

## **The NPA Overhang - Magnitude, Solutions, Legal Reforms**

### **Introduction**

I have readily accepted the invitation of CII for an interaction on NPAs so that the central bank can convey its concerns to those who can offer right solutions to this vexing problem and at the same time hear their view points for possible mitigation role by the central bank and government. I am thus really grateful to have been given an opportunity to talk on a subject of great interest to all who have assembled here.

In fact, the problem of non performing assets (NPAs) is ravaging some of the even advanced economies like Japan. I had recently read an assessment by one of the international rating agencies that the real level of NPAs of China may be over 50 percent and for Indian system it can be placed at over 20 percent, after making a marginal allowance for ever-greening. Though soothing in comparison, it is not a matter of comfort. The interest bearing assets of Indian banks have so far derived comfort from a large proportion of them being held in the form of sovereign debt paper or sovereign guaranteed advances. The non-performing assets of Indian banks (both advances and investments taken together) form only around 5 per cent of the total assets at the end of March 2001. But this facet will undergo rapid change at any time if the defaults under guaranteed advances to undertakings of the some of the state governments escalate any further.

### **It is not anymore lenders' problem alone but equally that of borrowers too !**

The high level of NPAs in banks and financial institutions has been a matter of grave concern to the public as bank credit is the catalyst to the economic growth of the country and any bottleneck in the smooth flow of credit, one cause for which is the mounting NPAs, is bound to create adverse repercussions in the economy. NPAs are not therefore the concern of only lenders. I consider that forum like this, comprising of representatives of a major section of the beneficiaries of the financial system, should equally get concerned in a serious way on what they can do to address the gravity of the NPA problem of banks. I would rather urge them to lend a helping hand in the ongoing efforts of banks, and financial institutions to recover bad debts and arrest fresh accretions of NPAs.

### **Present prudential regulations**

The prudential norms on income recognition, asset classification and provisioning thereon, are implemented from the financial year 1992-93, as per the recommendation of the Committee on the Financial System (Narasimham Committee I). These norms have brought in quantification and objectivity into the assessment and provisioning for NPAs. We at the central bank constantly endeavour to ensure that our prescriptions in this regard are close to international norms. We are neither strict nor lax but just correct in tune with our needs and capabilities.

Under the prudential norms laid down by RBI

- ? Income should not be recognised on NPAs on accrual basis but should be booked only when it is actually received in respect of such accounts.
- ? An asset is considered as "non-performing" if interest or installments of principal due remain unpaid for more than 180 days (the lag would get reduced to 90 days from March 31, 2004 to conform to international norms). Any NPA would migrate from sub-standard

to doubtful category after 18 months (as against 12 months under international norms). It would get classified as loss asset if it is irrecoverable or only marginally collectible.

- ? The banks should make full provision for loss assets, 100 per cent of the unsecured portion of the doubtful asset plus 20 to 50 per cent of the secured portion (depending on the period for which the account is doubtful), and a general 10% (it is 20 per cent under international norms) of the outstanding balance in respect of sub-standard assets.

Detailed guidelines have been issued by RBI in October 2000 on valuation and provisioning for investment portfolio including credit substitutes.

### **Impact of NPAs on banks' profits and lending prowess**

The efficiency of a bank is not always reflected only by the size of its balance sheet but by the level of return on its assets. NPAs do not generate interest income for the banks, but at the same time banks are required to make provisions for such NPAs from their current profits.

NPAs have a deleterious effect on the return on assets in several ways –

- ? They erode current profits through provisioning requirements
- ? They result in reduced interest income
- ? They require higher provisioning requirements affecting profits and accretion to capital funds and capacity to increase good quality risk assets in future, and
- ? They limit recycling of funds, set in asset-liability mismatches, etc.

There is at times a tendency among some of the banks to understate the level of NPAs in order to reduce the provisioning and boost up bottom lines. It would only postpone the doomsday effect as happened in some of the banks with disastrous consequences, like getting branded as weak and losing credibility internationally, besides subjecting the senior management to vigilance and CBI process.

In the context of crippling effect on a bank's operations in all spheres, asset quality has been placed as one of the most important parameters in the measurement of a bank's performance under the CAMELS supervisory rating system of RBI.

### **Movement of NPAs over the years**

A glance through the statistics on the movement of NPAs of public sector banks since introduction of prudential norms in 1992-1993 will help us to understand the extent to which the public sector banks have made progress in reducing their NPA levels.

**Table -I**

Year	Gross NPAs		Net NPAs	
	Amount (Rs. Crore)	As a percentage to Total Advances	Amount (Rs. crore)	As a percentage to net advances
(1)	(2)	(3)	(4)	(5)
1992-1993	39253.14	23.18	Not compiled	
1993-1994	41041.33	24.78	19690.74	14.46

Year	Gross NPAs		Net NPAs	
	Amount (Rs. Crore)	As a percentage to Total Advances	Amount (Rs. crore)	As a percentage to net advances
1994-1995	38385.18	19.45	17566.64	10.67
1995-1996	41660.94	18.01	18297.49	8.90
1996-1997	43577.09	17.84	20284.73	9.18
1997-1998	45652.64	16.02	21232.13	8.15
1998-1999	51710.50	15.89	24211.49	8.13
1999-2000	53294.02	14.02	26187.60	7.42
2000-2001	54773.16	12.40	27968.11	6.74

The level of gross and net NPAs has been sliding down over the years. Gross NPA had come down from 23.18% in 1992-93 to 12.40% in 2000-01. Net NPA also moved down from 14.46% in 1993-94 to 6.74% in 2000-01. Still the NPA level can be considered of staggering magnitude in absolute terms costing the public sector banks more than Rs.5000 crores annually by way of loss of interest income, besides servicing and litigation costs. To be fair, I have to state that a major portion of the NPAs was a legacy of the pre-prudential days, when banks were accounting for interest as income on accrual basis even when the underlying advances were not performing.

It will be interesting to have a look at the movement of NPAs (gross and net), as a percentage of advances, group-wise over the last four years. This will give an idea of where banks, as different groups, stand in regard to their NPAs.

Bank group	Percentage of gross / net NPAs to total advances as at end March			
	1998	1999	2000	2001
Public sector banks	16.0 (8.2)	15.9 (8.1)	14.0 (7.4)	12.4 (6.7)
All private sector banks	8.7 (5.3)	10.8 (7.4)	8.2 (5.4)	8.5 (5.4)
Old private sector banks	10.9 (6.5)	13.1 (9.0)	10.8 (7.1)	11.1 (7.3)
New private sector banks	3.5 (2.6)	6.2 (4.5)	4.1 (2.9)	5.1 (3.1)
Foreign banks	6.4 (2.2)	7.6 (2.9)	7.0 (2.4)	6.8 (1.9)
All commercial banks	14.4 (7.3)	14.7 (7.6)	12.7 (6.8)	11.4 (6.2)

Note: Figures in parenthesis denote percentage of net NPAs to net advances

It may be observed that the malady of high level of NPAs eroding the profitability of banks is not confined to public sector banks alone, but it is equally present in the private sector banks too. While some of the foreign banks loan portfolio had been affected by a few large accounts turning NPA, it is a matter of concern that some of the new private sector banks which started off on a clean slate had acquired so quickly such a large level of NPAs.

### **Need for building up of loan loss provisions**

The net NPAs, i.e., that portion of NPAs which is not provided for, pose a major concern for solvency of the bank. To the credit of the Indian banking system's ability to provide for loan losses over a period, though not fully, the level of unprovided for NPAs i.e. net NPAs in public sector banks has been continuously declining from 14.46% in 1993-94 to 6.74% in 2000-01. This is still not at a level of comfort and it must be noted that the percentage of net NPAs to net advances in developed countries is around 2%.

As on 31 March 2001 public sector banks together held provisions at 42.83% of gross NPAs. Only 5 banks had provisioning levels to gross NPAs at more than 50 percent as on that date. Provisions held by private banks was at 35% of gross NPAs and as many as 19 old and 6 new private sector banks had less than 50 per cent provisioning. RBI has been advocating in various forums the need for banks building up provisions upto at least a level of 50% of the gross NPAs at the earliest. I would like to mention that RBI during this year had viewed with disfavour cases of banks which proposed to increase dividend levels without reaching a provisioning level of 50 per cent of gross NPAs and would continue the policy till the provisioning levels improve.

### **NPAs - Causes**

#### **Incidence and impact of directed lending to stock of NPAs**

In all forums of interactions the global multilateral institutions and rating agencies had with RBI and the Government, directed lending concept gets quoted as an important attribute and a contributory factor for the build up of NPAs in banks in India. It is a different matter that RBI and the Government are accused of soft attitude towards banks which do not fulfill the prescribed targets for priority sector lending, particularly agriculture and small scale sector. To put matters on a proper perspective, I thought I should share some information regarding the contribution by various segments of borrowers to the NPA stock of public sector banks. The picture in the following table as on March 31, 2001, I am sure, is self-revealing.

Borrowing segment-wise distribution of gross NPAs	Gross NPAs as on March 31, 2001	
	Amount (Rs. crores)	Percentage to total NPAs
Public sector units	1334.05	2.44
Large Industries	11498.10	20.99
Medium industries	8658.69	15.81
Other non priority sectors	9516.62	17.37
Agriculture	7311.40	13.35
Small scale industries	10284.97	18.78
Other priority sectors	6169.33	11.26

Total	54773.16	100.00
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I do understand that recovery of NPAs under priority sector advances particularly to agriculture and small-scale industries is sometimes hampered by externalities. Further, such NPAs are also spread over a large number of accounts and for small amounts. However, one fails to understand the reluctance of large borrowers to honour their repayment obligations. In many cases, failure of banks to take effective action against some of the defaulting large corporate borrowers was also noticed. This is a factor which prompted the Hon'ble Finance Minister in his recent meeting with CMDs of public sector banks to set a time frame for filing suits against such borrowers to facilitate public disclosure of defaults by big borrowers in the banking system.

Recovery of dues by banks is directly related to the performance of the borrowal unit/industrial segments. An internal study conducted by RBI shows that in the order of prominence, the following factors contribute to NPAs.

### **Internal factors**

- ? diversion of funds for
  - o expansion / diversification / modernization
  - o taking up new projects
  - o helping/promoting associate concerns
- ? time/cost overrun during the project implementation stage
- ? business (product, marketing, etc.) failure,
- ? inefficient management,
- ? strained labour relations,
- ? inappropriate technology/technical problems,
- ? product obsolescence, etc.

### **External factors**

- ? recession,
- ? non-payment in other countries
- ? inputs/power shortage,
- ? price escalation,
- ? accidents, and natural calamities, etc.
- ? changes in government policies in excise/import duties, pollution control orders, etc.,

Contribution to NPAs by factors like siphoning off funds thorough fraud/misappropriation was less significant in comparison with other factors.

Incidence of NPAs on account of deficiencies on the part of banks such as delay in sanction and disbursement of funds whereby borrowing units are starved of funds when in need, and delay in settlement of payments/subsidies by the Government bodies was on the low side in proportion to other factors.

Lack of effective co-ordination between banks and financial institutions in respect of large value projects does contribute to the emergence of NPAs even at the implementation stage. RBI had, in February 2000, drawn up certain ground rules in this regard in consultation

with banks, financial institutions and IBA and circulated the same among banks and financial institutions for implementation.

Susceptibility of the sanctioning authorities to external pressure, failings of the CEOs and the ineffectiveness of the Board to check his ways also contributed in no small measure to the unusual build up of NPAs in some of the banks.

One of the most prominent causes for NPAs, as often observed by RBI Inspectors, is the slackness on the part of the credit management staff in their follow up to detect and prevent diversion of funds in the post-disbursement stage.

The controversy as to who should be held responsible for diversion of funds – banks or borrowers – may not get settled and is not that material for recovery of NPAs. From the RBI side, I would like to stress that borrowers should, in the interest of the viability of the banking system on which they are dependent, resist all temptations to divert bank funds for uses other than for which they are sanctioned. Banks too on their part should be vigilant to detect and prevent diversion of funds as any failure in this front is a potential source of NPAs.

### **Implications of NPAs**

#### **Supervisory action that may arise on account of high level of NPAs**

One of the trigger points in the proposed Prompt Corrective Action (PCA) mechanism [which was widely circulated by RBI through the public domain] is the level of net NPAs. When the trigger point under the mechanism is activated by the performance of a bank, the mandatory actions would follow by way of restriction on expansion of risk-weighted assets, submission and implementation of capital restoration plan, prior approval of RBI for opening of new branches and new lines of business, paying off costly deposits and special drive to reduce the stock of NPAs, review of loan policy, etc.

#### **Other implications**

The most important business implication of the NPAs is that it leads to the credit risk management assuming priority over other aspects of bank's functioning. The bank's whole machinery would thus be pre-occupied with recovery procedures rather than concentrating on expanding business.

As already mentioned earlier, a bank with high level of NPAs would be forced to incur carrying costs on a non-income yielding assets. Other consequences would be reduction in interest income, high level of provisioning, stress on profitability and capital adequacy, gradual decline in ability to meet steady increase in cost, increased pressure on net interest margin (NIM) thereby reducing competitiveness, steady erosion of capital resources and increased difficulty in augmenting capital resources.

The lesser appreciated implications are reputational risks arising out of greater disclosures on quantum and movement of NPAs, provisions etc. The non-quantifiable implications can be psychological like 'play safe' attitude and risk aversion, lower morale and disinclination to take decisions at all levels of staff in the bank.

### **Management of NPAs**

The quality and performance of advances have a direct bearing on the profitability and viability of banks. Despite an efficient credit appraisal and disbursement mechanism, problems can still arise due to various factors. The essential component of a sound NPA management system is quick identification of non-performing advances, their containment at minimum levels and ensuring that their impingement on the financials is minimum.

The approach to NPA management has to be multi-pronged, calling for different strategies at different stages a credit facility passes through. RBI's guidelines to banks (issued in 1999) on Risk Management Systems outline the strategies to be followed for efficient management of credit portfolio. I would like to touch upon a few essential aspects of NPA management in this paper.

Excessive reliance on collateral has led Indian banks nowhere except to long drawn out litigation and hence it should not be sole criterion for sanction. Sanctions above certain limits should be through Committee which can assume the status of an 'Approval Grid'.

It is common to find banks running after the same borrower/borrower groups as we see from the spate of requests for considering proposals to lend beyond the prescribed exposure limits. I would like to caution that running after niche segment may be fine in the short run but is equally fraught with risk. Banks should rather manage within the appropriate exposure limits. A linkage to net owned funds also needs to be developed to control high leverages at borrower level.

Exchange of credit information among banks would be of immense help to them to avoid possible NPAs. There is no substitute for critical management information system and market intelligence.

We have come across cases of excellent appraisal and compliance with sanction procedures but no control at disbursement stage over compliance with the terms of sanction. To overcome this problem a mechanism for independent review of compliance with terms of sanction has to be put in place.

Close monitoring of the account particularly the larger ones is the primary solution. Emerging weakness in profitability and liquidity, recessionary trends, recovery of installments / interest with time lag, etc., should put the banks on caution. The objective should be to assess the liquidity of the borrower, both present and future prospects. Loan review mechanism is a tool to bring about qualitative improvement in credit administration. Banks should follow risk rating system to reveal the risk of lending. The risk-rating process should be different from regular loan renewal exercise and the exercise should be carried out at regular intervals. It is not enough for banks to aspire to become big players without being backed by development of internal rating models. This is going to be a pre-requisite under the New Capital Adequacy framework and if a bank wants to be an international player, it shall have to go for such a system.

Banks should ensure that sanctioning of further credit facilities is done only at higher levels. A quick review of all documents originally obtained and their validity should be made. A phased programme of exit from the account should also be considered.

## **Measures initiated by Reserve Bank and Government of India for reduction of NPAs**

### **Compromise settlement schemes**

The RBI / Government of India have been constantly goading the banks to take steps for arresting the incidence of fresh NPAs and have also been creating legal and regulatory environment to facilitate the recovery of existing NPAs of banks. More significant of them, I would like to recapitulate at this stage.

- ? The broad framework for compromise or negotiated settlement of NPAs advised by RBI in July 1995 continues to be in place. Banks are free to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements with the approval of their Boards, particularly for old and unresolved cases falling under the NPA category. The policy framework suggested by RBI provides for setting up of an independent Settlement Advisory Committees headed by a retired Judge of the High Court to scrutinise and recommend compromise proposals
- ? Specific guidelines were issued in May 1999 to public sector banks for one time non discretionary and non discriminatory settlement of NPAs of small sector. The scheme was operative upto September 30, 2000. [Public sector banks recovered Rs. 668 crore through compromise settlement under this scheme.]
- ? Guidelines were modified in July 2000 for recovery of the stock of NPAs of Rs. 5 crore and less as on 31 March 1997. [The above guidelines which were valid upto June 30, 2001 helped the public sector banks to recover Rs. 2600 crore by September 2001]
- ? An OTS Scheme covering advances of Rs.25000 and below continues to be in operation and guidelines in pursuance to the budget announcement of the Hon'ble Finance Minister providing for OTS for advances up to Rs.50,000 in respect of NPAs of small/marginal farmers are being drawn up.

### **Measures for faster legal process**

#### **Lok Adalats**

Lok Adalat institutions help banks to settle disputes involving accounts in “doubtful” and “loss” category, with outstanding balance of Rs.5 lakh for compromise settlement under Lok Adalats. Debt Recovery Tribunals have now been empowered to organize Lok Adalats to decide on cases of NPAs of Rs.10 lakhs and above. The public sector banks had recovered Rs.40.38 crore as on September 30, 2001, through the forum of Lok Adalat. The progress through this channel is expected to pick up in the coming years particularly looking at the recent initiatives taken by some of the public sector banks and DRTs in Mumbai.

#### **Debt Recovery Tribunals**

The Recovery of Debts due to Banks and Financial Institutions (amendment) Act, passed in March 2000 has helped in strengthening the functioning of DRTs. Provisions for placement of more than one Recovery Officer, power to attach defendant's property/assets before judgement, penal provisions for disobedience of Tribunal's order or for breach of any terms of the order and appointment of receiver with powers of realization, management, protection and preservation of property are expected to provide necessary teeth to the DRTs and speed up the recovery of NPAs in the times to come.

Though there are 22 DRTs set up at major centres in the country with Appellate Tribunals located in five centres viz. Allahabad, Mumbai, Delhi, Calcutta and Chennai, they could decide only 9814 cases for Rs.6264.71 crore pertaining to public sector banks since inception of DRT



mechanism and till September 30, 2001. The amount recovered in respect of these cases amounted to only Rs.1864.30 crore.

Looking at the huge task on hand with as many as 33049 cases involving Rs.42988.84 crore pending before them as on September 30, 2001, I would like the banks to institute appropriate documentation system and render all possible assistance to the DRTs for speeding up decisions and recovery of some of the well collateralised NPAs involving large amounts. I may add that familiarisation programmes have been offered in NIBM at periodical intervals to the presiding officers of DRTs in understanding the complexities of documentation and operational features and other legalities applicable of Indian banking system. RBI on its part has suggested to the Government to consider enactment of appropriate penal provisions against obstruction by borrowers in possession of attached properties by DRT receivers, and notify borrowers who default to honour the decrees passed against them.

### **Circulation of information on defaulters**

The RBI has put in place a system for periodical circulation of details of wilful defaults of borrowers of banks and financial institutions. This serves as a caution list while considering requests for new or additional credit limits from defaulting borrowing units and also from the directors /proprietors / partners of these entities. RBI also publishes a list of borrowers (with outstandings aggregating Rs. 1 crore and above) against whom suits have been filed by banks and FIs for recovery of their funds, as on 31<sup>st</sup> March every year. It is our experience that these measures had not contributed to any perceptible recoveries from the defaulting entities. However, they serve as negative basket of steps shutting off fresh loans to these defaulters. I strongly believe that a real breakthrough can come only if there is a change in the repayment psyche of the Indian borrowers.

### **Recovery action against large NPAs**

After a review of pendency in regard to NPAs by the Hon'ble Finance Minister, RBI had advised the public sector banks to examine all cases of wilful default of Rs 1 crore and above and file suits in such cases, and file criminal cases in regard to wilful defaults. Board of Directors are required to review NPA accounts of Rs.1 crore and above with special reference to fixing of staff accountability.

On their part RBI and the Government are contemplating several supporting measures including legal reforms, some of them I would like to highlight.

### **Asset Reconstruction Company:**

An Asset Reconstruction Company with an authorised capital of Rs.2000 crore and initial paid up capital Rs.1400 crore is to be set up as a trust for undertaking activities relating to asset reconstruction. It would negotiate with banks and financial institutions for acquiring distressed assets and develop markets for such assets.. Government of India proposes to go in for legal reforms to facilitate the functioning of ARC mechanism

### **Legal Reforms**

The Honourable Finance Minister in his recent budget speech has already announced the proposal for a comprehensive legislation on asset foreclosure and securitisation.

### **Corporate Debt Restructuring (CDR)**

Corporate Debt Restructuring mechanism has been institutionalised in 2001 to provide a timely and transparent system for restructuring of the corporate debts of Rs.20 crore and above with the banks and financial institutions. The CDR process would also enable viable corporate entities to

restructure their dues outside the existing legal framework and reduce the incidence of fresh NPAs. The CDR structure has been headquartered in IDBI, Mumbai and a Standing Forum and Core Group for administering the mechanism had already been put in place. The experiment however has not taken off at the desired pace though more than six months have lapsed since introduction. As announced by the Hon'ble Finance Minister in the Union Budget 2002-03, RBI has set up a high level Group under the Chairmanship of Shri. Vepa Kamesam, Deputy Governor, RBI to review the implementation procedures of CDR mechanism and to make it more effective. The Group will review the operation of the CDR Scheme, identify the operational difficulties, if any, in the smooth implementation of the scheme and suggest measures to make the operation of the scheme more efficient.

### **Credit Information Bureau**

Institutionalisation of information sharing arrangements through the newly formed Credit Information Bureau of India Ltd. (CIBIL) is under way. RBI is considering the recommendations of the S.R.Iyer Group (Chairman of CIBIL) to operationalise the scheme of information dissemination on defaults to the financial system. The main recommendations of the Group include dissemination of information relating to suit-filed accounts regardless of the amount claimed in the suit or amount of credit granted by a credit institution as also such irregular accounts where the borrower has given consent for disclosure. This, I hope, would prevent those who take advantage of lack of system of information sharing amongst lending institutions to borrow large amounts against same assets and property, which had in no small measure contributed to the incremental NPAs of banks.

### **Proposed guidelines on wilful defaults/diversion of funds**

RBI is examining the recommendation of Kohli Group on wilful defaulters. It is working out a proper definition covering such classes of defaulters so that credit denials to this group of borrowers can be made effective and criminal prosecution can be made demonstrative against wilful defaulters.

### **Corporate Governance**

A Consultative Group under the chairmanship of Dr.A.Ganguly was set up by the Reserve Bank to review the supervisory role of Boards of banks and financial institutions and to obtain feedback on the functioning of the Boards vis-à-vis compliance, transparency, disclosures, audit committees etc. and make recommendations for making the role of Board of Directors more effective with a view to minimising risks and over-exposure. The Group is finalising its recommendations shortly and may come out with guidelines for effective control and supervision by bank boards over credit management and NPA prevention measures.

### **Conclusion**

I am of the opinion NPAs are better avoided at the initial stage of credit consideration by putting in place rigorous and appropriate credit appraisal mechanism. In the changing scenario banks cannot behave imprudently while sanctioning credit and later run to supervisors / regulators for regulatory forbearance and owners or strategic partners to bail them out.

Secondly, the mindset of the borrowers need to change so that a culture of proper utilisation of credit facilities and timely repayment is developed. As you are aware, one of the main reasons for corporate default is on account of diversion of funds and corporate entities should come forward to avoid this practice in the interest of strong and sound financial system.

Finally, extending credit involves lenders and borrowers and both should realise their role and responsibilities. They should appreciate the difficulties of each other and should endeavour to work towards contributing to a healthy financial system.

I do hope that corporate entities would put their best foot forward in creating an environment where a healthy, vibrant and sound financial system can be built-up and sustained.

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Text of address by Deputy Governor (Shri G.P.Muniappan) at CII Banking Summit 2002 at Mumbai on April 1, 2002