CHAPTER 2

NON PERFORMING ASSETS (NPA)

: AN UNDERSTANDING
CHAPTER - 2

MEANING OF NON PERFORMING ASSET (NPA)

2.1 MEANING OF NON-PERFORMING ASSET

CORPORATE DEBT RESTRUCTURING

A Non-Performing Asset (NPA) is a credit facility in respect of which the interest and/or installment of principal has remained overdue for a specified period of time. The specified period is fixed as two quarters from 1995 onwards. With effect from March 31, 2001 an NPA shall be an advance where-

- Interest and/or installments of principal remain overdue for a period of more than 90 days in respect of a Term Loan.
- Account remains 'out of order' in respect of Overdraft/ Cash Credit (OD/CC).
- Bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agriculture, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

For the purposes of convergence to international norms, NPAs identification norms are now based on 90
days with effect from March 31, 2004.

Overdue' in respect of credit facility due to a bank means it is not paid on the due date fixed by the bank.

An account is treated as 'Out of Order' in case the outstanding balance remains continuously in excess of the sanctioned limit/ drawing power. If the outstanding balance in the principal account is less than the sanctioned limit/ drawing power, but there is no credits continuously for a period of 90 days as on the balance sheet date or the credits are not enough to cover the interest debited during the same period, these accounts are treated as 'Out of Order'.

**MEANING OF NON-PERFORMING ASSET**

Banks should classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter with effect from March 31, 2004.

**INCOME RECOGNITION POLICY**

Generally interest on NPA accounts should not be recognized on accrual basis but is booked as income only when it is actually received. Even if the Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realized.

Two exceptions are-
Interest on advances against term deposits, NSCs, IVPs, KVPs and life policies: Income may be recognized on due date despite the account is NPA provided adequate margin is available in the accounts.

Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognized on an accrual basis over the period of time covered by renegotiated or rescheduled extension of credit.

If any advance account including bills purchased and discounted becomes NPA at the close of any particular accounting year, the interest on such advances accrued and credited to income account but not realized should be reversed. This applies to Government guaranteed accounts also.

Any fees, commission or similar income in respect of NPA that have accrued should cease to accrue in the current period, and if any such accrued but not realized income had been recognized in the past period should be reversed.

In respect of leased asset, finance charge accrued and credited to income account before the asset became NPA and remaining unrealized should be reversed or provided for in the current accounting period. Determination of finance charge is guided by AS-19 issued by the ICAI.
Interest realized on income may be credited to income account if such interest is not credited to account out of the proceeds of the fresh / additional credit facilities sanctioned to the borrower concerned. In absence of a clear cut agreement between the bank and the borrower, the bank can appropriate the recoveries in NPAs at its discretion. It may appropriate it either towards principal first or interest due first. However, the banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

It is at the discretion of banks to maintain pro forma records for interest on an NPA account or take the interest on NPA account to Interest Suspense Account.

Banks are required to report NPAs on 31 March each year after the completion of audit in the following format:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. GROSS ADVANCES.</td>
<td></td>
</tr>
<tr>
<td>2. Gross NPAs</td>
<td></td>
</tr>
<tr>
<td>3. GROSS NPAs AS A PERCENTAGE OF GROSS ADVANCES</td>
<td></td>
</tr>
<tr>
<td>4. Total Deductions (i + ii + iii + iv)</td>
<td></td>
</tr>
<tr>
<td>1. Balance in Interest Suspense account $</td>
<td></td>
</tr>
<tr>
<td>2. DICGC/ECGC claims received and held pending adjustment</td>
<td></td>
</tr>
</tbody>
</table>
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Meaning Of Non Performing Asset (NPA)

3. Part payment received and kept in suspense account
4. Total provisions held
5. Net advances (1-4)
6. Net NPAs (2-4)

5. NET NPAs AS A PERCENTAGE OF NET ADVANCES

*Excluding technical write off of Rs. __________ crore.

**Excluding amount of technical write off (Rs __________ crore) and provision on standard assets (Rs __________ crore)

$ Banks which do not maintain an Interest suspense account to park the accrued interest on NPAs, may furnish the amount of interest receivable on NPAs as a footnote to this statement.

Note: For the purpose of this Statement. 'gross advances' mean all outstanding loans and advances including advances for which refinance has received but excluding rediscounted bills, and advances written off at Head Office level (Technical write off).

While reporting NPAs to the RBI, a bank is required to reduce the amount of the outstanding gross advances and gross NPAs by the amount technical write off, if any, should be reduced from the outstanding gross advances and gross NPAs to avoid any distortion in the quantum of
NPA's being reported.

**ASSET CLASSIFICATION** - NPAs are classified into three categories:

- **Sub-standard Assets**
- **Doubtful Assets**
- **Loss Assets**

Assets classified as NPA for a period not exceeding eighteen months. With effect from 31-3-2005, a period of not exceeding 12 months. The current net worth of the borrower/guarantor has all the weaknesses inherent in assets and so such borrower/guarantor weaknesses are considered uncollectible or the current.
market value of the that were classified little value security charged is as sub-standard. that its not enough to Added continuance ensure recovery of characteristics are as a blanket the dues to the that collection or asset is not banks in full. liquidation of the warranted asset is highly although questionable and there may be improbable. some salvage or recovery value.

Accounts with temporary deficiencies may not be identified as NPA. Certain accounts are regularized near about the balance sheet date. Proper care should be taken while identification of NPA in respect of such accounts.

**RECOGNITION ON PROJECTS UNDER IMPLEMENTATION**

The banks have been advised to recognize income on accrual basis in respect of the three categories of projects, under implementation which are classified as 'standard'. RBI allows banks to recognize the income on accrual basis using the word 'may', which gives discretion to the bank with regard to recognition of income. However, in case of uncertainties related to such income, members should consider the compliance with revenue recognition norms explained in AS 9, Revenue Recognition.
Some of the banks created provisions against project under implementation prior to the issuance of the earlier circular by the RBI stating that project under implementation are not required to classified as non performing assets for a period not exceeding two years beyond the date when the project ought to be completed. Existing provisions already made need not be reversed upon reclassification of any such advances as tendered pursuant to the applicable norms.

2.2 RBI GUIDELINES ON NON PERFORMING ASSETS

INTERNAL CONTROL MECHANISM FOR NPA IDENTIFICATION:

Banks are required to establish appropriate internal systems to eliminate delay the identification of NPAs, especially in respect of high value accounts or postponement of NPA identification. A minimum cut off point to decide a high value account is to be decided upon on the basis of level of business of the bank. The cut off point should be valid for the entire accounting year. Responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines.
COMMENT - This should form important criteria of evaluation of internal control system in bank by the statutory auditors. Accounts with temporary deficiencies: Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. Banks are required to adopt the following steps while classifying such deficient accounts:

- Drawing power is required to be arrived at based on the stock statement which is current. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. A working capital borrowable account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

- Regular and ad hoc credit limits need to be reviewed / regularized not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal Review of credit
Meaning Of Non Performing Asset (NPA)

limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular / ad hoc credit limits have not been reviewed/renewed within 180 days from the due date/date of ad hoc sanction will be treated as NPA.

OTHER ISSUES IN NPA RECOGNITION-

<table>
<thead>
<tr>
<th>S.N.</th>
<th>Issues</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Borrower-wise asset classification</td>
<td>If a credit facility to a borrower becomes a problem credit, all facilities granted by a bank to a borrower are treated as NPA. For this purpose devolvement of letter of credit or invoked guarantee is also considered as borrower's principal operating account.</td>
</tr>
<tr>
<td>2.</td>
<td>Advances under consortium Arrangements</td>
<td>In case remittances by the borrower under consortium is pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account is treated as NPA.</td>
</tr>
<tr>
<td>3.</td>
<td>Erosion of value of security to less than 5096 of the assessed value</td>
<td>In case value of security is less than 5096 of the value assessed by the bank or accepted by the RBI at the time of last. Inspection and the account is treated as NPA's account,</td>
</tr>
</tbody>
</table>
and then such account should be straightaway classified into doubtful category.

4. Erosion of value of security to less than 1096 of the assessed value

In case value of security is less than 1096 of the value assessed by the bank or accepted by the RBI at the time of last inspection and the account is treated as NPAs account, then such account should be straightaway classified into loss asset category.

5. Loans with moratorium for payment of interest

Finance given for industrial projects or for agricultural plantations where moratorium is available for payment of interest, accounts are treated as NPAs if they become overdue after due date for payment of interest not with reference to debit of interest in the book.

6. Government granted advances

The credit facilities backed by Government guarantee though overdue may be treated as NPAs only when the Government repudiates guarantee when invoked.

However, this exemption is not
applicable for income recognition. In case the guarantee is invoked but remain due for more than 90 days income should not be recognized.

7. Availability of security / net worth of borrower / guarantor

Recognition of NPAs is based on record of recovery not on availability of security or net worth of the borrower.

8. Take out finance

Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. There exists a time lag in such taking over.

The norms of asset classification will have to be followed by the concerned bank / financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPAs on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognize income on accrual basis and
account for the same only when it is paid by the borrower / taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPAs pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed.

The taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

9. Post Shipment Supplier's Credit

In respect of Post Shipment Credit extended by the banks covering export of goods to countries for which the ECGC's Cover is available; advance may not be treated as NPA to the extent payment has been received from the EXIM Bank for this purpose.
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10. Export Project Finance

If the importer has cleared dues in full by depositing the money in the bank abroad, but the lending bank could not recover the amount because of political developments, the lending needs establish documentary evidence that the importer has cleared the dues in full.

Then asset classification may be deferred after a period of one year from the date the amount was deposited by the importer in the bank abroad.

11. Advances under rehabilitation approved by BIFR / TLI

Existing credit facilities sanctioned to a unit under rehabilitation package approved by BIFR/TLI is continued to be classified as sub-standard or doubtful as the case may be.

Additional facilities sanctioned under the rehabilitation packages Income Recognition, Asset Classification norms will become applicable after a period of one year from the date of disbursement.

12. Project under Project where financial closure

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Meaning Of Non Performing Asset (NPA)

had been achieved and formally documented may be treated as standard asset for a period not exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project.

Projects sanctioned before 1997 with original project cost of Rs. 100 crore or more where financial closure was not formally documented and where deemed date of completion of the project has been decided by a group of outside experts may be treated as standard asset for a period of not exceeding two years beyond the deemed date of completion of the project.

Projects sanctioned before 1997 with original project cost of less than Rs. 100 crore or more where financial closure was not formally documented may be treated as standard asset for a period of not exceeding two years.
years beyond the date of completion of the project as originally envisaged at the time of sanction.

In the aforementioned cases, banks are now allowed recognize income on accrual basis vide Df30D. BP.BC.74/21.04.048/2002-03.

13. Net debit balance arising out of un reconciled entries in inter-branch transactions

Banks are required to make 100% provision if the un reconciled entries are pending for period of more than six months. While making provision, banks should ensure that (l) credit balances in the blocked accounts are considered and (it) the net debit in one category is not set off against net credit in another category.

**Disclosure:** Banks / Financial Institutions should also disclose in their published annual Balance Sheets, under "Notes on Accounts", the following information in respect of corporate debt restructuring undertaken during the year:

a) Total amount of loan assets subjected to restructuring under CDR.

\[ [(a) = (b) + (c) + (d)] \]
b) The amount of standard assets subjected to CDR.

c) The amount of sub-standard assets subjected to CDR.

d) The amount of doubtful assets subjected to CDR.

<table>
<thead>
<tr>
<th>Type of Assets</th>
<th>Period</th>
<th>% Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard Assets</td>
<td></td>
<td>0.25% on global portfolio basis</td>
</tr>
</tbody>
</table>

This provision is not reckoned for arriving at net NP As. This Provision is not netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under other "Liabilities and Provisions".

Sub-standard Assets

A general provision of 10% of total outstanding without making any allowance for DICGC / ECGC guarantee cover and securities available. The 'unsecured exposures' which are
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**Meaning Of Non Performing Asset (NPA)**

identified as 'substandard' would attract additional provision of 10 percent, *i.e.*, a total of 20 percent on the outstanding balance.

<table>
<thead>
<tr>
<th>Doubtful Assets to the extent not covered by security</th>
<th>Up to one year</th>
<th>One to three years</th>
<th>More than three years:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>100%</td>
<td>20%</td>
</tr>
<tr>
<td>To the extent covered by security</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Outstanding NPAs as on 31-3-2004</td>
<td>60% w.e.f. 31-3-2005</td>
<td>70% w.e.f. 31-3-2006</td>
</tr>
<tr>
<td></td>
<td>Advances classified as doubtful on or after 31-3-2004</td>
<td>100% w.e.f. 31-3-2005</td>
<td></td>
</tr>
</tbody>
</table>

**Loss Asset**

**Floating Provision**

100%

Over and above the provisions stated, a bank can make floating provisions. This will improve overall financial strength of the bank.
| Provision on leased Assets Sub-standard assets | 10% of the sum of the net investment in the lease and the unrealized portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 - Leases' issued by the ICAI. |
| Unsecured lease exposures identified as 'sub-standard' | Additional provision of 10 per cent, i.e., a total of 20 per cent. |
| Doubtful assets | 100 per cent of the extent to which the finance is not secured by realizable value of the leased asset. Realizable value to be estimated on a realistic basis. |
| Additional provision for Doubtful assets | 20% 30% |
Categorized
doubtful
up to one year

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<table>
<thead>
<tr>
<th>Category</th>
<th>ECGC classification</th>
<th>Provisioning requirement (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insignificant</td>
<td>A1</td>
<td>0.25</td>
</tr>
<tr>
<td>Low</td>
<td>A2</td>
<td>0.25</td>
</tr>
<tr>
<td>Moderate</td>
<td>B1</td>
<td>15</td>
</tr>
<tr>
<td>High</td>
<td>B2</td>
<td>20</td>
</tr>
<tr>
<td>Very High</td>
<td>C1</td>
<td>100</td>
</tr>
<tr>
<td>Restricted</td>
<td>C2</td>
<td>100</td>
</tr>
<tr>
<td>Off - credit</td>
<td>D</td>
<td>100</td>
</tr>
</tbody>
</table>

PROVISIONING FOR COUNTRY RISK

Banks shall make provisions, with effect from the year ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent according to the risk categories.
Provisioning norms for sale of financial assets to Securitisation Company (SC)/Reconstruction company (RC):

1. If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e. book value less provisions held)
2. If the sale is for a value higher than the NBV

3. With a view to enabling banks to meet the shortfall, if any, banks are advised to build up provisions significantly above the minimum regulatory requirements for their NPAs, particularly for those assets which they propose to sell to securitisation/reconstruction companies.

The shortfall should be debited to the profit and loss account of that year.
The excess provision will not be reversed but will be utilized to meet the shortfall/loss on account of sale of other financial assets to SC/RC.
NON PERFORMING ASSET AND ITS IMPACT

Corporate Debt Restructuring could be made more effective & efficient through strict policies for its use, compliance & monitoring for strengthening to the stake involved of share holders & for overall development of the economy.

IMPACT OF NPA ON INCOME RECOGNITION

Generally interest on NPA accounts should not be recognized on accrual basis but is booked as income only when it is actually received. Even if the Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realized.

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In respect of leased asset, finance charge accrued and credited to income account before the asset became NPA and remaining unrealized should be reversed or provided for in the current accounting period. Determination of finance charge is guided by AS-19 issued by the ICAI.

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Regular and *ad hoc* credit limits need to be reviewed / regularized not later than three months from the due date/date of *ad hoc* sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular / *ad hoc* credit limits have not been reviewed/renewed within 180 days from the due date/ date of *ad hoc* sanction will be treated as NPA.
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Meaning Of Non Performing Asset (NPA)

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However, this exemption is not applicable for income recognition. In case the guarantee is invoked but remain due for more than 90 days income should not be recognized.

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of long-term infrastructure projects. There exist a time lag in such taking over.

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The taking over institution, on taking over such assets, should make
provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

Export Project If the importer has cleared dues in full by depositing the money in the bank abroad, but the lending bank could not recover the amount because of political developments, the lending needs establish documentary evidence that the importer has cleared the dues in full.

Then asset classification may be deferred after a period of one year from the date the amount was deposited by the importer in the bank abroad.

Advances under Existing credit facilities sanctioned to a rehabilitation unit under rehabilitation package approved by approved by BIFR/TLI is continued to be classified as sub-standard or doubtful as the case may be.

Additional facilities sanctioned under the rehabilitation packages Income Recognition, Asset Classification norms will become applicable after a
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period of one year from the date of disbursement.

Project where financial closure had been achieved and formally documented may be treated as standard asset for a period not exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project.

Projects sanctioned before 1997 with original project cost of Rs. 100 crore or more where financial closure was not formally documented and where deemed date of completion of the project has been decided by a group of outside experts may be treated as standard asset for a period of not exceeding two years beyond the deemed date of completion of the project.

Projects sanctioned before 1997 with original project cost of less than Rs. 100 crore or more where financial closure was not formally documented may be treated as standard asset for a period of not exceeding two years.
Meaning Of Non Performing Asset (NPA)

beyond the date of completion of the project as originally envisaged at the time of sanction.

In the aforementioned cases, banks are now allowed recognize income on accrual basis vide Df30D. BP.BC.74/21.04.048/ 2002-03.

MENACE OF NON PERFORMING ASSET

Subsequent to the Asian currency crisis which severely crippled the financial system in most Asian currency, the magnitude of NPAs in Asian financial institutions was brought to light. Driven by the need to proactively tackle the soaring NPA levels the respective Governments embarked upon a program of substantial reform.

This involved setting up processes for early identification ad resolution of NPAs. The table below provides a proposed cross country comparison of approaches used for NPA resolution.

<table>
<thead>
<tr>
<th>Country</th>
<th>AMCs</th>
<th>Debt Restructuring Mechanism</th>
<th>Key Features</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>Centralised Agency - Danaharta</td>
<td>Corporate Debt Restructuring Committee</td>
<td>NPAs not sold to third parties by restructured.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Good, focused resolution by Danaharta</td>
<td></td>
</tr>
<tr>
<td>-------</td>
<td>-------</td>
<td>----------------------------------------</td>
<td></td>
</tr>
</tbody>
</table>

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**Meaning Of Non Performing Asset (NPA)**
<table>
<thead>
<tr>
<th>Country</th>
<th>Centralised Agency</th>
<th>Corporate Debt</th>
<th>Quick resolution of NPAs due to aggressive NPA disposal and restructuring.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea</td>
<td>KAMCO, now centralised by individual Bank based NPA resolution</td>
<td>Committee</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>Centralised Agency - Indonesia Bank Restructuring Agency (IBRS)</td>
<td>Indonesian Debt Restructuring Agency (INDRA) &amp; Jakarta Initiative Task Force (JITF)</td>
<td>Manu NPAs restructured but issue like transparency in restructuring process, poor bankruptcy laws, Government intervention and questionable court discussions have meant little progress to NPAs sale to third party.</td>
</tr>
</tbody>
</table>
Meaning Of Non Performing Asset (NPA)

| Thailand | Centralised Agencies | Corporate Debt Restructuring Authority (FSRA), Asset Management Corporation Now supplemented by Individual Bank based resolution | Corporate Debt Restructuring Agency (CDRAC) | Largely in-house restructuring of NPAs. Grace period for most restructuring coming to an end soon. Many lead to further rounds of restructuring. |

In addition to the above, some of the more recent and aggressive steps to resolve NPAs have been taken by Taiwan, Taiwanese financial institutions have been encouraged to merge (though with limited success) and from Bank based AMCs through the recent introduction of Financial Holding Company Act and Financial Institutions Mergers Act. Alongside the Ministry of Finance has followed a carrot and stick policy of specifying the required NPA ration for Banks (5% by end 2003), while also providing flexibility in modes of NPA asset resolution and a conducive regulatory and tax environment. Deferred loss write off provisions have been instituted to provide breathing space for lenders to absorb NPA write-offs. While it is too early to comment one of the success of the NPA resolution process in Taiwan, the early signs are
encouraging.

**INCOME RECOGNITION**

Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the Corresponding previous year which has not been realised should be reversed or provided for.

1. Interest income on advances against term deposits, NSCs, IVPS, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

2. Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

3. If Government guaranteed advances become NPA, the
interest on such advances should not be taken to income account unless the interest has been realised.

In respect of State Government guaranteed exposures' income cannot be recognised in standard accounts in defaults of income over 90 days.

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, unrealised interest accrued and credited to income account in the corresponding previous year(s), should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

**INCOME RECOGNITION ON PROJECTS UNDER IMPLEMENTATION**

The banks have been advised to recognise income on accrual basis in respect of the three categories of projects, under implementation which is classified as 'standard'. RBI allows banks to recognise the income on accrual basis using the word 'may', which gives a discretion to the bank with regard to recognition of income. However, in case of uncertainties related to such income, members should consider the compliance with revenue recognition norms explained in AS 9, Revenue Recognition.
Meaning Of Non Performing Asset (NPA)

Some of the banks created provisions against project under implementation prior to the issuance of the earlier circular by the RBI stating that project under implementation are not required to classified as non performing assets for a period not exceeding two years beyond the date when the project ought to be completed. Existing provisions already made need not be reversed upon reclassification of any such advances as tendered pursuant to the applicable norms.


MEANING OF SECURITISATION

The securitization process involves the isolation of a pool of assets or rights to a set of cash flows and the repackaging of the asset or cash flows into securities. Securitisation is a process by which financial instruments are issued on the basis of underlying existing asset(s) or contingent asset(s). Examples of underlying existing assets are mortgage loan balance, debtors, credit card balance, finance lease balance, etc. On the other hand, example of contingent asset is securitization of future cash flow. Securitisation is viewed as a mechanism of enhancing capital.

In a securitization, an enterprise raises money by
issuing securities that are backed by specific assets. In most cases, the underlying assets are loans, such as mortgage loans or auto loans. The cash flow from the underlying assets usually is the source of funds for the borrower/issuer to make payments on the securities.

Securitization products. Includes asset-backed securities, residential mortgage-backed securities, commercial mortgage-backed securities, collateralized debt obligations, and asset-backed commercial paper.

Compared to traditional secured debt, securitizations are intended to provide a lender/investor with greater protection against the corporate credit risk of the originator of the assets. In principle, a securitization lender/investor is a kind of "super-secured creditor," with rights that surpass those of a traditional secured lender. Securitization employs the notion that the subject assets have been "sold" by the originator and, therefore, will not become entangled in bankruptcy proceedings if the originator files for protection under the bankruptcy code.

Accomplishing a "sale" of the securitized assets often requires the use of an SPE. A typical securitization is structured as a two-step transaction. In the first step, the originator transfers the subject assets to an SPE in a transfer designed to constitute a "true sale." In the second step, the SPE issues securities backed by the assets. The SPE uses the proceeds from selling
the securities to pay the originator for the assets. In addition, part of the "consideration" that the originator receives for transferring the assets to the SPE is its ownership of the SPE.

In some securitizations, the originator does not receive the equity in the SPE. Instead, the originator may retain the subordinate or equity position in the securitized assets through other means, such as variable fee structure.

To facilitate securitisation special purpose vehicles are formed. It is a legal entity formed for a limited purpose. It serves to hold the legal rights to the assets transferred from the originator. In the U.S., SPEs facilitate securitization by enabling the use of bankruptcy remote structures.

In the securitisation process there may exist servicer. It is an entity that collects payments on securitized assets and that administers securitization transactions. Administrative duties including processing remittances to investors and transmitting periodic reports to investors, rating agencies, and other interested parties. Often the originator of securitized assets acts as the servicer:

- **Primary servicer:** a company that actually performs routine servicing functions, especially processing collections. In some cases, a primary servicer refers
seriously delinquent loans to a special servicer. When assets from multiple originators back a single securitization, each originator might be the primary servicer of the assets that it originated. In such a case, the sponsor of the deal (a conduit or aggregator) generally would be the master servicer, and each originator would function as a sub-servicer.

*Master servicer:* a company responsible for making sure that the servicing function is carried out, but which may not actually perform the function itself. A securitization backed by assets from multiple originators often has a master servicer. The master servicer subcontracts the collection functions to other companies. A master servicer generally does not outsource administrative functions such as processing remittances and preparing investor reports.

*Sub-servicer:* a company that collects payments on securitized assets on behalf of a master servicer.

*Backup servicer:* an entity designated in advance to take over the servicing of securitized assets in case the primary servicer fails to perform its servicing duties.

*Special servicer:* a servicer designated specifically to handle collections and foreclosures on delinquent and
Problematic loans. In transactions that use a special servicer, there is also a primary servicer, that handles servicing of loans that are current or only mildly delinquent.

Securities issued to the investors in the securitisation process are termed as Pass Through Securities. A pool of fixed income securities backed by a package of assets. A servicing intermediary collects the monthly payments and, after deducting a fee, remits or passes them through to the holders of the pass through security. The most common type of pass through is a mortgage-backed certificate, where homeowners' payments pass from the original bank through a Government agency or investment bank to investors.

Loans are granted by

Future Cash

is Securitised

Servicer collects loan cash flow and services the investors

Investors deal in securitised instruments which carry the features of debt instruments with reinvestment risk as loan cash flow includes repayment of principal as well interest

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SECURITISATION - AN INNOVATION IN FINANCE

The securitization era began in the 1970s with the securitization of mortgage loans by the US Government sponsored enterprises like Fannie Mae, Ginnie Mae, and Freddie Mac. These agencies were created by the Federal Government with the objective of facilitating home ownership by providing a reliable supply of home mortgage financing. The securitization process enabled mortgage originators such as banks, thrift institutions, and insurers to move mortgage loans off their balance sheets, freeing up funds for additional lending. In the process, a new class of highly rated, liquid securities were created, enhancing portfolio opportunities for investors. Since 1970, trillions of dollars worth of mortgages have been securitized, and new issue volume reached $1.5 trillion by 2002. Following mortgaged-backed securities, the next major development in securitization was the introduction of asset-backed securities (ABS) based on other types of assets. This market began in 1985 with the securitization of approximately $1 billion in automobile loans and later expanded to include credit card receivables, commercial mortgage loans, home equity loans, aircraft-backed loans, and numerous other asset classes, reaching a volume of about $450 billion in new issues by 2002.

Another area of securitisation is insurance. The first securitization involving insurers took place in the US
in 1988 and involved sales of rights to emerging profits from blocks of life insurance policies and annuities. An innovative development occurred in 1992 when the Chicago Board of Trade (CBOT) introduced futures contracts that securitized property losses arising from natural catastrophes such as hurricanes and earthquakes. The past decade has witnessed the development of other types of catastrophic risk securities including (CAT) bonds as well as an increasing volume of life insurance and annuity securitizations. However, the volume of insurance transactions is still a very small in comparison with other types of asset-backed securities.

TYPES OF SECURITISATION

Important types of securitisation are (i) Mortgaged Backed Securitisation, (ii) Asset Backed Securitisation, (iii) Cash Flow Securitisation and (iv) Credit Card Securitisation.

MORTGAGED BACKED SECURITIES (MBS) –

An investment instrument that represents ownership of an undivided interest in a group of mortgages. Principal and interest from the individual mortgages are used to pay principal and interest on the MBS. The term "MBS" sometimes refers specifically to mortgage pass-through certificates issued or guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac.
ASSET BACKED SECURITISATION (ABS):

Securities backed by specific assets and the payments on which are tied to or derived from the cash flows produced by the underlying assets. Examples of typical collateral backing ABS include the following: auto loans, credit card receivables, home equity loans, manufactured housing loans, student loans, and equipment leases. In the U.S., the term ABS does not include securities backed by:
- Prime-quality first-lien mortgages,
- Commercial mortgage loans, or
- Pools of corporate bonds and loans.

CREDIT CARD ABS

This involves securitisation credit card receivables. The credit card industry in the US experienced rapid growth throughout the 1990s, with receivables outstanding increasing from $185 billion in 1990 to $572 billion outstanding at year-end 2000.

ILLUSTRATION SECURITIZATION PROCESS

A bank provides housing loans to various parties on the basis of mortgage of the land and the property which is proposed to be constructed. Assume that the bank lent Rs. 100 million to various house owners and holding the mortgage documents. It needs to raise capital for financing new mortgages. Partly it can finance new proposals from new deposits it raised. But that is not
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sufficient. It needs to grow at a faster rate. Its new housing loan demand is Rs. 200 million. One way to raise new funds is mortgage backed securitisation. The bank can securitise its first trench of mortgage loans of Rs. 100 cr. It can create bonds of Rs. 1000 each on the strength of the mortgaged assets and the underlying cash flow. The securitised bonds would be serviced using the principal and interest collections from the first trench mortgage loans. If the bank has given housing loans @9%fixed rate and issued securitised instruments @8%fixed rate, it earns @1%on the first trench loans, and @9%on the second trench. Thus it enhances its capital and earning.

Let us assume that the bank could securitise Rs. 80 million of the first trench mortgage loans @ 7%and lent the money raised @ 9%.Its profit and loss account before and after securitisation would be as follows:

<table>
<thead>
<tr>
<th>Profit &amp; Loss Account Before Securitisation</th>
<th>Profit &amp; Loss Account After Securitisation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rs. in Million</strong></td>
<td><strong>Rs. in Million</strong></td>
</tr>
<tr>
<td>Interest o mortgage loan @ 9% on Rs.100</td>
<td>Interest o mortgage loan @ 16.2</td>
</tr>
<tr>
<td>9.0 million.</td>
<td>9% on Rs.180 million.</td>
</tr>
<tr>
<td>Less : Interest paid @</td>
<td>Less : Interest paid @</td>
</tr>
<tr>
<td>8% on Rs.100 million.</td>
<td>7% on Rs.80 million.</td>
</tr>
<tr>
<td>8.0</td>
<td>And interest paid</td>
</tr>
</tbody>
</table>

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Meaning Of Non Performing Asset (NPA)

Gross Spread on 1.0 mortgage loans

2.6

@ 8% on Rs.100 8.0 million.

Of course, this is an oversimplified example in which cost of securitization is not included. Securitisation involves credit rating of mortgage loan portfolio, credit guarantee and expenses for servicing the retail investors who subscribed the securitised instruments.

Securitised instruments are termed as Pass Through Securities (PTS) which are either privately placed or sold through retail channel of the capital market. An escrow account is opened with a bank in which the principal and interest cash flow of the mortgage pool is deposited for onward payment to the investors of the securitised instruments. In case the pool comprises of monthly cash flow of principal and interest, the investor will get back principal and interest on monthly basis.