CHAPTER 1

Introduction

1.1 Background
1.2 Research Questions and Research Hypotheses
1.3 Relevance Of The Research
Chapter 1
Introduction

1.1 Background

The financial sector reforms have brought in a number of far reaching changes in the operational arena of Banking both in respect of approach and procedure. One such important dimension is Risk Management. Banks, in their course of business, are confronted with various kinds of financial and non-financial risks.

These may be classified into:

- Credit Risk

- Market Risk: arising from adverse changes in market variables like interest rates, exchange rates, equity price, etc. and gets manifested in the form of Liquidity Risk, Interest Rate Risk, Forex Risk, etc.

- Operational Risk: Risk of loss arising from human or technical error, fraud or business performance failure. For e.g., Settlement or Payment Risk, Administrative & Legal Risk.

Risk management in banking has gained prominence following the Basel II Accord (refer to Chapter 2 for details) and the level of loan losses experienced by banks during the Asian crisis. With the Reserve Bank of India's decision to implement Basel II, scheduled for year-end 2006-2007, a top priority for the Indian banking industry is the strengthening of the risk management systems to meet the regulatory requirements.

Managing these risks involves the following processes:

- **Risk Identification**: Involves understanding the nature of various kinds of risks, the circumstances that lead to a risk situation and knowing the causes due to which the risk can arise. In banks this is done through periodical review of the asset portfolio, risk rating of credit and investment exposures, analysis of loss arising out of human and system failures like frauds, wrong posting of credit, consequent withdrawal of funds by persons not entitled for the same and technology related issues.

- **Risk Measurement or Quantification**: Involves an assessment of the degree of the risk to which a particular transaction or an activity is exposed. Banks adopt different methodologies and techniques to quantify various risks.
• **Risk Monitoring**: Involves supervision of the various risks that banks face and a critical analysis and classification of loan loss events.

• **Risk Mitigation by Control or Transfer**: Involves risk control through proper selection of borrower, proper documentation, security and adequate follow up at the post sanction stage, understanding the various factors typical to a particular industry, activity or business line to which the unit belongs, analysis of trends and assessment of future prospects, monitoring the portfolio and fixing suitable exposure ceilings on borrowing activities, industries, etc. In respect of market risk, asset liability management and credit derivatives are some of the risk mitigating measures. Operational risk can be controlled by constant review of systems and mitigated through introduction of fresh controls and through transfer of risk.

Of the three types of risks mentioned earlier, this research has concentrated on credit risk. Credit Risk is simply defined as the probability that a bank borrower will fail to meet its obligation in accordance with agreed terms and involves inability or unwillingness of a customer to meet commitment (Kalavathy, 2000). Credit risk is generally made up of transaction risk or default risk and portfolio risk. Default risk arises from individual credit transactions of the bank at a micro-level and is evaluated through the technical, financial and other analysis of individual borrowers. On the other hand, portfolio risk arises out of total credit exposures of the bank at a macro-level. Portfolio risk may be intrinsic for e.g., a particular group or type of customers or industry may have a higher risk as compared to other groups. It may also arise out of undue concentration of credit to single borrowers or counter-parties or a group of borrowers in a particular geographic location, etc. The credit risk of a bank's portfolio depends on both external and internal factors. The external factors are the state of the economy, wide swings in commodity/equity prices, foreign exchange rates and interest rates, trade restrictions, economic sanctions, government policies, etc. The internal factors are deficiencies in loan policies/administration, absence of prudential credit concentration limits, inadequately defined lending limits for loan officers/credit committees, deficiencies in appraisal of borrowers' financial position, excessive dependence on collaterals and inadequate risk pricing, absence of loan review mechanism and post-sanction surveillance, etc. Credit risk may take the following forms:

• **Direct Lending**: principal or/and interest may not be repaid.
• Non-fund Business: funds may not be received from the constituents upon crystallization of the liability as in the case of Bank Guarantees, LCs, etc.

• Treasury Operations: payments due from counter parties, under the contracts may not be received.

• Securities Lending: funds/ securities settlement may not be effected.

Exposure to credit risk continues to be the leading source of problems in banks worldwide. This has necessitated a systematic approach towards managing the risk and credit risk management has emerged as the most critical element for the safe and sound banking activities.

Credit risk management has become all the more important in the current Indian policy environment of financial sector reforms, increasing deregulation and a move for privatisation of public sector banks (PSBs). While these measures result in more autonomy for the banks, at the same time banks are exposed to more competition. Further, banks are expected to exert financial discipline on commercial sector by allocating credit judiciously through prudent and efficient credit risk management practices. Thus the present day emphasis is on credit risk management and profitability in banks. Profitability, once relegated to a secondary importance, now becomes the prime mover of financial strength and performance of banks.

Credit risk management process encompasses the following areas as per Reserve Bank guidelines (RBI, 2002a):

• Measurement of risk through credit rating/ scoring

• Quantifying the risk through estimating expected loan losses

• Fixing Credit Price

• Risk control

One of the significant fallout of prudent credit risk management practices is superior quality of the loan assets. The quality of loan assets gets reflected in the Non-Performing Asset (NPA) figures of the banks. In recent times there has been extensive discussion on the accumulation of huge non-performing assets (NPAs) on the balance sheets of the Indian banks, more specifically, the public sector banks. PSBs figure prominently in the debate not only because they dominate the banking industry, but also since they have much larger NPAs compared with the private and foreign banks operating in the country. Public sector banks accounted for 89.8 per cent of the gross NPAs of the banking industry during 1997-98 and 79.7 per cent of those assets as in
2001-02 (RBI, 2000 & RBI, 2002). This raises a concern in the industry and academia because it is generally felt that NPAs reduce the profitability of a bank, weaken its financial health and erode its solvency. NPA do not yield any return while they incur a cost; they eat into earnings made elsewhere by way of demand for provisions; delayed/truncated payments lead to opportunity losses; and make stakeholders wary about their investment.

The presence of large NPAs affect a bank’s profit in a number of ways: (a) through reduced interest income, and (b) through the creation of reserves and provisions at the expense of profits (Mukherjee, 2003). This decline in profits has a bearing on variables like capital to risk-weighted assets ratio (CRAR, or the capital adequacy ratio). With the dip in profit it becomes difficult for the bank to raise Tier-I capital. So the capital base is affected. In the face of declining profit, in order to maintain the stipulated CRAR, the banks may have to raise Tier-II capital through bond-issues. The interest cost will be then higher, pushing the cost ratio of the banks up and thereby resulting in further shrinkage of profit.

Different countries experienced a variety of problems on account of high NPAs. The effects ranged from liquidity crisis, deposit runs and bank failures that led to writing-offs of non-performing loans, mergers and acquisitions, restructuring and even closure of weak banks (Lindgren et al, 1996). In India, the depth of the problem of bad debts was first realized only in early 1990s. Subsequently, following the recommendations of the Narsimham Committee (1991, 1998) and Verma Committee (1999) (refer to Appendix 1.1a 1.1b for details), some steps have been taken to tackle the problem of old NPAs.

There are two concepts related to non-performing assets- gross and net (refer to Appendix 1.2). Gross NPAs refers to all NPAs on a bank’s balance sheet irrespective of the provisions made. It consists of all non-standard assets, viz. sub-standard, doubtful, and loss assets. Net NPA is gross NPA less provisions. While gross NPA reflects the quality of the loans made by banks, net NPA shows the actual burden of banks. Gross NPAs at Rs.60,841 crores (12.8% of gross advances) as at March 2000, were higher in absolute terms by Rs.2,119 crores over the levels at March 1999, although in percentage terms, in relation to gross advances, there was an improvement from 14.7% to 12.8%. The gross NPA to gross advances ratio and the net NPA to net advances ratios for public sector banks declined significantly from 17.8 to 11.1 per cent and from 9.2 to 5.8 per cent, respectively between 1996-97 and 2001-02 (RBI, 2000 & RBI, 2002). These ratios
for the old private sector banks remained more or less the same, but for the new ones the ratios increased by more than 6 and nearly 3 percentage points, respectively during this period (RBI, 2000 & RBI, 2002). The ratios improved further during the period 2002-05 (RBI, 2005) as can be seen from Table 1.1. However, banks cannot relax with this performance and has to give a concerted effort to reduce the NPA levels further and be at par with international banks.

### Table 1.1

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross NPAs/Gross Advance</th>
<th>Net NPAs/Net Advances</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>17.80</td>
<td>9.20</td>
</tr>
<tr>
<td>1998</td>
<td>16.00</td>
<td>8.20</td>
</tr>
<tr>
<td>1999</td>
<td>15.90</td>
<td>8.10</td>
</tr>
<tr>
<td>2000</td>
<td>14.00</td>
<td>7.40</td>
</tr>
<tr>
<td>2001</td>
<td>12.40</td>
<td>6.70</td>
</tr>
<tr>
<td>2002</td>
<td>11.10</td>
<td>5.80</td>
</tr>
<tr>
<td>2003</td>
<td>9.36</td>
<td>4.53</td>
</tr>
<tr>
<td>2004</td>
<td>7.79</td>
<td>2.99</td>
</tr>
<tr>
<td>2005</td>
<td>5.53</td>
<td>2.06</td>
</tr>
</tbody>
</table>

Source: RBI Report on Trend and Progress of Banking in India

Since there is always an element of judgment in projecting and valuing uncertain future receipts, there always remains some probability of a loan becoming non-performing. So elimination of NPAs is neither plausible nor desirable (Mukherjee, 2003). But at the same time, presence of large NPAs is detrimental to a bank’s health. So the bank has to keep vigil constantly on the generation of fresh NPAs. In 2002, fresh addition of NPAs was Rs. 24,824.32 crores whereas reduction during the year was Rs. 17,502.10 crores only (RBI, 2002). Such high figures of loan defaults put a question mark on the credit appraisal and follow up techniques applied by banks (Sharma, 2005).

To keep creation of fresh NPAs in check, adoption of proper and continuous selection and monitoring techniques and development of internal risk-assessment models are extremely necessary (Mukherjee, 2003). Therefore, banks need to develop a sound appraisal process whereby bad borrowers can be identified at the initial stage. Moreover, proper credit monitoring has to be implemented so as to arrest the slippage of standard assets to non-performing zone. With this twin approach of prevention, the banker shall be in a better position to contain the NPA level.
Hence, with the above background in mind, this research has tried to answer the following six questions and three hypotheses.

1.2 Research Questions And Hypotheses

1.2.1 Research Questions

1. What is the level of effectiveness of the credit appraisal process?

2. To what extent the banks use the concept of portfolio management while evaluating a loan proposal to take care of the credit risk involved?

3. What is the level of effectiveness of the various measures taken up to recover non-performing assets (NPA) and to reduce the incidence of NPA?

4. To what extent the reduction in NPA has been made a criterion for the performance appraisal of bank managers?

5. What are the critical factors adversely or favourably affecting the recovery performance of banks?

6. What should be the loan evaluation structure appropriate for effective pre-appraisal of loan proposals to minimise credit risk?

1.2.2 Hypotheses and Background

a. Hypothesis I

Background

Credit appraisal is the best early opportunity available to the bankers to ensure the asset quality. Empirical studies have proved that ‘adverse selection’ is one of the major reasons for the growing number of NPAs. Therefore, the banker has to be careful at the entry level itself (Namboodiri, 2001-02).

Lack of adequate care while appraising the proposal in the initial stage has ultimately resulted in non-performing assets. This has been the main reason, which has contributed significantly to the volume on such assets (Toor N.S., 1996).
Because of Basel II requirements banks now have gone for new appraisal and credit risk rating model but no significant comparative study has been made by researchers to assess the weaknesses in credit appraisal and effectiveness of the new rating models. Hence, the following hypothesis is examined within the context of Basel II requirements.

**Hypothesis I**: Weaknesses in credit appraisal is a major cause of accounts turning into bad loans.

While testing this hypothesis, the major thrust is on assessing the effectiveness of the credit rating models used in credit appraisals by banks.

b. **Hypothesis II**

**Background**

Risk monitoring is important at the post sanction stage. Early warning signals are not to be ignored. Strategies are also to be worked out for problem accounts to control risk. Organisational systems and support is also vital for risk control. There is also a need for separate organisational set-up at macro/micro levels for timely monitoring to identify potential loan assets and initiate action. On-site and Off-site surveillance measures are also to be taken (Ramachandran N., 1997).

15 out of 16 public sector banks, covered in a study, added fresh NPAs, which were higher than recoveries effected by them during the year 1999-2000. It needs hardly to be emphasized that unless slippage of standard assets to NPAs is effectively curbed, it is impossible to control and curtail NPAs to minimum possible level. Weaknesses in credit appraisal and credit monitoring have been identified as major reasons for the accounts turning into non-performing assets (Vidwans H.P., 2001-2002). These aspects have been further examined through the following hypothesis.

**Hypothesis II**: Stricter credit monitoring will ensure the advances from becoming non-performing i.e., another way of saying that the lapses in credit monitoring will turn advances into NPA.

c. **Hypothesis III**

**Background**

The growing blockage of huge funds in non-performing assets and the poor recoveries has compelled bankers to consider recovery as a key performance area. So all
efforts are required to be made, at all levels in the bank, for recovery of advances. Recovery action starts with a reminder letter to the borrowers. All borrowers may not respond and therefore it becomes essential to visit them personally. Generally speaking, every planned visit to a borrower’s premises help in recovery (Patel & Kaveri, 1998).

Parmer's (1995) study found that out of nine independent controllable variables considered, one single variable namely number of follow-up visits has positive correlation with recovery.

Hence the relationship between follow-up visits and recovery percentage has been further tested in recent context.

Hypothesis III: The number of follow-up visits by bank staff has positive correlation with recovery of NPAs.

1.3 Relevance Of The Research

From literature surveyed, it has been found that studies related to credit risk in the Indian context has been mostly on the curative aspect i.e. on NPA management. But today, in the competitive business scenario the banker needs to gear up to the extend quality lending which will ensure that there is no growth of fresh NPAs. Today bankers' performance is linked with the quality of assets they are handling in their portfolio of loans. Therefore, unless the bankers try to prevent assets from becoming non-performing they cannot expect their banks to do well. Today, the preventive aspect of credit risk management is more important in order to arrest fresh NPAs. It is also important that the curative approach of reducing NPAs needs to be addressed seriously. This research attempts to look into both these aspects of credit risk management.

It needs no mention that the relevance of research grows when it is done at the micro level. Credit culture is region specific and hence the causes for NPA and its recovery also tend to be typical of a particular region. Grass root level studies are limited in number and mostly confined to regions outside the North-Eastern Region. Serious studies relating to credit risk of banks in the north-eastern region is yet to be seen. Hence, relevance of the study in this region becomes more essential. Further the relevance of the research work will be more prominent in view of the Basel II norms to be implemented on 31st March, 2007 by Indian banks.

This research thus, covers both the preventive and curative aspects of credit risk management practice of the public sector banks operating in the North-Eastern Region.
This research has addressed few issues which would enlighten and help banks in modifying their new credit rating models and appraisal systems. This research significantly contributes to the better management of credit risk by banks in particular and refinement or modification of banks' credit rating systems.

a. **Academic Relevance**—While there is a growing empirical literature on external ratings, there is still very little research work on banks internal rating systems, especially their effectiveness in the context of Basel II requirements. This research addresses many issues on the development of internal ratings and identify areas of weaknesses, which model developers need to look into. Further it suggests direction for future research in the light of the New Capital Accord (Basel II) of the Basel Committee on Banking Supervision (BCBS).

b. **Relevance to the Industry**—The major cause of serious banking problems continue to be strictly related to the low quality of credit, poor portfolio risk management and insensitivity to changes in economic and other environmental variables. For banks, loans are the largest and most obvious source of credit risk. Therefore, for effective management of credit risk, focused attention on credit delivery, review and recovery of loans is a pre-requisite. The study is aimed at this – an evaluation of the credit delivery, review and recovery process.

Thus this research has relevance for practitioners as it critically assesses the banks’ rating models and the parameters used in such models. Moreover, the study has attempted to suggest a system which could identify and predict the borrower health at the stage of loan appraisal. This will help banks to refine their credit rating models in order to manage credit risk in the context of Basel II requirements.
Narasimham Committee on Financial Sector Reforms

The problem of NPAs was first brought into focus by the Narasimhan Committee on financial system (1991), set up at the advent of the liberalization process. It was pointed out by the Committee that the genesis of the problem was in the laxity of the prudential norms relating to income recognition, asset classification and provisioning (refer Appendix 1.2). The Committee among other things placed emphasis on identifying problem loans of banks and making provision for such loans and so instituted a proper definition of NPAs. Apart from identification of bad assets, the Committee also suggested some ways to deal with them. In order to speed up the process of recovery of problem loans, it recommended the setting up of Debt Recovery Tribunals to adjudicate on bad debts of banks and also of an Asset Reconstruction Fund to take such loans off the bank’s balance sheets. At the same time, to improve the financial health of banks, several other measures relating to freeing of interest rates on deposits and advances, reduction of cash reserve ratio (CRR) and statutory liquidity ratio (SLR) and deregulation of entry of new private sector banks, etc were taken by RBI. During 1991 to 1998, we see the implementation of the Committee recommendations in the form of reduction of Bank Rate from 12 to 9%, CRR from 15 to 11% and SLR from 38.5 to 25%. To reduce dependence on government, PSBs were allowed to access the capital market to raise equity.

The Narasimham Committee on Banking Sector Reforms (1998) suggested the second-generation reforms. For improving the financial health of banks, the Committee mainly stressed improved capital adequacy along with asset classification norms and resolution of NPA related problems.

Recommendations of the Narasimham Committee (1998):

- The Committee recommended that the capital adequacy ratio be increased to 9 percent by 2000 and further to 10 percent by 2002.

- It also suggested that measures of capital adequacy should take into account the market risk of the bank’s assets along with the credit risk. In this context, banks were encouraged to undertake risk management practices by adopting value at risk (VaR) modeling that takes care of market price fluctuations, foreign exchange rate volatility.
and interest rate changes. Further, it proposed that the entire portfolio of government securities with banks be market to market within a three-year period.

- Regarding prudential norms, the Committee suggested that an asset be classified as "doubtful" if it is in the substandard category for 18 months to begin with, and this be reduced to 12 months gradually. The Committee suggested that banks be asked to adopt the international standard with respect to income recognition, thereby reducing the relevant time period from 180 days to 90 days.

- As for NPAs, it was proposed that the average level of net NPAs as a fraction of credit outstanding for all banks be reduced to 5 per cent or less by 2000 and to 3 per cent by 2002. For banks with international presence, the corresponding targets for gross and net NPAs were proposed to be 5 per cent and 3 per cent, and 3 per cent and 0 per cent, respectively.

- The Committee expressed concern over the financial health of banks and recommended two criteria for identifying a weak bank. These were: (a) accumulated losses and net NPAs exceed the net worth of the bank, and (b) operating profits less the income on recapitalisation bonds have been negative for three consecutive years.

- For banks with high NPA portfolio, the Committee proposed the establishment of an Asset Reconstruction Company (ARC) to tide over the backlog of NPAs. ARCs would issue bonds guaranteed by government and the proceeds from these would be used to buy the bad assets of banks at a discount.

- The Committee, however, discouraged recapitalisation of banks using government funds.

- To bring about efficiency, the Committee prescribed measures to improve customer servicing through extensive application of information and communication technology, employment of competent and skilled labour, reduction of overstaffing, especially in PSBs, simplification of documentation systems, introduction of computer audit, etc.

Appendix 1.1 b

Recommendations of the Verma Committee (1999)

The Verma Committee formed in order to formulate appropriate policies to deal with weak PSBs, emphasized that "NPAs have been the single most vexing problem faced by the public sector banks. Banks that have been identified as weak are mainly so because of the loss of their income, high carrying costs of NPAs both in terms of their funding as well as provisioning and the general stagnation of operations caused by the NPAs in their books" (RBI, 1999a). The Committee pointed out that the dismal performance of the weak PSBs were not merely on account of exogenous shocks, but also attributable to internal problems like limited number of products, poor risk management systems and mediocre service. The Committee identified three weak PSBs, viz. Indian Bank, UCO Bank and United Bank of India, on the basis of seven parameters related to solvency, earning capacity and profitability. However, the Committee concluded that mergers and narrow banking are unlikely to resolve the problem of weak banks. Hence, the Committee prescribed operational and organizational restructuring.

In line with the recommendations of these Committees, a number of steps have been taken to resolve the problems of NPA. Significant moves have been undertaken by the Govt. like abolition of SICA (Sick Industries Companies Act) in 2001, promulgation of the NPA Ordinance in 2002 to remove the constraints faced in the recovery process.

Apart from significant strengthening of prudential norms, the central bank has instructed banks to improve their screening and monitoring of loans and disclose more information in order to enhance the transparency of the system. The RBI is emphasizing the establishment and enforcement of internal procedures for the management of risk, credit assessment and approval, and monitoring of borrower’s performance to ensure timely payment of interest as well as principal.

Appendix 1.2

Prudential Norms

Reserve Bank of India started implementing the prudential guidelines on asset classification, income recognition and provisioning on loan assets based on the recommendations of the Narasimham Committee, in a phased manner commencing with the accounting year beginning from 1st April, 1992.

A. Asset Classification

Loan accounts are required to be classified as four categories to assess the general quality of portfolio and also for making provision against loan losses. These are Standard Assets, Sub-standard Assets, Doubtful Assets and Loss Assets. The latter three types of assets are called Non-performing Assets.

Standard assets is one which does not disclose any problems and which does not carry more than normal risk to the business.

Non-Performing Assets (NPA): A non-performing asset (NPA) was defined as a credit facility in respect of which the interest and/ or instalment of principal has remained 'past due' for a specified period of time. The specified period was reduced in a phased manner as under:

<table>
<thead>
<tr>
<th>Year ending March 31</th>
<th>Specified Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>four quarters</td>
</tr>
<tr>
<td>1994</td>
<td>three quarters</td>
</tr>
<tr>
<td>1995</td>
<td>two quarters</td>
</tr>
</tbody>
</table>

An amount due under any facility is treated as "past due" when it has not been paid within 30 days from the due date. Due to improvements in the payment, recovery climate, upgradation of technology, etc., it was decided to dispense with 'past due concept' with effect from March 31, 2001. Accordingly, as from that date, a Non-performing Asset shall be an advance where i) interest and/ or instalment of principal remain overdue (not paid on due date fixed by bank) for a period of more than 180 days in respect of Term Loan, ii) the account remains 'out of order' i.e. outstanding balance remains continuously in excess of the sanctioned limit/ drawing power or in case where outstanding balance is within sanctioned limit/ drawing power but there are no credits continuously for 180 days as on the Balance Sheet date or credits are not enough to cover the interest debited during the same period, in respect of an Overdraft/cash Credit (OD/CC), iii) the bill remains overdue for a period of more than 180 days in respect of bill purchased and discounted, iv) interest and/ or instalment of principal remains overdue.
Appendix 1.2 (...contd)

for two harvest seasons but for a period not exceeding two half years in the case of an agricultural advance and v) any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

With a view to moving towards international best practices and to ensure greater transparency, the '90 days overdue' norm for identification of NPAs has been adopted, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or advance where i) interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of Term Loan, ii) the account remains 'out of order' for 90 days in respect of an Overdraft/cash Credit (OD/CC), iii) the bill remains overdue for a period of more than 90 days in respect of bill purchased and discounted, iv) interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an agricultural advance. With effect from September 30, 2004, a loan granted for long duration crops will be treated as NPA if the instalment of principal or interest thereon remains overdue for one crop season and v) any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

NPA Categories

Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing: a) Sub-standard Assets b) Doubtful Assets and c) Loss Assets. Sub-standard is one, which was classified as NPA for a period not exceeding two years. With effect from 31 March 2001, a sub-standard asset is one, which has remained NPA for a period less than or equal to 18 months. With effect from 31 March 2005, a sub-standard asset is one, which has remained NPA for a period less than or equal to 12 months. A doubtful asset was one, which remained NPA for a period exceeding two years. With effect from 31 March 2001, an asset is to be classified as doubtful, if it has remained NPA for a period exceeding 18 months. With effect from March 31, 2005, an asset is classified as doubtful if it remained in the sub-standard category for 12 months. A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectable and of such value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.
Appendix 1.2 (...contd)

B. **Income Recognition**

The Narasimham Committee had recommended that income stops accruing when interest or instalment of principal is not paid within 180 days (90 days at present). Thus banks cannot credit income to their profit and loss account to the debit of loan account unless recovery takes place. Income stops accruing on an NPA account.

C. **Provisioning for Loans/advances**

Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security and the erosion over time in the value of security charged to the banks, provision is to be made in the following manner:

- **Loss Assets**: 100% of the outstanding to be provided for

- **Doubtful Assets**:
  
  a. 100% of the extent to which the advance is not covered by the realizable value (unsecured portion) of the security.
  
  b. Depending upon the period for which loan assets has remained doubtful, the provision are required to be made on the secured portion as follows:

  - Upto one year: 20%
  - One to three years: 30%
  - More than 3 years:
    - Prior to 31.03.05: 50%
    - W.e.f 31.03.05: 60%
    - W.e.f 31.03.06: 75%
    - W.e.f 31.03.07: 100%

- **Sub-standard Asset**: A general provision of 10% of total outstanding is to be made in case of secured advances. An additional 10% is to be provided for in case of unsecured advances i.e., advances where the realizable value of security is less than 10% of the outstanding exposure.

- **Standard Asset**: With effect from 31.03.00, a provision of 0.25% of total outstanding is made on standard assets.

D. **Capital Adequacy Norms**

The Narasimham Committee recommended that the minimum capital to risk assets ratio to be increased to 10% from the then existing level of 8%. Presently, as per RBI norms the capital adequacy ratio should be 9%. This is stringent than Basel II.