

NON-PERFORMING ASSETS

NPA's – An overview

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INTRODUCTION

Even as a global phenomena in banking, some NPAs are bound to exist and are inevitable because of the very nature of bank's business in dealing with people and money and giving support to growth of the economy, but these are supposed to be generally within manageable limits. NPAs whether secured or unsecured initially become bank's burden, but gradually the burden of the financial system and then finally the burden of economy. Implications of NPAs are erosion of (both assets and liquidity) balance sheets of banks effecting owners, depositors, employees, good borrowers, general customers, general public and the economy. Banks have to make provisions on advances depending on the classification of assets ranging from 10 to 100 per cent. There is a link between Capital Adequacy and provisioning. The criterion of Capital Adequacy will have to be met after ensuring that adequate provisions have been made. The task of reaching Capital Adequacy is truly difficult. Capital Adequacy Ratio (CAR) also known as Capital to Risk (Weighted) Assets Ratio (CRAR) i.e. it is a ratio of a bank's capital to its risk. There is an inverse relationship between profitability and CAR/CRAR. Higher CAR reflects that, higher amount of money remains idle causing loss of interest income to the bank. If CAR is high all the times it is not good for bank because bank's large amount of money is stuck in provisions or risk management or the business is exposed to interest rate fluctuations and it is an indication that the bank is likely to become sick very soon. Therefore NPAs for the above said reasons are not bankable assets because not only the income interest on the loan asset is lost but also that, they warrant certain per cent of the amount (out of profit) for their maintenance in the books of the bank.

It is relevant in this context to refer to paragraph no. 63 of the judgment of Supreme Court in (*Transcore vs. Union Of India & Anr. : AIR 2007 SC712*) which is extracted and reproduced here under:-

63. Therefore, when Section 13(4) talks about taking possession of the secured assets or management of the business of the borrower, it is because a right is

created by the borrower in favour of the bank/ FI when he takes a loan secured by pledge, hypothecation, mortgage or charge. For example, when a company takes a loan and pledges its financial asset, it is the duty of that company to see that the margin between what the company borrows and the extent to which the loan is covered by the value of the financial asset hypothecated is retained. If the borrower company does not repay, becomes a defaulter and does not keep up the value of the financial asset which depletes then the borrower fails in its obligation which results in a mis-match between the asset and the liability in the books of the bank/ FI. Therefore, Sections 5 and 9 talks of acquisition of the secured interest so that the balance sheet of the bank/ FI remains clean. Same applies to immovable property charged or mortgaged to the bank/ FI. These are some of the factors which the Authorised Officer of the bank/ FI has to keep in mind when he gives notice under Section 13(2) of the NPA Act. Hence, equity, exists in the bank/FI and not in the borrower. Therefore, apart from obligation to repay, the borrower undertakes to keep the margin and the value of the securities hypothecated so that there is no mis-match between the asset-liability in the books of the bank/FI. This obligation is different and distinct from the obligation to repay. It is the former obligation of the borrower which attracts the provisions of NPA Act which seeks to enforce it by measures mentioned in Section 13(4) of NPA Act”

As can be seen from the above paragraph in the judgment, it is the duty of the borrower to see that the margin between what he borrows and the extent to which the loan is covered by the value of the financial asset hypothecated is retained. If the borrower company does not repay and becomes a defaulter and does not keep up the value of the financial asset which depletes, then the borrower fails in its obligation which results in a mismatch between the asset and the liability in the books of the bank/FI. Therefore, apart from obligation to repay, the borrower is supposed to keep the margin and the value of the securities hypothecated so that there is no mismatch between the asset-liability in the books of the bank/FI. This obligation is different and distinct from the obligation to repay. If it is the former obligation of the borrower which attracts the provisions of SARFAESI Act for taking measures mentioned in Section 13(4) of NPA Act, then same analogy should apply to immovable secured assets also. But in case of immovable secured assets, the question of depletion in value (like in hypothecated secured assets) does not arise. Further the value of the immovable secured asset would not fall on passage of time. In fact the value of immovable

asset goes up on passage of time. There is no need for borrower to undertake to keep the margin by the value of the financial asset as in case of movable secured assets and ensure that there is no occurrence of mismatch between the asset and liability in the books of the bank/FI.

Para 4 of Master Circular RBI/2010-11/74 DBOD. No. BP.BC. 21/21.04.048/2010-11 is extracted and reproduced herein below for a glance.

“4. Asset classification

4.1 Categories of NPAs Banks are required to classify nonperforming assets further into the following three categories based on the period for which the asset has remained nonperforming and the realisability of the dues:

- I. Substandard Assets.
- II. Doubtful Assets.
- III. Loss Assets.

4.1.1 Substandard Assets

With effect from 31 March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

4.1.2 Doubtful Assets

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

4.1.3 Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

As can be seen from the RBI's prudential norms (particularly the above underlined paragraphs) the main aim of RBI's Prudential Norms is quick identification and elimination of NPAs from the books of accounts to strengthen the viability of the banks and to maintain clean (NPA less) balance sheet. Elimination of NPA is essential because such loan asset is not considered as a 'bankable asset' and therefore is unwarranted in the books although there may be some salvage or recovery value.

Thus Bank/FI as a secured creditor has absolute discretion to eliminate the identified NPAs from its books in order to maintain clean balance sheet. Writing off the account is immediate solution to strengthen the viability of bank or assignment of NPA to Asset Reconstruction Co. or enforcement of security interest under Sec.13 of SARFAESI Act. It is bank's option as to which course of action it wishes to choose. Normally bank today wishes to choose SARFAESI Act for which interference of any court or authority is not required. Some salvage or recovery value of such NPA is not the matter for consideration. What is material is quick elimination of NPAs by enforcement of security interest.

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