Non Performing Assets (NPAs)

What Is a Non-Performing Asset (NPA)?
A nonperforming asset (NPA) refers to a classification for loans or advances that are in default or in arrears. A loan is in arrears when principal or interest payments are late or missed. A loan is in default when the lender considers the loan agreement to be broken and the debtor is unable to meet his obligations.

Non-Performing Assets refers to that classification of loans and advances in the books of a lender in which the there is no payment of interest and principal have been received and are “past due”. In most of the cases debt has been classified as Non-Performing Assets where the loan payments have been outstanding for more than 90 days. In the term sheet/sanction letter of every loan, the period of default under which the loan will be classified as non-performing assets are generally mentioned.

KEY TAKEAWAYS

- Nonperforming assets (NPAs) are recorded on a bank's balance sheet after a prolonged period of non-payment by the borrower.
- NPAs place financial burden on the lender; a significant number of NPAs over a period of time may indicate to regulators that the financial health of the bank is in jeopardy.
- NPAs can be classified as a substandard asset, doubtful asset, or loss asset, depending on the length of time overdue and probability of repayment.
- Lenders have options to recover their losses, including taking possession of any collateral or selling off the loan at a significant discount to a collection agency.

How Non-Performing Assets (NPA) Work

- Nonperforming assets are listed on the balance sheet of a bank or other financial institution. After a prolonged period of non-payment, the lender will force the borrower to liquidate any assets that were pledged as part of the debt agreement. If no assets were pledged, the lender might write-off the asset as a bad debt and then sell it at a discount to a collection agency.
- In most cases, debt is classified as nonperforming when loan payments have not been made for a period of 90 days. While 90 days is the
standard, the amount of elapsed time may be shorter or longer depending on the terms and conditions of each individual loan. A loan can be classified as a nonperforming asset at any point during the term of the loan or at its maturity.

For example, assume a company with a $10 million loan with interest-only payments of $50,000 per month fails to make a payment for three consecutive months. The lender may be required to categorize the loan as nonperforming to meet regulatory requirements. Alternatively, a loan can also be categorized as nonperforming if a company makes all interest payments but cannot repay the principal at maturity.

Carrying nonperforming assets, also referred to as nonperforming loans, on the balance sheet places significant burden on the lender. The nonpayment of interest or principal reduces the lender's cash flow, which can disrupt budgets and decrease earnings. Loan loss provisions, which are set aside to cover potential losses, reduce the capital available to provide subsequent loans to other borrowers. Once the actual losses from defaulted loans are determined, they are written off against earnings. Carrying a significant amount of NPAs on the balance sheet over a period of time is an indicator to regulators that the financial health of the bank is at risk.

Types of Non-Performing Assets (NPA)

Although the most common nonperforming assets are term loans, there are other forms of nonperforming assets as well.

- Overdraft and cash credit (OD/CC) accounts left out-of-order for more than 90 days
- Agricultural advances whose interest or principal installment payments remain overdue for two crop/harvest seasons for short duration crops or overdue one crop season for long duration crops
- Expected payment on any other type of account is overdue for more than 90 days

Recording Non-Performing Assets (NPA)

Banks are required to classify nonperforming assets into one of three categories according to how long the asset has been non-performing: sub-standard assets, doubtful assets, and loss assets.
A sub-standard asset is an asset classified as an NPA for less than 12 months. A doubtful asset is an asset that has been non-performing for more than 12 months. Loss assets are loans with losses identified by the bank, auditor, or inspector that need to be fully written off. They typically have an extended period of non-payment, and it can be reasonably assumed that it will not be repaid.

Banks are required to make sub standardization of the non-performing assets (NPA) into the following type of four broad groups: –

1 – Standard Assets
Standard assets are those assets which have remained non-performing assets for a period of 12 months or less than 12 months and the risk of the asset is normal

2 – Sub- Standard Assets
For a period of more than 12 months, non-performing assets are classified under sub-standard assets. Such kind of advances possess more than normal risk and the creditworthiness of the borrower is quite weak. Banks are generally ready to take some haircut on the loan amounts which are categorized under this asset class

3 – Doubtful Debts
For a period which is exceeding 18 months, non-performing assets come under the category of Doubtful Debts. Doubtful debts itself means that the bank is highly doubtful of the recovery of its advances. The collection of such kind of advances is highly questionable and there is the least probability that the loan amount can be recovered from the party. Such kind of advances put the bank liquidity and reputation at jeopardy

4 – Loss Assets
The final classification of non-performing assets is loss assets were the loan has been identified either by the bank itself or an external auditor or internal auditor that the loan amount collection is not possible, and a bank has to take a dent in its balance sheet. The Bank, in this case, has to write off the entire loan amount outstanding or need to make a provision for full amount which needs to write off in future.
Special Considerations
Recovering Losses
Lenders generally have four options to recoup some or all losses resulting from nonperforming assets. When companies struggle to service their debt, lenders may take proactive steps to restructure loans to maintain cash flow and avoid classifying the loan as nonperforming altogether. When loans in default are collateralized by the borrower’s assets, lenders can take possession of the collateral and sell it to cover losses.

Lenders can also convert bad loans into equity, which may appreciate to the point of full recovery of principal lost in the defaulted loan. When bonds are converted to new equity shares, the value of the original shares is usually eliminated. As a last resort, banks can sell bad debts at steep discounts to companies that specialize in loan collections. Lenders typically sell defaulted loans that are unsecured or when other methods of recovery are deemed not to be cost-effective.

• Why Loan Accounts go Bad?

BORROWER-SIDE

➢ Lack of Planning
➢ Diversion of Funds
➢ Disputes within
➢ No contribution
➢ No modernization
➢ Improper monitoring
➢ Industrial Relations
➢ Natural Calamities

BANKER – SIDE

➢ Defective Sanction
➢ No post-sanction supervision, etc
➢ Delay in releases
➢ Directed lending
➢ Slow decision making process

IMPACT OF NPA:

• Profitability
• Liquidity & Opportunity Cost
• Waste of valuable Management time
• Loss of credibility as high NPA reflect poorly on Management
• Impact on Share Price
• Gross NPA more than 10% in case of Co-op. Banks, Supervisory Action follows & restrictions imposed.

TOOLS FOR RECOVERING NPA:

• LOK ADALATS
• DEBT RECOVERY TRIBUNALS (DRT)
• ASSET RECOVERY CONSTRUCTION COMPANY INDIA LIMITED (ARCIL)
• CORPORATE DEBT RESTRUCTURING (CDR)

DEBT RECOVERY TRIBUNALS (DRT): -

➢ To recover their bad Debt quickly & efficiently.
➢ 33 Debt Recovery Tribunal & 5 Debt Recovery Appellate Tribunal
➢ It is the special court established by Central Government for the purpose of recovering money belonging to the banks or financial institutions.

➢ The judges of this court are the retired judges of High Courts.
➢ In this court, only the recovery cases of Rs.10 Lacs & above can be filed.

SARFAESI Act: -

➢ The Act provides three alternative methods for recovery of non-performing assets, namely: -

- Securitization

- Asset Reconstruction

- Enforcement of Security without the intervention of the Court.

➢ Bad loans with outstanding above Rs. 1.00 Lac.
➢ NPA loan accounts where the amount is less than 20% of the Principal & Interest are not eligible to be dealt with under this Act.
➢ To issue demand notice to the defaulting borrower & guarantor, calling upon them to discharge their dues in full within 60 days from the date of
the notice.

- To give notice to any person who has acquired any of the secured assets from the borrower to surrender the same to the Bank.

- To ask any debtor of the borrower to pay any sum due or becoming due to the borrower.

- Any Security Interest created over Agricultural Land cannot be proceeded with.

**Some Tips for Auditors:**

- Verify the previous year’s audited NPA Statement to confirm that all the Accounts which were NPA last year have been covered in Current Year Statement except those which are closed or upgraded.

- If closed, whether from genuine sources. If upgraded, whether from proper recovery in the account.

- Tally the number of accounts.
- Verify whether unrealized Interest has been reversed in respect of accounts which have slipped during the year.
- Verify that proper classification has been done with reference to Date of NPA.
- Whether valuation report for Immovable Properties is on record & it is within 3 years. See that, valuation is taken as per Valuation Report at Distress Value.
- In case of depreciable assets, depreciation has been considered at the time of valuation.
- Securities shown are properly under lien of the Bank.
- All the accounts related to particular borrower have been treated as NPA under lowest category applicable & provision made accordingly.
- In case of D1 & D2 accounts, unsecured portion is provided for @ 100%.
- Verify overdue/overdrawn/SMA accounts to ensure that all NPA A/cs have been covered in the Statement & provided for.
- Ensure that a/cs are not upgraded after restructuring except cases covered by special regulatory treatment.
- Ensure that OIR as per Balance Sheet tallies with that as per NPA Statement.