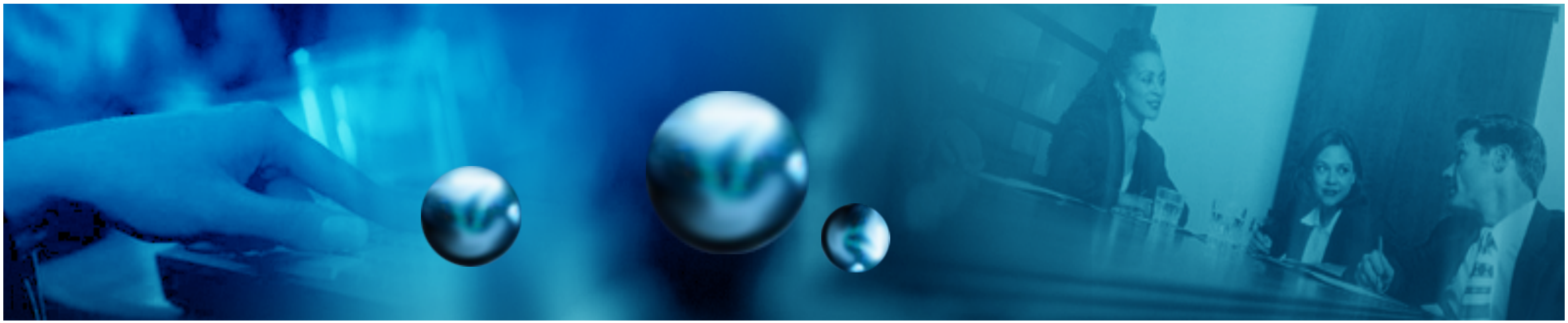
Bank Branch Statutory Audit
Prudential Norms on Income Recognition, Asset Classification and Provisioning



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Agenda

- Objective
- Identification of Account as NPA
- Exceptions / Clarifications
- Projects under Implementation
- Asset Classification and Provisioning
- Guidelines on Restructuring of Advances
- Early recognition of financial distress
- Revitalization of distressed assets
- Points to ponder

Objective

- 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 realizable value thereof.

Important RBI Circulars

- Master Circular No. RBI 2015-16/101DBR. No.BP.BC.2/21.04.048/2015-16 dated July 01, 2015 on IRAC Norms
  - Part A – General Guidelines
  - Part B – Prudential Guidelines on Restructuring
  - Part C – Early recognition of financial distress
- Master Circular dated July 01, 2015 on Disclosure in Financial Statements – Notes to Accounts
- Circulars dated November 21, 2016 & December 28, 2016

Asset Types

- **Standard Assets:**
- Performing Assets (PA)
- Do not carry risk more than normal banking risk

- **Non-Performing Assets (NPAs)**
- Not Performing
- Cease to generate income for the Bank
- Higher risk than normal banking risk
- NPA as per various criteria defined

Criteria for 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

Criteria for 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.

**Definitions*
crop season – 'period up to harvesting of crops raised' as determined by SLBC (State Level Bankers' Committee)
Long duration crop – Crops wherein crop season is more than 12 months

Criteria for NPA

Agricultural Advances	Banks have discretion of rescheduling the agricultural advances in case of natural calamities, which impair repaying capacity
Reference Circulars of Reserve Bank of India	FIDD.CO.Plan.BC.54/04.09.01/ 2014-15 dated April 23, 2015 FIDD.No.FSD.BC.52/ 05.10.001/2014-15 dated March 25, 2015
FIDD.CO.Plan.BC.54/04.09.01/ 2014-15 dated April 23, 2015	Defines 'Farm Credit'.

Criteria for NPA

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 Securitization transaction.
Credit Card dues	The minimum amount payable is not paid within 90 days from the payment due date mentioned in the statement

Criteria for NPA

Cash Credit Accounts If the account is 'out of order'

Conditions for out of order status

- Outstanding Balance remains continuously in excess of sanctioned limit / drawing power for more than 90 days
- No credit continuously for 90 days as on the date of Balance Sheet
- Credits in the account are not sufficient to cover interest debited during the same period

Criteria for NPA

What is ‘Overdue’?

If an amount due to bank under any credit facility is not paid on the due date fixed by the bank.

Criteria for NPA

Accounts with Temporary Deficiencies

- 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.
- In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (circular no. No. C&I/Circular/ 2014-15/689 dated 29 September 2014 issued by the Indian Banks Association).

Non-renewal/ Non-regularization of ***regular / adhoc limit*** within 180 days from the due date

Criteria for NPA

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.
- Central Government guaranteed advance to be classified as NPA only if Government repudiates the guarantee when invoked.

Criteria for NPA

Exceptions / Clarifications

Classification Qua Borrower

All facilities granted to a borrower shall be treated as NPA & not only that facility which has become irregular.

- ➢ Special emphasis for duplicate Customer ID of the Borrower
- ➢ Case of devolved LCs

Exception

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

Criteria for NPA

Exceptions / Clarifications

(ii) Bill Discounted against accepted LC

However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA.

Criteria for NPA

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 otherwise the account in such deprived banks might be treated as NPA for non-servicing.

Criteria for NPA

Exceptions / Clarifications

Straightaway Classification (Potential threat of recovery)

- Erosion in Value ….. Where realizable 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 realizable 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**.

Criteria for NPA

Exceptions / Clarifications

Straightaway Classification (Potential threat of recovery)

- Fraud …..
  - 100% to be provided irrespective of security spread over 4 quarters commencing from the quarter in which fraud has been detected.
  - If not reported to RBI, 100% to be provided instantly

Criteria for NPA

Exceptions / Clarifications

Solitary or few credit entries recorded before Balance Sheet to regularize the account

Whether the account is having inherent weakness?

Yes

Mark the account as NPA

No

The bank to evidence the auditors about manner of regularization of account

Criteria for NPA

Mandatory Valuation of Securities

Applicable only if balance in NPA is Rs. 5 crores & above

- Annual Stock Audit by external agencies
- Immovable Properties – Valuation to be carried out once in three years by approve valuer

Criteria for NPA

Quick Reference to Para 4.2.5

If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as ‘standard’ accounts.

Quick Reference to Para 4.2.2

The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines

Deferment for SSA Recognition

Circular dated November 21, 2016

Eligibility:

i) Running working capital finance (CC/OD), Crop loans with sanctioned limits upto Rs. 1 crore
ii) Term Loans with original sanctioned limit upto Rs. 1 crore
iii) Loans to NBFC / Housing Finance Companies, PACs
iv) Loans by State Co-op. Bank to DCCBs

Conditions:

i) Dues are payable between 01.Nov.16 to 31.Dec.16
ii) Deferment restricted to the above period for further 60 days
iii) Applies only to PAs and not to existing NPAs

Deferment for SSA Recognition

Circular dated December 28, 2016

Eligibility:

i) Running working capital finance (CC/OD), Crop loans with sanctioned limits upto Rs. 1 crore

ii) **Business (including Agriculture)** Term Loans with original sanctioned limit upto Rs. 1 crore

(both limits are mutually exclusive)

Conditions:

i) Dues are payable between 01.Nov.16 to 31.Dec.16

ii) Deferment restricted to the above period for further 30 days (i.e., in all 60 + 30 = 90 days)

iii) Applies only to PAs and not to existing NPAs

Deferment for SSA Recognition

- CC account continuously overdrawn and becoming NPA on 1 November, 2016 will be given benefit of 90 days more and will now become NPA on 30 January, 2017.

- TL installment due on 30 August, 2016 becoming NPA on 29 November, 2016 will now become NPA on 28 February, 2017.

Projects under Implementation

Essentials

Project loan means any <u>term loan</u> which has been extended for the purpose of <u>setting up of an economic venture</u>.

The bank needs to clearly spell out ‘Date of Completion’ (DC) and ‘Date of Commencement of Commercial Operations’ (DCCO) at the time of sanction.

Type of Project Loan:

1. Infrastructure Sector
2. Non-Infrastructure Sector

Projects under Implementation

When not considered as Restructuring?

If *change in repayment schedule* is caused due to increase in project outlay on account of increase in scope and size of the project & following conditions are fulfilled:

1. The increase in scope and size of the project takes place before commencement of commercial operations of the existing project;
2. The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay;
3. The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCO;
4. On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

Projects under Implementation

Deferment of DCCO

If deferment and consequential shift in repayment schedule is for <u>equal or shorter duration,</u> then the account is not considered as restructuring if:

Particulars	Infrastructure	Non-Infrastructure
Revised DCCO is within	Two years from original DCCO	One year from original DCCO
Revision due to Court Case	2 + 2 Years from original DCCO	
Revision due to any other reason beyond the control of promoters	2 + 1 Years from original DCCO	1 + 1 Years from original DCCO

Projects under Implementation

Deferment of DCCO & Retention of Class – Conditions

1. Benefit of asset classification not applicable to CRE
2. Application for restructuring (deferment of DCCO) is received upto two years from date of original DCCO for Infrastructure and one year w.r.t. non-infrastructure
3. Account needs to be standard
4. If moratorium given for interest, income on accrual can be booked till two years from date of original DCCO for Infrastructure and one year w.r.t. non-infrastructure
5. Additional provision of 5% if extended beyond two years from date of original DCCO for Infrastructure and one year w.r.t. non-infrastructure

Projects under Implementation

Deferment of DCCO & Retention of Class – Conditions

6. Additional provision of sacrifice (diminution in fair value) for standard assets is required to be made for extension of DCCO

7. In case of Infrastructure projects under implementation, appointed date is shifted due to inability of concession authority to comply requisite conditions, the loan need not be treated as 'restructuring' provided:

   i. Project should be Public Private Partnership model
   ii. Loan is not yet disbursed
   iii. Revised date is documented by way of supplementary agreement
   iv. Viability to be re-assed and sanctioned

Projects under Implementation

Retention of Class – Change of Ownership (2+2+2)

Additional extension of DCCO permitted upto 2 years with retention of class subject to:

1. Project is stalled due to inadequacies of the promoters;
2. Change of ownership resulting in high probability of commencement of commercial operations;
3. New promoters need to have sufficient expertise
4. New promoters should own at least 51% of paid up equity
5. Viability of the project to be established
6. Intra-group company take over not eligible

Projects under Implementation

Retention of Class – Change of Ownership (2+2+2)

Additional extension of DCCO permitted upto 2 years with retention of class subject to:

7. Asset classification would be as of reference date (date on which preliminary binding agreement is executed)
8. Take over to be completed within 90 days
9. New promoters to demonstrate commitment by bringing in substantial portion of additional funds
10. Repayment schedule not to exceed beyond 85% of economic life
11. Facility available only once

Projects under Implementation

Retention of Class – Financing of Cost Over-runs

Standby Credit Facility:

1. Sanctioned at the time of initial financial closure
2. Purpose is to fund cost overruns, if required
3. To be disbursed only if cost overruns and not otherwise
4. Subsequent Standby Credit facility permitted if DCCO extended upto 2 / 1 year for infra and non-infra
5. Exemption from definition of restructuring provided:
   i. Interest during construction due to delay can be funded
   ii. Other cost overruns limited to 10% of original cost

Projects under Implementation

Retention of Class – Financing of Cost Over-runs

Standby Credit Facility:

5. Exemption from definition of restructuring provided:
   - iii. Debt / Equity Ratio need to be unchanged (promoters to infuse funds)
   - iv. Disbursement only after promoter's contribution
   - v. No other change in terms and conditions
   - vi. 10% cost-over run ceiling is excluding interest but including currency fluctuations

Income Recognition

For NPA accounts income should be recognised on realisation basis.

When an account becomes non-performing, unrealised interest / fees / commission of the previous periods should be reversed or provided. UIPY & INCA

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 (unlisted) equity or any other instrument, income recognised should be fully provided (if listed, income recognised to the extent of MV)

Income Recognition

Suggested though not mandatory

- Unrealised Expenses
- Unrealised Interest
- 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 <u>uniform and consistent manner</u>.

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

Provisioning Norms

Primary Responsibility is of the Bank Management and Auditors

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%
▪Restructured accounts (First 2 years from the date of restructuring).	5.00%

Provisioning Norms

Sub-standard Asset

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

Definition of Secured Loan:

If security is not less than 10% of exposure (funded & non-funded) ab initio

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

**Intangible Security: Considered only if backed by legally enforceable and recoverable right over collection and rest of intangibles like rights, licenses, etc. are considered as 'Unsecured'*

Provisioning Norms

Provisions under Special Circumstances

Advances under rehabilitation program (BIFR)

i. Provision to be continued
ii. Eligible for up gradation if renegotiated terms have worked satisfactorily for one year

For Additional facilities, no provision required for one year

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

Categories of Loan which can be restructured

- Industrial Units
- SMEs
- Industrial Units under CDR Mechanism
- 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.
- Borrowers indulging in frauds and malfeasance are ineligible.
- BIFR cases eligible for restructuring subject to approval from BIFR.

Guidelines on Restructuring of Advances

Stage at which restructuring can take place

Before Commencement of Commercial Production

After commencement of commercial production
but
Asset is classified as NPA

After commencement of commercial production
but
Asset is PA

Guidelines on Restructuring of Advances

Asset Classification Norms

Standard Asset to be reclassified as SSA

NPA will further slip to lower category as per pre-restructured repayment schedule

Additional finance to be treated as Standard for one year

All accounts eligible for up gradation after satisfactory performance of one year

Guidelines on Restructuring of Advances

Satisfactory Performance

Non-Agri CC A/C
Account should not be out of order for more than 90 days
(+)
No overdue at the end of specified period

Non-Agri Term Loan A/C
No payment remained overdue for more than 90 days
(+)
No overdue at the end of specified period

Agricultural Loans
No overdue at the end of specified period

Provisioning Requirements

Normal provision as per Asset Classification

Provision for diminution in fair value, recomputed at each Balance Sheet date (Sacrifice)
(If loan exposure is less than 1 crore, provision can be made @ 5% notionally)

Two years from the date of restructuring
Additional provision of 5%

Calculation of Sacrifice

Discounting Rate = BPLR/MCLR/ Base Rate + appropriate Term and Credit Risk premium on the date of restructuring **applicable to borrower category**

Apply Discounting Rate to future Cash Inflows of principal and interest and calculate NPV as per original and revised repayment schedules

Total provision not to exceed 100%

Working Capital Finance
Tenure to be presumed at One Year for calculation of Sacrifice

Guidelines on Restructuring of Advances

Special Regulatory Treatment

Not available for
Consumer Loans
Personal Advances
Capital Market Exposures
CRE Exposures

Incentive for quick implementation of package withdrawn w.e.f. April 01, 2015 except for change in DCCO (Shri B Mahapatra Working Group)

Mandatory compliance in restructuring

- Right to recompense
- To ensure promoters' "skin in the game"

Early Recognition of Financial Distress

Framework of Revitalizing Distressed Assets in the Economy (30.Jan.2014)

Setting up of CRILC (Central Repository of Information on Large Credits)

Coverage for Fund and Non-Fund based exposures above Rs. 5 crores excluding crop loans, Inter-Bank / SIDBI / EXIM / NHB / NABARD exposures

Categories	Particulars
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. 60-90 days

Early Recognition of Financial Distress

Examples of SMA 0 Incipient Stress

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

Early Recognition of Financial Distress

Formation of Joint Lender's Forum (JLF)

Trigger

- Reporting under SMA 0 for 3 quarters / year
- Reporting under SMA 1 for 2 quarters / year
- Reporting under SMA 2 at any time during the year

Mandatory

If Exposure is above Rs. 100 crores
(inclusion of off-shore lender not mandatory)

Formulation of Corrective Action Plan (CAP)

Early Recognition of Financial Distress

Corrective Action Plan (CAP)

Step I …. Rectification

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

Step II …. Restructuring

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

Step III …. Recovery

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

Early Recognition of Financial Distress

Penal Measures for non-adherence of reporting of SMA status to CRILC / Ever-greening of Accounts

Asset Classification	Period of NPA	Current Provisioning	Accelerated Provision
Standard	NA		5%
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%

Early Recognition of Financial Distress

Penal Measures for non-adherence of reporting of SMA status to CRILC / Ever-greening of Accounts

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

Early Recognition of Financial Distress

Penal Measures for non-adherence of reporting of SMA status to CRILC / Ever-greening of Accounts

Applicable if the lenders fail to convey the JLF or agree upon common CAP

If escrow maintaining bank does not adhere to terms, lowest NPA status classification amongst the lenders to be adopted

Strategic Debt Restructuring (SDR)

Class of Asset Retention permitted

1. Initiative by JLF to change the ownership structure
2. Needs to be agreed upon by at least 75% of creditors in value terms and 60% in number terms
3. Post-conversion (of debt to equity), all lenders under JLF to hold at least 51% or more of equity shares of the company
4. Can be divested in favor of new promoters subsequently
5. JLF must approve SDR package within 90 days from the date of deciding to undertake SDR
6. Existing asset classification norm as on reference date would be retained for a period of 18 months and then normal IRAC

Reiteration of Points

Some important references to RBI Circular

Para 4.2.2 : Banks should establish appropriate internal systems (including technology enabled processes) for proper and timely identification of NPAs, especially in respect of high value accounts.

Para 4.2.5 : If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as ‘standard’ accounts

Annex 5 : A restructured account is one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider.

Points to Ponder

Divergences in NPA observed by RBI AFI

Verification Parameters in CBS vis-à-vis RBI Circular

Purity of Master Data in CBS

Reversal of un-serviced Interest of NPA

Availability of valuation of security for advances below 5 crores

Authenticity and regularity of stock statements

Date of NPA – current and prior year of newly identified NPAs

Unique Customer-id of borrower accounts

Accounts upgraded during the year

Regularisation of account subsequent to balance sheet date

Points to Ponder

Accounts other than Advances accounts including Sundries / Suspense Accounts

Accounts transferred to other branches – control over identification / classification of accounts

Income leakages identified and resulting in overdrawing of accounts

Recalculation of Drawing Power

Early Mortality Cases

Ever-greening of accounts

MOCs vis-à-vis Main Audit Report vis-à-vis LFAR

Thank you

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