BANK BRANCH AUDIT

AUDIT OF ADVANCES
& IRAC NORMS

06TH FEBRUARY 2015

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AGENDA

- Audit of Advances to include types of advances and nature of securities.
- The process adopted by banks for advances.
- IRAC Norms
- Accounting and Audit process

Type of Advances and Nature of Securities

- Fund based facilities
  - Cash Credit
  - Working Capital Demand Loan (WCDL)
  - Term Loans
  - Foreign Currency Loans
  - Overdrafts
  - Bills
  - Export Credit

Type of Advances and Nature of Securities

- Non Fund based facilities
  - Letter of Credit
  - Guarantees

Nature of Securities

- Primary and Collateral Securities
- Mode of Creation of Security
  - Mortgage
  - Pledge
  - Hypothecation
  - Assignment
  - Set-off

Types of Securities

- Personal Security of Guarantor
- Fixed and Floating Charges
- Margin
- Stock Exchange securities and other insruments
- Goods
- Documents of Title to Goods (such as Bill of Lading, Railway receipts, Godown Receipts etc…
- Gold Ornaments and bullions
- Life Insurance Policies
- Plantations
- Immovable Property
- Third Party Guarantee
- Banker's General Lien

The process adopted by banks for advances

- Credit Appraisal
- Sanction
- Disbursement
- Documentation
- Monitoring and Supervision
  - End use of Funds
  - Post-sanction Inspection
  - Stock Audit and Stock Inspection
- Renewal of Advances

Nature of Borrowing arrangements

- Sole Banking
- Consortium Arrangements
- Multiple Banking

Restrictions on Advances

- Advance against Bank's own shares
- Advances to Bank's Directors and Relatives of Directors
- Advances against sensitive commodities under Selective Credit Control (SCC) e.g Buffer stock of sugar with sugar mills
- Loans and advances against shares, Debenture and Bonds
- Advances to Individuals
  - Amount of Advance
  - Margin
  - Lending Policy
- Advances to Share/ Stock/ Commodity Brokers
- Advances to Market makers
- Advances for Financing Promoters Contribution
- Loan against CDs / IDRs

Restrictions on Advances

- Finance to NBFCs based on laid down policy by the bank
- Bridge Loan / Interim Finance
- Advances against collateral security of shares to NBFCs
- Restriction of Guarantees for Placement of funds with NBFCs
- Bank Finance to Equipment Leasing Companies
- Advances against FDRs issued by other Banks
- Advances against Bullion/Primary Gold
- Advances against Gold Ornaments & Jewellery

IRAC Norms

- Objectives
- Important Circulars
- Identification of Account as NPA
- Exceptions / Clarifications
- Projects under Implementation
- Asset Classification and Provisioning
- Guidelines on Restructuring of Advances
- Frame work for Revitalisation of distressed assets
- Some issues

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.

RBI Circular Reference

- Master Circular dated 1st July 2015 on IRAC Norms.

  (Divided in three parts)

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.

Identification of Account as NPA

Loans or Advance	▪ 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	▪ Loans with moratorium for payment of interest . ▪ Housing Loan or similar advance to staff.

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.
Credit Card Account	If the minimum amount due is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month.

Identification of Account as NPA ...

- **Cash Credit / Overdrafts** ⇒ Account remains 'out of order'

The account is treated as 'out of order' if :

✓ 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.

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 / 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.

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.

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: Credit facility to Primary Agricultural Credit Society (PACS) and Farmers Service Societies (FSS) under on lending arrangement.

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.

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.

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.

Exceptions / Clarifications…

- Advances to PACS / Farmers Service Societies(FSS) ceded to commercial banks
- Government Guarantee Advances
- Agricultural Advances affected by Natural Calamities (para 4.2.13 of the master circular)
- Advances granted under Rehabilitation packages by BIFR/Term Lending institutions (One year locking period)
- Receipt of claim from ECGC / Exim bank
- Takeout Finance
- Advance to staff

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.**

Classification - Projects under Implementation…

- **Infrastructure Sector**
  - ✓Classify as NPA any time before commencement of commercial operations, if it 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, **even if regular as per record of recovery** unless restructured and eligible to be classified as standard.

Classification - Projects under Implementation…

*If a project loan classified as standard is restructured any time during the period of two years from original DCCO ,it can be retained as **standard,** if fresh DCCO is fixed within following limits*

- ➢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 received 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.

Classification - Projects under Implementation…

- **Non Infrastructure Sector**
  - ✓Classify as NPA any time before commencement of commercial operations, if it 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, **even if regular as per record of recovery** unless restructured and eligible to be classified as standard.

Classification - Projects under Implementation…

- *If a project loan classified as standard is restructured any time during the period of **one year** from original DCCO ,it can be retained as **standard,** if fresh DCCO is fixed within following limits*
- Another one year 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 **one year** from original DCCO.
- Bank should maintain necessary provision as long as these are standard assets.

Classification - Projects under Implementation…

- Project Loan for Commercial Real Estate(CRE)

- For CRE projects mere extension of DCCO would not be considered as restructuring
- If the revised DCCO falls within a period of one year from the date of original DCCO
- There is no change in other terms and conditions except possible shift of the repayment schedule

Classification - Projects under Implementation…

Other Issues:

- *All other aspects of restructuring of project loans before commencement of commercial operations would be governed by Part B of Master Circular*
- **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.

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 in respect of NPA is converted into equity or any other instrument, income recognised should be fully provided.

Income Recognition…

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.

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.

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

Exceptions / Clarifications …

Straightaway Classification

- ✓Where realisable value of security is less than 50% of the value assessed, account to be straightaway classified as Doubtful Asset.
- ✓Where realisable value of security is less than 10% of outstanding balance, account to be straightaway classified as Loss Asset.

Provisioning Norms

Standard Asset

- Direct advances to Agricultural and SME sector 0.25%
- Commercial Real Estate (CRE) -1%
- CRE Residential Housing Sector(RH) .75%
- Others .40%
- Housing Loans at teaser rates 2 % for one year then .40% when the rates are re set at higher rates.

Provisioning Norms…

Sub-standard Asset

- 15% of total outstanding
- 25% of total outstanding if loan is unsecured

✓ ***Unsecured exposure is defined as an exposure where the realizable value of the security as assessed by the bank/approved valuer/RBI inspecting officer is not more than 10% ab initio of the outstanding exposure***

Provisioning Norms…

- Project Loans restructured and other restructured loans with effect from 1st June 2013 (flow) 5.00%
- Stock of Project Loan classified as restructured as on 1st June 2013
- 31-3-14 3.5%
- 31-3-15 4.25%
- 31-3-16 5.00%

Provisioning Norms…

Doubtful Assets:

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

Loss Asset:

100% should be provided for

Banks should have total provisioning coverage ratio of not less than 70% with reference to the gross NPA position in banks as on September 30 2010

Provisioning Norms …

Valuation of Securities

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

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.

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.

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.(***new appendix on viability parameters)***
  - ✓ Borrowers indulging in frauds and malfeasance are ineligible.
  - ✓ BIFR cases eligible for restructuring subject to approval from BIFR.

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.
  - ✓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 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.

Guidelines on Restructuring of Advances…

- Special Regulatory Treatment for asset classification.
  - ✓**Not available to following categories of advances:**
    - ∗Consumer and personnel advances
    - ∗Advances 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 in 120 days from the date of approval under CDR
- ✓Within 120 days from the date of receipt of application by Bank in other cases.

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 SSI borrower with outstanding upto Rs.25 lacs & infrastructure projects)

ii. Unit becomes viable in 8 (earlier10) years, if it is engaged in infrastructure activities and in 5 (earlier7) years in case of other units.

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 higher of 20% of bank's sacrifice or 2% of restructured debt

v. Personal guarantee is offered by promoters.

vi. The restructuring is not **'repeated restructuring'**

Key Terms relevant for Restructuring

- ✓ Viability parameters
- ✓ Specified period
- ✓ Repeated Restructuring

Framework for Revitalisation of Distressed Assets

- Banks are required to identify incipient stress the account by creating three sub category under the Special Mention Account – SMA – 0, SMA – 1, SMA – 2.
- Banks to report SMA Accounts to Central Repository of Information on Large Credits of RBI.
- As soon as an account is reported as SMA 2, Banks have to form Joint Lender's Forum (JLF).

Framework for Revitalisation of Distressed Assets …

- JLF to decide Corrective Action Plan (CAP)
- CAP to include
  - **Rectification**
    - Obtain commitment of identifiable cash flows
    - No sacrifice / loss of lenders
    - Additional finance can be provided but no ever-greening of account

Framework for Revitalisation of Distressed Assets …

- **Restructuring**
  - Provided its prima facie viable and borrower is not willful defaulter
  - Quick implementation benefits available if the account if the approved package is implemented within 90 days
- **Recovery**
  - If first two options fail, due recovery process to be resorted

Framework for Revitalisation of Distressed Assets …

- JLF required to arrive at in agreement within 30 days from the reporting of SMA-2.
- Restructuring can either be referred to CDR or done independently by JLF.
- If aggregate exposure of Rs.500 crores above, TEV and Restructuring package will be subjected to evaluation by independent evaluation committee.

Framework for Revitalisation of Distressed Assets …

- While restructuring proposals is under consideration by the JLF/CDR, the usual asset classification norm would continue to apply.
- Accelerated provision in cases where banks fail to report SMS status of the accounts to CRILC.
- Banks would be required to identify directors whose name appear more than once in the list of wilful defaulters as also non cooperative borrowers.
- The provisioning for such cases will be at the rate of 5% if it is a standard account and accelerated provision.

Strategic Debt Restructuring

- This involves initiating of majors such as change of ownership in accounts which felt to achieve the projected viability milestones
- SDR involves measure of converting loan dues into equity shares of the borrower account
- SDR includes following features
  - Initial restructure, JLF must incorporate as part of restructuring conditions to convert entire loan (including unpaid interest), or part thereof, into shares in the company subject to non fulfillment of ' critical conditions'
  - These conditions must be supported by necessary approvals and resolutions from the borrower company as required and to the extent laws and regulations, to enable lenders to exercise the right
  - Such decision should be approved by majority JLF members (minimum 75% by value of creditors and 60% creditors by number)
  - Post collection JLF members should collectively hold at least 51% or more of the equity shares
  - Henceforth all Banks to include necessary covenants in all load agreement to include SDR

Strategic Debt Restructuring

- Invoking of SDR will not be treated as restructuring
- Asset classification to continue for 18 months based on the classification at the time of conversion
- The bank should consider appointing the suitable professional management to run the affairs of the company
- The lenders should divest their holdings to new promoter as soon as possible

Strategic Debt Restructuring

- Upon divesting to investor the account may be upgraded to standard, though the amount of provision will not be allowed to be reversed.
- The above benefit shall be available provided
  - The new promoter does not belong to or is associate of the original promoter group
  - He owns at least 51% (incase the company falls under foreign investment restrictions and the new promoter is a foreign investor lesser % as approved)
- Conversion to take place at fair value based on restriction under section 53 of company act 2013
- The conversion though will result into bank holding more than 20 % the accounting standards applicable for such holdings will not be applied

IRAC Norms- some Issues

- Divergence in NPA observed by RBI
- NPA classification fiasco in one of the Nationalised Banks
- Verification of parameters set in the system for classification of account as NPA
- Non reversal of ***total*** interest in account classified as NPA
- Recognition of interest income in NPA A/cs
- Non availability of value of securities in case of NPA below Rs.5 Cr.
- Non submission of Stock Statement by small borrowers.

IRAC Norms- some Issues

- By virtue of reversal of interest ,it is found that the account has become NPA in earlier year
- Carry forward of date of NPA
- Whether norms of classification of accounts qua borrower would apply for agricultural and non agricultural loans?
- Branch is located in rented premises and loan is given against this premises. Issue of recovery of interest and principal?
- Classification of accounts transferred from other branches
- NPA regularised after balance sheet date but before signing the accounts

IRAC Norms- some Issues

- Accounts upgraded during the year
- 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
- Debit balance in nominal accounts be verified for provisioning
- MOCs be issued for correcting Asset classification, provisioning, income recognition
- Effect of MOCs passed in earlier year/quarter

Auditing Aspects

- The audit of advances at the branches is critical to overall audit opinion formation. Broadly we may look at following aspects besides our individual audit discretion
  - 10 top exposures at the bank
  - SMA-1 list as on 31st January 2016 to evaluate the right status and classification as of 31st March 2016
  - List of early mortality cases
  - List of restructured accounts during the year
  - List of CDR/SDR account
  - Unsecured exposure above Rs. 1 Crore

Auditing Aspects

- Crucial auditing aspects
  - Computation of drawing power
  - Examination of Loan documents
  - Centralization and location of original loan documents
  - Review of operation of the selected accounts
  - Verification of securities
  - Close look at any material change in the constitution or promoter holding in borrower account selected for audit
  - Lending under consortium / multiple banking arrangements
  - Up gradation of accounts
- Aspects relating to LFAR and reporting discipline therein

Thank you!