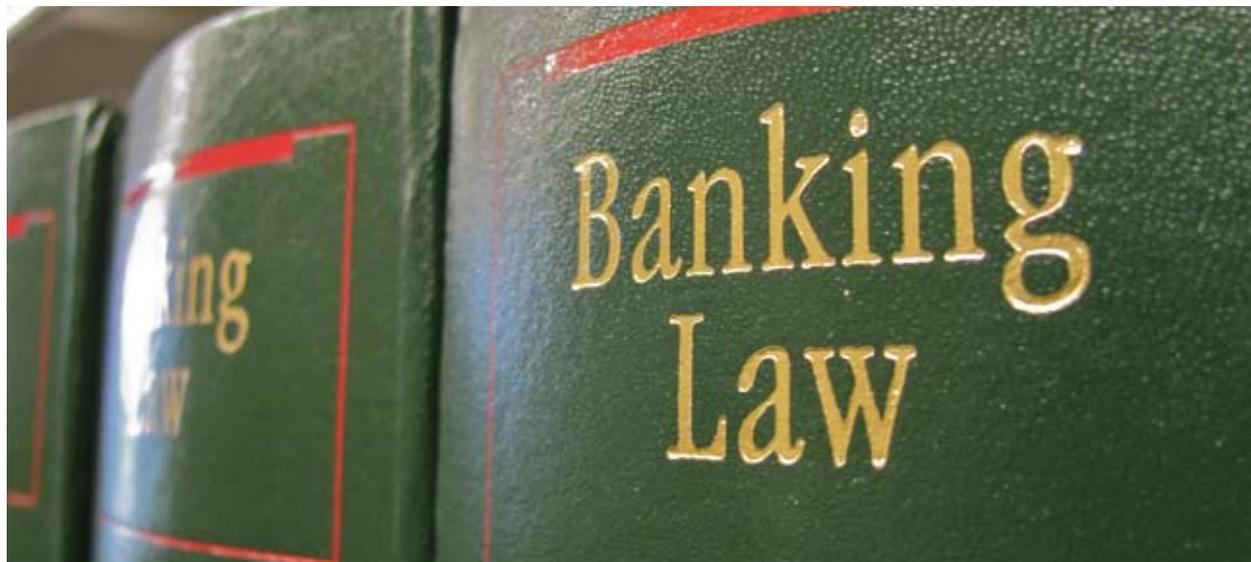


Bank Audit — Points to Ponder



Right from the day banks started lending, the rescheduling and restructuring of advances have become part and parcel of banking as the ultimate idea of lenders was to recover such loans under stress with minimum loss. It is in recent times that the RBI came out with a structured approach towards the process of restructuring so as to prevent banks from resorting to ever greening. Nevertheless, sectors do get affected by business cycles and to deny them legitimate support would not be fit and proper. There has been a proposition in some quarters that any nod now by the regulator for a second restructuring would make the banks gloss over virtual NPAs. This line of argument fails to see the impact that would befall the sectors under stress such as telecom, infrastructure, textiles, power, etc. The regulator is surely weighing the pros and cons of advocating relaxation in the number of times an account can be restructured without affecting its performing status. Be that as it may, from the point of view of income recognition and asset classification, restructure has proved to be a bug bear to many. While there are not very many changes over the year with regard to the regulatory guidelines affecting the audit aspects of banks, nevertheless, the feedback received from many fronts suggests that in some areas, audit fraternity has entertained certain doubts. This article aims at discussing these in detail.

A. Restructuring & Infrastructure Advances

General:

One such aspect is of restructuring and rescheduling of advance; for some, the special dispensation provided by the RBI under Circulars dated 8th December, 2008; 2nd, January, 2009, and 4th February, 2009, are still available; for some, all advances restructured post the said circular would become non-performing assets. The truth, as usual, lies in between.

The special dispensation mainly gave the benefit of a second restructure to most advances without affecting their performing status. It also made advances in certain sectors like commercial real estate, to avail the benefits of restructure (if it is for the first time) without any adverse effect on the performing status. This special dispensation has now been done away with.



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All the loans can be rescheduled, renegotiated and restructured, and the effect on restructuring is tabulated below:

S. No	Nature of the Loan	Remarks	Ref. to RBI DBOD circular
1	Industrial Loan	Including projects under implementation: a. Infrastructure Loans b. Non-Infrastructure	No: 37 dtd. August 27, 2008 No: 121 dtd. April 6, 2009 No: 124 dtd. April 17, 2009 No: 125 dtd. April 17, 2009 No: 85 dtd. March 31, 2010 No: 96 dtd. April 23, 2010 No: 49 dtd. October 7, 2010
2	Non-Industrial	Special Regulatory concessions available subject to compliance of norms	No: 37 dtd. August 27, 2008 No: 121 dtd. April 6, 2009
3	Commercial Real Estate	Special Regulatory concession is not available after 1 st July, 2009. To be classified as NPA	No: 93 dtd. December 8, 2008
4	Capital Market	To be classified NPA	No: 37 dtd. August 27, 2008
5	Consumer & Personal	To be classified NPA	No: 37 dtd. August 27, 2008
6	Housing Loans	Can be restructured; AC depends upon compliance of sanction terms	No: 37 dtd. August 27, 2008 Dtd. November 3, 2008
7	Agriculture	Restructuring on account of natural calamities, to be governed by special norms prescribed by RPCD	Master circular on agriculture advances affected by natural calamities and ADWRS circulars

Let us review the norms as per the Regulator, as per its Circular.

DBOD.BP.PC.17/21/048/2009-10 dated 1st July, 2009

S. No		Remarks	Criteria
1	Eligibility	Standard/substandard/doubtful assets; Account can be single/multi banking/syndication or consortium; Corporates or non-corporates engaged in any activity; consumer and personal advances excluded; Capital market exposure with funded and non-funded outstanding of above ₹10 crore	a) Financial viability to be established; b) Retrospective rescheduling/restructuring/renegotiation not allowed; c) Accounts tainted with fraud/malfeasance and loss assets to be excluded; d) Accounts of willful defaulters may be entertained with board's approval;
2	Performing Status	Not to be downgraded if certain conditions are met	Package to be implemented within 120 days of its approval by the appropriate authority;

S. No		Remarks	Criteria
3	Condition 1 Security	To be fully secured with tangible security	Tangible security to include primary/collateral/bank guarantee/government guarantee; Exceptions: SSI accounts with outstanding of ₹25 lakh and below: Infrastructure projects provided the cash flows are adequate for repayment, escrow mechanism in place and bank to have a clear and legal first claim on the cash flows
4	Condition 2 Viability	It should be viable over a period of seven years	For infrastructure projects, a 10-year period can be considered
5	Condition 3 Repayment Period	Not to exceed 10 years including period of moratorium	For infrastructure projects, a 15-year term may be considered
6	Condition 4 Promoters Contribution	Promoters sacrifice and additional funds should at least be 15% of bank's sacrifice	
7	Condition 5 Personal Guarantee	Personal guarantee of the promoters should be available.	Exception would be only for units affected by external factors relating to the economy and the industry
8	Condition 6 Repeated Restructure	Account should not have been restructured earlier; restructure would include modification in terms of advance/securities such as repayment period, repayable amount, number of installments, rate of interest (other than due to competitive reasons)	Extension of repayment tenor of a floating rate loan so as to keep the EMI's same if made applicable to a class of loans, will not amount to restructure

As per the above, one of the conditions is that promoters should bring additional funds to a minimum of 15% of the bank's sacrifice. This requirement has been modified in the Circular 49 dated 7th October, 2010, in that the promoters can bring in upfront one-half (50%) of the said 15% and the balance within a period of one year. If no additional funds are brought in, i.e. upfront or within one year, the asset classification would revert back to the position on the date of reference. The above circular also stipulates that the promoter need not necessarily bring their contribution in cash and they can be brought in the form of de-rating of equity, conversion of unsecured loan into equity or as interest free loans.

One should keep in mind that the core of the restructure is establishment of viability through cash flow. If cash flow includes promoters' fund which is critical for viability and if it is not brought in, the entire exercise of restructuring would turn out to be ineffective, futile and infructuous. Similarly, conversion of existing unsecured loan into equity, if was not envisaged in the original sanction, the same also would affect the cash flow and perhaps its viability as well. Any change in the cash flow affecting the viability and repayment should be commented. The modification in terms even if it is as per the regulator's circular cannot be at the cost the proposed cash flows.

On the conditionality of the account being fully secured, a partial modification was introduced with

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reference to waiver of security for WCTL as per para 5 of the Circular 124 dated 17th April 2009, but has been done away with, thereby making the full security cover essential for WCTL accounts as well.

By the Circular 125 dated 17th April, 2009, for project loans, rights, licenses, authorisations, etc., charged to banks as collaterals were not to be reckoned as tangible securities.

However, vide the Circular 96 dated 23rd April, 2010, for infrastructure projects, banks may treat the annuities under the BOT model in respect of road/highway projects and toll collection rights (where there are provisions to compensate the project sponsor), which are legally enforceable and irrevocable and which operate through a mechanism of escrow accounts, as tangible securities.

B. Project under Implementation

For all project loans, the date of commencement of commercial operations (DCCO) is to be fixed at the time of financial closure and is to be mentioned in the sanction order. As per the RBI norms, any delay by a period of two years for infrastructure and six months for non-infrastructure projects beyond the DCCP fixed in the original sanction renders the account NPA. RBI Circular DBOD No: BP BC 85 dated 31st March 2010, introduced certain modifications in this regard. The circular outlines the following steps to be taken before calling such an account non-performing:

1. First step is to classify the loans into Infrastructure and non-infrastructure categories.
2. Both the infrastructure and non infrastructure loans will be classified NPA if there are arrears of interest/ installments beyond 90 days.
3. An infrastructure loan will be classified NPA, if it does not commence operations, two years beyond the DCCP mentioned in the original sanction unless an extension is granted.

4. The non-performing status would befall on the loan even if there are no arrears beyond 90 days.
5. A non-infrastructure loan will be classified NPA, if it does not commence operation six months beyond the DCCP mentioned in the original sanction unless an extension of period is granted.
6. An extension of time for the DCCP amounts to restructuring.
7. In addition to mere extension, the existing terms and conditions can be restructured and rescheduled.
8. Also, the installment amount and schedule of the loan can be modified, if there is an increase in scope and size of the project (and this modification is not treated as an exercise in restructuring) provided:
 - (a) The rise in cost is due to increased scope and the quantum is 25% or more of the original project cost;
 - (b) The project is viable;
 - (c) The new rating is not below the previous rating by more than one notch; and
 - (d) The increase in scope and size of the project takes place before the commencement of commercial operation of the existing project. (Here the word "existing" means original.)
9. For infrastructure projects, the additional period of extension for fresh DCCP can be given:
 - (a) If the delay is attributed to reasons involving court/arbitration cases, the additional period can go up by another two years, i.e. total of four years from the DCCP mentioned in the original sanction; and
 - (b) For all other reasons, additional period of extension is one year, i.e., a period of three years in all.
10. For non-infrastructure projects, the additional period of extension can be given another six months, i.e. a total period of 12 months from the original DCCP.
11. Since an extension of additional time would amount to restructuring, all the usual conditions of the restructuring circulars have to be complied with, as described under Para A (3) above.
12. If moratorium is given for payment of interest, bank cannot account interest income on accrual basis for the extended period of DCCP.
13. For a list of approved categories of infrastructure projects, one may refer to the master circular on loans and advances.

C. Treasury

Settlement date accounting:

By the Circular 58 dated 4th November, 2010, the accounting procedure for investment in securities has been modified to settlement date for recording

purchase and sale. Interestingly, *this modification is available for government securities and not for other investments like equity and other instruments.*

Exposures in Derivative contracts:

By the Circular 48 dated 1st October, 2010, bilateral netting of counter party credit exposures in derivative contracts are not permitted on MTM valuations, for the purpose of capital adequacy and exposure norms.

Sale of HTM investments:

As per the Circular 34 dated 6th August 2010, if the value of sale and transfer of securities to/from HTM category exceeds 5% of the book value of investments held in HTM category at the beginning of the year, bank should disclose the market value of the investments held under HTM and indicate the excess of book value over market value for which provision is not made.

By the Circular 56 dated 1st November, 2010, it was clarified that the one time transfer of transfer of securities to/from HTM at the beginning of the year and sale to RBI under pre announced OMO auctions will be excluded from the 5% cap. Further, banks are permitted to undertake repos from HFT, AFS and HTM categories

Zero Coupon bonds:

By the Circular 44 dated 29th September, 2010, banks have been prohibited from investing in zero coupon bonds issued by corporate and NBFCs unless the issuer builds up sinking funds for all accrued interest and invests the fund in liquid securities. Such investments normally form part of restructure proposals involving conversion of FITL. (Refer also to the master circular on the valuation of zero coupon bonds.)

Investments in bonds issued by infrastructure companies:

By the Circular 97 dated 23rd April 2010, investment by banks in long term bonds issued by companies engaged in executing infrastructure projects and having a minimum residual maturity of seven years may be classified under HTM. While reckoning this seven-year term, the regulator has clarified that the minimum residual period of seven years is relevant only at the time of investment in bonds. Banks can continue to classify them under HTM even if the residual period falls below seven years after the initial investment.

Investments in unrated non-SLR securities:

Bank's investment in unlisted non-SLR securities has been restricted to 10% of its total investments in non-SLR securities as on the previous March figure. Banks are allowed to invest in unrated bonds issued

By the Circular 58 dated 4th November, 2010, the accounting procedure for investment in securities has been modified to Settlement date for recording purchase and sale. Interestingly, this modification is available for government securities and not for other investments like equity and other instruments. ☺

by companies engaged in infrastructure activities up to 10% within the ceiling of unlisted non-SLR securities. By the Circular 98 dated 23rd April, 2010, it is stated that during the time lag between issuance and listing of such securities with exchanges, such investment is considered as listed. However, if such a security is not listed within the specified period, the same will have to conform to the ceiling of 10% and no further investment would be allowed until the cap is reduced to 10%.

D. Provisioning Requirements

1. Provision on Standard assets:

By the Circular 58 dated 5th November, 2009, the provision requirements for standard assets were given as under:

(a) Direct advances to agriculture and SME sector: (reduced from 0.40 to 0.25)	0.25%
(b) Commercial real estate sector	1.00%
(c) All other advances	0.40%

The regulator has since clarified that the reduction to 0.25% is applicable to micro industries and not to medium enterprise and letters SME means small and micro enterprise, not medium enterprises.

Provision with respect to sacrifice on applying present value in restructured accounts:

Detailed guidelines are given in the Circular 121 dated 9th April 2009, on the computation of diminishing in fair value of a restructured loan and provision required to be made in this regard. With the adoption of base rate system from 1st July 2010, it is possible that the sacrifice may have to recomputed and provided in the years when the base rate undergoes a change. It is also stated in the RBI circulars that interest rate reduction due to market forces may not necessitate the re-calculation of sacrifice and provisions.

Provision on Project Loans where extension given for DCCP:

As stated earlier by the Circular 85 dated 31st March, 2009, additional provision on standard restructured accounts where extension is given to the DCCP both

for infrastructure and non-infrastructure accounts:

S. No	Percentage	Infrastructure	Non infrastructure
1	0.40%	Until two years from the original DCCO	Until the first six months from the original DCCO
2	1.00	During the third & fourth year after the original DCCO	During the next six months

Provision for housing loans on teaser rates:

Apart from specifying 'loan to value' caps on housing loans and identifying the risk weights to be adopted for such loans, the regulator has also stipulated a provision of 2% on such loans which are in standard asset category. Once they move into higher rates, a year after they maintain their performance on such higher rates, a lower provision of 0.40% is made applicable to them.

It is mandatory for banks to reimburse its customers on account of failed ATM transactions within 12 working days, failing which the banks shall pay a penalty of ₹100 per day. Banks will have to furnish to the regulator every quarter details of such penalties, reasons for delays and details of action taken.

Banks shall make 100 % provisioning for all unreconciled debit entries outstanding for a period exceeding two years in their Nostro accounts, which originated on or after 1st April, 2002.

All credit entries which originated after 1st April, 2002 and which are outstanding for more than three years, should be transferred to a blocked account and shown as outstanding liabilities. They should be reckoned for CRR/SLR purposes.

Disclosures:

Base Rate: By the Circular 88 dated 9th April, 2010, banks are required to disclose the Base Rate transparently.

HTM investments: By the Circular 56 dated 1st November, 2010, bank should disclose the market value of HTM investments over the book value where the transfer to/from HTM exceeds 5% of the book value of HTM at the beginning of the year.

Bank's investment in unlisted non-SLR securities has been restricted to 10% of its total investments in non-SLR securities as on the previous March figure. Banks are allowed to invest in unrated bonds issued by companies engaged in infrastructure activities up to 10% within the ceiling of unlisted non-SLR securities. By the Circular 98 dated 23rd April, 2010, it is stated that during the time lag between issuance and listing of such securities with exchanges, such investment is considered as listed. ☺

E. A Few of Important Circulars Issued By Regulator in Last One Year

1. Prudential coverage ratio- DBOD BP BC 87- 21/04/2011
2. Enhancement of rates of provisioning for NPAs and restructured accounts-DBOD BP BC 94 -18/05/2011
 - On substandard secured advances - Provisioning to be 15% of the outstandings
 - On substandard unsecured advances - Provisioning to be at 25% of the outstandings
 - Unsecured infrastructure advances with escrow safeguards - Provisioning to be 20% of the outstandings
 - On doubtful assets (up to one year) category - 25 % of the secured portion
 - On doubtful (in one to three year) category - 40% of the secured portion
 - On doubtful assets of three years and beyond - 100% of the outstandings to be provided
 - The unsecured part of doubtful assets will continue to get provided at 100%
 - Restructured standard assets to be provided at 2%
 - Restructured assets which get upgraded will have to be provided at 2% up to a period of one year from the date of upgradation
3. Maintenance of SLR- DBOD Ret BC 92- 09-05-2011
4. Accounting for repo/reverse repo transactions- clarification - IDMD 29-30/05/2011
5. Investments in units of domestic mutual funds - A.P. (Dir) 8 – 09/08/2011
6. Prudential norms for off balance sheet exposures - DBOD BP BC 28 -11/08/2011
7. Inclusion of credit under KCC under direct financing for agriculture -13/10/2011
8. Comprehensive guidelines on derivatives: Modifications - DBOD BP BC 27- 02/08/2011
9. Comprehensive guidelines on derivatives: Modifications - DBOD BP BC 44 – 02/11/2011
10. Reduction in CRR- DBOD Ret BC 74- 24/01/2012

(Note: This article aims to provide a snapshot of the recent pronouncements from the Regulator (RBI) and by no means can it be called complete). ■