

Seminar on Statutory Bank Branch Audit


**Prudential Norms of Income
Recognition and Assets Classification**

WIRC of ICAI

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Coverage



- Objectives
- Relevant RBI Circulars
- Identification of Account as NPA
- Exceptions / Clarifications
- Projects under Implementation
- Asset Classification and Provisioning
- Guidelines on Restructuring of Advances
- Early recognition of financial distress

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Objectives



- The classification of assets of banks has to be done on the basis of objective criteria, which would ensure a uniform and consistent application of the norms.
- The provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof.

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RBI Circular Reference

- Master Circular dated July 01, 2014 on IRAC Norms
- Master Circular dated July 01, 2014 on Disclosure in Financial Statements – Notes to Accounts

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Asset Type

- **STANDARD ASSET / PERFORMING ASSET**
The account is not non-performing and does not carry more than the normal risk attached to the business.
- **NON-PERFORMING ASSET (NPA)**
 - ✓The asset ceases to generate income for the bank.
 - ✓Higher risk than normal risk attached to business.
 - ✓Non performing as per various criteria for various types of loans.

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Identification of Account as NPA

Loans or Advance	<ul style="list-style-type: none"> ▪ Interest and/or installment remains overdue for a period of more than 90 days in respect of a term loan. ▪ As per para 2.1.3, an account is classified as NPA only if interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.
Exceptions	<ul style="list-style-type: none"> ▪ Loans with moratorium for payment of interest ▪ Housing Loan or similar advance to staff

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Identification of Account as NPA ...	
Bills Purchased and discounted	Bill remains overdue for a Discounted period of more than 90 days.
Agricultural Advances	Interest or installment remains overdue for two crop seasons for short duration crop, one crop season for long duration crop.
Derivative Transaction	Overdue receivables representing positive mark to market value of a derivative contract remaining unpaid for a period of 90 days from specified due date.
Liquidity facility	Remains outstanding for more than 90 days in respect of Securitisation transaction.

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Identification of Account as NPA ...	
Credit Card dues	The minimum amount payable is not paid within 90 days from the next statement date

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Identification of Account as NPA ...	
<p>▪ Cash Credit / Overdrafts ⇒ Account remains 'out of order'</p> <p>The account is treated as 'out of order' if :</p> <ul style="list-style-type: none"> ✓ Outstanding Balance remains continuously in excess of sanctioned limit/drawing power (for how many days?) or ✓ No credit continuously for 90 days as on the date of Balance Sheet or ✓ Credits in the account are not sufficient to cover interest debited during the same period. 	

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Exceptions / Clarifications



Temporary deficiency

- ✓ Outstanding Balance in account based on the drawing power calculated from stock statements older than 3 months would be deemed as irregular & if such irregular drawing are permitted for a period of 90 days, account needs to be classified as NPA.
- ✓ Non-renewal/ Non-regularisation of regular/ adhoc limit within 180 days from the due date.

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Exceptions / Clarifications ...



- Advances against term deposits, NSCs, IVPs, KVPs and Life Insurance Policies need not be treated as NPAs, till security cover is sufficient to cover outstanding balance.
- Income to be recognised subject to availability of margin.
- Advance against gold ornaments / Government securities not exempt.

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Exceptions / Clarifications ...



- Central Government guaranteed advance to be classified as NPA only if Government repudiates the guarantee when invoked.
- Classification Qua Borrower
 - ✓ All facilities granted to a borrower shall be treated as NPA & not only that facility which has become irregular.

Exception:

- (i) Credit facility to Primary Agricultural Credit Society (PACS) and Farmers Service Societies (FSS) under on lending arrangement; (ii) Bill Discounted against accepted LC

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Exceptions / Clarifications ...



Consortium Advances

- Member banks shall classify the accounts according to their own record of recovery.
- Bank needs to arrange to get their share of recovery or obtain an express consent from the Lead Bank.

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Exceptions / Clarifications ...



Straightaway Classification

(potential threat of recovery)

- ✓ Erosion in Value Where realisable value of security is less than 50% of the value assessed (*by bank or value accepted in last RBI Inspection*), account to be straightaway classified as **Doubtful Asset**.
- ✓ Where realisable value (*as assessed by Bank / Valuator / RBI Inspector*) of security is less than 10% of outstanding balance, account to be straightaway classified as **Loss Asset**.

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Exceptions / Clarifications ...



Valuation of Securities

- ✓ In respect of NPAs with the balance of Rs. 5.00 crores & above, bank needs to formulate policy for
 1. annual stock audit by external agencies;
 2. in respect of immovable properties, valuation to be carried out once in 3 years by approved valuer.

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Exceptions / Clarifications ...



Solitary Credit Entry

- ✓ Care should be taken that a solitary or few credits in the account made at/near the balance sheet date extinguishing the overdue interest/principal is not the only criteria for classifying the asset as standard.

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Exceptions / Clarifications...



Regularisation of Account

- ✓ Account need not be classified as NPA if account has been regularised by the date of Balance sheet by payment of overdue through genuine sources & not by sanction of additional facility or transfer of funds between accounts.

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Common excuses for non-identification of NPAs



- Interest charged to account is not due on the same day but is due from the next day
- The financial position of borrower is sound and the account is having healthy turnover though is overdrawn for a period of not less than 90 days
- Only one account is overdrawn and all other accounts have instalments paid in advance
- The account has been not listed in Overdue Statement as its within limit though not overdrawn

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Common excuses / issues in non-identification of NPAs



- In case of Term Loans, the account was having 4 instalments overdue during the year but is having only 2 instalments as at year-end Whether the account identification / classification is to be done only at year-end or during the year?
- The account is regularised after the year end either during the audit process or before signing of balance sheet of the bank

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Classification – Projects under Implementation



- 'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks should fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure.
- For all projects financed by the FIs/ banks **after 28th May, 2002**, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.
- **These asset classification norms would apply to the project loans before commencement of commercial operations.**

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Classification – Projects under Implementation...



- Any change in the repayment schedule of a project loan due to increase in the project outlay would not be treated as restructuring if :
 - ✓ The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.
 - ✓ The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.
 - ✓ The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCO.
 - ✓ On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

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Classification – Projects under Implementation...



▪ Infrastructure Sector

- ✓ Classify as NPA any time before commencement of commercial operations, if interest/ installment is 90 days overdue unless restructured and eligible to be classified as standard.
- ✓ Classify as NPA if its fails to commence commercial operations within two years from the original DCCO unless restructured and eligible to be classified a standard.

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Classification – Projects under Implementation...



- ✓ **Permissible limit for extension of date of commencement of commercial operations.**
 - Court cases : another two years beyond the extended period of two years
 - Other reason: another one year beyond the extended period of two years.
- ✓ **Other conditions:**
 - Application for restructuring should be receive before the expiry of period of two years from original DCCO.
 - If there is a moratorium, bank should not recognise income beyond two years from original DCCO.
 - Bank should maintain necessary provision as long as these are standard assets.

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Classification – Projects under Implementation...



• Non Infrastructure Sector

- ✓ Classify as NPA any time before commencement of commercial operations, if interest/ installment is 90 days overdue unless restructured and eligible to be classified as standard.
- ✓ Classify as NPA if its fails to commence commercial operations within one year from the original DCCO unless restructured and eligible to be classified a standard.

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Classification – Projects under Implementation...



✓ Permissible limit for extension of date of commencement of commercial operations.

- Other reason: another two years beyond the extended period of one year.

✓ Other conditions:

- Application for restructuring should be received before the expiry of period of one year from original DCCO.
- If there is a moratorium, bank should not recognise income beyond twelve months from original DCCO.
- Bank should maintain necessary provision as long as these are standard assets.

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Classification – Projects under Implementation...



Bank should maintain necessary provision as long as these are standard assets (in addition to sacrifice)

Particulars	Provisioning Requirements
If revised DCCO is within two years from original DCCO	0.40%
If revised DCCO is extended beyond two years from original DCCO (i.e., upto four / three years)	Restructured w.e.f. June 01, 2013: 5% from date of such restructuring till revised DCCO or two years from date of restructuring whichever is earlier

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Classification – Projects under Implementation...



Bank should maintain necessary provision as long as these are standard assets (in addition to sacrifice)

Particulars	Provisioning Requirements
If revised DCCO is extended beyond two years from original DCCO (i.e., upto four / three years)	Stock of project loans which are classified as restructured as on June 01, 2013: (to be spread in four quarters) 3.50% w.e.f. March 31, 2014 4.25% w.e.f. March 31, 2015 5.00% w.e.f. March 31, 2016 (from date of such restructuring till revised DCCO or two years from date of restructuring whichever is earlier)

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Income Recognition

- For NPA accounts income should be recognised on realisation basis.
- When an account becomes non-performing, unrealised interest of the previous periods should be reversed or provided.
- Interest income on additional finance in NPA account should be recognised on cash basis.
- In project loan, funding of interest in respect of NPA if recognised as income, should be fully provided.
- If interest due is converted into equity or any other instrument, income recognised should be fully provided.

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Income Recognition...

Order of Adjustment of Recoveries - *Priority*

Unrealised Expenses

Unrealised Interest

Amount of Principal Outstanding

Clarification vide Master Circular - in the absence of clear agreement between the Bank and the Borrower, an appropriate policy to be followed in uniform and consistent manner.

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Classification Norms

- **Standard Asset**
The account is not non-performing.
- **Sub-Standard Asset**
A sub standard Asset is one which has remained NPA for a period of less than or equal to 12 months.
- **Loss Assets**
These are accounts, identified by the bank or internal or external auditors or by RBI Inspectors as wholly irrecoverable but the amount for which has not been written off.

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Classification Norms...

- Doubtful Asset - Three Categories

Category	Period
Doubtful - I	up to One Year
Doubtful - II	One to Three Years
Doubtful - III	More than Three Years

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Provisioning Norms

Standard Asset

- | | |
|--|-------|
| ▪ Agricultural and SMEs Sectors | 0.25% |
| ▪ Commercial Real Estate (CRE) Section | 1.00% |
| ▪ CRE – Residential Housing Project | 0.75% |
| ▪ Others | 0.40% |
| ▪ Housing Loan during teaser rate period | 2.00% |

Sub-standard Asset

- 15% of total outstanding
- 25% of total outstanding if loan is unsecured
- 20% of total outstanding if infrastructure loan provided its backed by escrow facility with first charge

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Provisioning Norms...

Doubtful Assets:

Period	Provision	(Secured + Unsecured)
Up to 1 year	25%	+ 100%
1 to 3 years	40%	+ 100%
More than 3 years	100%	+ 100%


Loss Asset:

100% should be provided for

Provisioning Coverage Ratio (PCR) @ 70% at 30.Sep.2010 NPA level

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Provisioning for Country Risk




- In respect of a country where its net funded exposure is $\geq 1\%$ of its total assets

Risk Category	ECGC classification	Provisioning requirement (%)
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very High	C1	25
Restricted	C2	100
Off-Credit	D	100

- Lower provision (25%) in respect of short term exposure

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Provisioning Norms




Provision Under Special Circumstances

- Advance under rehabilitation programme approved by BIFR / Institutions, Provision should be continued to be made on existing facilities.
- Additional facilities no provision for a period of one year.
- In case of advances guaranteed by CGTSI/ECGC, Provision should be made only for balance in excess of the amount guaranteed by these corporations.

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Some other aspects



- Take out Finance
- Post-shipment supplier credit
(ECGC guaranteed claim settlement in 30 days)
- Export Project Finance
(The lending bank needs establish through documentary evidence that importer has cleared the dues in full in the bank abroad when its PA)

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Some other aspects

Take out Finance

- A typical arrangement with other financier about refinancing of a existing infrastructure loans
- If repayment cycle is extended, the account will not be considered as restructuring provided ...
 - Account should be standard
 - Account should not have been restructured in the past
 - Should have been substantially taken over (> 50%)
 - Repayment period should be in line with lifecycle of project

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Guidelines on Restructuring of Advances

- Restructuring divided in following four categories;
 - i. Industrial Units.
 - ii. Industrial Units under CDR Mechanism
 - iii. SMEs
 - iv. All other advances.

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Guidelines on Restructuring of Advances...

- Eligibility
 - ✓ Any account classified as standard, sub standard or doubtful.
 - ✓ Restructuring cannot be done retrospectively and usual asset classification norms would continue to apply.
 - ✓ Restructuring should be subject to customer agreeing to terms and conditions.
 - ✓ Financial viability should be established.
 - ✓ Borrowers indulging in frauds and malfeasance or in eligible.
 - ✓ BIFR cases eligible for restructuring subject to approval from BIFR.

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Guidelines on Restructuring of Advances...



▪ Asset Classification Norms

✓ Restructuring of accounts could take place in following stages:

- ☐ Before commencement of commercial production
- ☐ After commencement of commercial production / operation but before the asset has been classified as 'Sub Standard'.
- ☐ After the commencement of commercial production / operation and after the asset has been classified as 'Sub Standard' or doubtful.

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Guidelines on Restructuring of Advances...



▪ Asset Classification Norms (Cont'd)

- ✓ Standard Asset would get reclassified as sub standard and account which is already NPA would continue to have the same classification.
- ✓ Additional finance would be treated as standard upto a period of one year. *{Exception to borrower-wise classification}*
- ✓ All restructured accounts, classified as NPA upon restructuring would be eligible for upgradation after observation of satisfactory performance for the period of one year.

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Guidelines on Restructuring of Advances...



▪ Provisioning Norms

- ✓ Total provision required would be normal provision plus provision in lieu of diminution in fair value of advances.
- ✓ Diminution in fair value would be required to be recomputed on each balance sheet date.
- ✓ Banks have option of notionally computing the diminution in fair value and providing at 5% in case of all restructured accounts where the total dues to bank is less than one crore.

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Guidelines on Restructuring of Advances...



▪ Special Regulatory Treatment for asset classification.

✓ Not available to following categories of advances:

- Consumer and personnel advances
- Advances is classified as capital market exposure
- Advances classified as commercial real estate exposure.

i. Incentive for quick implementation of package

The asset classification status may be restored if the approved package is implemented :

- ✓ Within 120 days from the date of approval under CDR
- ✓ Within 120 days from the date of receipt of application by Bank in other cases.

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Guidelines on Restructuring of Advances...



II. Asset classification benefits

a. Standard advance will not be reclassified as sub standard upon restructuring if following conditions are satisfied.

- i. Dues of the bank are fully secured by tangible security (except MSE borrower with outstanding upto Rs.25 lacs & infrastructure projects)
- ii. Unit becomes viable in 8 years, if it is engaged in infrastructure activities and in 5 years in case of other units.

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Guidelines on Restructuring of Advances...



iii. Repayment period including moratorium does not exceed 15 and 10 years for infrastructure and other projects respectively (10 years ceiling won't apply to restructured housing loan accounts)

iv. Promoters sacrifice and additional funds brought by them should be a minimum of 20% of bank's sacrifice or 2% of restructured debt whichever is higher and must be brought up-front though its not required to be in cash

v. Personal guarantee is offered by promoters.

vi. The restructuring is not 'repeated restructuring'

b. During the specified period the asset classification of sub standard / doubtful accounts will not deteriorate, if satisfactory performance is demonstrated during the specified period.

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Guidelines on Restructuring of Advances...



- c. Working Group under Chairmanship of B. Mahapatra
Recommendations
Quick Implementation incentives to be withdrawn w.e.f. May 01, 2015 except cases related to change of DCCO

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Early Recognition of Financial Distress



Framework of Revitalising Distressed Assets in the Economy (Dt.: 30.Jan.2014 and later on incorporated in Master Circular)

- Setting up of CRILC (Central Repository of Information on Large Credits)
Coverage for Fund and non-fund based exposures above Rs. 5 crores
Categories
SMA 0 Not overdue for more than 30 days
but showing signs of incipient stress
SMA 1 Principal / Interest overdue bet. 30-60 days
SMA 2 Principal / Interest overdue bet. 61-90 days

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Early Recognition of Financial Distress



- Formation of Joint Lenders' Forum
- Reporting under SMA 0 for 3 quarters / year
 - Reporting under SMA 1 for 2 quarters / year
 - Reporting under SMA 2 any time / year
 - Mandatory to for JLF if exposure is above Rs. 100 crores

Formulate CAP (Corrective Action Plan)

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Early Recognition of Financial Distress



Formulate CAP (Corrective Action Plan)

1. Rectification

- Obtain commitment of identifiable cash flows
- No sacrifice / loss of lenders
- Additional finance can be provided but no ever-greening of account

2. Restructuring

- Provided its prima facie viable and borrower is not willful defaulter

3. Recovery

If first two options fail, due recovery process to be resorted

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Early Recognition of Financial Distress



Restructuring – Other Points

- Quick implementation benefits available if the account if the approved package is implemented within 90 days

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Early Recognition of Financial Distress



Penal measures for non-adherence of reporting of SMA status to CRILC / Ever greening of A/Cs

Asset Classification	Period of NPA	Current Provisioning	Accelerated Provision
SSA (Secured)	Up to 6 months	15%	No Change
	6 – 12 months	15%	25%
SSA (Unsecured ab-initio)	Up to 6 months	25% (Other than Infra)	25%
		20% (Infra)	25%
	6 – 12 months	25% (Other than Infra)	40%
		20% (Infra)	40%

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Early Recognition of Financial Distress

Penal measures for non-adherence of reporting of SMA status to CRILC / Ever greening of A/Cs

Asset Classification	Period of NPA	Current Provisioning	Accelerated Provision
DA – 1	2 nd Year	25% (Secured)	40%
		100% (Unsecured)	100%
DA – 2	3 rd and 4 th Year	40% (Secured)	100%
		100% (Unsecured)	100%
DA – 2	5 th Year onwards	100%	100%

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Early Recognition of Financial Distress

Penal measures for non-adherence of reporting of SMA status to CRILC / Ever greening of A/Cs

If the lenders fail to convey the JLF or agree upon common CAP

- The accounts will be subjected to accelerated provisions
- The account though standard will attract 5% provision
- If Escrow maintaining bank doesn't adhere to terms, lowest NPA status classification amongst the lenders

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Early Recognition of Financial Distress

Examples of SMA o stress

- Delay beyond 90 days for submission of stock statements / Financial Statements / Renewal of facility
- Prevention of conduct of stock audit
- Reduction of DP by more than 20% post-stock audit
- Actual sales short of more than 40% as compared to projections
- Return of more than 3 cheques / overdue bills in span of 30 days

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Early Recognition of Financial Distress



Examples of SMA o stress

6. Devolvement of LC / BG and its non-payment beyond 30 days
7. Third request for extension of time to create security
8. Increase in frequent overdrafts in Current A/C
9. Borrower reporting stress in business / financials
10. Promoters pledging / selling their shares in the borrower company due to financial stress

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Issues w.r.t. NPAs / General



- Diamond Industry Related NPAs and valuation of security
- Classification norms being changed to facility-wise instead of borrower-wise in certain cases
- Non-classification of NPAs by Banks with usage of technology
- Non-purification of Master Data by banks for NPA identification packages
- Reversal of Interest through Ledger Account
- Need for Account Operations for identification of NPAs
- Upgraded Restructured Accounts – Provision to be retained inspite of being standard
- NPA Provisions should be net of Interest Suspense Account
- PCR – Provision Coverage Ratio of 70%
- RBI AFI comments – “Banks have tendency to evergreen accounts in the garb of repeated restructuring”
- RBI AFI vis-à-vis Bank / Statutory Auditors Classification

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Any Questions



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