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Management of Non Performing Assets

The Significance of Banlance Sheet Transparency

ABSTRACT

The NPAs, apart from not yielding any revenue locks up a more or less equal amount of outstanding as provision which is going to be culled out of the current diminishing level of profits and retained earnings. It is also ironical that incomes recognized from good performing assets do not become available as lending resources but will have to be used as provisions and support for NPA. Moreover NPA as long as they form part of the bank's balance sheet exhibit a weak factor. A question that arises is how much risk can a bank afford to take? Recent happenings in the world – like Enron, Worldcom, Xerox – do not give much confidence to banks. In case after case, these giant corporates became bankrupt and failed to provide investors with clearer and more complete information there by introducing a degree of risk that many investors could neither anticipate nor welcome. The history of financial institutions also reveals the fact that the biggest banking failures were due to credit risk. In line with the international practices and as per the recommendations made by the Committee on the Financial System , the Reserve Bank of India has introduced, in a phased manner, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts. Banks are urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows with borrowers. This would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.

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1. PREAMBLE

In the present context of bank balance sheet transparency, income recognition and the consequential need to make provisions (on account of new classification of bank's assets particularly advances), it becomes very much significant and important to focus attention on the bank's non-performing assets (NPAs). The NPAs, apart from not yielding any revenue locks up a more or less equal amount of outstanding as provision which is going to be culled out of the current diminishing level of profits and retained earnings. It is also ironical that incomes recognized from good performing assets do not become available as lending resources but will have to be used as provisions and support for NPA. Moreover NPA as long as they form part of the bank's balance sheet exhibit a weak factor. This may prove a hurdle if the bank were to go to the capital market to augment its capital. Added to this disadvantage, the present of large percentage of NPA in a balance sheet will make the authorities to re-examine the viability of the bank itself. In the light of foregoing implications, it is necessary that the bank management embark upon a concentrated task and endeavour to recover from NPA or take such steps as are necessary to convert NPA into performing assets. This involves not only special focus of administrative attention and involvement but also sharpening of the

tactics and skill coupled with the ability to negotiate and follow up effectively. 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' as indicated below, 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.

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

'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'

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. 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 realisability of the dues: a) Sub-standard Assets; b) Doubtful Assets; and c) Loss Assets

A non-performing asset (NPA) is a loan or an advance

Sub-standard Assets

With effect from 31 March 2005, a sub-standard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, 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.

Doubtful Assets

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months.

A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, 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.

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

India transited to a 90 day NPL recognition norm (from 180 day norm) in 2004.

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.

3. DIMENSIONS OF NPA

a) Non-recycling of bank credit.

b) Adverse implications for profitability of credit operations and erosion of lendable resources owing to attendant write offs and waivers.

c) Revenue squeeze on account of non recognition of income on NPA.

d) Increase in provisions on account of NPA being degenerating into sub standard / doubtful / loss assets.

e) Need to raise additional resources to meet the increased capital requirements arising on account of more risk weighted assets.

f) Inability to infuse confidence in the minds of the public when NPA constitute a large portion of bank's assets; this has its effect on deposit mobilization, bank borrowings, capital increase, income accretion and profitability etc.

4. MANAGEMENT OF NPAs RECOVERY THROUGH NON LEGAL MEASURES

There are obvious limitations of the legal recovery system and the banks cannot entirely depend upon them. Money has opportunity cost; so if the dues are recovered early, they can be redeployed at a higher rate of return. Hence the time factor in the case of recovery becomes very important

Non legal remedies are expected to enable the banks to recover, possibly only a part of their dues, but at a much faster pace. Besides this, they also save the expenses and unproductive labour involved in the legal process. They enable the banks to immediately improve their liquidity position. For example, out of an incremental deposit of Rs.100, a bank can lend only Rs.70 (after CRR and SLR) and that too, only Rs.42 at commercial rate of interest. But it is not so in the case of amount recovered from NPAs, since it can be relent to the full extent (of course, including priority advances).

Some of the non legal measures are:

- compromise proposals / negotiated settlements
- debt discounting
- encouraging mergers & acquisitions
- debt swaps
- discounting decrees
- use of state government machinery

5. INDIAN ECONOMY & NPA

There has been considerable improvement in the asset quality of Indian banks. India transited to a 90 day NPL recognition norm (from 180 day norm) in 2004. Nonetheless, non performing loans (NPLs) as ratios of both total advances and assets have declined substantially and consistently since the mid 1990s (table below). Improvements in the credit appraisal process, upturn of the business cycle, new initiatives for resolution of NPLs (including promulgation of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest – SARFAESI Act, 2002) and greater provisioning and write-off of NPLs enabled by greater profitability, have kept incremental NPLs low.

Table 1: Non Performing Loans (NPL) of Scheduled Commercial Banks

Year	Gross NPL / Advances	Gross NPL / Assets	Net NPL / Advances	Net NPL / Assets (per cent)
1996-97	15.7	7	8.1	3.3
1997-98	14.4	6.4	7.3	3
1998-99	14.7	6.2	7.6	2.9
1999-00	12.7	5.5	6.8	2.7
2000-01	11.4	4.9	6.2	2.5
2001-02	10.4	4.6	5.5	2.3
2002-03	8.8	4	4.4	1.9
2003-04	7.2	3.3	2.9	1.2
2004-05	5.2	2.6	2	0.9
Source: Reserve Bank of India				

Table 2: NPAs as a percentage of total assets

	Gross NPAs / Total Assets(per cent)			
	2001-02	**2002-03**	**2003-04**	**2004-05**
Scheduled Commercial Banks	4.60	4.00	3.30	2.50
Public Sector Banks	4.89	4.21	3.50	2.74
Nationalized Banks	5.21	4.66	3.86	2.98
Private Sector Banks	4.36	3.97	2.82	2.05
Old Private Sector Banks	5.20	4.34	3.64	3.15
New Private Sector Banks	3.90	3.76	2.42	1.55
Foreign Banks in India	2.41	2.44	2.13	1.42
Source: Reserve Bank of India				

	Net NPAs / Total Assets (per cent)			
	2001-02	**2002-03**	**2003-04**	**2004-05**
Scheduled Commercial Banks	2.30	1.90	1.20	0.90
Public Sector Banks	2.42	1.93	1.28	0.99
Nationalised Banks	2.69	2.16	1.40	0.96
Private Sector Banks	2.49	2.32	1.32	0.97
Old Private Sector Banks	3.23	2.61	1.77	1.39
New Private Sector Banks	2.10	2.16	1.10	0.78
Foreign Banks in India	0.81	0.79	0.66	0.42
Source: Reserve Bank of India				

Table 3: NPAs AS PERCENTAGE OF ADVANCES

	Gross NPAs / Gross Advances (per cent)			
	2001-02	2002-03	2003-04	2004-05
Scheduled Commercial Banks	10.40	8.80	7.20	5.20
Public Sector Banks	11.09	9.36	7.79	5.53
Nationalised Banks	11.01	9.72	8.21	5.84
Private Sector Banks	9.64	8.07	5.84	4.44
Old Private Sector Banks	11.01	8.86	7.59	5.97
New Private Sector Banks	8.86	7.64	4.99	3.59
Foreign Banks in India	5.38	5.25	4.62	2.85
Source: Reserve Bank of India				

	Net NPAs / Net Advances (per cent)			
	2001-02	**2002-03**	**2003-04**	**2004-05**
Scheduled Commercial Banks	5.50	4.40	2.90	2.00
Public Sector Banks	5.82	4.53	2.99	2.06
Nationalised Banks	6.01	4.74	3.14	1.96
Private Sector Banks	5.73	4.95	2.84	2.17
Old Private Sector Banks	7.13	5.54	3.85	2.74
New Private Sector Banks	4.94	4.63	2.36	1.85
Foreign Banks in India	1.89	1.76	1.48	0.86
Source: Reserve Bank of India				

Table 4: SECTOR WISE NPAs

	Sector wise NPAs (per cent)					
	Agriculture	**SSI**	**Others**	**Priority sector**	**Public sector**	**Non Priority sector**
Public Sector Banks	15.21	16.43	17.42	49.05	0.94	50.00
Nationalised Banks	15.58	18.79	16.88	51.25	0.88	47.87
Private Sector Banks	5.29	10.96	8.62	24.87	0.48	74.65
Old Private Sector Banks	7.19	18.71	16.19	42.09	0.20	57.72
New Private Sector Banks	3.53	3.77	1.60	8.90	0.75	90.35
Source: Reserve Bank of India						

6. GLOBAL DEVELOPMENTS AND NPAs

The core banking business is of mobilizing the deposits and utilizing it for lending to industry. Lending business is generally encouraged because it has the effect of funds being transferred from the system to productive purposes which results into economic growth.

However, lending also carries credit risk, which arises from the failure of borrower to fulfill its contractual obligations either during the course of a transaction or on a future obligation. A question that arises is how much risk can a bank afford to take? Recent happenings in the world – like Enron, Worldcom, Xerox – do not give much confidence to banks. In case after case, these giant corporates became bankrupt and failed to provide investors with clearer and more complete information there by introducing a degree of risk that many investors could neither anticipate nor welcome. The history of financial institutions also reveals the fact that the biggest banking failures were due to credit risk.

Due to this, majority of banks are restricting their lending operations to secured avenues only with adequate collateral on which to fall back upon in a situation of default.

7. ACCOUNTING STANDARDS

On the basis of the recommendations of the Working Group on Compliance with Accounting Standards by banks, which was constituted by the Reserve Bank of India with Shri N.D. Gupta, the then President of the Institute of Chartered Accountants of India, as Chairman, the following guidelines are issued to banks by RBI with a view to eliminating the gaps in compliance by banks with the Accounting Standard issued by ICAI.

These guidelines pertains to the following Accounting Standards (AS) which are already operational:

Accounting Standard	Pertaining to
5	Net Profit or Loss for the period, prior period items and changes in accounting policies
9	Revenue Recognition
15	Accounting for the effects of changes in foreign exchange rates
17	Segment Reporting
18	Related party disclosures
22	Accounting for taxes on income
23	Accounting for investments in associates in consolidated financial statements
25	Interim financial reporting
27	Financial reporting of interests in joint ventures

Banks should place guidelines before the Board of Directors and ensure strict compliance with effect from the accounting year ending March 31, 2003.

8. PROVISIONING NORMS

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. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines.

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

Lending also carries credit risk, which arises from the failure of borrower to fulfill its contractual obligations either during the course of a transaction or on a future obligation.

Unsecured exposure is defined as an exposure where the realizable value of the security, as assessed by the bank/approved valuers/Reserve/ Bank's inspecting officers, is not more than 10 percent, ab-initio, of the outstanding exposure.

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

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

In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 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	20
One to three years	30
More than three years (i) outstanding stock of NPAs as on March 31, 2004	- 60 percent with effect from March 31, 2005 - 75 percent with effect from March 31, 2006 - 100 percent with effect from March 31, 2007
(ii) advances classified as `doubtful more than three years' on or after April 1, 2004	- 100 percent with effect from March 31, 2005

Sub- standard Assets

A general provision of 10 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.

The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 percent, i.e., a total of 20 percent on the outstanding balance. The provisioning requirement for unsecured 'doubtful' assets is 100 percent. Unsecured exposure is defined as an exposure where the realizable value of the security, as assessed by the bank/approved valuers/ Reserve /Bank's inspecting officers, is not more than 10 percent, ab-initio, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees, comfort letters etc.

Standard Assets

i) The banks should make a general provision of a minimum of 0.25 percent on standard assets on global loan portfolio basis.
ii) The provisions on standard assets should not be reckoned for arriving at net NPAs.
iii) The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions – Others' in Schedules 5 of the balance sheet.

Credit risk and NPAs

Quite often credit risk management (CRM) is confused with managing non performing assets (NPAs). However, there is an appreciable difference between the two. NPAs are a result of past action whose effects are realized in the present i.e., they represent credit risk that has already materialized and default has already taken place.

On the other hand, managing credit risk is a much more forward looking approach and is mainly concerned with managing the quality of credit portfolio before default takes place. In other words, an attempt is made to avoid possible default by properly managing credit risk.

Considering the current global situation and unreliable information in financial statements, there is high credit risk in the banking and lending business. To crease a defence against such uncertainty, bankers are expected to develop an effective internal credit risk models for the purpose of credit risk management.

9. CONCLUSION

In line with the international practices and as per the recommendations made by the Committee on the Financial System (Chairman Shri M. Narasimham), the Reserve Bank of India has introduced, in a phased manner, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts.

To crease a defence against such uncertainty, bankers are expected to develop an effective internal credit risk models for the purpose of credit risk management.

The classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms. Also, the provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof.

Banks are urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows with borrowers. This would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.

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