CHAPTER IV

NON-PERFORMING ASSETS OF BANKS
An attempt is made in this chapter to examine the means and mechanism adopted under the New Policy Directions to strengthen the banking system for its sound operations.

The healthy of banking section is depended upon the degree of non-performing assets. Reforms initiated in the banking sector in India since the beginning of the 1990 have been on the lines of the recommendations of the Committee on Financial System headed by M.Narasimham. The Report was submitted in 1991. One of the major recommendations made by this Committee was for the adoption of uniform Accounting Practices by banks, particularly in regard to income recognition, classification of assets and provision of bad debts. According to the Committee "... a proper system of income recognition and provisioning is fundamental to the preservation of strength and stability of the banking system". In this context, it recommended the adoption of the international practice of treating an asset as 'non-performing' when interest is overdue for atleast two quarters, and where interest is not recognised on accrual basis but is booked as income only when actually received. Further, the Committee recommended that a transition period of three years, starting with the year 1991-92, to be given to the banks and financial institutions to harmonise their accounting practices with the new norms.

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Before the introduction of the Committee's norms and procedures, the banks and financial institutions were following the 'Health Code System' introduced by Reserve Bank of India in 1985 to classify their advance portfolios. The Health Code System consisted of eight sub codes such as (i) satisfactory, (ii) irregular, (iii) sick (viable/under nursing), (iv) sick (non-viable/sticky), (v) advances recalled, (vi) suit-filed accounts, (vii) decreed debts and, (viii) debts classified by banks as bad/doubtful. Advances classified under Health Codes (HC) 5 to 8 were to be considered as NPAs. It is noteworthy that even though advances might be classified by banks as 'sick non-viable' (HC4) they are not required to be considered as NPAs.

According to the RBI's direction to banks, issued in May 1989, in regard to income recognition was not to charge and take into their income account, interest on loan classified under HC 6, 7 and 8 from the quarter in which the individual accounts were so classified.

In October 1990, the Reserve Bank of India advised banks that while advances classified as HC 5 were also to be similarly treated for income recognition, for advances under HC 4. The non-performing advances classified under HC 4, 5, 6 and 8 as a percentage of public sector banks stood at 13.59
per cent at the end of March 1991 and increased to 14.46 per cent in March 1992.²

It is worthwhile noting that the replacement of the old definition by the new definition of NPAs recommended by the Narasimham Committee without going into its quantitative implications. The Reserve Bank of India initiated the implementation of the new definition from the financial year 1991-92. However, while the Narasimham Committee had adopted the "international practice" of treating as NPA when interest was overdue for at least two quarters. The Reserve Bank of India directed the banks to introduce this norm by phasing it over three years, starting with the target of four quarters for 1992-93, three quarters for 1993-94 and two quarters for 1994-95. Further the Reserve Bank of India advised the banks not to charge, and take into income account, interest on any NPAs.

In line with the recommendations of the Narasimham Committee, the Reserve Bank of India advised the banks in 1991-92 to classify their assets into four categories, (i) standard assets, (ii) substandard assets, (iii) doubtful debts and (iv) loss assets.

In the context of practical difficulties faced in implementing the new prudential norms set for classification
and provisioning by banks, the Reserve Bank of India set up an Informal Working Group to examine. It has recommended the following relaxations:

(1) An amount under any credit facility should be treated as 'past due' only when it remains outstanding for 30 days beyond the due date;

(2) Banks should adopt agricultural season as the basis for treatment as NPA of advances granted for agricultural purpose where interest payment is an half-yearly basis synchronising with harvest;

(3) For the purpose of treating an advance as NPA, net worth of borrower/guarantor need not be taken into account;

(4) If the salvage value of security is negligible, it may not be considered while providing for loss assets;

(5) In the case of project financing, reckoning of 'past due' shall commence only from the 'due' date for payment;

(6) Treatment of NPA has to be borrower-wise;

(7) Only credit facilities with an outstanding balance of Rs.25,000 and above need to be considered while calculating NPAs; and
(8) Aggregate provisioning against advances with an outstanding balance of less than Rs.25,000 has to be of 2.5 per cent of the total outstanding amount.³

Changes made by the Reserve Bank of India in provisioning requirements of NPAs between 1992-97 is presented in Table 4.1. The overdue period of interest, which was fixed of as four quarters in 1992-93, was reduced to two quarters by 1994-95 (not applied to agricultural advances) and provisioning requirements against small loans of less than Rs.25,000 was raised from 2.5 per cent in 1992-93, to 15 per cent by 1996-97. Thus, provisioning against small outstanding loans was to be increased by six times of what was required to be set apart to start with. However, no change was made in the provisioning requirement against outstanding large loans (i.e., loans of outstanding amount exceeding Rs.25,000) classified as substandard assets (10 per cent) or doubtful assets (20 to 100 per cent).

NON-PERFORMING ASSETS OF PUBLIC SECTOR BANKS

Data on NPAs of public sector banks between 1993 and 1996-97 agree presented in Table 4.2. Interestingly, the proportion of total NPAs to total advances declined from 24.2 per cent in 1993 to 17.3 per cent in 1996. During this
### TABLE 4.1

**CHANGES IN OVERDUE PERIOD OF INTERESTS AND PROVISIONING REQUIREMENTS WITH REGARD TO NPAs (1992-97)**

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<tbody>
<tr>
<td>Non-Performing assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>interest overdue period (Number of Quarters)</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Provisioning requirements (per cent)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>small loans (less than Rs.25,000)</td>
<td>2.05</td>
<td>5.00</td>
<td>7.05</td>
<td>10.00</td>
<td>15.00</td>
</tr>
<tr>
<td>Large Loans :</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Sub-standard Assets</td>
<td>10.00</td>
<td>10.00</td>
<td>10.00</td>
<td>10.00</td>
<td>10.00</td>
</tr>
<tr>
<td>(b) Doubtful Assets :</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Secured Portion</td>
<td>20.50</td>
<td>20.50</td>
<td>20.50</td>
<td>20.50</td>
<td>20.50</td>
</tr>
<tr>
<td>(ii) Unsecured Portion</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>(c) Loss assets</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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</tbody>
</table>

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<th></th>
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</thead>
<tbody>
<tr>
<td>Sub standard Assets</td>
<td>12551.95</td>
<td>7757.50</td>
<td>9292.17</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>(08.30)</td>
<td>(03.93)</td>
<td>(04.10)</td>
<td></td>
</tr>
<tr>
<td>Doubtful Assets</td>
<td>20106.35</td>
<td>22913.34</td>
<td>24706.91</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>(13.30)</td>
<td>(11.61)</td>
<td>(10.80)</td>
<td></td>
</tr>
<tr>
<td>Loan Assets</td>
<td>3929.98</td>
<td>3732.09</td>
<td>4351.28</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>(02.60)</td>
<td>(01.89)</td>
<td>(01.90)</td>
<td></td>
</tr>
<tr>
<td>Advances with balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>less than Rs.25,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>classified as NPAs</td>
<td>-</td>
<td>3982.25</td>
<td>1226.58</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(02.02)</td>
<td>(0.50)</td>
<td></td>
</tr>
<tr>
<td>Total NPAs</td>
<td>36588.03</td>
<td>38385.18</td>
<td>39583.94</td>
<td>20284.73</td>
</tr>
<tr>
<td>Total Advances</td>
<td>67287</td>
<td>197402</td>
<td>229232</td>
<td>223315</td>
</tr>
<tr>
<td>NPAs as percentage of total advances</td>
<td>(5/6 x 100)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>24.20</td>
<td>19.45</td>
<td>17.30</td>
<td>9.18</td>
</tr>
</tbody>
</table>

period, the proportion of doubtful assets declined from 13.30 per cent to 10.80 per cent in 1996, substandard assets, from 8.30 per cent to 4.10 per cent and loss assets from 2.60 per cent to 1.90 per cent. The decline is most remarkable for outstanding loans of less than Rs.25,000.

Equally remarkable is the drastic decline in NPAs of public sector banks during 1996-97. In 1996, total NPAs amounted to Rs.39,583.94 crores or 17.3 per cent of total bank advances. By 1997, this figure is reported to have declined to Rs.20,284 crores or 9.18 per cent of total advances. A decline in NPAs by Rs.19,299.94 crores and 8.12 per cent points in a period of just one year. This drastic decline is achieved by the Reserve Bank of India bringing about a definitional change in NPAs. It introduced a new concept of 'Net NPAs' in 1996-97 (which according to Reserve Bank of India in an internationally recognised concept) in place of gross NPAs followed by it earlier. According to Reserve Bank of India, NPA is derived from gross NPA by deducting:

(i) balance in interest suspense account, i.e., interest due but not received,

(ii) DICGS/ECGS claim received and kept in suspense account pending adjustment (for final settlement),
(iii) past payment received and kept in suspense account, and
(iv) total provisions held.4

PRIORITY SECTOR NPAs

The priority sector advances accounted for 47 per cent of the total NPAs. Priority sector lending is supposed to meet "the imperatives of societal concerns for assisting the truly weaker sections and tiny units". The total outstanding priority sector advances to public sector banks amounted to Rs.79,131 crore as on March 31, 1997. This is worked out to 41.70 per cent of net bank credit on the date. It means that non-performing advances to priority sector amounted to Rs.9,533.8 crores. But with no information available for any earlier year on non-performing priority sector advances, it is difficult to say whether these advances are declining or increasing; and in what proportion. However, assuming that non-performing priority sector advances at the end of 1995-96 were as much as Rs.9,533.8 crores i.e., as at the end of 1996-97, they would have worked out to 24.1 per cent of gross NPAs of public sector banks. It is infer that if priority sector NPAs are high, it must be on account of large loans in the sense the outstanding amount is in excess of Rs.25,000.
MEASURES TO STRENGTHEN BANKING SYSTEM

A considerable growth has been covered in making the financial system a more sound by meeting the requirements of a more competitive and open economy since the announcement of the first measure of the financial sector in the Union Budget in the year 1991-92 to the second report of the Narasimham Committee in 1998. The four major measures that have recommended for ensuring the banking structure so sound and its operations on healthy basis for attaining the goals of the banking sector in particular and the economy of India in general. The four measures are:

1. Framing the policy conditions right; and removing the operational constraints of the financial system. What the reform process has tried to achieve is to lower the share of pre-empted resources in the total resources of the banking system through gradual liberalisation of cash reserve ratio and statutory reserve ratio.

2. Directional change has been in the area creating a more competitive environment in the financial sector. Relaxation of entry and exist norms, reduction in the public ownership in banking and letting the banks assess to capital market for meeting their funds requirement.
3. Strengthening the market institutions and allowing greater freedom to financial intermediaries. In other words, gradual liberalisation of interest rates, development of money, capital and debt markets, and giving operational flexibility to the banks in the management of their assets and liabilities subject to the prudential guidelines.

4. Ensuring 'safety' aspects of the financial system. It is the core of the challenges facing the financial system at present.

MEANS AND MECHANISM

Directed lending to social sectors, non-commercial orientation, waiving of loans as well as interest, raising trend in non-performing assets made the banks to adjust to the market environment having prudential norms. As corollary, most of the public sector banks has disclosed 'Bleeding Balance Sheet' in the beginning of post-reform period. Over a period of time, the banks have began to adjust and adopt to the competitive environment. In this context how far the commercial banks have strengthened themselves under the New Policy Directions, calls for an examination.
In an over-whelming business environment, it is a desirable to have an evaluation system to monitor the performance of the commercial banks. The Padmanabhan Committee which was constituted in February 1995, after detailed study, it opined that the present system of inspection rating based only on the assessed solvency status is inadequate and unrealistic as well. The supervisory mechanism when properly conceived and implemented becomes a strong base on which modern banking system depends for its credibility. Bank supervision assumes considerable importance in the context of maintaining stability and soundness of country's financial system. On the other hand the periodical review with in-built checks throw light on solvency, liquidity, quality and sound management of banking system. The means for effective mechanism to achieve good results are:

1. Capital adequacy  
2. Asset quality  
3. Management evaluation  
4. Earning potential  
5. Liquidity  
6. Systems and Controls
These means which are said in the above are being adopted in Indian Banking system on the recommendations of the Narasimham Committee. They are analysed critically and carefully to have knowledge on the soundness and healthy pattern of banking business.

CAPITAL ADEQUACY: Capital aids to maintain the confidence of public and also acts as a cushion to absorb unforeseen losses. It acts unique and powerful tool to make the commercial banks sound and to attract enough business. Prior to liberalisation policy, the capital base of commercial banks was very weak. It was around 1.50 per cent to risk weighted assets. A 8.00 per cent has to be achieved by 1992 as per the recommendations of Bank of International Settlement (BIS) Committee which was headed by 'cooke'. Erosion of profitability which resulted in low accretion to reserves had made the Reserve Bank of India to ask the commercial banks to achieve 4 per cent capital adequacy by March 1994, and 8 per cent by March 1996.

The capital adequacy constitutes two components namely (a) core capital and (b) supplementary capital. The former forms paid-up share capital, disclosed reserves, share premium, retained profits, general reserve and legal reserve. The latter consists of undisclosed reserves, assets revaluation reserves, general loan loss reserves, hybrid
capital and sub-ordinated term debt. At any circumstances, the latter should not exceed the former. The subordinate debt capital should not exceed 50 per cent of core capital.

All the 27 public sector banks have achieved capital adequacy norm of 8 per cent by 1997.

**ASSET QUALITY**

Balance sheet provides an opportunity which highlight the strength, and hide the weaknesses. To refer to this, perhaps it is a common saying that balance sheet is one which hides more than reveals. On the introduction of prudential norms such as income recognition, asset classification and provisioning, the very thrust of balance sheet has changed. It is not only discloses the quantity of assets and liabilities at the end of the year but also reveals the quality (health) as well. Assets classification can be carried out on the criteria of recovery of interest/instalment or both. The banks and financial institutions were advised to classify their assets into (a) Performing Assets (PA), (b) Non-Performing Assets (NPA).

Interest income is recognised on the 'accrual' basis in the performing assets while interest income is recognised on 'realisation' in non-performing assets. Credit weakness and extent of dependence on collateral security for
realisation of dues have taken into assets classification. Accordingly the assets are classified into as follows:

1. **STANDARD ASSETS**: Standard asset is one which does not disclose any problem and does not carry more than normal risk attached to the business.

2. **SUBSTANDARD ASSETS**: Substandard assets are those which include assets classified as non-performing asset for a period not exceeding two years.

3. **DOUBTFUL ASSETS**: If any asset is non-performing asset for a period exceeding two years, then it is termed as doubtful asset, and would also include loans in respect of which instalments are overdue for a period exceeding two years.

4. **LOSS ASSETS**: The account shall be classified as loss asset in any of the following conditions namely: (a) account is classified as NPA, (b) realisable value of the security is nil, and (c) account is identified as bad/irrecoverable by the bank.

   However, credit facilities guaranteed by State Government or Central Government even if classified as NPA for income recognition purpose shall be classified as 'Standard Assets'. The NPA to total advances of the public
sector banks is accounted for 23.20 per cent in 1992-93, 19.08 per cent in 1994-95 and 16.00 per cent in 1997-98. The NPA should be below 15 per cent as per Reserve Bank of India norm. The concept of NPA served as useful technique in highlighting the weaknesses of the banking system.

MANAGEMENT : Like duty goes along with right, authority goes along with responsibility. The cut-throat competition may lead some banks into unfamiliar area wherein risk yet unknown. Management has to make in-depth studies to manage efficiently for viability in the environment. Grappling with interest rate and risk management will, of course be an integral component of asset-liability management. In this connection, Human Resources should be developed by means of providing training modules so as to acquire both knowledge and skills in forward carrying the business with the expected goals. Knowledge on computer applications, is another measure which support the strengthening system of management.

EARNINGS : Earnings indicate capabilities and capacities of the banks in carrying their business with desired degree of margin. By 1993 the number of commercial banks publishes losses were 17 which reduced to 8 by 1996. The operating profits of 19 out of 27 commercial banks were Rs.7,643 crores by 1996. Increased spread is the result of better asset-liability management. Income on loans and advances
constituted 49 per cent, investments 31 per cent and others 20 per cent.

LIQUIDITY: Relaxation in CRR and SLR have ceased out the situation of liquidity. SLR has been brought down to 31.50 per cent with effect from October 29, 1994. For any increase in the net demand and time liabilities from September 13, 1994 SLR was prescribed at 25 per cent. The Busy Season Credit Policy announced on October 19, 1996. The Reserve Bank of India reduced CRR into the stages as: October 26, 1996 - 11.50 per cent; November 9, 1996 - 11 per cent; January 4, 1997 - 10.5 per cent; and January 18, 1997 - 10 per cent. Each percentage reduction in CRR will increase liquidity about Rs.4,275 crores. The banking sector thus would get an additional lendable resources to the tune of Rs.8,530 crores in totality. The market which reports indicate that the banks are in lookout for good claims where the credit risk is very low.

SYSTEMS AND CONTROLS: Increasing incidents of frauds is causing a deep concern and alert the banking sector to check this unscrupulous phenomena. Inspection is to be enforced on a continuous and an on-going process rather a periodical one. During 1995-96, the number of frauds reported were 2,240 with a financial loss of Rs.13237 crores. Reserve Bank of India has taken a stringent action in 'Black Listing' the alters of
Indian Bank'. The circumstances under which the incidence of fraud is to be examined with absolute professional approach. Let see how the auditors sail in the disturbed water in the days to come. The health of banking sector and its effective working in achieving the objectives depend upon the degree of performing assets.
REFERENCES


2. Ibid., p. 58.
