CHAPTER - II

NON-PERFORMING ASSETS – CONCEPTUAL FRAMEWORK

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2.1 Indian Banking System – An Overview

For a long time the regulated Indian financial sector was largely represented by the Banking system. Banks by virtue of their business operation assume a pivotal position in the economy by holding the savings of the people, creating money supply and serving as a conduit for the central bank to carry out the monetary policy initiatives. By administering the national payment and settlement system and acting as intermediary between the saving and investment community and allocating investment efficiently according to the returns to the various sectors in the economy they perform a central role. However, the role of Indian Banking System has undergone a number of changes depending on the requirement of the economy at the material time.

Until the adoption of liberalization and globalization policy, Indian banking sector is dominated by the public sector banks. In order to ensure banking for all, fourteen commercial banks were nationalized on 19th of July, 1969 by Mrs. Indira Gandhi the then Prime minister, with another installment of nationalization of six banks on 15th of April, 1980. Presently Indian banking system has 26 commercial banks [State Bank of Sourashtra is to merge with State Bank of India, and parliament has already nod his head for the same. The Public sector banks of India comprises State bank of India with her associates and 19 other commercial banks.

Amongst the scheduled banks in the Indian Banking system, commercial banks and cooperative societies (banks) have been in existent for a pretty long time.
Following is an overview of the structure of the Indian banks:

Structural Pattern of Scheduled Banks in India

- **Scheduled Commercial Banks**
  - Regional Rural Banks (86)
  - Public Sector Banks (26)
  - Nationalized Banks (19)
  - Old Private Banks (16)
  - New Private Sector Banks (9)

- **Scheduled Co-Operative Banks**
  - Foreign Banks in India (12)
  - Urban Co-Operative Banks (53)
  - State Co-Operative Banks (31)

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An important development in the system of banking was establishment of Regional Rural banks (RRBs) in the seventies to cater the needs of the rural Indians. RRBs combine the local feel and familiarity with rural problems, which the cooperatives posses, and the degree of business organization as well as the ability to mobilize deposits, which the commercial bank possess [Iyenger, 2007]. The process of consolidation through amalgamation of RRBs has been initiated, resulting in a decline in the total number of RRBs to 86 as on March 2009 (which includes a new RRB set up in the Union Territory of Puducherry) and further to 84 as on July 31, 2009. The process of recapitalization of RRBs with negative net worth is complete, with 27 RRBs fully recapitalized with an amount of Rs.1,796 crore at end-July 2009.

Besides commercial banks, the cooperative banks and Regional Rural banks, a variety of specialized financial institutions have been set up in the country in order to cater the specific needs of trade, commerce, agriculture, industry, housing and other activities. Among them, NABARD, EXIM bank, NHB, HUDCO, IDBI, IFCI Ltd., ICICI, SIDBI, IDFC, PFC, LIC, UTI, GIC, DICG etc are most important.

Private sector banks got a fillip in India, as history repeats itself, with the liberalization programme emerged in 90s. As part of it, in 1994, Housing Development Finance Corporation Limited (HDFC) was among the first private bank to set up in India. Since then Private sector banks have been playing a crucial role in enhancing customer oriented products and technological up-gradation. The new private sector banks and foreign banks have embraced technology right from the inception of their operations, left no choice with the public sector banks but to innovate and
compete in the process. At present, in India, more than 20 private sector banks are operating successfully.

However, now-a-days, the commercial banks have been changed the way of their business in multifarious ways i.e., geographical expansion, amount of credit, better risk management process, higher customer quality standards, designing customized products for various categories of customers etc. Some SCBs are approaching capital market for raising funds, increases their accountability. The banks are become tech-savvy. The technological up-gradation has made banking available anytime, anywhere. The transition phase that emerged with NEP, the Indian banks have successfully gone through.

2.2 Banking Sector Reform and Evolution of Prudential Norms

In 90s’ when the Government policy thrust changed towards globalization and liberalization and economic reforms were initiated to change the controlled economy to market based economy,( after 70’s) banking system again came in for a major overhaul. It was evident that financial sector reforms had to begin with banking reforms and major reforms were initiated in 1991 to the banking system.

As part of the reform process, there were other changes, which also had an impact on the traditional role of the banker in terms of resource mobilization and deployment. These were caused by the entry of private banks, deregulation of interest rates, deepening and widening of capital markets enabling the corporate with good rating to access the capital
markets and finally privatization and abroad basing ownership of some of the public sector banks. While the earlier changes affected the bank’s business profile, the last factor made the banks accountable for profits to a new group of shareholders. This implies that the banks had to have balance sheets that are transparent and drawn as per the requirements of the accounting standards practiced in India as well as global standards.

These changes were occurring not only in India rather all over world, the banking system had been changing at a spectacular pace. World over the regulators were seized with the problem of assessing the strengths of banks through various measures. As early as July 1988, Regulators from all over the world were agreed and released the agreed framework on international convergence of capital measure and capital standards (Basel Committee). The Bank for International Settlements, headquartered at Basel, Switzerland, appointed a Committee on Banking Supervision popularly known as Basel Committee, prescribed important regulations, rules and procedures to be followed by International banks in their operation and banking activities (Basel-I), inter alia, to combat the magnitude of NPAs.

The Committee had adopted the risk weighted assets approach which assigns weight to both on and off balance sheet exposures of a bank according to their perceived risk as the method of measuring capital adequacy and as the minimum standard of 8% capita adequacy ratio (CAR) to be achieved by 1992. The objective was to strengthen the soundness and stability of the banks and have a framework fair and consistent in its application to different countries. With movement of investments around the glove made easy through technology; the banks
carrying the resultant risks had to adequately protect the saving community; failing which the contagion effect could be devastating. Hence regulators worked out various standards for measuring the efficiency and safety of the banks.

Such a requirement brought back the focus of banks to their basic function namely earning profits and growing through increase in capital. In India the earlier emphasis had been on social banking and increase in the asset base without much accent on profitability. But the capital adequacy standards brought back the attention of bank managements to profitability as the primary objective. Reserve Bank of India (RBI) appointed a committee, headed by Narasimham, to come out with a system for rating of the banks which would be a basis for supervisory attention. The committee recommended the assessment of banks on the basis of CAMEL, an internationally accepted rating measure based on Capital, Asset Quality, Management, Earnings and Liquidity.

With privatization, the banks were anyway required to furnish these in the balance sheet for the shareholders to assess the strength of the bank. To increase the transparency of the banks’ balance sheets and provide the necessary cushion for asset impairment, the Narasimham committee report (NC-I) came out with Income Recognition and Asset Classification (IRAC) norms. IRAC norms detailed the framework for classification of assets of the banks according to their status and the provisioning requirement. The classification was also brought down to four categories instead of the eight that were prevailing. The health code system did not furnish a transparent, uniform and objective yardstick for measurement of the health of an advance. It did not specify the time limit for the advance to be called up after being classified as a sticky loan or in
booking income from the asset. The continued booking of income on sticky advances also increased the outstanding balances in the advance accounts and distorted the reported figure of advances. Thus the IRAC norms were an improvement on the Health code system since it took care of these lacunae. RBI introduced IRAC norms for the Indian banks in a phased manner over a three year period beginning 1992-93. According to NC-I, banks now need to recognize income on the basis of their booking the income on actual basis than on accrual basis. Norm on Asset Classification specifies that assets are to classify according to the level of risks attached to them.

The effect of these changes in the regulatory environment meant that banks had to switch from social banking to commercial banking. While the earlier system in the words of Narasimham committee report “has evolved under the aegis of an activist promotional policy appropriate to the early phases of financial development and has achieved notable success in terms of resource mobilization and credit extension to agriculture and industry and has assisted in meeting major development objectives”, the banks had lost their operational and functional efficiency. The same report observed that the decline in productivity and efficiency has led to the serious erosion of profitability, even to the point of raising serious doubts about the viability of some important constituent of the system. The financial sector reforms brought about a paradigm shift in the earlier way of looking at a bank’s performance.

Globalization has brought to the fore more risk, as corporate customers who were performing very well under a protected environment had to face competition from outside. Barriers in movement of goods, services and finance have been brought down. This meant survival of best
quality, low cost manufacturers and service providers and not those the licenses only. With this, the risk profile of our portfolio was enlarging. The RBI has made the norms of capital adequacy and IRAC more stringent with every passing year. The regulators would also the banks to put in place systems to evaluate and provide for the emerging risk. Thus at a time when the pressure on profitability is increasing on account of business constraints, there is additional need for profits for more provisioning and building capital adequacy.

2.3 *Historical Conceptualisations of Non-Performing Assets in India*

During pre-1985, borrower accounts were classified as Regular, Temporarily Regular, Sick/ Sticky loans. But the system was unable to provide information regarding the health of individual advances, the quality of credit portfolio or the extent of advances causing concern for banks. However, on November, 7th, 1985 with the intention of implementing a comprehensive, uniform credit monitoring and controlling system, RBI came with a prescription for introduction of Health Code for borrowers’ account in Banks. It came with a great hope that it would tackle the soaring effects of problems. The Health Code system, thus, classified the advances in the following categories:

Satisfactory - Advances where all terms and conditions are compiled with.

Irregular - Advances where irregularities are found but occasionally.
Sick-viable – Advances which are sick but viable.

Sick- Non viable- Advances where irregularities persist for a long period and there are no immediate prospects of regularization.

Advances Recalled - Where the repayment is highly doubtful and where decision has been taken to recall the advance.

Suit filed accounts - Where legal actions have been initiated and suit filed against the borrower for non payment of installments.

Decreed Debts – Where suit have been filed and decrees obtained.

Bad and Doubtful Debts – Where the recoverability of installment is highly doubtful or there is no chance of recoverability at all.

Under the above health code system, RBI classified the problem loans into three categories; viz., Bad and Doubtful Advances, Suit filed and Decreed Debts and Advances with major undesirable features. As discussed before, the health code system was serving as a useful monitoring tool but it could not serve the purpose of ‘transparency’. Lack of uniformity and objectivity was the major lacunae of the system. To overcome the problem of health code system, RBI introduced the IRAC norms in 1992-93. Since then various amendments are being announced in the IRAC norms by RBI through its policy initiatives every year.
Non-Performing Assets

A non-performing asset is any asset which cease to generate income and/or in default. As per IRAC norms of 1992-93, a NPA is defined as a credit facility in respect of which the interest and/or installment of principal has remained ‘past due’ for a specified period of time. If any advance or credit facility granted by a bank to a borrower becomes non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exists certain advances / credit facilities having performing status.

According to IRAC norms 2001-02, w.e.f March 2001, an asset is to be considered as NPA if it remains over due for a period of more than 180 days (2 quarter).

According to Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances of RBI (RBI/2009-10/39, DBOD.No.BP.BC.17/21.04.048/2009-10), a NPA of a bank (except RRBs) is defined as below:

"an asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank". A non performing asset (NPA) is a loan or an advance where;

i. interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
ii. the account remains 'out of order', in respect of an Overdraft/Cash Credit (OD/CC),

iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the installment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the installment of principal or interest thereon remains overdue for one crop season for long duration crops,

vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction (undertaken in terms of guidelines on securitization dated February 1, 2006).

vii. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

The important guidelines, according to the latest circular on IRAC, for classifying a credit facility as NPA are:

**Term Loan:** A term loan where interest and/or installment of principal remain overdue for a period of more than 90 days will be treated as NPA.
**Overdraft/cash credit:** An overdraft/cash credit will become NPA under the following circumstances:

a) If the outstanding balance remains continuously in excess of the sanctioned limit or the drawing power, or

b) If there are not credits continuously for 90 days as on the balance sheet date or the credits are not enough to cover the interest debited during the same period.

**Bill Purchased and Discounted:** If the bills remain overdue for a period of more than 90 days then such bills would be classified as NPA.

**Agricultural Advances:**

(a) A loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for two crop seasons.

(b) A loan granted for long duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season.

**Any other credit facility:** In case of any other credit facility, if the amount to be received remains overdue for a period of more than 90 days then such a facility will be classified as NPA.
Fig.2.1 The Evolution of NPA in India

- Pre 1985 -> A/cs classified as Regular/ Temporarily Regular,
  Sick/Sticky -> PB/RD

- Nov. 1985 -> RBI guidelines on introduction of Health code for Borrowers Accounts in Banks [Implemented in SBI w.e.f 1.1.86]

- 1992-3 -> Introduction of Prudential norms on IRAC & Provisioning

- March 2001 -> Amendment in IRAC norms – dispensed of Past Due concept- introduction of Overdue concept of 180 days

- Dec 2002 -> SMAs – Potentially weak accounts (>= 1 cr) between Standard & Sub-standard assets

- April 2003 -> SMA- Any amount of outstanding

- May 2004 -> Stressed Assets

- Oct 2004 -> Creation of Stressed Assets Management Group

- April 2005 -> Definitional change – Transition to the 90 days norms.
2.4 Income Recognition and Assets Classification Norms

Given below are the important instructions on IRAC norms as amended up to date.

Income recognition

As per the extant guidelines, from the year ended 31st March 1993, income from non-performing asset should not be recognized on accrual basis but should be booked only when actually received.

Asset Classification

According to the IRAC norms, banks are now classify their assets into the following four categories, taking into account the degree of weakness and extant of dependence of security for realization of dues.

Fig. 2.2 Classification of Loan Assets
**Standard Assets**

Standard Asset is one which does not disclose any problem and which does not carry more than normal risks attached to the business. Such an asset is a performing asset.

**Sub-standard Assets**

An asset is to be classified as sub-standard if it remains NPA up to a period not exceeding 12 month w.e.f March 31 2009 in place of earlier norm of 18 months or 24 months.

**Doubtful Assets**

An asset is classified as doubtful if it remains NPA for a period exceeding 12 months. Where an account is in doubtful category has been rescheduled, the account will continue as doubtful asset and can be upgraded only after one year of satisfactory performance under the rescheduled terms.

Doubtful assets are again classified as Doubtful I, Doubtful II and Doubtful III category. An asset is classified as Doubtful I if it remains non-performing for a period of 12 months. If an asset remains in doubtful category for a period exceeding 12 months but less than 36 months, it is classified as Doubtful II asset. When an asset remains in doubtful category for exceeding 36 months, it is called as Doubtful III assets.
**Loss Assets**

An asset will be classified as 'Loss' where the dues are considered uncollectible or an only marginally collectible but the amount has not been written off. A loss asset is to be identified by the bank or internal or external auditors or the RBI inspectors. It is likely that there could be some salvage value for the security available in a loan account which is, however, insignificant as compared to the total outstanding in the account.

Sub-standard, doubtful and loss assets are individually or collectively known as NPAs.

The Securitization Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act, 2002 defines Non-Performing Asset as “an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss assets in accordance with the direction or guidelines relating to asset classification issued by the RBI”

**2.5 Some other important definitions**

‘NPA Management’

The policies and pro-active initiatives lay down by SBI in order to prevent generation and recovery of NPAs. The policies entails for the
management of NPAs by State Bank of India is called as the NPA Management Policies (NMP).

'Past Due'

An account should be considered “past due” when it remains outstanding for 30 days beyond due date. It is pertinent to mention that though RBI permitted 30 days grace period to decide past due status, in SBI any amount due was taken as past due.

'Out of Order' status

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

'Overdue' Status

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

'Gross NPAs'

The total default amount which ceases to generate income for the bank. These include sub-standard assets, doubtful assets and loss assets of the bank.
‘Net NPAs’

Net NPAs are derived from gross NPAs by excluding:

i) Balance in Interest Suspense account, i.e. interest due but not received;

ii) DICGC/ECGC claim received and kept in suspense account pending adjustment for final settlement;

iii) Part payment received and kept in suspense account; and

iv) Total provisions held.

2.6 Cost of NPAs

Like any other commercial organization, the primary objective of a bank would be to enhance the profitability from their operations, generate surpluses adequate for ensuring growth and increase shareholder value. In today’s competitive scenario profits are the index of efficiency and the banks’ rating are decided on the basis of the return on assets, return on the equity and the business/profit generated per employee. These indicate the functional, operating and allocative efficiency of the banks and the investors compare these indices to evaluate the banks. The capital adequacy norms ensure that banks cannot increase their assets without increasing their capital. Only profitable banks or those that are perceived to have clear edge over others to generate future profits are likely to be rewarded by the investors with their funds. This can be seen from the fact that SBI share prices are equal or less than some of the new generation banks with technology edge, good management and clear strategies for future profits and growth. In the era where capital market decides
allocation of funds among competing investments, profitability is the key factor for such allocation.

Today the CRR, SLR preemptions has been brought down to 24% and priority sector lending can be dovetailed to the profitability objective. The corporate have a choice of going directly to the capital market and a plethora of lending institutions. The banking products are also more and specific to customer requirements rather than generic. Most importantly there is deregulation of interest rates and banks have been allowed to price their deposits and advances based on their asset liability profiles. So today banks are only being regulated and not controlled. Banks are now required to compete with different financial options that a customer has and offer the finest rates for their services.

Under the circumstances assets that do not earn any income to the bank affect the profits in a number of ways:

**Effect on Profitability**

- The resources locked up in NPAs are borrowed at a cost and have to earn a minimum return to service this cost.

- NPAs on the one hand do not earn any income but on the other hand drain the profits earned by performing assets through the chain of provisioning requirements.

- Since they do not earn interest, bring down the yield on advances and the net interest margin or the spread.

- NPAs have a direct impact on Return on Assets (ROA) and Return on Equity (ROE), the two main parameters for measuring
profitability of the bank. ROA will be affected because while the total assets include the NPAs, they do not contribute to profits, which is the denominator in the ratio. ROE is also affected as provisioning eats more and more into profits earned.

➤ If the provisions are added back to the profits SBI would be one of the top rated banks in terms of ROA and ROE.

**Effect on Capital Adequacy**

➤ The risk weight on these assets is a hundred percent and capital has to be blocked. These assets do not produce income to sustain the capital blocked by them, which again drains the profits earned on the other performing assets.

➤ If the banks are required to provide for the entire outstanding NPAs (not provided so far) it could wipe out half of our net worth and reduce the capital adequacy by half.

**Capital Market Perception**

➤ NPAs bring down the profits, affect the shareholder value and thus adversely affect the investor confidence.

➤ New branch licenses are not given to the banks where they have high level of NPAs. It also affects the ability of the bank to start other business ventures. For example RBI stipulated minimum NPA percentage for issue of licenses for insurance business.
Other Costs

- As the income earned on performing assets subsidize NPAs, the ability of the bank to offer finer spreads to good customers comes down. This is in turn makes the best customers choose other cheaper financing options and the banks’ asset portfolio quality deteriorates. This result in future NPAs.

- The cost of maintaining these assets include administration costs, legal costs and cost of procuring the resources locked in, thereby, and increases borrowing costs.

- Maximum importance on NPAs affects other aspects of banking business, thus, demoralize the operating staff.

The most important business implication of the NPAs is that it leads to the credit risk management assuming priority over other aspects of bank’s functioning. The bank’s whole machinery would thus be pre-occupied with recovery procedures rather than concentrating on expanding business. As already mentioned hereinabove, a bank with high level of NPAs would be forced to incur carrying costs on a non-income yielding assets. Other consequences would be reduction in interest income, high level of provisioning, stress on profitability and capital adequacy, gradual decline in ability to meet steady increase in cost, increased pressure on net interest margin (NIM) thereby reducing competitiveness, steady erosion of capital resources and increased difficulty in augmenting capital resources. The lesser-appreciated implications are reputational risks arising out of greater disclosures on quantum and movement of NPAs, provisions etc. The non-quantifiable implications can be psychological.
like ‘play safe’ attitude and risk aversion, lower morale and disinclination to take decisions at all levels of staff in the bank. Two decades of regimented and directed banking to credit delivery has deprived bank managers of the instinct skill and knowledge. Nationalized banking did not produce a spring of talent resources from within. Directive Inputs and course direction came externally from RBI and Finance Ministry which were/are external to the day-to-day affairs and problems of the Indian banking industry (Batra, 2003). The system did not promote initiative and talent, but bred corruption and nepotism. This is the scene of Indian Banking struggling hard to transition from old primitive systems and values to modern professional business ethics and corporate good governance.

NPA has affected the profitability, liquidity and competitive functioning of Public and Private Sector Banks and finally the psychology of the bankers in respect of their disposition towards credit delivery and credit expansion. NPAs initially become the banks’ burden but gradually the burden of the financial system and then the burden of the economy. Implications of NPAs are reflected in the shrinking bottom line and eroding balance sheets of banks. The problem characterized by erosion of assets and liquidity also affects owners, depositors, employees, good borrowers, general customers and the economy. The borrowers who fail to repay the banks’ dues virtually turn out to be very wise in the whole game of banking [Krishnan, 2004]. If unchecked, it may lead to loss of public confidence and systematic risk. Thus there are enough reasons for the perturbation for banks to initiate immediate steps to contain the existing NPAs, improve the asset quality and maintain standard asset.
COST OF NPAS

NPAs Impact

Lower ROE & ROA
Lower image & rating of bank
Disclosure reduces investors' Confidence
Increases costs/
Difficulties in raising capital

NPAs don't generate income
Require provisioning
Opportunity Loss due to non-
cycling of funds
100% net weight on net NPAs for CAR

Capital gets blocked in NPAs
Utilizes Capital but does not generate income to sustain the capital that is locked
Recapitalization by Govt. comes with strings

Administration & Recovery costs of NPAs
Legal Costs
Effect on employee morale and decision making

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