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Verification of Advances with Special reference to IRAC Norms

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Disclaimer

- This presentation is only to share my views on the subject and cannot be construed to be the views of M/s.S.R.R.K.Sharma Associates as a professional advice.

PRUDENTIAL NORMS

Evolution of Prudential Norms

- The recommendations of Mr.Narasimhan committee that provisions should be made on the basis of classification of advances were accepted by RBI with some modifications in the year 1992.
- The RBI through its circular No.BP.BC.129/21.04.043-92 dt.27-4-1992 issued guidelines to be followed by all scheduled commercial banks for income recognition, asset classification, provisioning and other related matters. These guidelines are commonly referred as ‘Prudential guidelines’ or ‘Prudential norms’.
- With the introduction of prudential norms, the health code-based system for classification of advances has ceased.
- Since, then RBI has issued many circulars and master circulars in this regard.
- The latest Master circular No.RBI/2015-16/101 DBRNo.BP.BC.2/21.4.048/2015-16 issued on 1st July,

Prudential Norms – RBI Guidelines

– Classification of advances
– Classification Norms relating to NPAs
– Income Recognition
– Provisioning requirements
– Disclosures

What is NON PERFORMING ASSET

- The status of an Asset may be
  - a performing or
  - non-performing.
- A asset, including leased asset becomes non-performing “WHEN IT CEASES TO GENERATE INCOME FOR THE BANK”.

Classification of Advances:

Broad categories of advances for the purpose of provisioning

- **Standard asset** – Which does not disclosed any problems and does not carry more than normal risk.
- **Sub-Standard Asset** – which has remained NPA for a period less than or equal to twelve months
- **Doubtful Asset** - Which has remained as substandard for a period of twelve months.
- **Loss Asset** – Loss has been identified by the bank or internal or external auditors or RBI inspection.

Up gradation of NPA accounts is permissible on repayment of arrears of interest and principal by the borrower. Such accounts should no longer be treated as NPA and may be classified as standard account directly. ***Up gradation within NPA category is not***

Classification Norms relating to NPAs.

- **Term Loans**: A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.

- **Cash Credits and Overdrafts**: A cash credit or overdraft account is treated as NPA if it remains out of order 90 days.

- **Bills Purchased and Discounted**: Bills purchased and discounted are treated as NPA if they remain overdue for a period of more than 90 days.

- **Other Loans(Demand loans) :** overdue for a period of more than 90 days.

Classification Norms relating to NPAs

contd…

- **Credit Card Dues**: The account will be treated as NPA if minimum amount due as mentioned in the statement is not paid fully within 90 days from the payment due date mentioned in the statement.

- **Securitisation**: The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days.

- **Derivative transactions :** the overdue receivables, if these remain unpaid for a period of 90 days from the specified due date for payment.

Classification Norms relating to NPAs
contd…

- **Agricultural Advances:** A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

  As per the guidelines, "***Long duration***" crops would be crops with crop season longer than one year and crops, which are not long duration crops would be treated as "***Short duration***" crops. *The crops season would be as determined by State Level Bankers Committee in each State.*

- The above norms should be made applicable to (i) Farm credit (ii) Agriculture Infrastructure and (iii) Ancillary Activities as per revised guidelines issued by Reserve Bank of India (RBI-2014-15/573 FIDD.CO. Plan. BC. 54/04.09.01/2014-15 dated April 23, 2015)

‘Out of order Status’

- An account should be treated as ‘OUT OF ORDER’ :
  - If the outstanding balance remains continuously in excess of the sanctioned limit/drawing power(whichever is lower).
  - In cases where the o/s balance in the principal operating account is less than the sanctioned limit or drawing power(whichever is low), but there are no credits continuously for 90 days as on the date of Balances sheet
  - If credits are not enough to cover the interest debited during the same period.

‘Overdue’

- Any amount due to the bank under any facility is overdue if it is not paid on the due date fixed by the bank.

- In line with the international best practices and to ensure greater transparency, the RBI has directed the banks to adopt *‘90 days’* overdue norm.

Special circumstances

- **Advances Granted Under Rehabilitation Packages Approved by BIFR/Term Lending Institutions**

  In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset.

  This classification cannot be upgraded by the bank unless the package of renegotiated terms has worked satisfactorily for a period of one year.

  As regards the **additional** facilities sanctioned as per package finalised by BIFR/term lending institutions, the income recognition, asset classification norms would apply after a period of one year from the date of disbursement.

Special circumstances contd…

- **Post Shipment Supplier's Credit**

Where the credit extended by banks are guaranteed by EXIM Bank, the extent to which payment has been received from EXIM bank on guarantee, the advance may not be treated as NPA.

Special circumstances contd…

- **Takeout Finance**
  - Under Takeout Finance arrangement, the bank or financial institution financing the project transfers to another bank or financial institution, the outstanding of a project finance.
  - During the time-lag involved in the taking-over, the account may slip into NPA.
  - In respect of such takeout finances, the taking over bank/ institution should classify the account as NPA on the basis of the actual date of NPA with the previous institution/bank irrespective of the fact that the account was not in its books as on that date.
  - Similarly, the lending institution should also make provision against any asset turning into NPA pending its take over by the take over institution. As and when the asset is taken over by the taking over institution, the lending institution can reverse such provision.

Special circumstances contd…

- **Export Project Finance**
  - Where the actual importer has paid the dues to the bank abroad and the proceeds have not been made good to the bank granting finance due to any political reasons, such account need not be classified as NPA if the bank is able to establish through documentary evidence that the importer has cleared the dues in full.
  - The account will, however, have to be considered as NPA if at the end of one year from the date the amount was deposited by the importer in the bank abroad, the amount has not still been remitted to the bank.

Special circumstances contd…

- **Project Finance Under Moratorium Period**
  - In the case of bank finance given for industrial projects or for agricultural plantations etc., where moratorium is available for payment of interest, payment of such interest become due after the moratorium or gestation period is over, and not on the date of debit of interest. Therefore, such amounts of interest do not become overdue and hence the accounts do not become NPA, with reference to the date of debit of interest.

  - They become overdue after due date for payment of interest as per the terms of sanction and consequently NPA norms would apply to those advances from that due date.

Special circumstances contd…

- **Advances to Staff**
  - Interest bearing staff advances as a banker should be included as part of advances portfolio of the bank.
  - In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.
  - The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets

Special circumstances contd…

- **Government guaranteed advances**
  - The credit facilities backed by guarantees of central govt. though over due may be NPA only when the govt. repudiates the guarantee when invoked. But for recognition of income such advances are treated as NPA.
  - This exception is not available for State Govt. guaranteed loans.

- **Advances under Consortium:**
  - Consortium advances should be based on the record recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances.

Master Circular - References

- Prudential norms for banks for the sale of financial assets to Secutarisation company/Reconstruction company.
- Guidelines on purchase /sale of Non Performing Assets.
- Prudential Guidelines on Restructuring of Advances .
- Prudential norms for conversion of Principal into debt/equity.
- Prudential norms for conversion of unpaid interest into “Funded Interest Term Loan”, debt or equity instruments.
- Direct agricultural advances.
- Projects under implementation .
- Corporate Debt Restructuring (CDR) Mechanism .
- SME Debt Restructuring Mechanism.
- S4A Mechanism.

Other Points

- Net Worth of Borrower/Guarantor or Availability of Security
  - Since income recognition is based on recoveries, net worth of borrower/ guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security guarantee is not relevant for determining whether or not an account is NPA.
- Accounts with temporary deficiencies not to be classified as NPAs.
- Regularisation near about balance sheet date to be handled properly.

Other Points contd…

- Asset classification to be borrower-wise not facility-wise.
- LCBD Facilities: The bill discounted against accepted LC would be treated as PA even though rest of facilities of borrower are treated as NPA. (since exposure of the bank in such cases would be in LC issuing bank and not on the borrower.)
- Erosion in value of securities/frauds committed by borrowers
  - If erosion in the value of securities by more than 50%, asset to be classified as doubtful straight away.
  - If realisable value of securities is less than 10 % of outstanding in the borrower account asset should be classified as loss asset.
- Advances against Term Deposits, NSCs, KVPs, IVPs and life policies etc need not be treated as NPAs provided

Other Points contd…

- In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, it is advised that the following would be applicable from the financial year 2009-10 onwards :
  - a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.
  - b) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans

Other Points contd…

- In case of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.
- The provisions on standard assets should not be reckoned for arriving at net NPAs.
- The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in Schedule 5

Income Recognition

- The guidelines requires that banks should not recognise income on non performing assets until it is actually realised.
- Interest income on advances against on term deposits, NSCs, IVPs, KVPs and Life policies may be recognised on accrual basis provided adequate margin is available in the accounts.
- Fees and commissions earned as a result of negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of the time covered by the re-negotiated or rescheduled extension of credit.
- Interest on Govt. guaranteed NPA advances should not be taken to income account unless the interest has been realised

Income Recognition contd…

- **Reversal of income:**
  - In case of new NPAs as at the close of the any year interest accrued and credited in the past periods , should be reversed , if the same is not realised.
  - Similarly, any fees, commission and similar income accrued should be reversed if uncollected.
  - All un-recovered finance charges recognised on leased assets should be reversed or provided for.
  - In case of NPA advance under take-out finance income should not be recognised unless realised from the borrower/taking over institution.

Income Recognition contd…

- **Partial recoveries in NPAs:**
  - In absence of clear agreement for re-appropriation of recoveries in NPAs, banks should adopt an accounting principle and exercise the right of appropriation of recoveries in an uniform and consistent manner.
  - Interest realized on NPA accounts can be recognised provided credits in the account are not out of fresh/additional facilities sanctioned to the borrower concerned.

Provisioning for Loans and Advances:

- Loss assets – 100% of the outstanding should be provided for unless written off.
- Doubtful Assets:
  - Unsecured portion of the outstanding balances – 100%
  - Secured portion
    - 25% - in case of doubtful assets upto one year,
    - 40% - in case of doubtful assets more than one year and upto three years
    - 100% - more than three years

Provisioning for Loans and Advances
contd…

- Sub-Standard asset
  - 15% general provision on outstanding.
  - Additional 10% provision for unsecured exposures. (Unsecured exposure means where realisable value of the Tangible security as assessed by bank/approved valuers/RBI inspectors is not more than 10%, *ab initio*, of the outstanding exposure). This additional 10% provision is applicable for unsecured portion of Leased Asset also.
  - Infrastructure loan accounts attracts overall 20% provisioning.
- Standard assets
  - Direct advances to Agricultural and SME sectors – 0.25%
  - Advances to Commercial Real Estate – 1.00%
  - Advances to Commercial Real Estate – Residential Housing – 0.75%
  - Housing advances during teaser rate interest – 2.00%
  - Restructured advances - Dealt separately

Provisioning for Loans and Advances
contd…

- **Provisioning for certain specific types of Advances:**
  - Advances granted under rehabilitation packages approved by BIFR/Term Lending Institutions
    - On existing credit facilities to continue the same provisioning as per IRAC norms.
    - On additional facilities provisioning not required for one year from the date of disbursement
    - On additional credit facilities granted to sick SSI Units under consortium agreement under rehabilitation packages/nursing programmes provisioning is not required for a period of one year.
  - Advances against gold ornaments, Govt Securities attract provisioning as per their classification

Provisioning for Loans and Advances

contd…

- **Provisioning for certain specific types of Advances:**
  - Doubtful Advances guaranteed by ECGC/CGTSI:
    - In case of above advances provisioning should be made only for balance in excess of guaranteed amount by these corporations.
  - Reserve for exchange rate fluctuation account (revaluation gain) on NPAs not to be taken to income. Bank should treat this as provision against corresponding asset.

Provisioning for Loans and Advances contd…

- Banks have to make a provision for country risk on net funded country exposure on a graded scale ranging from 0.25 to 100% according to risk category.

- Banks have to maintain provision coverage ratio at 70% on going basis.

- Banks are advised to build up provision to meet the shortfall in case of the asset they propose to sell to securitisation/reconstruction companies.

- Floating provision :
  - The bank's board of directors should lay down approved policy regarding level of floating provision to be created.

- Purchase and sale of NPAs :
  - The selling bank should debit the shortfall to the profit and loss a/c, if sale price is below the net book value. Excess realised should not be treated as income, but will be utilised to meet the shortfall/loss on account of sale of other non-performing assets.
  - The purchasing bank has to make provision appropriate to its

SMA ACCOUNTS

Now, Before a loan account turns into a NPA, banks are required to identify incipient stress in the account by creating three sub-categories under the Special Mention Account (SMA) category as given in the table below:

SMA Subcategories & Basis for classification

- SMA-0 Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress .
- SMA-1 Principal or interest payment overdue between 31-60 days
- SMA-2 Principal or interest payment overdue between 61-90 days

'Special Mention Account' (SMA) was introduced in terms of RBI Circular No.DBS.CO. OSMOS/ B.C./4/33.04.006/2002-2003 dated September 12, 2002, whereby banks are required to identify incipient stress in the account by creating a sub-asset category viz., SMA.

Accelerated Provisioning

In cases where banks fail to report SMA status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts or evergreen the account, banks will be subjected to accelerated provisioning for these accounts and/or other supervisory actions as deemed appropriate by RBI. The current provisioning requirement and the revised accelerated provisioning in respect of such non performing accounts are mentioned in the table given below .

In addition to the cases mentioned in the table, accelerated provision is applicable if any of the lenders who have agreed to the restructuring decision under the CAP by JLF and is a signatory to the ICA and DCA, but changes their stance later on, or delays/refuses to implement the package, will also be subjected to accelerated provisioning

Asset Classification	Period as NPA	Current Provisioning (%)	Revised Accelerated Provisioning (%)
Sub-Standard (Secured)	Up to 6 months	15	No change
	6 months to 1 year	15	25
Sub-standard (unsecured abinitio)	Up to 6 months	25 (other than infrastructure loans)	25
	6 months to 1 year	20 (infrastructure loans)	
Doubtful I	2nd year	25 (secured portion)	40 (secured portion)
		100 (unsecured portion)	100 (unsecured portion)
Doubtful II	3rd & 4th year	40 (secured portion)	100 for both secured and unsecured portions
		100 (unsecured portions)	

Classification of Advances in Financial Statement as per Third Schedule of Banking Regulation Act

- Third Schedule to the Banking Regulation Act, requires classification of advances as follows:
  - Nature of Advance
  - Nature and extent of security
  - Place of making advance (in India or outside India)

Classification of Advances in Financial Statement as per Third Schedule of Banking Regulation Act

Nature of Advance	Nature and extent of security	Place of making advance (in India or outside India)

• Bills purchased and discounted
• Cash credits, Overdrafts and Demand Loans
• Term Loans
	• Secured by tangible assets
	• Covered by bank/govt guarantees
	• Unsecured
		• Advances in India
		  ○ Priority sector(annexure A)
		  ○ Public sector
		  ○ Banks
		  ○ Others
		• Advances outside India
		  ○ Due from Banks
		  ○ Due from others
		  ○ Bills purchased and discounted
		  ○ Syndicated loans
		  ○ Others

Annexure 'A'

– **Priority Sector Advances include –**

- Advances for agriculture and other allied activities
- Advances to minority communities
- Advances to micro/small/medium scale enterprises
- Advances to retail traders and small business enterprises
- Advances to professionals and self employed
- Advances to Housing Finance Companies (HCFs)@: The RBI, vide its Circular No. RPCD. Co. Plan. BC 74/04.09.01/2008-09 dated December 8, 2008 on "Priority Sector Lending – Loans to Housing Finance Companies (HFCs), decides that loans granted by banks to HFCS, approved by National Housing Bank for the purpose of refinance, for on-lending to individuals for purchase/construction of dwelling unit may be classified under priority sector, provided the housing loans granted by HFCs do not exceed Rs.20 lakh per de\dwelling unit per family. However, the eligibility under this measure shall be restricted to five per cent of the individual bank's total priority sector lending, on an ongoing basis. Further, this special dispensation shall apply to loans granted by banks to HFCs up to 31.03.10, which will continue to be under the priority sector lending till 31.3.2010
- Advances sanctioned to state sponsored organizations for scheduled castes/scheduled tribes
- Educational loans
- Housing loans upto prescribed limits
- Funds provided to RRBs
- Micro credit
- Any other priority sector advances, such as SEPUP (Self-Employment Programme for Urban Poor), PMRY (Prime Minister's Rozgar Yojana), SEEUY (Self-Employment

THANK YOU

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