THE INSTITUTE OF
CHARTERED ACCOUNTANT OF INDIA

Seminar on Statutory Audit of Bank Branches

Income Recognition, Asset Classification and Provisioning pertaining to Advances

Speaker:

CA. Sanjay Khemani

Partner, M. M. Nissim & Co.

Friday, March 20, 2015

Legal Basis of RBI guidelines

Banking Regulation Act, 1949

Sec.21 :

- Power to RBI to determine ‘policy’ in relation to advances, for all banks or for a particular bank, and the banks are duty-bound to follow it.

Sec.35A :

- Power to RBI to issue ‘directions’ in the interest of banking policy and the banks are duty-bound to follow it.

Sec.5 (ca)

- "banking policy" means any policy specified from time to time by the RBI in the interest of the banking system or in the interest of monetary stability or sound economic growth

Macro overview

- Single largest item of a bank's balance sheet
- IRAC Norms: Refer Master Circular no. DBOD.No.BP.BC.9/21.04.048/2014-15 dated 1st July, 2014 for updated guidelines till 30th June, 2014
- IRAC norms vs Accounting Standards
- Asset Classification: Primary responsibility of Bank's Management <u>and</u> statutory auditors
- Appropriation of <u>recoveries in a uniform and consistent</u> manner.
- Income Recognition: Based on record of recovery
  - On accrual basis for performing advances
  - On cash basis for non performing advances
  - Unrealised interest to be <u>reversed</u>
- Asset Classification:
  - Objective criteria?
  - Uniform and consistent application
- Provisioning:
  - Age of non-performance
  - Realisable value of security

Income Recognition-Exceptions

- Interest on Central Govt. guaranteed advances which would have been NPA but for such guarantee- Cash Basis
- Interest on loan against FD, NSC, IVP, KVP & Life policies- Accrual basis as long as <u>adequate margin</u> is available
- Interest on additional finance in NPA account classified as standard- Cash basis.
- Fees and commissions earned as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis <u>over the period of time covered by the renegotiated or rescheduled extension of credit</u>. {Para 3.1.3 of MC}
- For infra project loans, income is not to be booked under accrual system beyond 2 years from original DCCO. {Para 4.2.15.3(iv)(a) of MC}
- For non-infra project loans, income is not to be booked under accrual system beyond 1 year from original DCCO. {Para 4.2.15.4(iii)(a) of MC}

A Brief Snapshot

- Types of Assets:

Standard Assets
* Not non-performing * does not carry more than the normal risk to the business.

Non Performing Assets
* Ceases to generate income * Higher risk
* Various criteria for based on types of loans

Sub Standard Assets

Loss Assets

Doubtful Assets

Doubtful - 1

Doubtful - 2

Doubtful - 3

A Brief Snapshot

- Movement of an asset through various stages

Sub-Standard
- NPA for a period less than or equal to 12 months
- 15% of secured/
- 25% of unsecured

Doubtful-1
- Substandard category for a period of 12 months
- 25% of secured + 100% of unsecured

Doubtful- 2
- Doubtful-1 category for a period of more than 12 months
- 40% of secured + 100% of unsecured

Doubtful- 3
- Doubtful-2 category for a period of more than 24 months
- 100%

Asset Classification-Governance

Identification on <u>ongoing basis</u>

Qua Borrower <u>across the bank</u>

Record of <u>own recovery</u>

Regularisation through <u>genuine source</u> & not by additional facility

A<u>ppropriate internal systems</u> for proper and <u>timely identification of NPAs</u>

M<u>inimum cut-off point</u>, valid for entire accounting year, to decide a high value accounts along with responsibility and validation levels for proper asset classification, <u>not later than 1 month from the date on which the account would have been classified as NPA</u>, in case of doubts

Asset Classification-Governance

Board approved policy for computation of drawing power

Board approved policy for settlement of crystallised MTM of derivative contracts in instalments.
{Para 3 of DBOD.No.BP.BC.31/21.04.157/2012-13 dated July 23, 2012}

Board approved policy for writing off of bad debts/ losses and compromise proposals for Private Sector Banks.
{DBOD.No. BP.BC-68/21.04.048/2012-13 dated January 1, 2013}

Provisions at a rate > regulatory minimum:

(a) To be approved by Board ; (b) Consistently applied on year to year basis. {Para 5.7 of MC}

Asset Classification-Guidelines

Term Loan:

- Interest and/or instalment of principal remain overdue for a period of more than 90 days.

Overdraft/Cash Credit:

- Account remains 'out of order'. An account to be treated as 'out of order' if
  - ❖ the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. Days?
  - ❖ no credit continuously for 90 days as on the reporting date.
  - ❖ credits are not enough to cover the interest debited during the same period

Bills Purchased / Discounted:

- The bill purchased or discounted remains overdue for a period of more than 90 days

- Interest due & charged during any quarter not serviced fully within 90 days from the end of the quarter. {Para 2.1.3 of MC}

Asset Classification-Guidelines

Agricultural Advances:

- Short duration crops - Instalment of principal or Interest remains overdue for **two crop seasons**.
- Long duration crops - Instalment of principal or Interest remains overdue for **one crop season**.

Crop season - the period up to harvesting of the crops raised as determined by the State Level Bankers' Committee in each State.

Credit card dues:

- Minimum amount due not paid fully within 90 days from the next statement date
- Gap between two statements should not be more than a month.

Project loans

Infra- Beyond 2 years of DCCO

Non infra- Beyond 1 year of DCCO

Derivative Transactions:

- Overdue receivables representing positive MTM value of a derivative contract remaining unpaid for a period of 90 days from specified due date.

Asset Classification-Guidelines

Accounts where there is erosion in the value of security/frauds committed by borrowers *{Para 4.2.9 of MC}*

- Asset should be straightaway classified as doubtful or loss asset as appropriate, if:
  - ❖ Potential threats for recovery on account of erosion in the value of security or non-availability of security
  - ❖ Existence of other factors such as frauds committed by borrowers.

An account **not** to be classified as NPA, only on the basis of **temporary deficiencies**

- Non-availability of adequate drawing power based on the latest available stock statement,
- Balance outstanding exceeding the limit temporarily,
- Non-submission of stock statements, and
- Non-renewal of the limits on the due date, etc.

Asset Classification-Guidelines

Accounts regularised near about the balance sheet date *{Para 4.2.6 of MC}*

- A generally irregular account, regularised in the near period of the balance sheet date where a **solitary or a few credits are recorded**, should be carefully checked.
- Account indicates inherent weakness, the account should be deemed as a NPA.

Asset Classification to be borrower-wise and not facility-wise *{Para 4.2.7 of MC}*

- All facilities granted to a borrower to be treated as NPA and not the particular facility which has become irregular.
- All investment in all the securities issued by a borrower to be treated as NPI and not the particular investment which has become irregular.

Advances under consortium arrangements *{Para 4.2.8 of MC}*

- Accounts to be classified by member banks, individually, based on their own records of recovery.
- The banks should arrange to get their share of recovery transferred or get an express consent from the lead bank to ensure proper asset classification in their respective books.

Upgradation of loan accounts classified as NPAs *{Para 4.2.5 of MC}*

- A/C classified as NPA can be upgraded if arrears of interest and principal are paid by the borrower.

Asset Classification-Exceptions

- Bill discounted under LC; However, if unpaid on due date, back dating
- MTM losses of Forward & plain vanilla derivative entered into between April 2007 & June 2008: Only that facility is NPA
- Advances guaranteed by Central Government
- Loan against TDR, NSC, IVP, KVP & life policies- Adequate margin
- Solitary credit
- Escrow A/c maintaining bank: Non payment to other members, lowest classification & accelerated provisions
- Additional finance (restructured) standard up to one year.
- Additional finance (rehabilitation) standard up to one year.
- Delay in achieving DCCO beyond certain period
- Non-reviewing/ non-renewal of regular/ *ad hoc* limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA {Para 4.2.4 (ii) of MC}
- Draw-downs based on stock statements older than 3 months deemed irregular and continuous 90 days of such irregularity renders the a/c an NPA. {Para 4.2.4.(i) of MC}

Asset Classification-Exceptions

<u>Post-shipment Supplier's Credit</u> <u>*{Para 4.2.17 of MC}*</u>

- In respect of post-shipment credit covered under ECGC, if EXIM Bank pays the guaranteed amount within a period of 30 days from the day the bank invokes the guarantee: Not an NPA to the extent of payment received from Exim

<u>Export Project Finance</u> <u>*{Para 4.2.18 of MC}*</u>

- In respect of export project finance, there could be instances where the actual importer has paid the dues to the bank abroad but the bank in turn is unable to remit the amount due to political developments such as war, strife, UN embargo, etc.
- In such cases, where the lending bank is able to establish through documentary evidence that the importer has cleared the dues in full by depositing the amount in the bank abroad before it turned into NPA in the books of the bank, but the importer's country is not allowing the funds to be remitted due to political or other reasons, the asset classification may be made after a period of one year from the date the amount was deposited by the importer in the bank abroad.

Divergences - Asset Classification

- Ignoring ageing of non-performance
- Overstating security value, ignoring stock audit findings
- Overstating DP
- Falsifying date of NPA
- Up-gradation of NPAs before all arrears are cleared, particularly retail loans
- Non-reporting of restructuring cases
- DCCO stretching beyond prescribed grace period
- Ever-greening (through corporate loans, NFB facilities, loans to associates etc.)
- Bridge Loans / STLs - roll-over or wrongful regularisation
- Funding of NFB exposure
- Use of tactical single credits before reporting date
- Fraudulent operations in loan a/c ignored
- Wrong computation
- Mono crop seasons vs bi-crop seasons in agricultural loans

Provisioning Norms:

The **primary responsibility** for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the **statutory auditors**.

Minimum prescribed provisions:

Loss assets *{Para 5.2 of MC}*

- Loss assets should be fully written off.
- If loss assets are remain in the books for any reason, 100 % should be provided.

Doubtful assets *{Para 5.3 of MC}*

- 100 % if advance not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.
- For secured portion, at the rates ranging from 25 % to 100 % of the secured portion depending upon the period for which the asset has remained doubtful:

Period of advances remained in 'doubtful' category	Provision requirement (%)
Up to one year	25 % Secured + 100 % Unsecured
One to three years	40 % Secured + 100 % Unsecured
More than three years	100 % Secured + 100 % Unsecured

Provisioning Norms:

<u>Sub Standard assets</u> *<u>{Para 5.4 of MC}</u>*

- General provision of 15%, without making any allowance for ECGC guarantee cover and <u>securities</u> available.
- Additional provision of 10%, i.e. total 25% on 'unsecured exposures'.
- Provisioning @ 20% instead of 25% in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts.

<u>Standard assets</u> *<u>{Para 5.5 of MC}</u>*

- Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:
- a. Direct advances to agricultural and SME sectors at 0.25%;
- b. Advances to Commercial Real Estate (CRE) Sector at 1%;
- c. Advance to commercial Real Estate – Residential Housing Sector at 0.75%
- d. Housing loan at teaser rates 2% and 0.40% after 1 year from the date on which the rates are reset at higher rates
- e. All other loans and advances not included in (a), (b), (c) and (d) above at 0.40% (Medium Enterprises will attract 0.40% standard asset provisioning.)

<u>Restructured Standard:</u> till revised DCCO or 2 years from restructuring plus moratorium

- Restructured as on 01-06-13: 4.25% for FY 2015 and 5% for FY 2016 & thereafter
- Restructured from 01-06-13: 5%
- Restructured NPA becoming standard- 5% in first year

Provisions under Special Circumstances:

SMA-2 Accounts: 5%

Lender not reporting within time frame

JLF not formed by leader

Fails to agree on the CAP: All

Provision for non reporting of SMA-2 or non implementation of CAP

Sub standard (secured)- between 6-12 months: 25%

Sub standard (ubsecured)- between 6-12 months: 40%

D-1- 40%

D-2 100%

Unhedged foreign currency exposure

- Likely loss up to 15% of EBID: Nil
- Likely loss > 15% <= 30% of EBID: 0.20%
- Likely loss > 30% <= 50% of EBID: 0.40%
- Likely loss > 50% <= 75% of EBID: 0.60%
- Likely loss > 75% of EBID: 0.80%

Provisioning: Other issues

NPAs of Rs. 5 Crores or more:

- Annual Stock Audit by External Agencies
- Triennial valuation of immovable properties

Advances covered by ECGC/CGTSI guarantee: In case of Advances classified as doubtful, Provision to be made only for the balance in excess of the amount guaranteed by the corporation.

Sale of financial assets to securitisation company (SC)/ reconstruction company (RC):

- Sale is at a price below the NBV: Shortfall to be debited to the P&L. Bank has option to spread it over 2 years
- Sale is at a price higher the NBV : The excess provision to be reversed when cash received is higher than the NBV

** Net Book Value (NBV) = book value less provisions held.*

No provision for a period of one year from the date of disbursement on additional facilities sanctioned as per package finalised by BIFR / institutions.

Reserve for exchange rate fluctuation

Provisioning for Overdue foreign currency loans disbursed in INR

- Following procedure may be adopted:
  - Loss on revaluation of asset to be booked in P&L a/c.
  - Usual Provisions applicable as per IRAC norms.
  - Entire Revaluation Gain on asset to be used to make provisions against the corresponding assets.

{Para 5.9.7 of MC}

Provisioning for Country Risk

Where Net Funded Exposure* >= 1 % of Total Assets

Includes **Indirect Country Risk** (Discount Factor 50%)

(where the domestic borrowers with large economic dependence on certain countries) {DBOD.BP.BC.71/21.04.103/2002-03 dated February 19, 2003}

W.e.f. the year ending March 31, 2003, Banks shall make provisions, on the net funded country exposures on a graded scale ranging from 0.25 to 100 % according to the risk categories prescribed. (Para 5.9.8 of MC)

Provision to be in addition to the provisions required to be held according to the asset classification status of the asset.

In the case of 'loss assets' and 'doubtful assets', provision held, including provision for country risk, may not exceed 100% of the outstanding.

Divergences - Provisioning

- Valuation of financial securities created out of restructured a/cs
- Restructuring of Preference Shares
- Harmonising classification of investments with loans
- Unamortised income
- Fraud cases
- Accrual of certain fee incomes on accrual basis against stated policy
- Not recognising non-performance of other receivables
- Appropriation of recovery from NPAs / written-off accounts

Additional Provisioning- snapshot

Diminution of Fair Value in case of Restructured Loans (NPAs)	Restructured Advances (NPAs) upgraded to 'Standard	Restructured Advances classified as 'Standard'
Drawn-down Liquidity Facilities under Securitisation Transactions	MTM Receivables from Derivative Exposures	Housing loans at Teaser Rates

Restructuring

Changes in the repayment schedule or interest rate

Eligibility criteria for restructuring of advances (Para 12.1 of MC)

1. Reschedule/ restructure/ renegotiate cannot be with retrospective effect
2. Usual asset classification to continue pending restructuring
3. Date of approval of restructuring package relevant
4. Restructuring can be based on alteration/ changes in the original loan agreement with the formal application of the debtor.
5. Restructuring can be initiated by bank subject to customer agreeing to the terms and conditions.
6. No restructuring unless the financial viability is established.
7. In case of borrowers indulging in frauds and malfeasance, banks to satisfy that the borrower is in a position to rectify the wilful default.
8. BIFR cases eligible for restructuring subject to approval from BIFR.

Restructuring

<u>Asset classification norms</u> (Para 12.2 of MC)

- Restructuring of advances could take place in the following stages:
  a) before commencement of commercial production/ operation;
  b) after commencement of commercial production/ operation but before the asset has been classified as 'sub-standard';
  c) after commencement of commercial production/ operation and the asset has been classified as 'sub-standard' or 'doubtful'.
- Standard Assets should be immediately re- classified as Sub-standard Assets upon restructuring, subject to exceptions
- If satisfactory performance after the specified period not evidenced, then apply pre-restructuring schedule
- Provision for sacrifice for erosion in fair value
- Such provision to be recomputed <u>every year</u>
- Second restructuring-

  Standard becomes NPA

  NPA to be classified from the date it became NPA for the first time

Restructuring

Withdrawal of regulatory forbearance w.e.f. 01-04-2015

Mere extension of DCCO with consequential change in schedule- No restructuring

Extension of DCCO

- Infra
  - Up to 2 years: Not considered restructured
  - Beyond 2 years:
    - Court Cases: another 2 years
    - Other reasons: 1 year
- Non infra: up to 1 year- not considered restructured
  - Beyond 1 year- 1 year

Change in repayment schedule due to increase in project scope

- Changes before DCCO
- Cost of additional scope: at least 25% higher excluding cost overrun
- Rating not lower by more than 1 notch

Restructuring

Funding of cost overrun (w.e.f. 14-08-14)

- Standby facility sanctioned initially: As per terms
- Subsequently: If due to extension of DCCO
  - Fund IDC on account of delay
  - Others: 10% of original cost
  - No deterioration of DER
  - Disbursement only after entire promoters contribution

Long term project loan to infra and core sector

1. Sanctioned after 15th July, 2014
2. Amortisation schedule- Modified after DCCO- 1st time- No restructuring
3. Amortisation schedule- Modified after DCCO- 2nd time- Considered restructuring

Restructuring

Refinancing of project loans: Not considered restructured

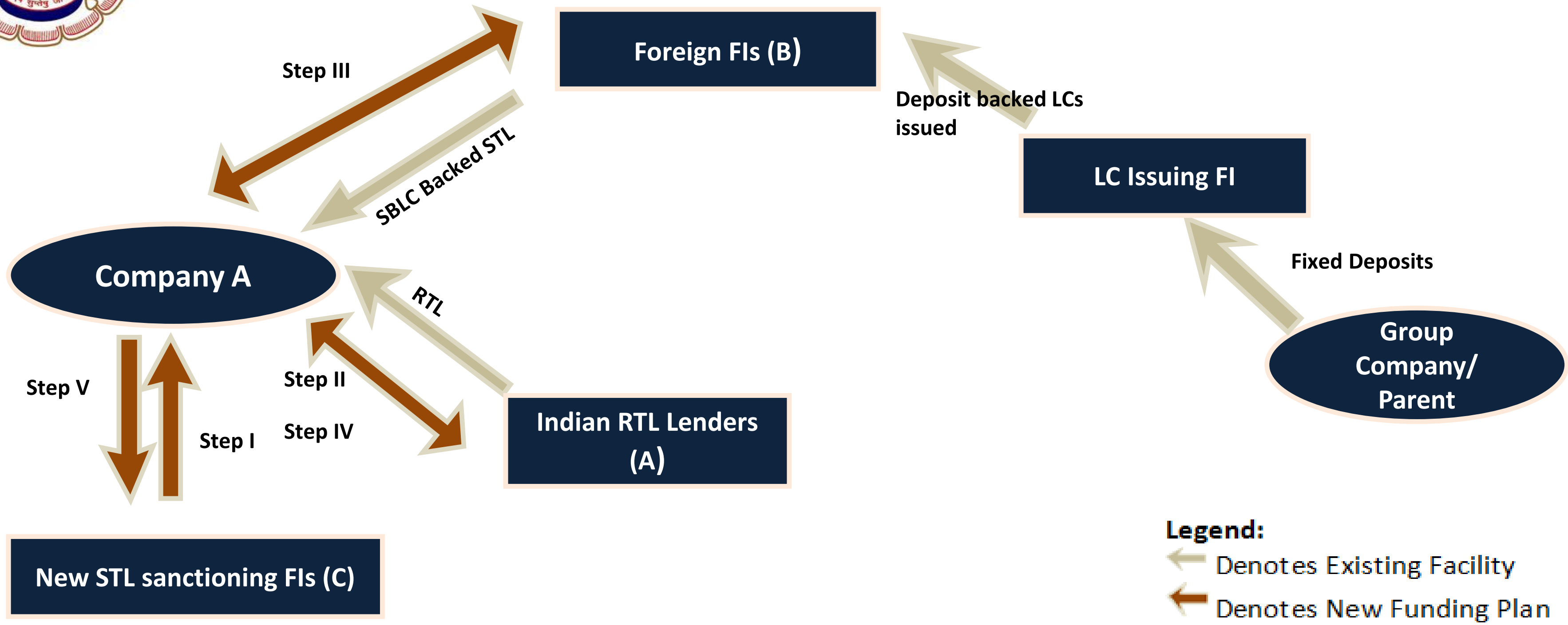
- Standard in the books of existing lenders
- Exposure of all Banks at least Rs. 1000 Crores
- Project has started operations
- Repayment term within 85% of initial economic life/concession period
- AT least 25% of outstanding loan is taken by new lenders

Divergences - Restructuring

- Repeated restructuring / masking through 'expansion'
- Restructuring after non-performance sets in
- Forced protection of NPV under restructuring
- Retrospective 'cut-off' date
- Restructuring of A/Cs not eligible for restructuring / special regulatory dispensation
- Conditions or restructuring not fulfilled
- Upgradation without 1 year satisfactory performance
- Failed restructuring reckoned from pre-restructuring perspective
- Reference to RBI
- Wrong computation in diminution in fair value
- Failed restructuring cases – ageing since pre-restructured position
- Restructuring of various schematic retail loans e.g. car, education etc. / Across-the-board or suo moto restructuring of crop loans
- BIFR stay on repayment
- Date of reference when first reference to CDR is rejected and second reference is admitted
- Term Loans – Overdue interest and / or instalment of principal

Thank You

Novel Structure



Modus Operandi:

Step I- Financial Institutions in India denoted by C in the figure that do not have any prior exposure sanction a Short Term Loan

Step II- Proceeds from Step I are used to close a part of the existing rupee term loans granted by existing lenders, denoted by A. The same is used to close the loan held with a few of the lenders. Post the closure, the institutions wherein the existing loan was closed sanction a new facility.

Step III-. Proceeds for new sanction is used to close the existing SBLC backed STLs granted. Post the closure, these FIs (denoted by B) grant a loan

Step IV- These proceeds are used to close the rest of the existing RTL with the other lenders in the group 'A'. After the closure of existing account, these institutions sanction another loan under the guise of funding the new business model.

Step V- The proceeds from this sanction is used to close the STL sanctioned by institutions under 'C'.