

Structuring Audit Skills on Restructured Advances



This article aims at bringing about the key areas of the bank branch audit particularly relevant to the year 2015-16, in the advent of the latest developments in the regulatory framework. The offshoot of restructuring of advances in the banks, both under CDR mechanism and non CDR mechanism, has posed many challenges for the branch auditor at the branch level. The special regulatory treatment for restructured advances also has expired on 31st March 2015. Thus, the verification of restructured accounts has to be done keeping in mind the strictures given by the regulators prior to 31st March 2015 and post 1st April 2015. The intricate procedures and instructions have a direct impact on the quality of our audit function. Thus, it is imperative for the branch auditor to know the process and procedures of the restructured accounts and their audit checks and balances. Read on...

The Background

The Reserve Bank of India has given autonomy to all the banks to restructure the loans of borrowers *vide* Circular No. *DBOD.No.BP.BC.9/21.04.048/2012-13 2nd July 2012, Part- B Para 9 to 18*. The restructuring of advances can be done by CDR or non CDR mechanism. All the banks have framed their rules and regulations within the regulators' overall

framework for bringing efficacy of their systems. We the auditors, both at the branch level and the central audit level, have to sharpen our knowledge and skills to be watch dogs to monitor the whole process and its implementation from the legal and pragmatic angle while exercising our attest function as auditors.

To take cognisance of the deteriorating situation of asset quality in banks and to arrest further delinquency in loan accounts, a discussion paper was mooted on 17th December 2013 and a comprehensive guideline was framed captioned ***Frame Work For Revitalizing Distressed Assets In The Economy*** on 30th January 2014. This was further fine-tuned to introduce the strategic debt restructuring (SDR) mechanism *vide* RBI Circular No *DBR/BP.BC.*



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No.101/21.04.132/2014-15 dated 8th June 2015. The SDR is aimed at taking the control of management of the borrower entity to revitalise the asset and the entity also. The disincentive of imposing a penalty of enhanced provisioning of 5% on such standard assets which does not confirm with the later instructions is also made. All these efforts are done by the regulators with the intent to bring back the sound asset quality.

This article covers the entire gamut of restructured accounts, the auditors' focus and check list for verification of such assets and a brief description on revitalising of distressed assets introduced on 30th January 2014.

The Salient Features

The Corporate Debt Restructuring Mechanism (CDR):

- The CDR is introduced for loans of industrial and non-industrial borrowers enjoying multiple banking or consortium banking facility.
- The CDR mechanism will cover only multiple banking accounts/ syndication/ consortium accounts of corporate borrowers engaged in any type of activity with outstanding fund-based and non-fund based exposure of ₹10 crore and above by banks and institutions.
- CDR is a non-statutory mechanism which is a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA) shall provide the legal basis to the CDR mechanism.
- The viability of the project and future cash flows is the prime eligibility criteria for restructuring.

Timing of Restructuring of Advances:

The accounts can be restructured at any time during the tenure before or after commencement of commercial production/operation and/or at any stage of classification of advance under standard, sub-standard or doubtful. However, assets classified as standard shall be immediately classified as sub-standard on restructuring.

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Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package.

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Eligibility Criteria for Restructuring of Advances:

- Banks may restructure any accounts classified otherwise as a loss asset.
- Banks cannot reschedule or restructure loan accounts with retrospective effect.
- Each restructuring has to be with a detailed proposal *suo moto* by banks or against application of the borrower. However, if it is done *suo moto* by banks, the terms of restructuring has to be agreed upon by the borrower.
- The process of reclassification of an asset as per prudential norms should not stop merely because restructuring proposal is under consideration.
- The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide asset classification after restructuring/rescheduling/renegotiation.
- If there is undue delay in sanctioning and in the meantime assets quality further undergoes deterioration, it would be a matter of supervisory concern.

Asset Classification Norms of Restructured Advances:

- The NPAs, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule.
- Upgradation of asset classification is permitted on satisfactory performance of one year under restructured terms.
- If satisfactory performance after the specified 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.
- Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package.
- Provision against the restructured advances as per the existing provisioning norms should be held and cannot be written back on restructuring.
- Restructuring resulting in reduction in the rate

of interest and/or rescheduling of the repayment of principal amount will result in diminution in the fair value of the advance. Such provision should be held in addition to the provisions as per existing provisioning norms.

- Erosion in the fair value of the advance should be computed as the difference between the "fair values" worked out based on present value of cash flows from advance before and after restructuring. This along with the usual provisions should not be more than 100% outstanding.
- A portion of the unserviced interest can be funded as a distinct loan called the "funded interest term loan" (FITL).
- The FITL created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified.
- The unrealised income represented by FITL should have a corresponding credit in an account styled as "sundry liabilities account".
- Only on repayment in case of FITL, the amount received will be recognised in the profit and loss account, while simultaneously reducing the balance in the "sundry liabilities account".

Features of Special Regulatory Treatment of Restructured Advances:

- As an incentive to quick implementation of CDR and non CDR mechanism, package of restructuring would be granted special regulatory treatment with respect to asset classification.
- The accounts satisfying the conditions would be restored with the asset classification as on the date of reference to the CDR cell or as on the date of receipt of application from the borrower by the bank/branch in respect of non CDR cases.
- The advances covered under CDR mechanism have to implement the package within 120 days of approval by CDR Cell.
- In non CDR cases, the bank has to implement the restructuring package within 120 days of receipt of application.
- The unit becomes viable within 5 years and in case of units engaged in infrastructure, the viability time is relaxed up to 8 years.
- Repayment period is not exceeding 10 years and 15 years in case of infrastructure units except in the case of home loans.

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- The promoter to bring minimum 20% of bank sacrifice or 2% of restructured debt whichever is higher up front.
- Promoters to furnish personal guarantee for the restructured debt.
- However, in both CDR and non CDR cases, the advance should be fully secured by tangible assets, except for advances granted to:
 - MSE borrowers, where the outstanding is up to ₹25 lakh.
 - Infrastructure projects, where cash flows are satisfactory and have established legal first claim on such cash flows by escrow mechanism.

Frame Work for Revitalising Distressed Assets in the Economy

The Master Circular on prudential norms issued on 1st July 2014 vide Part-C described and insisted the bankers for early detection of financial distress and for proactive steps to be taken to revitalise the distressed assets. The salient features include:

- The bankers to identify incipient weakness in a loan account and classify it under the category of Special Mention Accounts or SMAs.
- The broad categories of SMAs are SMA-0, SMA-1 and SMA-2. Where SMA-0 is an account where the interest or principal is overdue for payment for more than 30 days and account showing incipient stress. SMA-1 is that where the weakness exists between 31 to 60 days and SMA-2, 61 to 90 days.
- The bankers have to compulsorily upload the information about SMA accounts to a data domain called CRILC or Central Repository of Information of Larger Credits. Accelerated provisioning have been insisted for non-compliance vide Para 26.
- Bankers to mandatorily form a Joint Lenders Forum (JLF) for all accounts identified as SMA-2 where the total exposure under fund based and

non-fund based (aggregate exposure/AE) exceeds more than ₹ 1,000 million. The formation of JLF is optional for accounts less than ₹ 1,000 million. However, all other conditions apply for AE below ₹ 1,000 million also.

- JLF is to be formed by leader of the consortium or otherwise lender with the highest AE.
- JLF to explore possibilities of correcting weakness in the account and to arrive at a feasible solution to preserve the economic value of the underlying assets called the Corrective Action Plan or CAP.
- The CAP should include obtaining a commitment from the borrower to regularise the account before slipping it to NPA, provide additional finance on a need based formula, consider restructuring the advance if the borrower is not *prima facie* a willful defaulter, recommend for taking up the case with the CDR Cell for restructuring under CDR mechanism, etc.

Strategic Debt Restructuring Mechanism

Further to the above mechanism of revitalisation of assets, RBI *vide* Circular DBR/BPBC. No.101/21.04.132/2014-15 dated 8th June 2015 has introduced the Strategic Debt Restructuring (SDR) mechanism. The back drop of the SDR mechanism is the persistent irregularity and the companies not able to come off the stress due to operational and management inefficiencies. The banks have made substantial sacrifice to the restructuring and with a view to ensure more “skin in the game” of promoters, the bankers are to explore the possibility in the JLF and actively consider the option of change in ownership. The salient features of the same are:

- *The initial covenants of the restructuring by JLF itself should incorporate the option to convert the entire loan including the unpaid interest.*
- *The approvals and authorisation from the stake holders as per the law and regulation have to be obtained which is a pre-condition for restructuring. The time limit of 90 days is fixed for the JLF to approve the SDR conversion package.*
- *The bankers after examining the viability of entering into ownership should convert the loan and interest to equity so as to be sure that the bankers collectively acquire the majority shareholding in the company. Further, as soon as possible divest the holdings in favour of a new promoter.*
- *The invocation of SDR will not be treated as restructuring for the purpose of asset classification and provisioning would be continued as per IRAC*

norms only after a period of 18 months from the reference date.

- *The pricing formula of the shares acquired under SDR would be exempted from SEBI regulations subject to certain conditions and exempted from regulatory ceiling on capital market exposures provided it is reported to RBI in due course.*

Challenges to be Addressed

The challenges faced by the auditors are manifold in verification and validation of restructured accounts. The central statutory auditors as well as the branch auditors have their own role to play to consolidate the efforts to ensure a true and fair presentation of the financial statements.

- The viability of the project is a prime condition for any restructuring. The pragmatic and rational assessment of the viability is a matter of audit concern. Many a times, the crux of restructuring itself have failures due to irrational and illusionary assessments of the *technical evaluation of viability called the TEV*. The auditors have to assess the viability from the broad parameters set in by the RBI *vide* Appendix Part B of the Master Circular on prudential norms dated 1st July 2015 and by taking cognisance of the ground realities involved.
- The *Master Circular No. DBR No. BPBC2/21.04.048/2015-16 DT. 01/07/2015* has reiterated in Para 19.2.5 that the creating of sundry liabilities account as a back to back entry while granting any loans for funding the interest component, known as funded interest term loan (FITL). There is a misconception that the figures for the funded interest term loans and the sundry liability created back to back should tally at the global level. There can always be differences between the two, mainly due to the interest loaded to the FITL account which remains uncollected till the FITL account is classified as standard asset. The CSAs should be verifying the reconciliation of the aggregate balance in the

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FITL accounts to the sundry liabilities account, at the global level.

- The implementation of calculation of NPV to address diminution in value of asset is followed by different banks in different ways. The compliance of salient factors as prescribed *vide* Para 12.4.2 of *Master Circular DBOD.No.BP.BC.9/21.04.048/2014-15* of RBI is a matter of audit concern. The CSA should take up the challenge to vouch and ensure that the logical links established in the calculation are proper and considering the fact that parameters as prescribed to give the accurate figures in spirits. Further, the diminution in value has to be recalculated at every balance sheet date with any further developments in relaxation or conditions of sanction terms granted, if any, from time to time.
- The major aspect to be considered is the slipping of restructured accounts to NPA during the course of the year. It is stipulated that such accounts should be treated at par with any other accounts totally ignoring the restructuring process. Any default by the borrower in adhering to the repayment commitments has to be dealt with in the manner prescribed in Annexure 7 of Master Circular on IRAC norms in the year 2012 which *inter alia* include:
 - *To withdraw the concessions/reduction granted while restructuring and restore the account at the pre-restructured status.*
 - *To classify the advance as per regular course from the original date of NPA at the pre-restructured amount.*
- The stipulation and enforcement of the recompense clause poses a great deal of difficulty in the real time. Any prepayment/closure or exit out of restructure by the borrower is allowed only after exercising the right to recompense i.e. the compensation specified while restructuring for prepayment should be collected. Refer Para 5.7 of Annexure No. 4 of the Master Circular. More often, this is not seen enforced at the ground level.

Apart from the above macro aspects, the following micro factors also are the challenges faced in the real time at the branch and at the head office level:

- The documentation standards, especially at the branch level, to get a written request and

The upgradation of the restructured accounts can be made only on satisfactory performance during the specified period of one year from the first payment of interest or principal on the credit facility with longest moratorium period as per restructuring package.

- acceptance of the restructuring of any loan account is reported to be poor and inadequate.
- Adherence of the CUT OFF date as informed by the CDR Cell/ bank authorities to the furtherance of the implementation of restructuring package.
- The infusing of promoters contribution and its timing is not properly factored while assessment of the classification of the restructured accounts.
- The system generated NPA statement often picks up the FITL accounts also slipping to be NPA and apply provisioning norms as in any other advance accounts. This leads to duplication of provisions, as the FITL accounts are created with a full back to back sundry liability account.
- The upgradation of the restructured accounts can be made only on satisfactory performance during the specified period of one year from the first payment of interest or principal on the credit facility with longest moratorium period as per restructuring package. Refer Para 12.2.4 and Para (vii) of Annexure 5 to the Master Circular *abid.*
- Proper classification and reporting to CRILC is made by the branch for identification and classification of an account under SMA- 0, 1 and 2. Critically analyse the incipient weakness in the account and report or recommend for classification as NPA.
- The head offices of all banks have facilitated to draw a report on SMA branch wise. If not, the branch auditor may get a management representation to this effect that no borrower account figures out in SMA category or report to central statutory auditor.
- The formation of JLF and reporting of the SMA accounts as per the guidelines are seen not done on a time bound manner by the branches.
- The CAP is implemented within the time line of 30 days from being reported as SMA-2 or from the date of request from the borrower as stipulated in Para 22.3 of Part C of Master Circular *abid.* ■