

# **Chapter 3**

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## **Review of Literature & Theoretical background of NPAs**

## **A . Review of literature**

It is always says that, past experience provide perfection to future. So this chapter deals with study / review of available literature relating to the Non – Performing Assets.

The major methods for NPAs research are case studies, feasibility studies and may find place in various journals, as research paper. The Indian Co-operative Review, Co-operative Prospective, The Maharashtra Co-operative Quarterly publish case study regularly. The RBI and NABARD have trusted quality research tools and techniques in their enquiry committee report on co-operation. Similarly journal of Institute of Chartered Accountants of India, The Institute of Cost and Works Accountants of India also publishes articles in respect of NPAs.

Some non published sources are also available as thesis of M. Phil and Ph.D. students of universities, project report of MBA students. Researcher has found some problems of scarcity of literature in respect of NPAs, because very few studies have been undertaken, which is mentioned below in this chapter.

1. P.N.Joshi, <sup>1</sup> Ex-chairman, United Western Bank Ltd, said that, the adoption of the International Accounting Norms in early nineties led to the vast amount of NPAs in the banking system. The deficiencies in the infrastructure, euphoria of globalization, frequently changing Government policies, inability of the corporate sector to expeditiously adapt to the new situation complicated the NPAs problem. The SSI units, which are dependent on the corporate large units suffered significantly due to elongation of bill payment by the mother industry. In addition, the problem of renovation and absence of technology to produce quality goods led to increase in NPAs. In the then existing legal system was time consuming, DRTs and DRATs were set up under a separate Act passed in 1993. As there were still a few lacunae in the legal provision, the Securitization Act was passed in December 2002.

Simultaneously, RBI encouraged banks to make settlement transparently and in a non discriminatory manner through One Time Settlement (OTS) Scheme announced by RBI. OTS Scheme was reissued by the RBI in 2003. The Finance Minister also has endeavored to come to the earned by banks in the 'buy – back' of Government Securities Scheme tax deductible, if utilized for provisioning in respect of NPAs. Thus various steps have been taken by the authorities to bring down the level of NPAs in banks and financial institution. Effectiveness of these various measure will depend upon implementation of provisions in an expeditious manner.

2. Padmashri Mujumdar, <sup>1</sup> a Lecturer in Economics, G.A. College of Commerce and Management, Shivaji University present a paper on Non – Performing Assets and Urban Co-operative Banks. According to her opinion, the problem of the banks has become acute. This is more severe in case of UCBs due to their very nature. She reviewed that the gross NPAs of UCBs is increasing by years to year. In 1999 the gross NPAs as a percentage of total advance was 11.7 % . It was increased to 21.9% upto 31 March, 2002. The significant increase in gross NPAs was due to very high NPAs of a few large UCBs in Gujarat. To overcome this problem various policies are adopted by the banks. But the UCBs face more practical difficulties in adopting these measures. In case of one UCB in Sangali district, the major banking business is in rural area. Therefore, in such area the valuation agencies are always absent and it become more costly for the bank to hire the valuator from outside especially for a single loan proposal. Similarly, it is very difficult to apply the international banking norms for the banking system of the developing country like India. But it is also not advisable to avoid these international norms by Indian banks. Therefore, the banks should follow effective policy to overcome the problem of NPAs by adopting preventive as well as curative measures.

3. Dr. Prakash S. Kamble,<sup>2</sup> in his case in The Maharashtra Co-operative Quarterly, June 2004 says that, The foregoing analysis of working, progress and financial performance of co-operative banking in India in the past reform period reveals some major and important problems of Indian co-operative banks, which reflect the impact of New Economic policy and the provision in economic reform measures. This does not means that banking sector has only suffered from economic reform. No doubt, this sector has benefited from reform package. But in case of co-operative banking in India, the number and degree of evil consequences is rather high are seen in their present problems.

The co-operative banking sector in India has been facing a cut throat competition from the different categories of banks. NPAs of all categories of co-operative banks in India were significantly higher. They stood at 21.9% of total advances in 2002-03. In case of SCBs, 13.42% for StCBs and 19.7% for DCCBs. Hence the problem of growing NPAs is a crucial problem before co-operative banking sector. The recovery performance of these banks was very poor. The co-operative banks have been facing the problem of deficit, as their expenditure size and growth was significantly higher than their income. The growing NPAs have made these banks to incur rapidly growing expenditure on provision and contingencies.

4. Rajendra Kakker,<sup>3</sup> MD & CEO of Asset Reconstruction Company (India) Limited, in his article ( NPAs Management ) discussed the role of Asset Reconstruction companies in managing NPAs. The Asset Reconstruction Company (ARCs) are organization unit created to manage and recover illiquid NPAs acquired from banking system. As on February 28, 2005 RBI has issued license to 3 ARCs to be formed in India. Further he explain working of Asset Reconstruction Company (India) Limited (Arcil) and how it is advantages to banks.

- Arcil sets up a trust ( The Trust ) for purpose of acquiring NPAs on the books of bank ( Assets ).
- The Assets would be acquired at fair value based on assessment of realizable amount and time to resolution.
- The trust raises resources through formulation of scheme by issuing Security Receipts (SRs) from QIBs. Such monies are utilized towards payment of purchase consideration for the Financial Assets (FAs) to the sellers.
- At the time of redemption of SRs excess of realization over face value of SRs after providing for return is shared with SRs holders.

5. Sanjay Kumar,<sup>4</sup> AICWA, Ph.D. Faculty Associate, Bankers Institute of Rural Development, submitted article in respect of Non Performing Assets in regional rural banks. According to his opinion RRBs by mandate have a local area of operation which is very small confined to 1 to 3 districts and are basically purveyor of small and medium sized loans. As such they can exercise much flexibility, afford close monitoring by regular contact, and thus has lower risk coefficient than that of large loans disbursed by commercial banks. However despite a low risk coefficient, RRBs suffer an unduly high level of NPAs, due to past policies of directed credit, faculty appraisal and very poor monitoring. But at the same time on the basis of its inherent plus points of small and local area of operation and low risk, there is a great possibility to reduce the NPAs and to improve the quality of loan portfolio on a long term basis provided concerted efforts are made and strategies followed. The article also discusses size wise analysis of NPAs, impact of NPAs and also Management of NPAs.

6. Dr. Debabrata Mitra,<sup>5</sup> Reader, PG Department of Commerce, University of North Bengal, present Narashimham Committee II recommendation

(1998) i.e. Effect of Reforms Process on Financial Performance of Banks. The recommendations cover following aspects about NPAs.

- Risk weight for a Government guaranteed account must be 100% and NPAs level should be brought down to 5% by 2000 and 3 % by 2002. and an asset should be classified as doubtful if it is in the sub - standard category for 18 months instead of present 24 months and gradually to replace it by international norm of 90 days.
- Government guarantee account must also be categorized as NPAs under the usual norms. He also study performance of Banking sector in Post Reforms period by considering NPAs of Indian Private Banks, Nationalised Banks and SBI Associate for the period from 1996-97 to 2004-05.

7. Dr. CH Rajesham <sup>6</sup> professor of Commerce & Management at Katatiya University, Khammam Andhra Pradesh, present article in respect of NPAs Management. He studied NPAs at Global Level. Also studied NPAs of Commercial banks during 2002 to 2005. He says that, NPAs have negative impact on the productivity, achievement of capital adequacy level, fund development and mobilization policy, credibility of the banking system and overall economy. Therefore, concerted efforts are required at Ministry of Finance, RBI and banks level to control the menace of NPAs. It will be better if the government does not use PSBs as means accomplishing its political objectives by lending to unviable projects, announcing loan and loan waiver Schemes etc. The PSBs should not be loaded with the twin objective of profitability and social welfare, which are mutually incongruent. This calls for a strong political will. When backed by a strong political will the Indian banks will be able to find satisfactory solution to the problem of mounting NPAs.

8. While studying unpublished sources, researcher faced some problems of scarcity of literature in the field of NPAs at M. Phil or Ph.D. level. There are only two research paper / project report at MBA level in Bharati vidyapeeth University, Pune. One is submitted by Tushar B. Sidanale as “study of Non-Performing Assets with reference to The Ratnakar Bank Ltd Kolhapur”. And another is “ A study of Non-Performing Assets with reference to The Belgaum District Central Co-operative Bank Ltd Belgaum”. In this paper researcher has analysed the NPAs of respective bank only and also evaluate various causes for NPAs, as lack of through examination of loan proposal, Lack of machinery for recovery of loan, Neglecting the schedule of repayment, vested interest of bank employee, no consideration of credit and capacity of borrower etc. <sup>7</sup>

## **B. Theoretical Background of NPAs**

### **1. GENERAL**

- 1.1. In order to reflect a bank actual financial health in its balance sheet and as per the recommendations made by the Committee on Financial System (Chairman Shri M. Narasimham), the Reserve Bank has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the primary (urban) co-operative banks.
- 1.2. Broadly, the policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, 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. Availability of security or net worth of the borrower/ guarantor should not be taken into account for the purpose of treating an advance as nonperforming asset or otherwise. The provisioning should be made on the basis of the classification of assets into different categories.
- 1.3. The requirements of the State Co-operative Societies Acts and / or rules made thereunder or other statutory enactments may continue to be followed, if they are more stringent than those prescribed hereby.
- 1.4. With the introduction of prudential norms, the Health Code based system for classification of advances has ceased to be a subject of supervisory interest. As such, all related reporting requirements, etc. also ceased to be a supervisory requirement, but could be continued in the banks entirely at their discretion and the management policy, if felt necessary.

### **2. NON-PERFORMING ASSETS (NPA)**

#### **2.1 Classification of Assets as Non-Performing**

- 2.1.1 An asset becomes non-performing when it ceases to generate income for the bank. Earlier an asset was considered as nonperforming asset (NPA) based on the concept of 'Past Due'. A 'non performing asset' (NPA) was defined as credit in respect of which interest and/ or installment of principal has remained 'past due' for a specific period of time. The specific period was reduced in a phased manner as under:



Year ended March, -----	31 Specific period -----
1993	4 quarters
1994	3 quarters
1995	2 quarters

An amount is considered as past due, when it remains outstanding for 30 days beyond the due date. However, with effect from March 31, 2001 the 'past due' concept has been dispensed with and the period is reckoned from the due date of payment.

2.1.2 With a view to moving towards international best practices and to ensure greater transparency, '90 days' overdue\* norms for identification of NPAs have been made applicable from the year ended March 31, 2004. As such, save and except certain relaxations mentioned at para 2.1.3 and 2.1.4 below, with effect from March 31, 2004, a non-performing asset shall be 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'@ for a period of more than 90 days, 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) In the case of direct agricultural advances as listed in Annex 1, the overdue norm specified at para 2.1.5 would be applicable. In respect of agricultural loans, other than those specified in Annex 1, identification of NPAs would be done on the same basis as non-agricultural advances.
- (v) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

\* Any amount due to the bank under any credit facility, if not paid by the due date fixed by the bank becomes overdue.

@ "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 or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'".

**As per Wide Circular UND PCB Cir No. 1/90.14.00/05-06 dated July 4, 2005 Tier-I banks were permitted to classify loan accounts as NPAs based on 180 day.**

2.1.3 Unit banks i.e. banks having a single branch/ HO with deposits upto Rs. 100 crore and banks having multiple branches within a single district with deposits upto Rs. 100 crore have been permitted to classify loan accounts as NPAs based on 180 days delinquency norm instead of the extant 90 days norm. This relaxation will be in force for three financial years i.e. financial years ended/ ending March 31, 2005, 2006 and 2007. The details of the changes and The consequent impact on the existing instructions with regard to asset classification and income recognition in respect of these banks are given in the Annex 5. The deposit base of Rs. 100 crore for the above will be determined on the basis of average of the fortnightly Net Demand and Time Liabilities in the financial year concerned. For the above category of banks, an account would be classified as Non Performing Asset if the :

- (i) Interest and/or installment of principal remain overdue for a period of more than 180 days in respect of a Term Loan.
- (ii) The account remains 'Out of order' for a period of more than 180 days, in respect of an Overdraft/Cash Credit (OD/CC).
- (iii) The bill remains overdue for a period of more than 180 days, in the case of bills purchased and discounted.
- (iv) Any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

The relaxations are given for the explicit purpose of enabling the UCBs concerned to transit to the 90 day NPA norm in the year 2007-2008 by building up adequate provisions and strengthening their appraisal, disbursement and post disbursement procedures.

2.1.4 All UCBs other than those referred to at para 2.1.3 shall classify their loan accounts as NPA as per 90 day norm as hitherto. However, Gold loans and small loans up to Rs. 1 lakh will be governed by the 90-day norm with effect from the year ending March 31, 2007. Till then, they will be governed by the 180-day norm as hitherto.

### **2.1.5 Agricultural Advance:**

- (i) With effect from September 30, 2004 the following revised norms are applicable to all direct agricultural advances :
  - a) A loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for two crop seasons.
  - b) A loan granted for long duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season.
- (ii) For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.
- (iii) The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each state.
- (iv) Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him. In respect of agricultural loans, other than those specified in the Annex 1 and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances which, at present, is the 90 days delinquency norm.
- (v) Banks should ensure that while granting loans and advances, realistic repayment schedules are fixed on the basis of cash flows / fluidity with the borrowers.

### **2.1.6 Identification of assets as NPAs should be done on an ongoing basis**

The system should ensure that identification of NPAs is done on an ongoing basis and doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per prescribed norms. Banks should also make provisions for NPAs as at the end of each calendar quarter i.e as at the end of March/ June/ September/ December, so that the income and expenditure account for the respective quarters as well as the P&L account and balance sheet for the year end reflects the provision made for NPAs.

### **2.1.7 Charging of interest at monthly rests**

- (i) Banks should charge interest at monthly rests in the context of adoption of 90 days norm for recognition of loan impairment w.e.f. from the year ended March 31, 2004 and consequential need for close monitoring of borrowers' accounts. However, the date of classification of an advance as NPA as stated in preceding paras, should not be changed on account of charging of interest at monthly basis.
- (ii) The existing practice of charging/compounding of interest on agricultural advances would be linked to crop seasons and the instructions regarding charging of interest on monthly rests shall not be applicable to agricultural advances.
- (iii) While compounding interest at monthly rests effective from April 1, 2003 banks should ensure that in respect of advances where administered interest rates are applicable, they should re-align the rates suitably keeping in view the minimum lending rate charged by the bank (in view of the freedom given to them for fixing lending rates) so that they comply with the same. In all other cases also, banks should ensure that the effective rate does not go up merely on account of the switchover to the system of charging interest on monthly rests.
- (iv) Banks should take into consideration due date/s fixed on the basis of fluidity with borrowers and harvesting/ marketing season while charging interest and compound the same if the loan/ installment becomes overdue in respect of short duration crops and allied agricultural activities.

## **2.2 Treatment of Accounts as NPAs**

### **2.2.1 Record of Recovery**

- (i) The treatment of an asset as NPA should be based on the record of recovery. Banks should not treat an advance as NPA merely due to existence of some deficiencies which are of temporary in nature such as non-availability of adequate drawing power, balance outstanding exceeding the limit, on submission of stock statements and the non-renewal of the limits on the due date, etc. Where there is a threat of loss, or the recoverability of the advances is in doubt, the asset should be treated as NPA.
- (ii) A credit facility should be treated as NPA as per norms given in

paragraph 2.1 above. However, where the accounts of the borrowers have been regularised by repayment of overdue amounts through genuine sources (not by sanction of additional facilities or transfer of funds between accounts), the accounts need not be treated as NPAs. In such cases, it should, however, be ensured that the accounts remain in order subsequently and a solitary credit entry made in an account on or before the balance sheet date which extinguishes the overdue amount of interest or installment of principal is not reckoned as the sole criteria for treatment the account as a standard asset.

### **2.2.2 Treatment of NPAs – Borrower-wise and not Facility-wise**

- (i) In respect of a borrower having more than one facility with a bank, all the facilities granted by the bank will have to be treated as NPA and not the particular facility or part thereof which has become irregular.
- (ii) However, in respect of consortium advances or financing under multiple banking arrangements, each bank may classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances.

### **2.2.3 Agricultural Advances – Default in repayment due to natural Calamities.**

- (i) Where natural calamities impair the repaying capacity of agricultural borrowers, primary (urban) co-operative banks, as a relief measure may decide on their own to:
  - (a) convert the short-term production loan into a term loan or re-schedule the repayment period, and
  - (b) sanction fresh short-term loans
- (ii) In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as non performing asset (NPA). The asset classification of these loans would, therefore, be governed by the revised terms and conditions and these would be treated as NPA under the extant norms applicable for classifying agricultural advances as NPAs.

#### **2.2.4 Housing Loan to Staff**

In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/ advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates.

#### **2.2.5 Credit facilities Guaranteed by Central /State Government**

- (i) The credit facilities backed by guarantee of the Central Government though overdue should not be treated as NPA.
- (ii) This exemption from classification of government guaranteed advances as NPA is not for the purpose of recognition of income.
- (iii) From the year ended March 31, 2006, State Government guaranteed advance and investment in State Government guaranteed securities would attract asset classification and provisioning norms, if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days irrespective of the fact whether the guarantee have been invoked or not.

#### **2.2.6 Project Financing**

In the case of bank finance given for industrial projects where moratorium is available for payment of interest, payment of interest becomes due only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

#### **2.2.7 Concept of Commencement of Commercial Production and Restructuring of Loan Accounts**

- (i) Where a unit commences commercial production, but the level and volume of production reached immediately after the date of completion of the project is not adequate to generate the required cash flow to service the loan, it may be necessary to re-fix the repayment schedule. In such cases, the Board of Directors of the bank may lay down broad parameters for guidance of the staff for taking a view whether the unit has stabilised commercial production and there is a need for rescheduling of the loan to treat such advance as NPA or not. In framing these parameters, the following points may be kept in view:

- (a) In order to arrive at a decision as to whether the unit/project has achieved regular commercial production, the main guiding factor would be whether the unit has achieved cash break-even in order to service the loan.
  - (b) If in the opinion of the bank, the bottleneck in achieving regular commercial production is of a temporary nature not indicative of any long-term impairment of the unit's economic viability and it is likely to achieve cash break even if some time is allowed, the bank may reschedule the loan and treat the asset as standard.
  - (c) However, the lead time would normally not exceed one year from the schedule of commencement of commercial production as indicated in the terms of sanction.
- (ii) In respect of credit facilities sanctioned under consortium arrangements, the decision as to whether the borrowing unit has achieved regular commercial production and there is a need for rescheduling may be taken by the lead institution or lead bank and other participating institutions/banks may follow the same.
- (iii) (a) Treatment of restructured accounts
  - (i) Restructuring/rescheduling/re negotiation of the terms of loan agreement in respect of standard and substandard accounts can take place at three stages, viz. (a) before commencement of commercial production, (b) after commencement of commercial production but before the asset has been classified as sub-standard, and (c) after commencement of commercial production and the asset has been classified as sub-standard.
  - (ii) In each of the foregoing three stages, the rescheduling, etc. of principal and/or of interest could take place with or without sacrifice.
- (b) Treatment of restructured standard accounts
  - (i) A rescheduling of the installments of principal alone, at any of the stages at (a) and (b) above would not cause a standard asset to be classified in the substandard category provided the loan/credit facility is fully secured.

- (ii) A rescheduling of interest element at any of the aforesaid two stages would not cause an asset to be down-graded to sub-standard category subject to the condition that the amount of sacrifice, if any, in the element of interest, is either written off or provision is made to the extent of the sacrifice involved.

(c) Treatment of restructured sub-standard accounts

- (i) A rescheduling of the installment of principal alone would render a sub-standard asset eligible to be continued in the sub-standard category for the specified period, provided the loan/credit facility is fully secured.
- (ii) A rescheduling of interest element would render a substandard asset eligible to be continued to be classified in substandard category for the specified period subject to the condition that the amount of sacrifice, if any, in the element of interest, is either written off or provision is made to the extent of the sacrifice involved.
- (iii) The substandard accounts which have been subjected to restructuring, etc. whether in respect of principal installment or interest amount, would be eligible to be upgraded to the standard category only after the specified period, i.e. one year after the date when the first payment of interest or principal, whichever is earlier, falls due, subject to satisfactory performance during the period.
- (iv) In case, however, the satisfactory performance during the one year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

(d) Applicability

- (i) The foregoing norms for restructuring, etc. would be applicable to standard and sub-standard assets only. All other prudential guidelines relating to income recognition, asset classification and provisioning would remain unaltered.
- (ii) The aforesaid instructions would be applicable to all types of credit facilities, including working capital limit extended to industrial units, provided they are fully covered by tangible securities.
- (iii) These guidelines are not applicable to credit facilities extended to traders.



- (iv) While assessing the extent of security available to the credit facilities, collateral security would also be reckoned, provided such collateral is a tangible security properly charged to the bank and is not in the intangible form like guarantee, etc.

(e) General

All standard and sub-standard accounts subjected to restructuring, etc. would be eligible for fresh financing of funding requirements, as per normal policy parameters and eligibility criteria.

**2.2.8 Debt restructuring mechanism for Small and Medium Enterprises (SMEs)-**

As part of announcement made by the Government of India for improving flow of credit to small and medium enterprises, certain guidelines have been issued to UCBs for restructuring of debt of all eligible small and medium enterprises (SMEs). Details are furnished in Annex 4.

**2.2.9 Other Advances**

- (i) Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and Life policies need not be treated as NPAs although interest thereon may not have been paid for more than 90 days provided adequate margin is available in the accounts.
- (ii) Primary (urban) co-operative banks should fix monthly/quarterly installments for repayment of gold loans for non-agricultural purposes taking into account the pattern of income generation and repayment capacity of the borrowers and such gold loan accounts may be treated as NPAs if installments of principal and/ or interest thereon are overdue for more than 90 days.
- (iii) As regards gold loans granted for agricultural purposes, interest is required to be charged as per Supreme Court judgment at yearly intervals and payment should coincide with the harvesting of crops. Accordingly, such advances will be treated as NPA only if installments of principal and/or interest become overdue after due date.

**2.2.10 Recognition of Income on Investment Treated as NPAs**

The investments are also subject to the prudential norms on income recognition. Banks should not book income on accrual basis in respect of any security irrespective of the category in which it is included, where the interest/principal is in arrears for more than 90 days .

### **2.2.11 NPA Reporting to Reserve Bank**

The primary (urban) co-operative banks should report the figures of NPAs to the Regional Office of the Reserve Bank at the end of each year within two months from the close of the year in the prescribed proforma given in the Annex 2.

## **3 ASSET CLASSIFICATION**

### **3.1 Classification**

3.1.1 The primary (urban) co-operative banks should classify their assets into the following broad groups, viz.

- (i) Standard Assets
- (ii) Sub-standard Assets
- (iii) Doubtful Assets
- (iv) Loss Assets

### **3.2 Definitions**

#### **3.2.1 Standard Assets**

Standard Asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset should not be an NPA.

#### **3.2.2 Sub-standard Assets**

- (i) With effect from March 31, 2005 an asset would be classified as sub-standard if it remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrowers/ guarantors 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 assets 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.
- (ii) An asset where the terms of the loan agreement regarding interest and principal have been re-negotiated or rescheduled after commencement of production, should be classified as substandard and should remain in such category for at least 12 months of satisfactory performance under the re-negotiated or rescheduled terms. In other words, the classification of an asset should not be

upgraded merely as a result of rescheduling, unless there is satisfactory compliance of this condition.

### **3.2.3 Doubtful Assets**

With effect from March 31, 2005, an asset is required to be classified as doubtful, if it has remained NPA for more than 12 months. As in the case of sub-standard assets, rescheduling does not entitle the bank to upgrade the quality of an advance automatically. A loan classified as doubtful has all the weaknesses inherent as that 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.

Note: Consequent to change in asset classification norms w.e.f. March 31, 2005 banks are permitted to phase the consequent additional provisioning over a five year period commencing from the year ended March 31, 2005, with a minimum of 10 % of the required provision in each of the first two years and the balance in equal installments over the subsequent three years.

### **3.2.4 Loss Assets**

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

## **3.3 Guidelines for Classification of Assets**

### **3.3.1 Basic Considerations**

- (i) Broadly speaking, classification of assets into above categories should be done taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation of dues.
- (ii) In respect of accounts where there are potential threats to recovery on account of erosion in the value of security and existence of other factors such as, frauds committed by borrowers, it will not be prudent for the banks to classify them first as sub-standard and then as doubtful after expiry of 12 months from the date the account has become NPA. Such accounts should be straight away classified as

doubtful asset or loss asset, as appropriate, irrespective of the period for which it has remained as NPA.

### **3.3.2 Advances Granted under Rehabilitation Packages Approved by BIFR/Term Lending Institutions**

- (i) Banks are not permitted to upgrade the classification of any advance in respect of which the terms have been re-negotiated unless the package of re-negotiated terms has worked satisfactorily for a period of one year. While the existing credit facilities sanctioned to a unit under rehabilitation packages approved by BIFR/term lending institutions will continue to be classified as sub-standard or doubtful as the case may be in respect of additional facilities sanctioned under the rehabilitation packages the income recognition and asset classification norms will become applicable after a period of one year from the date of disbursement.
- (ii) A similar relaxation be made in respect of SSI units which are identified as sick by banks themselves and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements.

### **3.3.3 Internal System for Classification of Assets as NPA**

- (i) Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. The banks may fix a minimum cut-off point to decide what would constitute a high value account depending upon their respective business levels. The cut-off point should be valid for the entire accounting year.
- (ii) Responsibility and validation levels for ensuring proper asset classification may be fixed by the bank.
- (iii) The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines.
- (iv) RBI would continue to identify the divergences arising due to non-compliance, for fixing accountability. Where there is willful non-compliance by the official responsible for classification and is well documented, RBI would initiate deterrent action including imposition of monetary penalties.

## 4. PROVISIONING NORMS

### 4.1 Norms for Provisioning on Loans & Advances

4.1.1 In conformity with the prudential norms, provisions should be made on the non-performing assets on the basis of classification of assets into prescribed categories as detailed in paragraph 3 above.

4.1.2 Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against loss assets, doubtful assets and substandard assets as below:

#### (i) Loss Assets

- (a) The entire assets should be written off after obtaining necessary approval from the competent authority and as per the provisions of the Co-operative Societies Act/Rules. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.
- (b) In respect of an asset identified as a loss asset, full provision at 100 per cent should be made if the expected salvage value of the security is negligible.

#### (ii) Doubtful Assets

- (a) 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse should be made and the realisable value is estimated on a realistic basis.
- (b) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 per cent to 100 per cent 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 per cent
One to three years	30 per cent
More than three years	- 50 per cent as on March 31, 2006
(i) outstanding stock of NPAs as on March 31, 2006	- 60 per cent with effect from March 31, 2007

(ii) advances classified as 'doubtful for more than three years' on or after April 1, 2006	- 75 per cent with effect from March 31, 2008
	- 100 per cent with effect from March 31, 2009
	- 100 percent

Two illustrations are furnished below for clarity in this regard.

**Illustration 1. Existing stock of advances classified as 'doubtful more than 3 years' as on March 31, 2006**

The outstanding amount as on March 31, 2006: Rs 25,000

Realisable value of security: Rs 20,000

Period for which the advance has remained in 'doubtful' category as on March 31, 2006: 4 years (i.e. Doubtful more than 3 years)

**Provisioning requirement:**

As on	Provisions on secured portion		Provision on unsecured portion		Total (Rs.)
	%	Amount	%	Amount	
March 31, 2006	50	10000	100	5000	15000
March 31, 2007	60	12000	100	5000	17000
March 31, 2008	75	15000	100	5000	20000
March 31, 2009	100	20000	100	5000	25000

**Illustration 2 : Advances classified as doubtful more than three years on or after April 1, 2006**

The outstanding amount as on March 31, 2006 Rs. 10000/-

Realisable value of security: Rs 8,000/-

Period for which the advance has remained in 'doubtful' category as on March 31, 2006: 2.5 years

**Provisioning requirement:**

As on	Asset Classifications	Provisions on secured portion		Provision on unsecured portion		Total (Rs.)
		%	Amount	%	Amount	
March 31, 2006	Doubtful for 1 to 3 years	30	2400	100	2000	4400
March 31, 2007	Doubtful more than 3 years	100	8000	100	2000	10000

### **(iii) Sub-standard Assets**

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

### **(iv) Provision on Standard Assets**

- (a) From the year ended March 31, 2000, the banks should make a general provision of a minimum of 0.25 per cent on standard assets.
- (b) However, unit banks and banks having multiple branches within a single district with deposit of Rs 100 crore and above and all other UCBs operating in more than one district will be subjected to higher provisioning norms on standard asset as under:
  - i. The general provisioning requirement for 'standard advances' shall be 0.40 per cent from the present level of 0.25 percent. However, direct advances to agricultural and SME sectors which are standard assets, would attract a uniform provisioning requirement of 0.25 per cent of the funded outstanding on a portfolio basis, as hitherto
  - ii. For personal loans, loans and advances qualifying as capital market exposures and commercial real estate loans provisioning requirement would be 1.0 %.
- (c) The provisions towards "standard assets" need not be netted from gross advances but shown separately as "Contingent Provision against Standard Assets" under "Other Funds and Reserves" {item.2 (viii) of Capital and Liabilities} in the Balance Sheet.
- (d) In case banks are already maintaining excess provision than what is required/prescribed by Statutory Auditor/RBI Inspection for impaired credits under Bad and Doubtful Debt Reserve, additional provision required for Standard Assets may be segregated from Bad and Doubtful Debt Reserve and the same may be parked under the head "Contingent Provisions against Standard Assets" with the approval of their Board of Directors. Shortfall if any, on this account maybe made good in the normal course.

- (e) The above contingent provision will be eligible for inclusion in Tier II capital.

#### **(v) Higher provisions**

There is no objection if the banks create bad and doubtful debts reserve beyond the specified limits on their own or if provided in the respective State Co-operative Societies Acts.

#### **4.2 Provisioning for Retirement Benefits**

Primary (urban) co-operative banks may have retirement benefit schemes for their staff, viz. Provident Fund, Gratuity and Pension. It is necessary that such liabilities are estimated on actuarial basis and full provision should be made every year for the purpose in their Profit and Loss Account.

#### **4.3 Provisioning Norms for sale of financial assets to Securitisation Companies( SC)/ Reconstruction Companies(RC)**

- (a) If the sale to SC/RC is at a price below the net book value(NBV) (i.e. book value less the provision held), the short fall should be written off / debited to P&L A/c of that year, subject to the provisions of the co-operative societies acts/rules/administrative guidelines in regard to write-off of debts.
- (b) If the sale is for a value higher than the NBV, the excess provision will not be reserved but will be utilised to meet the shortfall/ loss on account of sale of other assets to SC/RC.

#### **4.4 Guidelines for Provisions in Specific Cases**

##### **(i) State Government guaranteed advances**

From the year ended March 31, 2006, State Government guaranteed advance and investment in State Government guaranteed securities would attract extant provisioning norms, if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days irrespective of the fact whether the guarantee have been invoked or not.

##### **(ii) Advances granted under rehabilitation packages approved by BIFR/term lending institutions.**



- (a) The existing credit facilities sanctioned to a unit under rehabilitation package approved by BIFR/term lending institutions, should continue to be classified as sub-standard or doubtful asset as the case may be.
- (b) However, the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, the income recognition and asset classification norms will become applicable after a period of one year from the date of disbursement.
- (c) In respect of additional credit facilities granted to SSI units which are identified as sick and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provision need be made for a period of one year.
- (iii) Advances against fixed/term deposit, NSCs eligible for surrender, IVPs, KVPs, and life policies are exempted from provisioning requirements.
- (iv) Advances against gold ornaments, government securities and all other kinds of securities are not exempted from provisioning requirements.
- (v) Advances covered by ECGC/DICGC guarantee
  - (a) In the case of advances guaranteed by DICGC/ECGC, provision should be made only for the balance in excess of the amount guaranteed by these Corporations. Further, while arriving at the provision required to be made for Doubtful Assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then provision made as illustrated hereunder:

#### Example

Outstanding Balance	Rs. 4 lakhs
DICGC Cover	50 per cent
Period for which the advance has remained doubtful	More than 3 years
Value of security held ( excludes worth of borrower/guarantor)	Rs.1.50 lakhs

Provision required to be made

Outstanding balance	Rs.4.00 lakhs
Less: Value of security held	Rs.1.50 lakhs

15375

Unrealised balance Rs.2.50 lakhs Less: DICGC Cover (50% of unrealisable balance)	Rs.1.25 lakhs
Net unsecured balance	Rs.1.25 lakhs
Provision for unsecured portion of advance	Rs.1.25 lakhs (@ 100 per cent of unsecured portion)
Provision for secured portion of advance (as on March 31 2005)	Rs.0.90 lakhs (@ 60 per cent of secured portion of Rs.1.50 lakh).
Total provision required to be Made	Rs.2.15 lakhs ( as on March 31,2005).

- (b) In case the banks are following more stringent method of provisioning in respect of advances covered by the guarantees of DICGC/ ECGC, as compared to the method given above, they may have the option to continue to follow the same procedure.

## 5. DIVERSION IN ASSET CLASSIFICATION AND PROVISIONING

- (i) Banks should ensure scrupulous compliance with the instructions for recognition of credit impairment and view aberrations by dealing officials seriously.
- (ii) Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. Banks should fix a minimum cut off point to decide what would constitute a high value account depending upon their respective levels. The cut off point should be valid for the entire year.
- (iii) The responsibility and validation levels for ensuring proper asset classification may be fixed by the banks.
- (iv) Where there is willful non-compliance by the officials responsible for classification and is well documented, RBI would initiate deterrent action including imposition of monetary penalties.

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