NON-PERFORMING ASSETS IN INDIA:

FROM RECOGNITION FAILURES TO REGULATORY DISCIPLINE

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NPAs are not just bad loans - they are delayed truths.

For years, stress in India's financial system remained concealed behind restructuring and evergreening, until regulatory discipline forced timely recognition. This shift coincided with a broader macroeconomic recovery marked by improved growth, stronger corporate balance sheets, and enhanced capital buffers. As a result, India's GNPA ratio, which peaked at over 11% in 2018, declined to around 2.6% by FY 2024–25, driven by stricter recognition norms, higher provisioning, and robust resolution frameworks.

Against this macroeconomic and regulatory backdrop, it becomes essential to understand what constitutes a Non-Performing Asset, how it is identified, and why its classification matters for lenders and the broader financial system.

Understanding NPA, GNPA, NNPA and PCR in Brief -

Simply put, a **Non-Performing Asset (NPA)** refers to any loans or advance, the principal or interest payment for which remains overdue for a period of 90 days or more.

In banking parlance, the asset ceases to generate income - it signals stress in the bank's asset quality.

GNPA (Gross NPA) - represents the total value of all loans that have become non-performing, without deducting any provisions. It shows the overall level of bad loans on a bank's books before adjustments.

NNPA (Net NPA) - is calculated by subtracting provisions and recoveries from GNPA. It reflects the actual remaining loss risk the bank still faces after accounting for expected losses.

Provision Coverage Ratio (PCR) - indicates what percentage of NPAs are covered by the bank's provisions. A higher PCR means the bank is better prepared to absorb potential loan losses.

Evolution of NPA Recognition Norms: Then vs Now

Earlier Framework

Initially, asset classification was based on the “past due” concept, under which loans became NPAs only after remaining unpaid beyond a specified period. This period was progressively tightened—from four quarters in 1993, to three quarters in 1994, and two quarters in 1995. By March 2001, the RBI abolished the “past due” approach altogether, requiring default to be reckoned immediately from the due date.

Provisioning norms were also structured based on asset ageing, with doubtful assets requiring provisions ranging from 25% to 100%, and loss assets mandating full provisioning where recovery was considered improbable.

Current / Updated Framework

Over time, the RBI has moved towards greater harmonisation, discipline, and transparency:

- Uniform 90-day norm for NBFCs: NPA recognition has been standardised across NBFCs, replacing earlier 180-day norms applicable to certain entities.
- Income recognition & provisioning: Interest on NPAs is recognised only on a cash basis, and provisioning continues to depend on asset classification and ageing.
- Stronger regulatory focus: Enhanced supervision, tighter classification norms, and improved recovery mechanisms have strengthened the overall stressed-asset resolution framework.

In sum, NPAs are not merely an asset-quality issue but a capital and regulatory concern under Basel III. Early stress recognition through SMA monitoring and EWS plays a crucial role in smoothing provisioning cycles, preserving CRAR, and ensuring financial stability.

Reasons for Increasing Non Performing Assets

Several structural, macro, and institutional factors contribute to higher NPAs in Indian banks / NBFCs. Some key reasons:

1. Poor Credit Appraisal: Weak loan assessment and manipulated borrower financials lead to lending to customers who cannot repay.

2. Macroeconomic Shocks: Slowdowns, commodity price crashes, inflation, and interest rate changes reduce borrowers’ cash flows, causing defaults.

3. **Wilful Defaults:** Some borrowers intentionally choose not to repay despite having the capacity, often linked to weak corporate governance.

4. **Institutional Weaknesses:** Poor monitoring, slow legal processes, and inefficient recovery mechanisms (like DRTs/ARCs) delay resolution.

5. **Policy Pressures:** Priority Sector Lending requirements sometimes push banks to lend in riskier, less viable segments.

<u>How NPAs Affect Banks / NBFCs and the economy :</u>

1. Profitability

NPAs reduce profitability because banks must make high provisions that directly cut into profits, and interest on NPAs is booked only when actually received, lowering income. Additionally, deteriorating asset quality forces banks to lend more cautiously, slowing growth in interest-earning assets and further reducing profitability.

2. Share Price & Valuation

High NPAs increase credit risk, causing investors to value banks more cautiously and demand a higher cost of capital. Provisioning also reduces retained earnings and weakens the capital base, which further pressures valuations. If NPAs continue rising or recoveries remain poor, the market may downgrade the bank's outlook, leading to a re-rating and a fall in share price.

3. Reputation

A high NPA ratio signals weak credit discipline and risk management, reducing trust among depositors, investors, and borrowers. Persistent stress also invites stricter regulatory scrutiny, and in severe cases may lead to PCA restrictions (Prompt Corrective Action). As reputation deteriorates, the bank's funding cost rises because lenders demand a higher risk premium and depositors prefer safer institutions.

4. Impact on Domestic Companies

High NPAs force banks to tighten credit, making borrowing costlier and less accessible. This slows business expansion, delays projects, and may lead to job losses due to reduced investment and cash-flow stress.

5. Global Impact

Elevated NPAs weaken financial stability and investor confidence, increase contagion risk, and can restrict global credit flows. Reduced bank profitability and higher defaults also impact global investors through falling values of international equities, bonds, and debt funds.

*In such situations, banks may be incentivised to delay the recognition of stress in loan accounts. One such practice is **evergreening of loans**.*

Evergreening of Loans: Practices and Regulatory Crackdown

Evergreening of Loans refers to the practice where banks extend fresh loans to borrowers mainly to **repay existing stressed or defaulted loans**, instead of resolving the underlying credit issues. This creates an illusion that the loan is performing, while in reality, the borrower is still unable to service the debt.

Common examples of evergreening include:

- **Round-tripping** – The borrower takes a new loan to repay an old one, without improving their cash flow.
- **Fresh loans to repay old loans** – Instead of addressing defaults, banks provide new credit to cover overdue amounts.
- **Transferring to group entities** – Moving debt within related companies to mask non-performance.

In 2023, the RBI issued a circular to curb the practice of evergreening and other "innovative accounting methods" used by banks to disguise stressed loans. The RBI emphasized that banks must **recognize non-performing assets (NPAs) accurately** and not use loans to mask defaults. This directive aims to improve **transparency in financial reporting**, ensure **realistic assessment of asset quality**, and strengthen overall **banking sector stability**. By enforcing stricter recognition norms, the RBI seeks to prevent hidden credit risks and promote responsible lending.

Measures to Control NPAs – Government of India & RBI

The Government of India and the RBI have adopted a multi-pronged approach to address the NPA problem, covering prevention, early detection, restructuring, and recovery

(A) Preventive & Information-Based Measures

Credit Information Bureau (2000) - Enables sharing of borrower credit information and identification of wilful defaulters, helping banks assess credit risk and prevent fresh NPAs.

Joint Lenders' Forum (2014) - Facilitates coordination among lenders to prevent multiple banking arrangements being misused to service old loans, thereby discouraging evergreening.

(B) Early Detection & Recognition

Asset Quality Review (2015) - RBI-led exercise to ensure early recognition of stressed assets and prevent postponement of NPA classification.

(C) Restructuring & Resolution Frameworks

Corporate Debt Restructuring (2005) - Allows viable companies temporary relief through restructuring of debt repayment terms.

5:25 Rule / Flexible Structuring (2014) - Enables refinancing of long-term infrastructure and core sector loans by matching repayment schedules with project cash flows.

Strategic Debt Restructuring (SDR) – 2015 - Permits banks to convert defaulted debt into equity and take control of borrower management to revive stressed assets.

(D) Recovery & Clean-Up Mechanisms

Debt Recovery Tribunals (DRT) - Provide a fast-track judicial mechanism for recovery of bank dues under the Recovery of Debts and Bankruptcy Act.

Asset Reconstruction Companies (ARCs) - Acquire stressed assets from banks and attempt recovery or resolution outside traditional court processes.

Insolvency and Bankruptcy Code (2016) - Introduced a time-bound, creditor-driven insolvency resolution framework, significantly improving recovery rates and credit discipline.

(E) Banking System Reforms

Mission Indradhanush (2015) -_Comprehensive reform programme aimed at strengthening Public Sector Banks through capital infusion, governance reforms, and accountability mechanisms.

NPAs and Their Effect on CRAR and Basel III Compliance

Non-Performing Assets (NPAs) have a direct and material impact on a bank's capital adequacy and regulatory compliance. Under Basel III norms, banks are required to maintain a minimum Capital to Risk-Weighted Assets Ratio (CRAR). As NPAs rise, provisioning requirements increase and capital is eroded, while stressed exposures attract higher risk weights. This combination inflates Risk-Weighted Assets (RWA) and compresses CRAR, forcing banks to raise additional capital or curtail lending. Accordingly, effective NPA management is critical to sustaining capital buffers, balance-sheet strength, and growth.

While formal NPA classification continues to be governed by the 90-day overdue norm, regulators have increasingly emphasised early identification of stress to prevent sudden deterioration in asset quality and capital ratios. Delayed recognition of stress can result in sharp provisioning shocks, adversely affecting CRAR and Basel III buffers.

In this context, banks now actively monitor Special Mention Accounts (SMA):

- SMA-0: Overdue up to 30 days
- SMA-1: Overdue 31–60 days
- SMA-2: Overdue 61–90 days

The RBI encourages the use of Early Warning Signals (EWS) and data-driven analytics, including borrower cash-flow monitoring and behavioural analysis, to flag stress even before repayment defaults occur. This approach—often referred to as the *"Day-0 recognition" debate* - does not alter the legal NPA definition but strengthens supervisory oversight and capital planning.

Conclusion

The evolution of India's NPA framework marks a decisive shift from delayed recognition and balance-sheet forbearance to transparency, discipline, and capital accountability. What was once a system tolerant of restructuring and evergreening has been progressively replaced by stricter asset-classification norms, higher provisioning standards, and time-bound resolution mechanisms. This transition has not only improved reported asset quality but has also strengthened bank balance sheets, restored market confidence, and aligned India's banking system more closely with global Basel III standards.

Going forward, the emphasis on early stress detection through Special Mention Account monitoring, Early Warning Signals, and data-driven credit assessment underscores the regulator's intent to prevent the re-emergence of hidden stress. NPAs today are no longer merely a symptom of borrower distress; they are a test of institutional discipline, governance, and risk culture. Sustaining this progress will require banks and NBFCs to embed early recognition and prudent capital management at the core of their lending practices, ensuring that credit growth remains both resilient and responsible.