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A STUDY ON NPA AND ITS MANAGEMENT

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Abstract

The basic function of banking is accepting deposits for the purpose of lending. Banking is the backbone of economy of any country. Banking plays a vital role in the development of an economy. Banks lend funds in the form of loans and advances for the purpose of development. The public money is being advanced as loans and banks are responsible for the money and they have to return the same to depositors at the time of maturity. For the smooth functioning of banking the payment of interest and repayment of principal of the loan account is very essential and if it does not happen the process of recycling of fund will get affected and the banks will lack liquidity of funds. If the payment of interest and repayment of principal is not made in a loan account for a particular period it is classified as Non Performing Asset (NPA). These accounts are categorized as Sub-Standard, Doubtful and Loss according to the period of irregularity. Because of Non Performing Assets profitability of banks is getting reduced by provisioning in the Profit and Loss account. In addition to this a high level of Non Performing Assets puts strain on a bank's net worth because banks have to maintain a desired level of Capital Adequacy. This paper is mainly focused on Non Performing Assets, asset classification, reasons and impact of NPA, different measures available for reducing or controlling NPA, etc.

Key Words: Non Performing Asset, Capital Adequacy, Profitability, Provisioning.

Introduction

Banking Regulation Act of India, 1949 defines banking as “accepting for the purpose of lending or of investment of deposits of money from public, repayable on demand or otherwise or withdrawable by cheque, draft, order or otherwise”. The funds are accepted as deposits and the same are advanced as loans. The deposits are collected at a lower rate of interest and the loans are advanced at a higher rate of interest. The difference between these two rates of interest is the main income of the bank. The deposits accepted by a bank are treated as its liabilities and the loans advanced by a bank are treated as its assets. If the payment of interest and repayment of principal is made as and when it fall due, the asset is called Performing Asset or Standard Asset. If the payment of interest and repayment of principal is not made within due date and continued in the same position up to specified period it is called as Non Performing Asset (NPA). NPA means any asset of a bank which does not produce any income for the bank.

According to Reserve Bank of India a Non Performing Asset (NPA) is a loan or an advance where;

1. Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,

2. The account remains ‘out of order’ as indicated at paragraph 2.2 below, in respect of an Overdraft/Cash Credit (OD/CC),

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

4. The installment of principal or interest there on remains overdue for two crop seasons for short duration crops,

5. The installment of principal or interest there on remains overdue for one crop season for long duration crops,

6. The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006.

7. In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

NPA Classification.

The NPA accounts are classified into three categories on the basis of the period for which the asset has remained non performing and realisability of the dues. The three categories of NPA are Substandard Assets, Doubtful Assets and Loss Assets.

1. Substandard Assets

A substandard asset is an asset which has remained NPA for a period less than or equal to 12 months. In such cases the current net worth of the borrower or the guarantor or the current market value of the security charged is not enough to ensure the recovery of the dues to the bank in full.

2. Doubtful Assets

An asset is classified as Doubtful if it has remained as substandard category for a period of 12 months.

3. Loss Assets

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

Provisioning for NPA Accounts

The banks are responsible for proper asset classification and making adequate provision for any diminution in the value of loan assets, investment, or other assets. The banks are required to make adequate and necessary provisions in terms of prudential guidelines. As per the norms provisions should be made on NPA on the basis of classification of assets into prescribed categories such as substandard, doubtful and loss. The provisioning for each category is given below.

Substandard Assets

In case of substandard assets a general provision of 15% on total outstanding should be made. The unsecured exposures which are identified as 'Substandard' would attract additional provision of 10% i.e. a total of 25% on the outstanding balance. However in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as Substandard will attract a provisioning of 20% instead of aforesaid prescription of 25%. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows.

Doubtful Assets

In case of doubtful assets 100% of the extent to which the advance is not covered by the realizable value of the security to which the bank has valid record and the realizable value is estimated on realistic basis.

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

Period for which the advance has remained in doubtful status	Provision required
Up to one year	25%
One to three year	40%
More than three years	100%

Loss Assets

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

Reasons for NPA

The main reasons for account becoming NPA are:

1. Diversion of Funds :

In many occasions the funds or loans are not used for the same purpose for which it was sanctioned. Many of the customers are diverting funds for some other purpose. It is the responsibility of the bank, which has sanctioned the loan, to make sure that the fund is utilized for the purpose for which it was sanctioned. When the fund is diverted this may not generate the income as expected and repayment is not made and the account turns into NPA.

2. Delay in Completion of the Project:

This is another important reason for NPA. When the completion of the project for which the loan was sanctioned is delayed the borrowers may not be able to start the repayment as per the terms and conditions of the sanction. This may cause for account becoming NPA.

3. Business Failure:

If the business for which the loan is advanced fails to generate sufficient income, the borrower may not be able to repay the loan or maintain the account properly and the account may become NPA.

4. Poor Recovery of Receivables:

The receivables are to be collected in a specified time. If it is not done the funds will get blocked and recycling of the funds may not be possible. This will affect the income generation of the business and repayment of the loan is not made on time. This causes for account becoming NPA.

5. Deficiencies on the Part of the Bank:

In many cases deficiencies on the part of the bank also cause for account becoming NPA. The main deficiencies such as wrong credit appraisals, delay in identifying warning signals and follow up, delay in settlement of payments, lack of proper pre-sanction enquiry, etc. may lead to account becoming NPA.

6. Absence of Regular Industrial Visit and Monitoring :

The bank officials have to monitor the accounts regularly to identify the warning signals of NPA in advance. They have to visit the industrial units as per the guidelines of the bank. Then only the proper action to prevent the slippage of the account to NPA can be taken.

7. Fraudulent Practices :

Fraudulent practices from the part of customers and the bankers may be the reasons for NPA. The customers may submit manipulated financial statements and other documents. They may offer securities which may not be realizable if required. Banks may sanction loans to ineligible customers without any security.

8. Recession in the Economy :

Recession in the economy may cause for shortage of funds and its liquidity. Recycling of funds get affected due to recession and causes for account becoming NPA.

9. Natural Calamities :

Whenever any natural calamity happens the entire financial system get affected and it may take some time to become normal stage. In such situation the borrowers may not able to make repayment in time and the accounts become NPA.

Effects of NPA

The level of Non Performing Assets is very important as far as profitability of a bank is concerned. The effects of NPA are discussed below.

1. Impact on Balance Sheet of banks:

In present scenario NPA management is one of the foremost and formidable problems faced by the banks in India. Every year the level of NPA is increased. The increasing level of NPA is caused for reducing the confidence of share holders, depositors, lenders, etc. It causes for poor recycling of funds which in turn will have deleterious effect on the deployment of credit. It affects the financial soundness of the bank.

2. Impact on Profitability :

As far as bank's profitability is concerned, NPA is considered as double edged sword. Due to NPA the bank stops to earn income on one hand and attract higher provisioning on the other hand. On an average, banks are providing around 25% to 30% additional provision on incremental NPA which has direct bearing on the profitability of the banks.

3. Impact on Capacity for lending:

The increased level of NPA causes for reduction in bank's capacity for lending more and thus results in lesser interest income.

4. Impact on Liability Management :

Because of increased level of NPA banks are forced to reduce the rate of interest on deposits on one hand and likely to levy higher rate of interest on advances. This affects bank's business and economic growth.

5. Impact on Capital Adequacy :

As per Basel Norms, banks are required to maintain adequate capital on risk-weighted assets on an ongoing basis. Every increase in NPA level adds to risk weighted assets which warrant the bank to shore up their capital base further.

6. Impact on Confidence of Share Holders and Public:

The increased level of NPA has an adverse effect on profitability of the bank and the share holders do not get a market return on their capital. The confidence of public on bank is getting reduced due to NPA.

7. Impact on Financial Ratios :

The high level of NPA has an impact on all important financial ratios of a bank. The important ratios are Net Interest Margin, Return on Assets, Profitability , Dividend payout ratio, Provision Coverage ratio, Credit Contraction, etc. which may likely to erode the value of Share holders, depositors, borrowers, employees and public at large.

8. Impact on Goodwill :

If the level of NPA is very high the value of the goodwill of banks is getting reduced. The facts such as level of NPA, profitability, liquidity, goodwill ,etc. are related with each other.

Management of Non Performing Assets

The saying 'prevention is better than cure' is very apt in case of NPA. Proper evaluation of credit proposals helps banks in detecting the unviable projects at the first instance. The detailed informations about the unit, industry, management, promoters, etc. should be collected.

It is very important to develop specialized skills in the area of appraisal, monitoring and recovery to ensure the quality of credit portfolio. Bank should be equipped with the latest credit risk management techniques to protect bank funds and minimize risks.

Timely follow up of the loans and advances is very important to control and reduce NPA. To have better control on the assets created out of borrowings, banks need to watch the functioning of the units by paying frequent visits and this is to be done to all the units irrespective whether the account is performing or non performing.

Selection of eligible borrowers, viable economic activity, adequate finance and timely disbursement, end use of funds and timely recovery of loans should be focus areas for preventing or reducing the addition of new NPAs.

Tools for NPA Recovery

There are some tools for recovery of NPA which can be used effectively. Lok Adalat, Debt Recovery Tribunal (DRT), SARFAESI Act, ARCIL, etc. are the important tools used for NPA recovery.

1. Lok Adalat

Usually Lok Adalat is used for settlement of disputes involving account in 'doubtful' and 'loss' category. This method is proved to be quite effective for speedy justice and recovery of small loans.

2. Debt Recovery Tribunal (DRT)

This method is used to recover the NPA amounting Rs.10.00 lacs and above. It is the special court establishing by central government for the purpose of bank or any financial institutions recovery. The retired judges of High Court are appointed as the judges of this court.

3. SARFAESI Act.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (also known as the SARFAESI Act) helps for recovery of NPA without intervention of any court. This Act covers NPA accounts with outstanding of Rs.1.00 lac and above. When the account becomes NPA the banks have to issue Demand Notice under this Act to the borrower. By issuing Demand Notice banks demand for repayment of due in full within 60 days by clearly stating amount due and intention for enforcement. If the borrower does not discharge dues in full within 60 day banks may take possession (including sale, lease, assignment) of secured asset, or take over management of business of borrower or appoint manager for secured asset without intervention of any court.

4. Asset Reconstruction Company (India) Ltd. (ARCIL)

ARCIL is the first asset reconstruction company (ARC) of India. It is a company which was set up with the objective of taking over Non Performing Assets (NPA) from banks or financial institutions and to reconstruct or repack these assets to make these assets saleable.

Conclusion

Presently in Indian banking scenario, NPA is the most important area to be taken care. For survival of the banks the level existing NPA is to be reduced and all measures to be taken to have control over addition of new NPAs. Since it affects profitability and liquidity of the banks, increase in NPA will affect the entire economy also. So the banks should strictly adhere to all guidelines while sanctioning the loans and the follow up should be done properly in time. In case of existing NPA Accounts banks should use all the recovery tools such as SARFAESI Act, DRT etc. without any delay. The banks should try to make aware the customers regarding the necessity of proper repayment of the loan at the time of sanctioning itself. If the loans are sanctioned according to guidelines, proper efforts are put for follow up and the available recovery tools are used in time, the level of NPA can be controlled and reduced.

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