Verification of Advances with Special Reference to Prudential Norms

In absolute figures NPAs have doubled in last three to four fiscals. As per PTI report on 14th December 2012 in current fiscal in Nationalised banks alone frauds reported in first six months from April to September 2012 are to the tune of ₹5,200 crore. RBI is very strict with KYC and anti- money laundering norms, and irregularities in these are viewed seriously and penalties are being imposed on banks for non adherence to this norms. Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. Extension in moratorium period should not be allowed afterwards unless justified by strong convincing reason/evidence of genuine reason. Banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner. The date of NPA is very important as that will determine the age of NPA hence we need to verify critically the actual date on which account has turned NPA. In no situation the date NPA should be changed. We have to see the advances are being paid off from genuine sources and not by ever greening techniques. It is intended to cover in this article, the latest Prudential norms related to verification of advances.

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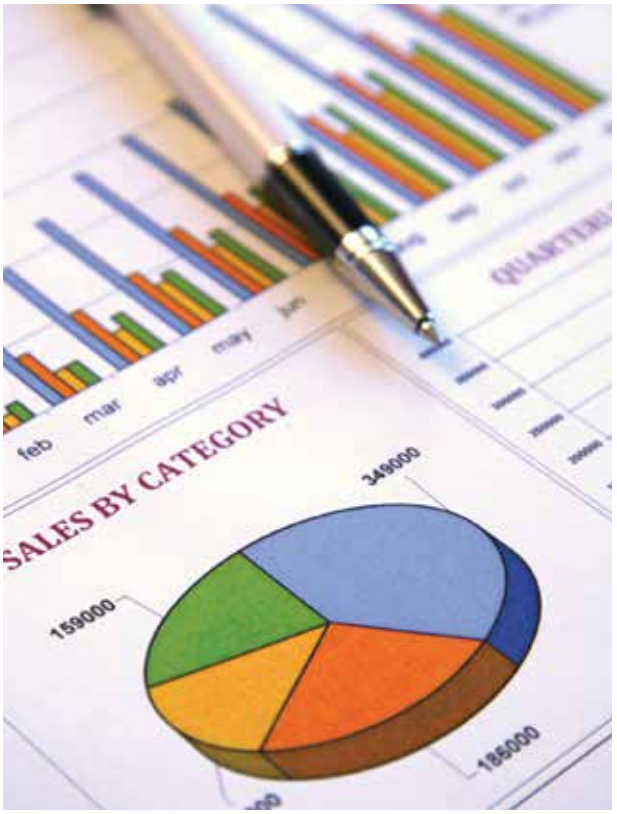

There has been a sea change in business dynamics of banking in India due to entry and growth of private sector banks. All banks are under pressure for growth in business. Comparatively lesser number of borrowers is approaching banks but banks are in search of good borrowers to retain their business. This has led to pressure on banks to increase business. Due to this, loans are given to parties who are otherwise financially not very sound. Also, overall economic slowdown has further put pressure on banking. In absolute figures, NPAs have doubled in last three to four fiscals. The manufacturing sector is not performing well, service sector too is under pressure for margins. Software/ITES, which is major export revenue earning sector, has also not done good and same is the case with sectors like aviation and to a great extent insurance. In turn there is pressure of recovery of such loans and threat of advances becoming Non Performing Asset (NPA). Overall, recovery of advances is delayed and or it is strictly not as per schedule. In such weak cases,

the banks are aggressive in follow up for recovery and latterly counting 90 days time line so that the account does not turn out to be NPA. This scenario has led pressure on we as auditors to verify the status of the accounts and take a call whether a particular account needs to be classified as NPA or not.

Further we as auditors face many challenges in bank audit. Technological developments have completely changed bank audit scenario in CBS environment. Issue of late appointment and lesser availability of time for audit is also there as not only the appointments are done in mid-march by some of the banks but also they allow beginning the statutory audit early.

Another reason of concern is that banking sector is fraud prone and it again increases our responsibilities in carrying out bank–branch audit. There have been many scams in banking sector. As per PTI report on 14th December 2012 in current fiscal in Nationalised banks alone frauds reported in first six months from April to September 2012 is to the tune of ₹5,200 crore, which has increased many fold if we compare it with an earlier report of 25th February 2010 which said that frauds have cost banks ₹5,517 crore in last four fiscals from April 2005 to March 2009.

RBI is very strict with KYC and anti-money laundering norms, and irregularities in these are viewed seriously and penalties are being imposed on banks for non adherence with these norms.

Due to above-mentioned developments, in bank audit, we need to plan very well so that we are able to carry out audit effectively. There are various acts applicable in bank audit but we must be up to date with RBI guidelines and requirements for banking sector. Most of these guidelines are issued by RBI trough circulars, which are available on Reserve Bank of India's website i.e. www.rbi.org.in.

Verification of advances is one of the important aspects of bank audit. While doing verification of advances, impact of irregularities needs to be seen from the point of view of its asset classification. Advances are classified based on RBI Guillotines. Originally RBI had health code system which was replaced by IRAC norms way back in 1992-93. Now income recognition norms are made objective based on record of recovery.

Any irregularities having bearing on NPA (Non-Performing Asset) status of the advances needs to be examined carefully. In other words, while examining any advances; we need to check what will be the impact of irregularity in advance on its NPA status. As per RBI circular, when asset cease to generate income, it becomes NPA.

Reserve Bank of India every year issues Master circular for norms for classifications of Advances in various categories of NPA. This year like every year RBI has issued master circular DBOD.No.BP.BC.9 /21.04.048/2012-13 on 2nd July, 2012 Key points of the circular are summarised as under:

Type of facility	To be Classified as NPA if
Term Loan	Interest and/or installment of principal remain overdue for more than 90 days.
Working Capital Finances (Over draft and Cash Credit)	If accounts remain out of order for more than 90 days. Out of order: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account 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, these accounts should be treated as 'out of order'.
Bills	The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
Agricultural Advances	**Short duration crops** The installment of principal or interest thereon remains overdue for two crop seasons. **Long duration crops** The installment of principal or interest thereon remains overdue for one crop season. **Natural calamities** Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulment of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines contained in RBI circular DBOD. No.BP.BC.9 /21.04.048/2012-13.

Type of facility	To be Classified as NPA if
Liquidity Facilities	The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated 1st February, 2006
Derivative Transactions,	The overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.
Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.	

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

Further advances needs to be classified in categories as Standard, Sub-standard, Doubtful and loss Asset. Following are criteria for classifications of NPA:

NPA Category	Criteria for classification
Sub- Standard Asset	A substandard asset would be which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.
Doubtful Asset	An asset would be classified as doubtful if it has remained in the sub¬standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable. For provisioning, Doubtful Assets are further classified as per age in doubtful category, in sub- categories generally called as D-1, D-2 and D-3.
Loss Asset	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 asset is not warranted although there may be some salvage or recovery value.
Accounts where there is erosion in the value of security/frauds committed by borrowers	In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non¬availability of security and existence of other factors such as frauds committed by borrowers it will not be prudent that such accounts should go through various stages of asset classification. In cases of such serious credit impairment the asset should be straightaway classified as doubtful or loss asset as appropriate:

Value	Classification to be done
Less than 50 %	Doubtful Asset
Less than 10 %	Loss Asset – Full Provision

Internal Control Systems to Eliminate Tendency to Delay or Postpone Identification of NPAs

Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. The banks may fix a minimum cut-off point to decide what would constitute a high value account depending upon their respective business levels. The cutoff point should be valid for the entire accounting year. Responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines.

So, in any case let's say advance was becoming NPA on 30th June 2012 and there was a doubt about whether that advances needs to be classified as NPA or not? Any such doubt should be resolved by bank by July 2012.

Other issues in classifications of advances as NPA:

Accounts with Temporary deficiencies	Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, Drawing power is required to be arrived at based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding which is older than three months would be deemed as irregular. It will become NPA if irregular drawings are permitted for a continuous period of 90 days even though the unit may be working or borrower's financial position is satisfactory.
Regular and ad hoc credit limits	Regular and ad hoc credit limits need to be reviewed/regularised not later than three months from the due date/ date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/renewed within 180 days from the due date/date of ad hoc sanction will be treated as NPA.
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 handled with care 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 banks must furnish satisfactory evidence to the Statutory Auditors/Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.
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 installment of principal or payment of interest on the respective due dates. In my view, extension in moratorium period should not be allowed afterwards unless justified by strong convincing reason/evidence of genuine reason.
Government Guaranteed Advances	Central 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. State Government guaranteed Advances 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.

Other Points to be considered in classification of an advances as NPA:

- Asset Classification needs to be done borrower wise and not facility wise, hence even if one small facility is NPA large borrower's all accounts will become NPA.
- Consortium Advances: 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.
- 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, provided adequate margin is available in the accounts.
  Here plain reading of the RBI circular says advance against life policies need not be treated as NPA. In my view intention must be to exempt only advances against traditional plans issued by Life Insurance Corporation of India and not advances against life policies such as ULIP or which are issued by private companies may not be covered by this exemption.
- Advances against gold ornaments, government securities and all other securities are not covered the NPA classification exemption.
- Valuation of Security for provisioning purposes
  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 ₹5 crore and above stock audit at annual intervals by external agencies would be mandotary in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

Provisioning Norms

Standard Assets	(A)direct advances to agricultural and SME sectors at 0.25%; (b) advances to Commercial Real Estate (CRE) Sector at 1.00%; (c) all other loans and advances not included in (a) and (b) above at 0.40%
Sub-standard Assets	Secured exposure: 10% on outstanding balance unsecured exposures for escrow accounts available in respect of infrastructure lending, infrastructure loan accounts: 15% on outstanding balance Other unsecured exposures: 20% on outstanding balance
Doubtful Assets	Unsecured Portion : 100% Secured Portion :

Period for which the advance has remained in 'doubtful' category	Provision requirement (%)
Up to one year –D1	25
One to three years-D2	40
More than three years –D3	100

Loss Assets	100 %

Income Recognition

The policy of income recognition has to be objective and based on the record of recovery. Internationally income from non-performing assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, the banks should not charge and take to income account interest on any NPA.

However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised 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 realised.

Interest Application/Reversal of Income

On an account turning NPA, banks should reverse the interest already charged and not collected in the past periods by debiting Profit & Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books. For the purpose of computing Gross Advances, interest recorded in the Memorandum Account should not be taken into account.

This will apply 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 with respect to past periods, if uncollected.

Leased Assets

The *finance charge* 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 unrealised, should be reversed or provided for in the current accounting period.

Appropriation of Recovery in NPAs

Interest realised 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.

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e. towards principal or interest due), banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

Zero Per Cent Interest Finance Schemes for Consumer Durables

As per the circular RBI/2012-13/70 DBOD.No.Dir. BC. 5/13.03.00/2012-13 dated on 2nd July, 2012 banks should refrain from offering low/zero percent interest rates on consumer durable advances to borrowers.

As per the circular RBI/2012-13/79 DBOD.No.Dir. BC.4/13.03.00/2012-13 dated 2nd July 12

Advances Against Bank's Own Shares

In terms of Section 20(1) of the Banking Regulation Act, 1949, a bank cannot grant any loans and advances on the security of its own shares

Advances to Bank's Directors

2.1.2.1 Section 20(1) of the Banking Regulation Act, 1949 also lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest

Guidelines on Settlement of Non Performing Assets-Obtaining Consent Decree from Court

We have to verify that once a case is filed before a Court/DRT/BIFR, any settlement arrived at with the borrower is subject to obtaining a consent decree from the Court/DRT/BIFR concerned.

Certain Practical Points

- The date of NPA is very important as that will determine the age of NPA hence we need to verify critically the actual date on which account has turned NPA. In no situation the date NPA should be changed.
- In case NPA, the auditor should carefully examine security as it will change the amount of provisioning if advances are found to be unsecured.
- The advance becoming NPA is important date and needs to be examined whether the same is correctly determined as age of NPA determines its provisioning amounts.
- The restructuring of advances should not be repeated restructuring.
- There are various ever greening techniques are being resorted for not classifying advance as NPA; we have to see the advances are being paid off from genuine sources and not by ever greening techniques.
- Restructuring should be allowed in genuine cases. Restructuring should be done before account become NPA else the account would continue to remain as NPA if it was taken up for restructuring after it become NPA. Application of restructuring should be backed with all necessary projections of financial viability and should have all documents needed for considering the case for restructuring. Repeated restructuring should not be allowed. Advances should financially viable for granting restructuring. Loss in present value of money due to restructuring needs to be provided for.

Conclusion

We have to keep in mind many aspects while verifying the advance account such as application, credit appraisal, documentation, review monitoring and recovery etc. As classification, provisioning and income recognition is governed by RBI norms, we have to carry out audit of advances based on latest RBI norms and directives. ■