Non-performing assets are a drag on the profitability of any bank. It is important that banks build early warning signals into their operations, so that potential loan defaulters are spotted before they can cause undue harm to the financial institution.

The term Non-Performing Assets (NPAs) refers to an advance facility, in respect of which the interest or instalment of principal has remained overdue for a period exceeding 90 consecutive days. An asset becomes non-performing when it ceases to generate income for the bank. The guiding principle is that the income on NPAs should not be recognised on accrual basis and should be treated as income only when actually received. Moreover, banks have been instructed that the interest on NPAs should not be taken as the income.

Common classification of assets

Once an asset falls under the NPA category, banks are required by the Reserve Bank of India (RBI) to make provision for the uncollected interest on these assets. For this purpose they have to classify their assets, based on the strength and on collateral securities, into four types, as mentioned below:

Standard assets. A standard asset is an asset that does not pose any problem—it is not a non-performing asset. Since this asset does not carry any extra risk, banks were not required to make any provision for uncollected interest for these assets in the past. At present, however, they need to keep a small provision of 0.25 per cent of total outstanding

Sub-standard assets. A sub-standard asset is an asset that has been a NPA for a period not exceeding two years. A general provision of 10 per cent of total outstandings should be made in this category.

Doubtful assets. A doubtful asset was earlier an asset that had been a NPA for a period exceeding two years. This period was reduced to 18 months with effect from March 31, 2001. The general provision to be made on this asset is: up to one year—20 per cent; one year to three years—30 per cent; and more than 3 years—50 per cent.

Loss assets. A loss asset is an asset that has been identified by the banks, the internal or external auditors, or the RBI inspectors, but the amount has not been written off fully or partly.

Even though accounts are classified as standard, sub-standard, doubtful and loss assets, if these are not realisable, such advances can be straightaway classified as NPAs, irrespective of the stipulated period mentioned by the bank authorities.
Guidelines for minimising NPAs

Banks are required to follow certain guidelines in order to minimise the non-performing assets. These are listed below:

**Use of appropriate internal systems.** Banks should establish appropriate internal systems to eliminate delays or postponement in the identification of NPAs, especially for high value accounts.

**Classification of accounts with temporary deficiencies.** The classification of an asset as a NPA should be based on the record of recovery. Banks should not classify an advance account as an NPA merely due to the existence of some deficiencies, which are temporary in nature, such as non-availability of adequate drawing power based on latest stock.

**Asset classification should be borrower-wise and not facility-wise.** It is difficult to envisage a situation where only one asset of a borrower becomes a problem with respect to recovery. Therefore, all the assets loaned by a bank to a borrower have to be treated as NPAs, and not a particular asset or a part thereof, interest payment for which has become irregular.

**Advances under consortium arrangements.** Asset classification of advances taken from consortiums should be based on the record of recovery of the individual member banks, as well as other aspects that have a bearing on the recoverability of these advances.

**Agricultural advances.** (a) In respect of advances granted for agricultural purposes, if the interest or instalment of principal remains unpaid for two harvest seasons after it becomes due, this advance is to be treated as a NPA.

(b) When natural calamities impair the repaying capacity of agricultural borrowers, banks may convert a short-term production loan into a term loan, or re-schedule the repayment period as a relief measure. In this case, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as a NPA.

**Restructuring/rescheduling of loans.** A standard asset, where the terms of the loan arrangement regarding interest and principal have been renegotiated or rescheduled after the commencement of production, should be treated as a sub-standard asset and should remain in that category for at least one year of satisfactory performance under the renegotiated or restructured terms. In case of sub-standard and doubtful assets also, rescheduling does not entitle a bank to upgrade the quality of advances automatically, unless there is satisfactory performance under the rescheduled/restructured terms.

The financial impact of NPAs

The failure of banks to recover interest and principal payments from NPAs could have some disastrous effects, which are listed below:

1. Owners of banks will not receive a market return on their capital. In the worst case scenario, if the bank fails, owners lose their assets. In modern times, this could affect a broad pool of shareholders.
2. Depositors will not receive a market return on savings. In the worst case scenario, if the bank fails, depositors lose their assets or uninsured balance. Banks will also redistribute losses to other borrowers by charging higher interest rates. Lower deposit rates and higher lending rates repress savings and financial markets, which hampers economic growth.
3. Non-performing loans represent bad investments. NPAs misallocate credit from good projects, which do not receive funding, to failed projects. Bad investments end up in misallocation of capital and, by extension, labour and natural resources. The economy performs below its production potential.
4. Non-performing loans may spill over the banking system and contract the money stock, which may lead to a financial crisis. This can happen if:
   (i) Many borrowers fail to pay interest and banks begin to experience liquidity shortages. These shortages can jam payments across the country.
   (ii) Due to illiquidity, banks are unable to pay depositors—for example, cash their pay cheques. This will lead to financial panic.
   (iii) Under-capitalised banks exceed the bank’s capital base.

The main underlying reasons for NPAs in India

An internal study conducted by the RBI shows that the following factors, in order of importance, contribute to NPAs:

1. Diversion of funds for expansion/modernisation
2. Taking up of new projects
3. Helping/promoting associate concerns
4. Business (product, marketing, etc) failure
5. Inefficiency in management
6. Slackness in credit management and monitoring
7. Use of inappropriate technology/technical problems
8. Lack of co-ordination among lenders
9. External factors
10. General recession
11. Input/power shortage
12. Price escalation
13. Exchange rate fluctuations
14. Accidents and natural calamities, etc.
15. Changes in government policies in excise/import duties, pollution control orders, etc.

Financial sector experts offer a few other reasons for NPAs in India.
These are listed below.

**Liberalisation of the economy.** The liberalisation of the Indian economy led to the removal of foreign trade restrictions and a reduction in import tariffs. A large number of borrowers were unable to compete in a free market, in which lower prices and greater choices were available to consumers. Further, borrowers operating in specific industries suffered due to political, fiscal and social compulsions that resulted from liberalisation (e.g., sugar and fertiliser industries).

**Tax monitoring of credits.** Loan proposals generally pass through many levels of scrutiny before approval is granted. However, the monitoring of sometimes-complex credit files has not received the attention it needed, which meant that early warning signals were not recognised and standard assets slipped to the NPA category without banks being able to take proactive measures to prevent this from happening. Adverse trends in borrowers’ performance were not noted in time.

**Over-optimistic promoters.** Promoters were often optimistic with respect to setting up of large projects and, in some cases, their intentions were not above board. Screening procedures did not always highlight these issues. Often, projects were set up with the expectation that part of the funding would be arranged from the capital markets, which were booming at the time of the project appraisal. When the capital markets subsequently crashed, the requisite funds could never be raised, promoters often lost interest and lenders were left stranded with incomplete or unviable projects.

**Directed lending.** Loans to some segments were dictated by government policies rather than commercial imperatives.

**Highly leveraged borrowers.** Some borrowers were undercapitalised and over burdened with debt to absorb the changing economic situation in the country. Operating within a protected market resulted in low appreciation of commercial/market risk.

**Funding mismatch.** In many cases, loans granted for the short term were used to fund long-term transactions.

**High cost of funds.** Interest rates as high as 20 per cent were not uncommon. Borrowers could not service this high-cost debt.

**Willful defaulters.** There were a number of borrowers who strategically defaulted on their debt service obligations, as they realised that the legal recourse available to creditors was slow in achieving results.

**Procedures for NPA identification and resolution in India**

Since a high number of NPAs dampens the performance of banks, it is important to identify potential problem accounts and monitor them closely. Though most banks have Early Warning Systems (EWS) for identification of potential NPAs, the actual processes followed differ from bank to bank. The EWS enables a bank to identify the borrower accounts that show signs of credit deterioration and initiate remedial action. Many banks have evolved and adopted an elaborate EWS, which allows them to identify potential distress signals and plan their options beforehand, accordingly.

The early warning signals indicate potential problems in the accounts, which include persistent irregularity in accounts and delays in servicing of interest payments. In addition, some of these banks review their exposure to borrower accounts every quarter based on published data, which serves as an important additional warning system. These early warning signals used by banks are generally independent of the risk rating systems and asset classification norms prescribed by RBI.

The major components or processes of the EWS followed by banks in India, as brought out by a study conducted by Reserve Bank of India at the insistence of the Board of Financial Supervision, are as follows:

1. Appointing a relationship manager/credit officer for monitoring accounts
2. Preparation of ‘know your client’ profiles
3. Following a credit rating system
4. Identification of watchlist/special mention category accounts
5. Monitoring of early warning signals

**Appointing a relationship manager/credit officer.** The relationship manager/credit officer is an official who is expected to have complete knowledge about the borrower, his business, his future plans, etc. This relationship manager has to keep in constant touch with the borrower and report all developments impacting the borrowable account. He is also expected to conduct
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scrutiny and activity inspections. In the credit monitoring process, the responsibility of monitoring a corporate account is vested with this officer.

Know Your Client (KYC). Most banks in India follow a system of preparing a ‘Know Your Client’ (KYC) profile/credit report. As a part of the ‘KYC’ system, visits are made to clients and their business units. The frequency of these visits depends on the nature and needs of the relationship.

Credit rating system. The credit rating system is essentially used to identify, measure and monitor the credit risk of an individual proposal. At the bank level, this credit rating system enables the tracking of the health of the complete credit portfolio of the bank. Most banks in India have put in place a system of internal credit rating. While most of the banks have developed their own models, a few banks have adopted credit rating models designed by rating agencies. Credit rating models take into account various types of risks associated with a prospective borrower. This exercise is generally done at the time of sanction of a new credit account and at the time of review/renewal of existing credit facilities.

Identification of watchlist/special mention category accounts. The grading of the bank’s risk assets is an important internal control tool. The purpose of identification of potential NPAs is to ensure that appropriate preventive and corrective steps are initiated by the bank to protect against the loan asset becoming non-performing. Most banks have a system to put certain borrowable accounts under a watchlist or special mention category, if advances operating under adverse business or economic conditions are exhibiting certain distress signals. These accounts generally exhibit weaknesses that are correctable but warrant close attention from the bank. Putting such accounts into a watchlist or special mention category helps to give the early warning signals, which enable relationship managers or credit officers to anticipate credit deterioration and take the necessary preventive steps so that these do not turn into non-performing advances.

Monitoring of early warning signals. It is important to be sensitive to signals of credit deteriorations, statement of receivables etc.

Finance-related warning signals
1. Persistent irregularity in the account
2. Default in repayment obligation
3. Deterioration in liquidity/working capital position
4. Substantial increase in long-term debts in relation to equity
5. Declining sales
6. Operating losses/net losses
7. Rising sales and falling profits
8. Disproportionate increase in overheads relative to sales
9. Rising level of bad debt losses
10. Operational warning signals
11. Low activity level in plant
12. Disorderly diversification/frequent changes in plans
13. Non-payment of wages/power bills
14. Loss of critical customers
15. Frequent labour problems
16. Evidence of aged inventory/large level of inventory

Management-related warning signals
1. Lack of co-operation from key personnel
2. Change in management, ownership or key personnel
3. Desire to take undue risks
4. Family disputes
5. Poor financial controls
6. Fudging of financial statements
7. Diversion of funds

Banking-related warning signals
1. Declining bank balances/declining operations in the account
2. Opening of account with other banks
3. Return of outward bills/dishonoured cheques
4. Sales transactions not routed through the account
5. Frequent requests for loan
6. Frequent delays in submitting stock statements, financial data, etc.

Signals relating to external factors
1. Economic recession
2. Emergence of new competition
3. Emergence of new technology
4. Changes in government/regulatory policies
5. Natural calamities

**Measures to reduce NPAs**

Today, NPAs are a major drag on a bank’s profitability. The reduction of NPAs to a significantly low level can strengthen the profitability of banks. A few suggestions that could help banks to do so are listed below:

1. Recovery of loans should be linked with employees’ performance appraisal; every bank as well as each branch must choose its own way to implement this.

2. Organisation of loan recovery camps with the help of local revenue authorities and gram panchayats can yield results.

3. A special recovery cell with committed staff and extra incentives on the basis of recovery performance should be set up.

4. Strengthening the Debt Recovery Tribunals (DRTs) with adequate staff and legal support can be considered. Borrowers that have small loans for recovery do not come under the DRTs at present. These tribunals should deal with all types of loans, and their geographical coverage should be extended.

5. Only those banks that are strongly committed to productivity and profitability should be transferred to the Asset Reconstruction Fund. Such banks may be allowed to write off a large volume of NPAs in a phased manner. The government should provide this benefit to such banks.

6. Banks should get some amount of operational freedom for lending. The stipulation of ‘priority sector’ lending can be relaxed on a case-to-case basis.

7. To improve the quality of lending, the design of lending schemes and the appraisal technique procedure for disbursement of loans should be based on applied research. Frequent exchange of information within and amongst banks in each region and across the regions should be encouraged.

An increase in the non-performing assets is not healthy for any bank. RBI has taken many steps to minimise the NPAs in India. For example, it has ordered banks to collect the interest on jewel loans once in three months. Banks must monitor their lending activities closely to minimise NPAs. They must use their funds optimally and follow innovative methods for debt collection.

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