NPAs IN BANKS: A THEORETICAL FRAMEWORK

Purpose and Overview

As the present study is mainly centered round the NPAs of DCCBs with particular focus on the KDCC Bank, it was considered necessary to provide a detailed theoretical framework of NPAs as applicable to DCCBs. The DCCBs come under the regulatory and supervisory framework of the NABARD. The definition of NPAs as provided by NABARD and its Prudential Norms on (i) Income Recognition, (ii) Asset Classification and (iii) Provisioning Requirements as explained in the succeeding paragraphs are applicable to all DCCBs. An attempt is therefore, made in this Chapter to provide a comprehensive theoretical framework as applicable to DCCBs in the light of the NABARD guidelines.

Definition of NPA

An asset becomes non-performing when it ceases to generate income for the bank. A non-performing asset is defined generally as “a credit facility in respect of which interest and/or instalment of principal has remained ‘past due’ for two quarters or more”. An amount due under any credit facility is treated as ‘past due’ when it has not been paid within 30 days from the due date.

With effect from 31 March 2001, it was decided to dispense with ‘past due’ concept and in place of the concept of ‘past due’ two new concepts have been introduced i.e., ‘out of order’ and ‘overdue’ explained below:

Out of Order

In respect of cash credit / overdraft facility an account should be treated as ‘out of order’, if the outstanding balance remains continuously in excess of the sanctioned limit / drawing power. In case where the outstanding balance in the principal operating account is
less than the sanctioned limit / drawing power, but there are no credits continuously for six months as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as ‘out of order’.

**Overdue**

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

**Treatment of Different Types of Loans and Advances as NPAs**

As from 31st March, 2001, different types of advances are treated as NPAs as under:

(1) **Term Loan**

Term loan shall be considered as NPA if the interest and / principal remains overdue for a period of more than 180 days.

(2) **Overdraft / Cash Credit**

Overdraft / Cash Credit shall be considered as a NPA if the account remains ‘out-of order’ for a period of more than 180 days.

(3) **Bills Purchased and Discounted**

Bill purchased and discounted shall be considered as a NPA if the bill remains overdue for a period of more than 180 days.

(4) **Agricultural Advances**

Advance granted for agricultural purposes shall be considered as NPA if the interest and / principal remains overdue for two harvest seasons but for a period not exceeding two
half years. Where interest payment is on half-yearly basis, synchronising with harvest, banks should adopt the agricultural season as the basis. In other words, if interest has not been paid during the last two seasons of harvest (covering two half-years) after the principal has become overdue then such an advance should be treated as NPA. This norm is applicable to all direct agricultural advances. In respect of agricultural advances other than direct agricultural advances, identification of NPA would be done on the same basis as non-agricultural advances which at present is the 180 days delinquency norm. Crop loans for each season, viz., Rabi and Kharif has to be treated as separate account and IRAC norms have to be applied accordingly.

(5) Advances for Allied Agricultural Activities as well as Non-Farm Sector

Credit facilities granted for other allied agricultural activities as well as for non-farm sector activities should be treated as NPA if amounts of instalments of principal and / or interest remain outstanding for a period of two quarters from the due date.

(6) Project / Housing Loans, etc.

In case of projects (industry, plantation, etc.) where moratorium is given for payment, [ loan becomes due only after moratorium or gestation period is over ] such a loan becomes overdue if instalment is not paid on due date. Similarly, in the case of housing loans or similar advances granted to staff members where interest is payable after recovery of principal, such loans should be classified as NPA when there is a default in repayment of principal on due date of payment and overdue criteria will be the basis for classification of assets.

(7) Consortium Advances

In respect of consortium advances each bank is required to classify the borrowal accounts according to its own recovery, i.e., on the record of recovery of the individual member banks. The banks participating in the consortium should therefore, arrange to get their share of recovery transferred from the lead bank of the consortium.
(8) Other Accounts

Other accounts shall be considered as NPA if the amount remains overdue for a period of more than 180 days.

(9) Different Facilities to Borrower

Short-term agricultural advances are granted by SCBs / DCCBs to DCCBs / PACs respectively for the purpose of on-lending. In respect of such advances as well as advances for other purposes, if any, granted under on-lending system, only that particular facility which became irregular should be treated as NPA and not all the other facilities granted to them. Crop loans for each season, viz., Rabi and Kharif have to be treated as separate accounts and accordingly IRAC norms have to be applied. In respect of all other direct loans and advances granted to a borrower, all such loans will become NPA even if one loan account becomes NPA.

(10) Performance of the Account as on the Date of Balance Sheet

The performance of the account as on the date of Balance Sheet only has to be taken into account for the purpose of NPA. Subsequent developments should not be considered for determining NPAs.

If interest and / or instalment of principal has remained unpaid for any two quarters out of the four quarters ending 31 March of the year concerned, the credit facility should be treated as NPA although the default may not be continuously for two quarters during the year.

PRUDENTIAL NORMS ON INCOME RECOGNITION

Income Recognition Policy

(1) The policy of income recognition should be based on record of recovery and therefore unrealised income should not be taken to Profit and Loss Account by SCBs / DCCBs.
However, in the case of certain States where the State Co-operative Act / Rules / Audit Manual provide for taking such unrealised interest to the income head in the Profit and Loss Account, it is necessary for those SCBs / DCCBs to make full provisioning for equivalent amount by charging to Profit and Loss Account. In other words, the SCBs / DCCBs which are charging interest on all overdue loans and if such interest remains unrealised the same may be taken to income account provided matching provision is fully made for the same by charging to Profit and Loss Account.

(2) Fee, commission and other income may be treated as income only when the account is classified as 'standard'. Besides, a matching provision should be created to the extent such items were treated as income in the previous year but not realised in the subsequent year.

(3) Fees and commission earned by banks as a result of renegotiation or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

(4) Even in case of credit facilities backed by Government Guarantee, overdue interest can be taken to Profit and Loss Account only if matching provision is made.

(5) The bills purchased / discounted should be treated as overdue, if the same remain unpaid. Interest may be charged on such bills and the same may be taken to Profit and Loss Account provided matching provision is made.

(6) Accrued interest on investments may be taken to Profit and Loss Account till maturity. However, the same has to be provided for fully, if interest is not realised on due date / date of maturity.

Reversal of Income

(1) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for, if the same is not realised. This will apply to Government guaranteed loan accounts also.
2) In respect of fees, commission and similar incomes that have accrued and credited to income account in the corresponding previous year, should be reversed or provided for with respect to past periods, if uncollected.

Appropriation of Recovery in NPAs

(1) Interest realised on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh / additional credit facilities sanctioned to the borrowers concerned.

(2) In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks should adopt the accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

PRUDENTIAL NORMS ON ASSET CLASSIFICATION

Criteria for Classification of Assets

Classification of agricultural and non-agricultural loans is required to be done into four categories, on the basis of age of overdues, as under:

(1) Standard Assets

Standard Asset is one which does not disclose any problem and which does not carry more than normal risk attached to business. Thus, in general, all the current loans, agricultural and non-agricultural loans which have not become NPA may be treated as Standard Asset.

(2) Sub-Standard Assets

A Non-Performing Asset may be classified as Sub-Standard Asset on the basis of the following criteria:
(i) An asset which has remained overdue for a period not exceeding 3 years in respect of both agricultural and non-agricultural loans should be treated as Sub-Standard.

(ii) In case of all types of term loans, where instalments are overdue for a period not exceeding 3 years, the entire outstanding in term loan should be treated as Sub-Standard.

(iii) An asset, where the terms and conditions of the loans regarding payment of interest and repayment of principal have been renegotiated or rescheduled, after commencement of production, should be classified as Sub-Standard and should remain so in such category for at least two years of satisfactory performance under the renegotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling unless there is satisfactory compliance of the above condition.

(3) Doubtful Asset

A Non-Performing Asset may be classified as Doubtful Asset on the basis of following criteria:

As asset which has remained overdue for a period exceeding 3 years in respect of both agricultural and non-agricultural loans should be treated as doubtful. In case of all types of term loans, where instalments are overdue for more than 3 years, the entire outstanding in term loan should be treated as doubtful. As in the case of Sub-Standard Assets, rescheduling does not entitle a bank to upgrade the quality of advance automatically.

(4) Loss Asset

Loss Assets are those where loss is identified by the bank / auditor or RBI / NABARD inspectors but the amount has not been written off wholly or partly. In other words, an asset which is considered unrealisable and/or of such little value that its continuance as a Doubtful Asset is not worthwhile, should be treated as a Loss Asset. Such Loss Assets will include overdue loans in cases (a) where decrees or execution petitions have been time barred or documents are lost or no other legal proof is available to claim the debt, (b) where the borrowers and their sureties are declared insolvent or have died leaving no tangible
assets, (c) where the borrowers have left the area of operation of the society leaving no property and their sureties have also no means to pay the dues, (d) where the loan is fictitious or when gross misutilisation is noticed and (e) amounts which cannot be recovered in case of liquidated societies.

GUIDELINES FOR CLASSIFICATION OF ASSETS

Broadly speaking, classification of assets into above categories should be done taking into account the degree of well-defined credit weakness and the extent of dependence on collateral security for realisation of dues. Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts.

(1) Accounts Regularised Near About the Balance Sheet Date

The asset classification of borrowal accounts where a solitary or a few credits are recorded before the Balance Sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors / Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

Thus if these accounts of the borrowers have been regularised by repayment of all overdue amounts, such accounts need not be treated as NPA and straightaway they may be upgraded to standard category. The status of an NPA account in doubtful category cannot be changed on account of part payment of dues.

It is difficult to envisage a situation when only one facility to a borrower becomes a problem credit and not others. Therefore, all the facilities granted by a bank to a borrower will have to be treated as NPA and not the particular facility or part thereof which has become irregular. This norm will not be applicable in the case of on-lending through PACs.
(2) Accounts Where There is Erosion in the Value of Security

A NPA need not go through the various stages of classification in cases of serious credit impairment and such assets should be straightway classified as Doubtful or Loss Asset as appropriate. Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI / NABARD at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to Doubtful Assets.

If the realisable value of the security, as assessed by the bank / approved valuers / RBI / NABARD is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightway classified as Loss Asset. It may be either written off or provided for by the bank.

(3) Advances Against Term Deposits, NSCs, IVPs, KVPs and Life Policies

Advances against Term Deposits, NSCs, IVPs, KVPs and Life Policies need not be treated as NPAs. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

(4) Loans with Moratorium for Payment of Interest

(i) In the case of bank finance given for industrial projects or for agricultural plantations, etc., where moratorium is available for payment of interest, payment of interest becomes ‘due’ only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue or NPA, with reference to the date of debit of interest. They become overdue after due date for repayment of instalment of principal or after the due date for payment of interest, if uncollected.

(ii) In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans / advances should be classified as NPA only when there is
a default in repayment of instalment of principal or payment of interest on the respective due dates.

(5) Agricultural Advances

(i) In respect of advances granted for agricultural purposes where interest and / or instalment of principal remains unpaid after it has become overdue for two harvest seasons but for a period not exceeding two half-years, such advances should be treated as NPA. The above norms should be made applicable to all direct agricultural advances. In respect of other agricultural advances including allied activities, assessment of NPA would be done as in the case of non-agricultural advances.

(ii) In case of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and / or instalment of principal remains unpaid, after it has become overdue for two harvest seasons but for a period not exceeding two half years. However, term loans which have been rephased / rescheduled after they have become NPA, should continue to be classified in the same category (Rescheduling / Rephasement will not change the NPA status).

(6) Government Guaranteed Advances

The credit facilities backed by guarantee of the State Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPAs is not for the purpose of recognition of income. With effect from 1st April, 2000, advances sanctioned against State Government guarantees should be classified as NPA and should be fully provided for in that year, if the guarantee is invoked and remains in default for more than 180 days. As regard advances guaranteed by State Government which stood invoked as on 31st March, 2000 but were not honoured by the State Government and continue to be in default for more than 180 days, provisioning shall be made with a minimum of 25% each year during the period 31st March, 2000 to 2003. Advances guaranteed by State Governments where the guarantee has been invoked on or after 1st April, 2000 and has
remained in default for more than two quarters should be classified as NPAs with effect from 1st April, 2000 and should be fully provided for from the year ending 31st March, 2001.

(7) Availability of Security / Networth of Borrower / Guarantor

The availability of security or net worth of borrower / guarantor should not be taken into account for the purpose of classifying an advance as NPA or otherwise, as income recognition and classification of assets is based on recovery.

(8) Amount Involved in Frauds

Amount involved in frauds should be classified as Sub-Standard, Doubtful and Loss Assets depending upon the prospects of recovery within a reasonable time frame, say 2 years, in each case on the basis of availability of insurance cover, court decree, security deposit / fidelity guarantee (in the case of employees).

(9) Deficit in Cadre Fund

The amount outstanding in the Cadre Fund has to be considered as Loss Asset and should be provided for fully, if no firm commitment from the State Government is forthcoming supported by suitable provision in the State budget.

(11) Asset Classification to be Done at Branch Level

Asset classification has to be done at Branch Level as the lending is done by the branches of the bank and relevant records are maintained at their level. However, provisioning is to be done at Head Office Level as preparation of financial statements for the entire bank is done at Head Office Level.
PRUDENTIAL NORMS ON PROVISIONING REQUIREMENTS

Need for Provisioning

Provisioning is necessary considering the erosion in the value of security charged to the banks over a period of time. Therefore, after the assets of DCCBs / SCBs are classified into various categories (viz., Standard, Sub-Standard, Doubtful and Loss Assets) necessary provision has to be made for the same. The details of provisioning requirements in respect of various categories of assets are mentioned below:

(1) Provisioning for Standard Assets

When the IRAC norms were introduced in the year 1996-97, no provisioning was required in respect of Standard Assets. From the year ended 31st March, 2000 banks are required to make provision on Standard Assets at a minimum of 0.25% of the total outstanding in this category. The advances granted against Term Deposits, National Savings Certificates (NSCs) eligible for surrender, Kisan Vikas Patras (KVPs), Indira Vikas Patras (IVPs), Life Policies, Staff Loans would attract provision of 0.25% prescribed for Standard Assets. The provision towards Standard Assets need not be netted from gross advances and should be shown separately as "Contingent Provision against Standard Assets" under "Other Liabilities and Provisions–Others".

(2) Provisioning for Sub-Standard Assets

A general provision of 10% of total outstanding in this category may be made.

(3) Provisioning for Doubtful Assets

(a) 100% is to be made to the extent to which the advance is not covered by realisable value of securities to which the bank has valid recourse and the realisable value is estimated on a realistic basis.
(b) Over and above item (a), provision is to be made depending upon the period for which an asset has remained overdue, 20% to 50% of the secured portion on the following basis:

<table>
<thead>
<tr>
<th>Criteria</th>
<th>% Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overdue more than 3 years but not exceeding 4 years</td>
<td>20</td>
</tr>
<tr>
<td>Overdue more than 4 years but not exceeding 6 years</td>
<td>30</td>
</tr>
<tr>
<td>Overdue exceeding 6 years</td>
<td>50</td>
</tr>
</tbody>
</table>

(4) Provisioning for Loss Assets

The entire Loss Asset should be written off. If the assets are permitted to be retained in the books for any reasons, 100% of the outstandings thereof should be fully provided for.

PROVISIONING FOR DIFFERENT TYPES ASSETS AND LIABILITIES

(1) Agricultural Loans

All agricultural Loans may be treated as fully secured as the same are disbursed against charge on land as provided in the respective State Co-operative Societies Act and Rules made thereunder.

(2) Treatment to Provident Fund and Gratuity Amount

Liabilities towards Provident Fund and Gratuity should be estimated on actuarial basis and fully provided for.
(3) Loans Exempted from Provisioning

Advances against Term Deposits, NSCs eligible for surrender, IVPs, KVPs and life Policies are exempted from provisioning. Therefore, the above accounts may not be classified as NPA. As they are treated as Standard Assets, a provision of 0.25% of the total loans outstanding prescribed for Standard Assets should be made.

(4) Loans Against Gold / Government Securities

Advances against gold ornaments, government securities and all other kinds of securities are not exempted from provisioning requirements.

(5) Depreciation in Investments—Accounting Procedure

The investment portfolio of a bank would normally consist of both Approved Securities (predominantly Government Securities) and ‘Other Securities’ (shares, debentures and bonds of co-operative and other institutions). Investments in approved securities should be bifurcated into ‘permanent’ and ‘current’ investments. Permanent investments are those which banks intend to hold till maturity and current investments are those which banks intend to deal in i.e., buy and sell on a day-to-day basis. There is, however, no minimum percentage stipulated for bifurcation of investments into ‘permanent’ and ‘current’ category. As regards current investments and other securities, they should be valued at lower of cost price or market value. Investments in shares of co-operative institutions may be valued at carrying cost price.

(6) Provision for Other Assets / Outstanding Liabilities

Loss in respect of cash balances / deposits with other banks, amounts in branch adjustment accounts, frauds and embezzlements and depreciation on building, furniture and vehicles, etc., may be assessed and fully provided for as per the existing practice.

With a view to ensuring full disclosure on the profitability and net worth of the bank, items not provided for or items of liabilities where inadequate provisions have been made
(e.g. Gratuity, Provident Fund, Income Tax, Interest accrued on deposits/borrowings, etc.), the Inspecting Officers should specify the same to arrive at the unprovided for expenditure and treat them as actual expenditure for the purpose of arriving at the net worth.

(7) Back-End Subsidy Scheme

Banks are permitted to take the loan outstanding under the Back-End Subsidy Scheme net of subsidy amount and make provision only on the balance amount. This relaxation is for the purpose of making provisions only and not for other purposes, such as for computation of gross loans and advances, asset classification, etc.

(8) Relaxation in Provisioning Norms

In order to give adequate time to co-operative banks to adjust themselves to the new system, phasing of provision was permitted as indicated below:

(i) First year of Introduction of Prudential Norms 1996-97

100% in respect of Loss Assets and not less than 30% of the provisioning needed in respect of Sub-Standard and Doubtful Assets.

(ii) Second Year 1997-98

100% in respect of Loss Assets and 20% of residual amount of Sub-Standard / Doubtful Assets together with current provision needed in respect of such assets classified in the second year.

(iii) Third Year 1998-99

100% in respect of Loss Assets and 20% of residual amount of Sub-Standard / Doubtful together with current provision needed in respect of such assets classified in the third year.
(iv) **Fourth Year 1999 – 2000**

100% in respect of Loss Assets and 30% of residual amount of Sub-Standard / Doubtful Assets together with current provision needed in respect of such assets classified in the fourth year.

In other words, all Doubtful and Sub-Standard Assets have to be provided fully from the fourth year onwards in addition to 100% for Loss Assets.

**Adoption of 90 Days’ Norm With Effect From 31-03-2006 for Classification of Non-Agricultural Loan or Advance as NPA**

A non-agricultural loan or advance is classified as NPA if interest and / or principal remain overdue for a period of more than 180 days. With effect from 31st March, 2006 a non-agricultural loan or advance shall be classified as NPA if –

(a) interest and / or principal remain overdue for a period of more than 90 days in respect of a term loan;

(b) the account remains ‘out of order’ for a period of more than 90 days, in respect of an overdraft / cash credit;

(c) the bill remains overdue for a period of more than 90 days in case of bill purchased / discounted ; or

(d) any amount to be received remains overdue for a period of more than 90 days in respect other accounts

Agricultural loan or advance will continue to be classified as NPA if interest and / or principal remain overdue for two harvest seasons but for a period not exceeding two half years. But other agricultural loans or advances including those for activities allied to
agriculture, 90 days' delinquency norm will be applicable with effect from 31st March, 2006.

**Provisioning With Effect From 31st March, 2004 for Smooth Transition to 90 Days' Norm With Effect From 31st March, 2006**

The DCCBs are required to chalk out an appropriate transition path for smoothly moving over to 90 days' norm. As a facilitating measure, the banks should move over to charging interest on monthly rests by 1st April, 2004 except for agricultural loans and loans for activities allied to agriculture. However, the date of classification of loan or advance as NPA should not be changed on account of interest at monthly rests. The DCCBs should therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 180 days from the end of the quarter with effect from 1st April, 2004 and with effect from 31st March, 2006 within 90 days from the end of the quarter. The DCCBs are required to substantially upgrade their existing Management Information System for collecting data on loans, where interest and / or instalment of principal remain overdue for a period of more than 90 days in order to crystallise NPAs on 90 days' norm.

The DCCBs should also commence making additional provision for such loans (i.e., loans where the interest and / or instalment of principal has remained overdue for more than 90 days but less than 180 days), starting from the year ending 31st March 2004 in a phased manner as detailed below. Such additional provisions would strengthen the Balance Sheets of DCCBs ensure their smooth transition to the 90 days' norm with effect from 31st March, 2006.

1. 25 % of the additional provisioning to be provided by 31st March, 2004.
2. 50 % of the additional provisioning to be provided by 31st March, 2005.
3. 100 % of the additional provisioning to be provided by 31st March, 2006.