# Audit of advances and compliance of norms

# PREPARATORY STEPS BEFORE COMMENCING AUDIT

- Study all available reports- RBI inspection, previous statutory audit, concurrent audit, credit audit reports etc. Summarize deficiencies in internal control, documentation, monitoring and salient observations which need follow up
- Obtain
  - Branch head's financial powers
  - List of new loans sanctioned during the year
  - List of credit facilities enhanced during the

# PREPARATORY STEPS BEFORE COMMENCING VERIFICATION

- List of large advances (credit facilities to borrowers beyond a monetary threshold)
- List of credit facilities restructured during the year
- List of credit facilities upgraded from NPA to PA
- List of stressed assets per various circulars of RBI
- List of accounts referred to Joint lenders forum.
- Credit facilities denominated in foreign currency (PCFCs, FBD, FTL, FLC, FBG etc)
- Marginal Cost of fund based lending rate (MCLR) prevailing during the year

# PREPARATORY STEPS BEFORE COMMENCING VERIFICATION

- Select sample of accounts to be audited
  - End to end
  - for asset classification only
  - to ascertain current status of accounts commented in various audit reports
- Understand/have a walk through of core banking software - setup, data fields, validations, reports available particularly for identification and application of IRAC norms, controls for application of interest/fees, charging of service tax, system generated entries etc.

## AUDIT STEPS TO BE CARRIED – END TO END

- For select sample, review accounts through entire gamut of life cycle of credit facility. Review all credit facilities to select borrower (s) together.

  Appraisal, sanction, acceptance of sanction terms by borrower, documentation, compliance with sanction terms by borrower, creation of charge, disbursement, post disbursement monitoring, recovery, rescheduling, reference to JLF, modification of terms, AC, interest calculations, rebate on bills discounted, recognition of income, reversal of income on NPAs, provisioning, sacrifices etc.

# AUDIT STEPS TO BE CARRIED – END TO END

- Interest rate to be charged to take into account penal interest for delays in payment of principal /interest, additional rate to be charged for delay in commencement of commercial production, delay in execution of charge for collateral securities, delays in submission of stock statements etc

- Income recognized on non fund based facilities, margin provided, devolved LCs and guarantees, recovery of the same etc

- To enquire whether provision is required for invoked LCs and BGs but not paid

# AUDIT STEPS TO BE CARRIED – END TO END

- To check whether credits in account are out of fresh credits either to borrower or a related party

- Analytical review of divergent trends in income received, yield on advances, movement of NPAs and provisions thereon.

# Forward contracts

- To test verify select settled as well as outstanding forward contracts with reference to sanction terms, advice from treasury, export/import contracts of customer, rates at which settled, cancellation/premature termination of contracts etc.
- To ensure that all outstanding forex contracts are translated at year end rates and disclosed as a contingent liability

# DOCUMENTATION

- Dependent on three factors
- Nature of legal entity (personal finance, sole proprietor, partnership, LLP, private/public company)
- Nature of security
- Consortium arrangements

# DOCUMENTATION

- Sanction letter and any modifications of the same-unconditionally accepted by borrower.
- DPN dated/executed by borrowers/partners /coobligant
- Certified true copy- partnership deed (duly registered with Registrar of Firms), LLP agreement, memorandum/articles of association, certificate of incorporation/commencement of business
- Certified true copy of resolutions passed by partners/board of directors authorizing borrowing, amount to be borrowed, securities to be given, persons authorized to execute documents etc.

# DOCUMENTATION (contd.)

- Certified true copy of resolutions passed under section 180 (1)(a)/(c ) of the Companies Act, 2013
- Search report of ROC records
- Registration/modification of charge
- Documents to support compliance with section 186 of the Companies Act, 2013 (inter corporate guarantees, security given)
- Deeds executed by guarantors, net worth statement, tax papers.
- All permissions to carry on business

# DOCUMENTATION (contd.)

- Based on security

  - Hypothecation/pledge agreement

  -Mortgage deed, original title deeds, khata certificate, search/encumbrance report, legal opinion, valuation report, tax paid receipts

  - Assignment of LIC policy/govt. security/book debts etc. in favor of bank

  - Bank's lien on listed shares/securities in depository/demat statements

  - RC book, duplicate keys, blank transfer forms etc.

## DOCUMENTATION (contd.)

- Joint consortium agreements
- Minutes of consortium meetings
- Calculation of DP for working capital finance, godown visit reports, verification of pledged items
- Forms 15CA / 15CB compliance by borrower.
- Acknowledgement of debt from borrower
- Reports by CAs on stock and book debts
- Insurance policies (assets, disruption of business, contractors all risk policy, professional indemnity etc.)

# OTHER DOCUMENTS TO BE READ

- Documentation / agreement with overseas bank/ any further confirmatory documents exchanged

## REVIEW OF BORROWERS FS/CLAUSE 41 STATEMENTS

- Financial performance, net worth, borrowings levels
- Transactions with other banks
- Capacity utilization, status of project implementation
- Qualifications in audit report, overdue statutory liabilities, bank dues, utilization of bank funds
- Indications of diversion of funds
- Validate current assets as per stock statements with FS/clause 41 statements
- Related party transactions

# REGULATORY ISSUES

a) bank cannot grant loans/advances against security of its shares.
b) restrictions on loans/advances to directors/ entities in which they hold interest.
c) Except with prior approval of RBI, remit debt due by its directors/specified related parties
d) not hold shares in any company (including as pledgee) exceeding lower of 30 % of latter's paid-up capital or 30% of its paid-up capital & reserves.

# REGULATORY ISSUES

e) Banks not to grant loans/advances without approval of its Board of Rs. 25 lakhs and above to directors of other banks/their specified related parties

f) RBI’s directives re credit against specified sensitive commodities.

g) No loans to be granted against partly paid shares.

h) No advances exceeding specified limit for purchase of securities through IPOs.

i) RBI’s directions-loans to corporates against security of shares held to meet promoters’ contribution to equity of new companies.

# REGULATORY ISSUES

j) RBI's directives-lending to infrastructure projects

k) Prudential exposures-single/group borrower limits

# ACCOUNTING STANDARDS

- Accounting of BG/LC fees on cash basis and not recognizing fees for unexpired period as a liability is in accordance with AS ?
- To test outstanding LCs and BGs extended to borrowers whose accounts have been classified as NPA with reference to AS 29.

# Meetings with branch auditors

- Audit reports to be drafted keeping in mind the provisions of relevant standards on auditing.
- Branch auditor to be requested to clearly & unambiguously set out observations with impact thereof. Not to make general comments.
- Branch auditor to be requested to summarize in his report comments in LFAR which have a bearing on true and fairness of FS
- Branch auditors to be encouraged to meet CSAs - major issues & disagreements with bank officials
- To maintain minutes of meetings/correspondence with branch auditors

# FOREX TREASURY

- Auditors carrying out treasury audit to review position of reconciliation of credit denominated in foreign currency as per branch records with mirror accounts maintained at treasury.
- Loss on revaluation of foreign currency assets to be booked in Profit & Loss Account. In addition to provisioning requirement as per IRAC norms, full revaluation gains, if any, on account of forex fluctuations to be used to make provision against corresponding assets.
- Provisioning for country risk – detailed later

# MEETINGS WITH BANK MANAGEMENT

- Auditors to maintain minutes of meetings with bank management and amongst themselves re discussions on advances, asset classification and provisioning.
- Auditors to maintain copies of presentation to those charged with governance.
- Representation letters to be obtained – to cover all aspects of advances, their true disclosure, that credit facilities have been sanctioned in accordance with all applicable norms, regulations, approvals, completeness of documentation, application of interest/fees, AC, provisioning etc.

# CLASSIFICATION OF ADVANCES

- All advances are to be classified between

  - Performing

  - Non performing

# Non Performing Advances

- Term loans-Interest and/ or instalments of principal remain overdue for a period > 90 days.
- Overdraft/ cash credit-account remains out of order
- Bills purchased/ discounted .. overdue for a period > 90 days

# Non Performing Advances (Contd.)

Agricultural Advances

- Instalment or interest remains overdue for two crop seasons for short duration crops
- Instalment or interest remains overdue for one crop season for long duration crops.

Securitisation transactions

- Liquidity facility remains outstanding for more than 90 days

# Non Performing Advances (Contd.)

Derivative Transactions

- Overdue receivables representing positive mark to market value remain unpaid for a period of 90 days from specified due date for payment.
- Accounts may also be classified as NPA in terms of paragraph 4.2.4 of master circular dated July 1, 2015

# Non Performing Advances (Contd.)

**Out of Order status**

- If the outstanding balance remains continuously in excess of sanctioned limit/ drawing power for 90 days or
- there are no credits continuously for a period of 90 days as on the date of the balance sheet or
- credits are not enough to cover the interest debited during the same period

**Overdue**

- Any amount due under any credit facility if not paid on due date fixed by the bank.

# INCOME RECOGNITION

- Income to be recognised on performing advances on accrual basis.
- Income on non performing advances (NPA) to be recognised only on cash basis.
- Interest on NPAs against term deposits, NSCs, KVPs, IVPs and life policies to be recognised on accrual basis only if adequate margin is available.
- Interest on government guaranteed NPAs to be accounted on cash basis
- Fees and commissions earned on renegotiation/rescheduling of debts to be recognized over the period of time covered by the renegotiated or rescheduled extension of credit

# INCOME RECOGNITION (Contd.)

**Reversal of Income on NPAs**

- On an advance becoming NPA, all unrealized interest accrued and credited to income account to be reversed. Banks to stop further application of interest.
- Fees, commission or similar income accrued but not realized to be reversed. Will apply to all government guaranteed accounts.
- All unrecovered finance charges recognized on leased assets to be reversed or provided for.

# INCOME RECOGNITION (Contd.)

**Appropriation of recovery in NPAs**

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

# ASSET CLASSIFICATION (AC)

Banks to classify NPAs into following 3 categories:

- Substandard assets - advance which has remained NPA for a period of < or equal to 12 months
- Doubtful assets- advance which has remained as substandard for a period of 12 months
- Loss assets- loss identified by bank or external/internal auditors or RBI inspection but not written off.
- Annexure 1 to master circular details manner of computation of gross/net advances, gross/net NPAs.

# ASSET CLASSIFICATION (Contd.)

Guidelines for classification of assets:

- Banks to establish internal controls to eliminate tendency to delay or postpone identification of NPAs.
- Availability of security or net worth of borrower/guarantor not to be taken into account for the purpose of treating an advance as NPA or otherwise.
- Accounts with temporary deficiencies not to be classified as NPAs.
- Outstanding in working capital accounts to be deemed irregular if DP is calculated from stock statements older than 3 months. Account to be classified as NPA if such irregular drawings are permitted for a continuous period of 90 days even though unit is working or borrower's financial position is satisfactory.
- Regular/adhoc credit limits not reviewed/renewed within 180 days from due date/date of adhoc sanction to be treated as NPA.

# ASSET CLASSIFICATION (Contd.)

- Up gradation of loan accounts classified as NPAs permissible on repayment of arrears of interest & principal by borrower.
- Accounts regularised by solitary or a few credits near about reporting date to be closely scrutinized.
- AC to be made borrower wise and not facility wise. Exception: Bills discounted under LC unless it was not honoured by LC issuing bank & not made good by borrower immediately.
- Debits arising out of devolvement of LCs or invoked guarantees, parked in separate account, to be treated as part of borrower's exposure, for application of prudential norms.
- Overdue receivables representing positive mark to market value of a derivative contract will be treated as NPA, if they remain unpaid for 90 days or more. In case overdues arising from forward contracts and plain vanilla swaps and options become NPA, all other funded facilities of the client will be classified as NPA, following principle of borrower wise classification for applying prudential norms.

# ASSET CLASSIFICATION (Contd.)

Exception: Other derivative contracts that were entered into during April 2007 to June 2008, which has already crystallized or might crystallize in future and is/becomes receivable from the client. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower wise asset classification, though such receivable for 90 days or more shall itself be classified as NPA, as per extant IRAC norms.

- In cases where the contract provides for settlement of the current mark to market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as NPA after an overdue period of 90 days.
- As the overdue receivables mentioned above would represent unrealized income booked on accrual basis, after 90 days of overdue period, the amount recognized as income to be reversed.

# ASSET CLASSIFICATION (Contd.)

- Classification of advances under consortium arrangements should be based on record of recovery of individual member banks
- Accounts where there is a erosion in the value of security to an extent of not less than 50% of that assessed by the bank or accepted by RBI at the time of last inspection / fraud committed by borrowers---such accounts to be classified right away as doubtful without retaining it in substandard category for 12 months.
- If the realisable value of securities is < 10% of the outstanding, the existence of the same to be ignored and to be classified as loss asset.
- Advances against security of term deposits, NSCs, KVP/ IVP, life policies need not be treated as NPA, provided adequate margin is available. Exemption not available for advances against gold ornaments, government securities and all other securities not covered by this exemption.
- Advances granted by banks to PACS (Primary Agrl. Credit society)/FSS (Farmers Service Societies)under on-lending system- classification to be done facility wise. All credit facilities sanctioned to a PACS/FSS will not become NPA. Other direct loans & advances granted by a bank to a member borrower of PACS/FSS outside on-lending arrangement will become NPA even if one of the facilities granted to same borrower is

# ASSET CLASSIFICATION (Contd.)

- Loans for industrial projects or for agricultural plantations with moratorium for payment of interest - interest becomes due only when moratorium or gestation period is over.
- Housing loans or similar advances granted to staff where interest is payable after recovery of principal- to be treated as NPA only when there is default in payment of instalment/interest on respective due dates.
- NPAs with state government guarantee to be classified ignoring fact of such guarantee
- Accounts with central government guarantee to be classified as NPA only if CG repudiates its guarantee when invoked. Exemption from classification of government guaranteed advances as NPA not available for recognition of income.

# Projects under implementation- project loans- deferment of DCCO

- Date of commencement of commercial operations (DCCO) to be spelt out at the time of financial closure.
- Deferment of DCCO/consequential shift in repayment schedule for equal or shorter duration (including start/end date of revised repayment schedule) will not be treated as restructuring provided:

  (a) Revised DCCO falls within a period of 2 years and 1 year from original DCCO stipulated at the time of financial closure for infrastructure/non-infrastructure projects respectively (including commercial real estate projects)respectively and (b)All other terms and conditions of the loan remain unchanged.
- As such project loans will be treated as standard assets in all respects, they will attract standard asset provision of 0.40 %.

# Projects under implementation- project loans- deferment of DCCO

- Banks can extend DCCO

For infrastructure projects-

up to additional 2 years ( Addl. 2+ original 2 years) in case delays are due to court /arbitration cases.

up to additional 1 year ( Addl. 1+ original 2 years) in case delays are due to factors beyond control of promoters.

For non infrastructure projects (other than commercial real estate exposure)

up to additional 12 months ( Addl. 1 year + original 1 year)

# Projects under implementation- project loans-deferment of DCCO

- In cases where there is moratorium for payment of interest, income should not be booked on accrual basis beyond the 2 years/1 year from original DCCO, considering high risk involved in such accounts
- Mere extension of DCCO will not be treated as restructuring, even if all other terms and conditions remain the same. Application for extension of DCCO to be received before expiry of 2 years/1 year from original DCCO and when account is still standard as per record of recovery.

# Projects under implementation

| Infrastructure sector | Provisions to be made for standard accounts |
| --- | --- |
| If revised DCCO is within 2 years from the original DCCO | 0.40% |
| If revised DCCO is extended beyond 2 years and up to 4 years /3 years from the original DCCO- project loans restructured | 5% from date of restructuring till the revised DCCO or 2 years from date of restructuring, whichever is later |
| Non infrastructure sector | |
| If revised DCCO is within 1 year from the original DCCO | 0.40% |
| If revised DCCO is extended beyond 1 year and up to 2 years from the original | 5% from date of restructuring for 2 years |

# Projects under implementation- project loans- deferment of DCCO

- In case of infrastructure projects under implementation, where Appointed Date (as defined in the concession agreement) is shifted due to inability of Concession Authority to comply with the requisite conditions, change in DCCO need not be treated as 'restructuring', subject to:-

  a) The project is an infrastructure project under PPP model awarded by a public authority;

  b) The loan disbursement is yet to begin;

  c) The revised DCCO is documented and

  d) Project viability has been reassessed & sanction from appropriate authority obtained.

# Projects under implementation- project loans- change in ownership

- To facilitate revival of projects stalled primarily due to inadequacies of current promoters, if a change of ownership takes place before original DCCO, banks may permit additional extension of DCCO up to 2 years, without any change in AC.
- In cases where change in ownership/extension of DCCO takes place before original DCCO, and if project fails to commence commercial operations by extended DCCO, project eligible for further extension of DCCO in terms of earlier guidelines. Holds good when change in ownership/extension of DCCO takes place during period quoted earlier.

# Projects under implementation- project loans- change in ownership- conditions

- Banks to be satisfied that implementation was affected primarily due to inadequacies of current promoters/management & with a change in ownership there is good probability of CCO within extended period;
- New promoters to own at least 51% of paid up capital of acquired project. If new promoter is a non-resident (NR), and in sectors where ceiling on FDI is less than 51%, new promoter to own at least 26% of paid up capital or up to applicable FDI limit, whichever is higher; bank to be satisfied that with this stake, new promoter controls management of project;
- Intra-group business restructuring of project by other entities belonging to existing promoter will not qualify for this facility.

# Projects under implementation- project loans- change in ownership- conditions

- AC of account as on ‘reference date’ would continue during extended period. Reference date is date of execution of preliminary binding agreement (PBA) between parties to transaction, provided that takeover as per the provisions of law is completed within 90 days from date of execution of PBA. During intervening period, usual AC norms would apply. If change in ownership is not completed within 90 days from PBA, reference date will be effective date of acquisition/takeover as per provisions of applicable law.

# Projects under implementation- project loans- change in ownership- conditions

- New owners to bring in substantial portion of additional monies required to complete project within extended time period. Financing of cost overruns to be subject to guidelines. Financing of cost overruns beyond ceiling to be treated as restructuring even if extension of DCCO is within limits prescribed.
- Repayment schedule not to extend beyond 85 % of economic life/concession period of project.
- Facility available to a project only once- not available during subsequent change in ownership.
- Loans would attract provisioning as per extant IRAC norms depending upon asset classification status.

# Projects under implementation

- Restructuring of project loans after commencement of commercial operations will be governed by instructions
- Change in repayment schedule of a project loan due to an increase in project outlay on account of increase in scope and size of the project, would not be treated as restructuring if

  a) Increase in scope/size of project takes place before commencement of commercial operations of existing project

  b) Raise in cost excluding any cost overrun in respect of the original project is 25% or more of the original outlay

# Projects under implementation

c) Viability of project is reassessed before approving the enhancement of scope and fixing a fresh DCCO.

d) On re rating (if already rated), the new rating is not below the previous rating by more than one notch.

# Income recognition

- Banks to recognise income on accrual basis in respect of projects under implementation & classified as standard. Banks to recognise income on NPAs relating to projects under implementation on realisation. Interest overdue & funded not to be recognized as income.
- If interest dues is converted into equity/other instrument & income recognised, full provision to be made to offset the same. (in addition to provision for depreciation in value of security as per investment valuation norms). If conversion of interest is into quoted equity, interest income to be recognised at market value as on the date of conversion, not exceeding amount of interest converted to equity. Such equity to be classified in available for sale category and valued accordingly

# Take out finance

- Norms of asset classification to be followed by bank in whose books the account stands
- Provision can be reversed as and when asset is taken over by taking over bank.
- Taking over bank should make provision treating the account as NPA from the actual date of it becoming NPA even though account was not in its books as on that date

# ECGC guaranteed accounts

- To the extent payment has been received from EXIM bank, advance not to be treated as NPA
- Export project finance- in cases where the actual importer has paid the dues to the bank abroad but not repatriated, asset need not be classified as NPA for a period of 1 year from the date the amount was deposited by the importer in a bank abroad.

# Advances under rehabilitation by BIFR/TLI

- Existing credit facilities will continue to be classified as substandard/doubtful
- Additional facilities sanctioned under rehabilitation package … income recognition and asset classification norms will be applicable after 1 year from date of disbursement
- No up-gradation permissible unless package has worked satisfactorily for 1 year

# Credit Card Accounts

- To be treated as NPA if minimum amount due, as mentioned in statement, is not paid fully within 90 days from next statement date. Gap between two statements should not be more than a month.
- Banks to follow this uniform method of determining over-due status while reporting to credit information companies and for levying of penal charges, if any.

# PROVISIONING NORMS

- Primary responsibility for making adequate provisions for NPAs is that of bank management and statutory auditors.
- Loss assets – 100% outstanding to be provided.
- Doubtful assets:

100% of unsecured portion of loan account

# PROVISIONING NORMS (Contd.)

- Doubtful assets (Contd.):

| Period for which advance has been remained in 'doubtful category | Provision requirement of Secured Portion |
|---|---|
| Up to one year | 25% |
| One to three years | 40% |
| More than three years: | 100% |
| Note: In respect of NPAs with balances of Rs. 5 crores and above, stock audits to be carried out annually. Immoveable properties to be valued once in three years. | |

# PROVISIONING NORMS (Contd.)

- Sub-standard assets – 15% of total outstanding without allowance for ECGC cover and securities available.

  Unsecured exposures to attract additional 10% provision i.e. 25% (20% for infrastructure funding in case there is mechanism to escrow cash flows & bank has a legal first claim on cash flows)

  Unsecured exposures means where realisable value of security, as assessed by bank/ approved valuers is not more than 10%, *ab-initio*, of outstanding exposure (all funded and non funded exposure). Security will mean tangible security provided but excludes

# PROVISIONING NORMS (Contd.)

For determining amount of unsecured advances (schedule 9 to bank's financial statements), rights, licenses, authorizations etc charged to the banks as collateral not to be considered as tangible security & to be reckoned as unsecured. Banks may treat annuities under BOT model (road/highway projects & toll collection rights) if there are provisions to compensate project sponsor if a certain level of traffic is not achieved, as tangible security, provided bank's right to receive annuities/ toll collection rights is legally enforceable/irrevocable.

# PROVISIONING NORMS (Contd.)

- Standard Assets

| Nature of advance | Provision % of outstanding balance |
| --- | --- |
| Advances to agrl., small & micro enterprises | 0.25% |
| Commercial real estate sector | 1% |
| CRE – Residential Housing Sector | 0.75% |
| Housing loan granted at ‘ Teaser Rates’ (provisioning to revert to 0.4% after 1 year from the date on which rates are reset at higher rates if the account remains standard) | 2% |
| All other Advances (including advances to medium enterprises) | 0.40% |
| Restructured advances | 5% |

# PROVISIONING NORMS (Contd.)

- Provisions-standard assets not to be deducted to arrive at net NPAs. To be included as a separate item in ‘ Other Liabilities & Provisions’.
- Provisions on individual portfolios to be calculated at rates applicable. Excess/shortfall in provisions vs position on any previous date, to be determined on aggregate basis. If provisions reqd. to be held on an aggregate basis is < that held as on Nov 15, 2008, surplus not to be reversed. Shortfall to be provided for

# PROVISIONING NORMS (Contd.)

- Interest suspense should be deducted from the relative advance and provision made on balance
- Doubtful advances guaranteed by ECGC--- provision to be made wrt balance outstanding minus value of security minus amount receivable from ECGC

# PROVISIONING NORMS (Contd.)

- High level of unhedged forex exposures of entities can increase probability of default in times of high currency volatility. Banks to make incremental provisions on their exposures to such entiti

| Likely Loss / EBID (%) | Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning |
|---|---|
| Up to 15% | 0 |
| > 15% and up to 30% | 20bps |
| > 30% and up to 50% | 40bps |
| > 50% and up to 75% | 60bps |
| >75% | 80bps |

# PROVISIONING NORMS (Contd.)

- Loss on revaluation of foreign currency assets to be booked in Profit & Loss Account. In addition to provisioning requirement as per IRAC norms, full revaluation gains, if any, on account of forex fluctuations to be used to make provision against corresponding assets.
- Provisioning for country risk

| Risk category | ECGC classification | Provisioning reqd (%) |
|---|---|---|
| Insignificant/low | A1 and A2 | 0.25 |
| Moderate | B1 | 5 |
| High | B2 | 20 |
| Very high | C1 | 25 |
| Restricted | C2 | 100 |
| Off credit | D | 100 |

# PROVISIONING NORMS (Contd.)

- Provisioning Coverage Ratio (PCR) is the ratio of provisioning to gross NPAs and indicates the extent of funds a bank has kept aside to cover loan losses.
- Banks to augment provisions (specific for NPAs +floating provisions) so that total PCRs including floating provisions is not less than 70% of gross NPA position as at end-Sept 2010. Surplus provision under PCR vis-a-vis as IRAC norms to be segregated into an account styled as countercyclical provisioning buffer

# Other matters in prudential norms

- Provisioning of existing loans/exposures of banks to companies having director/s (other than nominees of govt./FIs brought on board at the time of distress), whose name appears more than once in the list of wilful defaulters, will be 5% in cases of standard accounts; if such account is classified as NPA, it will attract accelerated provisioning. Similar consequences follow for non-cooperative borrowers for new loans/exposures and new loans/exposures to any other company promoted by such promoters/ directors or to a company on whose board any of the promoter / directors of this non-cooperative borrower is a director.

# Refinancing of project loans

- If banks refinance any existing infrastructure/project loans by way of take-out financing, (without a pre-determined agreement with other banks / FIs) and fix a longer repayment period, the same will not be restructuring if :

  i Such loans should be standard in the books of existing bank and not subject to restructuring in the past.

  ii Such loans to be substantially taken over from existing banks/FIs

  iii Repayment period should be fixed by taking into account life cycle/cash flows from the project

  iv. Project should have started commercial operation after achieving DCCO and above facility will be available only once during the life of the existing project loans- where aggregate exposure of all institutional lenders to such project is at a minimum of Rs.1,000 crore,

# Refinancing of project loans

- Banks may sanction a standby credit facility to fund cost overruns if needed at the time of initial financial closure, disbursed only if there is a cost overrun and taken into account while determining the project viability
- Where initial financial closure did not envisage financing of cost overruns, banks allowed to fund cost overruns on account of extension of DCCO up to 2 years & 1 year from original DCCO stipulated for infrastructure projects and others respectively, without treating loans as restructured subject to the following conditions:
- i) Banks may fund additional interest during construction (IDC), arising on account of delay in completion of a project ii) Other overruns (excluding IDC)- max. 10% of original project cost iii) Revised debt equity/ DSCR to be as per norms iv) Disbursements to start after promoters bring in their share of funding of cost overruns

# Rescheduling/ Restructuring of loans

- RBI had harmonized prudential norms on restructuring of advances by banks in Aug 2008 across all categories of debt restructuring mechanisms (including those under CDR mechanism/advances extended to SMEs.) (excluding those restructured due to natural calamities- covered by guidelines issued by Rural Planning and Credit Department). Norms revised in the wake of recommendations of working group set up to review existing guidelines.

- CDR mechanism available to eligible corporates engaged in non industrial activities.

# Rescheduling/ Restructuring of loans

- **Restructured account** is one where bank, for economic/legal reasons relating to borrower's financial difficulty, grants latter concessions that it would not otherwise consider. Restructuring may involve modification of terms of advances/securities (due to reasons other than competitive). Extension in repayment tenor of floating rate loans on reset of interest rate (so that EMI is unchanged) applied to a class of accounts uniformly will not render account to be classified as restructured. Extension/deferment of EMIs to individual borrowers (not an entire class) would render account to be classified as restructured.
- **Fully Secured-**When amounts due to bank (PV of principal/ interest receivable as per restructured loan terms) are fully covered by value of securities (tangible primary/collateral securities), bank's dues are considered as fully secured. Intangibles (guarantees of promoters / others) not to be considered (except state/central government guarantees)

# Rescheduling/ Restructuring of loans

- **Repeatedly restructured -** When a bank restructures an account a second time, it will be considered as repeatedly restructured . However, if 2nd restructuring takes place after period up to which concessions were extended under terms of 1st restructuring, it shall not be reckoned as repeatedly restructured.
- **Specified Period m**eans a period of 1 year from commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under terms of restructuring package
- **Satisfactory Performance**

  **Non-Agricultural CC/TL -** account should not be out of order any time/overdue during specified period for a duration of > 90 days and no overdues at end of specified period.

  **Agricultural account-**at end of specified period, account to be regular.

# Rescheduling/ Restructuring of loans

- BIFR cases to be restructured only with their approval
- Accounts not considered viable not to be restructured. Borrowers indulging in frauds/malfeasance to be ineligible. Banks can review borrowers treated as willful defaulters in the past and can be restructured with board's approval.
- General principles for classification of restructured advances laid out. Exceptions to general rule – special regulatory treatment for borrowers engaged in important business activities. Not available to consumer & personal advances, advances classified as capital market exposure and commercial real estate exposure.
- No restructuring retrospectively. If a restructuring proposal is under consideration, usual asset classification norms to apply. Asset classification status on the date of approval of restructuring would decide its status on restructuring

## Classification of restructured accounts

- Restructuring may take place at any stage (a) before commencement of commercial production/operation(CP/A) (b) after commencement of CP/A but before asset was classified as sub- standard (SSA) (c) after commencement of CP/A and asset was classified as SSA/doubtful.
- Standard advances (SA) to be classified as SSA upon restructuring.
- NPAs upon restructuring will have same asset classification, prior to restructuring & slip into lower classification categories as per extant norms wrt pre-restructuring repayment schedule.
- Restructured NPAs to be upgraded if satisfactory performance is observed during specified period
- Additional finance to be treated as SA during specified period. Interest on additional finance to NPA accounts to be accounted on cash basis. If restructured asset does not qualify for up-gradation at the end of specified period, addl. finance to be placed in same classification category as the restructured debt.

# Provision on restructured advances

- Restructured accounts classified as SA to attract higher provision in first 2 years of the date of restructuring. Advances involving moratorium on payment of interest/principal after restructuring to attract higher provision for period of moratorium and 2 years thereafter.
- Restructured accounts classified as NPA when upgraded to SA will attract a higher provision in the first year from the date of upgrading.
- Restructured advances to attract provision @ 5%.

# Provision for diminution in fair value (FV) of restructured advances

- Erosion in FV of advances resulting from change in contractual terms upon restructuring (financial concessions) to be provided in addition to that as per prudential norms. capped at 100% of outstanding debt amount.
- PV of cash flows based on pre and post restructuring schedule to be computed
- Discounting rate .. current BPLR/base rate/MCLR on the date of restructuring + appropriate term/ credit risk premium for borrower category, on the date of restructuring.

# Provision for diminution in FV of restructured advances

- Amount of principal converted into debt/equity instruments on restructuring to be held under AFS & valued as per usual valuation norms. As these instruments are marked to market, erosion in FV gets captured on such valuation. Therefore, for arriving at erosion in FV, NPV calculation of portion of principal not converted into debt/equity to be carried out. Total sacrifice for bank = NPV of the above portion + valuation loss on conversion into debt/equity instruments. Will also have bearing on amount of sacrifice required from promoters

# Provision for diminution in FV -restructured advances

- **CC/OD.. PV of cash flows to be computed based on higher of outstanding amount & limit, taking tenor of advance as 1 year. Term premium is the discount factor applicable for one year.**
- FV of term loan components (WCTL/FITL) to be computed as per actual cash flows taking term premium as applicable for maturity of respective term loan components.
- Any security taken in lieu of diminution in FV of advance to be valued at Re.1/- till maturity of security so that effect of charging off economic sacrifice to Profit & Loss account is not negated.
- **Diminution in FV to be computed every year till full repayment of outstanding & excess/short provision adjusted to capture changes in FV on account of changes in BPLR/base rate, term and credit premium.**
- **For advances < Rs. 1 crore, bank may provide @5% of restructured accounts in case of difficulty to compute PV at small/rural branches.**

# Risk weights for restructured advances

- Restructured housing loans to be risk weighted additionally by 25 percentage points
- In view of higher inherent risk in entities subject to restructuring, unrated standard / performing claims on corporates to be assigned higher risk weight of 125% until satisfactory performance under revised payment schedule for one year from date when first payment of interest / principal falls due under revised schedule.

# Conversion of NPAs Principal into securities

- **Debt/equity instruments created by conversion of outstanding principal to be classified in same asset category in which the restructured advance is classified. Movement in asset classification of these securities would be determined based on subsequent asset classification of restructured advance**
- **Such securities to be classified in AFS category & valued as per usual norms.** Equity classified as SA to be valued either at market value, if quoted or at break-up value (unquoted) (without considering revaluation reserve) to be ascertained from company's latest FS. In case latest FS is not available, shares to be valued at Re. 1. Equity instrument classified as NPA to be valued at market value, if quoted, and at Re 1 in case it is not quoted. Depreciation on these instruments not to be offset against appreciation in other securities held under AFS category.
- **FITL/Debt/equity instruments created by conversion of unpaid interest is to be classified in same asset category in which restructured advance was classified.**

## Conversion of NPAs unpaid interest into securities

- Unrealized income represented by FITL/security to have a corresponding credit to ‘ sundry liabilities account- interest capitalization’.
- Unrealized income converted into quoted equity can be recognized after account is upgraded to standard at market value of equity, on the date of up-gradation, not exceeding the amount of interest converted into equity.
- On repayment of FITL or sale/redemption of debt/equity, amount received to be recognized as income by debit to ‘sundry liabilities account- interest capitalization’.

# Exception to general rule- preconditions for special regulatory treatment

- Dues to bank to be fully secured except in respect of MSE borrowers with outstanding up to Rs. 25 lakhs and infrastructure projects (where cash flows generated are adequate for repayment of advance, appropriate escrow mechanism is in place and bank has a clear & valid first claim on cash flows)
- Unit becomes viable in 8 years (infrastructure projects) and 5 years (others)

# Preconditions to be eligible for special regulatory treatment (contd.)

- Repayment period (incl. moratorium) not to exceed a) Infrastructure advances -- 15 years

  b) Housing loans– within maximum period prescribed by BOD c) Others --- 10 years
- Promoters sacrifice & addl. funds brought not less than higher of 20% of bank’s sacrifice or 2% of restructured debt. Bank's sacrifice means amount of erosion in FV of advance or total sacrifice.

# Preconditions to be eligible for special regulatory treatment (contd.)

- Personal guarantee is offered by promoters (except where unit is affected by external factors pertaining to economy and industry)

- Restructuring under consideration is not a repeated restructuring .

# Preconditions to be eligible for special regulatory treatment (contd.)

- Approved package is implemented by bank within prescribed time limit (Within 120 days from date of approval under CDR mechanism or within 120 days from date of receipt of application by the bank in other cases)

# Special regulatory treatment

- Existing std. advance not be downgraded upon restructuring. Classification of existing NPAs not to deteriorate upon restructuring, if satisfactory performance is demonstrated during specified period. NPA to be upgraded if satisfactory performance is observed during specified period.
- Incentive withdrawn from April 1, 2015 except provisions relating to changes in DCCO. Wef April 1, 2015, a SA/NPA on restructuring (for reasons other than change in DCCO) to be classified as SSA/ would continue to have the same AC prior to restructuring & slip into further lower AC categories as per extant norms wrt pre-restructuring repayment schedule.

# Other miscellaneous conditions

- Banks to decide on convertibility into equity as a part of restructuring for listed companies keeping in view sec 19 of Banking Regulation Act, 1949 & relevant SEBI regulations.
- Conversion of debt to preference shares to be done as a last resort. Such conversion into equity/preference shares to be restricted to a cap 10 % of restructured debt. Conversion to equity should be done only in case of listed companies.
- Banks may incorporate a right to accelerate repayment. Restructuring packages to incorporate right to recompense clause.

# Other miscellaneous conditions

- Banks to disclose in its annual FS information relating to number, amount of advances restructured & amount of diminution in FV of restructured advances, as per format given in master circular. Would be required for advances restructured under CDR mechanism, SME Debt restructuring mechanism and other categories separately.

# Frame work to revitalize distressed assets in economy

**Joint lenders' forum(JLF)/Corrective action plan (CAP)**

Before a loan account turns into a NPA, banks are required to identify incipient stress by creating 3 subcategories under Special Mention Account (SMA4) category

| 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 (Please see Appendix to Part C) |
| SMA-1 | Principal or interest payment overdue between 31-60 days |
| SMA-2 | Principal or interest payment overdue between 61-90 days |

## Frame work to revitalize distressed assets in economy

- On an account being reported by lender(s) to CRILC as SMA-2, banks to form JLF if aggregate exposure (AE) [fund/non-fund based taken together] of lenders is Rs 1000 mio and above. Lenders have option of forming a JLF even when AE in an account is < Rs.1000 mio or an account is reported as SMA-0 or SMA-1. JLF to explore options to resolve stress in account
- While restructuring proposal is under consideration by JLF/CDR, usual asset classification norm would continue to apply.

**Frame work to revitalize distressed assets in economy**

- Special asset classification benefit on restructuring of accounts will be available for accounts restructured under these guidelines, subject to adherence to overall timeframe for approval of package detailed in master circular & implementation of the same within 90 days of approval. Classification status on date of formation of JLF will be relevant to decide asset classification status on implementation of package.
- If a bank fails to report SMA status of an account to CRILC/resorts to conceal status of account, banks will be required to accelerate provisioning as per para 31 of master guidelines/circular dated Sept 24, 2015.

# Frame work for revitalize distressed assets in economy

- Lenders agreeing to a restructuring decision under CAP by JLF but change stance later or delays/refuses to implement package or lenders fail to convene JLF or fail to agree upon a common CAP within stipulated time frame, will be subjected to accelerated provisioning if account is a NPA. If account is standard, provisioning requirement will be 5%.
- If an escrow maintaining bank under JLF/CDR mechanism does not appropriate proceeds of repayment among lenders as per agreed terms resulting into down gradation of asset classification in books of other lenders, account with escrow maintaining bank will attract the asset classification which is lowest among lending member banks.

# Illustrative list of signs of stress for categorising an account as SMA-0:

- Delay of 90 days or more in submission of stock statement / other stipulated operating control statements, credit monitoring or financial statements or non-renewal of facilities based on audited financials
- Actual sales/OP falling short of projections accepted for loan sanction by 40% or more, non-cooperation / prevention from conduct of stock audits, reduction of DP by 20% or more on stock audit, evidence of diversion of funds drop in internal risk rating by 2 notches in a single review.
- Return of 3 or more cheques (or electronic debit instructions) issued by borrowers in 30 days

# Illustrative list of signs of stress for categorising an account as SMA-0

- Devolvement of DPG/LCs/BGs and non-payment within 30 days.
- 3rd request for extension of time either for creation or perfection of securities or for compliance with any other terms and conditions of sanction.
- Increase in frequency of overdrafts
- Borrower reporting stress in business and financials.
- Promoter(s) pledging/selling shares in borrower company due to financial stress

# Provisioning- wilful defaulters

Provisioning in respect of existing exposures of banks to companies having directors (other than nominee directors of govt. /FIs brought at the time of distress), whose names appear more than once in the list of wilful defaulters, will be 5% in cases of SA; if such account is classified as NPA, it will attract accelerated provisioning as indicated earlier. No additional facilities to be granted by any bank/FI to the listed wilful defaulters.

# Strategic debt restructuring scheme (SDR)

- JLF/CDR cell to consider foll. options on restructuring:
- Possibility of transferring equity of borrower by promoters to lenders • Promoters infusing more equity into their companies • Transfer of promoters’ holdings to a security trustee/escrow arrangement till turnaround- to facilitate change in mgmt. control should lenders favour it.
- Banks may make a SDR by converting loan dues to equity
- JLF to incorporate as a condition, an option to convert loan/unpaid interest into shares if borrower not able to achieve viability milestones/adhere to critical conditions stipulated in restructuring package. To be supported by necessary approvals by shareholders of borrower

# Strategic debt restructuring scheme (SDR)

- To achieve change in ownership, lenders under JLF should collectively become majority shareholder by conversion of dues from borrower to equity, subject to each banks' total holdings in shares of borrower conforming to limits in section 19(2) of Banking Regulation Act, 1949
- Banks henceforth to include such covenants in loan agreements.
- Invocation of SDR not as restructuring under IRAC norms
- On conversion of debt to equity, existing AC as on reference date will continue for 18 months. Thereafter, the AC will be as per extant IRAC norms, assuming stand-

# Strategic debt restructuring scheme (SDR)

- JLF to divest equity holdings asap. On divestment of at least 26%, AC to be upgraded to standard. Provision held on date of divestment (not to be less than that held as at the reference date) not to be reversed. At the time of divestment to a new promoter, banks may refinance existing debt considering changed risk profile without treating it as restructuring. Banks to make provision for diminution in FV of existing debt on account of refinance. Banks may reverse provision held only when account perform satisfactorily during specified period. In case satisfactory performance during specified period is not evidenced, AC of restructured account to be as per IRAC norms as per repayment schedule on reference date.

# Strategic debt restructuring scheme (SDR)

- For listed companies, banks conversion of debt to equity under SDR will be exempted from obligation to make open offer under regulations 3/4 of SEBI Regulations.
- Equity shares acquired by banks under SDR to be subject to periodic MTM. Banks to have option of distributing depreciation on such equity shares over 4 quarters from date of conversion of debt to equity
- Conversion of debt to equity may result in its holding being > 20% of voting power. However, such investment may not be treated as investment in associate for preparation of CFS.

# Strategic debt restructuring scheme (SDR)

- As per clarification given in RBI wef November 10, 2016, stand still clause only applies to asset classification and banks shall not recognise income on accrual basis if the interest in not services within 90 days from due date.
- Banks shall make disclosures on invocation of SDR in annual financial statements as per given format.

# Scheme for Sustainable Structuring of Stressed Assets (S4A)

- Eligibility- account1 to meet following conditions:

  (i) Project has commenced commercial operations

  (ii) Aggregate exposure (including accrued interest) of all institutional lenders > Rs.500 crore (iii) Debt meets test of sustainability specified

- Debt level will be deemed sustainable if JLF/ consortium conclude through techno-economic viability (TEV) that debt of that principal value amongst total credit facilities owed to institutional lenders can be serviced over same tenor as that of existing facilities even if future cash flows remain at their current level. Sustainable debt should not be less than 50% of current funded liabilities (part A)

# Scheme for Sustainable Structuring of Stressed Assets

- Post resolution ownership of entity- could be either current promoter continues to hold control, new owner, lenders have acquired majority shareholding through conversion of debt
- JLF/consortium/bank shall, after TEV, bifurcate current dues of borrower into parts A (sustainable portion of debt) and B ( non sustainable portion)
- No moratorium-interest/principal repayment for servicing part A
- Part B to be converted into equity/redeemable cumulative optionally convertible preference shares.
- Valuation and MTM of part B securities specified
- Asset classification (AC) and provisioning: **change of promoter- AC/** provisioning requirement as per SDR/outside SDR scheme as applicable. No change- AC on date of lenders' decision to resolve account will continue for 180 days.

# Scheme for Sustainable Structuring of Stressed Assets

- If resolution not implemented within 180days, AC will be as per the extant norms, assuming there was no stand-still.
- If account was standard on reference date, both parts A and B will remain standard. Provisions made upfront by lenders to be least higher of 40% of part B debt or 20% of total debt. Provisions already held in account can be reckoned.
- If account was classified as NPA as on reference date, part B shall continue to be classified/provided for as NPA as per extant IRAC norms. The sustainable portion Part A may optionally be treated as standard upon implementation of the resolution by the all banks, subject to provisions made upfront by the lenders at least the higher of 50% of the amount held in part B or 25% of the aggregate outstanding. For this purpose, the provisions already held in the account can be reckoned.

# Scheme for Sustainable Structuring of Stressed Assets

- Lenders may upgrade parts A/B to SA after 1 year of satisfactory performance of part A loan. Lenders will continue to MTM part B instruments as per the norms
- If Part A subsequently slips into NPA, account will be classified with reference to AC on reference date and necessary provisions made
- Banks shall make disclosures in the FS on application of S4A as per format prescribed in IRAC norms

## Prudential norms-change in ownership of borrowers (Outside SDRS)

- Change in ownership- sale by lenders to new promoter of shares pledged or conversion of debt into equity outside SDR or bringing in new promoter (issue of fresh shares) by borrower or acquisition of borrower by another entity.
- Standstill clause for limited period to enable ownership change.
- On change in ownership of borrower, credit facilities may be upgraded as standard. Provision held shall not be reversed
- Banks to ensure that acquirer is not part of existing promoter group. New promoter to hold at least 51% of capital. Non resident investors to hold at least 26% ( in case there are sectorial FDI caps).
- Provision to be reversed on satisfactory performance during specified period. In contrary case, AC to be governed by extant AC norms wrt repayment schedule existing before change in ownership.
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# THANK YOU