PRUDENTIAL NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION

'Out of order'status

An out of order account is one in which the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or the outstanding balance is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period.

'Overdue'

Overdue is the unpaid amount due to the bank under any credit facility on due date.

Non-performing Assets

An asset (including a leased asset) ceases to generate income is treated as non performing asset (NPA). A Loan or an advance is classified as NPA as under:-

Nature of Facility	Parameters
Term Loan	Interest and/or instalment of principal remain overdue beyond 90 days
Overdraft/Cash Credit	Remains 'out of order' as indicated above
Bill Purchased/discounted	Remains overdue beyond 90 days
Crop Loans (short duration crops)	Instalment of principal or interest thereon remains overdue for 2 crop seasons
Crop Loans (Long duration crops)	Instalment of principal or interest thereon remains overdue for 1 crop season
Securitization transactions	Amount of liquidity facility remains outstanding beyond 90 days
Derivative transactions	Overdue receivables representing positive mark-to-market value of a derivative contract which remains unpaid beyond 90 days from specified due date for payment

Banks are required to classify an account as NPA wherein the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

INCOME RECOGNITION

- Income from NPA assets is to be recognized only when it is actually received. However, interest on advances against term deposits, NSC, IVPs, KVPs, and Life policies may be taken into income account on the due date provided adequate margin is available in the accounts.

- On an account (incl. bills purchased and discounted and Government guaranteed accounts) turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. Likewise fees, commission and similar income in respect of past periods, if uncollected, need to be reversed.

- Interest realized on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.

- Banks may continue to record such accrued interest, but not realized, in a Memorandum account in their books which should not be taken into account for computing Gross Advances,

ASSET CLASSIFICATION

NPAs are being classified, based on the period for which the asset has remained non-performing and realisability of the dues, into three categories as under:-

No.	Category	Parameters
01.	Substandard Assets	* Remained NPA for a period not less than or equal to **one** year. *In such cases, the current net worth of the borrower/guarantor or market value of the security charged is not enough to ensure recovery of the bank's dues; * Likely to sustain some loss if deficiencies are not corrected.
02.	Doubtful Assets	*Remained in substandard category beyond 1 year; *Recovery - highly questionable and improbable.
03.	Loss Assets	*Asset considered uncollectible and of little value but not written off wholly by the bank. *Continuance as bankable assets although it may have some salvage or recovery value.

Guidelines for Classification

- NPA classification should be done taking into account the degree of credit weaknesses and availability of collateral security for realization of dues.
- Banks should avoid the tendency to delay or postpone identification of NPAs especially in respect of high value accounts;
- Availability of security/net worth of the borrower/guarantor should not be taken into

account while identifying the NPA;

- Banks should not classify an advance account as NPA merely due to existence of some temporary aberration/deficiency such non-availability of adequate Drawing Power based on latest stock statement, over limit, non-submission of stock statement, renewal of account, etc.
- A working capital account would become NPA, if the irregularity continues beyond 90 days even though the unit would be working and its financial position is satisfactory.
- Regular and ad hoc limits are required to reviewed/regularized within 180 days from the due date/date of sanction; else, it is to be classified as NPA.
- A NPA Loan account, other than restructured and rescheduled, can be upgraded to standard assets upon payment of arrears of interest and principal.
- Asset classification should be on borrower-wise and not facility wise. In case one facility/investment of the borrower causes problem, all the facilities granted to the borrower are to be treated as NPA.
- Bills discounted facility under LC favouring a borrower need not be classified as NPA in case any other facility is NPA. However, in case of non-payment of bills under the LC on due date by the LC issuing bank and the borrower fails to make good the amount immediately, the outstanding under the Bills discounted is also to be classified as NPA.
- In account where there is potential threat of recovery on account of erosion in value of security(50%/10% of value assessed earlier or outstanding), non-availability of security, existence of other factors such as frauds committed by borrowers, etc. such asset should straightaway be classified as doubtful or loss asset as appropriate:
- Finance granted to PACS/FSS under the on-lending system, only that particular portion of credit in default to be classified as NPA.
- Advances against paper securities such as TDRs, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.
- Loan with moratorium for payment of interest, the amount of interest would become overdue after the due date for payment of interest, if uncollected.
- In staff housing loan or similar other accounts where the interest is to be recovered after repayment of principal, such accounts would become NPA only when there is default in repayment of principal or interest on respective due dates.
- Advances backed by guarantee of Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. However, State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days.

Consortium Arrangement

Asset classification of accounts under consortium is to be based on the record of recovery of the individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA.

Projects under implementation (Classification of NPA)

Project Loans are classified into 2 categories viz. Project Loans for infrastructure sector and Project Loans for non-infrastructure sector.

- An infrastructure project loan would be classified as NPA before the date of commencement of commercial operations (DCCO) as per record of recovery (90 days) unless it is restructured and eligible for classification as standard asset.
- An infrastructure project would be classified as NPA if it fails to commence commercial operations within 2 years from the original DCCO.
- If a project loan classified as standard asset is restructured any time during the period up to two years from the original date of DCCO, it can be retained as a standard asset if the fresh DCCO is fixed and the account continues to be serviced as per the restructured terms subject to the application for restructuring should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.
- Delay in infrastructure projects involving court cases and projects in other than court cases, extension of DCCO up to another 2 years (beyond the existing extended period of 2 years i.e. total extension of 4 years) and up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years) respectively is considered for treating them as NPA.
- A loan for a non-infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue).
- If the non-infrastructure project fails to commence commercial operations within 6 months from the original DCCO, it is to be treated as NPA, etc.

Other Issues

Any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project, **would not be treated as restructuring if:**

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

These guidelines would apply to those cases where the modification to terms of existing loans, as indicated above, are approved by banks from now onwards.

Income Recognition

Banks may recognize income on accrual basis in respect of standard projects under implementation and may not recognize income in respect of substandard projects. Banks are required to reverse the interest recognized in past wrongly. Full provision should be made in respect of “Funded Interest” in respect of NPA projects recognized as income.

If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity.

Take out Finance

Under Take out Finance, possibility of default, in view of the time-lag involved in taking-over, cannot be ruled out. The norms of asset classification will have to be followed by the concerned lending bank/financial institution and they should not recognize income on accrual basis, but only on actual receipt. Bank/FI should also make suitable provision pending the takeover by other institution. **Upon takeover of the account, the provision could be reversed.** But the taking over institution is required to make provision in its books treating it as NPA from the actual date of becoming NPA even though the account was not in its books as on that date.

Post-shipment Supplier's Credit

Post shipment Supplier’s Credit under the EXIM Bank Guarantee-cum-refinance programme, the extent payment has been received from the EXIM Bank, may not be treated as a non-performing asset for asset classification and provisioning purposes.

Export Project Finance

In the event of the export proceeds in respect of export project finance is held up due to political developments in the importer’s country, the asset classification may be made after a period of one year from the date the amount was deposited by the importer in the bank abroad.

Advances under rehabilitation approved by BIFR/ TLI

In case of a unit under rehabilitation package approved by BIFR/Term Lending Institution, the existing credit facilities continue to be classified as substandard or doubtful as the case may be. Asset classification norms would be applicable in respect of additional facilities sanctioned under the package after a period of one year from the date of disbursement.

PROVISIONING NORMS

In conformity with the prudential norms, and on the basis of classification of assets, etc. banks are required to make provisions on funded outstanding on global loan portfolio basis as under:-

No.	Category	Sector	Provision requirement
01.	Standard Assets	*Agriculture & SMEs *Commercial Real Estate (CRE) *Housing Loans at teaser rates and restructured advances *Restructured Accounts *under moratorium	*0.25% of funded outstanding *1.00% of funded Outstanding *2.00% during teaser rate period and 0.40% after 1 year of rate reset. *For restructured advances 2.00% for first 2 years from date of restructuring. *NPA restructured account @2.00% in the first 5 years from the date of upgradation. *2%in first 2 years from date of restructuring 2% for moratorium period and further 2 years (total 4 years)
02.	Substandard Assets	*All sectors *Unsecured Advances	*15%of o/stg. without making any allowance for ECGC and security available. *Additional 10% i.e. total 25% and for infrastructure loans & total 20% provided Escrow mechanism is available.
03.	Doubtful Assets	*All sectors *Covered by ECGC	*Secured portion 25/40/100% upto 1year/1-3 years/more than 3 years respectively. *Unsecured portion – 100% *Net of ECGC guaranteed & realizable value of security at the above rates.
04.	Loss Assets	All sectors	To be written off or 100% of the outstanding.

Provisioning Coverage Ratio (PCR) is essentially the ratio of provisioning to gross non-performing assets and indicates the extent of funds a bank has kept aside to cover loan losses. Banks are required to maintain their total provisioning coverage ratio, including floating provisions, at not less than 70% by September 2010.

<u>Provision under Special Circumstances</u>

a) Advances under rehabilitation package approved by BIFR/TL institutions

- Provision should continue to be made as per classification of assets as substandard or doubtful.
- Additional facilities sanctioned as per package, provision on additional facilities sanctioned be made for a period of one year from the date of disbursement including that of SSI units identified as sick and put under rehabilitation programme by banks.

b) Provision requirements based on assets classification status are applicable in respect of TDRs, NSC eligible for surrender, IVPs, KVPs, gold ornaments, government and other securities and LIC policies.

c) Amount held in Interest Suspense Account should be deducted from the relative advances and thereafter provisioning as per norms may be made on the net balance. Amount held in Interest Suspense account should not be reckoned as part of provisions

d) ECGC guaranteed doubtful assets, provision need only to be made on the balance in excess of the guaranteed amount by ECGC. While arriving the provision requirement, the realizable value of the security is first deducted from the outstanding balance.

<u>SALE OF FINANCIAL ASSETS TO SC/RC</u>

- Under the SARFAESI Act 2002, banks/FIs are permitted to sell financial assets to Securitization Companies (SC) and Reconstruction Companies (RC). A financial asset which can be sold to the SC/RC by any bank/ FI is:-

a) A NPA, including a non-performing bond/ debenture, and

b) A Standard Asset where:
   i) The asset is under consortium/multiple banking arrangements;

   ii) At least 75% of value of the asset is classified as NPA in the books of other banks/FIs; and

   iii) At least 75% (by value) of the banks/FIs who are under the consortium/multiple banking arrangements agree to the sale of the asset to SC/RC.

- The prudential guidelines have been grouped under various heads as under:-

a) Financial assets which can be sold.
b) Procedure for sale of banks'/ FIs' financial assets to SC/ RC, including valuation and pricing aspects.

c) Prudential norms, in the following areas, for banks/ FIs for sale of their financial assets to SC/ RC and for investing in bonds/debentures/ security receipts and any other securities offered by the SC/RC as compensation consequent upon sale of financial assets:

i) <u>Provisioning / Valuation norms</u>

- The financial assets when sold to SC/RC, the same will be removed from its books.
- If the sale price is below the Net Book Value (NBV) (i.e. book value less provision held), the shortfall should be debited to the profit and loss account of that year.
- It the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilized to meet the shortfall/loss on account of sale of other financial assets to SC/RC etc.

The securities (bonds/debentures) offered by SC/RC should satisfy the following conditions viz.-

- The securities must not have a term in excess of six years.
- The securities must carry a rate of interest which is not lower than 1.5% above the Bank Rate in force at the time of issue.
- The securities must be secured by an appropriate charge on the assets transferred.
- The securities must provide for part or full prepayment in the event the SC / RC sell the asset securing the security before the maturity date of the security.
- The commitment of the SC / RC to redeem the securities must be unconditional and not linked to the realization of the assets.
- Whenever the security is transferred to any other party, notice of transfer should be issued to the SC/ RC

Investment in debentures/bonds/security receipts/Pass-through certificates issued by SC/RC

- The valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/ FI's investment in debentures/ bonds/ security receipts/PTCs issued by SC/ RC.

Banks/FIs investment in SC/RC in debentures/bonds/security receipts/PTCs issued by SC/RC will constitute exposure on the SC/RC. As only a few SC/RC are being set up now, banks/ FIs will be allowed, in the initial years, to exceed prudential exposure ceiling on a case-to-case basis.

<u>PURCHASE & SALE OF NPAs</u>

Guidelines have been framed for undertaking purchase and sale of NPAs without involving SC/RC, as an option available, to develop a healthy secondary market NPAs.

The option would be conducted within the financial system and has to be initiated with due diligence and care.

- The guidelines are applicable to banks, FIs and NBFCs purchasing/ selling non performing financial assets, from/ to other banks/FIs/NBFCs (excluding SCs/RCs).
- A financial asset, including assets under multiple/consortium banking arrangements, would be eligible for purchase/sale in terms of the guidelines if it is a NPA/NPI in the books of the selling bank.
- The guidelines have been grouped under the following headings:

a) Procedure for purchase/ sale of non performing financial assets by banks, including valuation and pricing aspects.
b) Prudential norms for banks for purchase/ sale of non performing financial assets in areas viz.

    i) Asset classification norms
    ii) Provisioning norms
    iii) Accounting of recoveries
    iv) Capital adequacy norms
    iv) Exposure norms

c) Disclosure requirements

- The guidelines, procedure, prudential norms, exposure norms, disclosure requirements, etc. are detailed in the RBI Master Circular dt. 02.07.2012.

WRITE OFF OF NPAs

In terms of Section 43(D) of the Income Tax Act 1961, interest income of NPAs shall be chargeable to tax in the previous year in which it is credited to the bank's profit and loss account or received, whichever is earlier. Banks may either make full provision as per the guidelines or write off such advances or claim such tax benefits as are applicable. Recoveries made in such accounts should be offered for tax purposes as per the rules.

PRUDENTIAL GUIDELINES ON RESTRUCTURING OF ADVANCES

- A restructured account is one where the bank grants concessions, which would not otherwise consider, taking into account the borrower's financial difficulty. Restructuring involves modification of terms of advance/securities, which would generally include, among others, alteration of repayment period / repayable amount/ the amount of instalments / rate of interest, etc.
- Specified Period means a period of one year from the date when the first payment of interest or instalment of principal falls due under the terms of restructuring package.

The guidelines on restructuring issued by RBI are grouped in four categories as under:-

i) Restructuring of advances extended to industrial units.

ii) Restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism

iii) Restructuring of advances extended to Small and Medium Enterprises (SME)

iv) Restructuring of all other advances.

<u>Eligibility</u>

- Accounts classified under ‘Standard’, ‘Substandard’ and ‘doubtful’ categories.
- Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply.
- No account is taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package.
- Borrowers indulged in frauds and malfeasance is ineligible for restructuring.
- BIFR cases are not eligible for restructuring without their express approval. CDR Core Group in the case of advances restructured under CDR Mechanism / the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

<u>Asset classification norms</u>

Restructuring of advances could take place in the following stages:

(a) Before commencement of commercial production / operation;

(b) After commencement of commercial production / operation but before the asset has been classified as 'sub-standard';

(c) After commencement of commercial production / operation and the asset has been classified as 'sub-standard' or 'doubtful'.

Upon restructuring:-

- 'Standard assets' should be reclassified as 'sub-standard assets'
- NPAs would continue asset classification as prior to restructuring and may slip into further lower asset classification categories with reference to the pre-restructuring repayment schedule.
- All NPA accounts would be eligible for being reclassified as ‘standard’ category after observation of satisfactory performance during the ‘specified’ period. Thereafter, the

account would be governed as per the existing prudential norms with reference to repayment schedule.

- Additional finance considered may be treated as 'standard asset' during the 'specified period. 'Any Interest income should be recognized only on cash basis in respect of accounts classified as 'substandard' or 'doubtful' at pre-restructuring stage.
- A restructured standard asset is subjected to restructuring on a subsequent occasion; it should be classified as substandard. Similarly, a sub-standard or a doubtful restructured asset which is subjected to restructuring on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion.
- Interest income in respect of restructured standard asset can be recognized on accrual basis
- In case part of the outstanding principal amount is converted into debt or equity instruments as per the restructuring package, the asset so created will be classified in the same asset classification category in which the restructured advance has been classified.
- The FITL / debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified.

Banks will hold provision in respect of restructured assets as per existing provisioning norms

Asset classification benefits are available to banks subject to:-

- The dues of the banks are fully secured except SSI borrowers where the outstanding is upto Rs.25 Lakh
- Infrastructure projects provided the cash flows generated from these projects are adequate for repayment of the advance, escrow mechanism for the cash flows available, and banks have a clear and legal first claim on these cash flows.
- The unit becomes viable in 10 years, if it is engaged in infrastructure activities, and in 7 years in the case of other units.
- The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances other than restructured home loans.
- Promoters' sacrifice (contribution) and additional funds brought by them should be a minimum of 15% of banks' sacrifice upfront. However, if the banks are convinced that the promoters face genuine difficulty in bringing the share of sacrifice immediately, the promoters could be allowed to bring in 50% of their sacrifice i.e. 50% of 15% upfront and the balance within a period of one year.

<u>OBJECTIVE OF RESTRUCTURING</u>

It may be observed that the basic objective of restructuring is to preserve economic value of units and not ever greening of problem accounts. This can be achieved by banks and the borrowers only by careful assessment of the viability, quick detection of weaknesses in accounts and a time-bound implementation of restructuring packages.

The entire Corporate Debt Restructuring (CDR) Mechanism and SME Debt Restructuring Mechanism are detailed in RBI Master Circular.

06. AGRICULTURAL DEBT WAIVER AND DEBT RELIEF SCHEME 2008 (ADWDRS)

The guidelines pertaining to Income Recognition, Asset Classification and Provisioning, and Capital Adequacy as applicable to the loans covered by the debt waiver and debt relief scheme for farmers are as under:-

Norms for accounts under Debt Waiver

- The small and marginal farmers eligible for debt waiver, the ‘eligible amount’ for waiver may be transferred by the banks to a separate account named "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008" and the balance amount be as a "performing" asset.

- No provision for standard assets as per current norms is required to be made in respect of the balance amount, etc.

Norms for accounts under Debt Relief

- Under the scheme, the 'other' farmers, are given a rebate of 25% of the "eligible amount", by the Government by credit to his account and the balance (75%) is to be paid by the farmer in three instalments as detailed in the scheme.
- Upon payment of the entire share of 75%, banks may open an account for Debt Relief Scheme, similar to the one opened for the receivables from GOI under the Debt Waiver Scheme, and bearing the nomenclature "Amount receivable from Government of India under Agricultural Debt Relief Scheme 2008".

Asset Classification

- Farmers covered under Debt Relief Scheme and given undertaking to pay their share under One Time Settlement’ Scheme, the relevant amount can be treated as "standard" / "performing" provided adequate provision is made by the banks and the farmers pay their share of settlement with one month of the due dates.

Provisioning

- Accounts under Debt Relief Scheme are classified as ‘standard’ assets and attract the prudential provisioning as applicable to such assets.

- In case default/delay in making their share under OTS by farmers by the due dates (within one month), the outstanding amount in the relevant accounts shall be treated as NPA with reference to the original date of NPA and provisioning is to be made as applicable, etc.

Capital Adequacy

Amount outstanding under 'Amount receivable from GOI' attract zero risk weight for the purpose of capital adequacy norms and amount outstanding in the accounts covered under the Scheme is to be treated as a claim on the borrowers and risk weighted as per extant norms.

Grant of Fresh Loans to the Borrowers covered under the ADWDRS

- A small or marginal farmer is eligible for fresh agricultural loans upon the eligible amount being waived and the fresh loan may be treated as "performing asset", regardless of the asset classification of the loan subjected to the Debt Waiver.
- Similarly fresh short-term production loans and investment loans to "other farmers" may be treated as "performing assets", regardless of the asset classification of the loan subjected to the Debt Relief, and its subsequent asset classification should be governed by the extant IRAC norms.

(Source: RBI M.Circular)

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