4.1 INTRODUCTION

It has been observed that NPAs in absolute terms is increasing in banks. It indicates that the banks have not adopted effective preventive measures to arrest degradation of standard assets to NPA category. Prevention of NPAs is the most effective NPA management technique as prevention is better than cure. Due to NPA fear psychosis many bankers are adopting the following measures for avoiding NPA

(i) Lower exposure to Credit

(ii) Preference to Credit against tangible securities

(iii) Over & undue caution in credit decisions.

The above measures cannot help to check the increase in NPA; as because, extending credit to the borrowers is the basic business of the banks. They should not be averse to taking credit decisions. Rather in the new millennium they are required to take more critical credit decisions for their survival due to lower interest margin and stiff competition. Further, over cautious approach & obtaining tangible securities indiscriminately will not help in arresting NPA as NPA depends on the recoverability of interest & or installment, but not on the security. Therefore the banks are required to adopt not only proactive approaches to acquire quality loan assets but also effective preventive measures for arresting slippage of Standard Assets. In the Report on Trend and Progress of Banking in India, the Reserve Bank of India has observed that a lasting solution to the problem of NPAs can be achieved only with proper credit assessment and risk management mechanisms. For instance, in a situation of liquidity problem, the enthusiasm of the banking system to increase lending could compromise on asset quality, raising concerns about adverse selection, and the potential danger of addition to the stock
of NPAs. It is, therefore, necessary that the banking system is equipped with prudential norms to minimize, if not completely avoid the problem. As regards internal factors leading to NPAs, the onus for containing the same rests with the banks themselves. This would necessitate organizational restructuring, skill upgradation for proper assessment of creditworthiness and a change in the attitude of the banks towards legal action, which is traditionally viewed as a measure of the last resort. 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 in credit portfolio. But the incidence of NPA can be prevented to a great extent by adopting the following measures

- Credit Risk Management (CRM)
- Credit Marketing
- Management of Potential NPAs.

### 4.1.1 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. Credit risk is created with a creation of a loan asset by the bank. It is merely a chance or probability of default, which may vary from zero to 100 percent. 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. The portfolio risk of a bank depends on both external and internal factors. The external factors are the state of the economy, wide swings in commodity, equity prices, foreign exchange rates & interest rates, trade restrictions, economic sanctions, Government policies, etc. The internal factors are deficiencies in loan policies, administration, absence of prudential credit concentration limits, inadequately defined lending limits for the credit sanctioning authorities, deficiencies in appraisal of borrowers' financial position, excessive dependence on collaterals, inadequate risk pricing, absence of loan review mechanism and post sanction surveillance, etc.

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 followings

- Credit risk identification
- Credit risk assessment, quantification
- Credit risk pricing
- Credit risk control mechanism

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. It can be further grouped into various types like Managerial risk, Operational risk, Commercial risk, Financial risk, Transaction risk, etc. As there are many risk factors associated with a credit, it is important to identify the specific factors that may affect repayment of the proposed loan adversely.

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. Credit Scoring, Rating is an important scientific tool to assess the quality of individual credits i.e. the credit worthiness of the borrower, credit proposal for the purpose of granting, rejecting the credit proposal. Credit rating evaluates the risks associated with a credit proposition vis-a-vis different parameter values set by the bank depending on its risk bearing capacity. Based on individual experiences, banks should draw their own risk rating system in a structured manner, incorporating, inter alia, financial analysis, projections and sensitivity, industrial and management risks. They may use any number of financial ratios and operational parameters and collaterals as also qualitative aspects of management and industry characteristics that have bearing on the credit worthiness of borrowers. Risk is measured by making a quantitative assessment of the credit proposal.
to be rated against the set standards under each parameter and numerical credit score is arrived at. Based on the credit score the loan proposals are graded. For each numerical category, a quantitative definition of the borrower, the loan's underlying quality, and an analytic representation of the underlying financials of the borrower should be presented. Further, as a prudent risk management policy, each bank should prescribe the minimum rating below which no exposures would be undertaken.

After grading a loan proposal, it is required to quantify the credit risk through estimating the expected loan losses as well as the unexpected loan losses. The expected loss is the amount of money that a bank expects to loose on a loan in a year, net of recoveries and is driven by the expected probability of default and the expected recovery rate in default. The probability of default and the recovery rate would depend upon the grading of the loan and the historical behaviour of that grade. The unexpected loss is the amount by which the actual loss exceeds the expected loss. The measure of uncertainty of credit loss is the standard deviation of losses. To safeguard against this unexpected loss bank needs to set aside sufficient equity capital.

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 an accompanying low risks. Banks should evolve scientific systems to price the credit risks, which should have a bearing on the expected probability of default. The pricing of loans normally should be linked to risk rating. Risk based pricing helps banks in averting
‘adverse-selection’ and ‘earnings-volatility’ that are likely to threaten their very survival and also it helps in proactive provisioning that ensures adequate return on capital.

Credit Risk Control Mechanism

Risk is inherent in all lending decisions and elimination of risk completely is not possible. 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. The risk mitigating measures available to the banks are insurance cover of assets against loss, damage, calamity, etc.; institutional guarantee cover against default risk from DICGC, ECGC & CGTSI; reducing exposure, fixing higher level margin, obtaining collateral & counter guarantee, availing exchange derivatives like forward swap, neutralizing systematic risk by spreading over a number of sector and fixing exposure limit to particular sector. Loan Review Mechanism is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. There is a need for banks to develop and implement comprehensive procedures and reporting mechanisms so that loan review mechanism enables a bank

- To identify promptly loans which develop credit weaknesses and initiate timely corrective action
- To evaluate portfolio quality and isolate potential problem areas
- To provide information for determining adequacy of loan loss provision
- To assess the adequacy and adherence of loan policies and procedures to monitor compliance with relevant laws and regulations
To provide top management with information on credit administration, including credit sanction process, risk evaluation and post-sanction follow-up.

Portfolio Risk Management

The existing framework of tracking the Non Performing Loans around the balance sheet does not signal the quality of the entire loan book. Banks should evolve proper systems for identification of credit weakness well in advance. 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-tuning the credit risk management. The banks could also consider the following measures to maintain the portfolio quality

- Stipulate quantitative ceiling on aggregate exposure in specified rating categories.
- Evaluate the rating-wise distribution of borrowers in various industry, business segments, etc.
- Exposure to one industry, sector should be evaluated on the basis of overall rating distribution of the borrowers in the sector, group.
- Target rating-wise volume of loans, probable defaults and provisioning requirements as prudent planning exercise. For any deviation from the expected parameters, an exercise for restructuring of the portfolio should immediately be undertaken and if necessary, the entry-level criteria could be enhanced to insulate the portfolio from further deterioration.
Undertake rapid portfolio reviews, stress tests and scenario analysis when external environment undergoes rapid changes.

Introduce discriminatory time schedules for renewal of borrower limits.

Cardinal Principles of Lending

For acquiring the quality loan assets the bankers are required to follow some cardinal principles of Sending as discussed below

Safety: It depends upon the credit-worthiness of the borrower. The credit worthiness can be judged on the basis of age old 5 Cs criteria of credit i.e. Character, Capacity, Capital, Collateral and Conditions.

Liquidity: It depends upon the income generation capacity of the project, asset. The credit consideration should be based on cash flows but not purely collaterals and relationship. It is to be ensured that the repayment of the principal and the servicing of the interest are met through cash flows from operations. Preference should be given to those projects, activities, which can generate sufficient income even in adverse situations.

Security: Security serves as a safety valve for an unexpected emergent situation. But, indiscriminate acceptance of any security will not help in any way; as the banks are facing a lot of problems in the disposal of the tangible securities, which include property and plant & machinery acquired from the borrowers. While accepting any security, the banks should follow the 'MAST' principles of good security i.e. Marketability, Ascertain ability of value, Stability of value and Transferability.

Diversification of Risks Some exogenous factors like market recession, natural calamities, political changes, etc. may ruin even a prosperous business. To safeguard the loan portfolio against such unforeseen contingencies, banks should follow the principle of
diversification of risk based on the famous adage "Do not keep all the eggs in one
basket". The credit portfolio should be spread over a reasonably wide area, distributed
amongst a good number of borrowers belonging to different trades & industries.

Proper Credit Management Quality of lending depends upon proper credit
management, which involves the following aspects

➢ Proper Credit Investigation
➢ Scientific Credit Appraisal
➢ Technical Feasibility
➢ Managerialability
➢ Marketability
➢ Project Cost Assessment
➢ Economic Viability
➢ Financial Viability
➢ Sensitivity Analysis
➢ Timely Credit Disbursement
➢ Scientific Repayment Scheduling
➢ Proper Credit Documentation
➢ Effective Credit Supervision, Surveillance
➢ Effective Credit Management Information System
➢ Proactive Credit Policy and Loan Review Policy
4.1.2 CREDIT RISK 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. Because of this psychological factor some have developed procrastination in credit dispensation; make unnecessary & repeated queries; create procedural bottlenecks and neglect in credit supervision. These are also the causes for creation of NPA. Effective credit marketing is an important tool for prevention of NPAs. 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 the market to locate the prospective borrowers and finance them for productive activities, projects. Credit marketing involves the following steps

- Moving closer to customers,
- Identifying their financial needs,
- Developing geographic as well as activity specific credit products,
- Tuning these products to meet the specific needs of the individual customers,
- Pricing these products at a competitive rate, and
- Servicing these products in better way in comparison to the competitors.
Banks are required to develop in-house expertise for development & marketing of such credit products at a competitive price with a minimum risk.

4.1.3 MANAGEMENT OF POTENTIAL NPAs

Even after immunization, there is possibility of becoming an account NPA. Generally, all on 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 measures to check its slippage to NPA. This is what the management of Potential NPAs is. It is discussed elaborately in the following paragraphs. Potential NPA is a loan asset, which is going to be declared, classified as NPA as on the coming balance sheet date i.e. on 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.

Critical Due Amount (CDA)

It is the minimum amount due in a standard asset which if not recovered before 31st March of the current financial year will result the asset becoming NPA.

Identification of Potential NPA

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

➢ The interest to be debited during the above period may not be recovered. In other words, the credit entries, credit turnover may not be sufficient to cover the interest to be debited during the above period.

➢ The interest of at least one quarter debited during the first half year of the fiscal year may not be recovered till 31st March.

Then, such accounts may be identified as Potential NPAs. Further, a working capital borrower account becomes potential NPA if irregular drawings have been allowed prior to 1st October of the financial year.

In case of Bill purchased or discounted, if the bill amount remains over due since 1st October of the financial, it may be termed as Potential NPA. In case of Agricultural advance, where payment of interest & installment is synchronized with the harvesting and marketing of the produce, 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. In case of other loan facilities such as Letter of Credit devolved, Bank Guarantee invoked, debit balance in Savings, Current accounts due to credit card, OD facility, etc.; if any amount remains overdue since 1st October of the financial year, it may be treated as Potential NPA.

4.2 PREVENTION OF POTENTIAL NPA BECOMING NPA

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

➢ In case of Potential NPA (Term Loans)
➢ By recovering the critical due amount i.e. the amount of arrears of both interest and installment upto 1\textsuperscript{st} October of the financial year before or as on 31\textsuperscript{st} March of the financial year.

➢ By rescheduling the repayments where there is possibility of poor, nil recovery due to genuine causes beyond the control of the borrower.

➢ 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 1\textsuperscript{st} October to 31\textsuperscript{st} March of the financial year and at least one quarter interest of the first half year before or as on 31\textsuperscript{st} March. In case of a working capital borrowal account the potential NPA can be prevented of becoming NPA by obtaining the stock statements at least up to the month of July. In case of these categories of accounts where the due date or the date of ad hoc sanction falls before 1\textsuperscript{st} October, the regular and ad hoc credit limits should be reviewed, renewed in order to prevent it becoming NPA.

➢ In case of Potential NPA, Bills purchased and discounted

➢ By recovering the entire bill amounts overdue up to 1\textsuperscript{st} October of the financial year before or as on 31\textsuperscript{st} March.

➢ In case of Potential NPA, Agricultural advance where repayment is synchronized with the harvesting season

By recovering all the overdue interest and installments upto the month of March or the last harvesting season of the last financial year, whichever is earlier, before or as on 31\textsuperscript{st} March of the current financial year.
In all other cases of Potential NPAs

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

Table 4.1
GROSS ADVANCES AND GROSS NPA

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross advances</th>
<th>Gross NPA</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>8130511</td>
<td>142635</td>
<td>1.75</td>
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<tr>
<td>2008-09</td>
<td>9581952</td>
<td>181071</td>
<td>1.89</td>
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<td>2009-10</td>
<td>11471418</td>
<td>149560</td>
<td>1.31</td>
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<tr>
<td>2010-11</td>
<td>12247549</td>
<td>167432</td>
<td>1.37</td>
</tr>
<tr>
<td>2011-12</td>
<td>13055824</td>
<td>227574</td>
<td>1.74</td>
</tr>
<tr>
<td>Average</td>
<td>10897450</td>
<td>1736544</td>
<td>1.61</td>
</tr>
</tbody>
</table>

Sources Annual audited report KGB

From the table 4.1 it can be noticed that the gross advances of the bank increased from amount 8130511 in year 2007-2008 to amount 13055824 in 2011-12. A drastic increase of 160.57 percentage. At the same time gross NPAs also raised from 142635 in the year 2007-2008 to amount 227574 till the year 2011-12. It is showing an increase of 159.54 percentage.

At the same when we observe the percentage of Gross advances to gross NPA it was 1.75 during the year 2007-2008. it got increased to 1.89 in the year 2008-2009 during the year 2009-2010 and 2010-11 it came down to 1.31 and 1.37 got increased drastically to 1.74. On an average it was 1.61 percentage of gross NPA when compared to gross advances. It indicating an alarming signal to management to reduce the proportion of NPA.
Month-wise Action Plan for Prevention of Potential NPAs becoming NPAs

After completion of auditing and budget planning i.e. in the 1st week of May, the branch should identify all the potential NPAs under agricultural advances where payment of interest & installment is synchronized with the harvesting seasons i.e. all the loan accounts under this category where there is overdue up to the month of March of the last financial year. Then the branch should make a list of all these accounts with their critical due amount in each case; a copy of which may be forwarded to the controlling offices for their monitoring. Thereafter, the branch should pursue vigorously with these borrowers for recovery of the critical due amount as early as possible; but before 31st March of the current financial year. In respect of the agricultural borrowers where natural calamities have impaired their paying capacity, the branch should undertake immediately the rescheduling, restructuring of their loans so as to avoid these potential NPA accounts becoming NPAs. In the month of July, the stock statements in all working capital borrowal accounts should be obtained up to date. The branch should make a list of such borrowers where the stock statements up to the month of July have not been submitted and thereafter the branch should follow up with these borrowers for obtaining these stock statements at least. In the 1st week of October, the branch should identify all the potential NPA accounts under Term Loans where there is overdue up to the date of 1st October. Then the branch should make a list of all these accounts with their critical due amount in each case. Thereafter, the branch should pursue vigorously with these borrowers for recovery of the critical due amount as early as possible; but before 31st March of the current financial year. In the 1st week of October, the branch should identify all the potential NPA accounts under Bills purchased & discounted and all other accounts like
LC, BG, etc. where there is overdue up to the date of 1\textsuperscript{st} October. Then the branch should make a list of all these accounts with their critical due amount in each case. Thereafter, the branch should pursue vigorously with these borrowers, the concerned bank, branch for recovery of the critical due amount as early as possible; but before 31\textsuperscript{st} March of the current financial year. In the 1\textsuperscript{st} week of October the branch should review, renew all the regular and ad hoc credit limits which due date or the date of sanction falls prior to 1\textsuperscript{st} October and make a list of such accounts and complete their review, renewal before 31\textsuperscript{st} March of the current financial year. In the months of October, November & December the branch should identify all the potential NPA accounts under Cash Credit & Overdraft i.e. all the accounts under these categories where the balance outstanding remains or likely to remain continuously above the limit or drawing power and the credit entries are not sufficient to cover the interest amount to be debited during the half year and at least one quarter interest of the first half year. The branch should make a list of all these accounts with their critical due amount or likely to be due. Then after, the branch should follow vigorously with these borrowers to bring down the outstanding balance within the limit, drawing power and ensure sufficient credit turnover at least to cover the interest amount to be charged during the half year much before 31\textsuperscript{st} March. In the subsequent months of January to March, the branch should review their monthly progress; intensify their personal contact with the borrowers; plan effective strategies involving all the branch staff and execute these strategies on time bound. In the months of November and onwards the controlling offices should evaluate the magnitude of the potential NPAs vis-a-vis the capabilities of the branches for management of potential NPAs and accordingly extend the need based support instead of issuing formal reminders. As NPA concept is
not applicable to staff loans, Advances against the bank’s own deposits, NSC, LIC Policy, etc. there is no need to identify Potential NPAs under these categories.

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 infrastructural 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-

- Sectoral break up of advances
- Asset classification
- Movement of loan assets
- Potential NPA
- Fresh addition in NPA
- Reduction in NPA
- Provision required
- Uncharged Interest
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**

Creation of a comprehensive database on NPA for the following purposes

- To assess Asset Quality.
- To forecast Potential NPA.
- To monitor movement of Asset Classes in Asset Cycle.
- To arrest degradation of Standard assets.
- To monitor NPA reduction.
- To Assess progress & prospect of Compromise Settlement as well as Write off.
- To assess Provision requirements on realistic basis.
- To assess uncharged interest.
- To assess quantum of NPA involved in Legal process
- To assess Govt. guaranteed NPA accounts.

Identification of Risk Concentration.

- Development of Risk Assessment Models as well as Risk Management techniques.
- Analysis of NPA dimensions relating to geographical area, industry, sectors, activities.
- Formulation of Sound Credit Policy as well as Loan Recovery,NPA Management Policy
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.

Evaluation of NPA management quality.

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

The collection as well 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 generates 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 & networking at the branch and controlling office levels for the following purposes

- Forecasting of Potential NPA syndrome in each loan account.
- Automatic identification & categorization of NPA as on each balance sheet date.
Calculation of critical amounts for arresting slippage as well as upgradation.

Auto-generation of statistical returns for NPA-MIS.

Estimation of Provision requirement in each NPA a,c.

Transmission of data to management through networking.

Risk analysis & appraisal of credit proposals.

Sensitivity analysis of various impacts on NPA.

The Software for MIS should contain such particulars parameters fields which can generate necessary information for the above purposes. For the same, a model package is discussed in next page.

4.3 CREDIT & NPA MANAGEMENT POLICIES

Credit as well as NPA management Policies play very vital roles in effective NPA management. Defective Credit Policy is a precursor to creation of NPA in a bank. Similarly, defective NPA Management Policy (Recovery Management Policy) is also a precursor to non-reduction of NPAs. Both Credit Policy and NPA Management Policy are co-related just-like two parts of a coin. No one Policy can be formulated without recourse to other; rather there should be one policy encompassing both aspects. It may be termed as Credit Dispensation & Recovery Management Policy.

Today's Credit Policies as well as Recovery Management Policies of most banks are reactive policies. These policy documents are nothing but carbon copies of the guidelines of the Reserve Bank of India. On instructions of the RBI, the banks are formulating the policies but not as a part of business requirements. More ever, these policies are neither proactive nor pre-active. The RBI guidelines are indicative for formulation of progressive policy. These guidelines should act as benchmarks for
formulating of appropriate policy measures. Care should be taken that the RBI guidelines should not be violated while implementing any progressive Policy. In the era of LPG (Liberalization, Privatization & Globalization) the Policy should be visionary, progressive & pre-active. It should create dynamism & conducive atmosphere in the field level for achieving its objectives. In the above context each bank should formulate a suitable Credit Dispensation & Recovery Management Policy depending upon the size & complexity of the existing credit business, risk philosophy, market perception and the existing level of NPAs & capital. Some salient features for formulation of such a policy at corporate level are discussed in subsequent paragraphs. In the present competitive market, even every branch should formulate such a policy on the basis of its SWOT analysis keeping in view the overall corporate policy.
Fig. 2:

MAP
STATE & UNION TERRITORY - WISE CREDIT - DEPOSIT RATIO OF SCHEDULED COMMERCIAL BANKS - 2012
(As on March 31)

Figures in brackets indicate Credit - Deposit ratio for 2011
All figures are in per cent
By looking at map state and union territory-wise credit. Deposit ratio of scheduled commercial banks for 2011-2012.

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<th>Sl. No.</th>
<th>State</th>
<th>Credit-Deposit ratio</th>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>Jammu &amp; Kashmir</td>
<td>34.26</td>
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<td>2.</td>
<td>Himachal Pradesh</td>
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<td>Madhya Pradesh</td>
<td>51.16</td>
</tr>
<tr>
<td>21.</td>
<td>Gujarat</td>
<td>69.73</td>
</tr>
<tr>
<td>22.</td>
<td>Chattisgarh</td>
<td>53.48</td>
</tr>
<tr>
<td>23.</td>
<td>Orissa</td>
<td>46.92</td>
</tr>
<tr>
<td>24.</td>
<td>Maharashtra</td>
<td>87.08</td>
</tr>
<tr>
<td>25.</td>
<td>Andhra Pradesh</td>
<td>110.35</td>
</tr>
<tr>
<td>26.</td>
<td>Karnataka</td>
<td>70.74</td>
</tr>
<tr>
<td>Sl. No.</td>
<td>State</td>
<td>Credit-Deposit ratio</td>
</tr>
<tr>
<td>--------</td>
<td>---------------------</td>
<td>----------------------</td>
</tr>
<tr>
<td>27.</td>
<td>Tamil Nadu</td>
<td>116.16</td>
</tr>
<tr>
<td>28.</td>
<td>Kerala</td>
<td>75.55</td>
</tr>
<tr>
<td>29.</td>
<td>Goa</td>
<td>28.91</td>
</tr>
<tr>
<td>30.</td>
<td>Lakshadweep</td>
<td>9.72</td>
</tr>
<tr>
<td>31.</td>
<td>Andman Nicobar</td>
<td>37.96</td>
</tr>
<tr>
<td>32.</td>
<td>Div and Daman</td>
<td>17.21</td>
</tr>
<tr>
<td>33.</td>
<td>Dadra &amp; Nagar Havelli</td>
<td>34.44</td>
</tr>
</tbody>
</table>

As per the map from Jammu & Kashmir to Kerala and from Gujarat to Nagaland including state and union territories overall Tamil Nadu was the higher credit deposit ratio state upto 116.16 ratio Lakshadweep is lowest upto 9.72 as far as Karnataka State it was 70.74 ratio.

Over all by looking at ratio’s of all over the Indian it is clear that there is good scope for further improvement in this regard.
Table 4.2

PRIORITy AND Non-PRIORITY SECTOR ADVANCES

(amount in thousands)

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Priority sector</th>
<th>Non priority sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target under A.C.P.</td>
<td>3516303</td>
<td>4067010</td>
</tr>
<tr>
<td>Achievement</td>
<td>4744128</td>
<td>4712089</td>
</tr>
<tr>
<td>Achievement percentage</td>
<td>134.91</td>
<td>115.86</td>
</tr>
<tr>
<td>Total out standing</td>
<td>7428035</td>
<td>8118519</td>
</tr>
<tr>
<td>Outstanding amount between priority &amp; non priority sector</td>
<td>91.36</td>
<td>84.73</td>
</tr>
</tbody>
</table>

Sources: Annual audited report KGB
Objectives: The Corporate, Branch Credit objectives should be clearly set out in consonant with the overall corporate business objectives taking into consideration the following aspects

- The present strengths of the bank
- The present weaknesses of the bank.
- The future opportunities available to the bank.
- The future threats posed to the bank.

Generally, the long term objectives should be (1) sustained growth in credit and (2) containing NPA at the minimum level. The objectives should be suitably quantified. The policy should have long term as well as short term objectives; It should have flexibility for fine tuning with the overall Govt., RBI Credit Policy as well as with the environmental changes.

Research & Analysis: Before formulation of any policy the banks should conduct the following studies thoroughly.

- SWOT Analysis
- Dimension of NPAs
- NPA Causative factors
- Feedback analysis on the existing systems & policies.

These four studies are very important for formulation of a progressive policy. For the above purposes, every bank should have a mechanism for conducting systematic studies. Presently most banks are using their Statistical Department, Credit
Cell for such purpose, but it does not solve the purpose as it is a mere statistical analysis. Banks should have a separate Credit Research & Analysis Wing, Department with regional set up for taking care of the following aspects besides the above studies.

- Credit Risk Management i.e. Development of comprehensive credit risk assessment & rating models as well as credit risk control mechanism for the field functionaries.
- Development of various credit products.
- Credit forecasting on market trends & changes.
- Credit Product Pricing & Costing.

**SWOT Analysis:** The banks should know clearly their strengths & weaknesses in credit dispensation with respect to the following aspects

- Availability of credit personnel at branch level
- Credit & NPA management skill
- Credit sectors, activities, industries where the bank is strong or weak.
- Regions, branches where the bank is strong or weak.

Similarly, the banks should also know the opportunities & threats not only to their business but also to their borrowers. In this LPG era, opportunities as well as threats have increased manifold without any blanket cover; because liberalization, privatization & globalization have set in new markets, new competitions, new products, new technology & new customers. Therefore, the credit policy should take
care of the strengths, weakness, opportunities & threats of the bank. This will vary greatly from bank to bank.

**Dimension:** The dimension of NPA in a bank should be thoroughly studied with respect to the followings

- Geographic, Region wise dimension
- Sector, Activity, Industry wise dimension
- Delegated authority wise dimension
- Legal dimension

From this study the bank can know NPA prone areas, sectors, authorities & take corrective measures while formulating Credit Policy.

**NPA Causative factors:** There are numerous factors for creation of NPA in a bank. But these factors vary widely from bank to bank. Therefore, it is essentially required to know bank specific factors, which are contributing to high incidence of NPA. After knowing these factors clearly, then only the bank, branch can formulate an effective Credit Policy.

**4.4 VARIOUS ASPECTS OF CREDIT DISPENSATION & RECOVERY MANAGEMENT POLICY**

**Credit Policy Committee:** Each & every bank should set up a high level credit policy committee to deal with various issues pertaining to credit & NPA management.
Similar committees should be set up at Regional & branch levels to deal with such matters.

**Credit Risk Management** The Credit Policy should clearly spell out the credit risk management techniques to be adopted by the field functionaries. It should give comprehensive guidelines with respect to identification, evaluation, rating, monitoring and control of credit risk. The credit risk rating system should not be a generalized one; rather it should be activity, industry as well as geographic specific.

**Credit Decision** Presently the bankers are adopting reactive approach in credit decision. The credit appraisal is merely a justification of credit sanction. There is fear psychosis in the minds of the bankers for taking credit decisions. There is lack of scientific credit appraisal skill in the field functionaries. The above causes contribute to delayed & defective decision, which is one of the factors for high incidence of NPA. The Credit Policy can take care of these issues by the following ways

- The branch, bank should adopt committee approach in credit decision, sanction.
- It should remove the fear psychosis from the minds of the field functionaries.
- It should take care of the training needs of the field functionaries for improving their credit management skills, The untrained personnel should not be allowed to take credit decisions.
- The delegated authority should be clearly spelt out with respect to risk factors, exposure limit, activity, sectors, areas, etc.
- Credit appraisal techniques, models should be developed, standardized.
Table 4.3
DEMAND, RECOVERY AND OUTSTANDING

<table>
<thead>
<tr>
<th>Year</th>
<th>Demand</th>
<th>Recovery</th>
<th>Outstanding</th>
<th>Recovery percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>4076105</td>
<td>3671350</td>
<td>404755</td>
<td>90.07</td>
</tr>
<tr>
<td>2008-09</td>
<td>5725493</td>
<td>5251713</td>
<td>473780</td>
<td>91.72</td>
</tr>
<tr>
<td>2009-10</td>
<td>6861589</td>
<td>6437260</td>
<td>424329</td>
<td>93.82</td>
</tr>
<tr>
<td>2010-11</td>
<td>6457455</td>
<td>5895636</td>
<td>561819</td>
<td>91.30</td>
</tr>
<tr>
<td>2011-12</td>
<td>8247702</td>
<td>7530937</td>
<td>716765</td>
<td>91.31</td>
</tr>
<tr>
<td>Average</td>
<td>6273669</td>
<td>5757379</td>
<td>516290</td>
<td>91.64</td>
</tr>
</tbody>
</table>

Sources Annual audited report KGB

From the above table 4.3 it can be observed that recovery compared to the total demand for the year 2007-2008 was 90.07 percentage, consequently in the year 2008-2009 it was 91.72 percentage, in the year 2009-2010 it was 93.82 percentage at the same time in the year 2010-2011 it was 91.30 and in the year 2011-2012 it was 91.31 percentage. On an average during the study period recovery percentage over money in demand it was 91.64 percentage.

By looking at the recovery percentage during the study period showed consistency in fact in the year 2009-2010 it increased to highest value i.e. 93.82 percentage. At the same time when we look at the values of outstanding amount it also quiet alarming, in fact it was continuously increasing along with demand amount, on an average it was 8.36 percentage during the study period.
**Credit Delivery & Monitoring** Defective credit delivery & monitoring is one of the factors for high incidence of NPA. Therefore, the Credit Policy should specify a realistic staff set-up to deal with specified credit portfolio. Placement & charge hand-over of Credit personnel should be systematic. It should lay down credit disbursement and follow-up procedures.

**Credit Documentation** The Policy should also spell out the securities to be taken by the field functionaries for various credit risk ratings. The documents as well as documentation procedures should be standardized.

**Credit Pricing** In this deregulated environment the Credit Pricing is very crucial for getting credit business and making profit. There should be differential as well as floating price rate depending up on risk factor, cost of fund, spread & market rate. The policy should specify the price structure for different risk ratings & activities.

**Credit Marketing** In the competitive environment the Credit Marketing is very important not only for garnering the credit business but also for avoiding NPA. The policy should spell out the marketing strategies to be followed by the field functionaries.

**Credit Supervision** The main purpose of credit supervision is to identify the lacunae in the systems & suggest measures to rectify the same with a view to avoiding such recurrence. The Credit Policy should spell out proactive credit supervision procedures to be followed by the controlling offices and Inspection departments. Supervision should not be a fault finding, but a fault rectifying activity. Supervision should be not
only branch specific but also delegated authority specific. Supervision should provide feedback for policy formulation.

Accountability An important issue of Credit & NPA Management Policy is to address accountability. Accountability means owning responsibility for decisions taken and fixing liability for failure to take timely corrective action. Accountability procedures should take care of bonafide credit decisions and remove fear psychosis from the minds of field functionaries for taking judicious credit decisions. Suitable disciplinary action should be taken quickly where malafide is evident.

NPA Management Policy Despite the above measures taken by the bank, branch, there would be some amount of NPA created in the credit portfolio; as credit risk cannot be totally eliminated. NPA Management Policy should aim at reduction of NPA by upgradation as well as liquidation. For these objectives the banks should address the following issues

- Identification of NPA
- Organizational set-up
- Rephasement, Reschedulement, Rehabilitation Packages
- Legal Matters
- Compromise & Write-off
- Engagement of Private agencies
- Special Incentive Packages
- M.I.S. & I.T.
- NPA Reduction Strategies
Fig. 3: FLOWCHART OF NPA MANAGEMENT

4.5 ALTERNATE METHODS FOR NPA MANAGEMENT

An effective resolution of the problem of NPA is hampered on account of inadequate legal provisions, the existing bottlenecks in the debt recovery process, absence of alternate avenue for wiping out the chronic NPAs from the banks' balance sheets and lack of credit information exchange facilities among the banks. At the policy level, there is need for legislation, which will make recovery processes smoother and legal action quicker. In consultation with the Government, the Reserve Bank of India has initiated some measures on the above aspects for providing alternate methods to the banks for resolving their NPA problem. Some of the impending methods, which are under active consideration of the RBI, Government, are briefly discussed below.

Asset Reconstruction Company (ARC)

The Narasimham Committee as well as the Verma Committee has recommended to set up an asset reconstruction company to tackle the problem of non-performing assets in the banking industry. 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 shareholders 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, of course at a heavy cost.

**Corporate Debt Restructuring**

Another method suggested for the reduction of NPAs is Corporate Debt Restructuring. The process is mainly restructuring the debt portfolio of the borrowers among its creditors to assist the borrowers in the revival of the projects and continue operations through reduction in existing debt burden and establishment of credit lines with implied assumption that the lender would prefer reduction in risk to optimization of returns. The objective of CDR is to ensure a timely and transparent mechanism for restructuring of die debts of viable corporate entities affected by internal and external factors, outside the purview of BIFR, DRT or other legal proceedings, for the benefit of all concerned. The major features of the CDR mechanism are

- It would be a voluntary system based on debtor-creditor agreement and inter-creditor agreement,
- The scheme will not apply to accounts involving only one financial institution or one bank; instead, it will cover multiple banking accounts, syndication, consortium accounts with outstanding exposure of Rs.20 Crore and above by banks and institutions
- It would be only applicable to standard and substandard account, with potential cases of NPAs getting a priority.
Credit Information Bureau

A Credit Information Bureau has been established with a paid-up capital of Rs.25 crore, in order to coordinate sharing of information on the borrowers of credit institutions. The CIB will perform the role of collecting and disseminating information on the list of suit-filed accounts and the list of defaulters including willful defaulters, which is presently handled by the RBI.

Defaulters’ List

For providing information regarding the defaulter borrowers to the banks and financial institution, the RBI introduced annual publication of the list of defaulters (suit-filed cases) to banks and financial institutions of Rs. 1 crore. The coverage of the scheme was widened by bi-annual circulation of the names of defaulters of Rs. 1 crore and above in the doubtful or loss category. A scheme for collection and dissemination of information on willful defaulters with outstanding balance of Rs.25 lakh and above, on quarterly basis. Pending appropriate amendments in the banking laws, the RBI has also advised banks to incorporate a condition in the loan agreement for obtaining consent of the borrowers to disclose their names in the event of their becoming defaulters. RBI has advised the banks to complete the process of obtaining consent of the borrowers.

Apart from the things discussed in this chapter exhaustively an attempt has been made in order to enhance further on some of the relevant issues specifically addressed in the next chapter “Credit Risk Management”.

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