

## GENERAL STUDIES III

## Non-Performing Assets: Meaning, Types & Solutions | UPSC

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*Understand NPAs, the 90-day rule, asset classification, and their impact on India's banking system. Explore recovery mechanisms and UPSC practice questions. Non-performing assets reflect repayment stress in a bank's loan portfolio. These notes explain NPA identification, classification, key ratios, economic consequences, and resolution mechanisms, including the distinction between a technical write-off and a loan waiver.*

### Non-Performing Assets: Understanding India's Bad-Loan Challenge

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Bank lending supports investment, employment and consumption. When repayments remain unpaid beyond prescribed limits, loans may become non-performing assets. Understanding NPAs helps explain bank profitability, financial stability and the relationship between credit and economic growth.

**UPSC relevance:** GS Paper III — Indian economy, banking, investment and resource mobilisation; Prelims — banking terminology and financial institutions.

**Scope:** These notes explain the principal banking concepts. Detailed treatment depends on the lender, loan type and applicable RBI directions.

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## 1. What Is a Non-Performing Asset?

A non-performing asset, or NPA, is a loan or advance classified as non-performing under prescribed prudential criteria. It indicates that repayment performance has deteriorated sufficiently to require special accounting and regulatory treatment.

A loan is an asset for a bank because it represents a claim on the borrower and normally generates interest. For the borrower, the same loan is a liability.

### The general term-loan rule

A term loan ordinarily becomes an NPA when interest and/or an instalment of principal remains overdue for **more than 90 days**.

“Overdue” means unpaid on the contractual due date. A missed payment can, in rare cases, be overdue before the account becomes an NPA.

### Important exceptions and different tests

- **Cash credit and overdraft:** Classification uses the “out of order” test, covering persistent excess drawings or specified deficiencies in credits over a 90-day period.
- **Eligible short-duration crop loans:** Principal or interest overdue for two crop seasons.
- **Eligible long-duration crop loans:** Principal or interest overdue for one crop season.

Crop-season treatment applies to specified agricultural advances. It should not be extended automatically to every loan associated with agriculture.

## 2. Classification of Bank Assets

### Principal asset categories

| Category          | Meaning                                                                                                 |
|-------------------|---------------------------------------------------------------------------------------------------------|
| Standard asset    | An asset not classified as an NPA                                                                       |
| Substandard asset | An asset that has remained an NPA for up to 12 months                                                   |
| Doubtful asset    | An asset that has remained in the substandard category for 12 months                                    |
| Loss asset        | An identified loss considered uncollectible or of little banking value, although not wholly written off |

Severe impairment can justify more adverse classification without following every ageing stage mechanically. A loss asset does not necessarily mean that absolutely no recovery is possible.

## 3. Special Mention Accounts: Detecting Stress Early

Special Mention Accounts, or SMAs, identify repayment stress before ordinary term-loan accounts cross the NPA threshold.

### Overdue-based SMA bands for ordinary non-revolving loans

| Category | Overdue period                      |
|----------|-------------------------------------|
| SMA-0    | Up to 30 days overdue               |
| SMA-1    | More than 30 days and up to 60 days |
| SMA-2    | More than 60 days and up to 90 days |

Early identification enables lenders to investigate cash-flow problems and engage with borrower, before distress becomes more difficult to resolve.

#### 4. Gross NPA and Net NPA Ratios

##### Gross NPA ratio

Gross NPAs represent non-performing advances before the relevant provisions and regulatory deductions.

$$\text{Gross NPA Ratio} = (\text{Gross NPAs} \div \text{Gross Advances}) \times 100$$

If gross advances are ₹1,000 crore and gross NPAs are ₹50 crore, the gross NPA ratio is 5%.

##### Net NPA ratio

Net NPAs reflect the remaining amount after applicable provisions and specified adjustments. Net advances also incorporate the relevant deductions.

$$\text{Net NPA Ratio} = (\text{Net NPAs} \div \text{Net Advances}) \times 100$$

In a simplified illustration with no other adjustments, gross NPAs of ₹50 crore and eligible provisions of ₹30 crore leave net NPAs of ₹20 crore. If gross advances are ₹1,000 crore, corresponding net advances are ₹970 crore and the ratio is approximately 2.06%.

**Interpretation caution:** A falling NPA ratio can reflect recovery, upgrades, write-offs or growth in advances. It does not necessarily mean that every stressed borrower has repaid.

#### 5. Provisioning and Income Recognition

Provisioning recognises credit-loss exposure in financial accounts. It reduces reported profits and provides an accounting allowance against potential losses.

It is not equivalent to placing an identical amount of cash in a separate vault. Standard assets can also attract provisions.

For NPAs, interest income is generally recognised on actual realisation rather than continued accrual, subject to applicable rules. This prevents unpaid interest from overstating income.

## 6. Why Do NPAs Arise?

- **Economic slowdown:** Lower demand and cash generation weaken repayment.
- **Project delays:** Approval, land, construction or supply problems postpone revenue.
- **Weak appraisal:** Unrealistic forecasts and inadequate due diligence lead to unsuitable lending.
- **Excessive leverage:** Borrowers take on debt beyond sustainable cash flows.
- **External shocks:** Commodity prices, exchange rates or disasters disrupt viable businesses.
- **Governance failures:** Diversion of funds, fraud or connected lending can impair credit quality.
- **Delayed corrective action:** Concealing stress allows losses to accumulate.

Not every default involves fraud or wilful misconduct. A borrower may face genuine financial distress. Accountability requires examination of the facts.

## 7. Economic Consequences

### For banks

NPAs weaken interest income, increase provisioning and recovery costs, and can reduce profitability and capital strength.

### For businesses and households

Weakened lenders may become more cautious about new credit. Viable enterprises can face reduced access to finance, affecting investment and employment.

### For the wider economy

When highly indebted firms and weak bank balance sheets reinforce each other, the result is often described as the **twin balance-sheet problem**. Public recapitalisation can also create fiscal opportunity costs.

## 8. Resolution and Recovery Mechanisms

### A. Early restructuring

A viable borrower may require a sustainable change in repayment terms. Restructuring should follow applicable prudential rules and credible viability assessment; it does not automatically restore standard classification.

### B. SARFAESI framework

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 enables qualifying secured creditors to enforce eligible security interests through prescribed procedures and safeguards.

It is not an unrestricted power to seize every borrower asset. Statutory conditions, exclusions and remedies remain relevant.

## C. Debt Recovery Tribunals

DRTs provide a specialised mechanism for adjudication and recovery of eligible debts owed to banks and financial institutions.

## D. Insolvency and Bankruptcy Code

The Insolvency and Bankruptcy Code, 2016 provides a framework for resolving insolvency and maximising asset value. Corporate processes involve institutions such as the NCLT and insolvency professionals.

IBC is a collective resolution framework, not merely an individual lender's recovery short cut. Liquidation may follow where an appropriate resolution is not achieved.

## E. Asset Reconstruction Companies

ARCs acquire eligible stressed financial assets and pursue reconstruction or recovery. Aggregating exposures may improve coordination, but transferring a loan does not itself eliminate the underlying economic loss.

## F. Compromise settlements

A lender and borrower may negotiate settlement under the applicable framework. Such arrangements should be assessed against realistic recovery prospects, valuation and accountability requirements.

### 9. Write-Off, Waive and Haircut

Three frequently confused concepts

| Concept             | Meaning                                                                               |
|---------------------|---------------------------------------------------------------------------------------|
| Technical write-off | Accounting treatment that does not waive the lender's claim; recovery may continue    |
| Loan waiver         | Release from repayment obligations to the extent specified                            |
| Haircut             | Reduction in a creditor's claim or economic recovery under a settlement or resolution |

Haircut percentages should identify the reference amount and valuation basis. A reduction relative to admitted claims is different from recovery relative to liquidation value.

### 10. Preventing Fresh NPAs

1. Assess repayment capacity using realistic cash flows.
2. Monitor fund use and early-warning indicators.
3. Recognise stress promptly and transparently.
4. Resolve viable businesses before value deteriorates.
5. Improve valuation, recovery and adjudication capacity.
6. Strengthen bank governance and proportionate accountability.
7. Avoid evergreening: artificial financing or transactions used to conceal underlying repayment stress.

## 11. UPSC Prelims: Key Takeaways

- A loan is an asset for the lender and a liability for the borrower.
- The ordinary term-loan NPA rule is more than 90 days overdue.
- Eligible crop loans have crop-season-based criteria.
- Cash-credit and overdraft accounts use the out-of-order test.
- A loss asset is not defined solely by its age.
- Technical write-off is different from waiver.
- A lower NPA ratio does not necessarily indicate cash recovery.
- IBC focuses on insolvency resolution and value maximisation.

### Practice Question

Consider the following statements:

1. Every agricultural loan must be classified using the ordinary 90-day term-loan rule.
2. A technical write-off necessarily extinguishes the lender's claim against the borrower.
3. Growth in advances can reduce the gross NPA ratio even if the gross NPA amount is unchanged.

Which statement or statements are correct?

- A. 1 only
- B. 1 and 2 only
- C. 3 only
- D. 1, 2 and 3

#### View answer and explanation

**Correct answer: C. 3 only.** Specified agricultural advances use crop-season criteria. Technical write-offs do not waive claims. A larger denominator can lower the gross NPA ratio without reducing the NPA amount.

## 12. UPSC Mains Practice

**Question:** "Sustainable reduction of non-performing assets requires better credit governance as well as effective resolution mechanisms." Discuss. (250 words)

- Define NPAs and distinguish them from temporary overdue payments.
- Explain economic, project-related and governance causes.
- Discuss effects on banks, investment and employment.
- Evaluate restructuring, SARFAESI, DRTs, IBC and ARCs.
- Recommend early recognition, realistic lending and faster resolution.

## Conclusion

NPA management involves recognising losses honestly, preserving viable businesses and recovering value efficiently. Strong lending standards and timely resolution are essential to maintain confidence and support productive credit.

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