

The World bank recommendation for NPA classification

The 90 day rule appears for the same too so I suggest we recommend NPA classification on the basis of Probability of Default (a credit risk measurement tool) this will ensure the factoring of economic issues which are not presently happening.

As per PD the risk that the borrower will be unable or unwilling to repay its debt in full or on time, the risk of default is derived by analyzing the obligor's capacity to repay the debt in accordance with contractual terms. PD is generally associated with financial characteristics such as inadequate cash flow to service debt, declining revenues or operating margins, high leverage, declining or marginal liquidity, and the inability to successfully implement a business plan. In addition to these quantifiable factors, the borrower's willingness to repay also must be evaluated.

It applies to a particular assessment horizon, usually one year.

Credit scores, such as FICO for consumers or bond ratings from S&P, Fitch or Moodys for corporations or governments, typically imply a certain probability of default.

For group of obligors sharing similar credit risk characteristics such as a RMBS or pool of loans, a PD may be derived for a group of assets that is representative of the typical (average) obligor of the group.^[3] In comparison, a PD for a bond or commercial loan, are typically determined for a single entity.

Under Basel II, a default event on a debt obligation is said to have occurred if^[4]

- it is unlikely that the obligor will be able to repay its debt to the bank without giving up any pledged collateral
- the obligor is more than 90 days past due on a material credit obligation

The PD of an obligor not only depends on the risk characteristics of that particular obligor but also the economic environment and the degree to which it affects the obligor. Thus, the information available to estimate PD can be divided into two broad categories -

- Macroeconomic information like house price indices, unemployment, GDP growth rates, etc. - this information remains the same for multiple obligors.
- Obligor specific information like revenue growth (wholesale), number of times delinquent in the past six months (retail), etc. - this information is specific to a single obligor and can be either static or dynamic in nature. Examples of static characteristics are industry for wholesale loans and origination "loan to value ratio" for retail loans.