CHAPTER - VIII

STRATEGIES TO CONTROL NON PERFORMING ASSETS

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8.1 MEASURES TOWARDS RECOMMENDATIONS OF NARASIMHAM COMMITTEE

In the last more than five decades since independence, Banking in India has evolved through four distinct phases, i.e. (1) Foundation phase from 1950 to 1969; (2) Expansion phase from 1969 to 1984; (3) Consolidation phase from 1985 to 1990; and (4) Reform phase from 1991 onwards. For preserving the soundness of Banking system in India, it was felt necessary in 1990 that Banks/Financial Institutions should have effective risk management system, adequate capital provision, sound practices of supervision and regulation, transparency of operation, conducive Public Policy intervention, maintenance of Macroeconomic stability in the economy and so on.

The Committee on Financial system, well known as the Narasimham Committee, set up in 1991, to recommend measures for bringing about necessary reforms in the financial sector, did acknowledge the spectacular success of the public sector banks since the major banks were nationalized on 19 July 1969. But for twenty years after the nationalization, such spectacular development was witnessed in the spread of branch network of banks, mobilization of savings and in creating employment opportunities for half a million persons, rather than in the improvement of the services to the customers. Frauds, corruption and misutilization of public money were discovered and as many economists warned, if that trend would continue without any change, the banking industry might become a white elephant by the turn of the present century.

Further, the viability of a number of public sector banks became a matter of great concern, involving as it did, the savings of a huge number of people. The systematic and effective supervision and regulation of the banking and non-banking financial systems did not keep pace with the developments in these areas. In order to support the major changes that took place in trade and industrial policies and to protect the depositors and the investors, a thorough
review of the financial system was felt necessary. Hence, the Narasimham Committee was set up by the Government of India in August 1991 which submitted its Report within three months, i.e. in November of the same year. The rationale underlying the necessity of reforms in the financial system of the country may be recapitulated as follows.

(a) Productivity and efficiency of the system had suffered;
(b) Its portfolio quality had badly deteriorated;
(c) Its profitability had been eroded.
(d) Several public sector banks and financial institutions had become weak financially;
(e) Some public sector banks had been incurring losses year after year,
(f) Their customer service was poor.
(g) Their work technology was outmoded; and
(h) They were unable to meet the challenges of a competitive environment.

The Narasimham Committee in its report had proposed wide ranging reforms for:

(a) improving the financial viability of the banks;
(b) increasing their autonomy from Government direction;
(c) restructuring unviable banks;
(d) allowing a greater entry to the private sector in banking;
(e) furthering operational flexibility and competition among the financial institutions;
(f) liberalizing the capital market; and
(g) setting up of proper supervisory system.

The Committee made separate recommendations for the reform of: (1) the Banking Sector, (2) the Public Sector Financial Institutions, and (3) the Money and Capital
markets. We need not summarize these recommendations in this chapter as a lot has been said, analysed and discussed in various fora and the researcher needs not repeat it. Suffice it to say that the Government accepted all the major recommendations of the committee despite opposition from trade unions, political parties and the Finance Ministry officials. The Government started implementing them right away and the progress of the reform measures taken from 1991-92 till recently has been remarkable.

The aforesaid radical reforms taken as per the recommendations of the Narasimham Committee, have since changed the face and prospects of Indian banking and other financial institutions and intermediaries.

There had been improvement in several of the quantitative indices but there were many areas in which weaknesses still persisted. These included customer service, technological upgradation, improvement in housekeeping in terms of reconciliation of entries and balancing of books. The approach to handle the problem of NPAs differed from the Committee's recommendations.

It was against this backdrop that the Government considered it necessary to appoint a committee in November 1997 under the chairmanship of Mr. M. Narasimham himself to review the progress of banking sector reforms to date and chart a programme for further reforms necessary to strengthen India's financial system so as to make it internationally competitive. The Second Report was submitted on 23 April 1998. The Report sets the pace for the second generation of banking sector reforms.

After the second Narasimham committee was set, the former which was constituted in 1991 was popularly called Narasimham committee-I and the latter one which was formed in 1998 as Narasimham committee-II. In this chapter, we shall be discussing about recommendations and action taken on them in respect of the second committee. The following presentation throws light upon these two aspects.
Committee on Banking Sector Reforms (Narasimham Committee II) - Action taken on the recommendations

**RECOMMENDATIONS**

**Measures to strengthen the banking system:**

**Capital Adequacy:**

1. The Committee suggests that capital adequacy requirements take into account market risks in addition to the credit risks.

2. In the next three years, the entire portfolio of Government securities should be marked to market and this schedule of adjustment should be announced at the earliest.

3. The risk weight for a Government guaranteed advance should be the same as for other advances.

4. The Committee recommends that the minimum capital to risk assets ratio be increased to 10% from its present level of 8%, with an intermediate minimum target of 9% be achieved by the year 2000 and the ratio of 10% by 2002.

5. In respect of PSBs, the additional capital requirement will have to come from either the Govt. or the market.

**Asset quality, NPAs and Directed Credit:**

6. The Committee recommends that an asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off.

7. Introduction of the norm of 90 days for income recognition in a phased manner.

8. The committee has noted that NPA figures do not include advances covered by Government guarantees which have turned sticky and which in the absence of such guarantees would have been classified as NPA.

**ACTION TAKEN**

Banks are now required to assign for market risk. A risk weight of 2.5% for market risk has been introduced on investments in Govt. and other approved securities with effect from the year ending 31st March 2000.

For the year ending 31st March, 2000, banks were required to mark-to-market 75% of their investments in govt. and approved securities.

In cases of Govt. guaranteed advances, where the guarantee has been invoked and the concerned State Govt. has remained in default as on March 31, 2000, a risk weight of 20% on such advances, has been introduced.

The minimum capital to risk asset ratio (CRAR) for banks has been enhanced to 9% with effect from the year ending March 31, 2000.

Banks are permitted to access the capital market. Till recently 12 banks have already accessed capital market.

Banks have been advised that an asset will be classified as doubtful if it has remained in the substandard category for 18 months instead of 24 months as at present by March 31, 2001.

In the Monetary and Credit Policy announced in April 2001, the banks have been advised to chalk out an appropriate transition path for smoothly moving over to 90 days norm by March 31, 2004.

Prudential norms in respect of advances guaranteed by State Government where guarantee has been invoked and has remained in default for more than two quarters has been introduced in respect of advances sanctioned against State Government guarantee with effect from April 1, 2000.

Banks have been advised to make provisions for advances guaranteed by State Governments which stood invoked as on March 31, 2000, in phases, during the financial year ending March 31, 2000 to March, 2003 with a minimum of 25% each year.

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9. Banks and financial institutions should avoid the practice of "evergreening" by making fresh advances to their troubled constituents.

10. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5% by the year 2000 and to 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5% and 3% by the year 2000 and 2002, respectively, and net NPAs to 3% and 0% by these dates.

11. The Committee is of the firm view that in any effort at financial restructuring in the form of write-off the NPA portfolio from the books of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring.

12. For banks with a high a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the earlier CFS. In the first approach, all loan assets in the doubtful and loss categories could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds.

13. An alternative approach could be to enable the banks in difficulty to issue bonds which could form part of Tier II capital.

14. There is continuing need for banks to extend credit to agriculture and small scale sector which are important segments of the national economy on commercial considerations and on the basis of creditworthiness.

15. The Committee recommends that the interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs. 2 lakh should be deregulated for scheduled commercial banks.

16. With regard to income recognition, in India, income stops accruing when interest or instalment of principal is not paid within 180 days. The Committee recommends the introduction of the norm of 90 days in a phased manner by the year 2002.

17. At present, there is no requirement in India for a general provision on standard assets. In the Committee's view a general provision, say of 1% would be appropriate and RBI should consider its introduction in a phased manner.

The RBI has reiterated that banks and financial institutions should adhere to the prudential norms on asset classification provisioning, etc. and avoid the practice of "evergreening".

This is the long-term objective which RBI wants to pursue. Towards this direction a number of measures have been taken to arrest the growth of NPAs.

Banks have been advised to take effective steps for reduction of NPAs and also put in place risk management systems and practices to prevent re-emergence of fresh NPAs.

The proposal to set up an Asset Reconstruction Company (ARC) on a pilot basis to take over the NPAs of the three weak public sector banks, has been announced in the Union Budget for 1999-2000. The modalities for setting up the ARC are almost at final stages.

Banks are permitted to issue bonds for augmenting their Tier II capital.

The loans to agricultural and SSI sectors are now generally being granted on commercial considerations and on the basis of creditworthiness of the borrower.

As a first step towards deregulation of interest rates in the Monetary and Credit Policy announced in April, 1998, it has been stipulated that interest rates on loans up to Rs. 2 lakh should not exceed PLR which the banks are free to decide.

Considering the need to bring our norms in line with the best international practices, the recommendations made by the Committee would form long term objective. As the level of gross NPAs of banks come down because of better management practices, the recommendation to introduce the norm of 90 days will be examined in coming years by RBI.

To start with, a general provision on standard assets of a minimum of 0.25% from the year ended March 31, 2000 has been introduced.
18. There is a need for disclosure, in a prudent manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account and NPAs.

Banks are advised to disclose the following additional information from the accounting year ended March 31, 2000.

(i) Maturity pattern of loans and advances.
(ii) Maturity pattern of investment securities.
(iii) Foreign currency assets and liabilities
(iv) Movement in NPAs.
(v) Maturity pattern of deposits
(vi) Maturity pattern of borrowings
(vii) Lending to sensitive sectors as defined from time to time.

19. Banks should also pay greater attention to asset liability management to avoid mismatches and to cover, among others, liquidity and interest rate risks.

Detailed guidelines have been issued to banks on asset-liability management.

20. Banks should be encouraged to adopt statistical risk management techniques like value-at-Risk in respect of balance sheet items.

Comprehensive guidelines have been issued to enable banks to put in place appropriate risk management systems.

Systems and Methods in Banks:

21. An area requiring close scrutiny in the coming years would be computer audit, in view of large scale usage and reliance on information technology.

RBI had in 1992 emphasised to banks the importance of an effective management reporting system, segregation of the trading and back office functions, etc. After the recommendations, RBI has once again reiterated to banks about its stance.

22. There is enough international experience to show the dangers to an institution arising out of inadequate reporting to and checking by the back offices of trading transactions and positions taken. Banks should pay special attention to this aspect.

Banks have been advised to set up EDP Audit Cell, as part of their Inspection Department.

23. There is need to institute an independent loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs.

The public sector banks have been advised to put in place an independent Loan Review mechanism.

24. The Committee notes that public sector banks and financial institutions have yet to introduce a system of recruiting skilled manpower from the open market and recommends the same in a big way.

The public sector banks have been permitted to recruit from the open market or by way of campus recruitment, skilled personnel in areas like information technology, risk management, treasury operations, etc.

25. The management of individual banks must initiate steps to measure what adjustments in the size of their work force is necessary for the banks to remain efficient, competitive and viable. It will, therefore, be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives.

While some of the public sector banks have introduced VRS after consultations with Employees’ Unions, others are in the process of introducing such schemes.

26. The Committee would urge the management of Indian banks to renew the changing training needs in individual banks keeping in mind their own business environment and to address these urgently.

Banks have been advised to review the training needs and give more focus to emerging areas like Credit Management, Treasury Management, Risk Management, Information Technology, etc.
27. Globally, banking and financial systems have undergone fundamental changes because of the ongoing revolution in information and communications technology. The Committee has tried to list out series of implementation steps for achieving rapid induction of information technology in the banking system.

A Working Group was set up with representation from public sector banks, technology experts, to operationalise and implement the programme of computerisation for banks within a definite time frame. All the recommendations of Group have been accepted for implementation. Three standing Committees to review security policies, message formats, software, to examine legal issues on electronic banking and to monitor progress of computerization of branches of banks handing Govt. transactions have been formed. Public Sector Banks have been advised to report technology progress on 20 shortlisted action points.

Structural Issues:

28. The Committee has taken note of the twin phenomena of consolidation and convergence which the financial system is now experiencing globally. In India also banks and DFIs are moving closer to each other in the scope of their activities. The Committee is of the view that with such convergence of activities between banks and DFIs, the DFIs should, over a period of time, convert themselves to banks. There would then be only two forms of intermediaries, viz. Banking companies and non-banking finance companies

29. Margins between banks and between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complementarities of the concerned institutions and must make sound commercial sense.

30. A 'weak bank' should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recapitalisation bonds is negative for three consecutive years.

31. The policy of licensing new private banks (other than local area banks) may continue. The start up capital requirements of Rs. 100 crore were set in 1993 and these may be reviewed.

32. The Committee is of the view that there is need for a reform of the deposit insurance scheme. In India deposits are insured upto Rs. 1 lakh. There is, however, need to shift away from the 'fat' rate premiums to 'risk based' or 'variable rate' premiums

33. There must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market.

34. The minimum period of FD be reduced to 15 days.
Effectiveness of pre-sanction appraisal and post-sanction follow up systems in a bank can be gauged from the level of NPAs in its credit portfolio. Both the systems are of great significance particularly, under the present scenario when the economy is globalising and financial reforms are taking place, thereby exposing the banks to greater credit related risks. Such risks may include business-industry outlook, financials, interest, quality of management, etc. Banks have to endeavour to upgrade their appraisal and monitoring systems so as to keep pace with the changing economic and financial environment. If these systems are strong these would help the bank in identifying and sanctioning the loan proposals which are technically, financially, commercially and economically sound and viable, as also in closer monitoring of the performance of the units and conduct of their accounts for identification of weaknesses, if any, and taking prompt corrective actions. Both the pre-sanction appraisal of projects and post-sanction supervision and follow-up of loan accounts in banks are discussed in detail as under.

8.2.a. Pre-Sanction Appraisal of Projects

Banks appoint technical/specialist staff for appraising the projects for their technical feasibility and economic/financial viability. The various aspects which should be examined while appraising any project are discussed as under.

1. Appraisal of Market Demand and Potential

The market demand and potential is to be examined for each product item after taking into account the demand/supply position, availability of substitutes, selling price, discount structure, arrangement for after-sales service, etc. The main aspects to be critically analysed under this head may include the following.
(a) Size of market for the product(s), both local and export, based on present/expected demand and supply position.

(b) Position of competitors indicating the levels at which they are operating and as to how they are performing in terms of sales and profit.

(c) Buy-back arrangement under the foreign collaborations, if any, and for what quantity, price and period.

(d) Selling price with complete break-up, i.e., whole-sale, retail, discount structure, credit proposed to be offered, etc.

(e) Analysis of import and export and the government policies having influence on the products.

(f) Future demand for the product(s) based on reports published in important journals, newspapers and views expressed by the government and trade association, etc.

2. Appraisal of Technical Aspects

The important aspects requiring examination should cover the following.

(a) Product(s) proposed to be manufactured or services rendered in terms of quantity, value and their applications.

(b) Location of the unit indicating advantages and disadvantages, availability of infrastructural facilities, concessions available from the government in the area etc.

(c) Size of land and building, and whether open and covered area is enough for the present activity and for future expansion.

(d) Availability of technology and process of manufacture and whether the same have been subjected to frequent change in the past.

(e) Capacity of the plant/machinery, price, market report on the suppliers credentials and on performance of the machines.
(f) Arrangement for equipment needed for various utility services like boiler, compressor, effluent disposal, etc.

(g) Specification for raw materials needed, sources of supply, availability position, cost of transportation, etc.

(h) Arrangement made for inspection at intermediate and final stages of production, equipment needed for ensuring quality.

(i) Availability of licences and clearances, if any, required from the central/state governments and other agencies for setting up such a unit.

A proper technical appraisal can help in successful implementation of the project.

3. Economic and Financial Appraisal

The aspects need to be analysed under this head are discussed as under.

(i) Cost of Project

The major cost components of any project can be grouped under the following heads:

(a) Land and building including transfer, registration, development and construction charges.

(b) Plant and machinery, equipment for auxiliary services including sales tax, transportations, insurance, duty, foundation, power etc.

(c) Office equipments, furnitures/fixtures, lighting and other accessories, etc.

(d) Consultancy and know-how fees payable to foreign collaborators or consultants who are imparting the know-how.

(e) Annual recurring royalty payment is not reflected under this head but is accounted for under profitability.

(f) Preliminary expenses which also include cost of incorporation of the company, its registration, preparation of feasibility report, market surveys, etc.
(g) Per-operative expenses incurred, such as salary travelling, insurance, start-up expenses, mortgage expenses, etc incurred before starting of commercial production.

(h) Capital issue expenses in case of companies which are raising funds by issue of capital to public.

(j) Provision for contingencies to meet any unforeseen expenses such as price escalation or any other expenses inadvertently not included in the other cost heads.

(ii) Means of Finance

The cost of project, as discussed above, can be financed through the following means/sources:

(a) Capital brought in by the promoters and shareholders in the form of equity/debentures.

(b) Unsecured long-term loans and deposits raised from friends and relatives to remain in business till repayment of bank's loans.

(c) Term loans from institutions/banks which are repayable over a period of time.

(d) Deferred term credits offered by suppliers of plant/machinery, payable in instalments over a period of time.

(e) Raising funds through Euro-issues, foreign currency loans, premium on capital issues, etc. which are sometimes comparatively cheaper means of finance.

(f) Subsidies and development loans provided by the central/state government in notified backward districts to attract entrepreneurs.

(iii) Profitability Projections

The profitability projections should be prepared based on assumptions which
are realistic—neither optimistic nor pessimistic. The projections are worked out for a period covering the repayment of loans. The appraisal of the projections should cover scrutiny of various items of revenue and cost to ensure that these are achievable. While preparing profitability projections, the past trends of performance in industry and other environmental factors influencing the cost and revenue items should also be considered objectively.

(iv) Break-Even Analysis

Analysis of break-even point of a business enterprise would help in knowing the level of output or sales at which it would break-even, i.e. there is neither profit nor loss. A business earns profit if it operates at a level higher than the break-even point. If on the other hand, production is below this level, the business would incur loss.

(v) Fund-Flow Statement

A fund-flow statement is often described as a "Working Capital Flow" statement. It is derived by comparing the balance sheets on two specified dates and finding out the net changes in the various items appearing in the balance sheets. A critical analysis of the statement shows the various changes in sources and applications (uses) of funds, and to ultimately provide the position of net funds available with the business for repayment of the loans.

(vi) Balance Sheet Projections

The financial appraisal also includes study of projected balance sheet statement which provides the position of assets and liabilities of a unit at a particular time. In other words, the statement helps to analyse as to what an enterprise owns and what it owes at a particular point of time. An appraisal of the projected balance sheet data would reveal whether the concern is healthy, growing, and has a promising future or is stagnating.
(vii) Financial Ratios

While analysing the financial aspects of project, it would be advisable to analyse the important financial ratios over a period of time as it would tell us a lot about a unit's liquidity position, management's stake in the business, capacity to service the debts, etc.

4. Appraisal of Management and Organisation of Project

Appraisal of project would not be complete till it throws enough light on the management and organisation of the enterprise. It is seen that some projects fail not because these are not viable but because of the promoters and the key persons managing the same. The appraisal of a project should highlight the strengths and weaknesses of the management by commenting on the qualifications, experience, capability of the promoter(s) and key management personnels. Further, the report should also comment on the performance of other concerns wherein the promoters have interests. A business is more vulnerable if decision making is centralised and rests with a particular person, in other words, it is a "one man show".

8.2.b. Post-Sanction Supervision and Follow-up

Post-sanction supervision and follow-up of loan accounts in banks has assumed a lot of significance as it helps in keeping a close watch on their performance and for initiating timely corrective actions. Some of the important goals of monitoring are as under.

(a) To evaluate performance of a project financed by obtaining feed-back on operational and financial performance, such as, production, sales, profit and loss and comparing the same with the projections given in the project report.
(b) To keep a close watch on the project so that it is implemented as per schedule without any time and cost over-runs.

(c) To ensure that the funds sanctioned are utilised for the purpose for which these have been lent and that there is no diversion of such funds.

(d) To see that the terms and conditions stipulated in the sanction are complied with and that loans are repaid in time.

(e) To keep a check on the statutory liabilities, sundry creditors/debtors, accumulation of raw-materials, stock-in-process, finished goods, etc.

(f) To detect signals and symptoms of sickness so as to initiate timely corrective action. Also to check slippage of standard accounts to NPA category.

System and Techniques Used for Follow-up

The system adopted by banks to follow-up of the loan accounts having working capital limits of Rs 50 lakh and above is as advised by the Reserve Bank of India. The system is popularly known as Quarterly Information System (QIS). Some banks have evolved their own systems of monitoring and follow-up covering various types of loan accounts and have designed special formats to obtain feed-back reports on their functioning. Similarly, they have also evolved systems for monitoring performance of sick units put under rehabilitation and those where legal actions have been initiated for recovery of the dues. Apart from getting feed back reports on the prescribed formats, banks have also adopted the following techniques for monitoring the performance of the units.

(a) Banks have in place a surveillance system under which all big borrowal accounts are allocated to the designated officers at branch level to keep a close watch on day-to-day functioning.

(b) Technical staff is deputed to undertake on-the-spot studies and submit reports on the functioning of the units.
(c) Appointing bank officials as nominee directors on the Boards of the companies specially those which are not doing well and getting reports from them.

(d) Holding meetings with the borrowers of assisted units from time to time for understanding and resolving the difficulties, if any, faced by them.

(e) Appointing concurrent auditors and firms of chartered accountants and getting reports from them about the functioning of the units.

(f) Getting audited financial statements of the assisted units at the close of the year and subjecting these to scrutiny.

Making Follow-up System Effective

In order to bring effectiveness in the system, banks should review and strengthen the following areas:

(a) Create independent monitoring set-ups at their administrative offices manned by staff who are experienced and trained in handling loans.

(b) Undertake on-the-spot studies of units at periodic intervals to assess their health and initiate timely corrective action wherever required.

(c) Define role and responsibilities of officials assigned the monitoring function.

(d) Introduce a system of having frequent meetings with borrowers to find out as to how they are performing.

(e) To have better coordination between banks and term-lending institutions by having regular meetings to review the performance of the units.

8.3. DESIGNING AN EFFECTIVE SYSTEM FOR DEBT RECOVERY

The Reserve Bank of India (RBI), in its latest report Trend & Progress of Banking of India, 2001-02 observes that for Scheduled Commercial Banks (SCBs) as a
whole, the gross NPA rose to Rs. 70904 crore as compared to Rs. 63741 crore a year ago. The net NPAs also rose to Rs. 35546 crore as compared to Rs. 32461 crore in the previous year. The ratio of gross NPAs to the total assets of the SCBs declined however from 4.9 percent in 2000-2001 to 4.6 percent in 2001-02 while that of net NPAs to total assets declined from 2.5 percent to 2.5 percent. While a decline in these ratios is a welcome sign, the absolute size of NPAs is still a major cause for worry to the banks.

The burden of NPAs in the public sector banks (PSBs) is proving too heavy for them to shake off. With financial sector reforms having run for a decade, there appears to be no respite in the level of gross NPAs. Gross NPAs of PSBs stood at Rs. 56507 crore at the end of March 2002 up 3.3 percent from March 2001 level. The Debt Recovery Tribunals (DRTs) and one time settlement schemes have not achieved the desired purpose. It may be worth mentioning here the observations of the Trend and Progress of Banking 2001. "An effective resolution of the problem of NPAs is hampered on account of a sizeable overhang component arising from infirmities in the existing process of debt recovery, inadequate legal provisions on preclosure and bankruptcy and difficulties in the execution of court decree". At the same time, the recurring cost to the economy of retaining bad debts on bank balance sheets—the opportunity cost of funds locked up in bad loans—the cross subsidisation of interest rate that is inevitable when banks are compelled to keep interest rates on good loans high in order to cushion the drag on account of bad loans—demands a more permanent solution.

At present, there are two most effective and promising mechanisms for Debt Recovery which can to a large extent provide a permanent solution to problem.

a. Asset Reconstruction Companies, which are yet to be practically implemented.

b. Compromise And Negotiated Settlements, already in force

a. Asset Reconstruction Company, (ARC)

The Narasimham Committee Report (NCR-I) recommended that in order to wipe
out NPAs from bank's books, government should set up Asset Reconstruction Fund (ARF) to take over bad and doubtful assets. The recommendation was not accepted by the government, then. A number of concerns were expressed. First, it was felt that a centralised all-India fund would be severely handicapped in its recovery efforts by lack of widespread geographical reach which individual banks posses. Secondly, there could be a moral hazard problem and banks could become complacent about recovery and even the healthy accounts could also become sick accounts in course of time. Thirdly, given the large fiscal deficits, there would be a problem of financing the ARF. The NCR-II suggested the consideration of two alternative approaches to the problem as an alternative to the ARF. In the first approach, all loan assets in the doubtful and loss categories, which in any case, represent the bulk of the NPAs in most banks, should be identified and their realisable value determined. These assets could be transferred to an ARC which would issue to the banks, NPA swap bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive. An alternative approach to recapitalisation of banks with budgetary support could be to enable the banks, in difficulty, to issue bonds that could form part of tier-II capital. This would help the bank bolster capital adequacy which has been eroded because of the provisioning requirement of NPAs. However this is not a permanent solution to the problem and ARCs are definitely the chosen alternative.

Mechanism of ARC

In simplest terms, an ARC is a company which specialises in recovery and liquidation of assets. Restructuring of a bank through an ARC is completed in a systematic manner. First of all, it is examined whether the troubled bank will be viable after the restructuring operation, within a short time span. This analysis is conducted keeping in view the likely macro economic environment during the relevant period. If the evaluation shows non-viability
it would be prudent to go for liquidation or merger rather than committing more funds. Once viability is established, valuation of assets should be undertaken. This is a complex process in as much as each loan should be valued separately. The assessment has to be suitably calibrated by way of arriving at most realistic market value of the securities on a specific date. The next stage is the creation of the ARC and recapitalising the "good bank". The ARC can be an independent institution or a separate subsidiary or may form part of the bank itself. The main objective of an ARC is to maximise the return from the transferred asset after meeting the operational and financial costs. Thus, an ARC undertakes a wide range of functions, such as, repackaging and securitisation of assets, sale of assets, participation in liquidation proceedings, management of assets and their improvement to maximise return therefrom. In the next phase, the identified assets are transferred to ARC at the estimated realisable value. Considering that the financial and physical resources of the ARC may be limited, it is desirable to transfer only assets above a certain value, say Rs 1 crore. The remaining loans can be best handled by the bank itself. ARC takes necessary steps for sale or liquidation of all assets. However, the remaining non-recoverable assets are either transferred to a debt-collecting agency at a low price or may be written off. The final phase relates to winding up of the ARC with its net worth being returned to the parent company. Internal governance should be pursued vigorously so that the bank returns to profit and gains further strength by improving its capital. The Union Budget for 2002-03 announced the setting up of a pilot Asset Reconstruction Company (ARC) with the participation of public and private sector banks, FIs and multilateral agencies. This company will initiate measures for taking over NPAs in the banking sector and also develop a market for securitised loans.

International experience with Asset Reconstruction Companies

An Asset Reconstruction Company (ARC) specialises in recovery and liquidation
of assets. In several countries, including Czech Republic (1995), Sweden (1992) and Thailand (1998), the troubled bank was split into a ‘good’ bank and a ‘bad’ bank. This approach is probably best when only one or a few banks are in serious difficulty. In Hungary, bad banks issued bonds guaranteed by the government, which were bought by the good banks. In Poland, bad banks were not established as separate entities but many banks were required to establish a special organisational section for the management of impaired loans. The alternate approach, used in the United States (1989) during the Savings and Loan crisis and more recently in Korea (1997) and Malaysia (1998), has been to establish a single assets management corporation to purchase NPLs from a number of banks; in effect, there will be one large ‘bad’ bank for the whole banking industry. In case a large number of banks are in difficulty and the assets acquired have a certain degree of homogeneity, a single entity may reap economies of scale and make best use of scarce managerial talent. Other countries have tried variants of both types of approaches. Japan, for instance, established a type of private sector AMC, the Japanese Cooperative Credit Purchasing Company, to which the NPLs of banks were sold, while providing the banks with some tax benefits. In view of its limited success, the government launched a new scheme in November 1998 under which a troubled bank would be taken under government control after a report from the inspection agency.

Analysis in Indian Context

The ground realities in India are significantly different. About 46 percent of the total NPA of the public sector banks is in the priority sector. In this segment, the likely average size of a bad loan is small and the number of defaulting accounts very large. The ARC may not prove very effective in dealing with loans in this sector as such loans are spread out over a very large geographical area with concentration in rural areas. A bank with large network including rural areas is better placed for effecting recovery of these loans and much should not
be expected from an ARC which will have a centralised presence. Thus the focus of ARC will be limited to the remaining 50 percent of problem loans. To maintain efficiency of ARC, it is advisable to transfer only large loans to ARC. Though it has taken considerable time by the Government to decide on the matter, but now it is in the final stage for setting up an ARC, for weak banks, to start with. The proposed ARC is to have a paid-up capital of Rs 200 crore and authorized capital of Rs 2000 crore as starter. The share holders of ARC will be the public sector banks and the three financial institutions i.e. IDBI, ICICI and IFCI. The company will take over the doubtful and loss assets of the banks. A bank with NPAs may approach the ARC for reconstructing part of its doubtful assets. The ARC will take over these NPAs at a determined value and will then issue bonds to the respective bank at a decided coupon rate for a period of seven to ten years. This will give an opportunity to the banks to clean the chronic NPAs from their balance sheets.

b. Compromise and Negotiated Settlements

Recovery of banks’ dues from the defaulting borrowers, whose accounts are in NPA category and operations non-viable through compromise/negotiated settlement is a better option then filing of suits as legal process is extremely slow and expensive. Even in recovery suits where the banks have been able to obtain decrees against the borrowers, they are finding it difficult to get the same executed. To overcome this problem, banks have started formulating policy guidelines on compromise/negotiated settlement with the approval of their Boards stipulating the need/objective of such policy, nature and quantum of concessions/reliefs which can be permitted, powers of the officials at various levels of authority, system of monitoring and reporting of such cases to higher authorities, etc. Finance Minister in the Union-Budget for 1999-2000 announced a significant measure to contain the NPA by setting up of the "Settlement Advisory Committee" by the public sector banks for speedy recovery of their
dues through compromise route, avoiding the lengthy litigation process.

Given below are the various issues which should be kept in view while dealing with the cases under compromise/negotiated settlement.

RBI Guidelines

RBI has advised certain guidelines to be followed by the banks while considering proposals of compromise/negotiated settlement with the borrowers, highlights of which are as under.

(a) A compromise should be a negotiated settlement which will enable the bank to recover dues to the maximum extent possible at minimum expense and expeditiously.

(b) Proper distinction needs to be made between wilful defaulter and defaulter due to circumstances beyond his control.

(c) For assessing the realisable value of securities, wherever available, proper weightage should be given to the location, condition, marketable title and possession thereof.

(d) All compromise proposals sanctioned by the competent authority should be properly reported to the next higher authority.

(e) Proposals for compromise/negotiated settlement falling within the authority of Executive Director/Chairman and Managing Director/Management Committee and Board of the Bank should be first processed by a Committee of senior executives.

(f) Staff accountability should be examined and completed expeditiously within a given time frame.

Factors to be Considered While Dealing with Proposals of Compromise/ Negotiated Settlements
(i) Genuineness and keenness of the borrowers to settle bank's dues.

(ii) Reasons for default by the borrower by bringing out specifically in case, default is wilful.

(iii) Amount of loan recoverable indicating separately ledger balance, suspended/derecognised interest, recorded interest, penal interest, legal and other charges etc.

(iv) Compromise amount offered by the borrower and whether there is any loss of revenue to the bank.

(v) Nature and condition of primary and collateral securities and their realisable and market value.

(vi) Position of loan documents, and the availability of limitation in the account.

(vii) Financial standing of the borrowers and guarantors and in case of demise of any of them, the same needs to be indicated.

(viii) Chances of recovery and time likely to be taken if suit is filed for recovery of bank's dues. Possibility of compromise should also be explored even where suits are continuing or where court decrees have been awarded.

Advantages of compromise / Negotiated settlements

1) It reduces non-performing assets of the banks.

2) The banks can recycle the fund received as compromise amount for better earning.

3) The banks can save the manpower, time and expense involved in the legal process.

4) Generally any method other than compromise takes longer time. With the passage of time there is possibility of deterioration in the quality of asset/security and forced sale of security, in case of need, affects the market value; which may not fetch even the present compromise amount in future.
5) Sometimes the banks may not win the case in the Legal Proceedings due to defective documents/procedures.

6) The banks can get additional income due to recovery of partial amount of uncharged interest, if negotiated.

7) The banks can release the provisions held against the compromised NPA accounts.

8) The banks may get tax relief due to write-off of the unrealized portion of the outstanding balance.

9) It is less irksome method for NPA reduction.

Disadvantages

1) The banks incur loss on the differential amount between the loan outstanding and the compromise amount, due to the concessions offered to the borrower.

2) In absence of a foolproof mechanism there is room for unscrupulous transaction in the compromise process.

3) In absence of a progressive compromise settlement mechanism it vitiates the repayment culture of the banks.
8. 4. RECOVERING NPAs THROUGH JUDICIAL PROCESS

a. Debt Recovery Tribunals

Lack of expeditious court remedies has been one of the major impediments experienced by the banks in recovering their bad loans. Not only this the abnormal delays in obtaining court decrees has resulted in erosion of the mortgaged assets, poor realisation and write-off of substantial part of the loans. In many cases the banks have not been able to recover even the expenses incurred on legal fees and protection of the assets. No wonder the banks had for a long time been urging for setting up of special tribunals to deal with their claims expeditiously which somehow remained an illusion for more than a decade.

The report of Committee headed by Mr. T.Tiwaree, Chairman IRCI (1981) had gone into many of legal aspects and had envisaged special Tribunal along with a summary procedure. M. Narsimham Committee on the Financial system also regarded the setting up of special Tribunals as necessary for effecting speedy recovery. Taking note of these recommendations, the Govt. got a bill passed which provided for the setting up of the special Tribunals for the trial of claims for the recovery of debts due to banks and financial institutions. The proposal for the creation of DRTs for recovery of debts due to banks which had been given legislative shape and came into force with effect from June 24, 1993 (Act No. 51of 1993) was one of the most important legal development relevant to the lending business of banking. It deserved attention of all concerned because it was felt that the proposed Tribunals, if it could be made to function effectively, will be an adjudicatory body of considerable practical significance.

A DRT is vested with jurisdiction, power and authority to entertain and decide application from the bank for recovery of debt due to such bank. The Tribunal consists of only one person to be appointed by central Govt., known as presiding officer. The appellate tribunal is known as the Debts Recovery Appellate Tribunal.
(DRAT). The order passed by DRT will be appealable to the DRAT.

In response to the suggestions and recommendations of the various committees and working groups, the Recovery of Debts due to Banks and Financial Institutions (Amendment) Bill 1999, had been introduced in the parliament on 5th March 1999. This Bill sought to provide for:

i. Appointment of one or more Recovery Officers in a Debt Recovery Tribunal instead of only one Recovery Officer as at present.

ii. Set-off and counter claims.

iii. Appointment of Receivers and Commissioners by the Debt Recovery Tribunal.

iv. Transfer of cases from one Tribunal to another and appraisal of work of Presiding Officers of Tribunals by the Appellate Tribunal.

v. Empowering Debt Recovery Tribunal to straightaway issue certificate for recovery on the basis of decree or order of Civil courts.

vi. Enabling the Tribunal to issue certificate for recovery modifying its earlier certificate for enhancing the amount of recovery on the basis of final decision of the Appellate Tribunal.

vii. Laying of notifications under certain provisions of the Act before the parliament.

On 17.1.2000, the Government has come out with an ordinance amending the Recovery of Dues due to Banks and Financial institution (Amendment) Ordinance 2000 incorporating inter alia most of the changes recommended in the Amendment Bill of 5th March 1999.

The Government and the RBI have taken initiatives from time to time to get over various difficulties faced in the recovery of dues. It can be seen from the budget
proposals moved on 29.2.2004 that the Government has proposed to establish seven more tribunals. The amendments made from time to time to the Act clearly show the awareness of the Government and the RBI to the problems faced by the banks and financial institutions in getting their dues recovered through DRTs and DRATs. The Supreme Court has also shown keen interest by making valuable suggestions to the Government during the pendency of the case and by monitoring implementation of amendments to the Act. However the DRTs 22 DRTs set up at major centers in the country with Appellate Tribunals located in the five centers, they could decide only 9814 cases for Rs 6264.71 crores pertaining to PSBs since inception of DRT mechanism and till September 30, 2005, recovering only Rs. 1664.30 crores. Number of cases disposed have gone up from 8080 involving Rs. 1542 crores (2004-2005) to 12575 involving Rs. 2603 crores, in 2005-2006.

B. Filing of Suit for Recovery

Bankers try to avoid resorting to the course of remedies through court of law because the legal process is best with procedural and administrative delays. Besides entailing considerable amount of unrealizable expenditure, this process strains the relations with the customer. Bankers generally adopt other measures for recovering advances such as persuasion, moral pressure through introducers or even guarantors etc. These are simple, less time consuming and less expensive ways to recover bank dues. When banks are convinced that all these measures would not bring any positive result and the debt may become time barred or we have a fear that the securities charged may be alienated to the detriment of interest of the bank, banks resort to unavoidable legal action.

Suit filing-some ground realities

1. The time consumed in the entire process is very long. Starting with the formalities for filing suit till the execution of the court judgment, consume
considerable time. A sample study of the cases reveals that the average time taken by courts to dispose a suit filed case, ranges between 5 to 10 years and in actual practice, the time taken may still be more.

2. Even after long wait in majority of the cases, courts go on circumstantial evidence and technicalities of the case. They do not look into the contributions made by the banks and efforts made by bank through concessions extended in case of genuine difficulties of the borrowers and seem to keep at par willful defaulters with those of the genuine defaulters.

3. Some interesting contentions such as 'the borrower does not know the contents as it is in English, the rate of interest charged is very high, the rate of interest increased by banks subsequently to giving the loan is not binding upon the borrower and the borrower has not benefitted from the loan' etc., are being raised. It is disturbing to note that the courts also give credence to such contentions and take a technical view in the matters. For proving these matters point-wise, the bank officers during whose tenure the documents were executed have to be present. This involves lot of inconvenience at all levels, wastage of time and huge expenditure.

4. The court rulings and interpretations are such that even the available securities, primary as well as collateral, cannot be enforced by banks to realise their-dues partly or fully. Even where the securities can be enforced, the process takes considerable time. When banks finally realise their dues, the amount recovered is much less than the amount lent, once inflation is taken into account.

5. Suits filed by banks do not get any priority in the courts and they have to wait for their turn for the suit to come up for hearing by which time securities deteriorate in value and recovery if at all, is negligible. While the banks have to suffer delays in courts along with thousands of other litigants, efforts of the banks to convert securities into money by obtaining an interim order for sale of securities seldom succeed on account of objections raised by the defaulters and
lack of uniform approach on the part of the courts all over the country to such applications filed by the banks.

6. Even with all these hardships, if the bank wins the case and decree is obtained, the difficulties are not yet over for the bank. It has to again approach the court for its execution. The court then appoints a receiver to effect the sale of security. The experience reveals that there will often not be any purchaser and even if there is one, he may offer such a low price that it may not cover the amount of default resulting in a loss to the bank.

7. The court rulings on the suits filed by banks for recovery of amounts lent appear to have created an impression that the courts go more by an individual borrower's difficulty, genuineness or otherwise, rather than by the need for integrity and discipline in financial transactions, which is necessary for the proper functioning of the financial system.

8. There has developed a feeling amongst defaulters that they can resort to or force the banks to resort to legal action so that they can hold up repayments as long as possible or extract as much monetary concessions, as possible. This tendency has jeopardised repayment ethics.

C. Certificate Proceedings

The recovery of bank dues, particularly in small loan accounts through a court of law is such a lengthy and costly affair that the banks generally feel discouraged to go to the courts. In order to expedite the process of recovery through judicial process, several States have passed Agricultural Credit legislations for recovery of bank dues through more expeditious and efficacious proceedings, on the lines suggested by Talwar Committee on customer service (1977).

Under these recovery laws, a certificate obtained is deemed to be the decree of a civil court and the execution proceedings may be started against the debtor forthwith, thereafter. The procedure prescribed for the execution of certificates
for the realisation of the dues is similar to those of the execution of a decree. The issue of a certificate under the recovery certificates, cuts short the time spent for obtaining a decree in civil court. Further, the certificate is executed by the Executive Officers of the State and if a proper follow up is made, the legal process involved in it is both expeditious and efficacious as well as effective as compared to a civil suit.

Benefits

a: If followed properly, the decision is very quick.

b: No legal expenses or the cumbersome court procedures are involved.

c: Wastage of manpower in attending the courts etc. are saved.

d: Decree is as good as that of the civil court.

e: Because the Executive Officers of the state are involved there is better impact on the defaulters.

D. Decreed Accounts

In respect of decrees where outstandings involved are smaller, every account should be carefully examined on its own merits. If the attachable assets are not thre and/or the borrowers are not traceable and/or if the cost of executing the decree including the cost of obtaining the same, is going to be more than the possible recovery that can be made, the entire process of execution will be futile and the entire expenses, time and energy spent in this process would be of no use. Therefore the interest of the bank demands that such execution should not be undertaken and outstanding in such decreed account should be written off for which proposal should be submitted to the competent authority for approval.

Kinds of decrees

a) For payment of money: It is simple mortgage decree i.e. decrees for the
realisation of money charged on immovable property by sale.

b) For recovery or possession of land: It may be placed as other mortgage decree e.g. foreclosuer or redemption or by conditional sale:

c) For recovery of any property other than land or money: It may cover specific movable property, documents, account paper etc.

d) For ordering to do some act other than payment of money or to abstain from doing something i.e. under this may be classified decrees for specific performance of contracts, execution of documents, injunction etc.

-A purely declaratory decree cannot be executed and the decree to be executed must be a valid subsisting decree.

-If it is a conditional decree, condition must be fulfilled before execution.

-A decree which is on the faces of it a nullity cannot be executed.

-It must not be barred by limitation. The decree to be executed must be the decree of the court of the last instance. When the decree is invalid, reversed or modified by the Appellate Court, the decree capable of execution is the appealable decree.

New Law on Speedy Recovery of NPAs

Now it would be a new ball game between lenders and borrowers, with the advantage squarely shifting in favour of banks and financial institutions. This is because the ordinance for Securitisations and Reconstruction of Financial Assets has become law after receiving the assent of the president Mr. K.R. Narayanan on 21st June 2002. By arming banks with sweeping powers for asset recovery, the ordinance would turn the existing banker-borrower relationship upside down.

In what would send shivers down the spine of errant borrowers, the law provides that any lender would now be allowed to directly take possession of secured assets.
assets of the borrowers and dispose it of to realise dues without taking any legal recourse. In fact, henceforth, instead of banks and FIs which were queuing up before the debt recovery tribunals with recovery suits, it would be the lenders who would be sent scurrying to the tribunal, mainly to protest against the lenders and their strong-arm tactics. Thus, while the lenders have been provided enormous powers, the Ordinance has allowed borrowers aggrieved at the excesses of the banks to take their plea for redress to the DRTs. Here too there is a catch. A borrower aggrieved at any action taken by the lenders under the new law would have to pay 75 percent of the dues upfront before his plea is heard by the DRT or subsequently by the appellate DRT. The Ordinance allows banks to take action on their own to recover assets. Borrowers cannot any more delay settlement of dues by resorting to means such as evading summons.

The Ordinance arms the lenders with powers to directly initiate recovery procedures by taking possession of the secured assets of the borrowers which would include the transfer of all underlying rights. The lender could, in effect, attach, sell or auction any of the assets taken over by them. They can also decide to take over the management of the assets, appoint any person to manage the assets taken over and also order the settlement of dues from any other person who has acquired the secured assets from the borrower. The new law would not only help in recovering the existing NPAs of the banks and FIs, but also curb the instincts of wilful defaults in future. All powers conferred on the lenders would also be exercised by the Securitisation or Asset Resconstruction Companies (ARC) since along with the transfer of the bad assets of the lenders, the rights associated with it would also stand transferred to these companies.

New Bill to be Tough on Wilful Defaulters

Though the Bill to replace the Ordinance for NPA recovery has not made any concession for any category of defaulters for action by lenders under the new law, industry's plea for a distinction between wilful and non-wilful defaulters
has been met in practice. The message to the lenders from the Government would be to wield a heavier stick while dealing with cases of wilful defaults. For wilful defaulters, the banks and FIs can go a step-further than the powers provided under the new law, including launching criminal proceedings. The Reserve Bank of India had already instructed the banks and FIs regarding the measures to be taken against wilful defaulters with the latest set of directives having been given as recently as May 2002. In its latest offensive against wilful defaulters, the RBI had not only asked the lenders to explore the option of filing suits, but also suggested other punitive actions such as preventing them from accessing the capital market; stoppage of all additional finance for a period of five years from the date their names appear on the select list of wilful defaulters prepared by the banks.

8.5 OTHER TOOLS FOR BETTER MANAGEMENT OF NPAs

Banks cannot escape from credit business. Like any other business there is also risk associated with credit business. There is nothing like zero risk lending. It is accepted that a certain amount of NPA does arise is credit portfolio. Although it may not be possible to eliminate NPAs altogether, but surely there are certain tools to manage them in a better way. The important ones are as follows.

a) Credit Risk Management (CRM).

b) Credit Marketing.

c) Management of Potential NPAs.

d) Upgradation of NPAs.

e) Effective use of Management Information System & Information Technology in NPA Management

(a) Credit Risk Management

Of all kinds of risk that the banks are exposed to, credit risk poses a major
threat to the survival of banks. Credit Risk is defined as the potential loss that a bank may incur due to loan default i.e. non-payment or delayed payment of principal and/or interest. The Credit Risk of a bank is generally made up of (i) transaction risk and (ii) portfolio risk. The transaction risk is the default risk inherent to the individual business unit/loan account i.e. risk emanating from individual loan transactions. The portfolio risk in turn comprises intrinsic and concentration risk. It is nothing but aggregation of individual transaction risks associated with a specific or similar type of industry, business, borrower groups, geographical areas, same type of credit facility, credits of same maturity, etc.

(a) Transaction Risk Management

The credit risk cannot be avoided, but can be minimized to a great extent by adopting proper credit risk management techniques. Credit risk management involves the following:

(i) Credit risk identification.
(ii) Credit risk assessment/quantification.
(iii) Credit risk pricing.
(iv) Credit risk control mechanism.

(i) Credit Risk Identification:

Before lending, it is required to identify the determinants of risk involved with a particular credit. Broadly the risk element associated with an individual credit can be grouped under two heads. Systemic risk and Unsystemic risk. The former is exogenous to the individual business unit and it affects all the enterprises functioning in a particular industry/market/business though in varying degree on account of change in economic policies, general political environment, inflation, infrastructural changes, natural calamities, etc. The unsystemic risk is endogenous to a particular business unit and it arises out of factors like obsolete/breakdown in the machinery, labour unrest, product obsolescence, etc.
(ii) Credit Risk Assessment/Quantification:

After identification of the risk factors, it is also important to assess the degree of their adverse effects on the credit repayment. Then it is required to quantify the total risks involved in a particular credit proposal and assess whether it is wise to lend it.

(iii) Credit Risk Pricing:

Risk return pricing is a fundamental tenet of risk management. In a risk-return setting, borrowers with weak financials and hence placed in high credit risk category should be priced high in comparison to the borrowers with strong financials with a accompanying low risks.

(iv) Credit Risk Control Mechanism:

After analyzing the determinants and extent of the credit risk, it is required to develop suitable risk control mechanism to reduce the incidence of such risks in credit dispensation. The credit risk can be controlled by adopting suitable risk mitigating measures as well as an-effective Loan Review Mechanism/Credit Monitoring System.

(b) Portfolio Risk Management

Portfolio risk management helps in identifying concentration risk as a possible source of large scale defaults. Most of international banks have adopted various portfolio management techniques such as JP Morgan's CreditMetrics, Altman's Z Score, Credit Suisse's CreditRisk+, KMV Corporation's KMV Method, etc, for evaluation of credit portfolio. The banks may evaluate the utility of these models with suitable modifications to Indian environment for fine-turning the credit risk management. The banks could also consider the following measures to maintain the portfolio quality.
(i) Stipulate quantitative ceiling on aggregate exposure in specified rating categories.

(ii) Evaluate the rating-wise distribution of borrowers in various industry, business segments, etc.

(iii) Exposure to one industry/sector should be evaluated on the basis of overall rating distribution of the borrowers in the sector/group.

(iv) Target rating-wise volume of loans, probable defaults and provisioning requirements as prudent planning exercise.

(v) Undertake rapid portfolio reviews, stress tests and scenario analysis when external environment undergoes rapid changes.

(vi) Introduce discriminatory time schedules for renewal of borrower limits.

(b) Credit Marketing

Traditional way of lending is one of the causes for creation of NPA. Generally while lending to borrowers, most of the bankers think that they are obliging the borrowers with loan, rather they should be obliged to the good borrowers for giving a business opportunity. After liberalization, the importance of bank marketing is being felt by the bankers. Some of the banks have started aggressive marketing of their deposit products, but credit marketing is yet to pick up. A few banks have initiated credit marketing, but it is restricted to retail banking i.e. consumer finance, car finance, etc. It should be extended to Agriculture finance, Industrial finance, Trade finance, etc. In traditional way of lending the borrowers approach the bankers, but in credit marketing the bankers are required to go to the market to locate the prospective borrowers and finance them for productive activities/projects. Credit marketing involves the following steps.

(a) Moving closer to customers.

(b) Identifying their financial needs.

(c) Developing geographic as well as activity specific credit products.
(d) Tuning these products to meet the specific needs of the individual customers.

(e) Pricing these products at a competitive rate, and

(f) Servicing these products in better way in comparison to the competitors.

(c) Management of Potential NPAs

Even after immunization, there is possibility of an account becoming NPA. Generally, all of sudden an account does not become NPA. Long before, it starts showing symptoms of NPA. That is why it is important to diagnose the Potential NPA at the earliest possible and take suitable preventive measure to check its slippage to NPA. This is what the management of Potential NPAs is.

Potential NPA is a loan asset, which is going to be declared/classified as NPA as on the coming balance sheet date i.e. 31st March of the current financial year due to lack of recovery of Critical Due Amount (CDA). In other words, Potential NPA is a Standard Asset where certain due amount (known as critical due amount) if not recovered before 31st March of the current financial year will result into a Non-Performing Asset.

Identification of Potential NPA

(1) In case of Term Loans, if any amount of either interest or installment remains overdue since the date of 1st October of the financial year, the account may be noted as potential NPA.

(2) In case of Cash Credit & Overdraft accounts, if in between 1st October to 31st March of the financial year, there is possibility of happening of any of the followings:

(i) The outstanding balance may remain continuously in excess of the sanctioned limit or the drawing power.

(ii) The interest to be debited during the above period may not be recovered.
(iii) The interest of at least one quarter debited during the first half year of the fiscal year may not be recovered till 31st March.

(3) In case of Bill purchased or discounted, if the bill amount remains overdue since 1st October of the financial, it may be termed as Potential NPA.

(4) In case of Agricultural advance, if any amount of either interest or installment remaining overdue since the end of the last year harvesting season or 31st March of the last financial year, whichever is earlier, it may be treated as Potential NPA. 

(5) In case of other facilities if any amount remains overdue since 1st October of the financial year, it may be treated as Potential NPA.

Prevention of Potential NPA becoming NPA

Potential NPAs can be prevented from becoming NPAs by the following ways:

(1) In case of Potential NPA (Term Loans)
(a) By recovering the critical due amount i.e. the amount of arrears of both interest and installment upto 1st October of the financial year before or as on 31st March of the financial year.
(b) By rescheduling the repayments where there is possibility of poor/nil recovery due to genuine causes beyond the control of the borrower.

(2) In case of Potential NPA (Cash Credit & Overdraft accounts)
By keeping the outstanding balance under/below the sanctioned limit/drawing power for some time as well as by crediting sufficient amount (critical amount) to cover the interest amounts to be debited during the period of 1st October to 31st March of the financial year and the least one quarter interest of the first half year before or as on 31st March.

(3) In case of Potential NPA (Bills purchased and discounted): By recovering the entire bill amounts overdue up to 1st October of the financial year before as on 31st March.

(4) In case of Potential NPA (Agricultural advance) : By recovering all the overdue interest and installment upto the month of March or last harvesting season of the last financial year, whichever is earlier, before or as on 31st March of the
current financial year.

(5) In all other cases of Potential NPAs

By recovering all the overdue upto 1st October of current financial year before or as on 31st March.

(d) Upgradation of NPAs

Like prevention of NPAs, upgradation of NPAs is an equally important NPA management technique for reduction of NPA. High volume of NPAs in banks has created a psychological barrier in the minds of bankers towards the recoverability of NPA due to a paradox in the NPA concept. As per the NPA concept, for a certain amount of default, the whole amount outstanding in the account including other credit facilities of the borrowers becomes NPA. In other words, all the credit facilities are classified as NPAs because of few bills/instalments/interests or few amounts exceeding the limit/drawing power. It will be surprising to note that default of 2 to 5% of the NPA amount is responsible for creating 100% NPA in some cases. Whereas the gross outstanding of NPA is frightening, the recovery of certain critical amount is not impossible. Recovery of such critical amount will upgrade the NPA to Standard Asset in most cases.

Advantages of upgradation

Upgradation of NPAs has more advantages in comparison to liquidation of NPAs which are as follows:

(i) For upgradation of NPA, a smaller portion of NPA is required to be recovered whereas in case of liquidation the whole amount of NPA is required to be recovered.

(ii) The psychological pressure of recovery on borrowers as well as bankers will be less in case of upgradation of NPA in comparison to liquidation of NPA.

(iii) By upgradation of NPA, the asset becomes performing one which, if
maintained, can generate income whereas by liquidation, source of income is blocked.

(iv) Upgradation is less costly to liquidation of NPA.

Depending upon the change of upgradation, NPAs can be grouped under the following two categories:

(a) Fresh NPAs

(b) Hardcore/Chronic NPAs

(a) FRESH NPAs: The characteristics of fresh NPAs are as follows:

(i) These NPAs can be brought back to standard category by recovering certain critical amount. Generally, this critical amount is substantially less than the entire NPA amount.

(ii) Their status as NPA is not more than 3 years.

(iii) There is no fraud, but sufficient security is available in the account.

(iv) There is better chance for upgradation of these assets.

(v) Substandard & Doubtful assets will come under this category.

(b) CHRONIC NPAs: The characteristics of chronic/hardcore NPAs are as follows:

(i) These NPAs can be brought back to standard category by recovering major portion of the NPA amount.

(ii) Their status as NPA is generally more than 3 years.

(iii) There is less chance for upgradation of these assets.

(iv) Doubtful-2, Doubtful-3 and Loss assets will come under this category.

Non-performing assets can be upgraded to standard category by the following ways:
(i) Recovery of critical amount in case of Substandard & Doubtful assets.

(ii) Recovery of critical amount as well as addition of sufficient security in case of Loss assets.

(iii) Rephaseinent/Reschedulment of loans.

Recovery of Critical Amount

Determination of critical amount in a NPA account is very vital for its upgradation. Critical amount can be defined as the minimum overdue amount in a NPA account the recovery of which will upgrade the account to Standard category on the coming balance sheet date. The method of computation of critical amount in a NPA account is explained as per the exhibit below.

Exhibit No. 8.1

<table>
<thead>
<tr>
<th>Credit facility</th>
<th>Critical amount to be recovered</th>
<th>Critical date for calculation of critical overdue amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>i) Bills purchased &amp; discounted, Devolved LC, Debt due to credit card operation, etc.</td>
<td>Bill amounts of all the bills which would remain overdue for a period of more than 180 days as on 31st March of the fiscal year.</td>
<td>All bills which are overdue or becoming overdue prior to 1st October of the financial year.</td>
</tr>
<tr>
<td>ii) Cash credit &amp; Overdraft</td>
<td>All unrealized overdue interest (as per the record section of NPA record) plus the interest to be realized before 31st March of the fiscal year plus excess amount over the lower of limit/drawing power.</td>
<td>Month wise drawing power in between 1st October and 31st March of the financial year has to be determined and the higher D.P. is to be taken into consideration.</td>
</tr>
<tr>
<td>iii) Agricultural Advances</td>
<td>All installments &amp; interest which would be overdue for 2 half year/2 harvesting seasons &amp; more as on 31st March of the fiscal year.</td>
<td>All installments &amp; interests, which are overdue, till the end of last year harvesting season or 31st March of the last financial year, which is earlier.</td>
</tr>
<tr>
<td>iv) Term loans &amp; other credit facilities</td>
<td>All installments &amp; interest which would remain overdue for a period of more than 180 days as on 31st March of the fiscal year.</td>
<td>All installments &amp; interests which are overdue, till 1st October of the financial year.</td>
</tr>
</tbody>
</table>

Rephasing / Rescheduling of Loans

Some accounts become NPA because of default in loan repayment which is due to circumstances beyond control of the borrowers. Under such circumstances rephasing/rescheduling/rehabilitation is generally recommended.
Upgradation of restructured accounts:

The sub-standard accounts, which have been subjected to restructuring, etc., whether in respect of principal installment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after the specified period i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory performance during the period.

(e) Effective use of Management Information System & Information Technology in NPA Management

Proper Management Information System (MIS) is an important tool for effective NPA management. In a study it has been observed that lack of reliable MIS in banks is one cause for high NPAs. The Management Information System presently used in many banks does not help much in effective management of NPAs because it is simply collection of a bunch of statements for generating various reports for submission to the Banks' Board/Auditors/RBI/Governments. Moreover, it is unreliable and antiquated due to various infrastructurial bottlenecks. In the present MIS, banks collect about a score of returns annually; which are not only repetitive but also conflicting. The Reserve Bank of India introduced DSB returns under Supervisory Reporting System in 1995 as a measure of prudential supervision for ensuring financial soundness and safety of the banks. These quarterly returns provide NPA related information regarding the following aspects:

(i) Sectoral break up of advances

(ii) Asset classification

(iii) Movement of loan assets

(iv) Potential NPA
(v) Fresh addition in NPA
(vi) Reduction in NPA
(vii) Provision required
(viii) Uncharged Interest
(ix) Govt. guaranteed NPA accounts

An effective Management Information System on NPA should be designed & introduced in banks keeping in view of the following objectives for effective NPA management in the long run.

Objectives of NPA-MIS:-

1) Creation of a comprehensive database on NPA for the following purposes:
   (a) To assess Asset Quality
   (b) To forecast Potential NPA.
   (c) To Monitor movement of Asset Classes in Asset Cycle.
   (d) To arrest degradation of Standard assets.
   (e) To monitor NPA reduction.
   (f) To assess progress & prospect of Compromise Settlement as well as Write-off.
   (g) To assess Provision requirements on realistic basis.
   (h) To assess uncharged interest.
   (i) To assess quantum of NPA involved in Legal process.
   (j) To assess Govt. guaranteed NPA accounts.

2) Identification of Risk Concentration.

3) Development of Risk Assessment models as well as Risk Management
techniques.

4) Analysis of NPA dimensions relating to geographical area, industry/sectors/activities.

5) Formulation of sound Credit Policy as well as Loan Recovery/NPA Management Policy.

6) Comparative study of the bank's position vis-a-vis peer group as well as banking industry with respect to NPA dimensions, causes, remedies, etc.

7) Evaluation of NPA management quality.

8) Sensitivity analysis of impacts of policy changes of Govt./RBI/Bank; changing market forces; natural calamities etc on NPA.

The collection as well as updation of information for the NPA-MIS should be cost effective & time saving. The statements/returns used for the above purposes should be comprehensive, non-repetitive & easy reporting. The periodicity should be such as to serve practical utility to the said objectives. Manual compilation of data not only consumes valuable time but also includes statistical error, which ultimately generate unreliable information for decision making.

Use of Information Technology in NPA Management

There is hardly any use of IT in NPA management by banks. Presently banks are mainly using computers for day-to-day transaction of loan accounts at branch level and compilation of manually reported statistical data. Further, the software used in the banks are not effective in meeting the present needs of the banks, rather sometimes they create problems. For example, the cash credit packages presently used in some banks are unable to detect the NPA accounts, as a result payments are being made in the NPA accounts, thus increasing NPA pool of the banks. Banks should use proper software and networking at the branch and controlling office levels, for effective NPA Management.