Study on preventing slippage of NPA accounts

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The Chairman/Managing Director/Chief Executive Officer
All Commercial Banks (Excluding RRBs)

Dear Sir,

Study on preventing slippage of NPA accounts

A study at the behest of Board for Financial Supervision (BFS) was conducted by the Reserve Bank by scanning relevant information/data obtained from a select group of banks, as also by holding discussions with bank officials, who manage NPAs at the policy level as well as those who look after actual recovery, rehabilitation/revival, restructuring of accounts at the implementing level. On the basis of the study, we had suggested a framework of recommendations for preventing slippage of NPAs accounts from sub-standard to doubtful/loss category which had been circulated among banks for feedback and comments. Response from most banks to these recommendations has been positive and in addition, some useful suggestions too have been received, which have been taken into account at the time of finalisation of the recommendations. In view of suggestions from some of the banks, our guidelines for categorising assets under 'special mention' category may be taken as an indicative framework for internal control purpose, for assets with potential weaknesses which deserves close attention and which can be resolved through timely remedial action.

2. We shall be glad if these guidelines are placed before the Board of Directors of your bank in their next meeting. The objective underlying the exercise is to evolve a common minimum framework to tackle the problem of slippage of NPAs, and it is expected that banks will work out their strategic response in keeping with the broad thrust of these guidelines.

Yours faithfully,
(P. V. Subba Rao)
Chief General Manager-in-charge

Enclosure: Guidelines on preventing slippage of NPA accounts

Guidelines on preventing slippage of NPA accounts

Department of Banking Supervision
Reserve Bank of India
Central Office
September 2002

Guidelines on preventing slippage of NPAs

Background

An analysis of NPAs in the Indian banking system as on March 31, 2001 done internally in RBI had been put up to the Board for Financial Supervision (BFS) in its 79th meeting held on December 27, 2001. In this connection, the BFS directed to conduct a study on slippage of NPA accounts from sub-standard to doubtful category and to arrive at recommendations to prevent such slippage.

As directed by the BFS, a study was conducted by an in-house group in the Bank by scanning relevant information/data obtained from a select group of banks as also by holding discussions with bank officials, who manage NPAs at the policy level as well as those who look after actual recovery, rehabilitation/revival, restructuring of accounts at the implementing level. The group, on the basis of the study, had suggested a framework of recommendations for preventing slippage of NPAs relevant at the banks' level. The draft of these recommendations was circulated amongst the banks for their comments and feedback. While most of the banks concurred with the recommendations, some additional suggestions received from a number of respondents were analysed, and have been factored into the final recommendations.

Recommendations

The preventive and corrective measures suggested under the framework of recommendations are an indicative but not exhaustive set of guidelines relevant at banks' level. Appropriate action in respect of individual accounts may be taken keeping in view the peculiarities of the situation involved. Also, it was observed from the feedback received that a number of banks are already following some of the suggested measures in one form or the other in their NPA management. The objective underlying the exercise is to evolve a common minimum framework to tackle this problem, whilst leaving the individual banks/FIs free to formulate their own internal policies. Nevertheless, it is expected that concerned institutions will work out their strategic response in keeping with the broad thrust of these guidelines.

(i) Early Recognition of the problem:

a. **Recognise the problem early:** Invariably, by the time banks start their efforts to get involved in a revival process, it's too late to retrieve the situation - both in terms of rehabilitation of the project and recovery of bank's dues. Identification of weakness in the very beginning (i.e., when the account starts showing first signs of weakness regardless of the fact that it may not have become NPA) is imperative. Assessment of the potential of revival may be done on the basis of a techno-economic viability study. Restructuring should be attempted where, after an objective assessment of the viability and promoter's intention (and his stake), banks are convinced of a turnaround within a scheduled timeframe. In respect of totally unviable units as decided by the bank/consortium, it is better to facilitate winding up/selling of the unit early, so as to recover whatever is possible through legal means before the security position becomes worse.

b. **Recourse to the new ordinance:** The Government of India has promulgated an ordinance on June 21, 2002, called "The Securitisation and Reconstruction of financial Assets and Enforcement of Security Interest Ordinance, 2002" to facilitate foreclosure of financial assets. In respect of totally unviable units as decided by the bank/consortium, action under this ordinance may be initiated without any loss of time.

Banks are also strongly encouraged to take immediate recourse to this legal remedy where they encounter malfeasance on the part of promoters/borrowers.

c. **Early Alert System:** The strategy for management of NPAs may be governed by the circumstances connected to each individual case. Generally, the NPA is more likely to be resolved in terms of recovery if the company is in operation. For this to be effective there must be a system of identifying the weakness in accounts at an early stage. Banks may put in place an "Early Alert" system that captures early warning signals in respect of accounts showing first signs of weakness. This system may be an integral part of the risk management process of the bank. Internationally, there is a similar system of "Special Mention Accounts". Depending upon the identified weaknesses, one may go back (rather than with reference to current period) to a prior or earlier period in determining the rehabilitation response.

d. Under the "Early Alert" system, for internal monitoring purpose, banks may designate a time limit for overdue accounts to determine the threshold for a proactive intervention - well before the account becomes NPA. This is to enable a bank to assess whether the default is due to some inherent weakness or due to a temporary liquidity or cash flow problem, and accordingly calibrate its response. For example, where there is a default in an account for 30 days, it may be shifted to a special category. Out of the accounts, ones that show promise may be considered for granting incremental facility for specific purposes, such as for capital expenditure, by ensuring strictest possible end use of the money. All the accounts displaying unsatisfactory features/early warning signals should be put under potential NPA list for follow up and time bound action to prevent their slippage. The account may be classified as potential NPA on account of one or more of the following illustrative list of features even though the account may be regular:

1) Delay in submission of stock statement / Other control statements / financial statements.

2) Return of cheques issued by borrowers.
3) Devolvement of DPG instalments and non-payment within a reasonable period
4) Frequent devolvement of LC and non-payment within a reasonable period.
5) Frequent invocation of BGs and non-repayment within a reasonable period.
6) Return of bills / cheques discounted.
7) Non-payment of bills discounted or under collection.
8) Poor financial performance in terms of declining sales and profits, cash losses, net losses, erosion of net worth etc.
9) Incomplete documentation in terms of creation / registration of charge / mortgage etc.
10) Non-compliance of terms and conditions of sanction.

e. Special Mention Accounts:

A system of early recognition with timely and adequate interventions may form the focus of approach in dealing with slippage of NPAs. In this context, it is suggested that banks introduce a new asset category between ‘Standard’ and ‘Sub-standard’ for their own internal monitoring and follow up. This asset category may be in line with international practice of ‘Special Mention Assets’ used by FDIC, U.S.A., MAS, Singapore, etc., while keeping in view the local requirements. An asset may be transferred to this category once the earliest signs of sickness/ irregularities are identified. This will help banks to look at accounts with potential problems in a focused manner right from the onset of the problem, so that monitoring and remedial actions can be more effective. Once these accounts are categorized and reported as such, proper top management attention would also be ensured. Under off-site reporting, data on potential NPAs in terms of overdue position such as (i) Loans and Advances overdue for less than two quarters and (ii) Loans and Advances overdue for less than one quarter, are required to be submitted by banks on a quarterly basis. Banks already compile this data, which may be used gainfully by top management to gauge the potential asset problems. However, introduction of a ‘Special Mention’ category of assets would be on the basis of not only overdue position in the account but also other factors which reflect sickness/irregularities in the account. Some banks which already have ‘special mention’ category (by whichever name called) may continue the same on the basis of their internal norms.

A Special mention account may briefly have the following main characteristics:

- The asset has potential weaknesses which deserves close management attention and which can be resolved through timely remedial action.
- If left un-corrected, the potential weaknesses in Special mention assets may result in deterioration of the repayment prospects and subsequent adverse asset classification.
- Often a bank’s weak origination/servicing policies are the reason behind classification of an asset under the Special mention category though there may be cases where technical or other factors may also be responsible.
- Apart from continuing irregularities, “special mention accounts” may also be categorised on the basis of factors such as inadequate cash flows and management integrity.
- Special mention assets would not require provisioning, as they are not classified as NPAs. Nor are these proposed to be brought under regulatory oversight and prudential reporting immediately. The step is mainly with a view to alerting management to the prospects of such an account turning bad, and thus taking preventive action well in time.
- As regards introducing a ‘special mention’ category as part of RBI's 'Income Recognition and Asset Classification norms' (IRAC norms), it would be considered in due course.

(ii) Identifying borrowers with genuine intent:

Identifying borrowers with genuine intent from those who are non- serious with no commitment or stake in revival is a challenge confronting bankers. Here the role of frontline officials at the branch level is paramount as they are the ones who have intelligence inputs with regard to promoters' sincerity, wherewithal, and capability to achieve a turnaround. Based on this objective assessment, banks should decide as quickly as possible whether it would be worthwhile to commit additional finance.

In this regard, banks may consider having 'Special Investigative Audit' of all financial transactions/business transactions, books of accounts in order to ascertain real factors that contributed to sickness of the borrower. Banks may have a panel of technical experts with proven expertise and track record for preparation of techno – economic viability study of the projects of the borrowers.

Borrowers having genuine problems due to temporary mismatch in funds flow or sudden requirements of additional funds may be entertained at the branch level, and for this purpose a special limit to tide over such contingencies may be built into the sanction process itself. This will obviate the need to route the additional funding request through the controlling offices in deserving cases, and help avert many accounts slipping into NPA category.

(iii) Timeliness and adequacy of response:

Longer the delay in response (in fact, sometimes branch officials may have to act suo-moto), greater the injury to the account and the asset. Time is a crucial element in any restructuring/rehabilitation strategy. Further, the response decided on the basis of techno-economic study and promoter's commitment, has to be adequate in terms of extent of additional funding, relaxations etc. under the restructuring exercise. The package of assistance may be flexible, and where required, the bank may also look at the exit option.

(iv) Focus on Cash Flows:

While financing, at the time of restructuring, banks may not be guided by the conventional Funds Flow Analysis only, which could yield a potentially misleading picture. Appraisal for fresh credit requirements may be done by analysing Funds Flow in conjunction with Cash Flows rather than only on the basis of Funds Flow.

(v) Management effectiveness:

The general perception among borrowers is that it is lack of finance that leads to sickness and NPAs. But this may not be the case all the time. Management effectiveness in tackling adverse business conditions is a very important aspect that affects a borrowing unit's fortunes. Additional finance to an ailing unit may be committed by a bank only after basic viability of the enterprise also in the context of quality of management is examined and confirmed. Where the default is due to deeper malady, viability study or investigative audit should be done - it will be useful to have a consultant appointed as early as possible to examine this aspect. A proper techno-economic viability study must thus become the basis on which any future action can be considered.

(vi) Consortium/multiple financing:

a. During the exercise for assessment of viability and restructuring, a **pragmatic and unified approach** by all the lending banks/FIs as also sharing of all relevant information on the borrower would go a long way toward overall success of rehabilitation effort. However, there is an element of risk in any restructuring exercise, given the probability of success/failure. One may expect a success rate of 50% in restructuring efforts, for it is unrealistic to expect 100% success rate.

b. In some default cases, where the unit is still working, the bank should make sure that **it captures the cash flows** (there is a tendency on part of the borrowers to switch bankers once they default, for fear of getting their cash flows forfeited), and ensure that such cash flows are used for working capital purposes. Toward this end, there should be regular flow of information among consortium members. A bank, which is not part of the consortium may not be allowed to offer credit facilities to such defaulting clients. Current account facilities may also be denied at non-consortium banks to such clients and violation may attract penal action. The **Credit Information Bureau of India Ltd. (CIBIL)** may be very useful for meaningful information exchange on defaulting borrowers once the setup becomes fully operational,

c. In a forum of lenders, the priority of each lender will be different. While one set of lenders may be willing to wait for a longer time to recover its dues, another lender may have a much shorter timeframe in mind. So it is possible that the latter category of lenders may be willing to exit, even at a cost – i.e., by a discounted settlement of the exposure. Therefore, any plan for restructuring/rehabilitation may take this aspect into account.

d. **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 banks and FIs on a voluntary basis and outside the legal framework. Under this system, banks may greatly benefit in terms of restructuring of large standard accounts (potential NPAs) and viable sub-standard accounts with consortium/multiple banking arrangements.

(vii) Legal and related issues:

a. **Change in mindset regarding legal action:** Legal action may be initiated once the Banks/FIs are convinced and have reached the conclusion that rehabilitation is not possible and there is no other way out. This will put pressure on the borrowers and will reduce the chances of depletion in the value of the security. In this context, the new securities ordinance, as mentioned earlier, will go a long way in developing the culture of prompt repayment of banks' / FIs' dues. Under this ordinance, substantial powers have been granted to the Banks / FIs for enforcement of securities without the intervention of the courts / tribunals. Similarly powers have been given to Banks / FIs to take over the management of business of the defaulting borrowers. With these special powers a strong message is being sent to the borrowers of Banks /FIs across the country. Banks would do well to capitalise on this message in dealing with recalcitrant borrowers and wilful defaulters.

b. Banks may take recourse to criminal proceedings along with civil suit where misleading information has been furnished influencing the bank's credit decision. Also in case of value-less guarantees and diversion of funds, bank may not hesitate to initiate criminal proceedings. Also borrowers may be asked to declare on oath their borrowings, assets, and all other material facts, which can be the basis for criminal action in future, if details are not found to be correct.

c. When considering a plan for the revival/rehabilitation, the **lenders should retain the right to exercise control over the ownership/ management.** This can be done by ensuring pledge of promoter's shareholding to the lenders with a right to change ownership if certain covenants/stipulations are not met.

(viii) Auditor's Responsibility:

In case any falsification of accounts on the part of the borrowers is observed by the banks/FIs, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) if it is observed that the auditors were negligent or deficient in conducting the audit to enable the ICAI to examine and fix accountability of the auditors.

With a view to monitoring end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion/ siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors, the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers/auditors.

(ix) Government relief:

State Government relief (state tax waiver, subsidy etc.) in respect of accounts enjoying the same takes long time to come, thus worsening the overdue position. There is a need to work in the direction of cutting down/ reducing the time lag by closer monitoring.

While it may so happen that circumstances warrant a different course of action, the above set of guidelines may be adhered to as a broader framework for preventing slippage of NPAs.