sanction will be treated as NPA.

- Accounts regularized near balance sheet date: The asset classification of accounts where a solitary or few credits are recorded before the balance sheet date should be handled with care and without the scope of subjectivity. Where the accounts show the inherent weakness on the basis of data available, the account should be deemed as NPA. In other genuine cases, the bank must submit satisfactory evidence to the statutory auditors and inspecting officers about the manner of regularization of the account to eliminate doubts on their performing status.

- Asset classification to be borrower-wise and not facility wise:
  a) It is difficult to envisage the situation when only one facility to the borrower becomes the problem credit and not others. Therefore, all the facilities granted by the bank to a borrower will have to be treated as NPA and not the particular facility or part thereof which has become irregular.
  b) If the debits arising out of development of letter of credit or invoked guarantees are parked in a separate account, the balance outstanding in the borrower’s principle operating account for the purpose of application of prudential norms.

- Advances under consortium arrangement: Asset classification of accounts under consortium should be based on the record of recovery of the individual member bank. Where the remittances from the borrower under consortium lending arrangement are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of other member banks, and therefore be treated as NPA. The participating
banks is the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

- Accounts where there is erosion in the value of security:
  
a) A NPA need not go through the various stages of classification in case of serious credit impairments and such assets should be straightway classified as doubtful or loss assets. Erosion in the value of securities can be significant when the realizable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.
  
b) If the realizable value of the security, as assessed by the bank/approved valuers/RBI is less than 10 percent of the outstanding in the borrower account, the existence of the security should be ignored and the asset should be straight away classified as a loss asset. It may be either written off or fully provided for the bank.

- Agricultural Advances:
  
a) In respect of advances granted for agricultural purposes where interest and/or installment of principal remains unpaid after it has become overdue for two harvest seasons but for a period not exceeding two half-years, such an advance should be treated as NPA. The above norms should be made applicable only in respect of short-term agricultural loans for production and marketing of seasonal agricultural crops such as paddy, wheat, oilseeds sugarcane etc. but for the long-term duration crops, the loans will be treated as NPA, if the installment of principal remains unpaid for one crop season beyond the due date. In respect of other activities like horticulture, floriculture or allied activities such as animal husbandry, poultry farming etc. and the assessment of NPA would be done as in the case of other advances.
  
b) Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide their own relief measures-conversion of short-term loan into a term
loan or re-scheduling of the repayment periods; and /or sanctioning issued by RBI from time to time.

c) In such cases of conversion or re-scheduling, the term loan as well as fresh short-term loan may be treated as current dues and need not to be classified as NPA. The classification of these loans would thereafter be as per a new advance, governed by the revised terms and conditions.

5.5.1 ASSET QUALITY, NPAs AND DIRECTED CREDIT

The stability of financial institution is determined mainly based on its quality of assets and performance indicators. Quality of assets determines the survival and existence of business. Performance is judged on the basis of profitability. The financial institutions were considered stable during crisis period if the profitability and quality of assets is not affected\textsuperscript{22}. The stability of banking sector is vital for economic growth. The commercial banks dominate the sector, comprising more than three-fifths of the financial system assets. The financial intermediation by banks in India has played a central role in supporting the growth process, by mobilizing savings”. So any issues in banking sector directly impact the wellbeing of the economy. The emphasis during post-liberalization era in Indian banking sector is focused on improving the transparency and to integrate best practices in banking sector.

\begin{itemize}
\item An Asset is classified as doubtful, if in substandard category for 18 months, from the present norm of 24 months in the first instance and eventually for 12 months.
\item For the purpose of evaluating the quality of asset portfolio Government guaranteed advances that have turned sticky should be treated as NPAs. If, however, for reason of the sovereign guarantee argument such advances are excluded from the computations, these advances, which otherwise would have been classified as NPAs, should be separately shown as an aspect disclosure and greater transparency of operations.
\end{itemize}

To reduce the average level of net NPAs for all banks to below 5 per cent by the year 2000 and to 3 per cent by 2002. For those banks with international presence the objective should be to reduce the gross NPAs to 5 per cent and 3 per cent by the year 2000 and 2002 respectively and net NPAs to 3 per cent and 0 percent by these dates.

All loan assets in the doubtful and loss categories which represent bulk of the hard core NPAs in most banks should be identified and their realizable value determined. These assets could be transferred to an Asset Reconstruction Companies (ARCs), which would, in turn, issue bonds, equal to the realizable value of the assets transferred.

Alternatively the banks in difficulty could issue bonds that form part of Tier II capital. This will help the banks to blaster capital adequacy, which has been eroded because of the provisioning requirements for NPAs. As the banks in difficulty may find it difficult to attract subscribers to bonds, Government will need to guarantee these instruments, which would then make them eligible for SLR investment by banks and approved instruments for GIC and PF.

The interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs.2 Lakhs should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and Cooperative Credit Institutions.

5.6 CAPITAL ADEQUACY NORMS (CAR)

Capital Adequacy Ratio (CAR) is a significant parameter with regard to the strengthening and stability of the banking system. In 1988, Basel Committee on Banking Supervision (BCBS) introduced risk based capital adequacy norms through Basel I accord. Basel I mainly incorporated credit risk in calculating the capital adequacy norms of banks. It recommended a bank’s regulatory capital at 8 per cent of its risk weighted asset. As a part of financial reforms, India adopted Basel I norms for scheduled commercial banks in April 1992, and its implementation was spread over the next three years.

It was stipulated that foreign banks operating in India should achieve a CAR of 8 per cent by March 1993 while Indian banks with branches abroad should achieve the 8 per cent norm by March 1995. All other banks were to achieve a capital adequacy norm of 4 per cent by March, 1993 and the 8 per cent norm by March, 1996. In October 1998, the Reserve Bank of India raised the minimum regulatory CAR requirement to 9 per cent, and banks were advised to achieve this 9 per cent CAR level by March 31, 2000. The Reserve Bank of India has announced the implementation of Basel II norms in India for internationally active banks from March 2008 and for the domestic commercial banks from March 2009. The capital adequacy should bring safety to the bank and it should be more conservative when lending without sacrificing it revenue. This ratio shows the strength of a bank. The higher CAR the stronger the bank. It is arrived at by dividing the sum of Tier-I & Tier-II capital by aggregate of Risk Weighted Assets (RWA) Symbolically

\[
\text{CAR} = \frac{\text{Tier I} + \text{Tier II}}{\text{RWA}}
\]

- Tier - I capital includes equity capital & free reserves
- Tier - II capital comprise of subordinate debt of 5-7 years tenure, revaluation reserves, general provisions and loss reserves, hybrid debt capital instruments and undisclosed reserves and cumulative perpetual preference shares.

5.7 FACTORS CONTRIBUTING FOR RISE IN NPAS

There are many reasons as to why a loan goes bad. For a business, it could be because it fails to take off. Such a situation may arise because of sudden health expenditure or job loss or death. Often, it can be because of over-leveraging, when consumers borrow against most of their assets and, may be, have unsecured loans too. In such a case, any hit on income can jeopardize all repayments. They, however, can file for bankruptcy under Chapters 7, 11 and 13 of the United States Bankruptcy Code. Indians don’t have such an option.

In India, the situation has worsened due to banks aggressively pushing loans, even unsecured ones, to individuals to prevent idle assets on their books. President and founder of International Consumer Rights Protection Council, an NGO, says most customers in India are not financially educated and banks are luring them to take more and more loans, often without checking their financial position.
The banking sector has been facing the serious problems of the rising NPAs. But the problem of NPAs is more in public sector banks when compared to private sector banks and foreign banks. The NPAs in PSB are growing due to external as well as internal factors.

5.7.1 EXTERNAL FACTORS

Ineffective Recovery Tribunal: The Govt. has set of numbers of recovery tribunals, which works for recovery of loans and advances. Due to their negligence and ineffectiveness in their work the bank suffers the consequence of non-recover, their by reducing their profitability and liquidity.

Willful Defaults: There are borrowers who are able to pay back loans but are intentionally withdrawing it. These groups of people should be identified and proper measures should be taken in order to get back the money extended to them as advances and loans.

Natural Calamities: This is the major factor, which is creating alarming rise in NPAs of the PSBs. Even now and then India is hit by major natural calamities thus making the borrowers unable to pay back their loans. Thus the bank has to make large amount of provisions in order to compensate those loans, hence end up the fiscal with a reduced profit. Mainly our farmers depend on rain fall for cropping. Due to irregularities of rain fall the farmers are not to achieve the production level thus they are not repaying the loans.

Industrial Sickness: Improper project handling, ineffective management, lack of adequate resources, lack of advance technology, day to day changing Government policies give birth to industrial sickness. Hence the banks that finance those industries ultimately end up with a low recovery of their loans reducing their profitability and liquidity.

Lack of Demand: Entrepreneurs in India could not foresee their product demand and starts production which ultimately piles up their product thus making them unable to pay back the money they borrow to operate these activities. The banks recover the amount by selling of their assets, which covers a minimum label. Thus the banks record the non-recovered part as NPAs and have to make provision for it.
**Change in Government Policies:** With every new Government banking sector gets new policies for its operation. Thus it has to cope with the changing principles and policies for the regulation of the rising of NPAs. The fallout of handloom sector is continuing as most of the weavers Co-operative societies have become default largely due to withdrawal of state patronage. The rehabilitation plan worked out by the Central Government to revive the handloom sector has not yet been implemented. So the over dues due to the handloom sectors are becoming NPAs.

**5.7.2 INTERNAL FACTORS**

**Defective Lending process:** There are three cardinal principles of bank lending that have been followed by the commercial banks since long. (i) Principles of safety, (ii) Principle of liquidity and (iii) Principles of profitability By safety it means that the borrower is in a position to repay the loan both principal and interest. The repayment of loan depends upon the borrower’s- a) Capacity to pay, b) Willingness to pay.

Capacity to pay depends upon: Tangible assets and Success in business
Willingness to pay depends on: Character, Honesty and Reputation of borrower. The banker should, therefore take utmost care in ensuring that the enterprise or business for which a loan is sought is a sound one and the borrower is capable of carrying it out successfully.

**Inappropriate Technology:** Due to inappropriate technology and management information system, market driven decisions on real time basis cannot be taken. Proper Management Information System (MIS) and financial accounting system is not implemented in the banks, which leads to poor credit collection, thus it leads to increase in NPAs. All the branches of the bank should be computerized.

**Improper SWOT Analysis:** The improper strength, weakness, opportunity and threat analysis is another reason for rise in NPAs. While providing unsecured advances the banks depend more on the honesty, integrity, and financial soundness and credit worthiness of the borrower.

- Banks should consider the borrowers own capital investment.
- It should collect credit information of the borrowers from bankers; enquiry from market/segment of trade, industry, business and from external credit rating agencies.
- Analyze the Financial Statements: True picture of business will be revealed on analysis of Profit and loss Account and Balance Sheet.
- Purpose of the loan: When bankers give loan, it should analyze the purpose of the loan. To ensure safety and liquidity, banks should grant loan for productive purpose only. Bank should analyze the profitability, viability, long term acceptability of the project while financing.

**Poor Credit Appraisal System:** Poor credit appraisal is another factor for the rise in NPAs. Due to poor credit appraisal the bank gives advances to those who are notable to repay it back. They should use good credit appraisal to decrease the NPAs.

**Managerial Deficiencies:** The banker should always select the borrower very carefully and should take tangible assets as security to safe guard its interests. When accepting securities banks should consider the – 1) Marketability 2) Acceptability 3) Safety 4) Transferability. The banker should follow the principle of diversification of risk based on the popular maxim “do not keep all the eggs in one basket”; it means that the banker should not grant advances to a few big farms only or to concentrate them in few industries or in a few cities. If a new big customer meets misfortune or certain traders or industries affected adversely, the overall position of the bank will be affected.

**Absence of Regular Industrial Visits:** The irregularities in spot visit also increases the NPAs. Absence of regularly visit of bank officials to the customer point decreases the collection of interest and principle on the loan. The NPAs due to willful defaulters can be collected by regular visits.

**Re-loaning Process:** Non remittance of recoveries to higher financing agencies and reloaning of the same have already affected the smooth operation of the credit cycle. Due to re loaning to the defaulters and CCBs and PACs, the NPAs of OSCB is increasing day by day.

The origin of the burgeoning problem of NPAs lies in the quality of managing credit risk by the banks concerned. 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 potential to become non-performing.
To start with, performance in terms of profitability is a benchmark for any business enterprise including the banking industry. However, increasing NPAs have a direct impact on banks profitability as legally banks are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets as per the Reserve Bank of India (RBI) guidelines. Further, Reserve Bank of India (RBI) successfully creates excess liquidity in the system through various rate cuts and banks fail to utilize this benefit to its advantage due to the fear of burgeoning Non-performing assets.

5.8 IMPACT OF NPAs

The three letters “NPA” strike terror in banking sector and business circle today. NPA is short form of “Non Performing Asset”. The dreaded NPA rule says simply this: when interest or other due to a bank remains unpaid for more than 90 days, the entire bank loan automatically turns a non-performing asset. The recovery of loan has always been problem for banks and financial institution. To come out of these, the banks first needs to think is it possible to avoid NPA, if not be then it is to look at the factor responsible for it and managing those factors.

In the globalization era, banking and financial sectors get high priority. Indian banking sector is having a serious problem due to non performing assets. The earning capacity and profitability of the bank are highly affected. While the primary function of banks is to lend funds as loans to various sectors such as agriculture, trade, personal loans, housing loans etc., In recent times the banks have become very careful in increasing loans because of the main reason of increasing non-performing assets (NPAs). NPA is cleared as an advance for which interest or repayment of principal or both remain outstanding for a period of more than 90 days. The level of NPA act as an indicator viewing the bankers credit risks and competence of allocation of resource. Non-performing Asset is an important factor in the analysis of financial performance of a bank as it results in decreasing boundary and higher provisioning requirement for doubtful debts. Various banks from different groups mutually provide advances to different sectors like agricultural, priority sector, public sector and others.

The accumulation of huge non-performing assets in banks has assumed great importance. The depth of the problem of bad debts was assumed great importance, which
was first realized only in early 1990s. The magnitude of NPAs in banks and financial institutions is over Rs.1,50,000/- crores. While gross NPA reflects the quality of the loans made by banks, net NPA shows the actual burden of banks. Now it is increasingly evident that the major defaulters are the big borrowers coming from the non-priority sector. The banks and financial institutions have to take the initiative to reduce NPAs in a time bound strategic approach. Public sector banks figure prominently in the debate not only because they dominate the banking industries, but also since they have much larger NPAs compared with the private sector banks. This raises a concern in the industry and academics because it is generally felt that NPAs reduce the profitability of a bank, weaken its financial health and erode its solvency. For the recovery of NPAs a broad framework has evolved for the management of NPAs under which several options are provided for debt recovery and restructuring. Banks and Financial Institutions have the freedom to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements. The impact of NPAs on banks is significantly visible on the following areas:

5.8.1 PROFITABILITY

NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client. Because of the money getting blocked the prodigality of bank decreases not only by the amount of NPA but NPA lead to opportunity cost also as that much of profit invested in some return earning project/asset. So, NPA doesn’t affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low Return on Investment (ROI), which adversely affect current earning of bank.

5.8.2 LIQUIDITY

Money is getting blocked, decreased profit lead to lack of enough cash and which lead to borrowing money for shortest period of time which leads to additional cost to the company. Difficulty in operating the functions of bank such as routine payments and dues is another cause of NPA due to lack of money.

5.8.3 INVOLVEMENT MANAGEMENT

Time and efforts of management is another indirect cost which bank has to bear due to NPA. Time and efforts of management in handling and managing NPA would
have diverted to some fruitful activities, which would have given good returns. Now a day’s banks have special employees to deal and handle NPAs, which is additional cost to the bank.

5.8.4 CREDIT LOSS

Bank is facing problem of NPA then it adversely affect the value of bank in terms of market credit. It will lose its goodwill and brand image and credit which have negative impact to the people who are putting their money in the banks.

5.9 CONSEQUENCES OF NPA

➤ Owners do not receive a market return on their capital and in the worst case, if the banks fails, owners lose their assets. In modern times this may affect a broad pool of shareholders.
➤ Depositors do not receive a market return on saving. In the worst case if the bank fails, depositors lose their assets or uninsured balance.
➤ Banks redistribute losses to other borrowers by charging higher interest rates, lower deposit rates and higher lending rates repress saving and financial market, which hamper economic growth.
➤ Non-performing loans epitomize bad investment. 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.
➤ 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) Illiquidity constraints bank in paying depositors. (c) Under-capitalized banks exceed the bank’s capital base.

The most important business implication of the NPAs is that it leads to the credit risk management assuming priority over other aspects of bank’s functioning. The bank’s whole machinery would thus be pre-occupied with recovery procedures rather than concentrating on expanding business. RBI, through various circulars, stipulated guidelines to manage NPA. The higher NPA engage banking staff on NPA recovery
measures that includes filing suits to recover loan amount instead of devoting time for planning to mobilization of funds. Thus NPA impact the performance and profitability of banks. The most notable impact of NPA is change in banker’s sentiments which may hinder credit expansion to productive purpose. Banks may incline towards more risk-free investments to avoid and reduce riskiness, which is not conducive for the growth of economy. 

Banks cannot credit income to their profit and loss account to the debit of loan account unless recovery thereof takes place. Interest or other charges already debited but not recovered have to be provided for and provision on the amount of gross NPAs also to be made. All the loan accounts of the borrower would be treated as NPA, if one account is NPA. Many authors emphasized the straddling impact of NPA and stressed its impact on loan growth. A higher NPA force banks to invest in risk-free investments, thus directly affect the flow of funds for productive purpose (Tracey and Leon, 2011; and O’Brien, 1992). Issues relating to NPA affect all sectors (in particular if parallel issues with defaulting trade credit is also considered). The most serious impact, however, is on the financial institutions, which tend to own large portfolios, indirectly; the customers of these financial intermediaries are also implicated; deposit holders, share holders and so forth. Add to this, NPA is not only affecting the banks and its intermediaries, it is having impact on the development of the nation as well.

For a bank, NPA means unsettled loan, for which they have to incur financial losses. The cost for recovering NPA is as well considerable. There are banking failures on account of the mounting NPA since it is affecting the profitability and long run survival of the bank.

The NPA results in deleterious impact on the return on assets in the following ways
described. The interest income of banks will fall and it is to be accounted only on receipt basis.

- Banks profitability is affected adversely because of the provision of doubtful debts
  and consequent write off as bad debts.
- Return on Investment (ROI) is reduced.
- The capital adequacy ratio is disturbed as NPAs are entering into the calculation.
- The cost of capital will go up.
- The assets and liability mismatch will widen.
- The economic value additions (EVA) by banks gets upset because EVA is equal to
  the net operating profit minus cost of capital and
- It limits recycling of the funds.

5.10 PROVISION ON TYPES OF ASSETS

Provision is allocating money every year to meet possible future loss.

*Table 5.2 Provision on Types of Assets*

<table>
<thead>
<tr>
<th>TYPES OF ASSETS</th>
<th>PROVISIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Standard Assets</td>
<td>0.25% for all type of Standard Advances</td>
</tr>
<tr>
<td>2. Sub-Standard Assets</td>
<td>10% for all type of Standard Advances</td>
</tr>
<tr>
<td>3. Doubtful Assets</td>
<td></td>
</tr>
<tr>
<td>Up to one Year</td>
<td>100% of unsecured advances and 20% of secured advances</td>
</tr>
<tr>
<td>One to three Years</td>
<td>100% of unsecured advances and 30% of secured advances</td>
</tr>
<tr>
<td>More than three Year</td>
<td>100% of unsecured advances and 100% of secured advances</td>
</tr>
<tr>
<td>4. Loss Assets</td>
<td>100% of unsecured advances and 100% of secured advances</td>
</tr>
</tbody>
</table>

5.11 MANAGEMENT OF NPAs

After nationalization, the initial mandate that banks were given was to expand their branch network, saving rate and extend credit to the rural and SSI sectors.

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This mandate has been achieved admirably. Since the early 90’s the focus has shifted towards improving quality of assets and better risk management. The Narasimham committee has recommended prudential norms on income recognition, asset classification and provisioning. In India, banking sector acts as backbone of economy system. Today, Banking Industry is undergoing a transitional phase. Foundation of Indian banking industry is laid by PSBs and they hold more than 78% of total assets of banking industry. But they are held back with the excessive Non Performing Assets (NPA), high employee cost and somehow lack in intellectual capital.

The level of NPA act as an indicator viewing the bankers credit risks and competence of allocation of resource. A robust credit process begins with an in-depth appraisal focused on risk inherent in proposal and credit ratings of clients and ends with effective value addition to the bank. Further each NPA has to be examined in totality and on the basis of various other factors. The banks waging of a war on the menace of NPAs and its coining of new term ‘New profit avenues’ for the dreaded NPAs has been an unprecedented motivational factors and has resulted in a phenomenal reduction n its NPA level\(^\text{30}\). The successful implementation of banks NPA management strategy has led to recovery of unchanged income, release of locked funds for profitable redeployment, freeing of provisions, improved asset quality and substantial hike in profits.

5.12 PREVENTION OF NON-PERFORMING ASSETS

The high share of NPA in the credit portfolio of a bank particularly the public sector banks, has become a matter of grave concern for the mandarins of the financial system. The reasons are obvious: NPA do not yield any return while they incur a cost, they eat into earnings made elsewhere by way of demand for provisions for these NPAs. In the ultimate analysis, mounting NPAs can pose a great threat to the very fabric of the system of the country, as witnesses in some of the South-east Asian countries and hence prevention of NPAs has assumed a significant role.

Deficiencies in surveillance and governance of credit portfolio, besides weak appraisals, have been identified as the prime contributory factors for the alarming situation. The process to arrest the growth of NPAs should, therefore, start with earnest

evaluation of risks in the proposal, effective monitoring of loan accounts and initiation of timely remedial measures at the branch level. The niceties of risk evaluation and credit monitoring that can help a bank in arresting and annihilating NPAs are issues that need detailed deliberation. Developing deep into the problem, one draws the inference that the weak evaluation of the risks involved in loaning operations is one of the major factors responsible for NPAs. The inability of a borrower to discharge a repayment liability has two distinct facets: one, risk from externalities that are beyond the control of the borrowing unit and second, internal to the unit. The uncertainty makes management of NPAs a challenging task and that is where the ingenuity of the management of a bank is called for. Hence, any lending decision should always be preceded by a detailed risk analysis and the outcome should act as a guide for the credit decision.

The objective of the risk management is not to prevent risk taking, but to ensure that the risks are consciously taken with full knowledge, and understanding so that they can be mitigated. The purpose of managing risk is to prevent an institution to fail of materially damage its competitive position. Functions of risk management should actually be bank-specific dictated by the size and quality of balance sheet, complexity of functions, technical or professional manpower and the status of MIS in place. As an international practice, a committee approach has been introduced in India too, to manage various risks. Risk Management Committee, Credit Policy Committee, Asset Liability Management Committee etc., are some such committees that handle the risk management aspects.

The effectiveness of risk measurement depends on efficient Management Information System, computerization and net working of the branch activities. An objective and reliable data base has to be built for which the bank has to analyze its past performance data relating to loan defaults, trading losses, operational losses etc., and come out with benchmarks to prepare itself for future risk management activities. The extent to which a bank can take rise more consciously, anticipate adverse situations and hedge accordingly, would give it the competitive edge to be used for pricing its products. As per the Reserve Bank of India guidelines issued in October 1999, banks have to mange three major types of risks encountered, viz., Credit Risk, Market Risk and Operational Risk.
5.12.1 CREDIT RISK

For banks and financial institutions, management of credit risk is critical. Credit risk is defined as the possibility that a borrower or counter party will fail to meet its obligations in accordance with agreed terms. These loans in a bank’s portfolio stem from outright default due to inability or unwillingness of a customer or counter party to meet commitments in relation to lending, trading, settlement, and other financial transactions. The effective management of credit risk is a critical component of comprehensive risk management and is essential for the long-term success of any banking organization. Credit risk management encompasses identification, measurement, monitoring and control of the credit risk exposures.

5.12.2 MARKET RISK

Market Risk may be defined as the possibility of loss to a bank in the terms of earnings and capital, caused by the changes in the market variables. It is the risk that movements in equity and interest rate markets, currency exchanges rates, and commodity prices will adversely affect the value of on or off balance sheet positions.

5.12.3 OPERATIONAL RISK

Operational risk is the risk of loss arising from various types of technical or human errors or failed internal process, legal hurdles, fraud and failure of people and systems or from external agencies. It can result into low productivity and have greater impact on performance as compared to market and credit risk. Most banks internationally, admit in having poor measures of operational risk. Banks measure credit and market risk because they can, not because these are the biggest risk they face. Operational risk is larger, more dangerous and no one knows exactly what to do about it.

5.13 NPAs AS A MAJOR ISSUE AND CHALLENGE FOR BANKING INDUSTRY IN INDIA

Non-performing Assets are threatening the stability and demolishing bank’s profitability through a loss of interest income, write-off of the principal loan amount itself. RBI issued guidelines in 1993 based on recommendations of the Narasimham Committee that mandated identification and reduction of NPAs to be treated as a national priority because NPA direct toward credit risk that bank faces and its efficiency in allocating
resources. Profitability and earnings of banks are affected due to NPA numbers. In recent years financial reform led by RBI has helped in reducing NPA numbers.

Causes of Problem and Mechanisms used to solve the problem:

- Legal impediments and time consuming nature of asset disposal process.
  - Strengthening of Legal Norms.
  - Manipulation by the debtors using political influence has been a cause for industrial bad debt being so high.
- Aligning of prudential norms with international standards.
- Political tool - Directed Credit to SSI and Rural sectors.
- Legal mechanisms including creation of ARCs and partial disbanding of the BIFR.

The banking sector has been facing the serious problems of the rising NPAs. In fact PSBs are facing more problems than the private sector banks and foreign banks. The NPAs in PSBs are growing in comparison to other banks due to external as well as internal factors. One of the main causes of NPAs in the banking sector is the Directed loans system under which commercial banks are required to supply 40% percentage of their credit to priority sectors. Most significant sources of NPAs are directed loans supplied to the - micro sector are problematic of recoveries especially when some of its units become sick or weak. PSBs 7 percent of net advances were directed to these units. Poverty elevation programs like Integrated Rural Development Program (IRDP), Jawahar Rojgar Yojna (JRY), Prime Minister Rozgar Yojna (PMRY) etc. have failed miserably in meeting the objectives. Due to Political interference, manipulation, misuse of fund by & and unreliable customer the amount issued these type of schemes has become unrecoverable by and large.

In India, even on security taken against loans, provision has to be created. Further, Indian Banks have to make a 100 per cent provision on the amount not covered by the realizable value of securities in case of "doubtful" advance, while in some countries it is 75 per cent or just 50 per cent. The ASSOCHAM Study titled -Solvency Analysis of the Indian Banking sector reveals that on an average 24 per cent rise in net non performing assets have been registered by 25 public sector and commercial banks during the second quarter of the 2009 as against 2008. According to the RBI, "Reduction of NPAs in the Indian banking sector should be treated as a national priority item to make
the system stronger, resilient and geared to meet the challenges of globalization. It is necessary that a public debate is started soon on the problem of NPAs and their resolution.

5.14 STRATEGIES FOR MANAGEMENT OF NPAS

Indian commercial banks are adopting the measures to reduce and control the NPAs in accordance with the recommendations of RBI. These strategies are necessary to control NPAs. (A) Preventive management and (B) Curative management

5.14.1 PREVENTIVE MANAGEMENT

Preventive measures are to prevent the asset from becoming a non-performing asset. Banks has to concentrate on the following to minimize the level of NPAs.

1) Early Warning Signals (EWS)

The origin of the flourishing NPAs lies in the quality of managing credit assessment, risk management by the banks concerned. Banks should have adequate preventive measures, fixing pre sanctioning appraisal responsibility and having an effective post-disbursement supervision. Banks should continuously monitor loans to identify accounts that have potential to become non-performing.

It is important in any early warning system, to be sensitive to signals of credit deterioration. A host of early warning signals are used by different banks for identification of potential NPAs. Most banks in India have laid down a series of operational, financial, transactional indicators that could serve to identify emerging problems in credit exposures at an early stage. Further, it is revealed that the indicators which may trigger early warning system depend not only on default in payment of installment and interest but also other factors such as deterioration in operating and financial performance of the borrower, weakening industry characteristics, regulatory changes, and general economic conditions. Early warning signals can be classified into five broad categories viz: (A) Financial, (B) Operational, (C) Banking, (D) Management and (E) External factors.

(a) Financial warning signals: Financial related warning signals generally emanate from the borrowers’ balance sheet, income expenditure statement, statement of cash flows,
Following common warning signals are captured by some of the banks having relatively developed EWS: Persistent irregularity in the account, Default in repayment obligation, Devolvement of LC/invocation of guarantees, Deterioration in liquidity/working capital position, Substantial increase in long term debts in relation to equity and declining sales.

(b) **Operational signals:** Following operational signals are captured by some of the banks: Operating losses/net losses, Rising sales and falling profits, Disproportionate increase in overheads relative to sales, rising level of bad debt losses Operational warning signals, Low activity level in plant, Disorderly diversification/frequent changes in plan, Non-payment of wages/power bills, Loss of critical customer/s, Frequent labor problems, Evidence of aged inventory/large level of inventory.

(c) **Banking related signals:** Following are the banking related signals: Declining bank balances/declining operations in the account, Opening of account with other bank, Return of outward bills/dishonored cheques, Sales transactions not routed through the account, frequent requests for loan, frequent delays in submitting stock statements, financial data, etc.

(d) **Management related warning signals:** These following signals are related with management: Lack of co-operation from key personnel, Change in management, ownership or key personnel, Desire to take undue risks, Family disputes, Poor financial controls, Fudging of financial statements, Diversion of funds, etc.

(e) **Signals relating to external factors:** Signals like Economic recession, Emergence of new competition, Emergence of new technology, Changes in government / regulatory policies, Natural calamities are related to external factors

2) **Know your client (KYC)**

Most banks in India have a system of preparing `know your client’ (KYC) profile/credit report. As a part of KYC system, visits are made on clients and their places of business/units. The frequency of such visits depends on the nature and needs of relationship.
3) **Credit Assessment and Risk Management Mechanism**

Credit assessment and Risk management mechanism are ever lasting solution to the problem of NPAs. Managing credit risk is a much more forward-looking approach and is mainly concerned with managing the quality of credit portfolio before default takes place. The documentation of credit policy and credit audit immediately after the sanction is necessary to upgrade the quality of credit appraisal in banks. In a situation of liquidity overhang the enthusiasm of the banking system is to increase lending with compromise on asset quality, raising concern about adverse selection and potential danger of addition to the NPAs stock. It is necessary that the banking system is equipped with prudential norms to minimize if not completely avoid the problem of credit risk and develop an effective internal credit risk models for the purpose of credit risk management.

4) **Organizational restructuring**

With regard to internal factors leading to NPAs the onus for containing the same rest with the bank themselves. These will necessities organizational restructuring improvement in the managerial efficiency, skill up gradation for proper assessment of credit worthiness and a change in the attitude of the banks towards legal action, which is traditionally viewed as a measure of the last resort.

5) **Reduce Dependence on Interest**

The Indian banks are largely depending upon lending and investments. The banks in the developed countries do not depend upon this income whereas 86 percent of income of Indian banks is accounted from interest and the rest of the income is fee based. The banker can earn sufficient net margin by investing in safer securities though not at high rate of interest. It facilitates for limiting of high level of NPAs gradually. It is possible that average yield on loans and advances net default provisions and services costs do not exceed the average yield on safety securities because of the absence of risk and service cost.

6) **Watch-list/Special Mention Category**

The grading of the bank’s risk assets is an important internal control tool. It serves the need of the Management to identify and monitor potential risks of a loan asset. The purpose of identification of potential NPAs is to ensure that appropriate preventive / corrective steps could be initiated by the bank to protect against the loan asset becoming
non-performing. Most of the banks have a system to put certain borrowable accounts under watch list or special mention category if performing advances operating under adverse business or economic conditions are exhibiting certain distress signals. These accounts generally exhibit weaknesses which are correctable but warrant banks’ closer attention. The categorization of such accounts in watch list or special mention category provides early warning signals enabling Relationship Manager or Credit Officer to anticipate credit deterioration and take necessary preventive steps to avoid their slippage into non performing advances.

7) Willful Defaulters

RBI has issued revised guidelines in respect of detection of willful default and diversion and siphoning of funds. As per these guidelines a willful default occurs when a borrower defaults in meeting its obligations to the lender when it has capacity to honor the obligations or when funds have been utilized for purposes other than those for which finance was granted. The list of willful defaulters is required to be submitted to Securities Exchange Board of India (SEBI) and RBI to prevent their access to capital markets. Sharing of information of this nature helps banks in their due diligence exercise and helps in avoiding financing unscrupulous elements. RBI has advised lenders to initiate legal measures including criminal actions, wherever required, and undertake a proactive approach in change in management, where appropriate.

5.14.2 CURATIVE MANAGEMENT

The curative measures are designed to maximize recoveries so that banks funds locked up in NPAs are released for recycling. The Central government and RBI have taken steps for controlling incidence of fresh NPAs and creating legal and regulatory environment to facilitate the recovery of existing NPAs of banks. They are:

1) One Time Settlement Schemes/Compromise Settlement Schemes

This scheme covers all sectors sub-standard assets, doubtful or loss assets as on 31st March 2000. All cases on which the banks have initiated action under the SRFAESI Act and also cases pending before Courts/DRTs/BIFR, subject to consent decree being obtained from the Courts/DRTs/BIFR are covered. However cases of willful default, fraud and malfeasance are not covered. As per the OTS scheme, for NPAs up to
Rs. 10crores, the minimum amount that should be recovered should be 100% of the outstanding balance in the account.

2) **Lok Adalats or People’s Courts**

Lok Adalats are voluntary agencies created by the State Government to assist in matters of loan compromise. Lok Adalat institutions help banks to settle disputes involving account in “doubtful” and “loss” category, with outstanding balance of Rs.5 lakh for compromise settlement under Lok Adalat. Debt recovery tribunals have been empowered to organize Lok Adalat to decide on cases of NPAs of Rs. 10 lakh and above. This mechanism has proved to be quite effective for speedy justice and recovery of small loans. The progress through this channel is expected to pick up in the coming years.

3) **Debt Recovery Tribunals (DRTs)**

The Debt Recovery Tribunals have been established by the Government of India under an Act of Parliament (Act 51 of 1993) for expeditious adjudication and recovery of debts due to banks and financial institutions. The Debt Recovery Tribunal is also the appellate authority for appeals filed against the proceedings initiated by secured creditors under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act.

The recovery of debts due to banks and financial institution passed in March 2000 has helped in strengthening the function of DRTs. Provision for placement of more than one recovery officer, power to attach defendant’s property/assets before judgment, penal provision for disobedience of tribunal’s order or for breach of any terms of order and appointment of receiver with power of realization, management, protection and preservation of property are expected to provide necessary teeth to the DRTs and speed up the recovery of NPAs in the times to come.

DRTs which have been set up by the Government to facilitate speedy recovery by banks/DFIs, have not been able make much impact on loan recovery due to variety of reasons like inadequate number, lack of infrastructure, under staffing and frequent adjournment of cases. It is essential that DRT mechanism is strengthened and vested with a proper enforcement mechanism to enforce their orders. Non observation of any order passed by the tribunal should amount to contempt of court, the DRT should have right to initiate contempt proceedings. The DRT should empower to sell asset of the
debtor companies and forward the proceeds to the winding up court for distribution among the lenders.


The Government has passed the SARFAESI Act on 21 June 2002 in order to give teeth to the banks to proceed against the “willful defaulter”, and affect recoveries without the intervention of courts and tribunals. Securitization is a relatively new concept that is taking roots in India of late. It is still in its infancy with only a few market players. Securitization is considered an effective tool for improvement of capital adequacy. It is also seen as a tool for transferring the reinvestment risk, apart from credit risk helping the banks to maintain proper match between assets and liabilities. Securitization can also help in reducing the risk arising out of credit exposure norms and the imbalances of credit exposure, which can help in the maintenance of healthy assets. The SARFAESI Act intends to promote Securitization, pool together NPAs of banks to realize them and make enforcement of Security Interest Transfer.

The SARFAESI Act–2002 is seen as a booster, initially, for banks in tackling the menace of NPAs without having to approach the courts. With certain loopholes still remaining in the act, the experiences of banks were that the Act in its present form would not serve the envisaged objective of optimum recovery of NPAs, particularly with the hard-core NPA borrowers dragging the banks into endless litigation to delay the recovery process. The Supreme Court decision in regard to certain proviso of the SARFAESI Act also indicated this view.

5.15 CORPORATE DEBT RESTRUCTURING (CDR)

Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring of the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporate that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring
programme. CDR system in the country will have a three-tier structure: (a) CDR Standing Forum, (b) CDR Empowered Group, (c) CDR Cell.

5.15.1 CDR STANDING FORUM

The CDR Standing Forum would be the representative general body of all financial institutions and banks participating in CDR system. All financial institutions and banks should participate in the system in their own interest. CDR Standing Forum will be a self-empowered body, which will lay down policies and guidelines, guide and monitor the progress of corporate debt restructuring.

5.15.2 CDR EMPOWERED GROUP

The CDR Empowered Group would be mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified time frame of 90 days, or at best 180 days of reference to the Empowered Group.

5.15.3 CDR CELL

The CDR Standing Forum and the CDR Empowered Group will be assisted by a CDR Cell in all their functions. The CDR Cell will make the initial scrutiny of the proposals received from borrowers / lenders, by calling for proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group, within one month to decide whether rehabilitation is prima facie feasible, if so, the CDR Cell will proceed to prepare detailed Rehabilitation Plan with the help of lenders and if necessary, experts to be engaged from outside. If not found prima facie feasible, the lenders may start action for recovery of their dues.

5.16 CIRCULATION OF INFORMATION OF DEFAULTERS

The RBI has put in place a system for periodical circulation of details of willful defaulters of banks and financial institutions. The RBI also publishes a list of borrowers (with outstanding aggregate rupees one crore and above) against whom banks and financial institutions in recovery of funds have filed suits as on 31st March every year. It will serve as a caution list while considering a request for new or additional credit limits from defaulting borrowing units and also from the directors, proprietors and partners of these entities.
5.17 ASSET RECONSTRUCTION COMPANY (ARC)

Asset Reconstruction Companies world-wide can be classified into: (i) Government owned/supported ARC; (ii) Bank owned ARC workout units and bad bank models; (iii) Private Sector ARCs. India follows the Private sector ARC structure, where ARC may be set up by lenders, specialized investors in non-performing loans (NPLs) or corporations31. This empowerment encouraged the three major players in Indian banking system, namely, State Bank of India (SBI), ICICI Bank Limited (ICICI) and IDBI Bank Limited (IDBI) to come together to set-up the first ARC.

Asset Reconstruction Company India Limited (ARCIL) was incorporated as a public limited company on February 11, 2002 and obtained its certificate of commencement of business on May 7, 2003. In pursuance of Section 3 of the Securitization Act 2002, it holds a certificate of registration dated August 29, 2003, issued by the Reserve Bank of India (RBI) and operates under powers conferred under the Securitization Act, 2002. ARCIL is also a "financial institution" within the meaning of Section 2 (h) (ia) of the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (the "DRT Act"). ARCIL is the first ARC in the country to commence business of resolution of non-performing assets (NPAs) upon acquisition from Indian banks and financial institutions. As the first ARC, ARCIL has played a pioneering role in setting standards for the industry in India.

5.17.1 Unlocking capital for the banking system and the economy

The primary objective of ARCIL is to expedite recovery of the amounts locked in NPAs of lenders and thereby recycling capital. ARCIL thus, provides relief to the banking system by managing NPAs and help them concentrate on core banking activities thereby enhancing shareholders value.

5.17.2 Creating a vibrant market for distressed debt assets / securities in India
Offering a trading Platform for Lenders

ARCIL has made successful efforts in funneling investment from both from domestic and international players for funding these acquisitions of distressed assets, followed by showcasing them to prospective buyers. This has initiated creation of a

secondary market of distressed assets in the country besides hastening their resolution. The efforts of ARCIL would lead the country’s distressed debt market to international standards.

5.17.3 To evolve and create significant capacity in the system for quicker resolution of NPAs by deploying the assets optimally

With a view to achieving high delivery capabilities for resolution, ARCIL has put in place a structure aimed at outsourcing the various sub-functions of resolution to specialized agencies, wherever applicable under the provision of the Securitization Act, 2002. ARCIL has also encourage, groomed and developed many such agencies to enhance its capacity in line with the growth of its activity.

5.18 RECOVERY ACTION AGAINST LARGE NPAs

Among the various channels of recovery available to banks for dealing with bad loans, the SARFAESI Act and the Debt Recovery Tribunals (DRTs) have been the most effective in terms of amount recovered. The amount recovered as percentage of amount involved was the highest under the DRTs, followed by SARFAESI Act. The RBI has directed the PSBs to examine all cases of willful default of Rs. One crore and above and file criminal cases against willful defaulters. The board of directors are requested to review NPAs accounts of one crore and above with special reference to fix staff accountability in individually.

5.18.1 SALE AND PURCHASE OF NPAs

For providing an additional option and developing a healthy secondary market for NPAs, guidelines on sale/purchase of NPAs were issued in July 2005. The sale/purchase of NPA covers the procedure for purchase/sale of non-performing financial assets (NPFA) by banks, including valuation and pricing aspects; and prudential norms relating to asset classification, provisioning, accounting of recoveries, capital adequacy and exposure norms and disclosure requirements.

5.19 CREDIT INFORMATION BUREAU OF INDIA LTD. (CIBIL)

The institutionalization of information sharing arrangement is now possible through the newly formed Credit Information Bureau of India Limited (CIBIL). It was set up in January 2001, by SBI, HDFC and two foreign technology partners. This will
prevent those who take advantage of lack of system of information sharing amongst leading institutions to borrow large amount against same assets and property, which has in no measures contributed to the incremental of NPAs of banks. An efficient credit information system enhances the quality of credit decisions and improves the asset quality of banks apart from facilitating faster credit delivery. Banks/financial institutions have been advised RBI to obtain the consent of all their borrowers for dissemination of credit information to enable CIBIL to compile and disseminate credit information. Banks have been urged by RBI to make persistent efforts in obtaining consent from all of their borrowers, in order to establish an efficient credit information system, which would help in enhancing the quality of banks, apart from facilitating faster credit delivery\textsuperscript{32}.

In its annual report (2010) RBI noted that “management of NPA by banks remains an area of concern, particularly, due to the likelihood of deterioration of the quality of restructured advances”. The NPA of banks is an important criterion to assess the financial health of banking sector. It reflects the asset quality, credit risk and efficiency in the allocation of resources to the productive sectors.

Ahmed, J.U. (2010)\textsuperscript{33} noted that since the reform regime there has been various initiatives to contain growth of NPA to improve the asset quality of the banking sector. Commercial banks have envisaged the greatest renovation in their operation with the introduction of new concepts like income recognition, prudential accounting norms and capital adequacy ratio etc which have placed them in new platform. The growing competition from internal and external constituents and sluggish growth in economy coupled with poor credit-deposit ratio, the large volume of NPAs in the balance sheet and lack of automation and professionalization in the operation have been affecting the banking situation in the country. As regards the security system, the access to the data centre is strictly on a “\textbf{Need - to – know}” principle within CIBIL and the data transmission was on encrypted and secured channels.

\textsuperscript{32} Firdos Temurasp Shroff, “Modern Banking Technology”, Northern Book Centre, New Delhi, 2007, p.44
Murinde V and Yaseen H\textsuperscript{34} on management of NPA made it clear that the traditional approaches to bank regulation are not conducive for management of NPA. These approaches emphasized the view that the existence of capital adequacy regulation plays a crucial role in the long-term financing and solvency position of banks, especially in helping the banks to avoid bankruptcies and their negative externalities on the financial system. In general, capital or net worth serves as a buffer against losses and hence failure. Rather than accommodating measures to combat the NPA issues, the traditional measures tried to protect the interests of deposits through maintaining adequate capital in liquid form. This has impacted the availability of funds for productive purpose, since banks were not able to lend it, rather forced to keep as reserves.

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks. Borbora R.R. (2007)\textsuperscript{35} emphasized that the essential components of sound NPA management are (i) quick identification of NPAs, (ii) their containment at a minimum level and (iii) ensuring minimum impact of NPAs on the financials. Panta R. (2007)\textsuperscript{36} noted that all kinds of lending involves three stages where discretion needs to be exercised (a) Evaluation and assessment of the proposal (b) Timely monitoring and evaluation and (c) Proper assessment of exit decision and modality.

Containing NPAs has been in focus ever since the banking sector reforms were initiated in 1992 and RBI issued guidelines on income recognition, asset classification and provisioning norms. All banks have been making efforts to contain the NPA level and reduce the drag on their profitability. Now they are fully vigilant about the quality of their loan assets. Though it is always wise to follow-up of advances to

\textsuperscript{34} Murinde V. and Yaseen H., “The Impact of Basle Accord Regulations on Bank Capital and Risk Behavior: 3D Evidence from the Middle East and North Africa (MENA) Region”, 3\textsuperscript{rd} International Conference of the Centre for Regulation and Competition (CRC) on “Pro-Poor Regulation & Competition: Issues, Policies and Practices”, 2004

\textsuperscript{35} Borbora R.R., “Management of Non – Performing Assets (NPAs) in the Urban Cooperative Banks (UCBs)”, Reserve Bank of India, 2007

avoid NPAs but risk attached to lending cannot be completely eliminated. Aiming for a zero level NPAs in the banks would be unrealistic and would be like looking for ideal situations. So, if certain advances are converted into NPAs, it is necessary to efficiently manage them and appropriate and timely corrective steps must be taken. Reduction in NPAs is necessary to improve profitability of the banks. By the adoption of these measures banks can reduce their NPAs.

5.20 ESTABLISHMENT OF CREDIT COUNSELLING CENTRES AND FINANCIAL LITERACY DRIVE

Credit counseling serve three purposes: first, it explores various means to solve existing financial problems; second, it improves the quality of financial management by throwing light on the cost of misusing credit; third, it encourages the financially distressed section of people to assess the formal financial system. Few banks have already taken the initiative of opening Credit Counseling Centers in major towns, viz., Disha Trust (an initiative of ICICI Bank Ltd.), Abay Counseling Centre (an initiative of Bank of India) and Grameen Paramarsh Kendras (an initiative of Bank of Baroda). The centers assist the consumers facing credit problems arising from multiple credit cards, personal loans, housing loans and loans from societies. Most of these centers provide services that are curative in nature i.e., a service provided after a crisis has occurred. However, the two largest banks in the country, State Bank of India (SBI) and ICICI Bank, have launched financial literacy campaigns through leading newspapers. ICICI Bank’s campaign under the “Customer First” series can be viewed at the bank’s website. This kind of campaigns offers a basic understanding of all financial products and reduces the complexities and jargon associated with them. In turn it will lead to fewer occurrences of NPAs.
