Non-Performing Assets (NPA) Management and Reforms-Required

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Abstract.The role of financial sector in the economy is like blood in the human body. It gives strength, activation of organs / organization and in case of malfunctioning; disorientation of the same will effect health as well as structure. It is utmost necessary to monitor the same effectively and timely measures be taken for rectifications to stream line the activity.

Any growing economies biggest weakness is the inability to manage finance and this inability can turn into a major threat if this weakness is not overcome in the long run. In order to manage constant growth the government along with its financial institutions observe the behavior and trends of the international markets and modify their policies accordingly.

In nut shell we can say it is the ultimate public money in one form or another in the economy which is rotating economy and economy's real growth depends upon the fact that how effectively it is parked by Financial institutions and other agencies with various borrowers engaged in various sectors . It is the role of the financial institutions to identify the appropriate industry, promoters , activity and prospects of growth and after due diligence and analysis of business , genuine financial needs be funded in the form of fund based and non-fund based facilities so that it generate income and be remain a operating asset and not washed out in the form of Non Productive Asset i.e. Non-Performing Asset (NPA).Financial Institutions are the backbone of the nation which source the saving of the economy & lend to the industries after due diligence of the borrower to ensure public money is parked as per need of the economy & will be able to generate income to serve interest & remain performing asset. As soon as the borrower is unable to honor commitments it becomes NPA. These NPA's become a threat for the existence of financial institutions, so effective measures are required to monitor these assets.

Keywords: Non Performing Assets (NPA), Financial Sector, Central Bank, , Income Recognition, Asset Classification, Public Funds

1 Introduction

Financial sector of the economy consists of:

- Government controlled financial institutions, Banks, corporations, trust, stock and bond markets etc.
- Private Banks, institutions, NBFC, co-operatives etc.
- Centralized Monitoring agencies, like RBI etc.

The activity of all these are involved around flow of total money from one end and ultimate end use in operational activity of economy. The main incremental sources of the funds are either

i. foreign direct investment ,foreign donations, or
ii. Aids, foreign Gift or Savings of the individuals or reinvestment of accumulated profits of the organization .

1.1 Central Bank Role

Every economy is having the central Bank known as Banker's Bank or Government Bank to supplement the Government to regulate and monitor the economy's financial system in appropriate manner so that total money supply in the market is as per Growth needs and not effected substantially by business cycles of inflationary or recessionary trends . Banks of the country remain healthy and apply all controls, measures so that public money is effectively used to achieve economy's objective and funds not drained out into losses . To achieve the international level and trust of public be retained in Banking system Central Bank i.e. RBI has implemented various operational instructions from time to time including prudential norms for capital adequacy also .

It is primary need that Banks must KNOW THEIR CUSTOMER (KYC) . KYC norms are for proper identification of Bank's customer i.e. they are having proper Identity and they don't belongs to unethical group, names appear in Defaulter List or terrorist group .

The RBI has permitted banks to have their own interest rates for Deposits as well as for Lending. Banks are further instructed to have the Base rate (according to their cost of funds including some profit) below which they are not permitted to Lend . Further lending is regulated accordingly to RBI norms for Industry Exposure,Sectorial Deployment , Priority and non-priority sectors etc.

With these freedom to maximize their profitability Banks are allowed to have participation with mutual funds, LIC, Insurance companies etc.. To reign the galloping lending by Banks without supplemented by their financial strength i.e. capital Base and Capital adequacy norms were set as per BASEL III . Prudential norms were laid down for Recognition of income and classifications of financial Assets (i.e. Borrowers to whom Bank has lend the amount) as standard , Substandard , Doubtful , Loss . According to these norms , Banks have to account for the interest and other income and provide for the provisions from income , according to classification of financial Assets . Recently RBI has strictly advised to Banks to clean up their balance sheets by 31.03.2017 and all stressed Assets be supplemented by adequate provisions.The financial assets which are not Standard is called NON Performing Assets . The RBI has set the norms as under;

*Non -Performing Assets:*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;Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,The account remains 'out of order' (An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for 90 days. 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'.), in respect of an Overdraft/Cash Credit (OD/CC),

- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- The installment of principal or interest thereon remains overdue for two crop seasons for short duration crops,
- The installment of principal or interest thereon remains overdue for one crop season for long duration crops,

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.

In case of interest payments, 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.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.

2. Income Recognition

Income Recognition Policy

- The policy of income recognition has to be objective and based on the record of recovery. Internationally income from non-performing assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, the banks should not charge and take to income account interest on any NPA. This will apply to Government guaranteed accounts also.
- However, interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira VikasPatras (IVPs), KisanVikasPatras (KVPs) and Life policies may be taken to income account on the due date, 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 recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

Reversal of Income

- If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed 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 with respect to past periods, if uncollected.

Appropriation of Recovery In NPAS

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

Interest Application

On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest.

However, banks may continue to record such accrued interest in a Memorandum account in their books. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

3. Categories of NPAs

Banks are required to classify NON PERFORMING ASSETS further into the following three categories based on the period for which the asset has remained non performing and the reliability of the dues:

- Substandard Assets.
- Doubtful Assets.
- Loss Assets

3.1 Substandard Assets

With effect from March 31, 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

3.2 Doubtful Assets

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

3.3 Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

4. Guidelines for Classification of Assets

i. Broadly speaking, classification of assets into above categories should be done taking into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for realisation of dues.

ii. Banks should establish appropriate internal systems (including technology enabled processes) for proper and timely identification of NPAs, especially in respect of high value accounts.

iii. The availability of security or net worth of borrower/ guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise,

iv. The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature as under;

   A working capital borrower 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/ regularised not later than three months from the due date/date of ad hoc sanction.

v. It is difficult to envisage a situation when only one facility to a borrower/one investment in any of the securities issued by the borrower becomes a problem credit/investment and not others. Therefore, all the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not the particular facility/investment or part thereof which has become irregular.

vi. In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers it will not be prudent that such accounts should go through various stages of asset classification. In cases of such serious credit impairment, the asset should be straightaway classified as doubtful or loss asset as appropriate

vii. The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked.

viii. For all projects financed by the FIs/ Banks , the ‘Date of Completion’ and the ‘Date of Commencement of Commercial Operations’ (DCCO), of the project should be clearly spelt out at the time of financial closure of the project and the same should be formally documented. These should also be documented in the appraisal note by the bank during sanction of the loan. As these dates will be relevant in future to classify the accounts.

4. **Provisioning Norms**

General

i. The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors.

ii. In conformity with the prudential norms, provisions should be made on the non - performing assets on the basis of classification of assets into prescribed categories. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against substandard assets, doubtful assets and loss assets as below:

Loss Assets

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

Doubtful Assets

i. 100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

ii. In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has remained in 'doubtful' category	**Provision requirement (%)**
Up to one year	25
One to three years	40
More than three years	100

Note: Valuation of Security for provisioning purposes

With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

Substandard Assets

i. A general provision of 15 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.
ii. The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance .

Standard Assets

The provisioning requirements for all types of standard assets stands as below. Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:

- Farm Credit to agricultural activities and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;
- Advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;
- Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent[1]
- Housing loans extended at teaser rates and restructured advances as as indicated in Para 5.9.13 and 12.4 respectively;
- All other loans and advances not included in (a) (b) and (c) above at 0.40 per cent.

5. **NPA Management – Requirement of Effective Mechanism and Granular Data**

Asset quality of banks is one of the most important indicators of their financial health. Banks should, therefore put in place a robust MIS mechanism for early detection of signs of distress at individual account level as well as at segment level (asset class, industry, geographic, size, etc.). Such early warning signals should be used for putting in place an effective preventive asset quality management framework, including a transparent restructuring mechanism for viable accounts under distress within the prevailing regulatory framework, for preserving the economic value of those entities in all segments. Banks adopt all methods to revive the stressed assets either by restructuring or by other means.

Provisioning norms

Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring.

6. **Signs of Stress**

Illustrative list of signs of stress for categorising an account as SMA:

a. Delay of 90 days or more in (a) submission of stock statement / other stipulated operating control statements or (b) credit monitoring or financial statements or (c) non-renewal of facilities based on audited financials.
b. Actual sales / operating profits falling short of projections accepted for loan sanction by 40% or more; or a single event of non-cooperation / prevention from conduct of stock audits by banks; or reduction of Drawing Power (DP) by 20% or more after a stock audit; or evidence of diversion of funds for unapproved purpose; or drop in internal risk rating by 2 or more notches in a single review.
c. Return of 3 or more cheques (or electronic debit instructions) issued by borrowers in 30 days on grounds of non-availability of balance/DP in the account or return of 3 or more bills / cheques discounted or sent under collection by the borrower.
d. Devolvement of Deferred Payment Guarantee (DPG) installments or Letters of Credit (LCs) or invocation of Bank Guarantees (BGs) and its non-payment within 30 days.
e. Third request for extension of time either for creation or perfection of securities as against time specified in original sanction terms or for compliance with any other terms and conditions of sanction.
f. Increase in frequency of overdrafts in current accounts.
g. The borrower reporting stress in the business and financials.
h. Promoter(s) pledging/selling their shares in the borrower company due to financial stress.

7. **Capital Adequacy Norms**

To reign the galloping lending by Banks without supplemented by their financial strength i.e. capital Base and Capital adequacy norms were set as per BASEL – Details are as under;

In the recent few days we have heard a lot that government is been infusing lot of money in the public sector banks….. To understand why??? We have to first understand that what BASEL ACCORD or BASEL NORMS is all about.

Basel is a city in Switzerland which is also the headquarters of Bureau of International Settlement (BIS).BIS fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations. In total BIS has 60 member countries from all over the world .The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses.

According to Basel norms, Banks have to calculate their total capital comprising Tier 1 and Tier 2 capital

- Tier 1 capital ; Paid up Capital , Statutory Reserves, Other disclosed free reserves, Capital Reserves .Undisclosed reserves, Revaluation Reserves, General Provisions and loss reserves ,
- Tier 2 capital; Hybrid debt capital instruments such as bonds, Long term unsecured loans, Debt Capital Instruments etc
- Total of these Tier 1 and Tier 2 capital known as Total Capital .

All fund based and non fund based facilities of the Bank comprises Risk i.e. operational risk, market risk, capital risk. . The advances backed by Financial securities will have ZERO Risk on the other hand advances of various sectors /types will have different risk . The different weight is allocated according to Risk e.g. Real estate, advances against shares having more weight than 1 as compare to assets backed by tangible securities having weight less than 1 .The non fund facilities are also given weight according to exposure and securities . The amount of loans and advances are multiplied by RISK WEIGHT and total of these will be known as TOTAL RISK WEIGHTED ASSETS .

The capital adequacy ratio (car) is calculated to ensure that banks are not taking over exposure. Car is (total capital / risk weighted assets) x 100

India has accepted Basel accords for the banking system. India has implemented BASEL – I in 1999 and BASEL II in 2004 and accordingly CAR was fixed at 8 % and In 2008, Lehman Brothers collapsed in September 2008, the need for a fundamental strengthening of the Basel II

Journal of Business Management and Information Systems©2014QTanalytics
2394-3130 electronic ISSN

framework had become apparent In 2010, Basel III guidelines were released. The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity. The Reserve Bank of India has extended the timeline for full implementation of the Basel III capital regulations by a year to March 31, 2019.

Reforms Required To Control NPA And Effective Management of Public Funds By Banks And Financial Institutions

i. The above discussions shows that once the account falls under NPA category, Banks suffer in both ways i.e. on one side the interest or service charges are not charged and not form part of income on these accounts on the other side funds are blocked and not available for rotation and out of other generated income part is taken out as provision for bad debts , which further reduces profit and ultimately the total capital effected .Capital adequacy restraining further advances . Government has to induct further capital out of taxes / income from public to maintain the Capital Adequacy of Banks.

ii. The above analysis shows that Banks are playing with public money and lending to non-deserving industry or group with influences or without proper futuristic analysis based on authenticated data or survey. The accountability is fixed at lower level while project advances/ big advances are processed only after higher authorities agreed in principle to sanction despite of unfavorable of Risk Rating .Many concessions provided in interest , charges and other terms and conditions although not deserving as per norms or Credit Rating . There is urgent need to reform the policies and system of advances in banking system on the one side and on the other hand more controls required to handle the Non performing cases and disposal of their assets .Accountability be fixed at higher level who has influenced the lower level to initiate the proposal and sanctioned after reviewing all the facts and figures as placed. This will lead to morale Boosting and reduces the sanction of non viable projects, which are sanctioned otherwise by unethical means.

iii. The following reforms are required in Banking system and methodology to achieve the Goal of Higher productivity of Public Money .Single Window for all information; The Government is required to have the Data Center and research wing providing all support to furnish data for future demand, industries already involved and new entrants and stage of their progress. Development undertaken for expansion, expected import and export of products, its latest technology available and prices movement. The industry trend analysis and credit rating of existing industries in the trade .Likely chances of international movement in this field and scope for new entrant. The data should be updated every month and linked with ROC, Taxation, other agencies to cross verify the inputs . The same is accessible to every institution /Banks.

iv. Banks were advised that before opening current accounts/sanctioning post sale limits including non fund based facilities, they should obtain the concurrence of the main bankers and/or the banks which have sanctioned inventory limits. Such accounts already opened may also be reviewed in the light of these instructions and appropriate action should be taken. Many Banks extending facilities or discounting bills under LC without compliances.

v. Proper Analysis and central data and monitoring Cell ;It is observed that while analysis is made only past data is emphasized and very less emphasis and analytical futuristic assessment is made. The analysis and assessment of limits is based on traditional methods which are not aligned with present business deals and its operational activity in computerized environment. The advances are sanctioned based on project reports or as assessed by lead Bank. Most of the banks are not technically equipped with the project which they are financing and accept the cost as submitted in project report .The regular monitoring , analysis of MIS statements , transactions in the account in not done by banks due to lack of technical staff having knowledge of the same . Central data and monitoring Cell should exist at all ministries to monitor such accounts having substaintial investments.

vi. Genuiness of data submitted by the borrower are not cross checked by reviewing with suppliers authenticity as well as turnover shown by the company is matching with the turnover in Bank account or not . Margins required to be inducted by the borrower is evaporated in incorporation cost, land and building, other items which are overvalued . The banks should appoint Ex-Bankers with knowledge and qualifications for monitoring of the accounts with exposure of Rs 100/- crores and above from Banking system.

vii. Accountability of Rating Agencies ;It is mandatory for customers availing limits more than Rs 5.00 crores ,should get their company rated from Rating agencies i.e. CARE , Rating agencies after analysis certifies that company is competent to honor debts or not and to what extend Risk is involved . If account becomes irregular while rating shows good track of repayment, rating agencies should be panelized.

viii. Fair valuation of Assets ;The value of collateral securities like Land and Building ,is considered at market value while sanctioning (which effects internal rating and value of account) The valuation is much more than the properties of similar type registered with Registrar of properties during last few months of valuation Date . The Banks should modify the system.

ix. Early detection and correction; The Banks are under stress to save borrower accounts under SMA category and should not slip to NPA. Banks use undue means (by financing or transferring entries) and guide the customer to continue in SMA category . Banks prevent such SMA accounts to become NPA while account was under stress and require immediate corrective action.

x. NPA DISPOSAL TO GOVERENMENT MINISTRIES ONLY FOR REVIVAL ;All the projects which are under implementation stage and become NPA due to unforeseen calamities , fall of industrial demand , market business cycles , any other reason are written off from profits over a period . The Banks dispose off such accounts at throw away prices , which is national wastage . Such accounts be transferred to respective ministries with instruction to complete the projects with the Public Private Partnership and revenues were shared or linked the projects with Government establishment like power projects with NTPC , Steel projects with SAIL . The valuation of such accounts be in the form increase in Govt equity with the banks.