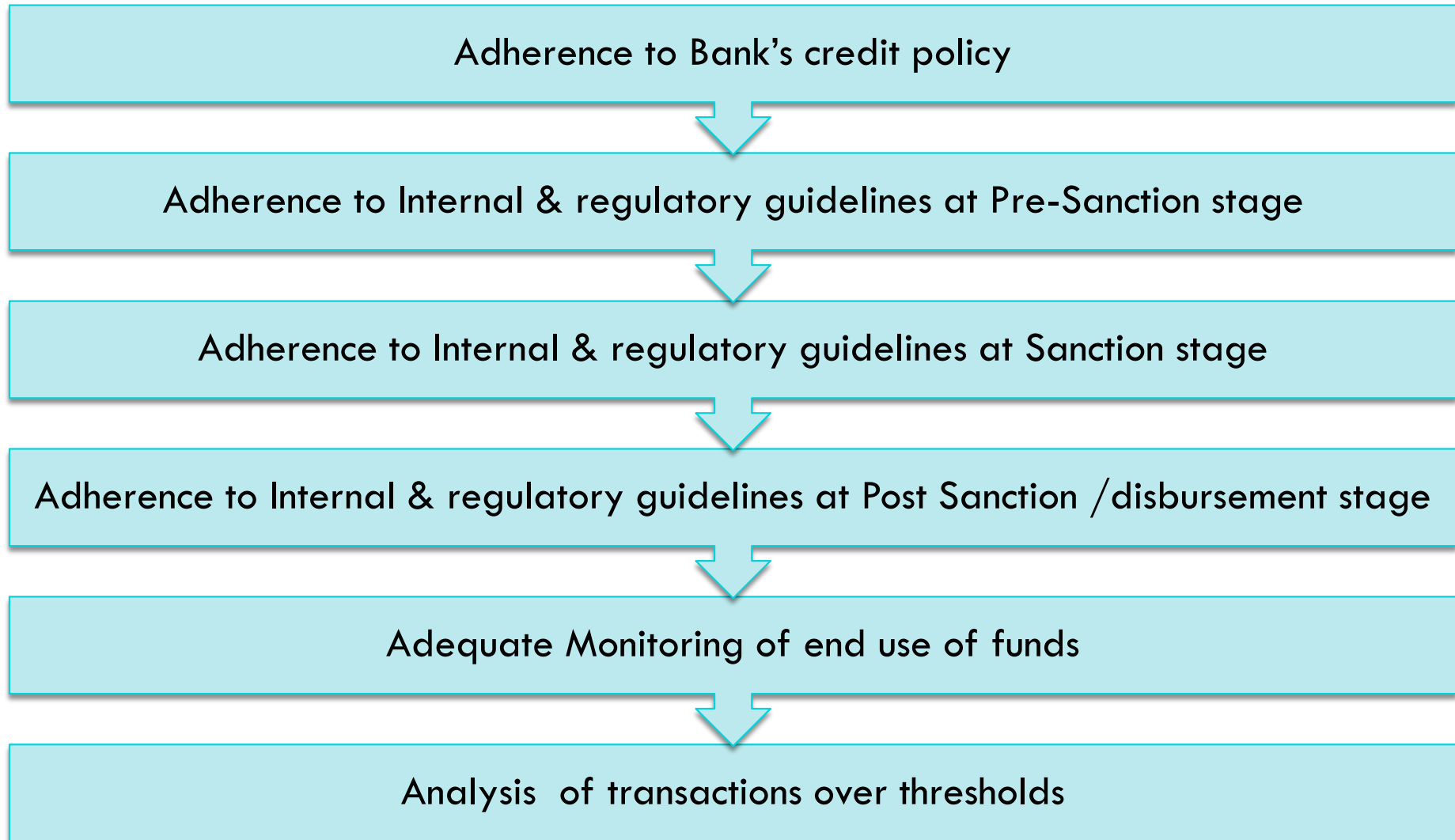


ADVANCES & NPA IN BANK AUDIT

CA Abhijit P. Sanzgiri

Audit of Advances



Thrust Areas

- Gaps in Underwriting – Due Diligence - KYCB
 - Borrower's business
 - Market Trends
 - Comparison with peer groups
 - Comparison of projections & actuals
 - Ratio analysis
 - SWOT analysis
 - Condition / Collateral / Character – 3 C's of credit

Thrust Areas

- ❑ Not obtaining statutory dues certificates
- ❑ Waiver for non compliance of pre & post sanction terms
- ❑ Zero Tolerance for critical documents not obtained impairing final right of recovery if borrower defaults
- ❑ Frequent Overdrawing, ad-hoc limits & TODs
- ❑ Accounts over utilized & not regularized on due dates
- ❑ Sanctions beyond delegation of powers
- ❑ Frequent cheque bouncings – Cash withdrawals
- ❑ Delayed submission of statements / audited accounts

Thrust Areas

- ❑ Underutilization of limits
- ❑ Limits not commensurate with Sales / Account turnover
- ❑ Non-submission of stock statements / age-wise classification of debtors – CA Certifications
- ❑ Under – Non insurance of stock – all risks not covered -
- ❑ Not routing entire transactions through accounts
- ❑ Not considering unpaid stock/creditors for DP
- ❑ Variance in audited accounts & statements submitted
- ❑ Restructuring of accounts immediately post disbursal
- ❑ Quick Mortality – Causes not found out / Staff accountability not fixed

Thrust Areas

- Deviation from Loan pricing policy
- Not sharing information with 4 Credit Information Co's
- Variance in stocks as per borrower submissions & found in course of stock audits – No explanations obtained -
- Stock statements not signed off by borrower
- NOC from other banks not obtained in case of limit takeover
- End use – Fund diversion not monitored
- RC book not on record for vehicle loans
- Debt equity ratio not maintained – Negative Capital
- Interest coverage ratio < 1

Thrust Areas

- ❑ Society Share Certificate / NOC not on record
- ❑ Charge creation not intimated to registrar < 30 days
- ❑ Deviation from strict adherence to IRAC norms
- ❑ Errors in reporting priority / weaker sector lending - Targets not achieved
- ❑ Issues persisting as of last year – Root cause not tackled – trend analysis of open issues not done –
- ❑ Focus not on addressing Process gaps – Risk dimension not given to open issues – No Risk owner fixed -
- ❑ Fraud aspect not considered in issues noted

Thrust areas

- Obtaining full set of financial statements – Quality of statutory audit – Discussions –
- Whether Appraisal Note covers all adverse issues –
- Delays in review / renewal
- Processing fees / charges not collected
- Quality / Consistency of valuation –
- Validity / completeness of documentation
- Not inspecting collaterals / monitoring maintenance
- Poor recovery procedures – Collaterals not getting sold at auctions – multiple auctions reducing reserve price -

Other Issues

- ❑ Controls over NEFT / RTGS
- ❑ Whether year end credits considered for STR
- ❑ Window dressing of accounts
- ❑ Related party Transactions
- ❑ Monitoring post year end account conduct
- ❑ Understand Spirit of what constitutes NPA
- ❑ Strict following up of Letter of Law
- ❑ Divergence noted by RBI – Time to introspect

Regulators prescription for bad loans

- A "deep surgery" is must for the clean-up that would require an "anaesthetic" in the form of recognising NPAs on their books.
- 2 ways to fight the problem of NPAs:
- One involves brushing the real issue under the carpet to protect profits, another is recognising the problem upfront & dealing with it.
- If the bank wants to pretend that everything is all right with the loan, it can only apply band aids - for any more drastic action, it would require NPA classification.

To the question of what comes first, clean up or growth,

I think the answer is unambiguously 'Clean up'

- Raghuram Rajan

Media Focus

- Accommodation entries – non competitive transactions done with connivance of officials to convert black money into white –well controlled & well organized racket by entry providers to willing tax evaders –
- Growing risk aversion – extra caution -
- Good money chasing bad money – Fresh Borrowings to repay past debt & interest -
- Has Bad Asset quality peaked ?
- Loan defaults are a business matter – when banks give out loans, they know the risks involved – a flourishing business may suddenly plummet -
- Do financials merit the loan in the 1st instance

NPA – IRAC norms

- Classification of assets to be based on objective criteria – Ensure uniform & consistent application of the IRAC norms –
- Provisioning to be based on asset classification on the period for which asset has remained non performing, availability of security & realizable value thereof –
- NPA ceases to generate income & carries a risk higher than normal banking risk -

Identification of NPA

Type of Facility	Criteria	Other Criteria
Term Loan	Interest and/or installment overdue > 90 days.	If interest is not serviced < 90 days from end of the end of the quarter.
Working Capital	<p>If accounts remain out of order > 90 days:</p> <ul style="list-style-type: none">• Outstanding balance remains continuously in excess of sanctioned limit/ drawing power (DP)• Where outstanding balance in principal operating account < sanctioned limit/ DP but-<ul style="list-style-type: none">• No credits continuously for 90 days or• Insufficient credits to cover interest debited during the period	<ul style="list-style-type: none">• Outstanding in the account based on stock statements older than 3 months will become NPA if such irregular drawings are permitted for a continuous period of 90 days.• Where regular/ad-hoc credit limits have not been reviewed/renewed within 180 days from the due date/date of ad-hoc sanction.

Identification of NPA

Type of Facility	Criteria
Bills purchased & discounted	Bill remains overdue for a period > 90 days in the case of bills purchased & discounted
Liquidity Facilities	Amount of liquidity facility remains outstanding > 90 days, in respect of a securitization transaction
Derivative Transactions	Overdue receivables representing positive MTM value of a derivative contract, if unpaid > 90 days from specified due date for payment
Government Guaranteed Advances	State Govt. - If interest &/or principal overdue > 90 days Central Govt. – Treated as NPA when Govt repudiates its guarantee when invoked. No income recognition if account out of order > 90 days.

Agricultural Advances

- **Short duration crops**

Installment of principal or interest thereon overdue for 2 crop seasons

- **Long duration crops**

Installment of principal or interest thereon overdue for 1 crop season

- **Natural calamities**

Where natural calamities impair repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of short-term production loan into a term loan or re-schedulement of repayment period; & sanctioning fresh short-term loan subject to guidelines in RBI Circular FIDD.No.FSD.BC.52/05.10.0012014-15 of March 25, 2015.

Credit Card Accounts

- Amount spent is billed to card users through a monthly statement with a definite due date for repayment.
- Users have options to pay either in full or in part, i.e., minimum amount due, on due date & roll-over balance amount to subsequent months' billing cycle.

Credit card account treated NPA if 'minimum amount due' not paid fully within 90 days from next statement date. Gap between 2 statements not being > 1 month

Controls Over Identification

IC systems to eliminate tendency to delay or postpone identification of NPAs

Establish appropriate IC systems to eliminate tendency to delay or postpone identification of NPAs, especially in high value accounts.

Fixing minimum cut off point on what constitutes high value account based on business levels.

Cut off point to be valid for entire accounting year.

Issues in Identification

- **Accounts regularized near about the balance sheet date**
Asset classification of accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care & without scope for subjectivity.
- **Where account indicates inherent weakness basis data available, account should be deemed as a NPA.**
- In other genuine cases, banks to furnish satisfactory evidence to Statutory Auditors/ Inspecting Officers about the manner of regularization of the account to eliminate doubts on their performing status.

Loans – Interest payment Moratorium

- If Moratorium is available for payment of interest - payment of interest is 'due' only after moratorium / gestation period is over & interest not overdue & account not NPA, on date of interest debit. Overdue only after due date for payment of interest, if uncollected.
- In housing loan or similar advances granted to staff members **where interest is payable after recovery of principal, interest not considered overdue from first quarter onwards**. NPA only on default in repayment of installment of principal or payment of interest on respective due dates.
- **Extension in moratorium period should ideally not be allowed afterwards unless justified by strong convincing reason.**

Consortium Advances

- Asset classification of accounts under consortium based on the **record of recovery of the individual member banks** & other aspects having a bearing on the recoverability of the advances
- Large value advances classified as NPA in 1 bank & having genuine weakness in another

Asset Classification

- Asset Classification **borrower wise - not facility wise.**
- All facilities granted to a borrower & investment in all securities issued by the borrower will be treated as NPA/NPI & not the particular facility/investment or part thereof becoming irregular
- Term Loans fully regular – CC overdrawn due to Term loan debit on specified dates -

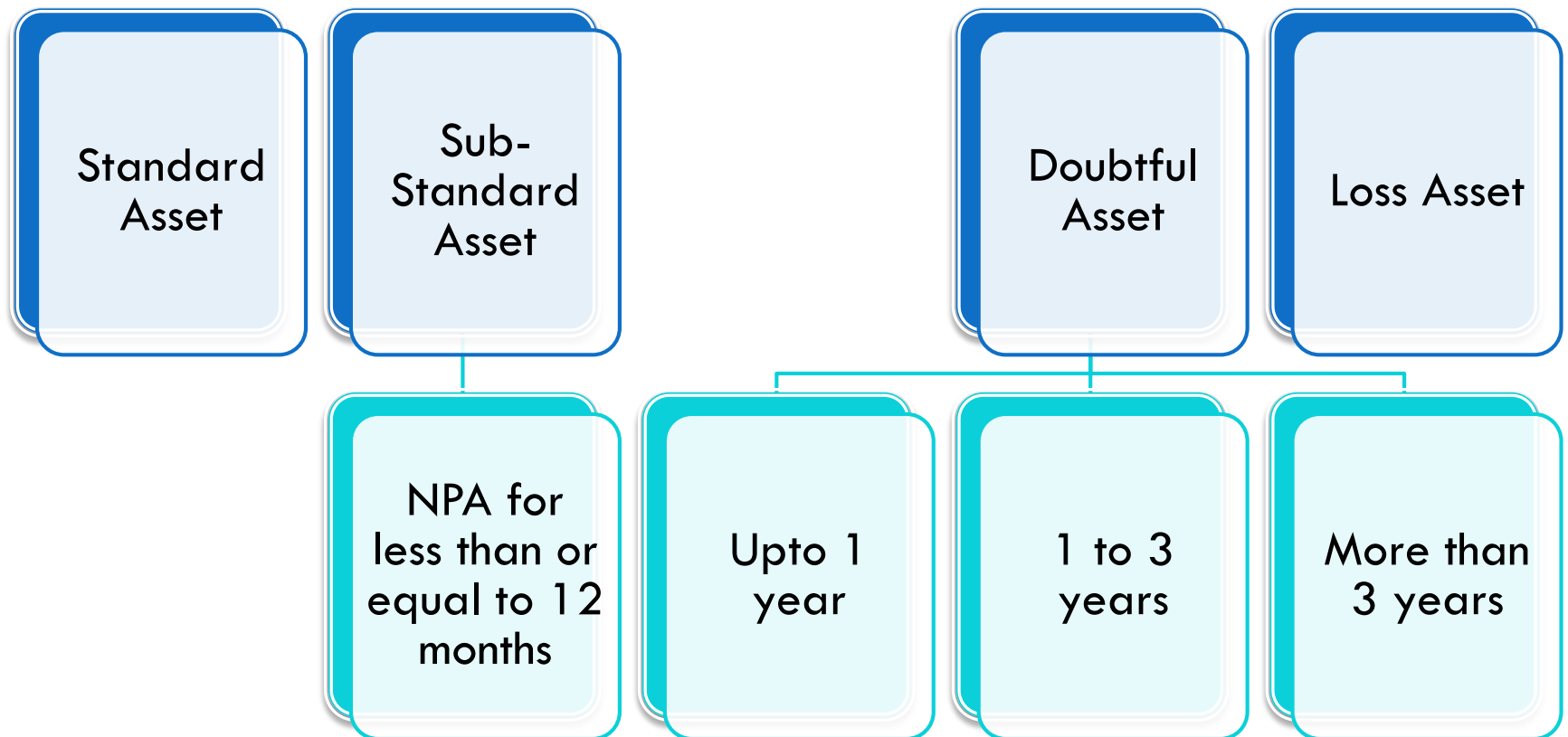
Exemption

- Advances against Term Deposits, NSCs, LIPs not NPAs, provided adequate margin is available in the accounts.
- Advances against gold ornaments, government securities & all other securities are not covered by this NPA classification exemption
- Small balances left outstanding to secure collateral

NPA classification

- Where realizable value of security $< 50\%$ value assessed by Bank / accepted in last RBI inspection, account to be straightaway classified as **Doubtful**
- Where realizable value as assessed by Bank / Valuer / RBI inspection is $< 10\%$ of outstanding balance, account to be straightway classified as **LOSS** asset
- 100% provision for fraud over 4 quarters commencing from the quarter in which fraud was detected – if Fraud not reported to RBI, 100% to be provided instantly

Classification of NPAs



Provision on NPA

- Substandard asset – 15%
- 25% if outstanding is unsecured (security < 10% of Funded – Non funded exposure ab-initio)
- 20% if infrastructure loan & backed by escrow facility with 1st charge
- Doubtful < 1 year – 25% + 100% of unsecured
- Doubtful 1-3 years – 40% +100% of unsecured
- Doubtful > 3 years – 100%
- Loss Asset -100% provision

Country risk provision

- Where net funded exposure is 15 of its total assets
 - Provision @ 0.25% - Low & insignificant risk in A1/A2 ECGC category
 - 5% provision – Moderate in B1 category
 - 20% provision – High in B2 category
 - 25% provision – Vey high in C1 category
 - 100% provision in C2 Restricted & D off credit category
-
- Lower provision @25% for short term exposures < 180 days

Classification	Provisioning
<u>Standard Assets</u>	
Credit to Agricultural activities & SMEs sectors	0.25 %
Advances to CRE Sector	1.00 %
Advances to CRE – Residential Housing Sector	0.75 %
Others	0.40 %
<u>Sub Standard Assets</u>	
Secured & ECGC Guarantee	15 %
Unsecured for escrow accounts	20 %
Other unsecured	25 %
<u>Doubtful Assets</u>	
Upto 1 year (D1)	25 %
1 to 3 years (D2)	40 %
More than 3 years (D3)	100 %
<u>Loss Assets</u>	100 %

Income Recognition

- Income recognition is objective as per recovery record
- Income from NPA not recognized on accrual basis but booked as income only if actually received.
- Interest on advances against term deposits, NSCs, LIPs taken to income account on due date, provided adequate margin is available in the accounts
- Fees & commissions earned on renegotiations or rescheduling of outstanding debts recognised on accrual basis over period of time covered by renegotiated or rescheduled extension of credit

Reversal of Income

- If any advance, including bills purchased & discounted, becomes NPA, entire interest accrued & credited to income account in the past periods, is reversed if not realized.
- Applicable also to Government guaranteed accounts
- Fees, commission & similar income accrued in NPA accounts will cease to accrue in the current period & will be reversed with respect to past periods, if uncollected.

Appropriation of recovery in NPAs

- Interest realized on NPAs to be taken to income provided credits in the accounts are not out of fresh/additional credit facilities sanctioned to the borrower concerned
- Banks to adopt 1 accounting principle & exercise right of appropriation of recoveries uniformly & consistently either towards Principal / Interest

Interest Application

- On an account turning NPA, reverse interest already charged & not collected by debiting P&L A/c, & stop further interest application
- Banks to continue recording such accrued interest in a Memorandum account in their books.
- For computing Gross Advances, interest recorded in the Memorandum account not to be considered

Upgradation of Accounts

- Advances to be paid off from genuine sources & not by granting fresh advances in any way.
- Account to be upgraded only after recovery of full dues in the account as on the date of it becoming NPA.
- Upgrades of NPA regularized post 31st March but before signing date by clearing all overdue on a case to case basis
 - If A/c is irregular post signing till date of RBI inspection, RBI could classify it as an NPA.

Valuation of Security

- Security to be carefully examined in NPA as it determines provisioning especially if advance is found unsecured.
- In NPAs > Rs.5.00 Crores, bank to formulate policy
 - Annual stock audit by external agencies &
 - In case of immovable properties, valuation to be carried out once in 3 years by approved valuer
- If property is auctioned at reserve price & not sold –
Valuation to be at a haircut on reserve price

Restructuring of Advances

□ Eligibility -

- Banks may restructure accounts classified under 'standard', 'substandard' and 'doubtful' categories.
- Banks cannot reschedule - restructure - renegotiate borrower accounts with retrospective effect.
- No account to be taken up for restructuring by banks unless financial viability is established & there is a reasonable certainty of repayment from the borrower
- Not available for Consumer / Personal / Capital market & Commercial real estate exposures

Asset Classification

- Restructuring/rescheduling/ renegotiation of the terms of loan agreement could take place:
 - Before commencement of commercial operations;
 - After commencement of commercial operations but before asset is classified as sub-standard;
 - After commencement of commercial operations & after asset is classified as sub-standard.
- On restructuring, account 'standard asset' would be reclassified as 'sub-standard asset' – NPA will slip one notch lower – all accounts eligible for upgradation after 1 year of satisfactory performance -
- Any additional finance may be treated as 'standard asset', up to a period of 1 year after first interest/principal payment, whichever is earlier, falls due under the approved restructuring package

Provisioning Norms

- Total provisions required against an a/c under restructuring -
Normal provision + Provision in lieu of diminution in fair value of advance (Sacrifice – as per borrower category discounting rate)
- Diminution in fair value to be re- computed on each balance sheet date till satisfactory completion of all repayment obligations
- Banks to provide shortfall in provision or reverse excess provision.
- Alternatively banks to notionally compute diminution in fair value & provide -5 % of the total exposure, in respect of a/c's where the total dues to bank are < Rs. 1 Crore.
- Additional 5% provision after 2 years from date of restructuring

Project loans -

- Project loan – Term Loan for infra / non infra for setting up an economic venture –
- Date of Completion & Date of Commencement of Commercial Operations to be clearly spelt out –
- If change in repayment schedule is due to project outlay increase due to scope and size increase & fulfillment of certain conditions – account being standard –
- Revised DCCO is ≤ 2 years of original DCCO for Infra & 1 year for Non Infra – 2+2 if for court reasons for Infra & 1+1 for Non infra –
- **NOT considered as Restructuring**

Revitalization of Distressed Assets

- Framework to ensure banking system recognizes financial distress early, takes prompt steps to resolve it & ensures fair recovery for lenders & investors
- Banks required to identify incipient stress in the account by creating 3 sub categories under Special Mention account (SMA)

Classification

SMA-0

- Principal or interest payment overdue < 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

SMA 0 – Incipient stress

Delays over 90 days for submission of stock statements / financial statements / facility renewal

Preventing conduct of stock audit

Reduction of DP $> 20\%$ in stock audit

Actual sales $< 40\%$ over projections

Return of > 3 cheques / bills over a 30 day period

LC devolvement - BG invocation not paid > 30 days

Extension > 3 times to create a security

Increase in frequent overdrafts in current accounts

Borrower reporting stress in business / financials

Promoters pledging / selling shares in the borrower company due to financial stress

Action against SMAs

- Banks to report SMA accounts as per prescribed limit of exposure to Central Repository of Information on Large Credits (CRILC) of RBI else penal measures apply
- For an account reported as SMA2, Banks to form a Joint Lender's Forum (JLF) which would decide Corrective Action Plan (CAP), either -
 - ▣ Rectification
 - ▣ Restructuring
 - ▣ Recovery
- While a restructuring proposal is under consideration by the JLF/CDR, usual asset classification norm to apply.

Willful Defaulters

- Default in meeting payment/repayment obligations:
 - When it has capacity to pay the obligations
 - Has not used funds for the purpose for which taken & diverted them for other purpose
 - Siphoned funds which are not available with defaulter in form of other assets
 - Disposed off movable fixed assets or immovable property given as security without permission

Diversion of Funds

- ❑ Utilizing short term funds for long term purposes
- ❑ Creating assets other than for which loan was sanctioned
- ❑ Transferring funds to subsidiaries/Group Companies
- ❑ Borrowing funds from other Banks without prior permission
- ❑ Investment in Equity/Debts of other companies without prior approval
- ❑ Shortfall in deployment of funds

Monitoring End use of Funds

- Meaningful scrutiny of quarterly progress reports / operating statements / balance sheets of borrowers;
- Regular inspection of borrowers' assets charged to lenders as security
- Periodical scrutiny of borrowers' books of accounts & 'no-lien' accounts maintained with other banks
- Periodical visits to assisted units
- Periodical stock audit for working capital finance
- Independent certification from CAs

Classification of Frauds

- Misappropriation & criminal breach of trust.
- Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts & conversion of property.
- Unauthorised credit facilities extended for reward or for illegal gratification.
- Negligence & cash shortages.
- Cheating & forgery.
- Irregularities in FX transactions.
- Any other type of fraud not coming under the specific heads

Annual review of Frauds

Adequacy of systems to detect frauds, once taken place, within shortest possible time.

Examination from staff angle & wherever necessary reported to the Vigilance Cell for further action in PSB

Meting out deterrent punishment wherever warranted, to persons found responsible.

Examination of laxity in following the systems & procedures & whether effective action is taken to ensure systems & procedures are scrupulously followed by staff concerned.

Reporting to local Police or CBI for investigation, as per guidelines issued in this regard to PSB's by GOI

Fraud Precautions

- ❑ Ensure use of 100% CTS - 2010 compliant cheques.
- ❑ Strengthen infrastructure at the cheque handling Service Branches & special attention on quality of equipment & personnel posted for CTS clearing, to ensure it is not merely a mechanical process.
- ❑ Ensure beneficiary is KYC compliant so that bank has recourse to him/her as long as he/she remains a customer
- ❑ Examination under UV lamp for cheques beyond threshold of 2 Lakhs
- ❑ Checking at multiple levels, of cheques above threshold of 5 Lakhs
- ❑ Close monitoring of Debit, Credits in new accounts as per risk categorization
- ❑ Sending SMS alert to payer/drawer for cheques received in clearing.

Other Issues

- Focus will be on IRAC norms – Money laundering
- FATCA Compliance
- ICOFR
- Is there a documented Process / Policy
- Are concepts of Risk / Controls understood
- Are things on paper or implemented in reality
- **Having courage of conviction to do what is right**

NPA issues

- ❑ Term loan debited to CC accounts – fully regular but Cc overdrawn –
- ❑ Enhanced limits not justified by documents submitted by borrower
- ❑ Date of NPA
- ❑ Manual override to automated NPA classification system
- ❑ Credits in other account / FD interest accrual set off for NPA classification

Success Trains – Failure Complains

- People are losing curiosity & the desire to learn & improve themselves & that in complacency & self satisfaction lies a low descent into mediocrity.
- The more you learn you learn that you still have a lot to learn – Learn – Unlearn – Relearn -
- We can not solve our problems with the same level of thinking that created them – Albert Einstein
- If you want something you have never had, then you got to do something that you never did