CHAPTER – III
PRUDENTIAL NORMS, CONCEPTS, SIGNIFICANCE AND CAUSES OF NON-PERFORMING ASSETS IN INDIAN BANKING INDUSTRY

Banking as an institution, dealing with lending and collection of money, in its most primitive form, is as old as authentic history. It followed the basic law of demand and supply where persons having excess money lent to persons who needed it for more productive purposes and were willing to pay a price for this. The operations were limited to the money lender knowing every person he lent money to. The lending was mostly security oriented and bad loans at present called non-performing assets or NPAs were unheard of. However, over a period of time the operations began to grow as the number of clients increased, resulting in the need for proper regulation and organization. Gradually, simple banking transformed itself into commercial banking, as at present known, according to requirements of the times. Commercial banking, itself, has undergone numerous changes all over the world, during the last five decades. In the case of India too, the changes during this period, have redefined the very complexion of commercial banking. As a matter of fact, the changes that have taken place in India have been far more significant and much more radical in some regards, than elsewhere in the world.

The problem of NPA’s is linked

To the function of lending money. The lending of money, collected from the public, for interest, instead of one’s own money, was the beginning of banking.

Though the present day banking does not restrict itself to traditional deposit collection and money lending, encompassing a wide sphere of financial activity, lending still remains the prime activity connected with banking. Most credit needs of the society, for carrying, commercial activities are fulfilled by the banks. The conventional credit from the banking system to the commercial sector comprises bank loans and advances in the form of term loans, demand loans, cash credit, overdrafts, inland and foreign bills purchased and discounted as well as investments in instruments issued by non-government sector. However, with deregulation, there
has been a shift in the bank asset portfolio mix, with a sharp increase in the share of investment in money market instruments such as commercial paper as well as capital market instruments such as shares and debentures issued by the commercial sector. The distribution of credit portfolio of the scheduled commercial banks (SCBs) covers mostly the working capital needs of various occupational sectors like agriculture, industry, transport, personal loans, and professional services, trade, etc. While that of the development financial institutions (DFIs) cover almost the entire gamut of basic industrial/infrastructure activities important to the society.

In the background of this enviable record of banks and DFIs as credit providers for commercial and industrial requirements of society, there is a growing doubt about their capacity to continue to meet these requirements in future too, due to non-recovery of loans advanced by them. This is evident from the staggering level of NPAs prevailing among the banks and DFIs. The problem assumes greater significance considering at the money lent by the banks is out of the deposits made by the public. The constant failure to recover the debts affects not only the recycling of funds but also the profitability of the banks. The unchecked growth of non-recovered debts has exposed the banks to both, credit and profit risks, and also pushed up their capital adequacy requirements.

Indian banking, whose environment, till early 90’s was insulated from the global context and dominated by state controls of directed credit delivery, regulated interest rates and investment structure, did not participate in the vibrant global banking revolution. Continued political interference and the absence of competition led to consequences that were opposite to what was happening in the west. Imperfect accounting standards and opaque balance sheets served as tools for hiding the shortcomings and failed to reveal the gradual deterioration and structural weakness of the country’s financial institutions to the public. This enabled the financial institutions to continue to flourish in a deceptive manifestation and false glitter, though stray symptoms of the brewing ailments were discernible.

The turning point came when the country was confronted with unprecedented economic crises, including balance of payment crises, in 1990, with India’s sovereign rating down graded. A whole package of reforms was announced to put the economy
back on rails, and Indian banking, too, suddenly woke up to the realities of the situation and geared up to face the problems. The Government hastily introduced the first phase of reforms in the financial and banking sectors in 1991. This was an effort to quickly restructure the health of the banking system and bridge the gap between Indian and global banking developments. During this decade, the reforms have covered almost every segment of the financial sector with banking, in particular, receiving major attention. Increase in the number of banks due to the entry of new private and foreign banks, increase in the transparency of balance sheets of the banks through the introduction of prudential norms and norms of disclosure, increase in the role of the market forces due to the deregulated interest rates, together with the rapid computerization and application of the benefits of information technology to banking operations, have all significantly influenced the operational environment of the Indian banking sector.

As banking in the country was deregulated and international standards came to be accepted and applied, banks had to unlearn their traditional operating methods of directed credit and investments and fixed interest rates, all of which had led to deterioration in the quality of loan portfolios, inadequacy of capital and the erosion of profitability. Banks had an entirely different environment, of a highly competitive market, under which to operate, innovate and thrive and their success depended on their ability to adapt to market changes, which called for new strategies, different from those related to regulated banking in a captive environment.

In the background of these complex changes, when the problem of NPA was belatedly recognized, for the first time at its peak velocity, during 1992-93, there was chaos and confusion. Banks were unable to analyse and make a realistic or complete assessment of the surmounting situation. It was not realized that the root of the problem of NPAs was centered elsewhere in multiple layers, as much outside the banking system, more particularly in the transient economy of the country, as within. Banking is not a compartmentalized and isolated sector de-linked from the rest of the economy. As has happened elsewhere in the world, a distressed national economy shifts a part of its negative results to the banking industry. In short, banks are ultimately made to finance the losses incurred by constituent industries and businesses. The lack of preparedness and structural weakness of our banking system
led to the emerging scenario and trying to switch over to globalization were only aggravating the crisis. The major reason for this situation was that the threat of NPAs was being surveyed and summarized by Reserve Bank of India (RBI) and Government of India with a bird’s eye-view of the banking industry, independent from the rest of the economy.

RBI looks at the banking industry’s average on a macro-basis, consolidating and tabulating the data submitted by different financial sectors like commercial banks, development financial institutions, regional rural banks (RRBs), urban cooperative banks (UCBs), non-banking financial companies (NBFC), etc., which at best is a distant view of one outside the system and not the felt view of a suffering participant. Individual banks inherit different cultures and they finance diverse sectors of the economy having non-identical attributes. There are diversities among banks based on ownership, as among the 27 public sector banks themselves, between different geographical regions and between different customers using bank credit. Similarly, NPAs’ concerns of individual banks summarized as a whole and expressed as a mathematical average for the entire bank cannot convey a dependable picture. The scenario is not so simple to be generalized for the industry as a whole, to prescribe a ready made package of a common solution for all banks and for all times.

Commercial Banks

In India, the magnitude of the problem of bad debts was first realized only in early 1990s. Subsequently, following the recommendations of Narasimham Committee (1991, 1998) and Verma Committee (1999), some steps have been taken to solve the problem of NPAs. Though concern regarding the reduction of NPAs in the balance sheets of the banks, particularly PSBs, continues to be expressed from every corner, there has hardly been any systematic evaluation of the best way of tackling the problem. There seems to be no unanimity in the proper policies to be followed in resolving this problem. There is also no consistency in the application of NPA norms, ever since these have been recognized.

Currently, NPA is defined

- As an advance where interest and / or installment of principal remains Over due for a period of more than 90 days in respect of a term loan;
The account remains “out of order” for a period of more than 90 days, in respect of an overdraft/cash credit;

The bill remains 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 short-term and one harvest season for long-term crop loans in the case of an advance granted for agricultural purpose (from 05-04-2004); and

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

**Causes of NPAs**

The various Committees have found the following causative factors for loan accounts turning NPAs. The over – regulated environment, both in the real as well as financial sector was one of the chief reasons, however, there are other important causes also as well:

- Diversion of funds, mostly for expansion/ diversification/ modernization/ new projects of business or for promoting associate concerns. This was coupled with the recessionary trends and failure to tap funds from the capital market and debt market.

- Factors internal to business like product/ marketing failure, inefficient management, inappropriate technology, labour unrest, product obsolescence, etc.

- Change in the macro-environment like recession, infrastructure bottlenecks, natural calamities, etc.

- Time/ cost overruns during project implementation stage.

- Government policies like changes in excise duties, pollution control, etc.

- Wilful default, fraud, and misappropriation, promoters/ directors disputes.

- Deficiencies on the part of banks like delay in release of sanctioned limits, under finance or over finance, delay in release of payments / subsidies by government.
NPA Concept and Prudential Norms

The banks, in their books, have different kinds of assets, such as cash in hand, balances with other banks, investment, loans and advances, fixed assets and other assets. The non-performing asset or NPA concept is restricted to loans, advances, and investments. As long as an asset generates the income expected from it and does not disclose any unusual risk other than normal risk, it is treated as a “Performing Asset”, and when it fails to generate the expected income, it becomes a “Non-Performing Asset” (NPA) when it ceases to generate income, i.e. interest, fees, commission, or any other due for the bank for more than 90 days.

In line with the international practices and as per the recommendations of Narasimham Committee, the Reserve Bank of India (RBI) for the first time issued certain guidelines for treating a credit facility as a non-performing asset to be followed from the accounting year 1992-93. These guidelines though, greatly welcome, could not fully address the problem of non-performance. RBI has subsequently been issuing number of circulars from time to time containing instructions/guidelines to banks on matters relating to prudential norms of income recognition, asset classification, and provisioning so as to move towards greater consistency and transparency in the published accounts. With the introduction of prudential norms, the health code – based system for classification of advances and all related reporting requirements has ceased to be the subject of supervisory interest.

The attempt of RBI is to frame a policy for income recognition that is objective and based on record of recovery rather than on any subjective consideration. Likewise, the classification of the assets of banks has to be done on the basis of objective criterion, which would ensure a uniform and consistent application of the norms. In addition, the provisioning has to be made on the basis of classification of the assets, which should further be based on the period for which the asset has remained non-performing, and the availability of the security and the realizable value thereof. An attempt has been made to consolidate the various circulars issued by RBI as of 17th July 2004 on the above subject matter. As per regulatory measures of 2007 Net NPAs ratio should be less than 10 percent.
Non – Performing Assets

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), bills account (bills purchased and discounted), etc.

TERM LOANS

A term loan account is to be treated as NPA as on balance sheet date if interest or loan installment remains overdue for a period of:

- Four quarters during the year ending 31st March 1993 (or)
- Three quarters during the year ending 31st March 1994 (or)
- More than 180 days during the year ending 31st March 1995-2003 and
- More than 90 days during the year ending 31st 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 basis of installment fixation also varies depending on the nature of estimated cash generation in the business. The periodicity of installment repayment may be monthly, quarterly, half yearly, or yearly, beyond the moratorium period, were provided. The quantum of installment may be equated, where the interest component is included into the installment itself, or it may be principal installment plus interest component.

Cash Credit or Overdraft Accounts

A running account such as cash credit or overdraft account is to be treated as NPA if the account remains out of order for a period of four quarters during the year ending 31st March, 1993, three quarters during the year ending 31st March, 1994, two quarters during the year ending 31st March 1995-2003 and one quarter with a view to move towards international best practices and to ensure greater transparency from the year ending 31st March 2004.
Out of Order

An account should be treated as “out of order”:

- If the outstanding balance remains continuously in excess of the sanctioned limit or drawing power (temporary deficiencies are not to be considered);
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credit continuously for the stipulated period; or
- Credits are not enough to cover the interest debited during the same period.

Bill Purchased / Discounted Accounts

The bills purchased / discounted account is to be treated as NPA if the bill remains overdue and unpaid for a period of 4 quarters during the year ending 31st March, 1993, three quarters during the year ending 31st March 1994, two quarters between the years ending 31st March, 1995 to 31st March, 2003 and one quarter during the year ending 31st March, 2004 onward. Due dates of the bills purchased/discounted should be ascertained as per accepted norms.

Overdue

Any amount due to the bank under any credit facility is ‘overdue’ if it is not paid on the due date fixed by the bank.

Other Credit Facilities

Any other credit facilities should be treated as NPA if any amount to be received in respect of that facility remains overdue date for a period of four quarters during the year ending 31st March, 1993, three quarters during the year ending 31st March, 1994, two quarters from 31st March, 1995, to 31st March, 2003 and one quarter from 31st March, 2004 onwards, in line with international best practices and to ensure greater transparency. The following action plan was interacted by banks, over a period of time, for an appropriate transition path to the 90-day norm:

- Banks moved over to charging of interest at monthly rates, from April 2002.
- However, banks continued to classify an account as NPA only if the interest charged during any quarter was not serviced fully within 180 days from the end of the quarter with effect from April 1, 1995.
Banks commenced making additional provisions for such loans, starting from the year ending March 31, 2002, which strengthened the balance sheet and ensured smooth transition to the 90 days norms by March 31, 2004.

Banks gradually enhanced provisioning requirements and voluntarily adopted practices of marking provisions much above the minimum prudential levels.

Since banks were making additional provision starting from March, 31, 2002 to absorb the impact due to reduction of the NPA period special emphasis was given to identify the accounts that may turn NPA with 90 days period norm and 10 percent additional provision was made over a period of three years starting from the year 2001 – 02.

GROSS NPA AND NET NPA

As per RBI circular, gross advance means, all outstanding loans and advances including advances for which refinance has been received but excluding re-discounted bills and advances written off at head office level (technical write off). RBI has advised that while reporting, banks have to reduce technical write off made at head office from gross advances too. The following are deducted from gross NPA to arrive at net NPA:

- Balance in interest suspense account, if applicable.
- DICGC/ECGC received and held pending adjustment.
- Part payment received and kept in suspense account.
- Total provisions made excluding technical write off made at head office.

The percentage of gross NPA to gross advances includes interest suspense account where the bank is following the accounting practice of debiting interest to the customer’s account and crediting interest to the suspense account. Net NPA should be below 10 percent from July 2007(RBI Bulletin, July 2007, Regulatory and other measures).
NORMS FOR TREATING DIFFERENT ADVANCES AS NON-PERFORMING

The following revised norms are adopted for treating different advances as non-performing with effect from the year ended 31st March, 2004. An account will be treated as NPA if:

Summarised RBI Guidelines For NPAs Recognition:

<table>
<thead>
<tr>
<th>Loans and Advances</th>
<th>Guidelines applicable from 31-3-2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan interest and/or instalment remains over due for more than</td>
<td>90 days</td>
</tr>
<tr>
<td>Overdraft/Cash Credit a/c remains out of order</td>
<td></td>
</tr>
<tr>
<td>Bills purchased and discounted remains over due for more than</td>
<td>90 days</td>
</tr>
<tr>
<td>Agricultural loan interest and/or instalment remains over due for</td>
<td>Two harvest seasons but not exceeding two and half years</td>
</tr>
<tr>
<td>Other accounts-any amount to be received remains over due for more than</td>
<td>90 days</td>
</tr>
</tbody>
</table>

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
3. Provisioning
1. **INCOME RECOGNITION**

For the purpose of income recognition, banks are required to classify their loan account into two categories:

- a) Performing asset (PA)
- b) Non-performing asset (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.

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 is 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 is 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, should be reversed along with current period unrealized interest. (Unrealized interest means excess of total debit in the account during the year by way of interest minus total credit genuine normal in the account). 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 a 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 reschedulment, as in a fresh account.

2. **ASSET CLASSIFICATION**

Loan assets of the banks are broadly classified as performing and non-performing while non-performing asset (NPA) is further classified into substandard, doubtful and loss assets.

The classification of assets into the above categories should be done taking into account the following:

**CHART NO: 2**

CLASSIFICATION OF ASSETS

- **Loan Assets**
  - Performing Assets (PA)
    - Standard Assets
    - Substandard
  - Non-Performing Assets (NPA)
    - Doubtful
    - Loss
(1) Status of the account – PA/ NPA.
(2) Degree of well defined credit weakness/ risks.
(3) Age of NPA for classification into substandard and doubtful category.

**Standard Asset**
- Standard asset is a credit facility, which is not classified as NPA and which does not disclose any problem and also does not carry more than the normal credit risk attached to a business.
- Central Government guarantee advances, if overdue, are classified as standard asset (unless Government repudiates its guarantee, when invoked) though interest on such advance is not to be taken to the income account if it is not realized. However, where such a guarantee, whether Central Government or State Government, is repudiated, when invoked, banks treat such advances as NPAs (doubtful or loss asset in case security is inadequate or not available, as the case may be) for all purposes, i.e. income recognition, asset classification, and provisioning norms (valid till 31st December, 2004).
- In case of advances guaranteed by a State Government where the guarantee has been invoked by the bank and the default of more than 90 days persist in the account, such account is to be classified as NPA in the normal course and necessary provision is to be made but if the guarantee has not been invoked, although overdue should not be treated as NPA.
- For the year ending 31-03-2005 State Government guaranteed advances, should be classified as sub-standard or doubtful or loss, after principal/any other amount due to the bank remains overdue for more than 180 days. With effect from the year ending 31-03-006 such accounts will be NPA if interest/principal/other dues remain overdue for more than 90 days. With respect to the income recognition norms no change is given.

**Sub-Standard Asset**
- Substandard asset is a credit facility, which has been classified as NPA for 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.

- However, an NPA account, where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors, such as, frauds committed by the borrower, should be straight away classified as doubtful or loss asset.

- An asset where the terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production, should be classified as substandard and should remain in such category for at least two years of satisfactory performance under the renegotiated or rescheduled terms. However, the period of two years has been reduced to one year with effect from the year ended March 31, 1999.

**Doubtful Asset**

- In the mid-term review of monetary and credit policy for 1998-99, RBI has decided that an asset should be classified as doubtful, if it has been remained in the substandard category for 18 months instead of 24 months, by March 31, 2001.

- A loan classified as doubtful has all the weakness inherent in a substandard account within the added characteristic that the weakness make collection or liquidation in full highly questionable on the basis of currently known facts, conditions, and value.

- A term loan which deserves to be classified as doubtful asset can not be upgraded to a standard asset by just reschedulement of principal and interest and thereby notionally wiping out the overdues. After reschedulement, the account will continue to be classified as doubtful asset for at least one year.

- For the purpose of provisioning, a doubtful asset is again classified into the following three sub-categories:
Loss Asset

- A loss asset is a credit facility where the bank’s internal or external auditors or the RBI inspectors have identified as loss but the amount hasn’t been written off, wholly or partly. In other words, such an asset is considered un-collectible and of such title value that it’s continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

- Accounts, where guarantee from DICGC/ECGC is available, they shouldn’t be classified as loss asset, unless the claims are not enforceable.

A term loan is sanctioned on 09.09.1998 with monthly installments and without any moratorium period. If in the account, there is no recovery at all and the value of realizable security is sufficient, this asset will be classified as follows:

<table>
<thead>
<tr>
<th>Balance Sheet Date</th>
<th>Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-03-1999</td>
<td>Standard</td>
</tr>
<tr>
<td>31-03-2000</td>
<td>SubStandard</td>
</tr>
<tr>
<td>31-03-2001</td>
<td>SubStandard</td>
</tr>
<tr>
<td>31-03-2002</td>
<td>Doubtful-1</td>
</tr>
<tr>
<td>31-03-2003</td>
<td>Doubtful-2</td>
</tr>
<tr>
<td>31-03-2005 and onwards</td>
<td>Doubtful-3</td>
</tr>
</tbody>
</table>

3. **PROVISIONING**

After proper classification of loan assets the banks are required to make sufficient provision against each of the NPA account for possible loan losses as per

<table>
<thead>
<tr>
<th>Category</th>
<th>Status as doubtful asset</th>
<th>Status as NPA</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Doubtful-1(DF-1)</td>
<td>Up to 1 year</td>
<td>Up to 2 ½ years</td>
</tr>
<tr>
<td>b) Doubtful-2(DF-2)</td>
<td>More than 1 to 3 years</td>
<td>Between 2 ½ to 4 ½ years</td>
</tr>
<tr>
<td>c) Doubtful-3(DF-3)</td>
<td>More than 3 years</td>
<td>More than 4 ½ years</td>
</tr>
</tbody>
</table>
prudential norms. The minimum amount of provision required to be made against a loan asset is different for different types of asset.

**Standard Asset**

At present, no provision is required. However, banks were expected to make a general provision of a minimum of 0.25 percent against standard assets for the year ending March 31, 2000 and onwards. In this connection the Reserve Bank of India clarified that:

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

**Sub-Standard Asset**

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

**Doubtful Asset**

The quantum of provision in case of doubtful assets depends upon the realizable value of security and the age of doubtfulness of the asset. Provision required is:

- 100 percent of the security shortfall, i.e. the extent to which the advances is not covered by the realizable value of security to which the Bank has the valid recourse and the realizable value is estimated on realistic basis; plus
- 10 percent to 50 percent of the secured portion depending upon the period for which the asset has remained doubtful.
Category Provision on the secured portion

<table>
<thead>
<tr>
<th>Category</th>
<th>Provision on the secured portion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Doubtful - 1</td>
<td>20 %</td>
</tr>
<tr>
<td>2 Doubtful - 2</td>
<td>30 %</td>
</tr>
<tr>
<td>3 Doubtful - 3</td>
<td>50 %</td>
</tr>
</tbody>
</table>

Additional – provisioning consequent upon the change in the definition of doubtful assets effective from 31st March, 2001 has to be made in phases under:

(a) As on 31-03-2001, 50 percent of the additional provisioning requirement on the assets, which became doubtful on account of new norm of 18 months for transition from Sub-standard assets to doubtful category.

(b) As on 31-03-2002, balance of the provisions not made during the previous year in addition to the provisions needed as on 31-03-2002.

With a view to bringing down the divergence arising out of difference in assessment of the value of security, in case of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the board would be mandatory in order to enhance the reliability of stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the board of directors. The Reserve bank of India has decided that from the year 1995-96, while arriving at the provision required to be made, realizable value of the securities should be deducted from the outstanding balance in respect of advances guaranteed by ECGC/DICGC.

Loss Assets

Provision required is 100 percent of the outstanding balance of the loss asset.

CAPITAL ADEQUACY NORMS

Capital Adequacy is considered a tool and standard measure for gauging financial strength of the banks. It is measured in terms of percentage of capital
employed by a bank in relation to the adjusted value of its assets, loans and advances both funded and non funded and investments as appearing in balance sheet by applying certain standard risk weights for arriving at their real values. A higher capital adequacy ratio means that the bank is sound and has enough cushions to take care of its loan loss provisions and payment of liabilities, if demanded. Higher non-performing assets requiring provisioning and derecognition of interest income would result in lowering of capital adequacy.

As regards, banking industry in India, whose average capital adequacy ratio was quite low till 1990, RBI considered it necessary to strengthen the same in a phased manner in line with the Basel Committee norms. Meanwhile Narasimham Committee, which was appointed by Government of India on “Financial System Reforms” submitted its report, Inter alia, recommending that banks and financial institutions operating in the country should achieve capital adequacy ratio of 4 percent in relation to risk weighted assets by March 1993 and reach a level of 8 percent by March 1996 and 9 percent by 2000 irrespective of the quality of the borrower. In the new system, a bank offering credit to better quality corporate entities is likely to require less regulatory capital. Narasimham Committee on banking sector reforms had suggested an increase of the capital to risk – adjusted asset ratio (CRAR) to 10 percent by 2002. As per regulatory measures of 2007 CRAR should not be less than 9 percent by July 2007.

The capital of a bank is of two types viz. Tier I capital and Tier II capital. Tier I capital is permanently and freely available to absorb losses without the bank being obliged to cease trading. It is important because it safeguards both the survival of the bank and the stability of the financial system. It comprises of paid up capital, statutory reserves and other disclosed free reserves, if any. The equity investments in subsidies, intangible assets, and losses in the current period, if any, are to be deducted to arrive at Tier I Capital.

Tier II capital consists of items less permanent in nature and generally absorbs losses in the event of liquidation of a bank, and so provides a lower level of protection for depositors and creditors. It comes into play in absorbing losses after the
bank has lost Tier I Capital. It would include disclosed reserves and fully paid cumulative preferential shares.

The capital adequacy norms in India are in line with the best practices as suggested by BIS. Once Basel II Accord is implemented, the method of estimation of risk capital will undergo a significant change. The RBI has already undertaken appropriate steps to prepare the Indian banking industry for such changes (IBA BULLETIN, January 2004, Page33).

FACTORS AFFECTING NPAs

The NPAs management has a direct bearing on the factors responsible for it. The introduction of the SARFAESI Act, the recovery scenario will change drastically. That the introduction of the Act will not only help in the recovery of the past NPAs but also would act as a preventive measure in the minds of the borrower. Presently the borrower knows that in case of default, the banker has limited options as the judicial process is slow and even if a suit for recovery is filed, it could easily be prolonged for 10-15 years. The new Act has empowered the bankers to seize the security without the intervention of the court or even take over the management of the company.

The other factors responsible for high NPAs in order of ranking are:

1. Change in Government policies including unfocussed liberalization.
2. Delay in release of adequate and timely credit.
3. Willful default.
4. Divergence of funds.
5. Inadequate post- follow up.
6. Non-availability of timely audited financials from the borrowers.
7. Lack of proper appraisal etc.

There are two extreme views with respect to the “inadequate post-follow up” with some bankers ranking this factor as one of the most important ones while some others ranking it last. Those who consider this factor important, feel that a strong follow up puts mental pressure on the borrower to return the government debt on priority vis–a–vis private departments. This follow up, if backed by strong legal
measures to recover the money, would persuade the borrower to try his best to return the bank’s money.

Once the bank has taken proper care at the pre – sanctioning stage and there are no external factors causing failure of production and/or fall in the expected income generation, the role of the management of the unit becomes very crucial. The respondents have indicated mismanagement and/or misutilisation of funds as an important factor contributing to the incidence of NPAs. Nevertheless, if the bank’s monitoring and post follow up is strong then it can immediately sight the diversion and mismanagement of funds. Frequent changes in the Government policies and time overrun in the implementation of the project due to various factors can have a cumulative effect on the health of the account and can be a significant cause of NPAs. The fall in income generation, whether on account of external causes like natural calamities or Government policies or due to various factors together, constrains the ability of the borrower to repay the loan with the result NPAs rise.

Willful default, another important factor is mainly on account of laxity on part of the bank in terms of appraisal, supervision, and follow-up. The bank is either not in a position to identify a willful defaulter or take punitive action on account of its own and/or the style of functioning of the legal system and/or non-cooperation of the government. Willful default can also arise on account of the typical mentality of the people in the area, which destroys the will and initiative to repay. Such mentality is further nursed by interference of self-centered politicians.

One of the reasons responsible for NPAs has also been the lack of proper appraisal. Though most banker’s opine that proposals are appraised with respect to the activity, industry, geographical area, etc, and the details of the promoters, directors/guarantors are checked with the RBI circulated caution list, the growing NPAs do not support this opinion. The fact is that most banks do not have appraisal teams and usually resort to appraisals of other institutions/ banks, who themselves have done a cut-paste job, thereby leading to half- baked appraisals, devoid of any similarity to ground realities. Some banks have introduced a centralized cell for appraisal for proposals above a certain value, which are processed by experienced and qualified officers.
The bankers are also of the view that in some cases, irrespective of the value of the account, impractical and unrealistic sanction stipulations result in creation of NPAs. They are of the opinion that cash budgeting will be more appropriate and relevant to the present banking environment than the conventional balance sheet system. This is due to the fact that it is of the utmost importance to the bank to ascertain whether the borrowing companies have cash with them to service the loan rather than knowing the financial position as on a particular date which could be molded to suit their interest. The various factors given above have also been found to be of relevance by RBI in its internal study though they vary slightly in order of ranking.

WILFUL DEFAULTERS

The RBI, in consultation with the Central Government constituted a Working Group on Willful Defaulters (WGWD) with Shri S.S.Kohli as its chairman. The Group submitted its report in November 2001. As per the new definition, a willful default would be deemed to have occurred if any of the following events is noted:

(a) The unit has defaulted in meeting its payment/ repayment obligations to the lender even when it has the capacity to honour the said obligations;

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

(c) The unit has defaulted in meeting its payment/ repayment obligations to the lender and has siphoned- off funds, i.e. funds are not available with the unit in the form of other assets.

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

**ADDITIONAL DISCLOSURES**

To enhance transparency in the annual reports of FIs in consonance with international best practices, additional disclosures of certain parameters were made effective from the financial year 2001-02. These disclosures relate to publication of movement in provisions held towards NPAs and depreciation in investment portfolio and are to be made in the annual report as part of “notes to accounts”. This would enable authentication of such information by the auditors. The disclosures are to be made even if the information is contained elsewhere in the annual report. The prescribed disclosures constitute the minimum, and it is considered desirable for DFIs to make further disclosure.