SEMINAR FOR BANK BRANCH STATUTORY AUDITORS

IRAC Norms & NPA Classification

Organised by

Auditing & Assurance Standards Board of ICAI

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DISCLAIMERS

- These are personal views of speakers and can not be construed to be the views of the ICAI.

- These views do not and shall not be considered as professional advice.

RBI CIRCULARS REFERENCE

- Master Circular dated April 01, 2023 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances
- Master Direction – RBI (Relief Measures by Banks in Areas affected by natural calamities) Directions, 2018 dated October 17, 2018
- Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 (updated as on December 28, 2023)

CRITERIA FOR NPA

Loans and Advances	▪ 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 as per certain specific provisions such as para 4.2.4, 4.2.9 and part B2*
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* *Long duration crop – Crops wherein crop season is more than 12 months*

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 Securitisation transaction.
Credit Card dues	The minimum amount payable is not paid within 90 days from the next statement 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.

AUTOMATION OF IRAC

- Appropriate internal systems for proper and timely identification of NPAs (Ref. Circular dated 14.Sep.2020 on automation of IRAC and provisioning process)

- Classification of SMA and NPA

Accounts to be flagged as a part of day-end process

- Challenges in automation and inherent limitations

(LCBD / Income recognition logic – Reversal of income & unrealized interest / Overdue logic / Availability of granular data)

CLARIFICATIONS ISSUED BY RBI FROM TIME TO TIME

a) Definition of 'out of order' – concept of moving 90 days

b) Upgradation of accounts classified as NPA (cust-id level)

- *Only when 'entire arrears on interest and principal' are paid by borrower.*
- *Clarity about 'partial recoveries' and 'subsequent recoveries'*

c) Applicability of 'out of order' to all loan products offered as Overdraft including those not meant for business

d) Concept of 'previous 90 days' for determination of 'out of order' status to include the day on which EoD process is run

CLARIFICATIONS ISSUED BY RBI FROM TIME TO TIME

e) Income recognition policy for loans with moratorium on payment of interest

Recognition of interest when moratorium of repayment of interest is granted

Sanctioned interest capitalization thus wont affect reversal of interest after NPA as its nature is considered as capital portion

CASE STUDY – 01 - QUESTION

- In case of Term Loan account, a borrower has prepaid 12 months' EMIs in the month of April and subsequently has not paid any amount to the credit of TL, would that account be required to be classified as NPA due to non-servicing of interest?

CASE STUDY – 01 - ANSWER

- In case of Term Loan, an account is classified as NPA only if the interest / instalment remains overdue for a period of more than 90 days. In the instant case, since there is a prepayment of EMIs, there is no amount overdue and hence the account would be classified as PA. It would be pertinent to note that the concept of servicing of interest does not apply to Term Loan accounts.

CASE STUDY – 02 - QUESTION

- In case of Term Loan account, if there is a moratorium granted for repayment of principal but interest is payable as and when debited, when such account can be classified as NPA? Would criteria of 90 days overdue apply to such account w.r.t. interest debited to the account?

CASE STUDY – 02 - ANSWER

- In the instant case, there is no principal repayment scheduled . Thus, presuming Mar’24 as cut-off date, if the interest debited in the account during the quarter of Oct-Dec’23 is not recovered during the next 90 days, then only the account would be classified as NPA.

CASE STUDY – 03 - QUESTION

- In case of Term Loan account, if there is a moratorium granted for repayment of principal as well as interest for first six months, would such account be classified as NPA if there is no repayment in the first six months?

CASE STUDY – 03 - ANSWER

- In case of Term Loans, an account would be classified as NPA only if there is any amount ‘overdue’ (beyond prescribed period of 90 days). In the instant case, since there is a moratorium period, there is no question of amount being due and hence there cannot be any amount which is overdue. Thus, such account would not be classified as NPA during first 6 months, though interest might be debited in the account during such period.

CASE STUDY – 04 - QUESTION

- A Term Loan account has 4 EMIs overdues as on Nov’23 and subsequently there is a partial recovery in the account, however, one or two instalments have remained overdue for rest of the period till Mar’24. Would this account be required to be classified as NPA as at Mar’24-end?

CASE STUDY – 04 - ANSWER

- As the account was having 4 EMIs overdue as at Nov’23, the account is required to be classified as NPA in Nov’23. Further, as there is a partial recovery in the account, the said account cannot be upgraded and thus, would be required to be classified as NPA with date of NPA as Nov’23.

CASE STUDY – 05 - QUESTION

- A Term Loan account has 4 EMIs overdues as on 31st Mar 2024 and subsequently, the entire overdues are recovered on 02 Apr 2024, i.e., before signing of the balance sheet by the statutory auditors. Would this account be required to be classified as NPA as at 31st Mar 2024?

CASE STUDY – 05 - ANSWER

- As the account was having 4 EMIs overdue as at 31stMar 2024 the account is required to be classified as NPA as at 31stMar 2024. Subsequent recoveries in the said account would make the account upgraded in the month of Apr’23 and would not have any impact on the asset classification for FY: 2023-24.

CASE STUDY – 06 - QUESTION

- In case of Agricultural Term Loan there is no repayment for a period of 6 months. Can the said account be classified as NPA ?

CASE STUDY – 06 - ANSWER

- Agricultural Loans will be classified as NPA if Interest or Principal remains overdue for two crop seasons for short duration crops and one crop season for long duration crops.

Definitions

Crop season – 'period up to harvesting of crops raised' as determined by SLBC

Long duration crop – Crops wherein crop season is more than 12 months

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

ACCOUNTS WITH TEMPORARY DEFICIENCIES

A) 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

Note: The leverage is *<u>applicable only for large borrowers</u>*

B) Non-renewal/ Non-regularization of regular / ad hoc limit within 180 days from the due date

CASE STUDY – 07 - QUESTION

- In case of Cash Credit facility, if an account is continuously overdrawn above the limit but not exceeding the drawing power (i.e., the outstanding balance is within DP) for a period of 91 days, would such account be classified as NPA?

CASE STUDY – 07 - ANSWER

- A Cash Credit account is classified as NPA if the same is 'out of order', i.e., when either of the three specified conditions are satisfied. In case if a CC account is continuously overdrawn for more than 90 days beyond limit or drawing power whichever is lower, such account would be classified as NPA. Even if an account has sufficient DP but is overdrawn beyond limit, the same would be required to be considered as fulfilling the said condition.

CASE STUDY – 08 - QUESTION

- In case of CC/OD facility, an account is operated within the limit but there are no credits in the said account since 1st Jan 24, would such account be required to be classified as NPA even though its not overdrawn for a single day?

CASE STUDY – 08 - ANSWER

- Yes the account would be required to be classified as NPA as the account is ‘out of order’ since there are no credits in the said account for 90 days as on balance sheet date. As there are no credits for period from 1st January to 31st March, the criteria of no credits in the account for 90 days is fulfilled.

CASE STUDY – 09 - QUESTION

- In case of CC/OD facility, an account is operated within the limit but the summation credits in the account in the last quarter of Jan-Mar’24 are less than the interest debited during the said quarter. What would be the classification of such account?

CASE STUDY – 09 - ANSWER

- Yes the account would be required to be classified as NPA as the account is ‘out of order’ since the account does not have credits sufficient to cover the interest debited during the same period.

CASE STUDY – 10 - QUESTION

- In case of CC/OD facility, an account has credit balance for a period of 10 days during the last quarter but does not have any credits during the said quarter, would the account be classified as NPA?

CASE STUDY – 10 - ANSWER

- Yes the account would still be required to be classified as NPA as the account is ‘out of order’ since there are no credits in the said account for 90 days as on balance sheet date. As there are no credits for period from 1st January to 31st March, the criteria of no credits in the account for 90 days is fulfilled.

CASE STUDY – 11 - QUESTION

- In case of a CC facility, if the last stock statement submitted is of Oct’23, would the said account be classified as NPA, due to non-submission of stock statement as at Mar’24?

CASE STUDY – 11 - ANSWER

- As per para 4.2.4 of Master Circular, the classification of advances should be based on record of recovery and any deficiencies which are temporary in nature like non-submission of stock statement need not construed to classify the account as NPA. Never the less, considering the difficulties of <u>large borrowers</u>, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

CASE STUDY – 12 - QUESTION

- In case of a CC facility is short reviewed twice for a period of 90 days each, i.e., firstly from Jul’23 to Sep’23 and the from Oct’23 to Dec’23. Would the said account be classified as PA or NPA as at Mar’24-end, if the same is not renewed till that time?

CASE STUDY – 12 - ANSWER

- Yes, the account would be required to be classified as NPA since the same is not regularly renewed within 180 days from the original due date for renewal.

CASE STUDY – 13 - QUESTION

- In case of working capital finance facilities if the trade creditors are more than book debts and stock, (but are below the level of trade creditors as specified in CMA data) would there be drawing power available for the said borrower?

CASE STUDY – 13 - ANSWER

- Though the banks are having varied practices of calculation of drawing power, it would be pertinent to note that the auditor needs to review the terms of the sanction of working capital finance wherein the drawing power calculation method would be prescribed. However, prima facie, if there is a negative working capital, question of availability of drawing power would not arise.

CASE STUDY – 14 - QUESTION

- In case of a CC facility, the bank has not charged penal interest and processing fees, applicable as per the terms of sanction. If the said penal interest is charged on the respective dates, the account would be continuously overdrawn for a period of more than 90 days considering value-dating effect of such penal interest. Would such account be classified as NPA with value dating effects of such revenue leakages?

CASE STUDY – 14 - ANSWER

- Though, technically the value dating of such revenue leakages should be considered for the purpose of review of the account and consideration of the ‘continuously overdrawn’ status, classification of an account should be on the basis of ‘record of recovery’, unless the revenue leakage or postponement of charges being debited to the account appears to be an intentional one.

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.
- 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

- **Order of Recovery**
- 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 uniform and consistent manner.

CLASSIFICATION NORMS

- Standard Asset
  The account is not non-performing.

- Sub-Standard Asset

  A sub standard Asset is one which has remained NPA for a period of less than or equal to 12 months.

- Loss Assets

  These are accounts, identified by the bank or internal or external auditors or by RBI Inspectors as wholly irrecoverable but the amount for which has not been written off.

CLASSIFICATION NORMS

Doubtful Asset - Three Categories

Category	Period
Doubtful - I	Up to One Year
Doubtful – II	One to Three Years
Doubtful - III	More than Three Years

PROJECTS UNDER IMPLEMENTATION

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

The bank needs to clearly spell out 'Date of Completion' (DC) and 'Date of Commencement of Commercial Operations' (DCCO).

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.

DEFERMENT OF DCCO

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

Particulars	Infrastructure	Non Infra
Revised DCCO is original	Within 2 years from DCCO	1 year from original DCCO
Revision due to court cases	2+2 Years from original DCCO	1+1 year from original DCCO
Revision due to any other reason	2+1 year from Original DCCO	1+1 year from original DCCO

PROVISIONING NORMS

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%

PROVISIONING NORMS

<u>Sub-standard Asset:</u>

- 15% of total outstanding
- 25% of total outstanding if loan is unsecured
- 20% of total outstanding if infrastructure loan provided its 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

*****_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'*

MANDATORY VALUATION OF SECURITY

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

Practical Aspects:

- Value of security vis-à-vis old valuation report
- FMV / Realisable / Distress Sale

CASE STUDY – 15 - QUESTION

- In case of a SSA account wherein the underlying security is in the form of FDR to the extent of 50% of the ledger balance, what would be the BDDR requirement?

CASE STUDY – 15 - ANSWER

- As the account is a secured SSA loan, the provision for BDDR would be required be made @ 15% on the balance outstanding on the entire ledger balance.

CASE STUDY – 16 - QUESTION

- Fraud is detected and reported by the Bank but the Bank has made provision @25% of the outstanding amount irrespective of the security value available for the said loan. Is It correct

CASE STUDY – 16 - ANSWER

- Yes, This is correct as the fraud is detected and reported by the Bank 100% provision is to be made in 4 quarters commencing from the quarter in which the fraud is detected.

If the fraud is detected but not reported then 100% provision is to be made instantly

CASE STUDY – 17 - QUESTION

- A borrower had availed OD against property to the tune of Rs. 5 crores against primary security of immovable property of Rs. 20 crores. Subsequently, the said property was subjected to valuation and the present value of the said property is Rs. 8 crores. Would this account be required to be classified as DA even though the outstanding balance is Rs. 2 crores.

CASE STUDY – 17 - ANSWER

- Yes, the said account would be required to be classified as DA though the said account is within limit, as the realisable value of the security has eroded beyond 50% of the value assessed earlier as per ‘Straightway Classification norms’ specified in para 4.2.9

STRAIGHTAWAY CLASSIFICATION (POTENTIAL THREAT OF RECOVERY)

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

PRACTICAL ASPECTS OF STRAIGHTAWAY CLASSIFICATION (POTENTIAL THREAT OF RECOVERY)

- **Standard Assets**
  - Reasons for erosion in value of security to be probed
  - In case of fraud, prudent to classify
  - Account being NPA is not an essential condition, but serious credit impairment may warrant straightaway classification
- **NPAs**
  - The account needs to be marked as DA / Loss without passing through SSA category

- Challenges in Automation in CBS

CASE STUDY – 18 - QUESTION

- In case of a borrower Cash Credit, Term loan and Bill Discounting under LC are the facilities outstanding. OF these 4 EMIs are pending in term loan will all the other loans are classified as NPA

CASE STUDY – 18 - ANSWER

- All the facilities of the borrower should be classified as NPA if one account becomes NPA. Accordingly 4 instalments are pending in term loan so it has become NPA. Accordingly Cash Credit will also be classified as NPA. But Bills discounting under LC should not be classified as NPA as per para 4.2.7.3 of master circular

CASE STUDY – 19 - QUESTION

- In case of consortium Term Loan the amount of instalments for the months from Dec to Mar has been deposited by the borrower with the Lead Bank on 30th March. Should the account with the member bank be classified as PA.

CASE STUDY – 19 - ANSWER

- In case of consortium finance the member bank should classify the account on the basis of their own record of recovery. In this case the amount of EMIs is not received by the member bank so the account with the member bank will be classified as NPA

CASE STUDY – 20 - QUESTION

- In case of Consortium finance granted to Company it is noticed from the consortium minutes that enquiry is in process against one of the directors of the Company. Further, as per the latest minutes of consortium meeting all the member banks along with the lead bank confirmed that there is zero overdue in the accounts with each of them. Should the account be classified as NPA.

CASE STUDY – 20 - ANSWER

- Merely the fact that enquiry is being in process against one of the Directors of the Company does not warrant to classify the account as NPA. In consortium each member bank should classify the account on the basis of record of recovery in their own account. As mentioned in the minutes there is zero overdue the account should be classified as PA

CASE STUDY – 21 - QUESTION

- In case of consortium finance lead bank has filed FIR against the borrower and reported the said account as fraud. After Investigations the borrower is declared as fraudster. But, the member bank has no overdue in the account. Can the account with member bank be classified as PA

CASE STUDY – 21 - ANSWER

- As the Lead Bank has reported the account as Fraud and the investigation agency have established the occurrence of fraud the account with the member bank can not be classified as PA.

GUIDELINES FOR RESTRUCTURING

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 FOR RESTRUCTURING

Stages When restructuring can take place

- Before Commencement of Commercial production
- After Commencement of Commercial production but the Asset is PA
- After Commencement of Commercial production but the Asset is NPA

Assets Classification

- Standard Assets to be reclassified as SSA
- NPA Restructured will continue to be in the same asset classification prior to the restructuring
- Additional finance to be treated as Standard for One Year

- **Upgradation**
- All the accounts are eligible for upgradation after satisfactory performance

GUIDELINES FOR RESTRUCTURING

Satisfactory performance (Para 17.2)

MSME with exposure less than 25 Crs

No repayment to remain overdue/ overdrawn for period of more than 30 days during one year period commencement from the first payment

Other

No default during the period from date of implementation of RP up to date of payment of at least 10% of outstanding principal debt (Min period of one year from first payment of Interest/principal)

GUIDELINES FOR RESTRUCTURING

Provisioning requirements (Para 18)

- Normal provision as per the assets classification
- Provision for diminution in the fair value of security discontinued

Accounts Under Resolution Plan

- Provision frozen for a period of 6 months from the date of submission of resolution plan
- Provisions to be made as per Para 12 of circular for delays in implementation of RP in addition to the existing provisions

PRUDENTIAL FRAMEWORK FOR RESOLUTION OF STRESS ASSETS

Implementation of Resolution Plan

- All lenders must put Board Approved Policy

- Expected that the lenders initiate the process of implementing Resolution Plan even before a default

- Once default is reported, “Review Period” of 30 days, wherein lenders may decide on resolution strategy, may choose to initiate legal proceedings for insolvency or recovery.

PRUDENTIAL FRAMEWORK FOR RESOLUTION OF STRESS ASSETS

Implementation of Resolution Plan

- If RP is to be implemented, all lenders to sign inter creditor agreement (ICA) during Review Period. Decision to be taken as agreed by lenders representing 75% by value of total outstanding credit facilities (FB+NFB) and 60%of lenders by number.

- On or after the reference date, resolution plan must be implemented within 180 days from end of review period

PRUDENTIAL FRAMEWORK FOR RESOLUTION OF STRESS ASSETS

Resolution Plan is Implemented if following conditions are satisfied

- RP Not involving Restructuring / Change in Ownership shall be deemed to be implemented only if the borrower is not in default with any of the lenders as on 180th day from the end of Review Period

PRUDENTIAL FRAMEWORK FOR RESOLUTION OF STRESS ASSETS

Resolution Plan is Implemented if following conditions are satisfied

RP involving Restructuring / Change in Ownership shall be deemed to be implemented only if following conditions are met:

- All related documentation, creation of security/charge / perfection of security are completed by the lenders
- New Capital Structure and changes in terms of conditions of the existing loans gets duly reflected in the books of the lenders and borrower

- Borrower is not in default with any of the lenders.

PRUDENTIAL FRAMEWORK FOR RESOLUTION OF STRESS ASSETS

Delayed Implementation of resolution Plan

Additional Provision Requirement

1. 180 days from end of review period – 20%
2. 365 days from end of commencement of review period: 15%

Overall provision should not exceed 100%

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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