NON-PERFORMING ASSETS: A THEORETICAL VIEW

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INTRODUCTION

the health of the financial sector is a matter of policy concern, especially in developing countries, where failure in financial intermediation can critically disrupt the development process. there is a link between financial sector stability and its growth. an important insight that emerges from the development in the financial sector in the 1990s is the need to treat financial stability as a dominant objective of macro-economic management and as a necessary, if not sufficient, condition for accelerating economic growth. the introduction of banking sector reforms in 1992 has been a watershed in the indian banking system. to instill the sense of competition among banks, make them financial viable and bring them on par with their foreign counterparts, in the new era of globalization rbi, on the recommendation of the narasimham committee on financial sector reforms have changed the outlook of indian banking by deregulating most of the activities enumerated above.

the committee headed by mr. m. narasimham, submitted its report on november 1991 and second report 1998. though the report covered the financial system of india as a whole, its main thirst was on the banking sector.the reforms have brought about not only structural changes in the indian banking, but also greatly influenced all types of banking entities in various aspects of operations, governance, transparency and accountability. out of various reform measures, the introduction of prudential norms has been the corner stone of banking reform process. the prudential norms cover aspects like income recognition, asset classification and provisioning. the banking sector in india currently, suffers from a number of weaknesses such as high costs, poor management, trade union pressure, political interference and unprofitable branches. an important problem of the commercial banking is the non-performing assets. the top most priority of bank is to manage its npa at the international prescribed level of 5% on a gross basis and 2.5% on the net basis or below.

definition of non-performing assets

an asset, including a leased asset, becomes non performing when it ceases to generate income for the bank. a non-performing asset was defined as a credit facility in respect of which the interest and/or installment of principal has remained 'past due' for a specific period of time. the specified period was reduced in a phased manner. during 1993 and 1994 it was for four quarters and three quarters respectively, but it was two quarters 1995 onwards.

all loans given by banks are classified as either standard or substandard loans.

standard assets: these are performing assets which are being serviced – repayment of principal at the interest rate that is agreed upon – as per the contract.

substandard assets or npas: when the borrower pays neither the interest nor the principal for a specified period of time, the loan is said to be non-performing. when a loan is classified as npa it goes through several phrases as the repayment gets delayed. if the borrower does not pay dues for 90 days, the loan becomes an npa and it is termed as "special mention account". if this loan remains sma for a period less than or equal to 12 months, it is termed as sub-standard asset.

a sub – standard asset requires a provision of 15 per cent on secured portion and 25 per cent on the unsecured exposure. after 12 months as sub-standard asset, it gets classified as doubtful asset-1(da-1) and requires a provision of 25 per cent on secured portion and 100 per cent on the unsecured portion.

once the account crosses one year as da-1, it becomes doubtful asset-2{da-2). once da-2 crosses three years, it becomes doubtful asset-3(da-3), and it requires 100 per cent provision irrespective of the availability of security. it is a loss making asset.

stressed assets

when an asset shows weakness and is likely to become an npa, it is considered a stressed asset.

npas can occur for a variety of reasons:

- bad lending practices.
- slowdown in economy.
- power distribution companies (discoms) could not repay due to government's populist policies of supplying power free or at a very concessional rate.
- steel companies are running losses due to competition from imports.
- infrastructure companies could not get clearances due to environmental reasons, natural calamities, business cycle.
- willful defaulters due to crony capitalism.

high levels of npas means:

banks' profitability diminishes.

precious capital is locked up.

cost of borrowing will rise as lendable assets shrink

stock prices of banks will go down and investors will lose

investment in economy suffers

if banks have to close down, employees and depositors lose

budget comes under pressure as bailouts have to be given

due to the improvements in the payment and settlement systems, recovery climate, upgradation of technology in the banks etc., it was decided to dispense 'past due' concepts with effect from march 2001. accordingly, from that date an advance shall become npa where interest and / or installment of principal remain overdue for a period of more than 180 days.

with a view of moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days overdue' norm for identification of npa from the year ending march 31, 2004, a non performing asset shall be a loan or an advance where,

- interest and / or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- the account remains 'out of order' for a period of more than 90 days in respect of an overdraft/ cash credit (od / cc)
- the bill remains overdue for a period of more than 90 days in the case of banks purchased and discounted.
- interest and / or installment of principal remains overdue for two harvest seasons but for a period not exceeding two and half years in case of an advance granted for agricultural purposes and
- any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

npas have a serious strain on the profitability as banks cannot book income on such accounts, while their funding cost and provisioning requirements are charged on their profits. npas constitute a real economic cost to the nation. so, npa have a direct impact on the banking profitability, liquidity and equity. among the various npa causing factors, defective legal system as well as ineffective npa management are two prime factors. the biggest ever challenge that the banking industry now faces is the management of npas. so, the banking governance should be given prime importance to tackle the mounting problems of npa.

what is being done for npa

provisioning

capital adequacy norms according to basel 3

sarfaesi act

arcs

foreclosure

one-time settlement

interest waiver

write-offs/write-downs

debt recovery tribunals

banking regulation act

recapitalization bonds

CONCLUSION

the quality of loan asset is one of the most vital factors for ascertaining the basic viability of the banking system. the mounting bank advances have made it very much essential for critical examination of the trend of npas of bank. it is impossible to eliminate npas totally in the banking business owing to externalities, but their incidence can be minimized. to take care of this problem on a long term basis a strategic planning should be broadly adopted.

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