

## Drastic Failure of RBI's Attempt to Recover the Non-Performing Assets, Will the RBI Standardize the Recovery of NPAS

written by Latha Shanmugam | May 21, 2019

The banking system in India

comprises commercial and cooperative banks, of which the former accounts for more than 90 per cent of banking system's assets. Besides a few foreign and Indian private banks, the commercial banks comprise nationalized banks (majority equity holding is with the Government), the State Bank of India (SBI)

(majority equity holding being with the Reserve Bank of India) and the associate

banks of SBI (majority holding being with State Bank of India). These banks, along with regional rural banks, constitute the public sector banking system in

India The banking industry has

undergone a sea change after the first phase of economic liberalization in 1991

and hence credit management. Asset quality was not prime concern in Indian banking sector till 1991, but was mainly focused on performance objectives such

as opening wide networks/branches, development of rural areas, priority sector

lending, higher employment generation, etc. While the primary function of banks

is to lend funds as loans to various sectors such as agriculture, industry, personal loans, housing loans etc., but in recent times the banks have become very cautious in extending loans. The reason being mounting nonperforming assets (NPAs) and nowadays these are one of the major concerns for banks in India.

Despite constituting special

Tribunals like Debt Recovery Tribunals under RDDBI Act, 1993, the Banks could not recover its dues to the extent expected. This led to further reforms in the

process and curtailing the delay in adjudication. In furtherance of financial reforms and extending the object of RDDBI Act, 1993, the Government has enacted

"The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002". The SARFAESI Act, 2002 is to curtail the delay in

the process of adjudication between the Banks and its borrowers. Following an asset quality review conducted by the RBI in 2015, Listed Indian banks saw bad

loans jump to over Rs 8.4 lakh crore as of September 2017.

To cope up with the

situation on February 12, 2018 Reserve Bank of India issued circular<sup>1</sup> on non-performing assets which stressed upon Implementation

of Resolution Plan, As soon as there is a

default in the borrower entity's account with any lender where all

lenders - singly or jointly - shall initiate steps to cure the default. But the

apex court turned the clock backwards and struck down a Reserve Bank of India

(RBI) circular<sup>2</sup> that gave defaulting companies 180 days to agree on a resolution plan with lenders or be taken to bankruptcy court to recover debt

of Rs 2,000 crore and above. The Circular<sup>3</sup> was thus challenged by corporate debtors across various sectors on the grounds that they were being pushed into the IBC process because of the time bomb set out in the Circular. The Supreme Court tagged all matters on this subject in Dharani Sugar and Chemicals Limited vs Union of India & Ors, struck down the Circular<sup>4</sup> as being ultra vires to Section 35AA of the Banking Regulation Act, 1949, which

empowers RBI to issue directions to banks to initiate IBC proceedings in specific matters basis authorisation from the Central government. However, the

two conditions: (i) Central government authorisation; and (ii) the circular being in relation to a specific default, were not adhered to by RBI with relation to the Circular<sup>5</sup>.

BACKGROUND:

What is NPA?

NPA (non-performing assets)

is related to banking and finance term. When bank or finance company is unable

to recover its lent money from borrower in 90 days than that amount which have

not been recovered will be treated as NPA. It represents bad loans, the borrowers of which failed to satisfy their repayment obligations.

With effect from March 31, 2004, a

non-performing asset (NPA) shall be a loan or an advance where;

- Interest and/ or instalment 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 bills purchased and discounted,
- Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and w.e.f 30.09.2004 following further amendments were issued by the Apex Bank,
- A loan granted for short duration crops will be treated as NPA if the instalment of principal or interest thereon remains overdue for two crop seasons.
- A loan granted for long duration crops will be treated as NPA if the instalment of principal or interest thereon remains overdue for one crop season.
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

If

any advance or credit facilities granted by banks to a borrower become nonperforming, 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. As per the prudential norms suggested by the Reserve

Bank of India (RBI), a bank cannot book interest on an NPA on accrual basis. In

other words such interests can be booked only when it has been actually received.

Narasimham

Committee that mandated identification and reduction of NPAs to be treated as a

national priority because NPA direct toward credit risk that bank faces and its

efficiency in allocating resources. Profitability and earnings of banks are affected due to NPA numbers. If we

glance on the numbers of non-performing assets we may come to know that As of June 2016, the total amount of Gross Non-Performing Assets (NPAs) for public and private sector banks is around Rs. 6 lakh crore.

Types of NPA

NPA may be classified into

a. Gross NPA :- Gross

NPA is advance which is considered irrecoverable, for which bank has made provisions, and which is still held in banks' books of account.

b. Net NPA :- Net NPA

is obtained by deducting items like interest due but not recovered, part payment received and kept in suspense account from Gross NPA.

Asset classification categories of NPAS

1. Standard assets :- Standard

assets are the ones in which the bank is receiving interest as well as the principal amount of the loan regularly from the customer. Here it is also very

important that in this case the arrears of interest and the principal amount of

loan do not exceed 90 days at the end of financial year. If asset fails to be in category of standard

asset that is amount due more than 90 days then it is NPA and NPAs are further

need to classify in sub categories.

Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained

non-performing and the reliability of the dues:

2. Sub-standard 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 month.

3. Doubtful assets :- A loan

classified as doubtful if it remained in the substandard category for 12 months.

4. Loss assets :- A loss asset is one which

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. Also, these assets would have been identified as „loss assets“ by the bank or internal or external auditors or the RBI inspection but the amount would not have been written-off wholly.

Provisioning norms for NPAs

After a proper

classification of loan assets the banks are required to make sufficient provision against each of the NPA account for possible loan losses as per prudential norms. The minimum amount of provision required to be made against a

loan asset is different for different types of assets. The details of the provisioning requirements as per the RBI guidelines are furnished below:

In terms of RBI circular No

RBI/2004/254/DBOD No. BP.BC.NO 97/21.04.141/2003-04 dated 17.06.2004, the Reserve Bank of India has decided that w.e.f March 31, 2005, a general provision

of 10 percent on total outstanding should be made without making any allowance

for ECGC guarantee cover and securities available.

NPAs under Substandard

Assets category, The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 percent, i.e a total of

20 percent on the outstanding balance. The provisioning requirement for unsecured doubtful assets is 100 percent. NPAs under Doubtful category.

In terms of RBI Circular No.

2004/261/DBOD BP.BC.99/21.04.048/2003-2004 dated 21.06.2004, Reserve Bank decided to introduce graded higher provisioning according to the age of NPAs in

doubtful category for more than three years, with effect from March 31, 2005. Consequently the increase in

provisioning requirement on the secured portion would be applied in a phase manner

over a three year period in respect of the existing stock of NPAs as classified

as 'doubtful for more three years as on March 31, 2004 as per clarification given hereunder: In respect of all advance classified as doubtful for more than

three years on or after 1 April, 2004 the provisioning requirement would be 100

percent.

Factors for rise in NPAs

The banking sector has been

facing the serious problems of the rising NPAs. But the problem of NPAs is more

in public sector banks when compared to private sector banks and foreign banks.

The NPAs are growing due to external as well as internal factors.

External factors

a. Ineffective recovery -

The Govt. has set up numbers of recovery tribunals, which works for recovery of loans and advances. Due to their negligence and ineffectiveness in their work the bank suffers the consequence of non-recover, thereby reducing their profitability and liquidity.

b. Wilful defaults - There are borrowers who are able to pay back loans but are intentionally withdrawing

it. These groups of people should be identified and proper measures should be taken in order to get back the money extended to them as advances and loans.

c. Natural calamities - This is the major factor, which is creating alarming rise in NPAs of the PSBs. Every

now and then India is hit by major natural calamities thus making the borrowers

unable to pay back there loans. Thus the bank has to make large amount of provisions in order to compensate those loans, hence end up the fiscal with a reduced profit.

d. Industrial sickness -

Improper project handling, ineffective management, lack of adequate resources,

lack of advance technology, day to day changing govt. Policies give birth to industrial sickness. Hence the banks that finance those industries ultimately end up with a low recovery of their loans reducing their profit and liquidity.

e. Lack of demand -

Entrepreneurs in India could not foresee their product demand and starts production which ultimately piles up their product thus making them unable to pay back the money they borrow to operate these activities. The banks recover the amount by selling of their assets, which covers a minimum label. Thus the banks record the non-recovered part as NPAs and has to make provision for it.

f. Change on govt. Policies

- With every new govt. banking sector gets new policies for its operation. Thus

it has to cope with the changing principles and policies for the regulation of

the rising of NPAs.

g. Directed loans system -

Under this commercial banks are required to supply 40% percentage of their credit to priority sectors. Most significant sources of NPAs are directed loans

supplied to the -micro sector are problematic of recoveries especially when some of its units become sick or weak.

Internal factors

a. Defective lending process

- There are three cardinal principles of bank lending that have been followed by the commercial banks since long. i. Principle of safety ii. Principle of liquidity iii. Principle of profitability.

b. Inappropriate technology

- Due to inappropriate technology and management information system, market driven decisions on real time basis can't be taken. Proper MIS and financial

accounting system is not implemented in the banks, which leads to poor credit collection, thus NPAs. All the branches of the bank should be computerized.

c. Improper spot analysis -

The improper strength, weakness, opportunity and threat analysis is another reason for rise in NPAs. While providing unsecured advances the banks depend more on the honesty, integrity, and financial soundness and credit worthiness of the borrower.

d. Poor credit appraisal

system - Poor credit appraisal is another factor for the rise in NPAs. Due to poor credit appraisal the bank give advances to those who are not able to repay

it back. They should use good credit appraisal to decrease the NPAs.

e. Managerial deficiencies

-The banker should always select the borrower very carefully and should take tangible assets as security to safe guard its interests. When accepting securities banks should consider the: 1. Marketability 2. Acceptability 3. Safety 4. Transferability

The banker should follow the

principle of diversification of risk based on the famous maxim do not keep all

the eggs in one basket, it means that the banker should not grant advances to a

few big firms only or to concentrate them in few industries or in a few cities.

If a new big customer meets misfortune or certain traders or industries affected adversely, the overall position of the bank will not be affected.

f. Absence of regular

industrial visit - The irregularities in spot visit also increases the NPAs.

Absence of regularly visit of bank officials to the customer point decreases the collection of interest and principals on the loan. The NPAs due to wilful defaulters can be collected by regular visits.

g. Faulty credit management

- like defective credit in recovery mechanism, lack of professionalism in the work force.

Impact of NPA

NPA impact the performance

and profitability of banks. The most notable impact of NPA is change in banker's sentiments which may hinder credit expansion to productive purpose. Banks may incline towards more riskfree investments to avoid and reduce riskiness, which is not conducive for the growth of economy. If the level of NPAs is not controlled timely they will:

- Reduce the earning capacity of assets and badly affect the ROI.
- The cost of capital will go up.
- The assets and liability mismatch will widen.
- Higher provisioning requirement on mounting NPAs adversely affect capital adequacy ratio and banks profitability.
- The economic value additions (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital.
- NPAs causes to decrease the value of share

sometimes even below their book value in the capital market.

- NPAs affect the risk facing ability of banks.

#### OBSERVATION:

Having pushed lenders into

resolving nearly 40 of the largest bad loan accounts via the Insolvency and Bankruptcy Code (IBC), the Reserve Bank of India (RBI) has now revised its stressed asset framework to ensure speedy resolution of bad loans in the future. An overarching theme of the new framework is a reliance on the IBC to resolve stressed assets, while doing away with a number of interim schemes introduced before India adopted a bankruptcy code. "In view of the enactment of

the Insolvency and Bankruptcy Code, 2016 (IBC), it has been decided to substitute the existing guidelines with a harmonised and simplified generic framework for resolution of stressed assets,"

Key

features of the new framework include doing away with schemes like Strategic Debt Restructuring (SDR), the Scheme for Sustainable Structuring of Stressed Assets (S4A), and the Corporate Debt Restructuring (CDR) scheme, among others.

To replace these schemes, the RBI has put in place a strict timeline over which

a resolution plan must be implemented, failing which stressed accounts must be

referred to the IBC. Listed Indian banks saw bad loans jump to over Rs 8.4 lakh crore as of September 2017, following an asset quality review conducted by the RBI in 2015. The revised rules come at a time when Indian banks are close to completing the process of bad loan recognition but resolution is in early stages.

The RBI framework adds that

a resolution plan must be initiated as soon as there is a default. The resolution plan may involve:

- Regularisation of the account by payment of all overdues by the borrower entity
- Sale of the exposures to other entities / investors
- Change in ownership
- Restructuring

The framework reiterates

that restructuring could involve modification to the terms and conditions of advances, including an alteration in the repayment period, the rate of interest

and the installments payable.

An account that has been

restructured shall immediately be downgraded to being a non-performing asset. Non-performing assets, which have been restructured, will continue to be classified as they were before the restructuring. Provisions attached to these

accounts would to be as per existing rules under the IRAC (Income Recognition and Asset Classification) norms. Accounts can be upgraded only when all the outstanding loans and facilities of the account demonstrate satisfactory performance. For accounts with an exposure of more than Rs 100 crore, the

borrower will also need to be rated 'investment grade' before the account is upgraded to standard status.

#### CONCLUSION:

By striking down the Circular, the Supreme Court has removed the mandatory requirement of banks/financial institutions to commence IBC proceedings at the end of 180 days from default if no resolution qua a corporate debtor is found. However, banks/financial institutions at their discretion can invoke IBC proceedings against any corporate debtor, with it being a statutory right.

The IBBI has, in its website, published an analysis of the SC ruling on the fate of this circular in

Dharani Sugars and Chemicals Ltd vs Union of India and others. The analysis shows that the apex court has upheld the Banking Regulation (Amendment) Act 2017, introducing sections 35AA and Sections 35AB as being constitutional (constitutionally valid). While Section 35AA conferred the discretionary power

on the RBI to instruct banks to commence insolvency proceedings against a defaulter,

Section 35AB permits the RBI to frame policies for stressed asset resolution.

In my opinion, the apex court ruling is likely to provide flexibility for pre-insolvency restructurings. The banks and promoters of defaulting companies may welcome the

flexibility to enter into consensual restructuring schemes and the availability

of a lengthier window can also help achieve complex restructuring transactions

in more realistic timetables (without the pressure of time periods set out in the circular). However, it remains to be seen if the exemptions which were applicable to such restructuring schemes from applicability of SEBI regulations

regarding change of control situations would continue to apply to contractual restructurings without the circular being in force. This can continue to incentivise

pre-bankruptcy restructurings, however with lesser compulsion / time constraints.

Although the SC may have struck down the RBI's February 12 circular<sup>6</sup> on stressed assets, but the apex court has not curtailed the rights of banks to initiate insolvency proceedings on their own. This is a statutory right available to them under the Insolvency and Bankruptcy Code (IBC) and the Governor's statement on framework for the resolution of the stressed assets shows that the RBI stands committed to maintain and enhance the momentum of resolution of stressed assets and adherence to credit discipline.<sup>7</sup>

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#### Footnotes

1. February 12, 2018 Reserve Bank of India
5. Dharani Sugar and Chemicals Limited vs Union of India & Ors



7. [https://rbi.org.in/scripts/bs\\_viewcontent.aspx?Id=3659](https://rbi.org.in/scripts/bs_viewcontent.aspx?Id=3659)  
King Stubb & Kasiva,  
Advocates & Attorneys  
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