Chapter 1

Introduction to Non-Performing Assets (NPAs)

1.1 Introduction to NPAs

An asset including a leased asset, when ceases to generate income for the bank or financial institution becomes a non-performing asset (NPA).

NPA is an advance or a loan for which principal amount or interest remains overdue. As per prudential norms of RBI any advance in respect of which principal or amount of interest remains overdue for a period of 90 days or more is treated as NPA. It is a classification used by the financial institutions or banks classification of advances or loans. In other words, a lender loses money when a borrower stops paying interest or repaying the principal on the loan. Such a loan is known as Non-Performing Asset (NPA).

EXAMPLE:

Company ABC has taken a loan of Rs.10 million from Bank XYZ on which it is required to pay Rs.10,000 of interest every month for 5 years. Now the borrower i.e. ABC company defaults on the payment of interest for three consecutive months that is 90 days. Therefore, the bank needs to classify the loan as NPA in its balance sheet for the relevant year. Also the interest is not recognised as income, the moment an account is treated as NPA.

There is a set framework on which non-performing asset works. Advances and loans are not immediately classified as NPA until the given periods of non-payment have elapsed. The lending institution and banks consider all the factors that might have made a borrower late on making principal or interest payments and in some cases where it is just and equitable and the factors are temporary in nature they extend the grace period.

The loans given by a bank are its assets. India's banking industry is seriously afflicted by huge amount of NPAs. NPAs are as such classified on bank or financial institution balance sheet

NPAs reduce the profits as well as the asset base of a bank or financial institution.

The NPAs percentage (out of total advances) is an important ratio for the banks or financial institutions to assess the quality of assets and the overall health of banks and financial institutions.

The prime reasons for NPAs are economic slowdown, CVC, flawed credit appraisal process, inadequate post disbursal monitoring, diversion of funds by promoters and consequential frauds, improper valuations of tangible and intangible securities, delayed reporting of frauds, rampant corruption, political and bureaucratic intervention in grant of loans flawed legal system and the wait and watch approach by banks. Besides fear of 3Cs i.e. Courts, CBI and CAG, apart from operational factors referred earlier, has its own role in timing of NPAs recognition and consequent recovery thereof.

High NPAs also adversely affects the decision making for fresh credit sanction and its disbursal. An increasing amount of bad loans prompt the banks to be extra cautious, which dries the credit channel and negatively effects the economic activity in the country. In the wake of the Covid-19 Pandemic, most of the businesses, particularly tourism, hospitality, amusement parks, theatres, auto industry, aviation etc. have been severely hit and large number of units face closures. Revival of business calls for expeditious disposal of credit proposals and also restructuring of existing loans wherever revival is a possibility.

Two steps are vital in resolving the NPA crisis:

1. Determining the current accumulation
2. Limit the future NPA growth

The principal factor for accumulating bad loans in the Indian banking system is exaggerated economic growth expectations and over ambitious projections erroneously or otherwise presented by borrowers and accepted by the lending institutions. This makes the bank disburse credit at times disproportionate to the requirements. If the high expectations do not materialize, bad loans accumulate. When an economy experiences healthy GDP growth, a substantial part of it is financed by the banking system's credit. As long as the GDP keeps growing, the repayment schedule does not get affected except in certain cases like siphoning of the funds, diversion of money for other uses, wilful defaulters etc. However, when the GDP growth slows down, the bad loans increase due to a host of macroeconomic factors, primary among those being interest rate, inflation, unemployment rate, and change in the exchange rates, which affect the capacity of borrowers to repay. At times Indian banking industry failed to appreciate genuine concerns of borrowers in time and it accentuated the problem. This is particularly true in case of credit needs of MSMEs.

Bank-related micro indicators such as appraisal and monitoring skills of bank staff, adoption of technology, appreciation of borrower's genuine needs, size of the bank, pricing of loans, decision making with regard to restructuring and settlement proposals, risks identification and mitigation measures taken, long term strategy and constraint of poor capital adequacy also contribute to accumulating bad loans. Credit policy and the "herd behaviour" of the banks with regard to certain category of loans also play a role in the growth of NPAs.

The jump in NPAs can be attributed to the disclosure norms and transparency pressures imposed by the Reserve Bank of India (RBI). Indian commercial banks had been under reporting the NPAs by way of restructuring or rolling over existing loans (ever greening of loans)—to make their balance sheets look cleaner than actuals. Fear of action in case of certain loans being classified as an NPA also contributed enormously to under reporting.

The trends in the growth rates of NPAs and GDP show that bad loans tend to grow with a lag in the GDP growth rates. This implies that once the GDP growth rate rises, the Indian banking system starts extending more credit. Roughly after two to three years of profitable growth once the economic activity slows down, bad loans start showing up. There is a negative relationship between GDP and NPA.

The massive jump in the quantum of NPAs made the bad loans more sensitive to the growth in GDP, which has reduced the time lag between the growth rates in NPA and GDP. The accumulated bad loans made banks apprehensive about extending loans liberally. Thus, any small fall in the GDP growth rate elicits a lot of caution, leading to decreased disbursal of bank credit, which in turn results in higher percentage of gross non-performing assets ratio. Increases in lending rates also contribute to higher NPAs.

In India, 'priority sector lending' is often cited as a significant reason for the accumulation of NPAs. This is not true. Accumulated NPAs in the priority sector is relatively small compared to the accumulated NPAs in the non-priority sector. In recent times the infrastructure sector has contributed significantly to the kitty of stressed assets.

Needless to say, economic revival is not possible unless GDP growth is accompanied by a sizeable increase in employment. Jobless growth will not create adequate purchasing power in the hands of the ordinary consumer. Without more purchasing power, no economic development can be sustained in the long run. This affects the sustainability of various businesses.

The origins of India's NPA problem lie in decisions taken during the early-2000s. During that period, India's GDP growth was surging to 9-10% per annum. Corporate profitability was amongst the highest globally, encouraging firms to hire labour aggressively, which sent wages soaring. Corporates launched new projects worth lakhs of crores, particularly in infrastructure-related areas such as power generation, steel, telecom, Highways, toll bridges real estate etc. In this period of boom—an astonishingly upbeat credit regime financed all these investments. However suddenly, things started to go wrong towards the end of that decade. The firms' costs soared far above their budgeted levels. Securing land and environmental clearances proved difficult and time-consuming. As if these problems were not enough, borrowing costs increased sharply. This is also the period when the banks lent throwing caution to winds for various reasons. This led to a lot of scams both within and outside the banking industry. Political, bureaucratic, banking and corporate corruption went hand in hand to loot the banks and in turn the public at large. Due to vested interests NPA identification was delayed through various dubious measures. Continued restructuring also helped in hiding NPAs. However, it was under Raghuram Rajan, Governor RBI the Asset Quality Review was undertaken in the banking industry, which to a large extent revealed the real magnitude and dimensions of NPAs.

Impact of NPAs

Let's shift our focus to the impact of NPAs. Foremost being lower profit margins. Stress in the banking sector caused less money available to fund productive projects, having a negative impact on the national economy. Banks began to charge higher interest rates to maintain the profit margins. As investments got stuck, unemployment grew, investors did not get rightful returns. This turned into a vicious cycle, the biggest casualty was the economy. Q4 of FY20 registered an abysmally low rate of GDP growth i.e. 3.1% which got worse due to adverse impact of Covid. Manufacturing had a negative growth. And for the economy to bounce back a number of measures were contemplated. Few of those are already operationalised. Nevertheless, notwithstanding the pandemic, level of NPAs remains a major area of concern and the quotient of it has only further been amplified with negative earnings and growth.

Banks or financial institutions may opt for collecting the outstanding debt or amount by foreclosing on whatsoever property or asset has been used to secure the said loan. For example, if any person takes a mortgage and that mortgage loan becomes a non performing asset, the bank may send the notice of foreclosure by disposal of mortgaged asset because it is being used as collateral for loan. This notice for foreclosure is generally called as Demand notice. Nowadays various laws have been enacted by the judiciary for recovery of NPAs to contain the adverse impact of the same on economy.

Loans / Advances can be in nature of term loans and working capital facilities. These can further be categorised into fund based and non-fund based facilities. There are some important key points which are to be kept in mind by the banks or financial institutions before giving any loan or advances to any individual or entity. These are termed as 4Cs that is Character, Collateral, Capacity, and Condition. These 4Cs are explained in brief hereunder-

- ***Character:*** The character of the borrower is required to be observed and judged. Past experience of the borrower with other banks or same bank may indicate willingness of the individual or entity to repay debt. The history of management, revenue streams, and the performance of shares on stock exchange and media coverage of the entity could be considered to form an opinion about the individual or the entity.
- ***Collateral:*** the value of the collateral which has been hypothecated mortgaged needs to be evaluated and measured. Proper valuation of the property or the asset has to be ascertained keeping in mind the total amount of loan and the possibility of recovery of money in case of a debt going bad.

- ***Capacity:*** The capacity of the entity's financials and the revenue projections relating to the future of the entity should be evaluated by the bank or the financial institution. Also, it may be important to study the product and the market share of the entity. Potential growth of market of product needs be assessed correctly. Also the lenders who are already there on the entity's balance sheet are to be communicated and sharing of collaterals need be agreed between the existing and new lenders.
- ***Condition:*** It is to be kept in mind that the overall environment and the market conditions for the industry are very important. As it is well known that internal and external factors affect the bank or any other lending institution and its business as well. Therefore all these factors are to be considered carefully and thoroughly. Bank while fixing the interest rates may consider the market from perspective of hardening of interest rate or otherwise. Also the bank may study the economic conditions policies of the govt. and the impact of the same on the business of the borrower.

The NPAs are of great significance in any economy as the larger the amount of NPAs any bank or financial institution holds, the weaker is its financial position. Also, it affects the income and liquidity of such bank or financial institution.

It is seen that for banks and other financial institutions NPAs can be kept in manageable limits depending upon the extent, causes and longevity of the same.

But if NPAs continue to pile up over time, it threatens the financial as well as the overall health of the entity and endangers its sustainability. Needless to say it impacts economic activity adversely.

The Indian Banking industry rather the whole financial sector is seriously affected by NPAs. Some of the additional points relating to NPAs are given below:-

- Loans worth more than Rs. 8.9 lakh crore are classified as Non-performing loans in India. This is despite write off as more than 8 lakh crores of NPAs in last ten years. Also ,these do not include highly stressed advances to agricultural sector, discoms and MSMEs, The same are yet to be identified as NPAs despite huge stress therein.
- The above figure roughly amounts to about 8% of total advances.
- Few of the banks have much higher percentage of NPAs.

- Due to pandemic the crisis of NPAs is getting worse day by day and it is affecting the economy of the country hugely.
- At times restructuring norms set by the government RBI have been misused to hide NPAs.

So, from the above introduction of NPA, it is very much visible that there needs to be a strict framework to resolve the problem of rising NPAs and improving the financial position of banks and financial institutions.

Generally, the problems related to NPA is solved by two ways one is at Centralised level in which all the banks, government and the other regulatory come all together and find a solution to the problem of NPAs. It could be by laying down some restructuring measures, govt. undertaking to make good the stressed loans, creation of bad bank etc. On the other hand, there is an another method which is at decentralised level. Under this the respective banks devise their own strategies to tackle the problem of NPAs. It could involve one time settlement; write off of loans, using Assets Recovery Companies (ARCs) etc. known for providing a vigorous approach towards the management of non-performing loans. This type of organisation uses the funds received from the public to wipe out NPAs from the books of the banks. Due to enormisity of problem being faced in respect of NPAs some companies see this as business opportunity and they are buying these NPAs from the companies or banks or the financial institutions at the lower rates by making payments to lenders either in cash or by issue of security receipt (SRS) or in a mixed manner. They become the lawful owners or we can say legal creditors for the borrowers. The selling rates for these NPAs would depend upon host of factors, e.g. security available, longevity of NPA, nature of loan i.e. personal or commercial.

1.2 Problem of NPAs

The most noteworthy emergency that the finance institutions as well as banking organizations face presently is the non-abated increment in NPAs which influence the rating of these banks and financial institutions. This to an extent affects the rating of the economy as well.

Regardless of the various measures taken by RBI/govt. there is no considerable decrease in the level of NPAs through genuine recoveries. The reduction in NPAs is primarily due to write off of such loans.

A focal point of banks and other money related establishments is a devise to mechanism to contain NPAs. It involves appraising the project more diligently by obtaining more information, assessing borrowers capacity to repay and above all involving a more trained staff force.

It is imperative that officials of banks and financial institutions are trained and are familiarised with the issues and quandaries of the borrowers who for the most part are straightforward and dependable yet have turned out to be defaulters because of conditions outside their ability to handle Such borrowers may be prepared to respond in a positive manner yet discover no real way to raise required assets at moderate expense and in reasonable time to satisfy their obligations. The banks ought to reorient their way to deal with such genuine borrowers.

The Magnitude of NPAs within Indian financial framework has risen to serious proportions over a period of time. Early 70's onwards the impairment in loans was primarily based upon the values of securities. The loans were monitored more on adhoc basis rather than any scientific basis. The Tondon committee (1973) brought in some consistency. This was further improved upon by the Chore Committee (1980), which too perceived the requirement for keeping an eye on the behaviour of the advances portfolio, and stressed on normal yearly survey of all borrowal accounts having the credit limits of more than Rs. 10,00,000. The Pendharkar Committee (1981) perceived the requirement for arranging Portfolio into various classifications to list the same by and large by the nature of the portfolio. In view of the board of Trustees' proposals, RBI presented the well-being code arrangement of sorting bank credit portfolio in the year 1985. This exhorted the institutions to characterize portfolio within a consistent and similar evaluating framework to some extent.

In 1988, the Bank for International Settlements (BIS), at Basel of Switzerland, defined its arrangement of prudential financial standards. Notwithstanding, RBI proceeded with its unit of Health code based upon of the Narasimhan Advisory group Report (Committee on Money Related Framework) formed in December 1991. This advisory group in addition to other things prescribed that BIS measures for money acknowledgment, resource characterization and provisioning in a staggered way over some time frame.

This brought about the development of the fresh norms for NPAs. In light of the Narasimhan Committee proposals, the RBI presented prudential norms for income recognition and classification of asset in banks in year 1992. It basically implied that a financial institution can maintain own portfolio with just two classifications of credits - "performing" and "non-performing", contingent upon the records of repayment. Further, so as understand the circumstance of the banks, the RBI acknowledged the proposal of the Narasimhan Committee to characterize advance resources into four categories namely standard, sub-standard doubtful and loss assets depending upon the period for which the amount was overdue and also the availability of security.

Classifications of Advances:

(i) Standard Assets

Standard asset is one which does not disclose any problem and which does not carry more than normal risk attached to the business. Such an asset is standard asset.

Further, interest on advances against Term Deposits, National Savings Certificates (NSCs), Kisan Vikas Patras (KVPs) and life insurance policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

(ii) Sub-Standard Assets

A sub-standard asset is one, which has remained NPA for a period less than or equal to 12 months; such as asset will have well defined credit weaknesses that jeopardize liquidation of the debt and are characterized by the distinct possibility that the bank will sustain some loss, if deficiencies are not corrected.

(a) However, Central Govt. Guaranteed advances, although categorized as NPA for the purpose of Income Recognition, are to be treated as Standard Assets (Govt. Guaranteed) unless Govt. repudiates its guarantee when invoked.

(b) State Govt. guaranteed advances are to be classified as sub-standard or doubtful or loss, after interest / principal/ any other amount due to the bank remains overdue for more than 90 days.

(iii) Doubtful Assets

An asset is classified as doubtful if it remained in the sub-standard category for more than 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.

(iv) Loss Assets

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

(v) Classification of NPA Straightway as a Doubtful/Loss in Case of Serious Credit Impairment

(a) The extant instructions provide that a NPA need not go through the various stages of classification in case of serious credit impairment 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. Such assets should be straightaway classified as a doubtful/ loss as appropriate viz.

(b) Erosion in the value of security can be reckoned as significant when the realizable value of the security is less than 50% of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(c) If the realizable value of the security, as assessed by the bank's approved valuers /RBI is less than 10% of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided by the Bank.

1.3 Types of NPAs

Basis of treating various facilities as NPAs is given hereunder:

(i) Term Loan

Term loan account will be treated as NPA if interest and/or instalment of principal remain overdue for a period of more than 90 days. Amount due to the bank under any credit facility is 'overdue', if it is not paid on the due date fixed by the bank and there is no scope for delays and / or post dues.

(ii) Cash Credit and Overdrafts

(a) A cash credit or overdraft account will be treated as NPA if the account remains 'out of order'. A Cash Credit and Overdraft account is treated as 'out of order' if:

- The outstanding balance remains continuously in excess sanctioned limit/drawing power for 90 days. Even though the outstanding balance is less than the sanctioned limit/drawing power, there are no credits continuously for 90 days as on the date.
- Even though the outstanding balance is less than the sanctioned limit/ drawing power, 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.

(b) Branches should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be calculated/ arrived at based on the stock statement which is current. However, considering the practical difficulties of large borrowers, stock statement relied upon by the banks for determining drawing power should not be older than three months The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. A working capital borrowal account will become NPA if such irregular drawings are permitted in the account for a continues period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

(c) Regular and adhoc credit limits need to be reviewed/regularised not later than three months from the due date/date of adhoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/date of adhoc sanction will be treated as NPA.

(iii) Bills Purchased and Discounted

The bills purchased/discounted account should be treated as NPA if the bill remains overdue for a period of more than 90 days.

(iv) Agricultural Advances

(a) The instalment of principal or interest there on remains overdue for two Crop seasons for short duration crops.

(b) The instalment of principal or interest there on remains overdue for one Crop seasons for long duration crops.

(c) It may be noted that short duration crop is one which is of duration of less than one year. And long term crop is one which takes more than 12 months period.

(v) Securitization Transactions

In respect of securitization transaction if the amount of liquidity facility remains outstanding for more than 90 days.

(vi) Derivatives Transactions

In respect of derivatives 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.

(vii) Credit Card Accounts

(a) In credit card accounts, the amount spent is billed to the card users through a monthly statement with a definite due date for repayment. An option is given to the card users to pay either the full amount or a fraction of it, i.e. minimum amount due, on the due date and roll-over the balance amount to the subsequent months' billing cycle.

(b) A credit card amount will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month.

(c) RBI has directed that Banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies and for the purpose of levying of penal charges, viz. late payment charges, etc., if any.

1.4 Factors causing and affecting NPA

Now a day's banks and other financial institutions are facing severe problem of ever increasing NPAs. Problem of increasing NPAs is more acute in case of the public sector banks/institution as in comparison with the other private and foreign bank/institutions operating in the country. Rise in the NPAs is caused by internal and external factors which are explained hereunder –

External Factors

(a) **Wilful Defaults by Borrowers** – This is one of the major problems for rise in NPAs. Despite having capacity to repay such borrowers do not repay the loans. They siphon off the funds through dubious ways. These borrowers are taking advantage of loopholes in the legal system in the country. Court cases filed by the bankers get dragged for years. In a large number of cases despite decrees being obtained by banks the same are not executed for decades. Number of Wilful defaulters in the last few years has gone up substantially. There is an urgent need to rein it.

(b) **Natural Disaster** – This is one of the important reasons behind the higher rate of NPA in the banks and the financial institutions. India is an agrarian based economy. The borrowers who are residing in the areas prone to natural calamities are unable to pay the loan amount which they have borrowed for the reason of natural calamities e.g. floods, draught etc which hamper their repayment capacity. To overcome the problems caused by natural calamities banks may create provisions to counter such situations. Mostly farmers take loan for growing crops in their fields and for water particularly in certain parts of the country they are dependent on monsoon. Deficit or excess of monsoon, both are bad for crops and reduce the repaying capacity of the farmers. Crop insurance has not tackled the issue adequately.

(c) **Industry Sickness** - Lack of demand, managerial deficiencies, technological obsolescence, high labour and power costs, lack of financial support at right time and inappropriate polices of govt. at times cause industrial slackness which in turn result in higher NPAs. Even slowdown in other world economies causes industrial sickness.

(d) **Lack of Demand** - Conditions like COVID, lack of adequate circulation of money create conditions leading to short fall of demand and build up of inventories. Inability on the part of manufactures retailers to sell their products leads to build up of receivables and inability to pay to payables. This vicious circle leads to default with lenders and consequent higher NPAs.

(e) **Change in Government Policies** – With the change in the governments at Centre or State there may be new policies introduced by the new governments. The companies have to manage with the new or the changed policies, regulations and principles which are introduced. At times these changes can lead to disruption in economic activity resulting in to higher NPAs.

(f) **Corruption** - Corruption at various levels contributes significantly to NPA problem.

(g) **Political Intervention** - Political intervention in disbursement of loans by banks and financial institutions for various reason, also contributes to problem of NPAs.

Internal Factors

(a) **Deficiencies in lending Process** –While lending to borrowers, banks and financial institutions generally follow three principles. These can be classified as principles of safety of loan, principle related to profitability and the principle of liquidity. The principle related to safety of loan means that the borrowers should be in the position to pay the interest as well principal. Capacity to repay depends upon the profitability of business, and the cash generation capacity there from. Most important factor is the integrity level of the borrowers. So at the time of providing loan to the borrower the banks and the financial institutions should consider past track record of the borrower, his capacity to repay the loan, owning of sufficient of assets to fulfil his obligations to repay the loans.

(b) **Technological Deficiencies** – Due to unsuitable or out dated technologies a business may not be able to produce and sell at competitive prices. Lack of appropriate and adequate management information system with regard to latest trends in market, banks are not able to evaluate a project appropriately.

(c) **SWOT Analysis** –SWOT is the abbreviation which is used to identify the Company's Strengths, Weaknesses, Opportunities and Threats. Identification of these is an important part of the analysis. If it goes wrong then the whole activity will be in vain. In this type of analysis, the banks and financial institutions try to assess the strengths, weaknesses, opportunities and threats faced by its borrowers. After proper evaluation of these factors the banks lend to borrowers. Any deficiency in SWOT analysis enhances the risk of borrowers' accounts turning NPA. It is generally observed that due to varied reason the SWOT analysis carried out by banks suffers from various deficiencies.

(d) **Poor Credit Appraisal System** – Credit Appraisal System is to assess the loan requirement received from the borrower based upon the detailed market study. It involves assessment of the projects based upon technical and economic feasibility. Also, it involves studying the project from the view point of govt. policies and consequently its sustainability. Operating cycle of the company needs be studied and limits to be fixed in accordance there with in case of working capital needs. And in case of term loans the payback period etc. needs to be studied. Appraisal of the loan proposals in Indian banking system has been found to be extremely weak and consequential high NPA's

(e) **Herd Activity** – While providing the loans to the borrower the banks and the financial institutions should very carefully examine the project and tangible and intangible assets of the entity to secure the amount provided as loan (includes both the principal as well as the interest) against it. The banks should follow the policy of diversified loans to different industries failing which failure of a particular sector could lead to disastrous result for bank in form of huge NPAs. As they say do not put all your eggs into the same basket. Banks need to avoid herd activity in lending. However, Indian banking has been seen to be suffering from this syndrome. In certain years all banks lent heavily to real estate, infrastructure, steel, textile and so on little realising that creation of overcapacity in any sector can be disastrous consequences.

(f) **Poor Monitoring** – One of the main reasons for growth of NPA's is poor monitoring by lenders post disbursal of such loans. End utilization of fund is not ensured. Also there is lack of visit by banks official to borrowers' premises or these are purely for record purposes. Similarly, the borrowers either do not file the statements expected to be filled or such statements are never studied and scrutinised by lenders. All this leads to borrowers making huge gain at the expenses of lenders. Even the inspections and concurrent audits are undertaken just for the sake of it and observations are never taken seriously, even if given.

1.5 Performance of Banks and NPA

Huge level of NPAs is one of the most challenging problems being faced by the banks and the financial institutions which provide loans to the individuals firms, corporates etc. Due to growing NPAs the banks and the other financial institutions are suffering huge losses, bad image in the local and international market, low credibility and so on. Banks have to take some important steps to stem NPAs growth to improve their image as well as their profitability. Higher NPA level shakes the confidence of investors, depositors in the banks and also impair lender's capacity to recycle the funds. This in turn leads to non-availability of credit to others who genuinely require the same.

Effect of Higher NPAs on Profitabiliy

Higher NPAs also affect:

1. **Profitability** – Banks and the other financial institutions get hit on the profit due to increase in the provision in respect of NPAs. Profitability of the bank majorly depends on the Performing Assets. Higher level of NPA's would result in higher non recognition of income in respect of such accounts and higher provisioning in against such accounts.

2. **Credit Shrinkage** –Growth of NPAs would generally result in non-recycling of fund and consequential inability of the banks to lend further due to poor Capital Adequacy Ratio (CAR). This in turn further leads to decline in income and growth of the banks and financial institutions.

3. **Adverse Impact on Asset Liability Management (ALM)** – The banks accept deposits and other borrowings with a view to lend and earn Net Interest Margin (NIM). NIM is difference between the interest earned and paid. Both the deposits and advances have got maturity

periods which banks have to match to be able to repay its liabilities in time and at the same time to maximise its returns during the intervening period. Higher level of NPAs create mismatch in ALM and banks at time have to borrow at high rates to meet their commitments. This impacts their NIM adversely.

4. **Capital Adequacy Ratio (CAR)** –CAR reflect the ratio of capital required by lending of institutions to meet the risk weighted assets. Higher NPAs will adversely impact CAR. In ordinary course of business bank needs to hold the certain level of Capital on risk weighted assets of the bank. A little increment in the NPAs will mean the higher risk weighted assets. The base measure of the Capital Adequacy Ratio required to be maintained by banks is 8%.

5. **Confidences of investors** –Investors are the owners of the entities. Be it govt. or private investor, each one of them expects reasonable return on their investments. In case the NPA level grows beyond a particular level investor confidence is shaken and they become risk averse and are not willing to invest further. All this has a serious impact on banks and financial institutions ability to lend further even for genuine business needs and this accentuates the NPA problem further.

6. **Public Trust** – Reliability of the financial institutions and the banks get affected when there is increase in the NPA level because it raises the question on the soundness of the banking system. People lose faith in the banking operations. Bank deposits get affected with increase in NPA level in the banks. In case the depositors feel unsafe to keep money with a bank, there can be a flight of deposits from that bank to others. Hence, we can also say that the whole economy get affected by the growing level of NPAs. Growth of NPAs affect the income and net profitability of banks and decline in net profitability leading to lower dividend pay-out ,Credit contraction etc. All these factor adversely affect the depositors, creditors, investors, and employees of the banks.

1.6 Present scenario of NPA in India

Gross NPAs have decreased from Rs. 9,33,779 crores in March 2019 to Rs. 5,71,515 crores in March 2023, demonstrating the effectiveness of measures such as the Insolvency and Bankruptcy Code (IBC), amendments to the SARFAESI Act, and the Prudential Framework for Resolution of Stressed Assets.

Some of the main reasons behind the increase in NPA in India are to be seen in the decade 2001-2010. When India was in stage of boom economy. At that point of time the public sector banks lent massively to the corporates. In the year 2008 to 2009 world economies including India to an extent suffered the financial crisis leading to reduced profit of the corporate. Break out of telecom scam and coal scam also had an adverse impact on economic environment. Lately, action by CBI in particular and arrest of certain bankers further lead to a risk averse attitude on the part of the bankers. Credit dried up and the infrastructure projects in particular came to halt. This has lead to higher gross NPAs in the economy.

Also many scams few of these being King Fisher Airways, Jet Airways, Dewan Housing & Finance Ltd, Aloke Industries, Varun Industries, CG Power, GVK, Videocon industries, PMC, Yes Bank, Reliance Telecom, Amrapli, Gujrat NRE Coke, Unitech Ltd etc, came to light.

1.7 Measures taken by Govt. & RBI

1.7.1 Plans recommended by the Narasimhan Committee

Problem of NPAs is not new to India. For tackling the same govt. has been taking several legal, financial and other policy measures from time to time. Govt. constituted a committee under. Narasimhan in 1991 and then again in 1998 to make recommendations. The committee made significant recommendations to improve banking in India. Some of the suggestions are given hereunder.

Narasimhan Committee Report 1991 - To promote the healthy development of the financial sector, the Narasimhan committee made following recommendations:

1. Establishment of 4 tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at the top and at bottom rural banks engaged in agricultural activities.
2. The supervisory functions over banks and financial institutions can be assigned to a quasi- autonomous body sponsored by RBI.
3. A phased reduction in statutory liquidity ratio.
4. Phased achievement of 8% capital adequacy ratio.
5. Abolition of branch licensing policy.

6. Proper classification of assets and full disclosure of accounts of banks and financial institutions.
7. Deregulation of Interest rates.
8. Delegation of direct lending activity of IDBI to a separate corporate body.
9. Competition among financial institutions on participating approach.
10. Setting up Asset Reconstruction fund to take over a portion of the loan portfolio of banks whose recovery has become difficult.

Banking Reform Measures of Government: – On the recommendations of Narasimhan Committee, following measures have been undertaken by government since 1991: –

Lowering SLR and CRR - The high SLR and CRR reduced the profits of the banks. The SLR had been reduced from 38.5% in 1991 to 25% in 1997. This has left more funds with banks for allocation to agriculture, industry, trade etc. The Cash Reserve Ratio (CRR) is the cash ratio of banks total deposits to be maintained with RBI. The CRR had been brought down from 15% in 1991 to 4.1% in June 2003. The purpose is to release the funds locked up with RBI.

Prudential Norms – Prudential norms have been implemented by RBI in order to impart professionalism in commercial banks. The purpose of prudential norms includes proper disclosure of income, classification of assets and provision for Bad debts so as to ensure that the books of commercial banks reflect the accurate and correct picture of financial position

Capital Adequacy Norms (CAN) – Capital Adequacy ratio (CAR) is the ratio of minimum capital to risk asset ratio. In April 1992, RBI fixed CAR at 8% to be attained in a particular time firms. By March 1996, all public sector banks were required to attain the ratio of 8%.

Deregulation of Interest Rates - The Narasimhan Committee advocated that interest rates should be allowed to be determined by market forces. Since 1992, interest rates have become much simpler and freer.

- Scheduled Commercial banks have now the freedom to set interest rates on their deposits subject to minimum floor rates and maximum ceiling rates.
- The interest rate on domestic term deposits has been decontrolled.

- The prime lending rate of SBI and other banks on general advances of over Rs. 2 lakhs has been reduced.
- The rate of Interest on bank loans above Rs. 2 lakhs has been fully decontrolled.
- The interest rates on deposits and advances of all co-operative banks have been deregulated subject to a minimum lending rate of 13%.

Recovery of Debts- The Government of India passed the "Recovery of debts due to Banks and Financial Institutions Act 1993" in order to facilitate and speed up the recovery of debts due to banks and financial institutions. Six Special Recovery Tribunals have been set up. An Appellate Tribunal has also been set up in Mumbai.

Competition from New Private Sector Banks- Banking is open to the private sector and recently licenses have been granted for local granted for Local Area Banks, Payment Banks, and Small Finance Banks etc.

New private sector banks have started functioning. These new private sector banks are allowed to raise capital contribution from foreign institutional investors up to 20% and from NRIs up to 40%. This has led to increased competition.

Access to Capital Market-The Banking Companies (Acquisition and Transfer of Undertakings) Act was amended to enable the banks to raise capital through public issues. This is subject to the provision that the holding of Central Government would not fall below 51% of paid-up-capital. SBI has already raised a substantial amount of funds through equity and bonds.

Freedom of Operation- Scheduled Commercial Banks are given freedom to open new branches and upgrade extension counters, after attaining capital adequacy ratio and prudential accounting norms. The banks are also permitted to close non-viable branches other than in rural areas.

Local Area Banks (LABs)- In 1996, RBI issued guidelines for setting up of Local Area Banks, and it gave it's approval for setting up of 7 LABs in private sector. LABs will help in mobilizing rural savings and in chanellising them into investment in local areas.

Supervision of Commercial Banks - The RBI has set up a Board of financial Supervision with an advisory Council to strengthen the supervision of banks and financial institutions. In 1993, RBI established a new department known as Department of Supervision as an independent unit for supervision of commercial banks.

1.7.2 Narasimhan Committee Report 1998

In 1998, the government appointed yet another committee under the chairmanship of Mr Narsimhan. It is better known as the Banking Sector Committee. It was told to review the banking reform progress and design a programme for further strengthening the financial system of India. The committee focused on various areas such as capital adequacy, bank mergers, bank legislation, etc.

It submitted its report to the Government in April 1998 with the following recommendations.

(a) **Strengthening Banks in India** - The committee considered the stronger banking system in the context of the Current Account Convertibility 'CAC'. It suggested that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the light of CAC. Thus, it recommended the merger of strong banks which will have 'multiplier effect' on the industry.

(b) **Narrow Banking** -Those days many public sector banks were facing a problem of the Non- performing assets (NPAs). Some of them had NPAs as high as 20% of their advances. Thus, for successful rehabilitation of these banks, it recommended 'Narrow Banking Concept' where weak banks will be allowed to place their funds only in the short term and risk-free assets.

(c) **Capital Adequacy Ratio** - In order to improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This will further improve their absorption capacity also. Currently, the capital adequacy ratio for Indian banks is at 9%.

(d) **Bank ownership** -As recommended earlier Committee again emphasised the need for the freedom for banks in their working and pitched for greater autonomy for banks, it felt that the government control over the banks in the form of management and ownership and bank autonomy do not go hand in hand and thus it recommended a review of functions of boards to enable them to adopt professional corporate strategy.

Review of banking laws - The committee considered that there was an urgent need for reviewing and amending main laws governing Indian Banking Industry like RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc. This up gradation will bring them in line with the present needs of the banking sector in India.

Apart from these major recommendations, the committee also recommended faster computerization, technology up gradation, training of staff, depoliticizing of banks, professionalism in banking, reviewing bank recruitment, etc.

The Debt Recovery Tribunal - The Debts Recovery Tribunals (DRTs) and Debts Recovery Appellate Tribunals (DRATs) were established under the Recovery of Debts and Bankruptcy Act (RDB Act), 1993 with the specific objective of providing expeditious adjudication and recovery of debts due to Banks and Financial Institutions.

Credit Information Bureau - Credit Information Bureau (India) Limited (CIBIL) is a credit bureau or credit information company, engaged in maintaining the records of all the credit-related activities of companies as well as individuals, including credit cards and loans.

Lok Adalats - Lok Adalat is one of the alternative dispute redressal mechanisms, it is a forum where disputes/cases pending in the court of law or at pre-litigation stage are settled/ compromised amicably. Lok Adalats have been given statutory status under the Legal Services Authorities Act, 1987.

Compromise Settlement - Resolution of a dispute by mutual agreement to avoid a lawsuit. Public policy favors the settlement of disputes to avoid lawsuits. However, as long as the parties agree to the terms and the court views the compromise as fair, the settlement will be upheld by the courts.

1.8 Measures taken by RBI and Govt. to Tackle NPAs

1.8.1 Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI)

The Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (also known as the SARFAESI Act) is an Indian law. It allows banks and other financial institution to auction residential or commercial properties (of Defaulter) to recover loans. The first asset reconstruction company (ARC) of India, ARCIL, was set up under this act. Under this act secured creditors (banks or financial institutions) have many right for enforcement of security interest under section 13 of SARFAESI Act, 2002. If borrower of financial assistance makes any default in repayment of loan or any installment and his account is classified as Nonperforming Asset by secured creditor, then secured creditor may require enforcement of security before expiry of period of limitation by written notice.

1.8.2 Asset Reconstruction Companies (ARC)

Banks are financial institutions that are engaged principally in the business of money lending and money borrowing. The customer base of the banking sector is very large and there is a substantial risk involved in lending money. While the banks always have the option of taking legal action on the defaulting borrowers, it is not always economically feasible to do so. The bank sometimes decides to just cut its losses, clean up its balance sheet and keep the business moving towards better avenues. This is where an Asset Reconstruction Company (ARC) comes in picture. ARCs take over loans from banks either against cash payment or against security receipt (SRS) or both.

Joint Lenders Forum (JLF) - Joint Lenders' Forum is a group of lenders bank which is formed when an asset (loan) of more Rs. 100 crore or more turns out to be a stressed asset. In other words, it can be said to be a tool by RBI for tackling the issue Non-Performing Assets (NPAs) in the country.

Corporate Debt Restructuring (CDR) -Corporate debt restructuring refers to the reorganization of a distressed company's outstanding obligations to its creditors. A corporate debt restructuring usually reduces the levels of debt, decreases the interest rate on the debt, and enhances the time to pay the debt back.

Strategic Debt Restructuring Scheme (SDR) - Strategic Debt Restructuring Scheme or the SDR from the RBI, enables banks who have given loans to corporates, to convert a part of the total outstanding loan amount and interest into majority shareholding equity in the company.

Scheme for Sustainable Structuring of Stressed Assets (S4A) - The Reserve Bank of India (RBI) has recently introduced a new scheme “Scheme for Sustainable Structuring of Stressed Assets (S4A)” for resolution of bad loans of large projects. The S4A will cover those projects which have started commercial operations and have outstanding loan of over Rs. 500 crore.

5/25 Scheme - Popularly known as the 5:25 scheme, it allows banks to extend long-term loans of 20-25 years to match the cash flow of projects, while refinancing them every five or seven years. It is endeavors to ease cash flows of infrastructure companies which were otherwise struggling to meet short term repayment schedule.

Insolvency and Bankruptcy Code (IBC) - Insolvency and Bankruptcy Code (IBC) 2016 was implemented through an Act of Parliament. It got Presidential assent in May 2016. It provides for a time-bound process to resolve insolvency. When a default in repayment occurs, creditors gain control over debtor's assets and take decisions to resolve insolvency.

Issues Related to Corporate Governance – For the appointment of the senior level persons specifically in public sector banks there is a need to have proper structure and guidance. Govt. has set up Banking Board Bureau (BBB) with a view to look into various aspect of governance in bank particularly the appointment of chairman, MD’s and EDs in banks. However, due to political interference, BBB has not been as effective as one would have wished it to be position of non-executive chairman of board has been created.

Other Measures – In recent time, the banks have started taking following measures to strengths the credit process and reduce the risk of NPAs:

(a) **Management of Credit Risk** – One can check the credit risk before providing the loan to the borrower by deep analysis of its financial statements. through sensitivity analysis and also taking adequate safeguard against the external factor prevailing in the market. Also the past track record and credit rating of the borrowers can be verified through CIBIL.

(b) **Strengthening The Credit Monitoring** – To strengthen the credit monitoring the banks are implementing more effective and reliable Management Information System (MIS) which will keep a watch on credit extended its utilisation etc. The monitoring systems consisting of concurrent Audit, Inspection, Asset Monitoring system, stock audit etc. would provide timely alerts to bank. New Information Technology systems implemented by banks are allowing them to manage loans by exception.

1.9 Importance of NPA Management

NPA management is a useful tool for enhancing the banking performance as it has a direct correlation with the overall quality asset management of the banks and financial institution. The Government of our country has developed several legislative constellations to support the activity of NPA Management in the financial institutions. Infusion of technology can enhance the performance of the financial activity. It has the capability to improve the quality of security and safety of investment as well as borrowing through efficient and timely reporting. Indian banking system is mainly categorised in two broad sectors namely of public and private. State Bank of India (SBI) is identified as the largest, most popular and the most profitable public sector bank in India. However, the adverse scenario of stressed asset has affected this bank as well. It is natural that being the largest bank in the country both in terms of number of branches and amount of advances and deposits, it has been the consortium leader in the most of the large advances. Also, it has been participant in all major advances. Impact of slowdown in economy had to have an impact on this bank as well.

Political interference is identified as a major reason of accelerating NPAs in Indian banking. The economy of the country has been facing several issues due to high level of NPAs in terms of disruption in growth and infrastructure development. Indian economy is dependent on the agriculture Therefore, huge burden of the agricultural sector loan is a significant challenge of NPA management (Vikram and Gayathri, 2018). Lack of transparency, inappropriate ratings, inappropriate documentation along with the valuation have been identified as the reasons for non-repayment of borrowed amount. In this context, the government of the country has to develop strict legislative measures and support the initiative of Central Bank (RBI) of the country. Public sector banks are identified as the financial institutions, which have largest interaction with the primary sector of the country whereas private sector banks mostly deal with the business community of the country in order to encourage the industry and enhance employment opportunities. Since the Global recession of 2008, through initially not much impacted, Indian banking industry has been adversely affected in terms of its performance and flexibility. The level of NPAs has continuously been rising then since then (Upadhyay and Gupta, 2016). Various govt. initiatives e.g. SARFAESI ACT, DRTs, ARCs etc. did not meet the success envisaged. To a small extent these reduced the NPAs but pandemic of 2020 has fuelled the NPA level further. The performance of Indian economy has severely been impacted in the current onset of global pandemic which adversely influences the performance of banking system. The prime aim of the banking nationalization was to support the economy of the country along with fair distribution of banking funds in different segments of the society. Therefore, it can be said that the public sector banking system is the main support of Indian financial performance as it supports the government activity beyond the limitations of Union budget. RBI has developed several teams to meet the challenges of NPAs in banking activity.

1.10 Concluding Note

This chapter is primarily focused on understanding the basic concept of non-performing assets in India. After discussing different aspects of NPA, it can be said that government of India and Reserve Bank of India developed and implemented various kind of measures and schemes to meet the Challenge of NPAs. Focus of Reserve Bank of India was to develop effective reporting framework through which every banking organization would be required to disclose the NPAs at the end of accounting period both in absolute numbers and as percentage of total advances. RBI also mandated for disclosure of movement of NPAs and the provisioning in respect thereof. Also, it required disclosure of all advances by their nature, securities, sector wise and of course the classification into Standard Sub-standard, Doubtful and Loss assets. To ensure that the burden of NPA provisioning is not too acute in any particular year it mandated for small provision on all standard assets. It provided cushion to bank to meet provisioning for NPAs in difficult years. RBI also foresaw that certain restructured assets may not turn performing and in such year the burden of NPA provisioning would be too huge. So, it mandated for certain provision against restructured assets besides disclosure of total amount of restructured assets. This chapter also discussed the internal and external factors causing NPAs.