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# The NPA Menace – A threat to Indian Banking

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## Abstract:

*As per Banking Regulation Act 1949 "Banking" means "Accepting deposits of the money from the public for the purpose of lending or Investment, repayable on demand or otherwise and withdrawable by cheque, draft or otherwise." The intermediation process is the principal function of a commercial bank. Since it involves a counterparty risk, which is inherent in banking. A banker should not expect that all its loans & advances portfolios' will not fetch returns/earnings in the normal course of banking business. The loans/advances are an important source of income for the banks. The strength and soundness of the banking system primarily depends on the quality and performance of the advances portfolio in addition to meeting timely repayment of financial obligations by borrowers. Banks have become an indispensable part of the economic system of the nation. The Banking setup today constitutes the heart of the financial structure of the country. Indian banking has made a significant progress after nationalisation especially in three aspects viz., branch expansion, deposit mobilisation and loan maximisation. Among these, monitoring of loans took a back seat in the era of mass and social banking. In the changing scenario of the banking, Non-Performing Assets have been the most vexed problem faced by the banks. The Reserve Bank of India (RBI) and Government of India (GOI) have initiated various measures to curb the NPA in the post financial sector reforms era but still feel incapable to solve this problem. This paper discusses about the continuation of the NPAs is a menace for the survival of the banks and a large threat to the growing economy. After elapse of more than two and a half decades of implementation of financial sector reforms and prudential norms for Income Recognition and Asset Classification (IRAC), it is the need of the hour to study this menace systematically causes, effects & control of NPAs.*

**Keywords-** Banking, NPA, Gross NPA, Public Sector banks, Private Sector Banks, IRAC norms, Credit Risk

## 1.1 INTRODUCTION:

The significant progress made by the Banking in India after nationalisation especially, in increase in number of branches, resource mobilisation and credit expansion. Due to the divided focus, monitoring of existing credit portfolio taken a back seat in the era of mass and social banking and then after. In the changing scenario of the banking, Non-Performing Assets have become the most critical problem faced by the banking Industry. At times Reserve Bank of India (RBI) and Government of India (GOI), initiated various measures to curb this mounting NPA in the post financial sector reforms phase. In the liberalised scenario, the NPAs menace continued and put the question of survival not only before the banking industry but also the growing economy. After elapse of about three decades of implementation of financial sector reforms and prudential norms for Income Recognition and Asset Classification (IRAC), it is the need of the hour to study this menace. The Reserve Bank of India in line with the international practices, introduced in a phased manner, the prudential norms for income recognition, asset classification and provisioning for the different assets of the bank to align a higher consistency & transparency in the published data. The policy based on IRAC norms shall be objective and record of recovery will be on actual consideration & the classification of assets of the bank shall be done on the basis of objective criteria to ensure a uniform and transparent application of the norms along with the provisioning on the basis of the classification of assets.

## 1.2 NON-PERFORMING ASSETS:

In the common words an asset, becomes non-performing when it ceases to generate income for Bank/FI, for that very purpose the asset in form of a credit facility was lent to earn interest etc. when it ceases it becomes NPA.

**A Non-Performing Asset (NPA) is a:**

**1.** Loan/advance where interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.

**2.** An Overdraft/Cash Credit (OD/CC), if the account remains ‘out of order’ as on date of Balance sheet for reasons as given below: (If the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for 90 days OR where the outstanding balance in the 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 sufficient to cover the interest debited during the same period, i.e., turnover in the account during the current quarter must be sufficient enough to cover the interest/other charges debited during the same quarter.)

**3.** In the case of bills purchased and bill discounted, remains overdue for a period of more than 90 days.

4. The installment of principal or interest thereon remains overdue in case of agriculture credit 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 (Crops with crop season longer than one year).

5. An account may also become NPA because of technical reasons such as delay in submission of stock- statement which is older than 3 months, irregular drawings permitted in the account for a continuous period of 90 days. An account where the regular/adhoc credit limit have not been reviewed/renewed within 180 days from the due date/ date of adhoc sanction (If any advance or credit facilities granted by banks to a borrower become nonperforming, 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 exist certain advances/credit facilities having performing status). As per the prudential norms suggested by Reserve Bank of India, a bank cannot book interest on an NPA on accrual basis. In other words such interests can be booked only when it has been actually received.

NPA may be classified into two categories

**(a)** Gross NPA: Gross NPA is the advance portfolio classified as NPA and considered irrecoverable, for which bank has made provisions, and which kept as NPA in banks' books of account.

**(b)** Net NPA: Net NPA is the amount excluding the items like interest due but not recovered, part payment received and kept in suspense account, any kind of subsidy kept separate account from Gross NPA.

### 1.2.1 Asset classification: categories of NPAs:

(1) **Standard assets**:

Standard assets are those in which the bank is recovering interest as well as the principal amount regularly from the customer as per sanctioned terms & conditions. Here it is also very important that in this case the arrears of interest and the principal amount of loan do not exceed 90 days at the end of financial year. If borrower fails to repay the due amount as per sanctioned T&C then according to IRAC norms the account becomes NPA, which further need to classify in different three sub categories:

**(2) Sub-standard assets**:

An account which has remained NPA for a period less than or equal to 12 month from the date of NPA.

**(3) Doubtful assets**:

A loan classified as doubtful if it remained in the sub-standard category for a period of 12 months and above up to a period of 36 months.

**(4) Loss Assets**:

Those which considered un-recoverable & due to closer of activity the probability of recovery since diminished to a large extent or become negligible in order to recover the outstanding dues of bank. The loss assets are identified & classified by the internal/external auditors of bank or by the RBI Inspection officials.

## 1.3 CAUSES FOR INCREASE NON PERFORMING ASSETS:

There are various causes which lead an asset to become Non-Performing, which can be classified:

**A.** The External Causes are those which are beyond the control of the borrower or the management.

**B.** The Internal Causes are those which are within the control of the borrower or management.

### 1.3.1 External Causes:

*Adverse Government Policy/guidelines affecting the production/marketing of sales of the product & services *Natural calamity leading to destruction of assets * Closure of factory due to strikes, court orders. *Recession in the Industry. *Adverse change in the projected demand due to factors like environmental regulations, change of fashion, change in consumer needs etc. *Non-realisation of Receivables. *Increased competition. *Competition from abroad. *Loss of employment. *Directed loans system under which commercial banks are required to extend 40% percent of their credit to priority sectors * Targeted lending to poverty elevation programs like IRDP, REGP,PMRY SUME, SEPUP,JRY etc.

### 1.3.2 Internal Causes:

(1) Management: *Wilful default. *Non Cooperative Borrowers *Dishonesty of partners/directors/proprietors *Dispute among partners, directors etc. *Lack of proper organizational set up & control mechanism.

**(2)** Marketing: *Inadequate product base. *Lack of distribution channels. *Irregular delivery. *In-appropriate pricing.

**(3)** Financial: *Faulty costing & pricing. *Lack of resources. *Diversion of funds for unproductive expenditure. *Costly outside borrowings. *Increased cost of production.

**(4)** Production: *Inappropriate technology. *Lack of production planning & control. *Frequent mechanical breakdowns. *Poor labour productivity. *Inferior quality of finished goods. *Faulty inventory planning. *Poor quality control.

## 1.4 EFFECTS OF NON-PERFORMING ASSETS:

The effects of Non-Performing Assets on the bank can be multidimensional which can be classified into 4 categories:

### (1) Effects on Profitability:

The effect of an account becoming NPA is as under:

**a)** As an account becomes NPA, it seizes charging interest etc. on that account means branch cannot debit the interest to the account and credit it to P/L, if the amount is not recovered within stipulated time. If it was credited to P/L but not realised a/a, then such income should be reversed by debiting P/L.

**b)** As per IRAC norms of RBI, bank has to provide for an amount of likely loss, due to the slippage of the account as NPA. Such provisioning requirement may vary from 25% to 100% of balance outstanding, depending upon the classification of an asset as sub-standard, doubtful or loss assets and also on the value of securities etc. Such provisions have to be made from the Gross Profit made in that year which includes interest income from other standard assets.

### (2) Effects of NPA on Quality of lending:

The most important consequence of an asset becoming NPA is the effect on the health of the advances portfolio which is measured in terms of its capacity to generate income. Ideally all advances, properly appraised & sanctioned, should remain performing till recovery of all the dues. Thus, the health and quality of the lending portfolio is measured by the level of non-performing assets. The higher the NPA level is, less healthy would be the portfolio. Higher percentage of NPA to total Advances reflects poor credit health of the bank due to quality of appraisal, follow-up & recovery. Thus, the level of NPA provides a quantitative as well as a qualitative picture of Credit Administration & Credit Management of the bank.

**(3) Effects on Capital Adequacy Ratio:**

As per RBI's CAR defines as ratio of unimpaired capital of free reserves to aggregate of weighted risk assets. It is different for banks having domestic as well as international branches base wef the year ending 31 March 2000, banks are required to maintain a minimum CRAR of 9% on an ongoing basis. The unimpaired capital & reserves can be strengthened either by issue of fresh capital or by profits plough back. While the issue of fresh capital will depend upon statutory guidelines, market conditions, performance of the bank etc. the addition to reserves is directly related to the profitability of the bank. The profitability in turn is dependent on the income earning capacity, which is dominated by interest income from Advances. If the Non-Performing Assets are more, the income generating capacity gets reduced & consequently the profitability is affected and thereby affecting the Capital Adequacy. The effect of not achieving the capital adequacy norm is that risk-weighted assets like advances cannot be increased without a corresponding increase of at least 9 % in unimpaired capital and reserves.

**(4) Effects on other factors:**

Besides the three effects discussed above few more are: International banks insist on all banks having equal prudential norms for doing business with them. Therefore, banks having large NPA would find it difficult to have banking relations with them, like opening of LCs, negotiation of documents under LCs etc. RBI has modified the licenses issue norms for opening of new branches, to banks having higher NPA level. High level of NPA prevents the banks from obtaining a good credit rating which in turn, would impact In present competitive environment, market analysts, press media, business channels, critically comment upon the bank.

## 1.5 REMEDIAL MEASURES:

The basic principles of effective NPAs Management is:

**a)** To control further increase in NPA portfolio of the bank (By effective Credit Monitoring & follow-up mechanism & assertive PNPA Management).

b) To reduce the existing NPAs level by way of recovery (By cash recovery & up gradation in existing NPA accounts) Since inception it is the basic need to keep the credit portfolio of the bank healthy by way of monitoring and follow up of all the advances accounts on day today basis on sanction terms & conditions through a close watch on the project/activities. Here the main focus is to keep the account in standard category instead of first allowing them to slip to NPA and then push forward the remedial measures to make NPA recovery. Persuasion and close monitoring of the account since beginning is the basic principles of recovery whereas the legal action initiation is the last resort to apply. The early warning signals of an account attracts meticulous monitoring, the concept of SMA-0-1-2 are recently introduced indicators, before account become NPA, if bank fails to understand these indicators as early warning signals, the account starts causing concern before converting to NPA. It is the juncture where the banker meticulously scrutinize the reasons behind it and if there is circumstantial default due to the valid unforeseen reasons, bank should explore the feasibility of re-habilitation to hand hold the borrower by way of re-structuring/reschedulement/ rephasement with or without the fresh capital induction as one of the important hand holding measure.

### 1.5.1 Preventive Remedial Measures:

To control further increase in NPA portfolio of the bank, initially the preventive measures, such as pre sanction quality credit appraisal risk assessment at regular interval must be done by the lending bank followed by an effective post-disbursement supervision. Credit assessment and Risk management mechanism are ever lasting solution to the problem of NPAs. Managing credit risk is an effective mechanism and is mainly concerned with managing the quality of credit portfolio before default takes place. The documented Credit Policy and Credit Audit as well as Recovery Policy ensures to improve the quality of credit appraisal & monitoring of credit portfolio in banks. In case of surplus liquidity the banking system may be bit rash to increase lending liberally, putting the asset quality on back seat raising concern of potential risk of addition to the NPAs in future. Assertive management of PNPAs is also an important mechanism to control future NPAs. Constant analysis and assertive efforts of recovery of the critical amount due to save the PNPA account to slip into NPA. Early warning signals (EWS) can be classified into different categories becomes the guiding factors foe effective NPAs management. The risk categorization of the bank's assets is an important internal measure which identify to monitor potential risks in a loan asset. The purpose of identification of PNPAs is to ensure that appropriate preventive/corrective steps could be initiated by the bank to protect against the loan asset becoming non-performing.

**1.5.2 Curative Remedial Measures:**

To reduce the existing NPAs level by way of recovery (By cash recovery & up gradation of existing NPAs) explained under curative remedial measures to release of funds since blocked in an account wef its classification in NPAs for further recycling of funds for productive purposes. Both GOI and RBI have raised few steps for to check fresh slippage to NPAs and to strengthen the legal and regulatory setup to facilitate the recovery of existing NPAs:

**1.5.2.1 The Debt Recovery Tribunals:**

DRTs have been established for expeditious adjudication and recovery of debts due to banks/FIs. The DRT is also the Appellate Authority for appeals filed against the proceedings initiated by secured creditors under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARAFESI Act). DRT setup includes Presiding Officer as Chairperson & Recovery Officer in charge enforceability besides Registrar along with administrative staff. For realization, management, protection and preservation of assets under disposal for recovery, it is expected to provide necessary teeth by the government to the DRTs to speed up the recovery of NPAs in the times to come. DRTs was set up by the Government to facilitate speedy recovery for banks/FIs, but the outcome says that they have not been able make much impact on loan recovery due to variety of reasons like inadequate number, lack of infrastructure, under staffing, legal hassles, frequent adjournment of cases etc.

**1.5.2.2 SARFAESI Act**:

The SARFAESI Act enforces the securitization and reconstruction of charged assets against the debt by the judgment creditor ie banks/FIs to realize them and make enforcement of security interest transfer. Initially the SARFAESI Act proved an assertive tool for Banks/FI to overcome the menace of NPAs without approaching to courts. With the passage of time certain loopholes in the act experienced by the banks/FIs that defense lawyer envisaged manipulations to create hurdles in recovery of NPAs, particularly with the hard-core NPA. Borrowers dragging the banks into endless litigation to delay the recovery process. Certain Supreme Court decisions in regard to modify few proviso of act to make it bit stringent. With the growth of the Financial Services Sector, the structured financial market is also growing significantly, where Securitization occupies a prominent place. The first ARC (Asset Reconstruction Company) ARCIL was incorporated as a public limited company under the SARAFESI Act 2002, as a "financial institution" under Recovery of Debts due to Banks and Financial Institutions Act, 1993 (the "DRT Act") for the business of resolution of no NPAs of banks/FIs. The primary objective of ARCIL is to expedite recovery of the amounts locked in NPAs of lenders and thereby recycling capital. ARCIL thus, provides relief to the banking system by managing NPAs and help them concentrate on core banking activities thereby enhancing stakeholder’s value.

**1.5.2.3 One Time Settlement Schemes (OTS):**

This scheme covers all NPAs (sub-standard, doubtful or loss assets wef 31st March’20) All the cases the banks where bank have initiated action(s) under the SARFAESI Act and also cases pending before Courts/DRTs/BIFR/etc, subject to consent decree obtained from the Courts/DRTs/BIFR are covered. (However cases of wilful default, fraud and malfeasance are not covered). As per the OTS scheme, for NPAs up to Rs 10.00 crores, the minimum amount that should be recovered should be 100% of the outstanding balance in the account on case to case basis)

**1.5.2.4 Lok Adalats:**

Lok Adalat institutions help banks to settle disputes involving account in ‘doubtful’ and ‘loss’ category, with outstanding balance of Rs. 5 lakh for compromise settlement under Lok Adalat. DRTs have been empowered to organize Lok Adalat to decide on cases of NPAs of Rs. 10 lakh and above. This mechanism has proved to be quite effective for speedy justice and recovery of small loans. The progress through this channel is expected to pick up in the coming years. Banks/FIs are now a day organizing Lok Adalats at frequent intervals and having satisfactory results.

**1.6 CONCLUSION:**

In fact the menace of NPAs not only dented the profitability of banks but also domestic economy. At times Reserve Bank of India and Government of India initiated various steps to control this menace of mounting NPA particularly in the post PLG (Privatization, Liberalization & Globalization) Era. After elapse of about three decades of implementation of financial sector reforms and prudential norms of Income Recognition and Asset Classification (IRAC), the actual picture of profitability in the books of banks/FIs surfaced in real sense. Blocked recycle of fund & income from interest on this fund is the root cause of this danger. The study discussed at length the causes & effect of the menace along with the remedial measures to overcome it. It is concluded that by pin-pointing the root causes of the problem and to neutralize its effect, banks/FIs has to focus much mutinously on preventive remedial measures in order to keep the existing credit portfolio healthy rather focusing on recovery through curative remedial mechanism after becoming them NPAs. In case if the genuine default the bank/FI should sympathetically hand-hold the borrower by giving Rehabilitation Package for revival of the project. However, OTS/compromise & settlement is also the effective tools if utilized judicially with a Win-Win motive. Government initiatives with a firm political will to move forward for legal & judicial reforms to make the enforceability of law, not only on a small borrower of priority sector but also on a large corporate tycoon in the similar fashion, in a more determined manner to tackle this menace to the national economy in an assertive way.

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