

Concept of Non-Performing Assets in Banking Industry and its application under SARFAESI Act

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In post reform era of Banking Industry, many changes in accounting standards like introduction of Asset Classification and Income Recognition were brought.

The introduction of concept of N.P.A. has been one of the most important change where entire system of accounting in loan accounts was re-written.

NPA is a loan account which becomes non-viable, non-performing in terms of the guidelines given by RBI. NPA arises because of mismatch between asset and liability; it represents an amount receivable and realizable by the Bank. In that sense, it is an asset in the hands of creditor. Introduction of NPA concept proceeds on the basis that the liability of borrower to repay has crystallized; that the debt has become due & that because of delay the account of borrower has become sub-standard and non-performer and non-income earning. The policy of income recognition is based on the 'record of recovery'. Income from NPAs is not recognized on accrual basis but is booked as income only when it is actually received.

It is noticeable that presently, every quarter, Banks have been projecting more and more grim picture in their financial results. This has not only been sending shivers down the spine of respective Banks but it has also been raising serious concerns for the regulator and the policy makers.

The gross NPA ratio of the Banks has witnessed sharp increase from 2.90 % as on 31st March, 2012 to 3.40 % as at end of March, 2013. Similarly, the Net NPA ratio has gone up from 1.30 % to 1.40 % during the same period.

Actually, an N.P.A. (Non Performing Asset) is a status in the books of a Bank wherein the assets i.e. the loans stop earning interest because the borrower has not been repaying the interest on time and/or not repaying the principal or the installment due.

As per norms of vogue, an NPA account after one year of its classification as NPA gets categorized as Doubtful. Consequently, the level of provision gets increased to different levels and with the passage of time for the accounts remaining under NPA category, the provisioning reaches up to the level of 100 percent.

Once a loan account is classified as NPA, the unrealized interest that was taken to Profit & Loss account on accrual basis shall be reversed.

A non performing asset is a credit facility in respect of which the interest and/or installment of principal has remained past due for a specified period of time unless it has been upgraded in accordance with the guidelines/circulars of the Bank. The terming of an account as N.P.A. has no link with the value of the secured asset. No debt or no account of a debtor is liable to be classified as a NPA without duly following the RBI guidelines.

Though the policy has been laid down by the Reserve Bank of India providing guidelines in the matter for declaring an asset to be NPA which requires Bank should establish

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appropriate systems to eliminate the tendency of delay or postpone the identification of NPA "RBI's prudential norms on income recognition, asset classification & provisioning pertaining to advances" were declared in the year of 2001

Now firstly we will discuss the norms according to which a borrowal account is declared as Non-Performing Asset. If any credit facility granted becomes non-performing, then the Bank will have to treat all the credit facilities granted to that borrower as non-performing without having any regard to the fact there may exist certain credit facilities to the borrower having a performing status. As per the guidelines, Banks are required to classify non-performing assets into three categories based on the period for which the asset has remained non-performing and the realisability of the dues.

1. Sub-standard assets category:

A sub-standard asset would be one which has not earned interest actually for a period less than or equal to 12 months. It indicates credit weakness and scope for loss if deficiencies are not corrected. These assets attract provisioning in the range of 15 % to 25 % of outstanding liabilities depending on realisability of securities available to the Bank.

2. Doubtful assets category:

An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. These assets carry higher provisioning compared to sub-standard assets, which ranges from 25 % to 100 % depending on the security available and age of the asset remained under doubtful category.

3. Loss assets category:

A loss asset is one where loss has been identified by the Bank or internal or external auditors or the Reserve Bank of India inspection but the amount has not been written off wholly. It is considered as uncollectible and warranted to continue as bankable asset since there is little scope for salvage or recovery value. It attracts 100 % provisioning.

Where a borrower has been granted multiple credit facilities; as per the existing norms, if any one facility becomes NPA, all other facilities have to be treated as NPA.

Classification of a loan account as NPA Block, brings with it some inevitable consequences. From the date an account is classified as NPA, no interest can be taken into the income head. Even the income taken by way of interest after the date of NPA classification of the account has to be reversed till it is actually realized – meaning thereby stoppage of current income.

Secondly, Provision (which is nothing but a portion of already earned profits or income from other accounts) at the rate ranging from 20-100 percent (depending upon the period an account remains under NPA category) of the entire loan amount classified as NPA has to be made- meaning thereby a strain on profits of Creditor Institution or Bank.

Extra capital is to be provided for that portion of NPA amount which is not covered by the value of the security held against the loan – meaning thereby another strain to get additional capital from the view point of Creditor / Bank.

Time and money to be spent on following up the borrower and to take up legal, non-legal measures like persuasion, one time settlement (OTS) – meaning thereby avoidable wastage of resources- yet another drain.

Stoppage of recycling of funds which otherwise could have been lent to other needy ones and thus stoppage of revolving income. Thus liquidity of funds for lending is reduced.

The problem of NPAs in the Indian Banking system is one of the foremost and the most formidable problems that had impact the entire banking system. Higher NPA ratio reduces the confidence of investors, depositors, lenders etc. It also causes poor recycling of funds, which in turn will have deleterious effect on the deployment of credit. The non-recovery of loans affect not only further availability of credit but also financial soundness of the Banks.

Stoppage of churning of funds causes slackness in the economy of the country. Simultaneously interest income is also reduced for the Creditors/Banks.

NPAs put detrimental impact on P&L account as Banks stop to earn income on one hand and attract higher provisioning compared to standard assets on the other hand. On an average Banks are providing around 25 % to 30 % additional provision on incremental NPAs which has direct bearing on the profitability of the Banks.

Due to high NPAs, Banks tend to lower the interest rates on deposits on one hand and likely to levy higher interest rates on advances. As per Basel norms, Banks are required to maintain adequate capital on risk-weighted assets on an ongoing basis. Every increase in NPA level adds to risk weighted assets which warrant the Banks to share up their capital base further. Capital has a price tag ranging from 12 % to 18 % since it is a scarce resource.

Normally share holders are interested to enhance value of their investments through higher dividends and market capitalization which is possible only when the Bank posts significant profit through improved business. The increased NPA level is likely to have adverse impact on the Bank business as well as profitability thereby the shareholders do not receive a market return on their capital and sometimes it may erode their value of investments. As per present guidelines, Banks whose Net NPA level is 5 % and above, are required to take prior permission from Reserve Bank of India to declare dividend and also stipulate a cap on dividend payout.

Rising incidence of NPA has a cascading impact on several financial ratios of the concerned Banks *viz.*, Net Interest Margin, Return on Assets, Profitability, Dividend Payout, Provision Coverage Ratio, Credit Connection etc. which may be likely to erode the value of all stakeholders including shareholders, depositors, borrowers, employees and public at large. Having discussed the definition, its impact on balance sheet, interest management, loan portfolio now we will discuss concept of NPA as it can be understood in relation to SARFAESI Act. There is nothing in the provisions of the SARFAESI Act which mandates a particular and formal process for classifying an account as NPA. What all the statute obligates is that the classification should be in harmony with the direction or guidelines issued by Reserve Bank of India relating to classification of assets. Such a classification may, in a case, be expressed in formal internal declaration. However that course of action does not appear from the text of the SARFAESI Act to be a condition precedent. No statutory format, express or by necessary implication, that requires Bank to follow a particular or formal procedure or requires a formal declaration as a condition precedent to classification of debt as NPA.

Under SARFAESI Act, to become an account Non-Performing Assets, the account must be of a borrower as defined in Section 2(f) which runs as follows :

Section 2(f): “borrower” means a person who has been granted Financial assistance by any Bank or any financial institution who has given any guarantee or created any mortgage or pledge as security for the financial assistance granted by any Bank or financial institution and includes a person who becomes a borrower of a securitization company or Reconstruction company consequent upon acquisition in relation to such financial assistance.

The default envisaged under the SARFAESI Act is defined under Section 2(j) which runs as follows:

Section 2(j) “default” means non payment of any principal debt or Interest thereon or any other amount payable by a borrower to any secured creditor consequent upon which the account of such borrower is classified as non-performing asset in the books of account of the Secured creditor

Further, such default must be not only of a borrower defined under Section 2 (f) of the SARFAESI Act but also in relation to a financial assistance as defined under Section 2(k) which runs as under:

Section 2(k) – “financial assistance” means any loan or advance grant or any debentures or bonds subscribed or any guarantees given or letter of credit established or any other credit facility extended by any Bank or financial institution.

Financial assets as defined in Section 2(l) must back the financial assistance as defined under Section 2(k). Section 2 (l) runs as under:

Section 2 (l): “financial asset” means debt or receivables and includes—

- (i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or
- (ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or
- (iii) a mortgage, charge, hypothecation or pledge of movable property; or
- (iv) any right or interest in the security, whether full or part underlying such debt or receivables, or
- (v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent, or
- (vi) any financial assistance;

Thus defining every concept, the Act has put limitations on the meanings which are self explanatory. Classifying the accounts as NPA is a condition precedent for issue of notice of demand under Section 13 (2) of the SARFAESI Act. Doubts in asset classification due to any reason are to be settled through specific internal channels within one month from the date on which the account would have been classified as N.P.A. as per Reserve Bank of India guidelines

A study of the definition shows the classification of account as sub-standard, doubtful or loss asset is a must before taking any action under Securitisation Act. This is noticeable that the borrower is entitled to be informed and any doubt or dispute is to be settled between the Secured Creditor/Bank and the borrower through any specific channel and even if there exist no specific internal channel to settle the dispute/doubt, the borrower is entitled to be informed and to get an opportunity to explain or represent against the intended classification of his account as N.P.A.

Once an account is classified as NPA then the account continues to remain NPA even if there is part payment unless upgraded by Bank or Financial Institutes in its books.

So far as adjustment of subsidy granted by Govt. or any other agency in loan account of borrower is concerned, it is noticeable that subsidy under schemes of Government to encourage the entrepreneurs can be availed on the satisfactory performance of the business. And as per norms the subsidy is to be paid to Bank adjustable to loan account if regular. When loan account become irregular and turns in Non-Performing Asset the Bank cannot adjust subsidy in loan account.¹

Though non-serving of interest will turn a loan account into N.P.A. category but a decision has to be taken at Bank level in this regard by appropriate authority classifying the account in respective category. An account can be classified in banking by any of the following methods.

Firstly – By marking the account on ledger as NPA by branch official who is dealing or otherwise authorized to do so in normal routine course of business.

Secondly – By being declared as NPA by any authority of banking system; like internal auditor or external auditor or Inspectors of R.B.I. etc.

No doubt that the above should be in tune with RBI guidelines.

It is the first step towards recovery of Bank dues. By classifying the accounts as NPA, the bank declares that it will proceed for recovery of its dues in its entirety. On the other side such classification will put the borrower on warn for adjusting the dues. Classifying the account as NPA will show that it has intention to adopt the various forms like recovery through Debt Recovery Tribunal, Securitization or declaration as willful defaulter.

Under the Securitisation Act, the amount of NPA is open for verification by the borrower. The Bank has to state in Demand notice under Section 13 (2) about the amount due. It has to be stated with reasonable certainty.

Before DRT Lucknow a case came with the facts that the term loan of first phase was released for Rs. 2.35 lacs but second phase of Rs 1.30 lacs was not disbursed as the applicant failed to fulfill the terms and conditions of the agreement of the loan. The Bank recalled the loan disbursed in first phase and proceedings under the Act were initiated after declaring the account as NPA. In the minutes of meeting dated 1st June, 2005 between the borrower and the Managing Director of the Bank, it was agreed that repayment of interest and installments shall start after three months and six months respectively after start of commercial activity. Since the start of commercial activity has to be necessary after the meeting dated 1st June, 2005 the account cannot be declared NPA after 180 days because the due date of repayment shall be after six months from the date of start of commercial activity of the borrower. Therefore, DRT held the account could not be classified as NPA in the month of August, 2005 as per RBI guidelines. The Bank has wrongly classified the same² Special care has to be taken in the cases where borrower is enjoying more than one facility. The date of NPA may be different in each case. Guidelines for N.P.A. may differ from Bank to Bank. The only restriction under the Act is that the account must be N.P.A. in accordance with R.B.I. or any other authority prescribed by law for the purpose. Summarizing the above we may said that though it is cumbersome for Banks to declare a loan account as N.P.A. in their books but the concept having

been adopted by the legislature under SARFAESI Act, a balance has been struck out between the conflicting interest of Banks and their defaulters. Having been changed from an accounting concept to statutory concept, the N.P.A. concept has been given a recognition that will stay long and will be pivotal for accounting for borrowal accounts in Bank.

Endnotes:

1. *Radhey Sham Gupta v. Bank of Baroda & Others* 2010 (2) Bank CLR 400 (DRT Luck)
2. *Rajmahal Hotel v. Central Bank of India*, 2006 (1) Bank CLR 647.