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DEVELOPMENT OF BANK ASSET CLASSIFICATION NORMS IN INDIA

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ABSTRACT

Non-Performing assets or bad loans are those assets on a bank's balance sheet which have become sticky and stopped producing income The prime indicator of the health of a bank or any financial institution which is in the business of money lending is the performance of its loans portfolio. If the asset quality is strong and generating income for the bank the other health indicators which are directly or otherwise reliant on merit of asset portfolio improve and strengthen.

Quality of asset portfolio however depends on many factors which amongst others primarily include due diligence in credit forwarding, credit management and administration mechanism of lending institutions. There are yet distinct external macro-economic factors and various other specific management driven factors such as risk appetite of the bank which determines the performance of assets.

The current paper is an attempt to focus on the evolution of bank asset classification standards in Indian Banking sector and draws a comparison with the international standards. The paper further analyses the NPA trend and movement for the past ten years from 2005 to 2015 as per the prevalent NPA classification norms in India and tries to draw insights from the findings.

KEYWORDS – Asset Classification, Asset Health Codes, Asset Quality in Banks, Income Recognition, Non-performing assets,

1. INTRODUCTION

The Non-performing assets are an intrinsic part of any lending and credit business, be it banks or other financial institutions. The real challenge nonetheless is to attempt and keep the levels of such non-performing assets within a comfortable and productive range, similar to attempts which try to balance between growth and inflation in an economy. Thus the task is to have a satisfactory level of non-performing assets, if not completely eliminate it.

One of the basic requirements of a well-functioning financial system is the proper management and maintenance of non-performing assets (NPA) and keeping it within a comfortable and satisfactory range. NPAs beyond a certain level cause concern because a non-performing loan affects recycling of credit and credit creation. It impacts profitability, requires higher provisioning and concerns not only bankers but regulators and policy makers alike who are entrusted with fueling the economic growth. (Thomas, 2015)

A Non-performing asset is a drag both on the balance sheet and the income statement of a bank. According to Singh (2013) the impact of NPA are manifold including that on a bank's profitability and capital adequacy. Samir and Kamra (2013) state that large percentages of NPAs have a deleterious impact on a bank's profit in a number of ways, which include reduced interest income, eroded profits through provisioning requirements, erosion of capital base and reduction in competitiveness. This asserts appropriately that Non-performing assets stresses the ability of a bank to post profits, creates asset liability mismatch for the bank and severely impairs a bank's capacity to refinance.

Chatterjee et el. (2012) conducted a comparative study of NPAs of public sector banks, private sector banks and foreign sector banks and conclude that NPAs have a negative influence on the achievement of capital adequacy level, funds mobilization and deployment policy, banking system credibility, productivity and overall economy.

Joseph and Prakash (2014) assert that the best indicator for the health of the banking industry in a country is its level of Non-performing assets (NPAs) and it reflects the performance of banks. Authors add that NPAs in the Indian banking sector have become a major concern for the Indian economy and that NPA has a direct impact on the profitability, liquidity and solvency position of the bank; higher NPA indicates inefficiency of the bank and lower NPA indicate better performance and management of funds.

In India, the concept of NPA spurted on the recommendations of the Report of the Committee on the Financial System (Narasimham, 1991) and based on those recommendations a suitable system for accounting and reporting of non-performing assets was developed.

According to the Narasimham Committee Report (1991), those assets (loans, advances, bills discounted, OD/CC, overdrafts, cash credit) for which the interest has remained outstanding for a period of 180 days should be booked as NPAs. In due course of time this period was reduced, and from April 1995 on-wards the loans, advances and assets which have not paid interest for 90 days were considered as NPAs.

2. THE EIGHT CATEGORY HEALTH CODE SYSTEM

The IRAC Norms (Income Recognition and Asset Classification Norms) as we know today did not exist before 1991 and the banking system in India had no even system of book-keeping for income recognition, asset classification and loan provisioning. The Indian Banks booked and recorded interest income on realization and also on accrual basis. This usually led to banks showing income to accounts which have long become sticky and stopped realizing income. The accrual system leads to faulty income recognition and wrong asset classification. Banks were showing profits in their books by mere book entries where in reality neither the accounts were regular nor the assets were standard.

However in 1985-86, the Reserve Bank of India had introduced an eight categories health code system (HCS) with the purpose of uniform monitoring and comprehensive scrutiny of individual loan accounts. The control function of management theory was the foundation for such a decision with a view that such a tool will help banks in monitoring and controlling individual advances. In December 1985, the RBI advised all commercial banks in India to introduce and follow the health classification system which specified the asset quality of individual advances in the eight categories with Health Code assigned to each borrower account subject to bi-annual review.

Health Code-1	SATISFACTORY	The account in which all terms and conditions are complying with and safety of advances are not in doubt.
Health Code-2	IRREGULAR	The account where safety of advances is not suspected, though there may be occasional irregularities.
Health Code-3	SICK-VIABLE	Advances to units which are sick but viable under nursing or revival programs.

Health Code-4	SICK-NON-VIABLE / STICKY	Advances where irregularities continue to persist and there are no immediate prospects of regularization.
Health Code-5	ADVANCES-RECALLED:	Advances where repayment is highly doubtful and nursing is not considered worth-while include accounts where decision has been taken to recall the advances.
Health Code-6	SUIT-FILE-ACCOUNTS:	Accounts where legal action or recovery proceedings have been initiated.
Health Code-7	DECREED DEBTS:	Accounts for which decrees have been obtained.
Health Code-8	BAD AND DOUBTFUL ACCOUNTS	The accounts in which the recovery is doubtful due to shortfall in the value of the securities and inability / unwillingness of the borrower to repay the banks' dues partly or wholly.

Table 1: Eight Category Health Code System

THE RBI had directed banks not to charge interest on borrower accounts classified under health code 5 to 8. In regard to health code 4, the RBI had directed banks to evolve a convincing system of income recognition considering the forecasts of recovery of amount. However, the classification of loan assets into the various health codes, particularly health codes 2, 3 and 4 was more of a subjective matter and did not clearly reflect nor fully absorbed by the decision-making banks the objective of the Reserve Bank guidelines: to impart increased transparency and uniformity in the balance sheets of commercial banks in India.

Nevertheless, the health code system was a welcome step, a mere leap, a baby step by the RBI towards a all-pervasive and rational policy of asset classification and income recognition which gave birth to IRAC Norms in India at par with world standards.

3. BANKING SECTOR REFORMS AND NON PERFORMING ASSETS

NARASIMHAM COMMITTEE REPORT (1991) AND THE FOUR CATEGORY NPA CLASSIFICATION

The economic reforms and the process of economic liberalization introduced by the Government of India in 1991 brought out the need for financial sector reforms. The Government appointed a Committee under the chairmanship of Shri M Narasimham on the Financial System in August 1991, with a purpose to examine all aspects relating to the structure, organization, functions and procedures of the financial system in India. The committee submitted its report in November 1991. One of the major recommendations of the Committee relates to the norms for income recognition, asset classification and provisioning for bad loans of Indian Banks.

The Narasimham Committee (1991) felt that the classification of assets according to the health codes was not in accordance with international standards. It believed that a policy of income recognition should be objective and based on the record of recovery rather than on subjective considerations. In addition, before the Indian banks complied with the capital adequacy norms, their assets had to be revalued on a more realistic basis of their realizable value. Thus, the Narasimham Committee (1991) believed a system of income recognition and provisioning is fundamental to preserve the strength and stability of the banking system. The international practice is that an asset is treated as non-performing when interest is due for at least two quarters. In respect of such non-performing assets, interest is not recognized on accrual basis but is booked as income only when it is actually received. The committee suggested that a similar practice be followed by banks in financial institutions in India and recommended that interest on NPAs be booked as income on accrual basis.

The NPA would be defined as advance, as on the balance sheet date in the following circumstances:

1. In respect of overdraft and cash credits, accounts remain out of order for a period of more than 180 days,

2. In respect of bills purchased and discounted, the bill remains overdue (An amount is considered overdue when it remains outstanding 30 days beyond the due date.) and unpaid for a period of more than 180 days,

3. In respect of other accounts, any account to be received remains past due for a period of more than 180 days.

As mentioned earlier, the grace period was reduced and from March 1995 onwards assets for which interest has unpaid for 90 days were considered as NPAs. Provisions need to be made for the NPAs and total NPA (gross) minus the provisions is defined as net NPA.

Besides providing a detailed definition of NPA, the Narasimham Committee (1991) also suggested that for the purpose of provisioning, banks and financial institutions should classify their assets by compressing the health codes into four broad groups;

[1] Standard

[2] Sub-standard,

[3] Doubtful and

[4] Loss.

Broadly, sub-standard assets would exhibit problems and include assets classified as non-performing for a period not exceeding two years. Doubtful assets are those that remain as such for more than two years and include loans that are overdue for more than two years. Loss assets are accounts where loss has been identified but amounts have not been written off. According to international norms, commercial banks need to keep aside a portion of their income as a provision against bad loans. The amount of the provision depends on the type of NPAs and the time duration. Now Indian banks need to make provisions for all bad loans.

4. INCOME RECOGNITION

Internationally income from non – performing assets is not an accrual basis but is taken into account as income only when it is actually received. It has been decided to adopt similar practice in our country also. Banks have been advised that they should not change and take into income account interest on all non – performing assets. The policy of income recognition has to be objective and based on the record of recovery. The criterion for treating a credit facility or borrower account as non-performing is as follows:

(A) TERM LOAN

The term loan becomes NPA when interest and / or installment remain past due for four quarters during 92-93, three quarter during 93-94. From the year 93-94 the term loan is treated as NPA in interest or installments of principle has remained overdue for any 2 quarters as on the balance sheet date, although the default may not be committed continuously for 2 quarters. This period will be reduced to 1 quarter with effect from 31st March 2004. If the account is regularized before the balance sheet date by repayment of overdue amounts through genuine sources (not by sanction of additional facilities or transfer of funds between accounts) the account need not be treated as NPA. Bank should, however, ensure that the account remains in order subsequently and a solitary credit entry made in the accounts on or before the balance sheet date to adjust the overdue interest or installment of principal is not reckoned as the sole criterion for treating the account as a standard asset (performing asset).

(B) CASH CREDIT AND OVERDRAFT FACILITY

A cash credit / overdraft account becomes NPA if it remains out of order for any two quarters in a financial year. Out of order means: (a) outstanding balance remains continuously in excess of sanctioned limit or drawing power whichever is lower.

(b) Where balance outstanding is less than sanctioned limit or drawing power.

(i) There are no credits in the account continuously for 3 months or

(ii) Credits are not enough to cover interest and expenses debited during 3 months

(C) BILLS PURCHASED AND DISCOUNTED

A BP / BD account becomes NPA if it remains overdue for two quarters, the position of the oldest account is to be reckoned for the purpose of income recognition.

(D) PROJECT FINANCE

In the case of bank finance given for industrial projects where moratorium is available for payment of interest, payment of interest becomes due only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

(E) HOUSING LOANS TO STAFF MEMBERS

In case of housing loan or similar advances granted to staff members where interest is payable after recovery of principle, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of installment principal or payment of on interest on the respective due dates.

(F) OTHER CREDIT FACILITIES

Any other credit facility is to be treated as NPA if it remains “Past Due” for a period of 4, 3 and 2 quarters during the year ended 31st March 1993, 1994 and 1995 onwards respectively.

5. ASSET CLASSIFICATION GUIDELINES (RESERVE BANK OF INDIA - 2015)

According to RBI Master Circular on Prudential norms on Income Recognition, Asset Classification and provisioning pertaining to Advances dated July 01, 2015; ‘An asset, including a leased asset, becomes non- performing when it ceases to generate income for the bank.’ Further the circular defines as follows: -

A. A non-performing asset (NPA) is a loan or an advance where;

i. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii. the account remains ‘out of order’ in respect of an Overdraft/Cash Credit (OD/CC),

iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,

vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

vii. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

In case of interest payments, banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

B. ‘Out of Order’ status

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for 90 days. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

C. ‘Overdue’

Any amount due to the bank under any credit facility is ‘overdue’ if it is not paid on the due date fixed by the bank.

D. Asset Classification and Category of NPAs

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 realization of the dues:

[1] Substandard Assets

[2] Doubtful Assets

[3] Loss Assets

Substandard Assets

With effect from March 31, 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

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.

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.

6. CLASSIFICATION OF LOAN ASSETS, NPA MOVEMENT AND ANALYSIS OF TREND

Classification of Loans (As Percentage of Total Advances)						
Year	Total Advances (In Billion Rs.)	Standard Advances	Sub Standard Advances	Doubtful Advances	Loss Advances	Gross NPAs
2005	11886	95.1	1.2	3.2	0.6	4.9

2006	15506	96.7	0.9	1.9	0.4	3.3
2007	20131	97.5	1.0	1.2	0.3	2.5
2008	25079	97.8	1.1	1.0	0.2	2.3
2009	30375	97.7	1.2	0.9	0.2	2.3
2010	35450	97.6	1.2	0.9	0.2	2.4
2011	43575	97.8	1.0	1.1	0.2	2.3
2012	51589	97.3	1.4	1.2	0.2	2.8
2013	59883	96.8	1.5	1.5	0.2	3.2
2014	68768	96.2	1.6	2.0	0.2	3.8
2015	75620	95.7	1.6	2.5	0.2	4.3

Table 2 Asset Classification in India

Table 02 represents the Classification of Loans of Scheduled Commercial Banks (SCBs) in India from 2005 to 2015 as per the four-category Asset Classification of Loans. Table 02 represents the Total Advances of SCBs in billion rupees for a period of ten years. Subsequent columns represent the four categories of asset classification standard (as a percentage of total advances for the specific year) viz. Standard advances, Sub -Standard advances, Doubtful advances, Loss advances and Gross NPA ratio in the last column.

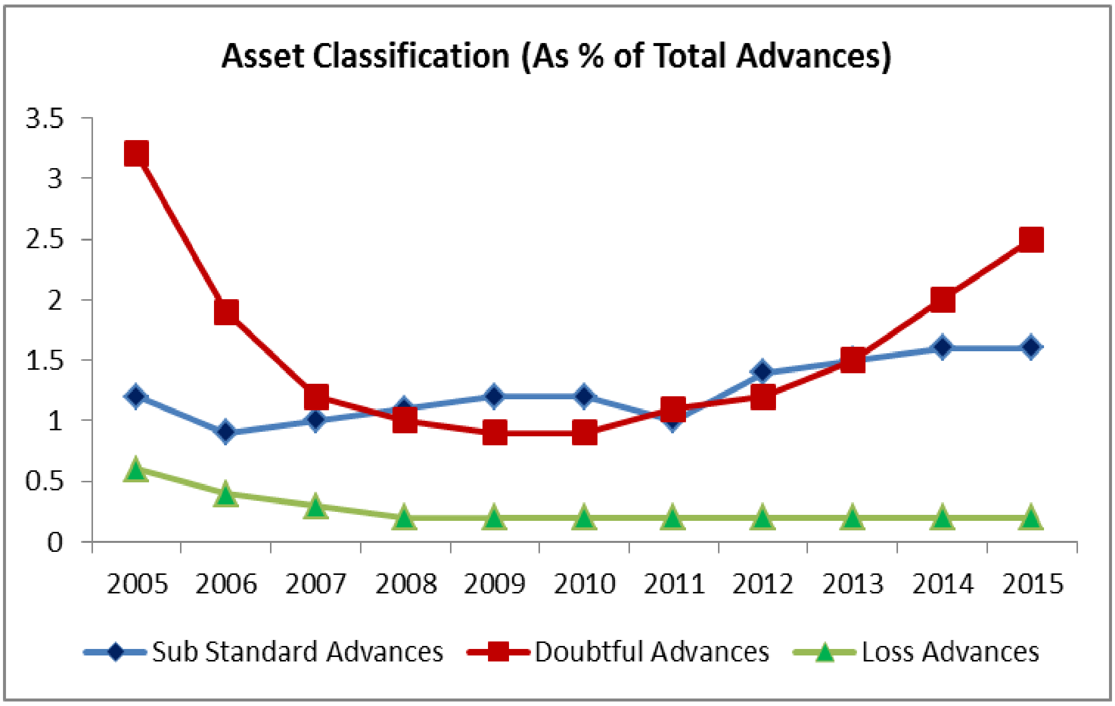

Chart 1 Trend in Movement of Asset Classification (4-Category Asset Classification System)

Chart 01 represents the movement and trend of Gross NPA ratio of SCBs compared with the movement of doubtful advances ratio for ten years from 2005 to 2015. The NPAs were at a high of about 05% of gross advances at the beginning of time-frame in current analysis. The trend eases around the years 2008 to 2011. Subsequently there has been a sharp and rapid rise in the Gross NPA and doubtful assets ratio of the SCBs. The world was rattled with the global financial crises and the sub-prime crises during and after 2008. The increase in NPAs post the four year span form 2008 to 2011 may be reminiscent of the fact that how Indian SCBs have been impacted by the global financial crises and other macro-economic changes within the country. The rising trend however points out at the problem of rising NPAs in Indian banking sector and the need for increased efforts for loan recovery across the Indian banking sector. The focus on loan recovery and is importance is heightened by the alarming fact that compared to 2005 the Total Advances in 2015 stand at almost 07 times the levels as were in 2005 suggesting that absolute numbers of gross non-performing loans in the economy are extremely shocking.

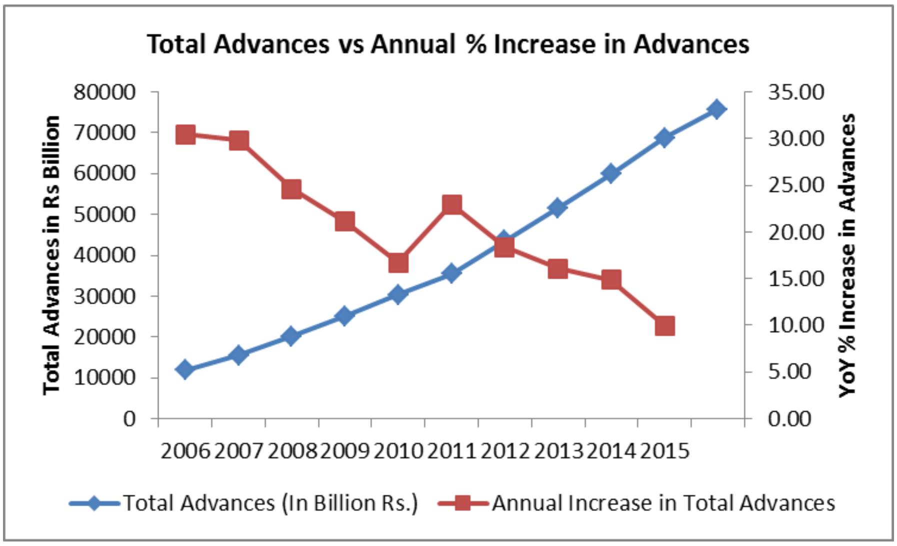

Chart 2 Trends in Movement of Total Advances and Annual Increase in Advances

Chart 02 represents the Total Advances in billion rupees for SCBs during 2005 to 2015. The increase is compared and contrasted by year on year percentage increase in total advances. It is quite evident that that during 2005 to 2008 increase in total advances of SCBS was above 20% YoY; clearly as high as 30% in 2006. Barring 2011 the YoY increase in total advances has shown a downward trend although still in excess of 10% YoY. The trend clearly indicates the fact that Indian banking sector has shifted its focus from increase in credit off-take. The trend may be inferred to as an increased focus towards loan recovery and better credit management rather than blind growth and miscalculated credit off-take.

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