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Developing the Asian Markets for Non-Performing Assets - Developments in India

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What is a Non Performing Asset

In India, an asset is classified as Non-Performing Asset (NPA) if interest or installments of principal due remain unpaid for more than 180 days. However, with effect from March, 2004, default status would be given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by a bank to a borrower becomes non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status.

Non Performing Assets in India: An overview of NPA status

India has acquired an alarming number of Non-Performing Assets (NPA's) over the last two decades. NPA's surfaced in the Indian banking scenario around the eighties. As on 31.3.2003,the banks and financial institutions in India hold NPA's worth Rs. 1,10,000 crore[2] (approximately).

As at 31.03.2001, the aggregate gross NPA's of all scheduled commercial banks amounted to Rs.63,883 crore. **Table 1** provides the figures of gross and net NPA's for the last four years. It shows an increase of Rs.13,068 Crore (more than 25%).

TABLE 1[3]

NPA Statistics - Scheduled Commercial Banks (Amount in Crore) Year	Total Advances	Gross NPA	Net Advances	Net NPA	%-age of Gross NPA to total advances	%-age of Net NPA to net advances
1997-98	352697	50815	325522	25734	14.4	7.3
1998-99	399496	58722	367012	27892	14.7	7.6
1999-2000	475113	60408	444292	30211	12.7	6.8
2000-2001	558766	63883	526329	32632	11.4	6.2

The apparent reduction of gross NPA's from 14.4% to 11.4% between 1998 and 2001 provides little comfort since this accomplishment is on account of credit growth, which was higher than the growth of Gross NPA's and not through appreciable recovery of NPA's. There is neither reduction nor even containment of the threat.

The gross NPA's and net NPA's for Public Sector Banks (PSBs) as at 31.03.2001 are 12.39% and 6.74% are higher than the figures for Scheduled Commercial Banks

[2] One Crore comprises of Ten Million Rupees.
[3] Source:*Personal website of R Kannan.*

(SCB's) at 11.4% and 6.2%. The comparative figures for PSBs, State Bank of India (SBI) Group and Nationalised Banks are provided in **Table 2 to 4**.

TABLE 2[4]

NPA of PSBs (Amount in Crore) Year	Total Advances	Gross NPA	Net NPA	%-age of Gross NPA to total advances	% of Net NPA to net advances
1996-97	244214	43577	20285	17.8 %	9.2 %
1997-98	284971	45563	21232	16.0 %	8.2 %
1998-99	325328	51710	24211	15.9 %	8.1 %
1999-2000	380077	53033	26188	14.00 %	7.9%
2000-2001	442134	54773	27967	12.39 %	6.74%

TABLE 3[5]

NPA of State Bank Group (Amount in Crore) Year	Total Advances	Gross NPA	Net NPA	%-age of Gross NPA to total advances	%-age of Net NPA to net advances
1997-98	113360	15522	6829	14.57%	6.98 %
1998-99	118959	18641	7764	15.67 %	7.74 %
1999-2000	129253	19773	7411	14.08 %	6.77 %
2000-2001	150390	20586	8125	12.73 %	6.26 %

TABLE 4[6]

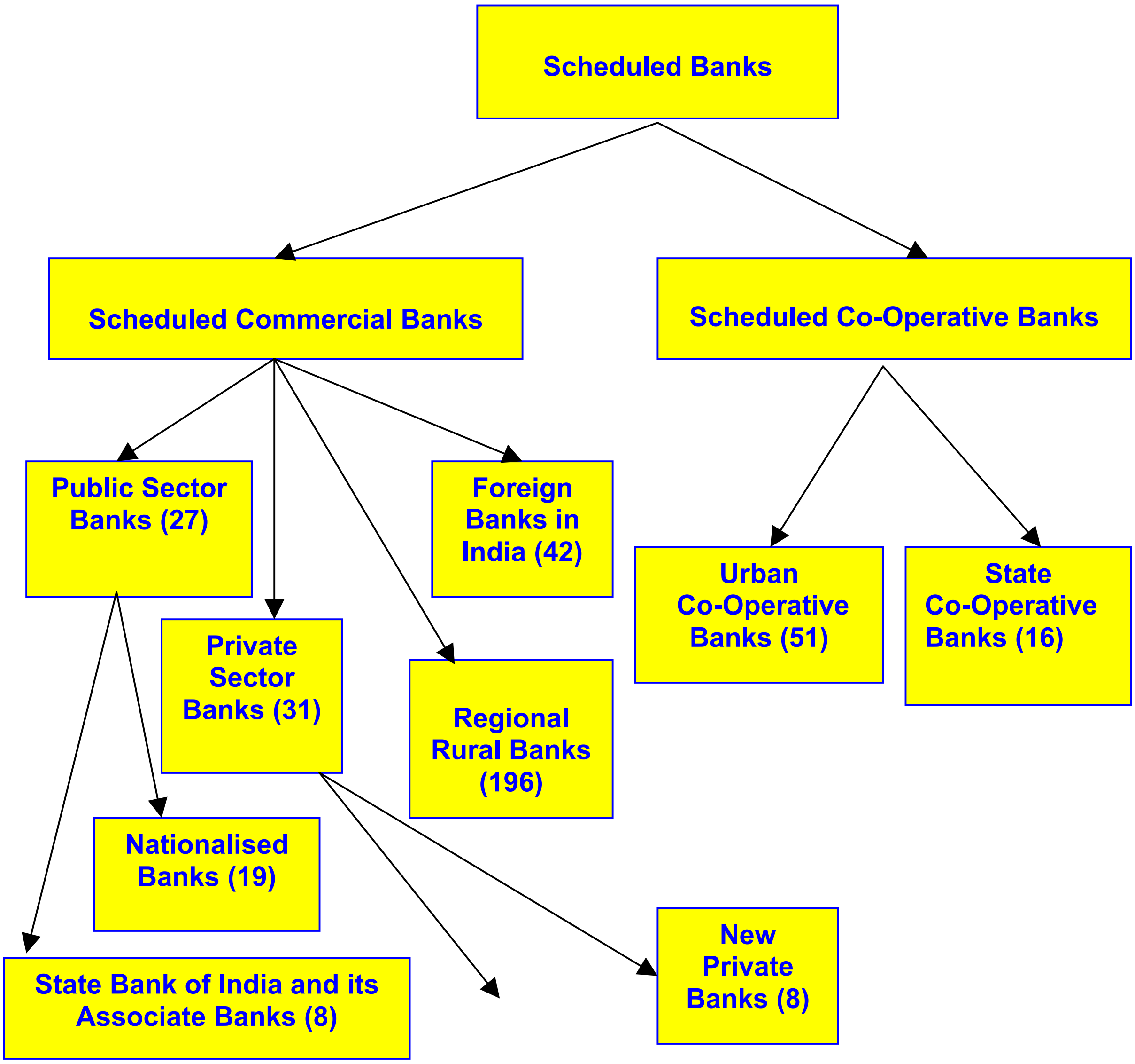
NPA of Nationalised Banks (Amount in Crore) Year	Total Advances	Gross NPA	Net NPA	%-age of Gross NPA to total advances	%-age of Net NPA to net advances
1997-98	166222	30130	14441	16.88	8.91
1998-99	188926	33069	15759	16.02	8.35
1999-2000	224818	33521	17399	13.99	7.80
2000-2001	264237	34609	16096	12.19	7.01

4 Source: *Personal website of R Kannan.*
5 Source: *Personal website of R Kannan.*
6 Source: *Personal website of R Kannan.*

The above figures are surely based on approximate values. Experience reveals that commercial banks in general suffer a tendency to understate their NPA figures. There is the practice of 'ever-greening' of advances, through subtle techniques. As per a report appearing in a national daily, the banking industry has under-estimated its NPAs by whopping Rs. 3,862.10 crore as on March 1997. The industry is also estimated to have under-provided to the extent of Rs 1,412.29 crore. Nineteen nationalised banks are stated to have underestimated their NPAs by Rs 3,029.29 crore.

Following is an overview of the structure of the Indian banks:

Structural Pattern of Scheduled Banks In India (As on March 31, 2001)[7]



[7] From an ADB report.

An analysis of factors contribu Old Private Banks (23) **'s**

An analysis of the contributory ting in the emergence of NPA's on a stupendous scale amongst Commercial Banks and Financial Institutions in the preceding decade and particularly in the early Nineties would lead to the following conceptualisation:

- PSBs performed creditably all through in respect of all parameters set for them. But in the early Nineties the truth emerged that PSBs were suffering from acute capital inadequacy and many of them were depicting negative profitability. This is because the paramters set for their functioning were deficient and they did not project the paramount need for these corporate goals. Incorrect goal perception and identification led them to wrong destination.

- Pre-reform era witnessed PSBs functioning under the overall control and direction of the Finance Ministry. Along with Reserve Bank of India (RBI) it decided/directed all aspects of the working of the banks. Banks were not free to price their products in competition with each other. They could not freely cater their products to any segment of their choice. They were unable to invest their funds in the best interest as they considered. It was thus a directed banking and the role of the Bank management was "executory".

- Since the 70s, the SCBs of India functioned totally as captive capsule units cut off from international banking and unable to participate in the structural transformations, the sweeping changes, and the new type of lending products emerging in the global banking Institutions. The personnel lacked desired training and knowledge resources required to compete with international players. Such and other chaotic conditions in parts of the Indian Banking industry had resulted in the accumulation of assets, which were termed as non-productive in an unprecedented level[8].

- Major policy decisions were taken externally by the Finance Ministry / RBI. Though Directors were to be appointed based on their possession of specialised knowledge in Banking and related discipline, the environment of receiving decisions from a political background as distinguished from a professional outfit, prevented the best talents coming to occupy the position as Directors of PSBs and taking part an active role in the deliberations of the Boards of these Banks.

- "Audit and Inspections" remained as functions under the control of the executive officers, which were not independent and were thus unable to correct the effect of serious flaws in policies and directions of the higher ups.

[8] From the title page of the project - "Indian Banking Today & Tomorrow" issued by RBI

- The quantum of credit extended by the PSBs increased by about 160 times in the three decades after nationalisation (from around 3000 crore in 1970 to 475113 Crore on 31.03.2000).[9] The Banks were not developed in terms of skills and expertise to regulate such stupendous growth in the volume and manage the diverse risks that emerged in the process.

- The need for organising an effective mechanism to gather and disseminate credit information amongst the commercial banks was never felt or implemented. The archaic laws of secrecy of customers-information that was binding Bankers in India, disabled banks to publish names of defaulters for common knowledge of the other Banks in the system.

- Effective recovery of defaulters and overdue of borrowers was "hampered on account of a sizeable overhang component arising from infirmities in the existing process of debt recovery, inadequate legal provisions on foreclosure and bankruptcy and difficulties in the execution of court decrees". But in India Legal remedies were beset with too many formalities and too very time-consuming. Laws continued favouring willful defaulters and the Banks were left helpless.

- Effective Corporate management was a concept alien to the corporate houses then. In respect of PSBs the boards were ineffective and the only/main shareholder was the Government of India. Government exercised multiple roles and concerns, and the instinct to act as a watchful shareholder and increase the shareholder's value of these corporate bodies (banks & Financial Institutions) was never felt/experienced by the Government.

- Credit management on the part of the lenders to the borrowers to secure their genuine and bonafide interests was not based on pragmatically calculated anticipated cash flows of the borrower concern, while recovery of installments of Term Loans was not out of profits and surplus generated but through recourse to the corpus of working capital of the borrowing concerns. This eventually led to the failure of the project financed leaving idle assets.

- Functional inefficiency was also caused due to over-staffing, manual processing of over-expanded operations and failure to computerise Banks in India, when elsewhere throughout the world the system was to switch over to computerisation of operations.

Impacts of NPA's on the working of Commercial Banks

[9] 6 data is taken from a source called *Personal website of R kannan*

NPA has affected the profitability, liquidity and competitive functioning of Public and Private Sector Banks and finally the psychology of the bankers in respect of their disposition towards credit delivery and credit expansion.

Impact on Profitability

Between 01.04.93 to 31.03.2001, commercial banks incurred a total amount of Rs.31251 crore towards provisioning NPA's[10]. This has brought Net NPA's to Rs.32632 crore or 6.2% of net advances. The enormous provisioning of NPA together with the holding cost of such non-productive assets over the years has acted as a severe drain on the profitability of the PSBs. Equity issues of nationalised banks that have already tapped the market are now quoted at a discount in the secondary market. This has alternatively forced PSBs to borrow heavily from the debt market to build Tier II Capital to meet capital adequacy norms putting severe pressure on their profit margins.

It is worthwhile to compare the aggregate figures of the 19 Nationalised banks for the year ended March 2001, as published by RBI in its Report on trends and progress of banking in India **(Table 5)**.

TABLE 5*

Nationalised banks operational statistics (Amount in Crore) Performance indicator	**Year ended Mar. 2000**	**Year ended Mar. 2001**
Earnings - Non-interest	6662.42	7159.41
Operating expenses	14251.87	17283.55
Difference	- 7589.45	- 10124.14
Earnings - interest income	50234.01	56967.11
Exp.-Interest expenses	35477.41	38789.64
Interest spread	14756.60	18177.47
Int. on Recap bonds	1797.88	1795.48
Operating Profit	5405.27	6257.85
Provisions	4766.15	5958.24
Net Profit	639.12	299.61

Though nationalised banks (except Indian Bank) are able to meet norms of Capital Adequacy, as per RBI guidelines, the fact that their net NPA in the average is as much as 7% is a potential threat for them. RBI has indicated the ideal position as Zero percent Net NPA. Even granting 3% net NPA within limits of tolerance the

[10] data herein is taken from a source called *Personal website of R kannan*

nationalised banks are holding an uncomfortable burden at 7.1% as at March 2001[11]. They have not been able to build additional capital needed for business expansion through internal generations or by tapping the equity market, but have resorted to II-Tier capital in the debt market or looking to recapitalistion by Government of India.

Impact on the outlook of Bankers towards Credit Delivery

The psychology of the banks today is to insulate themselves with zero percent risk and turn lukewarm to fresh credit. This has affected adversely credit growth compared to growth of deposits, resulting a low C/D Ratio around 50% to 54% for the industry.

It is evident that the existence of collateral security at best may convert the credit extended to productive sectors into an investment against real estate, but will not prevent the account turning into NPA. Further blocked assets and real estate represent the most illiquid security and NPA in such advances has the tendency to persist for a long duration. Nationalised banks have reached a dead-end of the tunnel and their future prosperity depends on an urgent solution of this hovering threat.

Excessive focus on credit risk management

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 hereinabove, 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.

Two decades of regimented and directed banking to credit delivery has deprived bank managers of the instinct skill and knowledge. Nationalised banking did not

[11] data is taken from a source called *Personal website of R kannan*

produce a spring of talent resources from within. Directive Inputs and course-direction came externally from RBI and Finance Ministry which were/are external to the day-to-day affairs and problems of the Indian banking industry. The system did not promote initiative and talent, but bred corruption and nepotism.

This is the scene of Indian Banking struggling hard to transition from old primitive systems and values to modern professional business ethics and corporate good governance.

High cost of funds due to NPAs

Quite often genuine borrowers face the difficulties in raising funds from banks due to mounting NPAs. Either the bank is reluctant in providing the requisite funds to the genuine borrowers or if the funds are provided, come at a very high cost to compensate the lender's losses caused due to high level of NPAs.

Therefore, quite often corporates prefer to raise funds through commercial papers (CPs) where the interest rate on working capital charged by banks is higher.

Impact on banks scrips on Stock Exchanges

In further of a report, the RBI has said informational asymetries arising from less on-site/off-site inspection, declining performance and shooting NPAs weighed heavily on bank stocks.

The RBI has for the first time included stock market behaviour of bank scrips in its annual review of the banking sector. As per a RBI Report, despite the various reforms being carried out in Indian stock exchanges, many bank scrips remain illiquid and thinly traded. In fact, out of 25 banks traded on the National Stock Exchange (NSE), the share of the top five banks in turnover and capitalisation constituted 96.4 per cent and 82.82 per cent respectively during 1998-99.

Meanwhile, the share price of HDFC Bank Ltd, a private-sector bank, showed a decline of a mere 1.1 per cent during the year 1998-99. The RBI Report says "Private sector bank stocks whose market performance was affected included Bank of Rajasthan, Federal Bank and HDFC Bank," and attributed the battering the scrips got in the secondary market to their poor performance in general and the concern of the market over their NPAs.

There are various other pressing factors that are relevant from the point of view of Indian banking operations with a view to focusing on NPAs and its related effects:

a. Excess liquidity-lending-default

The banks in India are faced with the problem of increasing liquidity in the system. Further, the Reserve Bank of India (RBI) is increasing the liquidity in the system through various rate cuts. Banks can get rid of its excess liquidity by increasing its lending but, often shy away from such an option due to the high risk of default.

In order to promote certain prudential norms for healthy banking practices, most of the developed economies require all banks to maintain minimum liquid and cash reserves broadly classified into Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

A rate cut (for instance, decrease in CRR) results into lesser funds to be locked up in RBI's vaults and further infuses greater funds into a system. However, almost all the banks are facing the problem of bad loans, non-performing assets, thinning margins, etc. as a result of which, banks are little reluctant in granting loans to corporates. As such, though in its monetary policy RBI announces rate cut but such news are no longer warmly greeted by the bankers.

b. Importance of credit rating in assessing the risk of default for lenders

Credit rating has been explained by Moody's, a credit rating agency, as forming an opinion of the future ability, legal obligation and willingness of a bond issuer or obligor to make full and timely payments on principal and interest due to the investors. Banks do rely on credit rating agencies to measure credit risk and assign a probability of default. However, credit rating is not foolproof. In fact, Enron was rated investment grade till as late as a month prior to it's filing for Chapter 11 bankruptcy when it was assigned an in-default status by the rating agencies. It depends on the information available to the credit rating agency. Besides, there may be conflict of interest, which a credit rating agency may not be able to resolve in the interest of investors and lenders.

Stock prices are an important (but not the sole) indicator of the credit risk involved. Stock prices are much more forward looking in assessing the creditworthiness of a business enterprise. Historical data proves that stock prices of companies such as Enron and WorldCom had started showing a falling trend many months prior to it being downgraded by credit rating agencies.

c. RBI guidelines on NPAs and ICAI Accounting Standard 9 on revenue recognition

In view of the guidelines issued by the Reserve Bank of India (RBI), income on NPAs should be recognised only when it is actually realised. As such, a doubt may arise as to whether the aforesaid guidelines with respect to recognition of interest income on NPAs on realization basis is consistent with Accounting Standard 9, `Revenue Recognition'. For this purpose, the guidelines issued by the RBI for treating certain assets as NPAs seem to be based on an assumption that the collection of interest on such assets is uncertain.

Therefore complying with AS 9, interest income is not recognized based on uncertainty involved but is recognized at a subsequent stage when actually realized thereby complying with RBI guidelines as well. In order to ensure proper appreciation of financial statements, banks should disclose the accounting policies adopted in respect of determination of NPAs and basis on which income is recognized with other significant accounting policies.

d. Usage of financial statements in assessing the risk of default for lenders

For banks and financial institutions, both the balance sheet and income statement have a key role to play by providing valuable information on a borrower's viability. However, the approach of scrutinizing financial statements is a backward looking approach. This is because the focus of accounting is on past performance and current positions.

The key accounting ratios generally used for the purpose of ascertaining the creditworthiness of a business entity are that of debt-equity ratio and interest coverage ratio. Highly rated companies generally have low leverage. This is because; high leverage is followed by high fixed interest charges, non-payment of which results into a default.

e. Capital Adequacy Ratio (CAR) of RBI and Basle committee on banking supervision (BCBS)

Based on the Basle norms under the Basle Capital Accord 1988, the RBI also issued similar capital adequacy norms for the Indian banks. According to these guidelines, the banks will have to identify their Tier-I and Tier-II capital and assign risk weights to the assets. Having done this they will have to assess the Capital to Risk Weighted Assets Ratio (CRAR). The minimum CAR which the Indian banks are required to meet is set at 9 percent. It should be taken into consideration that the bank's capital refers to the ability of bank to withstand losses due to risk exposures.

The Basel Committee on Banking Supervision (BCBS) has also laid down certain minimum risk based capital standards that apply to all internationally active commercial banks. That is, bank's capital should at least be 8% of their risk-weighted assets. This in fact helps bank to provide protection to the depositors and the creditors.

f. Capital Adequacy Ratio-Strengthening Further

The one important parameter that essentially relates to the bank's ability to sustain the losses due to risk exposures is the bank's capital. The intermediation activity exposes the bank to a variety of risks. Cases of big banks collapsing due to their bank's inability to sustain the risk exposures are readily available. Considering this, it is highly essential to examine the capital vis-á-vis the risk weighted assets. This is the Capital to Risk Weighted Assets Ratio (CRAR) as given by the Basle Committee.

This will indicate the comparative performance of a bank in relation to each group and the banking system as a whole. But if one prepares the comparative statistics for one's bank for the last three years, it will also indicate the direction in which his/her bank is progressing.

Current Status of NPA's and Indian Banks – A Statistical Introspection

Indian Banking in 2002 represents a sea change from what it was a preceding decade. It is a decade of Professional banking moving towards global standards. NPA in immediately after reform era began was a nightmare. Today it is still a problem (albeit a major problem, but under process of apparently firm control). Banks in general have performed extremely well in 2001-02.

In 1992-93, "the profitability of the PSBs as a group turned negative with as many as twelve nationalised banks reporting net losses[12]. By March 1996, the outer time limit prescribed for attaining capital adequacy of 8 per cent, eight public sector banks were still short of the prescribed Limit." The public sector banks which suffered losses of Rs.3,293 crore in 1992-93 and Rs.4,349 crore in 1993-94, i.e. in the initial years of introduction of prudential norms, have ended the year 1997-98 with a net profit of Rs.5027 crore. Net NPAs of public sector banks formed 8.2% of the net advances and 3.3% of the total assets as at the end of March 1998. Corresponding figures as at 31.03.2002 is 5.82% and 2.42%. PSBs recorded an aggregate net profit of Rs.8,301.24 crore in 2001-02. NPAs as at 2001-2002 group-wise can be seen from following table that reveals movement of scheduled banks activities in respect of NPAs:

Table 6*

Non-Performing Assets as Percentage of Total Assets – All Scheduled Commercial Banks									
Sr No	Name of the Bank	Gross NPAs/Total Assets				Net NPAs/Total Assets			
		1998-1999	1999-2000	2000-2001	2001-2002	1998-1999	1999-2000	2000-2001	2001-2002
1	Nationalised Banks	6.83	6.0	5.44	5.21	3.26	3.15	2.95	2.16
2	State Bank Group	6.52	5.88	5.11	4.39	2.94	2.60	2.35	2.00

[12] data is taken from a source called *Personal website of R kannan*

3	Total PSBs	6.71	5.95	5.31	4.89	3.14	2.94	2.72	2.42
4	Private Sector Banks (old)	5.78	5.22	5.14	5.20	3.56	3.27	3.28	3.22
5	Private Sector Banks (new)	2.26	1.60	2.05	3.91	1.59	1.08	1.18	2.10
6	Foreign Banks	3.10	3.16	3.04	2.43	1.10	1.03	0.77	0.82

Table 7*

Non-Performing Assets as Percentage of Total Advances – All Scheduled Commercial Banks									
Sr No	Name of the Bank	Gross NPAs/Total Advances				Net NPAs/Total Assets			
		1998-1999	1999-2000	2000-2001	2001-2002	1998-1999	1999-2000	2000-2001	2001-2002
1	Nationalised Banks	16.02	13.91	12.16	11.01	8.35	7.80	7.01	6.01
2	State Bank Group	15.67	14.08	12.73	11.25	7.74	6.77	6.27	5.45
3	Total PSBs	15.89	13.98	12.37	11.09	8.13	7.42	6.74	5.82
4	Private Sector Banks (old)	13.06	10.78	10.94	11.01	8.96	7.06	7.30	7.11
5	Private Sector Banks (new)	6.19	4.14	5.13	8.87	4.46	2.88	3.09	4.94
6	Foreign	7.59	6.99	6.84	5.38	2.94	2.41	1.82	1.89

	Banks								

[Source: RBI Publication - Trends and Progress in Indian Banking 2002]

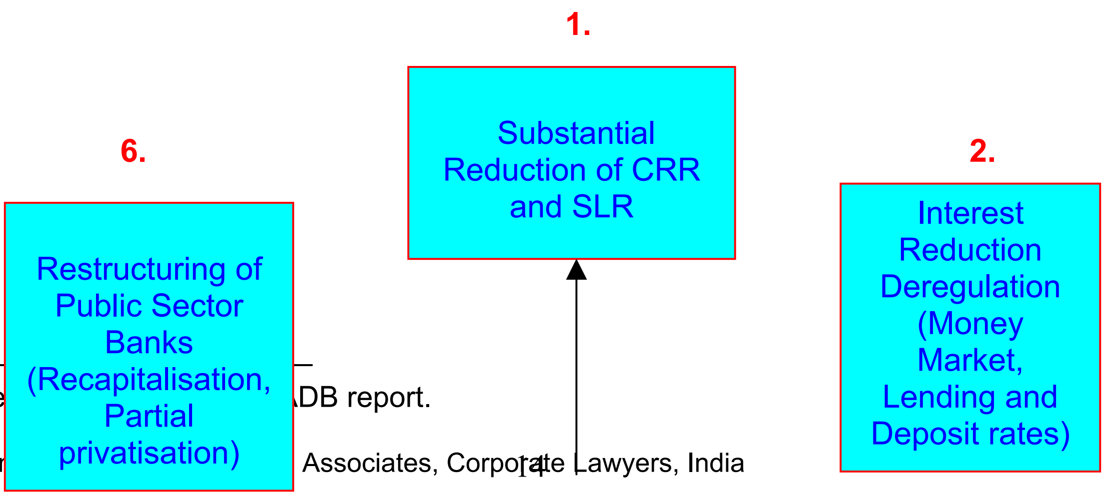
The hangover of the financial crises beginning this century called for urgent restructuring of financial institutions and public banks. That issue has been partly met by the government. In its section on issues and priorities for the economy, the Economic Survey, 2001-2002, considers that "...the time is now ripe for further development of the financial sector." It also candidly summarises the primary issue in this sector. For my inability to express it any better, I quote, "the dominance of public sector finance firms has important consequences for the allocative efficiency of the financial system and for corporate governance in the country. With the domination of public sector finance firms, a controlling interest in many listed companies is effectively held indirectly by the Government...This inhibits the market for corporate control and the development of widely held, board managed, professionally run companies" (Economic Survey, 2001-2002:37).

Measures taken to deal with NPAs

Having discussed the nature, cause, impacts and related issues with regard to NPAs in Indian banking scenario, we shall leap forward to next segment of the article where I shall bring forth various measures taken by the RBI, Government of India and other related agencies with only an aim to contain the ever increasing NPAs arising Indian banking functions and its immediate effect on Indian economy. To begin with, I must say the RBI and Government of India have been hecticly engaged themselves independent of each other to deal with the matter on various counts. Remarkably all that started and giving effects since India came out with reform package under Industrial Policy in 1991. These are discussed below:

Financial & Banking Sector Reforms

Indian Banking Sector (Financial & Legal) Reforms Since Industrial Policy of 1991 to reform Indian banking industry[13]



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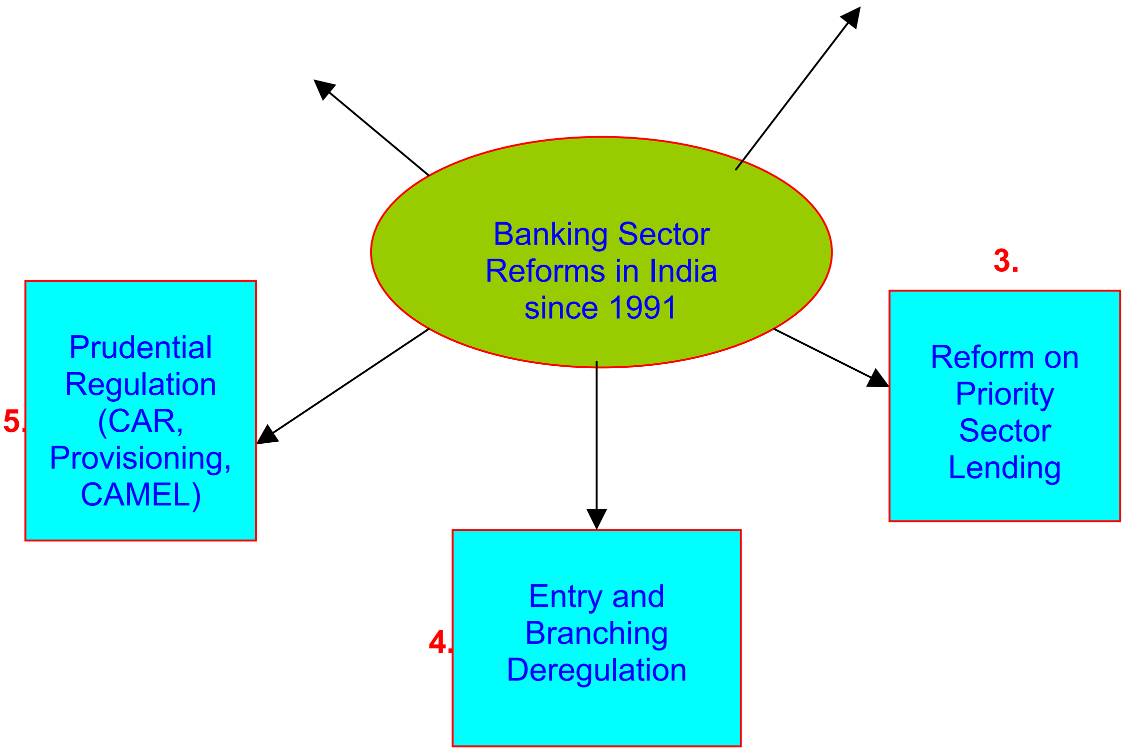


- Dismantling of controls and deregulation of working of commercial banks, permitting entry of new private sector Banks and permission for foreign banks to open more branches are steps that were carried out under banking sector reforms. These steps had the effect of opening Indian banking to global standards by making them to function efficiently in a competitive environment. This is the initial step to create a structural framework for the public sector banks to enable them to adjust to the new environment and turn into dynamic and self-reliant operating units.

- The process of deregulation freed the banks from the control of the Finance Ministry and RBI. The RBI, hereafter, acts a regulator. In the year 1994 RBI further fine-tuned the process by constituting a separated a Board of Financial Supervision (BFS) with the objective of segregating the supervisory role from the regulatory functions of RBI. Banks now operate independently in a competitive financial market, but have to comply with prudential norms and safeguards essential for their well-being.

- RBI in the year 1993 introduced prudential norms[14] as conveyed by Basel Accord of 1988 applicable to Indian banks. These included standards relating to Capital Adequacy, Income Recognition, Asset Classification and Provisioning for non-performing assets. This had the effect of providing a much-needed transparency with regards to the state of affairs of each bank and enabled instant corrective measures to be executed.

- Banks were permitted to seek infusion of fresh equity from the public retaining Government share of equity capital at 51%. A number of PSBs entered the

[14] For details of the said prudential norms, one can see schedule 2.

market and raised Tier I and Tier II capital accordingly. This has created a new class of stake-holder (albeit share-holders) vitally interested in the well being of the banks and qualified/empowered to question the Board of Directors at the appropriate forum.

- Norms of Corporate Good Governance: Corporate Governance, a phenomenon of recent origin in the wake of increasing competition and globalization, stipulates parameters of accountability, control and reporting functions of the Board of Directors and encompasses the relationship among various participants in determining the direction and performance of the corporation, the Board, management team, shareholders and other stake-holders. RBI emphasises the paramount importance of accepting this discipline by Banks. While SEBI has introduced a general set of norms applicable to all companies including banking companies, RBI has further covered the special needs of banking companies by appointing a group of experts under chairmanship of Dr. A. S. Ganguly and bring out appropriate set of standards, to make recommendations towards more effective functioning of bank boards. The Group was 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 submit recommendations for making the role of Board of Directors more effective with a view to minimising risks and over-exposure. PSBs and other commercial banks are now asked to implement the recommendations.

- In order to expedite credit and investment decisions by banks and financial institutions, and curb the accretion of fresh NPAs, Credit Information Bureau (India) Ltd., (CIBIL) was set up by State Bank of India in association with HDFC in August 2000, The CIBIL was to be technology driven to ensure speedy processing, periodic updating and availability of error-free data at all times in the system. As a first step towards activating the Credit Information Bureau (CIB), it was decided to initiate the process of collection and dissemination of some relevant information, within the existing legal framework. The RBI accordingly decided to constitute a Group drawing representation from CIB, Indian Banks' Association (IBA), select banks and FIs to examine the possibility of the CIB performing the role of collecting and disseminating information on the list of suit-filed accounts and the list of defaulters, including willful defaulters, which is presently handled by the Reserve Bank. The Group is expected also examine the other aspects of information collection and dissemination, such as, the extent, periodicity and coverage including the feasibility of supplying such information on-line, to members in future.

- Norms of Lenders' Liability: While successfully piloting the "The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Bill" in the houses of the Parliament by way of moderating the possible misuse of the powers under the legislation by Banks and Financial Institutions, the Finance Minister gave an assurance to bring out a code of Fair Practices defining Lenders Liability to the borrowers in respect of loans and advances extended by them. Consequent to the assurance by the Finance Minister, RBI during December, 2002 has come out with broad guidelines for framing the Fair Practices Code with regard to lenders' liability " to be followed by commercial banks and financial institutions, emphasising on transparency and proper assessment of borrowers' credit requirements". RBI has issued a draft of the model code and has advised the individual banks to adopt model guidelines for framing their respective Fair Practices Code with the approval of their Boards. This is a balancing measure. It imposes a self-discipline on the part of the Banks, which indirectly will only prevent accounts turning into NPA on account of Bank's own failures or wrong actions. (details can be seen from schedule 6 or from the RBI's official website www.rbi.org.in)

- Risk Assessment & Risk Management: There can be minimum risk in a captive controlled economy, where industry is protected by high tariff walls and banks by directed credit and directed interest rates, and directed investments. But along with such minimum risk, there would also be minimum growth of the economy. In India after total regulation for several decades, the economy witness around 3% average growth. The changing environment, on account of on-going process of liberalisation and reforms all round, of easing of import restrictions, resulting in an emerging New Indian Economic Order (NIEO) increases risks content whilst also unfolding new opportunities.

  Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. All these decades before the advent of reforms the exercise of risk assessment and risk management were never seriously considered or attempted, as the banks were operating in a captive economy.

  Since the year 1998, the RBI have been making serious efforts towards evolving suitable and comprehensive models for Risk-management by the Banks and to integrate this new discipline in the working systems of the Banks. The RBI has identified risk-prone areas in Asset-Liability Management, Credit Management, Changes in Market conditions and counter-party & Country Risks and has evolved suitable models for managing all such risk. RBI has also evolve a system of Risk based Supervision Banks. It also advised banks a parallel scheme for carrying out internal audit based on risk perception.

- e-banking & VRS: The influence of these areas of banking reforms may not appear directly relevant for handling reduction of NPAs. But computerisation provides for data-accuracy and operational efficiency and results in better Management Information Service (MIS). VRS rationalises the work force, which in turn results in better productivity and operational efficiency.

- Banks were told to hone credit skills to contain NPAs. The RBI in a circular November 2002 had said that increasing provisioning of already impaired assets and close monitoring of credit at the levels of sanction, disbursement and operations should be the priority for banks in the country.

- Even though RBI has expressed satisfaction over the sustained efforts of public sector banks in recovering problem loans, it has said the provisioning for NPAs of PSBs in fiscal year ended March 31, 2002, was only 42.5 per cent of gross NPAs. The current level of coverage is quite low against international standards, which are often as high as 140 per cent and, full provisioning towards already impaired assets needs to be a priority corporate goal.

- RBI made it clear in the report that it is not in favour of banks sustaining themselves on trading profits. While asking banks to follow a "more prudent policy on investments", the regulator goads them to sharpen their skills in credit assessment and disbursement.

- Suggesting an integrated approach by the banking system to identifying and dealing with defaults, the RBI says that the method of NPA management should be "multi-pronged, necessitating varied strategies suited to different stages" of passage of credit facility. Recognising a menace that bankers have always been trying to tackle - - unscrupulous borrowers playing one bank against the other - - the regulator says, "The banking system ought to be so geared that a defaulter in one place is recognised as a defaulter by the system" for which exchange of credit information is of utmost importance.

  The central bank, apart from stiffer asset classification norms it has said would introduce, has suggested, "although not commonly practised, it might be desirable to include other criteria, some of which exhibit forward-looking features.

- RBI has also cautioned banks on the use of gains from sale of investments. It has advised banks "to follow a more prudent policy for utilising the gains realised on sale of securities arising from decline in interest rates and also for building up adequate reserves to guard against any possible reversal of interest rate environment due to unexpected developments". Accordingly, banks are required to build an investment fluctuation reserve (IFR) of minimum 5 per cent of all investments in the `held for trading' and `available for sale' categories within five years. As on March 31, 2002, the IFR of all the banks put together stood at Rs 3,223 crore or 0.71 per cent of the total investment of Rs 4,54,000 crore. Of the total investments, the State Bank of India group alone accounted for Rs 1,85,587 crore against which it has set aside Rs 1,228 crore in IFR or a coverage of 0.66 per cent. (Details of such circular can be accessed from the RBI’s official website www.rbi.org.in)

- RBI Guidelines on Fair Practices Code for Lenders applicable to SCBs/AIFIs (excluding RRBs and LABS): According to the "fair practices code", which is at the core of the lender liability, the lenders must treat their borrowers fairly, and when they do not, they can be subject to litigation by the borrower for a variety of reasons, inter alia, two broad categories - breach of contract, breach of fiduciary duty, fraud and misrepresentation, negligent loan processing and administration.

- Consequent to the assurance by the Finance Minister, RBI during December 2002 has come out with broad guidelines for framing the Fair Practices Code with regard to lenders' liability " to be followed by commercial banks and financial institutions, emphasising on transparency and proper assessment of borrowers' credit requirements". (Details can be seen from schedule 6 or from the RBI's official website www.rbi.org.in)

As regards internal factors leading to NPAs, the onus rests with the banks themselves. This calls for organisational restructuring, improvement in managerial efficiency, skill upgradation for proper assessment of creditworthiness and a change in the attitude of the banks towards legal action which is traditionally viewed as a measure of the last resort. These are the elements on the agenda of the second phase of reforms.

Compromise settlement schemes

- 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 PSBs for one time non-discretionary and non-discriminatory settlement (OTS) of NPAs of small sector. The scheme was operative up to 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 (RESERVE BANK OF INDIA, BP.BC.11/21.0.040/99-00, July 27, 2000, Guidelines for recovery of dues relating to Non-Performing Assets (NPAs) of public sector banks). [The above guidelines which were valid up to June 30, 2001 helped the public sector banks to recover Rs. 2600 crore by September 2001 which can be accessed from the RBI's official website www.rbi.org.in)]

- 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.

- Guidance Notes for Securitisation Companies and Reconstruction Companies Reserve Bank of India: RBI has framed Guidelines and Directions to Securitisation Companies and Reconstruction Companies relating to registration and other matters pertaining to their working viz; prudential norms relating to income recognition, classification of assets, provisioning, accounting standards, capital adequacy, measures for asset reconstruction, deployment of funds and acquisition of financial assets.

  The Bank recognizes the fact that since the asset reconstruction activity mainly centers around non-performing loan assets, the whole process of asset reconstruction and matters related thereto has to be initiated with due diligence and care warranting the existence of a set of clear instructions which shall be complied with by all Securitisation Companies or Reconstruction Companies so that the process of asset reconstruction proceeds on smooth and sound lines. In addition, there is a need for specific guidance to these companies on certain matters. Accordingly, the Bank has framed a set of guidance notes listed below in certain matters, which are recommendatory in nature. (Details can be seen from schedule 14 and 15 or from the RBI's official website www.rbi.org.in)

- Circulation of information on defaulters: The RBI has put in place a system for periodical circulation of details of willful 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 outstanding aggregating Rs. 1 crore and above) against whom suits have been filed by banks and FIs for recovery of their funds, as on 31st 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. (RBI Circular on Wilful defaulters and action thereagainst, numbered DBOD. No.. DL(W).BC. /110 /20.16.003(1)/2001-02), May 30, 2002 which can be seen from schedule 13 or from the RBI's official website www.rbi.org.in).

- 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 willful default of Rs 1 crore and above and file suits in such cases, and file criminal cases in regard to willful 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 also contemplating several supporting measures including legal reforms, some of them I would like to highlight.

- Special Mention Accounts: In a recent circular, RBI has suggested to the banks to have a new asset category - `special mention accounts' - for early identification of bad debts. This would be strictly for internal monitoring. Loans and advances overdue for less than one quarter and two quarters would come under this category. Data regarding such accounts will have to be submitted by banks to RBI. However, 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. An asset may be transferred to this category once the earliest signs of sickness/irregularities are identified. This will help banks 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 categorised and reported as such, proper top management attention would also be ensured. 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 prevent the need to route the additional funding request through the controlling offices in deserving cases, and help avert many accounts slipping into NPA category.

- The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003[15]: The Bank is in the process of framing a set of standard guidelines in the matter of takeover of the management, sale or lease of whole or part of the business of the borrower. Securitisation Companies and Reconstruction Companies are, therefore, advised to refrain from exercising the measures of take over of management, sale or lease of the borrowers' business as provided for in Section 9 of the Act, until guidelines in this regard are notified by the Reserve Bank of India. As regards enforcement of security interest, Securitisation Companies and Reconstruction Companies may follow the Security Interest (Enforcement) Rules, 2002 notified by the Government of India as also the relevant provisions in the Act.

- RBI guidelines on classification of bank advances: Reserve Bank of India (RBI) has issued guidelines on provisioning requirement with respect to bank advances. In terms of these guidelines, bank advances are mainly classified into:

  Standard Assets: Such an asset is not a non-performing asset. In other words, it carries not more than normal risk attached to the business.

[15] Details can be had from schedule 14 and 15 or from the RBI's official website www.rbi.org.in)

Sub-standard Assets: It is classified as non-performing asset for a period not exceeding 18 months

Doubtful Assets: Asset that has remained NPA for a period exceeding 18 months is a doubtful asset.

Loss Assets: Here loss is identified by the banks concerned or by internal auditors or by external auditors or by Reserve Bank India (RBI) inspection.

In terms of RBI guidelines, as and when an asset becomes a NPA, such advances would be first classified as a sub-standard one for a period that should not exceed 18 months and subsequently as doubtful assets.

It should be noted that the above classification is only for the purpose of computing the amount of provision that should be made with respect to bank advances and certainly not for the purpose of presentation of advances in the banks balance sheet.

The Third Schedule to the Banking Regulation Act, 1949, solely governs presentation of advances in the balance sheet. Banks have started issuing notices under the Securitisation Act, 2002 directing the defaulter to either pay back the dues to the bank or else give the possession of the secured assets mentioned in the notice. However, is a potential threat to recovery if there is substantial erosion in the value of security given by the borrower or if borrower has committed fraud. Under such a situation it will be prudent to directly classify the advance as a doubtful or loss asset, as appropriate.

- 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.

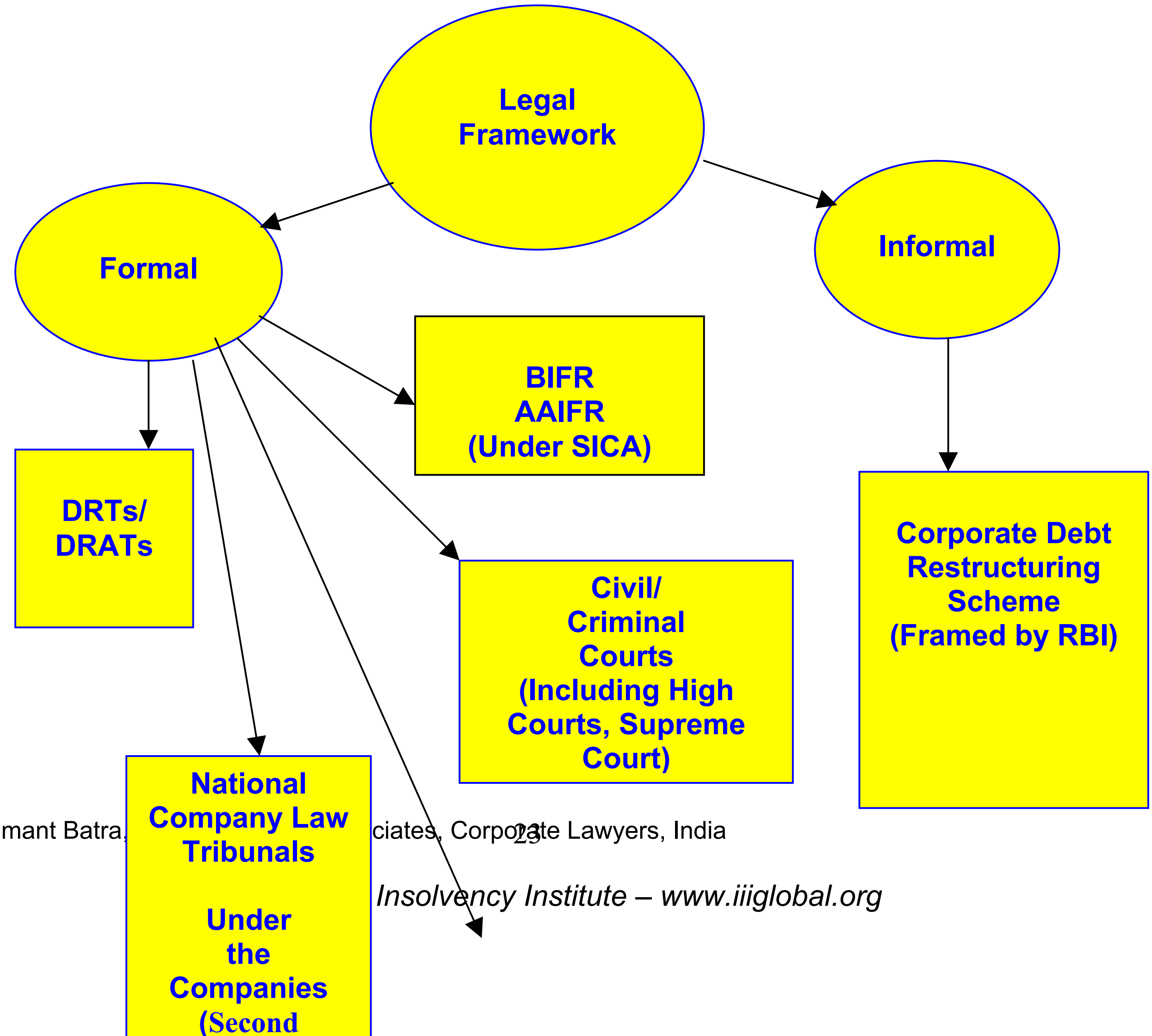
  An asset is considered as "non-performing" if interest or installments of principal due remain unpaid for more than 180 days (the lag would get reduced to 90 days from March 31, 2004 to conform to international norms). Any NPA would migrate from sub-standard to doubtful category after 18 months (as against 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."

RBI has issued detailed guidelines in October 2000 on valuation and provisioning for investment portfolio including credit substitutes.

Legal Reforms

Various legal reforms have been undertaken by the Government to improve the legal framework. Broadly, the formal and informal relevant legal framework is as under:



Company Courts

Formal Framework

Applicable Laws:

The Recovery of Debts Due to Banks and Financial Institutions Act, 1993;

The Recovery of Debts Due to Banks and Financial Institutions (Amendment) Act, 2000;

Code of Civil Procedure, 1908;

Code of Civil Procedure, 2002;

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

The Transfer of Property Act, 1882;

State Financial Corporations Act, 1951;

The Indian Contract Act, 1872;

The Companies Act, 1956;

The Companies (Amendment) Act, 2002;

The Negotiable Instrument Act 1881, and

The Negotiable Instrument (Amendment) Act 1988 and 2003.

The banks and financial institutions can enforce their securities by initiating recovery proceedings under the the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act) by filing an application for recovery of their dues before the DRT constituted under the said Act in various states in India. Once their claim is adjudicated, a Recovery Certificate for the amount found due and payable is issued by Debt Recovery Tribunal. On the basis of the Recovery Certificate, execution proceedings are initiated by the Recovery Officer appointed for facilitating recovery of money under the Recovery Certificate. The DRT Act and the rules and regulations framed there under provide for a self-contained mechanism and procedure for execution of Recovery Certificates. The sale is carried out by auctioneer or by receiver appointed by Recovery Officer under its supervision. DRT has adequate powers to grant injunction against the disposal or transfer or creation of third party interest by debtors in the properties charged to creditor. The DRT has the power to pass attachment orders in respect of charged properties. The power to appoint Receiver or remove any person from possession or custody of the property is also vested with the Tribunals. The execution proceedings before the Tribunals involve attachment of charged properties and sale thereof by way of public auction. The power to appoint Receiver for the properties is also available. In case of non realization of the decreed amount by way of sale of charged properties, the personal properties of the guarantors/sureties of the debtor company can also be attached and sold.

For claims below Rupees Ten Lakh (One Million Rupees), the banks and financial institutions are required to initiate proceedings under Code of Civil Procedure, 1908, as amended from time to time, in a Civil Court. The execution is carried out under Code of Civil Procedure. Under the Code of Civil Procedure, the Courts are empowered to pass injunction order restraining the debtor through itself or through its directors, authorized representatives, agents etc. from disposing of or parting with or dealing in any manner the subject property. The Courts are also empowered to pass attachment and sale order for subject property before judgment in case necessary. The procedure for execution of judgments/decrees is also very well laid down in the Code. In execution proceedings the powers for arrest or deposit of security amount are also been given to the Courts. The procedure for sale of subject property has also been well laid down. The sale of subject property is normally carried out by way of open public auction subject to confirmation of the Court. The provisions for appointment of Receiver and foreclosure, sale or redemption of mortgaged property by the Court and the procedure thereto have also been laid down in the Code.

The foreclosure proceedings, where DRT Act is not applicable, can be initiated under The Transfer of Property Act, 1882 by filing a mortgage suit where the procedure is the same as laid under Code of Civil Procedure.

State Financial Institutions established under the provisions of the State Financial Corporations Act, 1951 have been granted the rights to take over the management or possession or both of the industrial concern as well as the right to transfer by way of lease or sell and realise the property pledged, mortgaged, hypothecated or assigned to them under Section 29 of the said Act without intervention of the Court in case of default in payment by the borrower.

The enforcement of guarantees (not covered by DRT Act) and pledged security is under the Indian Contract Act, 1872.

The secured creditors, other than banks and financial institutions have to approach the Civil Court for enforcement of security by way of an ordinary suit for recovery or by filing a mortgage suit. In such case, the provisions of Code of Civil Procedure are invoked.

In the event of falure to honour the cheques issued by the borrowers to fulfill his financial obligations, the recovery through a legal notice is empowered by the Negotiable Instrument Act, 1881 and such provisions has been recently in 2003 to help the banks and financial institutions to recover its dues from the defaulters and in process thereby, banks can effectively avoid accumulation of NPAs.

Recent Significant Developments in Law making

In December 2002, the Indian Parliament passed the Companies (Second Amendment) Act, 2002 (Second Amendment) to restructure the Companies Act, 1956 (1956 Act) in a big way leading to the new regime of tackling corporate rescue and insolvency. The provisions of the Second Amendment are, however, yet to be notified and the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) which presently deals with the revival and rehabilitation of companies still remains to be repealed by passing of the Sick Industrial Companies (Special Provisions) Repeal Bill, 2001 by the Parliament. Till then, while the Board for Industrial and Financial Reconstruction (BIFR) set up under SICA continues to deal with revival and rehabilitation of companies, the High Court retains its jurisdiction as the liquidation court under the 1956 Act.

In the same month of the year 2002, the Indian Parliament passed another significant legislation - The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFESI) to regulate, for the first time in the country, the securitisation and reconstruction of financial assets. SARFESI also deals with enforcement of secured interest by secured creditors without the intervention of court.

The Companies (Second Amendment) Act, 2002: A critical analysis of the main provisions

The Companies (Second Amendment) Act, 2002 (Second Amendment) proposes amendment of the provisions of the 1956 Act for setting up of a National Company Law Tribunal[16] (NCLT) and its Appellate Tribunal[17]. Under the proposed legislation, NCLT will have -

[16] A new Part IB (Section 10FB to 10FP) has been incorporated by the Companies (Second Amendment)
Act, 2002.
[17] A new Part IC (Section 10FQ to 10GF) has been incorporated by the Companies (Second Amendment)
Act, 2002.

- The power to consider revival and rehabilitation of companies[18] – a mandate presently entrusted to BIFR under SICA.

- The jurisdiction and power relating to winding up of companies presently vested in the High Court. The winding up proceeding pending in High Courts shall stand transferred to the Tribunal.

- The jurisdiction & power exercised by the Company Law Board under the 1956 Act. The Company Law Board will stand abolished.

A composite law will, therefore, now deal with reorganization and liquidation of companies. The Second Amendment is a sound attempt towards creating a balance between reorganization and liquidation. However, it still remains to be seen as to how effective it proves in providing an orderly exit mechanism for failed enterprises, ending unproductive uses of business assets and transferring them to more efficient market participants.

Composition of NCLT, qualifications of Members & its benches

- NCLT will consist of a President and such number of Judicial and Technical Members not exceeding sixty-two in numbers.
- The President of NCLT will be a former judge or any person qualified for appointment as a High Court Judge.
- The Principal Bench will be located at New Delhi and Benches may be constituted at other places.
- Each of the Benches of NCLT will comprise of atleast a Judicial Member and a Technical Member. The winding up and reorganization matters will, however, be handled by Special Benches having three or more members comprising of atleast one Judicial Member, Technical Member and Member appointed under Labour related category[19].
- While the Judicial Member will be a person who has the prescribed experience as a judicial officer or as a member of Indian legal Services or Indian Company Law Services or has fifteen years experience as a practitioner, the Technical Member will be a person who has requisite experience as a Chartered Accountant, Cost and Works Accountant, Company Secretary etc.

No such qualifications are provided under SICA for appointment of Members with the result that BIFR has become a rehabilitation center for retired bureaucrats. There is no permanent Judge presiding over Liquidation Court and the Chief Justice designates a High Court Judge as a Company Court Judge by rotation of roster.

The Second Amendment seeks to improve upon the standards to be adopted to measure the competence, performance and services of a bankruptcy court by

[18] A new Part VIA (Section 424A to 424L) has been incorporated by the Companies (Second Amendment) Act, 2002.
[19] Section 10FA of the Companies (Second Amendment) Act, 2002.