

*Seminar on Bank Branch Audit
Borivali(Central) CPE Study Circle*

*Income Recognition & Asset
Classification(IRAC) Norms- NPAs*

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Today's Agenda:

- ❑ Overview of Indian Banking Industry w.r.t. Non-Performing Assets
- ❑ Important Circulars/Notifications issued by Reserve Bank of India
- ❑ Identification of Loan Account as "NPA" as per IRAC Norms
- ❑ Issues in Classification of advances as NPA
- ❑ Income Recognition, Reversal, Upgradation etc.
- ❑ Guidelines on Restructuring of Advances
- ❑ Few Practical issues from audit of NPA perspective
- ❑ Case Studies

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Overview of Indian Banking Industry w.r.t. NPA

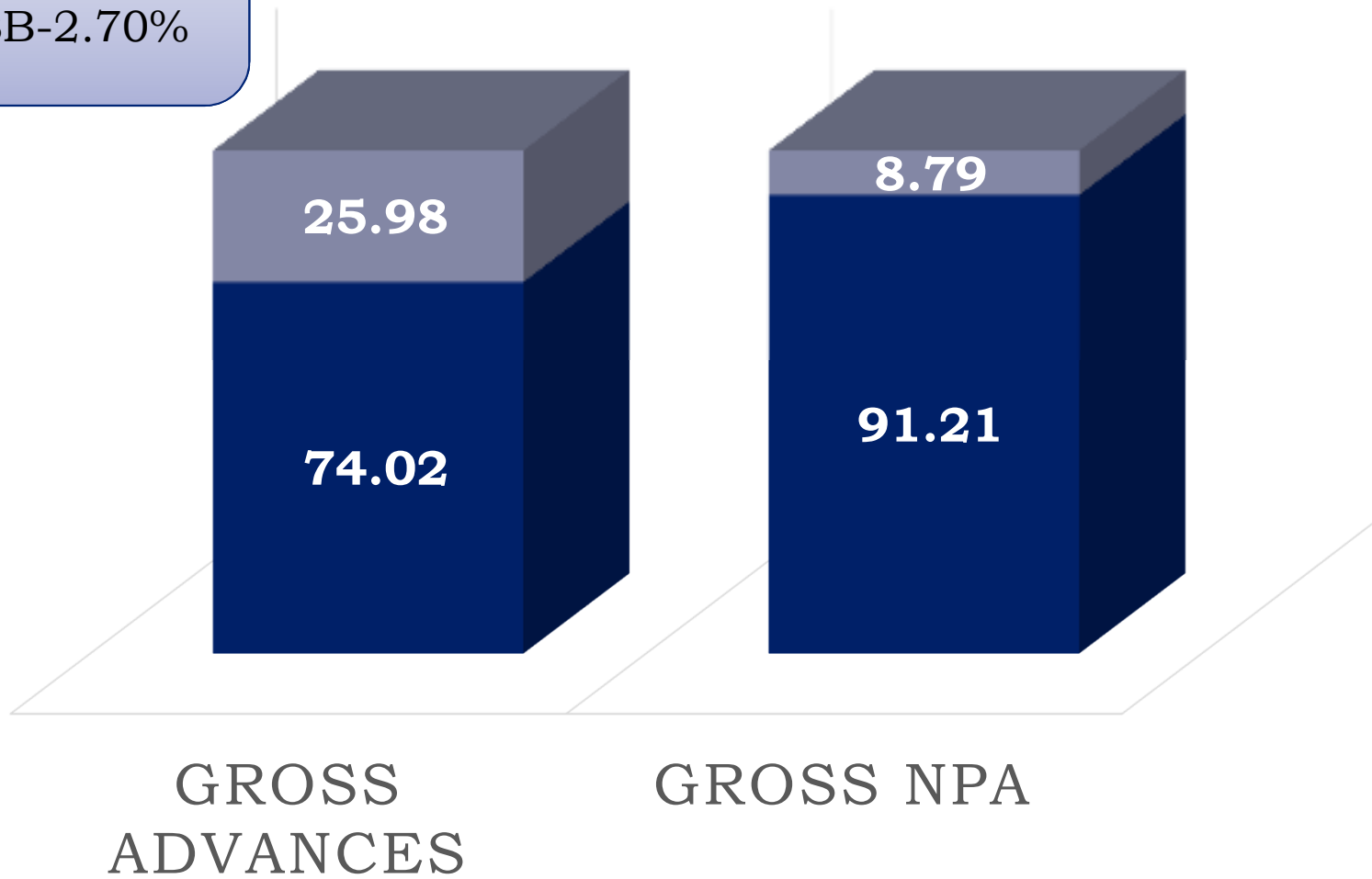
Indian Banking Industry: Performance

Particulars	2013-14 (In Billion)	2014-15 (In Billion)	2015-16 (In Billion)
Loans & Advances	67,352	73,882	78,965
Total Assets	1,09,759	1,20,370	1,29,589
% of Gross Loans & Advances to Total Assets	61.53%	61.38%	60.93%
Non-Performing Assets	2,642	3,233	6,120
Gross NPA ratio compared to Gross Advances	3.92%	4.30%	7.50%

Performance: Public Vs. Private Banks

GNPA Ratio
PUB-9.83%
PSB-2.70%

■ Public Bank ■ Private Bank



Perception Vs. Reality:

BAD LOANS

1140000000000: The great govt bank write-off

That is the amount of bad loans waived in last three financial years, more than the write-off in the previous nine

THE MOST GENEROUS

UTKARSHANAND

NEW DELHI, FEBRUARY 7

TWENTY-NINE state-owned banks wrote off a total of Rs 1.14 lakh crore of bad debts between financial years 2013 and 2015, much more than they had done in the preceding nine years.

In response to an RTI application filed by The Indian Express, the RBI disclosed that while bad debts stood at Rs 15,551 crore for

the financial year ending March 2012, they had shot up by over three times to Rs 52,542 crore by the end of March 2015.

Asked about the details of the biggest defaulters, whether individuals or business entities, whose bad debts to the tune of Rs 100 crore or more had been written off, the RBI said: "The required information is not available with us." Banks are required to report the bad debts on a consolidated basis, it said.

Even as the government has been trying to shore up public sector banks through equity capital and other measures, bad loans written off by them between 2004 and 2015 amount to more than Rs 2.11 lakh crore. More than half such loans (Rs 1,14,182 crore) have been waived off between 2013 and 2015.

Only two banks, State Bank of Saurashtra and State Bank of India, have shown zero bad debts in the past five years.

YOUR RIGHT TO KNOW AN EXPRESS RTI APPLICATION

In other words, while bad loans of public-sector banks grew at a rate of 4 per cent between 2004 and 2012, in financial years 2013 to 2015, they rose at almost 60 per cent. The bad

debts written off in financial year ending March 2015 make up 85 per cent of such loans since 2013.

The RTI reply also disclosed that bad debts have declined only four times since 2004. The last time was in 2011.

An analysis of the information available with the RBI till 2012-13 also shows that between 2009 and 2013, both the advance only public sector banks to individuals and business entities as well as their amount of

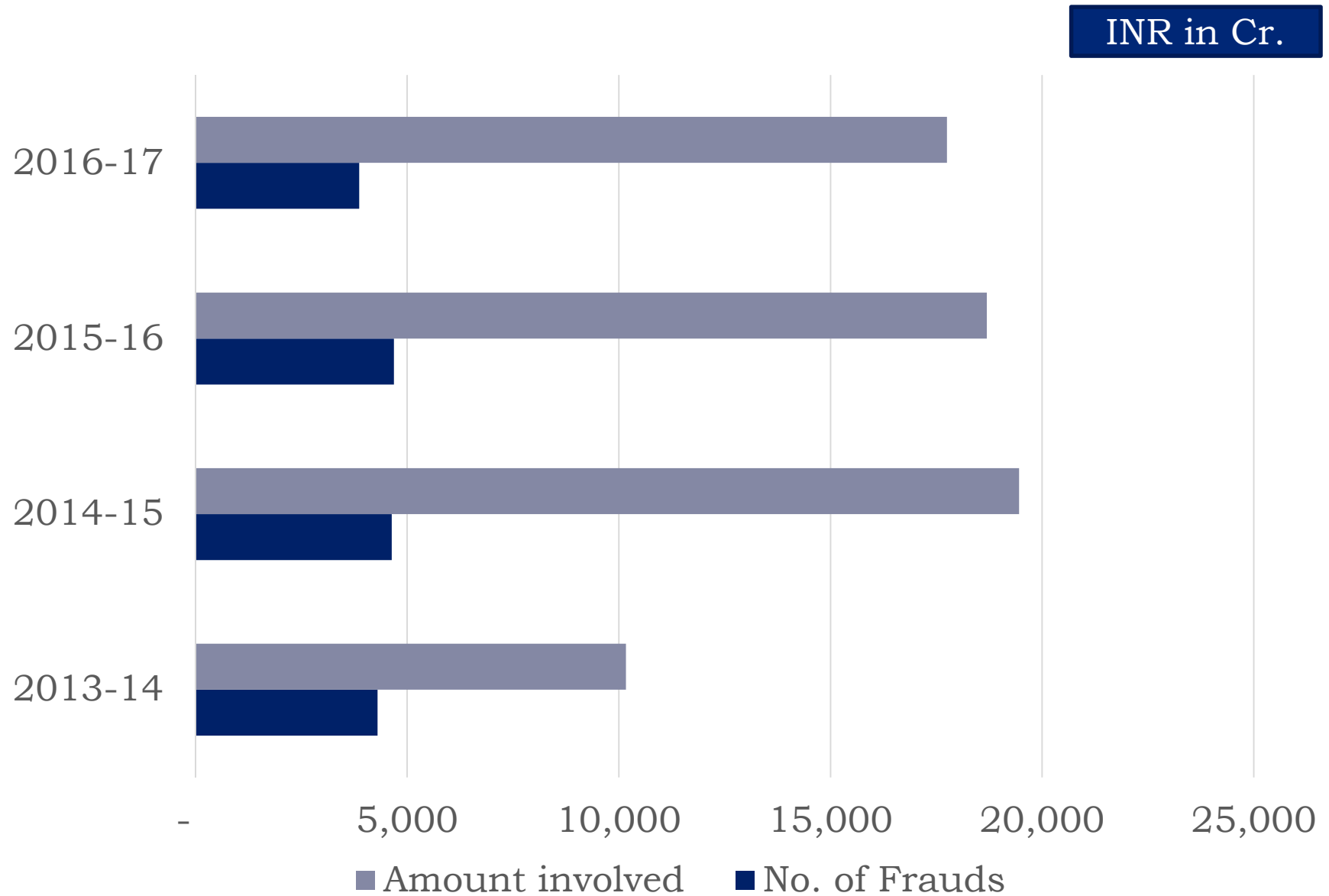
bad debts written off doubled. From 0.33 per cent of total advances in 2009, bad debts rose to 0.68 per cent in 2013.

Bank-wise break-up shows State Bank of India, India's largest bank, is way ahead of others in declaring loans as unrecoverable, with its bad debts shooting up almost four times since 2013 — from Rs 5,594 crore in 2013 to Rs 21,373 crore in 2015.

In fact, SBI's bad debts made

CONTINUED ON PAGE 2

Frauds in Banking Industry:



Global Comparison:

Table 2: Cross-Country Comparison of NPA to Total Loans (%)

Country	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Brazil	3.5	3.5	3.0	3.1	4.2	3.1	3.5	3.4	2.9	2.9
China	8.6	7.1	6.2	2.4	1.6	1.1	1.0	1.0	1.0	1.2
Euro area	1.8	1.3	1.8	2.8	4.8	5.4	6.0	7.5	7.9	6.8
Indonesia	7.3	5.9	4.0	3.2	3.3	2.5	2.1	1.8	1.7	2.1
India	5.2	3.5	2.7	2.4	2.2	2.4	2.7	3.4	4.0	4.3
Japan	1.8	1.8	1.5	2.4	2.4	2.5	2.4	2.4	2.3	1.9
Russia	2.6	2.4	2.5	3.8	9.5	8.2	6.6	6.0	6.0	6.7
United States	0.7	0.8	1.4	3.0	5.0	4.4	3.8	3.3	2.5	1.9
South Africa	1.8	1.1	1.4	3.9	5.9	5.8	4.7	4.0	3.6	3.2

Source: World Bank

Latest report- 8.6%- India, China-1.75%, USA-1.39%, Japan-1.47%

Important Circulars issued by RBI

Relevant Circulars applicable for FY 2016-17:

❑ Master Circular/Master Directions:

- Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning (IRAC) dated July 1,2015
- Master Direction - Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2016
- Master Direction on “Fraud Classification and Reporting” dated July 1,2016

❑ Other Circular/Notifications:

- Provisioning pertaining to Advances – Credit Card Accounts dated July 16,2015
- Provisioning pertaining to Fraud Accounts dated April 18,2016
- Provisioning pertaining to Advances- relaxation on account of demonetisation dated November 21,2016 and December 28,2016

Identification of Account as “NPA”

Types of Assets:

□ Standard Assets:

- The account/borrower is regular in paying the interest and the principal as and when due/demanded by the Bank.
- Normal risk and the provisioning on these advances depends on the category of the loans

□ Non-Performing Assets:

- Para 2.1.1. *“An asset, including a leased asset, becomes non performing when it **ceases to generate income** for the bank”*
- Only recovery need to be seen to classify an account as NPA
- No distinction between Secured and Unsecured assets for the purpose of the classification of account

Criteria for classification- NPA

Sr. No.	Type of Facility	Criteria –Para 2.1.2
(A)	Term Loans	<p><i>“interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan”</i> (para 2.1.3 of IRAC Norms)</p>
(B)	Overdraft/Cash Credit	<p><i>“the account remains ‘out of order as indicated in the IRAC Norms”</i></p> <p><i>Out of Order- para 2.2</i></p> <ul style="list-style-type: none"> ▪ Outstanding Balance > SL or DP continuously for 90 days ▪ No credits in accounts continuously for 90 days as on B/s date ▪ Credits in the accounts are not sufficient to cover interest debited during the same period

Criteria for classification- NPA

Sr. No.	Type of Facility	Criteria –Para 2.1.2 & 4.2.21
(C)	Bills Purchased & Discounted	<p>“the bills remain overdue for a period of more than 90 days “</p> <p>Overdue – any credit facility is overdue if it is not paid on the due date fixed by the bank (para 2.3)</p>
(D)	Credit Cards (change)	<p>“if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the statement”</p>
(E)	Derivative Transactions	<p>“overdue receivable representing positive M-t-M value of derivative contract remains unpaid for more than 90 days”</p>

Criteria for classification- NPA

Sr. No.	Type of Facility	Criteria –Para 2.1.2 & 4.2.21
(F)	Agricultural Advances	<ul style="list-style-type: none">▪ Short duration crop- if the instalment of principal or interest thereon remains overdue for two crop season;▪ Long duration crop- if the instalment of principal or interest thereon remains overdue for one crop season;▪ Crop season is decided by State Level Banker's committee

Classification of NPA: Asset Classification

- **Sub-Standard Assets: (SSA)**

- ✓ Account has remained **NPA** for a period less than or equal to 12 months

- **Doubtful Assets:**

- ✓ Account has remained **SSA** category for a period of 12 months- **DB-1**
- ✓ Account has remained in **DB-1** for 1-3 years –**DB-2**
- ✓ Account has remained in **DB-2** for more than 3 years-**DB-3**

- **Loss Assets:**

- ✓ Identified by the bank or internal or external auditor or the RBI inspection

SA-SSA-DB1-DB2-DB-3



Issues in Classification of advances as NPA:

□ Erosion in value of security/Frauds by borrower:

- In Certain circumstances the NPA are classified directly to Doubtful/Loss assets
- Potential threat of recovery due to *erosion in value of security* or *non availability of security* and *existence of other factors (e.g. Frauds)*
- Following classification policy should be adopted:

Case	Situation – <i>Realisable value of Security</i>	Classification
(A)	Less than 50%	DB
(B)	Less than 10%	Loss

Issues in Classification of advances as NPA:

□ Borrower Account with temporary deficiencies:

- Classification on the basis of record of recovery and not due to existence of deficiencies temporary in nature
 - *DP computed on basis of old Stock statement (3 months)*
 - *Balance in account exceeds temporarily*
 - *Non-renewal of limit on the due date (within 180 days)*

□ Borrower wise Vs. Facility wise

- All the facility granted by a bank to a borrower will be classified as NPA and not particular facility which has become irregular
- All facilities should be linked to single unique code (Cust_ID) for each borrower and the classification should be done on the basis of such ID.

How to ensure the correctness of DP computation and Borrower wise classification of NPA?

Issues in Classification of advances as NPA:

❑ Advances under consortium arrangement:

- Classification of accounts under these arrangements on the basis of record of recovery of the individual member bank
- Amount recovered by Lead banker not shared with other member is treated as “not serviced”

❑ Accounts regularised near Balance Sheet date:

- Irregular accounts- certain credits/recovery before the balance sheet date

❑ Advances against TD, NSC, KVP etc.

- Advances against these are not considered as NPA provided adequate margin is available with the Bank
- ~~Gold ornaments, G Sec~~

Special Relaxation due to Demonetisation:

- RBI Circular dated **November 21,2016** provides relaxation to following categories:
 - Term Loans with Sanction amount of less than INR 1 cr.;**(C-1)**
 - CC/OD facility or crop loans with Sanction amount of less than INR 1 cr. **(C-2)**
 - Loans sanctioned by Banks to NBFC, HFC etc. *(without any monetary limit)* **(C-3)**
 - Provides additional **60 days** for the dues payable between November 1,2016 and December 31,2016

- RBI Circular dated **December 28,2016**:
 - Additional **30 days (in total 90 days)** for C-1 and C-2 types of advances for the dues payable between the above mentioned dates

Special Relaxation due to Demonetisation:

- Other important aspect/conditions of the above notifications:
 - **ONLY** applicable to the dues payable between 01.11.2016 to 31.12.2016
 - Dues payable before and after the above mentioned dates are subject to IRAC norms
 - Additional time is only for deferring the classification of **STANDARD** assets to **SUB-STANDARD** assets
 - These relaxations are not applicable to further down gradation to lower categories of NPA

Provisioning Norms:

Sr. No.	Asset class (NPA)	Provisioning %
(A)	<p>Normal Category: Sub-Standard Assets (Fully Secured) Sub-Standard Assets (Unsecured)</p> <p>Unsecured exposure: <i>“Realisable value of security is not more than 10% of the outstanding exposure”</i></p> <p>Infrastructure Category: Sub-Standard Assets (Fully Secured) Sub-Standard Assets (Unsecured)</p>	<p>15% 25%</p> <p>15% 20%</p>
(B)	<p>Doubtful Assets: DB-1 (Upto 1 Year) DB-2 (1 to 3 Year) DB-3 (More than 3 Year)</p>	<p>25% 40% 100%</p>

Provisioning Norms:

Sr. No.	Asset class (NPA)	Provisioning %
(C)	Loss Assets	100%
(D)	Standard Assets: <ul style="list-style-type: none"> ▪ Direct Advances to Agriculture and SME Sector ▪ Advances to Commercial Real Estate (CRE) ▪ Advances to CRE- Residential Housing (CRE-RH) ▪ Housing Loan at Teaser rates (+ 1 Year) ▪ Restructure Advances (Other than Provision for Dim. In Value) ▪ All other loans not included in above 	0.25% 1.00% 0.75% 2.00% 5.00% 0.40%

Accelerated provisioning:

SMA status of accounts need to be reported to CRISIL-fails to report such status the bank will be subjected to accelerated provisioning (SSA- to the extent of 40% and DB to the extent of 100% in DB-2 category)

Provisioning Norms: Valuation of Security

- ❑ **NPA with balance of INR 5 cr. & above**
 - Stock audit at annual interval by external agencies to enhance reliability on the stock valuations

- ❑ **NPA cases secured against immovable property:**
 - Valuation of such security once in 3 year by an independent valuer

- ❑ **Infrastructure Projects (PPP Model):**
 - Detailed guidance & conditions in the para 5.4(iii)(c) of IRAC norms

Income Recognition & Reversal on NPA:

- ❑ Interest income on NPA **not** recognised on **accrual basis**- against the principal of certainty of collection as AS-9- Revenue Recognition
- ❑ Interest income on such accounts should be recognised on “Cash basis” or “Actual receipt” basis
- ❑ Exceptions:- Interest on advances against TD/KVP/NSC etc. subject to availability of Margin
- ❑ Advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income in past period should be reversed if the same is **NOT REALISED.**
- ❑ Fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if **UNCOLLECTED.**

Upgradation of NPA Account:

- ❑ If arrears of **interest and principal** are paid by the borrower in case of loan accounts classified as NPA, the account should no longer be treated as non-performing and may be classified as “Standard” accounts.

- ❑ Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the bank should be upgraded only when **ALL the outstanding loan/facilities** in the account **perform satisfactorily** during the specified period i.e. principal and interest on all facilities in the account are serviced as per terms of payment during that period.

- ❑ Comparison of NPA accounts/ critical accounts over a period- may highlight some serious concern over Upgradation of NPA account during a particular period

Recoveries in NPA Account:

□ *Recoveries before Balance Sheet date:*

- **Interest realised on NPA's** may be taken to income account provided credits in the accounts towards interest are **not out of fresh/additional credit facilities** sanctioned to borrower by the bank.
- No formal guidelines/agreement between bank and borrower w.r.t. apportionment of recoveries made- bank should adopt an accounting principle and exercise the right of appropriation of recoveries in uniform and consistent manner.

□ *Recoveries after Balance Sheet date:*

- No clear guidelines by the regulator- no objections as well in any Bank
- AS-4 Events occurring after the Balance Sheet date- Non adjusting event
- Temporary vs. Permanent deficiencies/weakness
- Best Judgement after review of facts and circumstances of each case

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 but after the asset has been classified as 'Sub Standard' or doubtful.

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. **(w.e.f. 01.04.2015)**
- ❖ Standard Account classified as NPA and NPA account retained in the same category on restructuring ,should be upgraded only when all the outstanding in account perform satisfactorily during ***'specified period'***
- ❖ Additional finance would be treated as standard during specified period. However **income should be recognized on cash basis** if pre restructuring facilities were classified as NPA.

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 too be recomputed on each balance sheet date. *(To capture the change in Fair Value on account of change in Base Rate, term premium and credit category)*
- ❖ 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.

Provision on Fraud Accounts:

- ❑ **Circular No. DBR.No.BP.BC.92/21.04.048/2015-16 dated April 18, 2016.**

- ❑ The bank have the option to make the provision over a period, **not exceeding four quarters**. The provision should start from the quarter in which the fraud has been detected.

- ❑ In case the above results in the full provisioning being made in **more than one financial year**, banks should debit 'other reserves' and credit the provision.

Practical Issues/Challenges:

- ❑ Divergence in NPA observed by RBI during the Inspections
- ❑ NPA classification in Nationalised Bank and Private Sector Bank
- ❑ Verification of parameters set in the system for classification of account as NPA (e.g. Repayment Schedule)
- ❑ Non reversal of **total** interest in account classified as NPA (Realised + Unrealised)
- ❑ Recognition of interest income in NPA A/c's (
- ❑ Non availability of value of securities in case of NPA below Rs.5 Cr.
- ❑ Non submission of Stock Statement by small borrowers.

Practical Issues/Challenges:

- ❑ Carry forward of date of NPA (from earlier year to current year)
- ❑ Classification of accounts qua borrower would apply for agricultural and non agricultural loans?
- ❑ Classification of accounts transferred from other branches
- ❑ NPA regularised after balance sheet date but before signing the accounts
- ❑ The Detailed Advances statement be tallied with GL, and individual accounts be checked for balances, security value, date of NPA, etc.
- ❑ Income Leakage- Rate of Interest fed in system is incorrect, DP is wrongly calculated, penal interest not recovered on late submission of Stock statements and Financials etc

Audit Approach:

- ❑ Automated classification of NPA- verify system, parameters, controls on modification of parameters, control on categorisation of NPA
- ❑ CC/OD/WC facility- verify the computation of drawing power, fresh sanction to escape the NPA classification, stock statement submission with the latest Balance Sheet.
- ❑ Reversal of unrealised interest on first time classification and subsequent transfer to memorandum account
- ❑ Borrower wise classification, Upgradation, and subsequent down gradation of NPA accounts are as per IRAC Norms
- ❑ Valuation of Security of main NPA cases- above a certain threshold determined by the Bank.
- ❑ No debits allowed in the NPA Accounts (e.g. Legal Charges debit separately)

Disclosures from Balance Sheet:

❖ Movement of NPA:

Particulars	2016-17	2015-16
Balance at the beginning of Year	XXXX	XXXX
(+) Additions during the year/Transfer	XXXX	XXXX
(-) Reduction during the year		
- Upgradation	XXXX	XXXX
- Recoveries	XXXX	XXXX
- Write-off	XXXX	XXXX
Closing at the end of Year	XXXX	XXXX



Microsoft Excel
07-2003 Workshee

Thank You

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