AIBOC NOTE

Asset Classification Norms and Provisioning Norms – Should be Rationale and Scientific

Lending is a credit risk.. Hence the lender either keeps a higher interest margin or keeps the provision for write off or does both. In the banking system in our country, lending rates are higher for unsecured loans because of this reason.

After 1991 when the neo liberal economic policies got implemented, interest rates were reduced for the corporates in a phased manner and correspondingly, the interest rates on deposits also were reduced. The net interest margin started coming down because of the policies of the Government implemented through Reserve Bank of India. This has lead to decline in the profitability of the Public Sector Banks.

Prior to 1991, we had Asset Classifications under a health code system where the loans were given a health code from 1 to 8. Even in those days, there were classifications viz. doubtful assets and loss assets. The practice of writing off loans was prevalent even then as certain portion of the loans that were advanced was not paid back by the borrowing entities on owing to various reasons. This did not affect the Banking System much as the loan amounts were small and delinquency was rare.

After 1991, Income Recognition and Asset Classification Norms (IRAC) was introduced which classified the assets into four types. The Reserve Bank of India had been changing the norms periodically. From the incurred loss model (actual), we moved over to expected loss model (projection). After the US financial crisis, though Indian Banks were not majorly affected during the financial crisis, we have been forced to switch over to this model by International agencies. These classifications were not based on Indian conditions but based on US Generally Accepted Accounting Principles and International Financial Reporting Standards (US GAAP and IFRS). This model was also recommended by BASEL Committee. Basel norms are recommendatory and not mandatory. Even if we accept them, the implementation can be done in future in a phased manner.

A discussion paper of Reserve Bank of India (2012) stated the reasons for changing the asset classification as follows:

1. The rate of standard asset provisions has not been determined based on any scientific analysis or credit loss history of Indian banks.
2. Banks make floating provisions at their own will without any pre-determined rules and not all banks make floating provisions. It makes inter-bank comparison difficult.
3. This provisioning framework does not have countercyclical or cycle smoothening elements. Though RBI has been following a policy of countercyclical variation or standard asset provisioning rates, the methodology has been largely based on current available data and judgement, rather than on an analysis of credit cycles and loss history.

The RBI asked the Banks to switch over to Estimated Loss Model which was not based on Indian conditions and there was no scientific methodology adopted. The Estimated Loss Model has not addressed the above issues scientifically.

The Reserve Bank of India had changed the norms for NPA periodically based on "Past Due" as under.

w.e.f. 31.03.1993 – 4 quarters

w.e.f 31.03.1994 – 3 quarters

w.e.f 31.03.2001 – 180 days

w.e.f.31.03.2004 – 90 days

w.e.f.28.02.2018 – 30 days.

The reason for non performing assets has been studied by Manish Kapoor *[1]

Those Attributable to Borrower :

a) Failure to bring in Required capital

b) Too ambitious project

c) Longer gestation period

[*1 Manish Kapoor, DAV College, Amritsar (published in International Journal of Innovations in Engineering Technology, Vol 3, Issue 3, Feb 2014)]

d) Unwanted Expenses

e) Over trading

f) Imbalances of inventories

g) Lack of proper planning

h) Dependence on single customers

I) Lack of expertise

j) Improper working Capital Mgmt.

k) Mis management

l) Diversion of Funds

m) Poor Quality Management

n) Heavy borrowings

o) **Poor Credit Collection**

p) Lack of Quality Control

Causes Attributable to Banks :

a) Wrong selection of borrower

b) Poor Credit appraisal

c) Unhelpful in supervision

d) Tough stand on issues

e) **Too inflexible attitude**

f) Systems overloaded

g) Non inspection of Units

h) Lack of motivation

i) Delay in sanction

j) **Lack of trained staff**

k) Lack of delegation of work

l) **Sudden credit squeeze by banks**

m) Lack of commitment to recovery

n) Lack of technical, personnel & zeal to work.

Other Causes :

a) **Lack of Infrastructure**

b) Fast changing technology

c) **Un helpful attitude of Government**

d) Changes in consumer preferences

e) **Increase in material cost due to Government policies**

f) **Government Policies**

g) **Credit policies**

h) **Taxation laws**

I) Civil commotion

j) Political hostility

k) Sluggish legal system

l) **Changes related to Banking amendment Act**

So it is very clear that NPA is not only because of willful default. But today the Government and RBI statements indicate that every default is seen as a willful default or a fraud which is not correct.

The Parliamentary Standing Committee Report on NPA states the reasons leading to NPAs as given below:

Main reasons for increase in NPAs of banks, inter-alia, are sluggishness in the domestic growth during the recent past, slowdown in recovery in the global economy and continuing uncertainty in the global markets leading to lower exports of various products like textiles, engineering goods, leather, gems, external factors including the ban in mining projects, delay in clearances affecting Power, Iron& Steel Sector, volatility in prices of raw material and the shortage in availability of power have impacted the operations in the Textiles, Iron & Steel, Infrastructure sectors, delay in collection of receivables causing a strain on various Infrastructure projects, aggressive lending by banks in past. *[2]

Mr. S. Gurumurthy, Charted accountant, Political Analyst and Columnist, in an article in New Indian Express on Nov 06, 2002 wrote this:

NPA RULE THAT KILLS BANKS, BUSINESSES AND THE ECONOMY ITSELF

NPA. The three letters strike terror in banking and business circles today. NPA is the short form of 'Non Performing Asst'. The dreaded NPA rule says simply this: when interest or other due to a bank remains unpaid for more than 180 days, the entire bank loan automatically turns a 'non-performing asset'. This arithmetic has made automatic the classification of a loan as performing or non performing. The recovery of loans has always been problem for banks and financial institutions. In the past after factoring different attributes of a loan like who has borrowed, their record, whether the industry is cyclical-they would classify their loans as good, doubtful or bad. How then did the paradigm shift from assessing a debt as doubtful or bad to automatic classification of debts into NPAs?

Before getting into details, let's look at the anatomy of the NPA issue in India. The first issue is when the Indian economy is not performing, can non performing accounts in banks be avoided? Cannot be. Another point. Many western scholars are coming round to the view that the infamous Washington Consensus, which is the mother of the idea of globalised NPA norms, is a failure. They now say that domestic finance should be based on counter cyclical approach, that is, if the economy is under performing there should be liberal financing to lift the economy. Today's NPA policy is precisely the other way round.

The second issue is the total amount of NPAs in the Indian financial system. This is estimated at Rs.120000 crores. Break this figure up. Just three categories of loans account for half this figure. Loans to petroleum sector (Rs.29000 crores), to steel sector (Rs.22000 crores), and to the infamous Enron power project (Rs.9000 crores), Can the banks tell steel and petroleum industries to go to hell? Not if our economy has to survive. These portfolios have to be restructured. Once restructured, they will disappear from the NPA radar. However the money sunk in Enron is gone. Eventually, for all its sins, the government will have to offer this amount as a subvention or as subsidy. Deducting these loans, the resulting balance Rs.60000 crores (over $12 billions) is within 10% of the total commercial credit of banks and financial institutions. This is less than 4% of our GDP.

[*[2] Report of the Standing Committee on Finance on NPAs, Feb 2016]

Look at Japan and China and other Asian nations in contrast. The total NPA in Japan is estimated at $1.26 trillions, equivalent to about 26% of Japan's GDP. In China it is $600 billions, that is, 45% of its GDP; in Malaysia 48% of its GDP; in Thailand 41% of its GDP, in Taiwan 27% of its GDP. Compare this with NPA at 4% of India's GDP. Where is the comparison? Yet despite all pressure Japan has steadfastly refused to accept the NPA norms universalised by the west. But surprisingly we have.

Universalised NPA, rule is a western strategy to keep global banking and finances under its thumb. It is tailor made to suit equity driven economies, that is, the Western ones. In the US where 55% of the households are linked to the stock market, equity constitutes most of business finance with debt playing only a limited role. In contrast in India less than 2% of household savings is invested in stocks. The result India is debt driven with more than 2/3 of the business funds being provided by debt. It is the other way round in the US driven by high equity and low debt. Where, with such low debt, interest or Principal remains overdue for more than 180 days, the debt may be automatically recorded as non-performing. In contrast in India where debt in business is two times the equity, if the large debt is not serviced for 180 days, it cannot be automatically labelled as non-performing, without further appraisal.

Yet once a borrower is unable to pay interest for more than 180 days his account is to be regarded as non performing and the new rule will deny him further credit, which he needs most then. With banks handling over 60% of national financial savings and the government handling the balance, where else will needy businessmen turn for funds? Thus, starved of funds, businesses, which are only weak, turn sick.

Even though the banker knows the problem, he cannot fix it, thanks to the rule. Should any banker breach the rule to solve the problem of his client he is sure to end up in CBI custody. Will any banker risk his job and self if he has to deviate from the rules to save businesses? Never. What then does he do? He does not lend at all. That is why Indian banks are flush with funds and the businesses are starved of them. By the way, how can CBI authority over bank business and globalisation co-exist? Has any advocate of globalisation though about it?

Not just on banks. The RBI has forced the NPA rule even on non banking finance institutions. Ask non banking finance companies about their experience. You will hear from them stories after stories as to how there is disconnect between the rule and their business. They will say how their clients like the Malabar lorry operators will tell them 'sir, for the next one year we will not pay any instalment; we will pay everything at the end of the year', and will do so promptly. But even though the finance companies would get their payments at the year end as the lorry operators had assured them, they would have to declare their accounts as NPAs meanwhile, leading to disastrous consequences to finance companies.

Indisputably, the NPA rule is unsuitable to banks and business; even harmful, killing both, why, our very economy, all at one stroke. Ask the bank heads in private, and see how critical they are about RBI for enforcing the global NPA standards as a fit-all-model. It will finish the banks and businesses they whisper. So do the finance company promoters who are more efficient than some bankers. Of course all of them only whisper, not talk. Yet everyone, including the media, swears by this suicidal rule as if it were an inerrant law. Why rules disconnected to India are framed? Simple. Those who frame them are disconnected from India.[*3]

The same arguments are relevant even today. From 180 days now the NPA classification has been changed to 30 days for no scientific reason. Economy is not doing well. NPA has only increased due to Asset Classification Norms. ARCs, IBC & NCLT have not helped. A look at the status of the first 12 large accounts shows the real picture (Annexure -1) *4

RBI in its financial stability report in December 2014 itself had identified 5 sectors contributing to 54% of total NPAs. They were Infrastructure, Iron & Steel, Textiles, Aviation and Mining (Including coal) [*5]

The Finance Standing Committee has assessed in detail the reasons for NPAs in different sectors. The major reason for NPA is not willful default but the poor economic growth and hurdles in getting the projects completed in time.

Here one has to note that it is the Government which directed Banks to lend to Steel, Power, Telecom, Infrastructure and Aviation as Development Financial Institutions (DFIs) were converted into Commercial Banks and privatized. It is because the Government wanted to reduce the fiscal deficit and reduce its investment in the above sectors and asked banks to lend under Public Private Partnership(PPP) Model. Unfortunately, under the PPP almost the entire investment is received as loan from Public Sector Banks. So the Private investment in PPP is negligible. Today the maximum NPA is in these sectors only. So the Government has to come to their rescue.

[*3] *New Indian Express, Nov.2002*

[*4] Economic Times 14th March 2018

[*5] Financial Stability Report, RBI, Dec 2016

The Parliament Standing Committee on NPA in its report submitted in Feb 2016, in the 6th recommendation (Total 14 Recommendations)

As a way forward, the Committee are of the view that developing and strengthening a vibrant bond market to finance infrastructure projects will be a sound proposition. At present, only banks and such other financial institutions are involved in funding large projects on a short term lending basis. There is also a huge mis-match between their deposit tenure and credit term. Thus, every time there is even a minor delay in projects, they are declared as NPAs and the banks have to resort to restructuring of the loans. Therefore, the Committee would recommend that the Government should make the necessary structural changes including revival of Development Financial Institutions (DFI) for long-term finance, especially for Infrastructure projects, which will go a long way in nipping the problem of NPAs in the bud. The Committee also urge the Government for allowing Infrastructure Finance Companies (IFCs) to purchase infrastructure projects turning into NPAs and keep them as Standard Assets, as this step would not only provide the much needed relief from stressed portfolio but also create an enabling environment for funding the infrastructure sector facing resource crunch. Besides, the IFCs should also be allowed to participate in equity. The Banks should have equity component built in the loan agreement itself. The Committee desire that the RBI should explore the possibility of developing a mechanism wherein there would be separate norms for NPA classification for infrastructure and non-infrastructure loans

By just implementing this one recommendation of the Parliamentary Standing Committee on Finance, the Government can help the Public Sector Banks to reduce their debt burden to a large extent. This will also help the companies involved in infrastructure promotion to survive. By converting these loans into long term debts, these companies will be encouraged to improve the infrastructure over a period of time which will provide a boost to the economy. When the debt of Reliance Defence could be converted into a long term debt to avoid declaring it as NPA why the same can't be applied for other loans? In fact international experiences show that countries which are supporting Development Financial Institutions through which long term credit is made available are seeing overall growth in the economy.

A cursory look at the Asset Classification and Provisioning norms show that we are using stringent norms which affect the Banks badly. (Annexure -2). So there is adequate scope for changing them. The AQR created havoc on banks' profit & loss accounts as many large lenders slipped into losses due to provisioning of even standard assets. Bad loans in the Indian banking system jumped 79 per cent in FY16, according to RBI data, mainly on account of the AQR. Hence, it is established that the robust rise in NPA in the Indian banking Sector is primarily because of the RBI's forceful implementation of AQR.

Moreover the Asset Reconstruction Companies have not helped as they pay only 15% of the outstanding loans to the Banks.

In 2001, the Gross NPAs of Public Sector Banks was 13.11% and it did not create any crisis whereas 12.5% GNPA now is creating a crisis because of the Provisioning norms.

Our recommendations:

1. RBI Circular to be Withdrawn:-
   Withdraw Cir.No.:RBI/2017-18/131 DBR.No.BP.BC.101/ 21.04.048 / 2017-18 dated 12th Feb 2018 issued by RBI as it is only going to increase the NPA and Provisions. It is estimated that all Public Sector Banks and most of the Private Banks also will make losses due to this revised norms. The net Loss to Banking system will be almost one lakh crores which will lead to a financial crisis which the country can't afford now.
2. **Asset Classification Norms to be changed**:-
   The Asset Classification Norms cannot be the same for all kind of loans. The security available has to be taken into account. Similarly the accounts which are guaranteed under Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) have to be classified differently. The Housing Loans which are having the mortgage of house property as security should not be classified as NPA in full. Many Housing Loans also have Insurance Cover. If at all a portion has to be classified as non-performing, it should be only the amount in default and not the whole outstanding.

   With the advent of De-monetization imbroglio and GST intricacies, SME borrowers (inclusive of Transport Operators) face the crisis of working capital flow in the market, raising the invoices challan and realization of receivables. Among other measures to revive their activities, the NPA recognition for Loans & Advances extended to SME borrowers e.g. retail Trade / Whole Sale, Small Business, Services, SSI & Ancillary Unit upto the limit of Rs.5 crs should be 180 days instead of 90 days at present after the loan is identified as SMA.

Since, no streamlined infrastructural facilities is available from the Govt Agencies in respect of forward & backward linkages, Loans extended to the Social & Downtrodden sector in order to implement the strategies and objectives of the Central Govt/ State Govt, (PMMY, Start Up Entrepreneurs, Alternative or Renewable Energy Sector, SC/ST and Women Entrepreneur), suffers from generation of income very often, and remains un-organised to cope up with the volatile economic situation. In order to recycle the Bank's fund, the NPA recognition norms should be 365 days instead of 90 days norms after the loan account becomes sub standard.

Provision for Standard Assets should be kept in abeyance.

Asset classification norms for different loans followed in different countries is given as Annexure 3-5. The details prove that in our country there is a need to change the present norms.

3. Restructuring of Loans should not be stopped:-

Restructuring is an accepted international practice. RBI report [*6] of the Working Group to review the existing prudential guidelines on restructuring of advances by Banks / Financial Institutions has come out with 23 recommendations on restructuring. Instead of implementing these recommendations the RBI is now trying to put an end to restructuring for loans above Rs.2000 Crores and referring them to NCLT which will be destroying the industries which need restructuring and also destroy the Banks which have lent based on the policies of the Government and RBI. The RBI has also withdrawn the restructuring schemes for new NPAs. This is dangerous. Both the Industry as well as the Banks will be affected. What we need is a relook on the restructuring and strengthening the system.

4. Provisioning Norms need change:-

The Provisioning Norms followed in different countries is given as annexure 1 & provisioning norms in our country is given as Annexure 2. Our Provisioning Norms are drastic and not scientific. Because of the Provisioning Norms, though the Operating Profit of Public Sector

*6 Report of the working Group on Restructuring RBI, 2012.

Banks including SBI and IDBI was Rs.1,58,982 crores as on March 2017, the total NPA Provisions was 1,63,939 crores. (See Annexure 6) which lead to a net loss.

Provisioning for Housing Loans cannot be same as that of an overdraft. Similarly the provisioning for the loans covered under CGMTSE should be different than that of other loans. The Provisioning Norms may also differ industry wise. For example: Infrastructure Industry and a medium enterprise cannot be treated at par. There has to be a scientific analysis of the provisioning norms. **Asking the Banks to provide 50% on the outstanding in the first year itself for accounts transferred to National Company Law Tribunal (NCLT)is totally irrational.** Again the Banks have been asked to provide another 50% in the second year. How can one imagine that there will be no recovery in these Corporate advances which are huge. Most of these concerns are running units and they have huge assets including land and building. The provisioning can be maximum 15% in the first year based on a fair assessment value.

The provisioning for the cases referred to NCLT has a scope of revival of the unit / takeover of the unit /closure of the unit. In each case the scope for recovery differs. Accordingly the provisions have to be made differently looking into the assets available, scope for revival of the unit and the security realizable based on the market value. The NCLT is not in a position to settle the cases within 180 days / 270 days due to various reasons including court cases. Hence the burden should not be thrust upon Banks by creating inappropriate provisions.

5. **Implement recommendations of the Parliamentary Standing Committee**: It is more than 2 years since the Parliamentary Standing Committee submitted its recommendations. They were supposed to have been implemented within a year. Neither the Government nor the RBI has taken any steps to implement the recommendations. We appeal to the Govt and RBI to implement the recommendations at the earliest.

6. **Reorient the Banking Policies:-** It is high time to review the Banking policies implemented in the last 27 years and reorient them

towards the upliftment of the masses of the country and give fillip to agriculture, horticulture, animal husbandry, fishery, food processing, cottage and village industries, small and micro enterprises, small and medium enterprises which will create employment and reduce the non performing assets. There should be ceiling on lending to corporates and they should move to the market for mobilisization of funds through bonds or shares. That will also add to scrutiny and supervision.

7. **No tax on NPA Provision**:- The Government should also consider waiver of tax on NPA provisions. The tax should be on Net Profit and not Gross Profit.

8. **Defer implementation of IND-As:-** Public sector banks would need to divert an estimated Rs 63,000 crore to meet increased provisioning requirements for loans under the new Ind-AS accounting standard and this would knock down their growth aspirations and hurt market share. Ind AS (as commonly known in India), is essentially bringing in the global standards on accounting to India. Corporate entities have already started implementing Ind AS from April 1, 2016, in a phased manner, whereas banks and NBFCs will start implementing it from April 1, 2018. Adoption of Ind AS is expected to significantly enhance comparability of the financial statements of Indian banks with their global peers whereas the banking infrastructure in India, the customer base, the loan profile are totally different from that of the global counterparts of Indian Banks. The biggest impact of Ind AS comes from Ind AS 109 (equivalent of IFRS 9), an accounting standard on Financial Instruments, which impacts almost all line-items of banks' balance sheets. Ind AS 109 will lead to early recognition and higher provisions for loans and off-balance sheet exposures using expected credit loss (ECL) model, thereby also impacting capital requirements of the banks. Here, the million dollar question is how much our Banks are ready to embrace Ind AS 109 at this moment. The Indian Banks have to upgrade their policies, IT systems and most importantly their capital. Without taking these factors into consideration, abrupt implementation of Ind AS will only bring further woes for the Indian banks by increasing their NPAs more. Hence as extended to LIC, Banks also should be permitted to defer the norms for atleast 2 years.

9. **Learn from the Experience of Foreign Banks quitting India:-** It is also very important to see the trend of Foreign Banks' operations in India. India has ceased to be a priority for multinational foreign banks since the financial crisis, as high capital and regulatory requirements in India have forced them to retreat into their domestic markets to save on costs and protect profitability. Now, let us have a look at some statistics. In the last five years, Deutsche Bank has sold its credit card business, Barclays has shut its retail banking business; Swiss lender UBS has given up its banking licence and so did US-based multinationals Morgan Stanley and Goldman Sachs; Bank of America-Merrill Lynch sold its wealth management business to Julius Baer and Dutch banking group ING sold its Indian operations to Kotak Mahindra Bank. The exodus continued in 2015 with British bank RBS, which shut 23 of its 31 branches in India. Again, Standard Chartered reduced by a quarter its staff in corporate and investment banking. HSBC, too, announced that it will shut down its private banking business. These foreign banks have been closing down their business in India owing to high capital and regulatory requirements in India; but the domestic banks do not have any option. At one end, we have to continuously endure the onslaught of the RBI and Govt and on the other hand, we are duty bound to serve the masses of the nation. Hence there is an urgent need to change the Asset Classification and provisioning norms as well as Capital Adequacy norms.

10. **Provide Interest on CRR:-** Another important aspect is CRR. The amount that banks set aside as CRR, does not fetch them any interest. Hence they have to bear the negative spread on such deposits. Over the past few years, the RBI has been using liquidity as a key instrument of monetary policy. By increasing the CRR (at times on temporary basis) from time to time, the additional burden is imposed on the banks. At a time, when the Public Sector Banks are going through a tough phase, mainly because of the onslaught of Govt, the RBI should reconsider its view on CRR.

11. **Reimburse Expenditure on Govt Schemes:-** Lastly, the public sector banks are used by the government as tools for implementing the government schemes or social welfare schemes. Right from

opening Jan Dhan Accounts, implementing Demonetization to the enrollment of aadhar, everything is being taken care of by the public sector banks on behalf of the government. It is unfortunate that the government does not reimburse a single penny to the banks which have been incurred by them as part of the implementation expenditure of the government schemes. Moreover, if the performance of the banks have declined in the last few years, then the government is solely responsible for this because these banks have been used all these days to look after the implementation of government schemes and restoring the Indian Economy after the abrupt declaration of demonetization. The RBI and the government should seriously consider the plight of the public sector banks and bring in solution to revive them instead of deteriorating them further.

12. Stop Cross Selling by Banks:

Banks are spending too much of their manpower on Cross Selling of Insurance Policies and Mutual Funds. This leads to mis selling due to incentives provided. Let Banks concentrate on lending.

13. Create Confidence in Bankers to give fresh credit:

Today Banks are scared of giving Credit. In 2017 the credit growth was only 2.4%. Many sectors show negative growth. (Annexure 7)

14. Reorient Credit to bring overall growth

Agriculture needs better growth with focus on small and marginal farmers. Food Processing can create huge employment but only 5.5% of Industry advances have gone to them. Infrastructure needs more attention. Their share in Industry has gone down to 19.85% (Annexure – 8) In a country which is developing RBI & Govt have a role to give directions to the growth path.

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