

Bank Branch Statutory Audit

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VERIFICATION OF IRAC NORMS

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Prudential Norms on Income Recognition & Asset Classification and Provisioning (IRAC Norms) (also referred to as Non-Performing Assets – NPA – Norms)

- Norms prescribed by RBI since 1992 for Income Recognition and Asset Classification Master Circular dt. 1st July, 2015 by RBI updated upto 30th June, 2015.
The paragraph numbers mentioned hereinafter pertain this above Master Circular
- Banks to classify all advances into standard, sub-standard, doubtful and loss assets, based on age of principal amount and interest overdue and the value of securities available there against.

Non Performing Asset (NPA)

An asset, including a leased asset, becomes NPA when it ceases to generate income for Bank. Specifically, various assets can be termed as NPA as follows: [Para 2.1.2]

Any amount due under any credit facility becomes “overdue”, if it is not paid on the “due date” fixed by the bank [Para 2.3]

- Term Loan – interest and / or instalment remains “overdue” for more than 90 days
- Cash Credit & Overdraft – the account remains “out of order” i.e.
 - outstanding balance remains continuously in excess of the sanctioned limit / drawing power; **OR**
 - outstanding balance is less than the sanctioned limit / drawing power limit, but there have been no credits continuously for 90 days / the credits are not enough to cover the interest debited during the same period. [Para 2.2]
- Bill Purchased / Discounted – the bill remains “overdue” (i.e. not paid on the due date) for more than 90 days
- Agricultural Advance (for details of components of Direct Agricultural Advance, refer Annexure-2 on Pg.100 of Master Circular)
 - ✓ Long Duration Crop Loan – principal or interest thereon remains “overdue” for 1 crop season. [Para 4.2.13]
 - ✓ Short Duration Crop Loan – principal or interest thereon remains “overdue” for 2 crop seasons [Para 4.2.13]
- Securitisation Transaction – amount of liquidity facility remains “overdue” for more than 90 days [Para 5.9.11]
- Derivative Transaction – overdue receivables representing +ve mark-to-market value remain unpaid for a period of 90 days [Para 5.9.12]

Income Recognition [Para 3]

- Policy of income recognition is based on the record of recovery. Thus,
 - Account considered as NPA, if interest charged during any quarter is not serviced fully within 90 days;
 - On account becoming NPA, all accrued interest, fees, commission, etc., which has been credited to income account, but has not been realised, has to be reversed; and
 - Thereafter, all interest, etc. to be accounted on receipt basis and not accrual basis [Para 3.2]
 - In case of leased assets, the finance charge component which had been credited to income account, but has not been realised, has to be reversed [Para 3.2.3]
- The above norms are also applicable to all government guaranteed accounts [3.1.1]
- Fees and commission earned as a result of renegotiation / rescheduling of outstanding debts can be taken on accrual basis during the period covered by the renegotiation / rescheduled extension of credit [Para 3.1.3]
- Interest on advances against Term deposit receipts, National Saving Certificates, Indira Vikas Patra, Kisan Vikas Patra and Life Insurance policies may be taken to income account, provided adequate margin is available. However, advances against gold ornaments, government and other securities are not covered by this exemption [Para 3.1.2]
- In case of advances, where moratorium has been granted for payment of interest, interest becomes “due” only after the moratorium period is over. [4.2.12(i)]
- Similarly, in case of housing or other loans granted to staff, where interest is payable after recovery of principal, interest becomes “due” only on the predetermined “due date”. [4.2.12(ii)]

Classification of NPAs [Para 4.1]

- Substandard Asset – an asset which has remained NPA for a period of less than or equal to 12 months.
- Doubtful Asset – an asset which has remained sub-standard for more than 12 months
- Loss Asset – an asset which has been identified as such, but has remained to be provided for / written off.

Provisions to be made [Para 5]

Provision has to be made for all the assets, whether it is a standard asset or a NPA. The norms for provisioning are as follows:

- Standard Asset – based on the type of advance, provision ranging from 0.25% (for a direct agricultural & SME loans) to 0.40% for all other loans to be made, except on Commercial Real Estate loans @1%, on Commercial Real Estate-Residential Housing Sector @0.75% and **Upto 5%** - on Restructured NPAs, now classified at Standard accounts. Provision not to be netted from the gross advances in the balance sheet, but to be shown separately as “Contingent Provision against Standard Assets” under “Other Liabilities & Provisions Others” in Schedule 5 of the balance sheet. [Para 5.5]
- Substandard Asset – a general provision of **15%** for secured portion of the advances (without considering any ECGC cover or securities available) (**20% on Infrastructure loans**) and a provision of **25%** for unsecured portion of the advances to be made. [Para 5.4]

- From FY 2009-10, rights, licenses, authorisations, etc. taken as collateral security in respect of projects (including infrastructure projects) not to be considered as tangible security and hence the advance to be unsecured [Para 5.4(iii)(a)]
- Doubtful Asset – a provision of 100% to be made for unsecured portion of advances, while a provision of **25/40/100%** to be made on secured portion, which has remained doubtful for upto 1 year / 1 – 3 years / more than 3 years respectively. [Para 5.3]
 - Loss Asset – a provision of 100% of outstanding amount has to be made.[Para 5.2]
 - Liquidity facility for Securitisation Transactions – the amount of such liquidity facility outstanding for more than 90 days should be fully provided for.[Para 5.9.11]

Summarized Position of Asset Classification & Provision is as follows:

Asset Classification		Provision Required
Performing (Standard) Asset (Overdue upto 90 days)		a) 0.25% on direct advance to Agricultural & SME sectors b) 0.75% on Commercial Real Estate (Residential Housing Sector loans) c) 1% on Commercial Real Estate Sector loans d) 0.40-2% on Housing loan with teaser rates e) Upto 5% - on Restructured NPAs, now classified at Standard accounts. f) 0.40% on those not covered above
Non-Performing Asset (NPA) (Overdue > 90 days)		
-	Sub-Standard (NPA upto 12 months wef. 31 st March, 2005)	15% on secured outstanding (<i>20% on Infrastructure loans</i>) 25% on unsecured outstanding
-	Doubtful (Sub-standard / NPA for > 12 months / erosion in security > 50%)	25 / 40 / 100% for secured doubtful O/s upto 1 year/ 1-3 years / > 3 years resp. 100% for unsecured doubtful advances
-	Loss (No chance of recovery / value of security < 10% of the outstanding)	100%

Floating Provision

Besides specific provisions, the bank can also make additional provision [Para 5.6]. It can be used only for extraordinary contingencies (general, market and credit) with prior approval of RBI

Floating provision can be netted from gross NPAs or can be treated as part of Tier II capital, under the overall ceiling of 1.25% of Risk Weighted Assets [Para 5.6.3]

Banks to make comprehensive disclosures on this in the “Notes to Accounts”.

Country Risk Provision

Besides above provision, if in any country, the **net funded exposure is one percent or more** of its total assets, banks are also required to make provision for country risk w.e.f. 31st March, 2003 on

net funded country exposure ranging from 0.25% to 100% as per the risk category classification provided by RBI. [Para 5.9.8]

Provisioning Coverage Ratio

A new concept - Specific + Floating provision should reach 70% of Gross NPAs by 30th September, 2010 [Para 5.10]

Certain Exemptions from Provision

- Advances against Term deposit receipts, National Saving Certificates, Indira Vikas Patra, Kisan Vikas Patra & Life Insurance policies need not be treated as NPA, provided adequate margin is available. However, advances against gold ornaments, government and other securities are not covered by this exemption.[Paras 4.2.11 & 5.9.2]
- Leased Asset – separate guidelines have been given for similar provisions to be made for secured and unsecured portion of leased assets. [Para 5.8]
- In respect of agricultural and other advances granted by banks to PACS / FSS under the on-lending system, only the particular credit facility which is in default (and not all credited facilities granted to the PACS / FSS) would be classified as NPA.[4.2.10]
- Post-shipment Supplier's Credit – to the extent payment is guaranteed under ECGC, the same need not be treated as NPA. [Para 4.2.17]
- Export Project Finance – where there is documentary evidence available to show that the foreign importer has paid the dues to the bank abroad, but the bank is unable to remit due to political or other reasons, the asset classification may be made after a period of one year from the date of deposit of the amount by the importer.[4.2.18]
- Advances covered by BIFR / ECGC / CGTSI Guarantees – separate guidelines have been given for provision to be made in case of accounts covered under the above. [Paras 4.2.19, 5.9.1, 5.9.4, 5.9.5]

Other Important Aspects of NPAs

- **Income recognition and asset classification is based on record of recovery** and hence availability of security or net worth of borrower / guarantor is not considered for the purpose of treating an account as NPA or otherwise. [Para 4.2.3]
- **Above norms are minimum prescribed.** Additional provision can be made by bank, which will not to be considered as floating provision and hence can be used to net off advances. [Para 5.7]
- **NPA** accounts are considered **borrowerwise** and not facilitywise. [Para 4.2.7(i)]
- While determining the total advances recoverable from a borrower, debits arising out of **devolvement of LCs** or **invoked guarantees** and not cleared are also to be added [Para 4.2.7(ii)]
- In **consortium advance**, the record of recovery at the bank being audited only has to be considered. [Para 4.2.8]
- In working capital borrowal account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" continues for 90 days,

account has to be classified as NPA, **even though the account is otherwise operated regularly.** [Para 4.2.4(i)]

- Similarly, **accounts** where regular / adhoc limits are **not reviewed within 180 days** from the due date / date of adhoc sanction, have to be considered as NPA. [Para 4.2.4(ii)]
- Accounts regularised with a few credits around the Balance Sheet date need to be carefully looked into (source of the credit, genuine entries, additional facilities granted in some other account etc.) [Para 4.2.6]
- In case of accounts where there is **erosion in value** of security or **fraud** has been committed by borrower, the same should straightaway be classified as **doubtful or loss**; specifically -
 - where value of security has eroded by more than 50%, account should be classified as 'doubtful' and
 - where realisable value of security is less than 10% of the outstanding amount, the existence of security should be ignored and the account should be classified as 'loss' [Para 4.2.9 & 5.4(ii)]
- If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance has not to be taken to income unless interest is realised. However, for purpose of asset classification, credit facility backed by Central Govt. guarantee, though overdue, can be treated as NPA only when the Govt. repudiates its guarantee, when invoked; this exception is not applicable for State Govt. guaranteed advances, where advance is to be considered NPA if it remains overdue for more than **90 days w.e.f. year ended 31st March, 2006.** [Para 4.2.14]
- RBI has given **extensive guidelines** for dealing with
 - a) **Projects under implementation** [Para 4.2.15]
 - b) **Takeout Finance** [Paras 4.2.16]
 - c) **Post-shipment Supplier's Credit** [Para 4.2.17]
 - d) **Export Credit Finance** [Paras 4.2.18]
 - e) **Advances in BIFR and other cases** [Paras 4.2.19]
 - f) **Transactions involving Direct Assignment of Cash Flows** [Para 4.2.20]
 - g) **Credit Card Accounts** [Para 4.2.21]
- For all accounts classified as 'Doubtful', necessary to determine
 - a) **existence of** primary and collateral **securities** properly charged to the Bank
 - b) its **present value** through approved valuer (once in 3 years) and
 - c) **inspection** (periodical). In case of NPAs with balance of Rs.5 crores and above, stock audit at annual interval by external agency is mandatory. [Note in Para 5.3]
- Suit filed accounts should generally be classified as doubtful, unless there is a strong justification to show it is Sub-standard.

Special Guidelines for NPAs

In the IRAC circular, over the years, RBI has issued and modified Guidelines for Restructuring of Advances, and its purchase / sale by various entities.

- Specific guidelines formulated on **sale** of financial assets to Securitisation Company (SC) / Reconstruction Company (RC) [Para 6] and **sale / purchase** of NPAs (other than to SC/RC) [Para 7]

- Specific guidelines have also been formulated for writing off of NPAs [Para 8]
- **Part B - 'Restructuring of Advances by Banks'** - Under the NPA norms, separate prudential guidelines have been provided [paras 15 to 23]. It includes 4 sets of guidelines on restructuring of advances extended to –
 - (i) Industrial units
 - (ii) Industrial units under Corporate Debt Restructuring mechanism (CDR)
 - (iii) Small & Medium enterprises (SME)
 - (iv) All other advances
- **Part C-1 - Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders** [paras 19 to 34]. This includes guidelines on Joint Lenders' Forum (JLF)
- **Part C-2 – Framework for Revitalising Distressed Assets** [paras 35 to 40]
- **Part C-3 – Strategic Debt Restructuring Scheme** [paras 41 to 49] – it deals with change in ownership of shares when restructuring is done

Upgradation of Accounts [Para 4.2.5]

- **Reschedule**ment of recovery **cannot give** the advance a **better classification** than the previous one.
- NPA accounts can be upgraded to Performing Accounts, provided all overdues are adjusted or atleast reduced to a period of less than 90 days
- However, **restructured / rescheduled accounts** under CDR or SME schemes **cannot be upgraded until 1 year** of satisfactory performance of the account.
- **Upgradation within the NPA category is not permitted** i.e. a Doubtful account cannot be made Sub-standard even if the overdues are reduced to less than 15 months.

Memorandum of Change (MOC) & Interpretation of Circular

- Once statement of accounts prepared and submitted to the Controlling Office, Auditors to make changes only through MOC. Many a times, changes suggested by Auditors not acceptable to Branch Managers and hence they refuse to sign the MOC. In this context, it may be noted that MOC is prepared by Auditors and **not mandatory for Branch Manager to sign it. Branch Manager's signature only denotes his concurrence to what has been stated by Auditors.**
- Further, Branch Managers interpret NPA Circular differently than what is actually stated in the circular, under the pretext that it is being done in a particular way for the last so many years – for eg. 3 to 5 year old vehicles, against which loans have become doubtful, are reflected at their purchase price 3/5 years old and not their depreciated value, or though stocks or book debts have not been inspected for a long period of time, their one or two year old values available with the Branch are taken for purpose of security. This is a very frequently used method by Branch Managers to avoid classification of NPAs or reduce the provision amount. It is recommended that Auditors should strictly go by what is stated in RBIs circular, which is quite unambiguous and not by the Branch Manager's interpretation of the same.

List of some Important Master Circulars / Directions issued by RBI

S.No.	Date	Particulars
MASTER CIRCULARS		
Advances		
1	1/7/2015	Master Circular – Exposure Norms
2	1/7/2015	Master Circular – Guarantees and Co-acceptances
3	1/7/2015	Master Circular – Guidelines for Relief Measures during Calamities
4	1/7/2015	Master Circular – Housing Finance
5	1/7/2015	Master Circular – Lending to MSME Sector
6	1/7/2015	Master Circular – Loans and Advances – Statutory and Other Restrictions
7	1/7/2015	Master Circular – Priority Sector Lending
8	1/7/2015	Master Circular – IRAC Norms
9	1/7/2015	Master Circular – Rupee / Foreign Currency Export Credit
10	1/7/2015	Master Circular – Wilful Defaulters
Foreign Exchange		
1	1/7/2015	Master Circular – FCRA Guidelines
2	1/7/2015	Master Circular – Foreign Investments in India
Special Programmes		
1	1/7/2015	Master Circular–Credit Facilities to Minority Communities
2	1/7/2015	Master Circular–Credit Facilities to SC and ST
3	30/7/2015	Master Circular–National Rural Livelihoods Mission (NRLM)
4	30/7/2015	Master Circular–National Urban Livelihoods Mission (NULM)
Miscellaneous		
1	1/7/2015	Master Circular – Basel III Capital Regulations
2	1/7/2015	Master Circular – Branch Licensing
3	1/7/2015	Master Circular – Brokerage on Relief / Saving Bonds
4	1/7/2015	Master Circular -- CRR and SLR
5	1/7/2015	Master Circular – Credit Card / Debit Card Operations of Banks
6	1/7/2015	Master Circular – Customer Service in banks
7	1/7/2015	Master Circular – Disbursement of Govt. Pension
8	1/7/2015	Master Circular – Disclosure in Financial Statements - Notes to Accounts
9	1/7/2015	Master Circular – Frauds – Classification and Reporting
10	1/7/2015	Master Circular – Govt. Business
11	1/7/2015	Master Circular – Nomination Facility for Relief / Saving Bonds
12	1/7/2015	Master Circular – OLTAS
13	1/7/2015	Master Circular – Para-Banking Activities
14	1/7/2015	Master Circular – Prudential Guidelines on Capital Adequacy (New CA Framework)
15	1/7/2015	Master Circular – Prudential Norms on Investments
16	1/7/2015	Master Circular – Self-Help Groups – Bank linkages

MASTER DIRECTIONS		
1	4/1/2016	Acquisition & Transfer of Immovable Properties under FEMA
2	4/1/2016	Compounding of Contraventions
3	4/1/2016	Deposit & Accounts
4	4/1/2016	Direct Investments by Residents Abroad
5	4/1/2016	ECB-External Commercial Borrowing
6	4/1/2016	Establishment of Office in India by Foreign Entities
7	4/1/2016	Export of Goods & Services
8	4/1/2016	Import of Goods & Services
9	4/1/2016	Insurance
10	4/1/2016	LRS-Liberalised Remittance Scheme
11	4/1/2016	Misc.
12	4/1/2016	Money Changing Activities
13	4/1/2016	Other Remittance Facilities
14	4/1/2016	Remittance of Assets
15	4/1/2016	Reporting under FEMA
16	4/1/2016	Transactions between Resident & NRI-PIOs
17	4/1/2016	Vostro Accounts
18	25/2/2016	KYC Direction, 2016
19	3/3/2016	RBI (Int. Rates on Advances) Direction, 2016
20	3/3/2016	RBI (Int. Rates on Deposits) Direction, 2016