

The Reserve Bank of India (RBI) has issued master circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances vide its circular no. DBOD No. BP.BC.10/21.04.048/2004-05 dated 17th July, 2004. The RBI has incorporated all instructions issued upto 30th June, 2004 and has been placed this master circular on the RBI website (<http://www.rbi.org.in>). The master circular supercedes the instructions contained in all the circulars issued till the said date. On perusal of the RBI website the author has not come across any other circular on the subject till 28th February, 2005. This article attempts to explain the role of the auditor in verification of the Non-Performing Assets (NPAs) in accordance with the aforesaid circular read with the relevant Auditing and Assurance Standards. In case of any doubt the readers are advised to refer to the original master circular.

Prudential Norms— Recent RBI Changes

—Manoj Fadnis

The Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances was introduced by the Reserve Bank of India (RBI) with effect from year ending 31st March, 1993. The objective is to ensure that the policy of income recognition should be objective and based on record of recovery rather than on any subjective consideration. Likewise, the classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms. Also, the provisioning should be made on the basis of the classification of assets depending on the period for which the asset has remained non-performing and the availability of security and the realizable value thereof.

Non-performing Assets

A Non-performing Asset (NPA) is defined as a credit facility in respect of which the interest and/or installment of principal has remained 'past due' for a specified period of time. With a view to moving towards international best practices and to ensure greater transparency, the '90 days' overdue' norm for identification of NPAs has been adopted, from the year ending March, 31, 2004. Accordingly, the NPA classification as at 31st of March, 2005 is discussed as hereunder :-

Term Loan: A Term Loan where interest and/or instalment of principal remain overdue for a period of more than 90 days will be treated as NPA. Thus an amount which falls due on 31st December, 2004 will be 90 days old, if unpaid, as on 31st March, 2005.

The requirement is that the overdue period should be more than 90 days. Therefore, such an amount need not be classified as NPA. Any amount which had become payable before 31st of December, 2004 will be NPA as at 31st of March, 2005 if it remains unpaid.

Overdraft/Cash Credit: An Overdraft/Cash Credit will become NPA as at 31st of March, 2005 under the following circumstances :

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

The period from 01st of January, 2005 to 31st of March, 2005 is of 90 days. Hence, the above two requirements will have to be tested for this period of 90 days to determine whether the account becomes NPA

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or not as on 31st March, 2005.

Bills Purchased and Discounted: If the bills remain overdue for a period of more than 90 days then such bills would be classified as NPA. As mentioned before, the bills purchased and discounted before 31st December, 2004, if unpaid as at 31st March, 2005 will be treated as NPA.

Agricultural Advance:

- (a) With effect from September, 30, 2004, a loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.
- (b) A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops, would be treated as "short duration" crops. The crop season for each crop, which means the period upto harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.
- (c) Thus an auditor should verify the

decision of the State Level Bankers Committee to ascertain whether a particular crops is of long duration or short duration. The interest and/or instalment of an agricultural loan which was outstanding as on 31st March, 2004 will become NPA as on 31st March, 2005 if it is a loan to a short duration crop. In case such interest and/or instalment outstanding as on 31st of March, 2004 and remaining unpaid as on 31st of March, 2005, pertain to a long duration crop then such a facility would become NPA if the period of one year is over as at 31st March, 2005.

Any other credit facility: In case of any other credit facility, if the amount to be received remains overdue for a period of more than 90 days then such a facility will be classified as NPA. As discussed before, if such an amount was due before 31st of December, 2004, then it shall become NPA as at 31st of March, 2005.

To facilitate the smooth transition to 90 days norm, the banks have shifted to charging of interest at monthly rests with effect from 01st April, 2002. However, the date of classification of an advance as NPA cannot be changed on account of charging of interest at monthly rests. Therefore, a credit facility will continue to be classified as NPA only if the interest charged during any quarter is not serviced within 90 days from the end of the quarter w.e.f. 31st March, 2004.

Any amount due to the bank under any credit facility is said to be overdue if it is not paid on the due date fixed by the bank.

Income Recognition

In case of a NPA, the interest is recognized when it is actually received and not merely on accrual basis. This is

also in accordance with the principles enunciated in Accounting Standard 9 on Revenue Recognition. As per this statement the recognition of interest should be deferred where there is uncertainty regarding its collection.

The above general rule, however, does not apply in case of advances against term deposits, NSCs, IVPs, KVPs and Life Policies provided adequate margin is available.

Fees and commissions earned by the banks as a result of re-negotiations per rescheduling of outstanding debts should be recognized on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

If the Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realized.

An advance which become NPA during the financial year 2004-05, interest accrued and credited to income account has to be revised or provided for if the same is not realized. This applies to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

The finance charges component of finance income (as defined in 'AS 19-Leases' issued by the Council of the Institute of Chartered Accountants of India (ICAI) on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealized, should be reversed or provided for in the current accounting period.

The issue of appropriation of partial recoveries in NPA accounts has always been a subject matter of

controversy. The RBI has in recent past advised the banks to adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

Asset Classification

The banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realizability of the dues:-

- (a) Sub-standard Assets
- (b) Doubtful Assets
- (c) Loss Assets

Sub-standard Assets: With effect from 31st of March, 2005, a Sub-standard Asset would be one, which has remained NPA for a period less than or equal to 12 months. Thus the earlier period of 18 months has now been reduced to 12 months.

Doubtful Assets: With effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. Thus the earlier period of exceeding 18 months has been reduced to 12 months.

Loss Assets: A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable assets is not warranted although there may be some salvage or recovery value.

Accounts with temporary deficiency:

- a) The classification of an asset as NPA should be based on the record of recovery. An account need not be classified as NPA merely due to the existence of

some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non submission of stock statements and non-renewal of the limits on due date etc. However, the outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. If such irregular drawings are permitted in the account for a continuous period of 90 days will render the account NPA, even though the unit may be working or the borrowers financial position is satisfactory. Accordingly the outstanding as on 31st March, 2005 in a cash credit account based on a stock statement of 30th September, 2004 or before, will be classified as NPA.

- (b) Regular and adhoc credit limits need to be reviewed/ regularized not later than three months from the due date/date of adhoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the auditor should verify whether the branch has evidence to show that renewal/ review of credit limit is already on and would be completed soon. Delay beyond six months is not considered desirable as a matter of general discipline. Hence in account where the regular/adhoc credit limit have not been reviewed/renewed within 180 days from the due date/ date of adhoc sanction will be treated as NPA.

Upgradation of loan accounts

classified as NPAs : If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and can be classified as 'standard' accounts.

Accounts regularised near about the balance sheet date: The asset classification of borrowal accounts where a solitary or a few credits are recorded before the balance sheet date should be verified properly and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the auditor should insist the banks to furnish satisfactory evidence about the manner of regularization of the account to eliminate doubts on their performing status.

Asset Classification to be borrower-wise and not facility-wise:

- (a) All the facilities granted by a bank to a borrower will have to be treated as NPA and not the particular facility or part thereof which has become irregular.
- (b) If the debits out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.

Advances to PACS/FSS ceded to Commercial Banks:

The above general rule of classification borrower-wise and not facility-wise has one exception. In respect of agricultural advances as well as advances for other purposes granted

by banks to ceded PACS/ FSS under the on-lending system, only that particular credit facility granted to PACS/ FSS which is in default for a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned to a PACS/ FSS. The other direct loans & advances, if any, granted by the bank to the member borrower of a PACS/ FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

Advances under consortium arrangements:

Asset classification of accounts under consortium should 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. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Accounts where there is erosion in the value of security:

(i) A NPA need not go through the various stages of classification in cases of serious credit impairment and such assets should be straightaway classified as

doubtful or loss asset as appropriate. Erosion in the value of security can be reckoned as significant when the realizable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(ii) If the realizable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

Advances against Term Deposits, NSCs, KVP/IVP, etc : Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

Loans with moratorium for payment of interest :

(i) In the case of bank finance given for industrial projects or for agricultural plantations etc. where moratorium is available for payment of interest, payment of interest becomes 'due' only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

(ii) In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.

Agricultural advances :

(i) Where natural calamities impair the repaying capacity of agricultural borrowers, banks are allowed to decide on their own as a relief measure -conversion of the short-term production loan into a term loan or rescheduling of the repayment period; and the sanctioning of fresh short term loan.

(ii) In such cases of conversion or re-scheduling, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or installment of principal remains unpaid, for two harvest seasons but for a period not exceeding two half years.

(iii) The debts as on March 31, 2004 of farmers, who have suffered production and income losses on account of successive natural calamities, i.e., drought, flood, or other calamities which might have occurred in the districts for two or more successive years during the past five years may be rescheduled/ restructured by the banks, provided the State Government

concerned has declared such districts as calamity affected.

Government guaranteed advances: The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPA is not for the purpose of recognition of income. With effect from 1st April 2000, advances sanctioned against State Government guarantees should be classified as NPA in the normal course, if the guarantee is invoked and remains in default for more than 90 days.

Restructuring/ Rescheduling of Loans :

- (i) In the context of restructuring of the accounts, the following stages at which the restructuring / rescheduling / renegotiation of the terms of loan agreement could take place, can be identified:
- before commencement of commercial production;
 - after commencement of commercial production but before the asset has been classified as sub standard,
 - after commencement of commercial production and after the asset has been classified as sub standard.

In each of the foregoing three stages, the rescheduling, etc., of principal and/or of interest could take place, with or without sacrifice, as part of the restructuring package evolved.

(ii) Treatment of Restructured Standard / Sub-standard Accounts

- A rescheduling of the instalments of principal alone, at any of the aforesaid first two stages would not cause a

standard asset to be classified in the sub standard category provided the loan/credit facility is fully secured. A substandard asset is eligible to be continued in the sub-standard category for the specified period, provided the loan/credit facility is fully secured.

- A rescheduling of interest element at any of the foregoing first two stages would not cause an asset to be downgraded to sub standard category subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. Under similar circumstances a rescheduling of interest element would render a sub-standard asset eligible to be continued to be classified in sub standard category.
- In case there is a sacrifice involved in the amount of interest in present value terms, as at (b) above, the amount of sacrifice should either be written off or provision made to the extent of the sacrifice involved.

(iii) Upgradation of restructured accounts:

The sub-standard accounts which have been subjected to restructuring etc., whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after the specified period i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory perfor-

mance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms as aforesaid, could also be reversed after the one year period. During this one year period, the sub-standard asset will not deteriorate in its classification if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

(iv) Other Issues:

- A trading account cannot be restructured/ rescheduled in the manner as discussed above. This is as trading involves only buying and selling of commodities and the problems associated with manufacturing units such as bottleneck in commercial production, time and cost escalation etc. are not applicable to them.
- While assessing the extent of security cover available to the credit facilities, which are being restructured/ rescheduled, collateral security would also be reckoned, provided such collateral is a tangible security properly charged to the bank and is not in the intangible form like guarantee etc. of the promoter/ others.
- The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restruc-

- turing/rescheduling/renewal.
- (d) Banks are not expected to repeatedly restructure/reschedule the amounts due to them unless there are very strong and valid reasons which warrant such repeated restructuring/rescheduling.
- (e) As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks are required to adopt the following:-
- (i) **Funded Interest:** Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/rescheduling/renewal of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.
- (ii) **Conversion into equity, debentures or any other instrument:** The amount outstanding converted into other instruments would normally comprise principal and the interest components. 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. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. 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. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realisation basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognised only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising

from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

- (f) Reversal of provision made for NPA is permitted when the account becomes a standard asset. The provision made in a restructured/rescheduled account towards interest sacrifice, may be reversed on satisfactory completion of all repayment obligations and the outstanding in the account is fully repaid. Banks are not permitted to re-compute the extent of sacrifice each year and make adjustments in the provisions made towards interest sacrifice.
- (g) While banks are permitted to consider other accounts also for restructuring, such accounts would have to qualify the basic test of viability before it is considered for restructuring.

Corporate Debt Restructuring (CDR System):

- (a) Accounting treatment for restructured accounts :
- (i) The restructuring of corporate debts under CDR system could take place in the following stages:
- before commencement of commercial production;
 - after commencement of commercial production but before the asset has been classified as 'sub-standard';
 - after commencement of commercial production and the asset has been classified as 'sub-standard' or 'doubtful'.

- (ii) The prudential treatment of the accounts, subjected to restructuring under CDR system, would be governed by the following norms:
- (iii) Treatment of 'standard' accounts restructured under CDR.
 - a. A rescheduling of the installments of principal alone, at any of the aforesaid first two stages would not cause a standard asset to be classified in the sub-standard category, provided the loan / credit facility is fully secured.
 - b. A rescheduling of interest element at any of the foregoing first two stages would not cause an asset to be downgraded to sub-standard category subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved.
- (iv) Treatment of 'sub-standard'/'doubtful' accounts restructured under CDR
 - a. A rescheduling of the instalments of principal alone, would render a sub-standard / 'doubtful' asset eligible to be continued in the sub-standard / 'doubtful' category for the specified period, provided the loan/credit facility is fully secured.
 - b. A rescheduling of interest element would render a sub-standard 'doubtful' asset eligible to be continued in this category for the specified

period subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms is either written off or provision is made to the extent of the sacrifice involved.

- c. In case there is a sacrifice involved in the amount of interest in present value terms, as at (b) above, the amount of sacrifice should either be written off or provision made to the extent of the sacrifice involved. Even in cases where the sacrifice is by way of write off of the past interest dues, the asset should continue to be treated as sub-standard / 'doubtful'
- (v) The sub-standard / doubtful accounts, which have been subjected to restructuring, etc. whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after the specified period, i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms as aforesaid, could also be reversed after the one-year period.
- (vi) During this one-year

period, the sub-standard / doubtful asset will not deteriorate in its classification if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

- (vii) The asset classification under CDR would continue to be bank-specific based on record of recovery of each bank, as per the existing prudential norms applicable to banks.

Projects under implementation

- (i) The projects under implementation are grouped into three categories for the purpose of determining the date when the project ought to be completed:
 - Category I:** Projects where financial closure had been achieved and formally documented.
 - Category II:** Projects sanctioned before 1997 with original project cost of Rs.100 crore or more where financial closure was not formally documented.
 - Category III:** Projects sanctioned before 1997 with original project cost of less than Rs.100 crore where financial closure was not formally documented.

Asset classification

- (ii) In case of each of the three categories, the date when the project ought to be completed and the classification of the under-

lying loan asset should be determined in the following manner:

Category I (Projects where financial closure had been achieved and formally documented): In such cases the date of completion of the project should be as envisaged at the time of original financial closure. In all such cases, the asset may be treated as standard asset for a period not exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project.

In case, however, in respect of a project financed after 1997, the financial closure had not been formally documented, the norms enumerated for category III below, would apply.

Category II : In such cases, the asset may be treated as standard asset for a period not exceeding two years beyond the deemed date of completion of the project.

Category III : In such cases the assets can be treated as standard asset only for a period not exceeding two years beyond the date of completion of the project as originally envisaged at the time of sanction.

(iii) In all the three foregoing categories, in case of time overruns beyond the aforesaid period of two years, the asset should be classified as sub-standard regardless of the record of recovery and provided for accordingly.

(iv) In all cases subsequent to 1997, it is necessary that the date of completion of the project is clearly spelt out at the time of financial closure of the project. In such cases, if the date of commencement of commercial production extends beyond a period of six months after the date of completion of the project, as originally envisaged at the time of initial financial closure of the project, the account should be

treated as a sub-standard asset.

Income recognition

(v) Banks can recognise income on accrual basis in respect of the above three categories of projects under implementation, which are classified as 'standard'.

(vi) Banks are not permitted to recognise income on accrual basis in respect of the above three categories of projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. Income in respect of Funded interest and where loans are converted into equity, debentures or any other instrument is to be recognized on the same basis as in the case of Restructuring/Reschedulement of Loans as discussed in para 4.16 (iv) (e).

Provisioning

(vii) While there is no change in the extant norms on provisioning for NPAs, banks which are already holding provisions against some of the accounts, which may now be classified as 'standard', can continue to hold the provisions and need not reverse the same.

Availability of security/net worth of borrower/guarantor

The availability of security or net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

Take-out Finance

Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, the

institution/the bank financing infrastructure projects have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a pre-determined basis. In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution cannot recognise income on accrual basis and account for the same only when it is paid by the borrower/ taking over institution (if the arrangement so provides). The lending institution is required to make provisions against any asset turning into NPA pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

Post-shipment Supplier's Credit :

(i) In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC's cover is available, EXIM Bank as introduced a guarantee-cum-refinance programme whereby, in the event of default, EXIM Bank will pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes

the guarantee after the exporter has filed claim with ECGC.

Export Project Finance

- (i) In respect of export project finance, there could be instances where the actual importer has paid the dues to the bank abroad but the bank in turn is unable to remit the amount due to political developments such as war, strife, UN embargo, etc.
- (ii) In such cases, where the lending bank is able to establish through documentary evidence that the importer has cleared the dues in full by depositing the amount in the bank abroad before it turned into NPA in the books of the bank, but the importer’s country is not allowing the funds to be remitted due to political or other reasons, 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.

Banks are not permitted to upgrade the classification of any advance in respect of which the terms have been re-negotiated unless the package of re-negotiated terms has worked satisfactorily for a period of one year. While the existing credit facilities sanctioned to a unit under rehabilitation packages approved by BIFR/term lending institutions will continue to be classified as sub-standard or doubtful as the case may be, in respect of additional facilities sanctioned under the rehabilitation packages, the Income Recognition, Asset Classification norms will become applicable after a period of one year from the date of disbursement.

Provision Norms

In conformity with the prudential norms, provisions are required to be made on the non-performing assets on the basis of classification of assets into prescribed categories. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks have to make provision against sub-standard assets, doubtful assets and loss assets as below:

Loss Assets: The entire asset has to be written off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding need be provided for.

Doubtful Assets:

- (i) 100 percent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.
- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful:
- (iii) Banks are permitted to phase the additional provisioning consequent upon the reduction in the transition period from substan-

dard to doubtful asset from 18 to 12 months over a four year period commencing from the year ending March 31, 2005, with a minimum of 20% each year.

- (iv) With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank have to be valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

Sub-standard Assets: A general provision of 10 percent on total outstanding is required to be made without making any allowance for DICGC/ECGC guarantee cover and securities available. The ‘unsecured exposures’ which are identified as ‘substandard’ would attract additional provision of 10 per cent, i.e., a total of 20 per cent on the outstanding balance. Unsecured exposure is defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank’s inspecting officers, is not more than 10 percent, *ab-initio*, of the outstanding exposure.

Period for which the advance has remained in ‘doubtful’ category	Provision requirement (%)
Upto one year	20
One to three years	30
More than three years	
i) Outstanding stock of NPAs as on March, 31, 2004	60 percent with effect from March 31, 2005 75 percent with effect from March 31, 2006 100 percent with effect from March 31, 2007
ii) Advances classified as ‘doubtful more than three years’ on or after April 1, 2004	100 percent with effect from March 31, 2005

'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees, comfort letters etc.

Standard Assets

- (i) From the year ending 31.03.2000, the banks have to make a general provision of a minimum of 0.25 percent on standard assets on global loan portfolio basis.
- (ii) The provisions on standard assets is not reckoned for arriving at net NPAs.
- (iii) The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

Provisions on Leased Assets

- (i) Sub-standard Assets
 - (a) 10 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 - Leases' issued by the ICAI.
 - (b) Unsecured lease exposures, which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 20 per cent.
- (ii) Doubtful Assets
100 percent of the extent to which the finance is not secured by the realizable value of the leased asset. Realisable value to be estimated on a realistic basis. The quantum of provision in the three categories of

doubtful leased assets is the same as in case of other doubtful advances.

iii) Loss Assets

The entire asset should be written-off. If for any reason, an asset is allowed to remain in books, 100 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component should be provided.

Government Guaranteed Advances

- Government guaranteed advances: With effect from 31st March, 2000, in respect of advances sanctioned against State Government guarantee, if the guarantee is invoked and remains in default for more than 90 days the banks are required to make normal provisions as discussed above.
- Advances granted under rehabilitation packages approved by BIFR/term lending institutions.
 - (i) In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset.
 - (ii) As regards the additional facilities sanctioned as per package finalized by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.
- Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, and life policies would attract provisioning requirements as applicable to their asset classification status.
- Advances against gold ornaments, government securities

and all other kinds of securities are not exempted from provisioning requirements.

- Treatment of interest suspense account : Amounts held in Interest Suspense Account is not to be reckoned as part of provisions. Amounts lying in the Interest Suspense Account is to be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.
- **Advances covered by ECGC/DICGC guarantee:** In the case of advances guaranteed by DICGC/ECGC, provision can be made only for the balance in excess of the amount guaranteed by these Corporations. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then provision made.
- **Advance covered by CGTSI guarantee:** In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Conclusion

The introduction of the IRAC Norms has certainly improved the collection of advances by the banks. There is now a general consciousness amongst the bankers and the borrowers regarding the concept of performing and non-performing assets. Today, the banks are evaluated on the basis of the percentages of their NPAs. This is indeed a landmark development in the Indian Banking Industry. ■