Case Studies in Non-performing Assets

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In banking, we can say that deposits make the banking possible, advances make the banking profitable and Non Performing Assets make the banks perishable. In past few years, we can observe that there is considerable increase in the bad loans in the banking sector in India especially in Public Sector Banks. As per Financial Stability report issued by the Reserve Bank of India for December 2019, Scheduled Commercial Banks' gross non-performing assets (GNPA) ratio was 9.3 per cent between March and September 2019 which indicates high level of NPAs in the financial sector. Further, the degradation of accounts from Standard to Non-performing Assets (NPAs) also increases the financial stress on the Public Sector banks. Read on...

During the past few years we have seen many banks being under the Prompt Corrective Action Framework by the RBI due to increase in their net NPAs.

Advances is one of the most critical part of the balance sheet of any bank and we as auditors are expected to certify the classification of advances as per the Income Recognition and Asset Classification (IRAC) norms issued by the Reserve Bank of India vide master circular on - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to *Advances No. RBI/2015-16/101 DBR.No.BP. BC.2/21.04.048/2015-16* dated 01st July 2015 and various other circulars issued by the RBI from time to time. Further, the RBI has instructed the banks to disclose the divergences in case additional gross NPAs identified by RBI exceed 15% of the published incremental gross NPAs for the reference period by the bank. Further, SEBI has also issued guidelines to the banks and had directed all listed banks to disclose any divergence in bad loan provisioning within 24 hours of receiving RBI's risk assessment report, rather than waiting to publish the details in their annual financial statements.

Due to this disclosure requirements, the responsibility of the auditors in respect of correct identification and provisioning of NPA accounts have increased manifold.

Identification of NPAs and case studies

Identification of NPAs is an important task in the audit of banks. Para 1.2, of the RBI master circular, states that 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.

Likewise, the policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Also, the provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof.

Non-performing Assets are any assets which cease to generate income for the bank. As per Para 2.1.2 of the master circular, an advance/loan account becomes a NPA where:

i. interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii. the account remains 'out of order' in respect of an overdraft/cash credit (OD/CC) for more than 90 days,

iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops.

The gist for classification of NPAs is that if any amount is overdue from the borrower for a period exceeding 90 days, then the account is to be treated as NPA.

Firstly, let us understand the meaning of 'Overdue'. Overdue means any amount which is due on a particular due date fixed by the bank but not paid on that due date. For example, a person had taken a personal loan of ₹ 2 lakhs from the lender on 30th June, 2019 on Equated Monthly Instalment (EMI) basis. The bank has fixed its date of payment of instalment as 10th of every month. If the borrower does not pay the EMI on or before the due date fixed by the bank which in the instant case is 10th then the account becomes overdue on 11th.

If any account remains overdue for a period exceeding 90 days then the account is to be treated as NPA.

Identification of NPAs of various types of advances, are explained below with the help of the following case studies.

1) Cash Credit Accounts/ Hypothecation of Goods Accounts

Cash credit accounts are running accounts and hence, are treated as NPA if it is out of order for more than 90 days. In this case, the account is deemed to be out of order if the following conditions are fulfilled:

a) The balance in the account is continuously in excess of the limit sanctioned/ drawing power whichever is lower for a period exceeding more than 90 days.

b) There are no credits in the account continuously for a period of 90 days as on the date of Balance sheet

c) Credits in the account are not sufficient to cover the interest debited during the account in the said period.

Drawing power should be calculated based on the stock statement which should not be older than 3 months. The outstanding in the account based on calculation of drawing power on the basis of stock statements older than 3 months will be deemed as irregular and if such irregularity continues for more than 90 days then the account will be treated as NPA.

> If any account remains overdue for a period exceeding 90 days then the account is to be treated as NPA

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.

Let us understand the identification of NPAs with the following illustrations:

Case I: The borrower had a cash credit limit of ₹ 50 crores and Non Fund Based Limit of ₹ 500 crores. On December 20, 2018, two BGs totaling ₹ 55.61 crores were invoked which were paid by overdrawing cash credit account. There were regular transactions in the account and sufficient credits were there in the account to take care of the interest debited during the said period. However, the balance outstanding was more than 50 crores continuously from 20/12/2018 to 31/03/2019. The drawing Power of the borrower was ₹ 50 crores as per the latest stock statement available on record. Hence, the account should be classified as NPA by the bank as the outstanding balance is in excess of Cash Credit Limit sanctioned or the drawing power computed, whichever is less.

Case II: There was an instance wherein the cash credit account was classified as standard by the bank on the basis of record of recovery. The account was regular and the transactions in the account were found to be satisfactory. The credits in the

account were sufficient to cover the interest debited during the said period. The account was properly renewed and the borrower was submitting the stock statements regularly on the basis of which the drawing power was calculated by the bank and the drawings were within the drawing power permitted as per the stock statement submitted by the borrower. *Prima facie,* there were no signs of weakness in the account. As the borrower was a large borrower, the stock audit was allotted and the stock audit report was on record. As per the stock audit report, it was observed that the stock statements submitted by the borrower were inflated and not in agreement with the actual stock verified by the stock auditor. Further, the valuation of stock was done at the market value instead of purchase price due to which the stock value was overstated. Further, the report stated that some of the raw material received by the borrower for job work, which did not belong to the borrower, was also included in the Stock Statement. As a result there was substantial decrease in the closing stock as calculated by the stock auditor and that as per the stock statement submitted by the borrower. Hence, the drawing power arrived at by the stock auditor was much lower than the sanctioned amount. As the balance outstanding in the account was in excess of the sanctioned limit/drawing power, the account needed to be classified as NPA.

Case III: Cash Credit account needs to be verified with regard to the accuracy of the data

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punched by the branch in the computer system with regards to the date of renewal. As per the IRAC norms mentioned earlier, if the account is not reviewed/renewed within 180 days from the due date, then the account will have to be treated as NPA. In some cases, it was observed that the branch personnel had just punched the date of renewal. However, no renewal papers were found on record. Hence, the accounts were classified as NPAs which were classified as Standard by the bank.

Case IV: The borrower had a cash credit limit of ₹ 50 crores. On December 30, 2018, Bank Guarantees totaling ₹ 25 crores were invoked and was parked in a separate advance bills account. The drawing power as per stock statements and stock audit report was ₹ 50 crores. The minimum balance outstanding in Cash Credit account during the last 90 days was ₹ 45 crores. Credits in the account were sufficient to cover the interest debited during the said period. As per Para 4.2.7 (ii) of the master circular, if the debits arising 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. Accordingly, if we assume that the devolved Bank Guarantee instead of debiting to advance bills account is debited to principal operating account of the borrower which is the cash credit account, then the balance outstanding in the cash credit account in the last 90 days will be more than the limit sanctioned. Minimum outstanding balance in the last 90 days will work out to ₹ 70 crores which is more than the limit sanctioned/Drawing Power of ₹ 50 crores. Hence, the account may be classified as Non Performing Asset.

Account regularised near 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. Further, the credits/repayment in the account should be out of income generating activities of the borrower, i.e., out of genuine sources and not out of any additional financing or window dressing. The different scenarios explaining the situations are:

Scenario I

The borrower was availing different credit facilities from the bank as follows:

Type of loan	Loan A/c no.	Sanctioned amount	Outstanding amount as on 30.03.2018	Outstanding amount as on 31.03.2018
Term Loan	1	1,50,00,000	1,70,55,098	1,32,83,098
Term Loan	2	55,00,000	43,95,798	17,34,798
Term Loan	3	50,00,000	57,28,576	41,43,576
Working capital loan	4	1,00,00,000	1,41,00,496	99,30,496
Loan against property	5	5,00,00,000	6,16,52,547 (as on 27.03.2018)	5,13,22,547

From the above table it can be observed that except term loan 2, all loan accounts were overdue till 30.03.2018. But on the Balance Sheet date, there is heavy recovery in these accounts resulting in recovery of total interest during the year.

On scrutiny of records, it was observed that the recovery in the accounts was due to additional loan given to the borrower by way of loan to the borrower with the purpose of business development. But instead of business development, the sanction proceeds were utilised to repay overdue amounts of above mentioned loan accounts sanctioned on 31.03.2018. As the recovery in the account is not out of income generating sources of the borrower, but out of the additional finance given by the bank, hence, in this scenario, the account may not be said to be regularised and would be classified as Non Performing Asset.

Scenario II

The borrower was having Term Loan account with the bank. As on 31st March 2019, total 12 instalments were outstanding amounting to ₹ 120000/-. There were no credits in the account during the year. However, on 31st March 2019, the borrower deposited cheque of ₹ 120000/- to clear the outstanding dues. Hence, the bank upgraded the account as on 31st March, 2019. However, subsequently, on 4th April, 2019, the cheque deposited got bounced. The bounced cheque should not be considered as credit in the account and accordingly the account is required to be degraded to Non Performing Asset instead of Standard asset.

2) Term Loans

Term loans are identified as NPAs if interest and/or instalment of principal remain overdue for a period of more than 90 days.

In case of interest payments, 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.

3) Advances under Consortium

The borrower was availing consortium advance with three banks out of which ABC bank was the lead bank. As per the consortium agreement, the lead bank, i.e., ABC bank was to remit the share of recovery of other participating bank and was responsible for intimating the drawing power to other member bank. However, the lead bank did not remit the share of recovery to the other member bank. The member bank classified the account as Standard. Further, the member bank contended that as the lead bank has not declared the account as NPA. There was also no express consent from the lead bank on record mentioning transfer of participating bank's share of recovery, to ensure proper asset classification in their respective books. However, in IRAC Master Circular para no. 4.2.8, it is clearly mentioned that the classification of accounts under consortium should be based on the record of recovery of the individual member banks. 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

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books of the participating bank and therefore, be treated as NPA.

4) Considerable Erosion in the Value of Security

4.1) The bank had given Loan Against Property of ₹ 32 lakhs for business purpose in February 2015. The value of the security was ascertained at ₹ 40 lakhs on the date of sanction vide valuation report of registered valuer. Subsequently, the account was classified as NPA by the bank as on 30th June 2018 as substandard and the bank obtained fresh valuation certificate of the security mortgaged valued at ₹ 19 lakhs. As per IRAC Master Circular Para No. 4.2.9 i a, Erosion in value of security is considered as significant when the realisable value of security is less than 50% of the value assessed by the bank/ RBI at the time of last inspection. Where there is significant erosion, the NPAs may be straightaway classified under Doubtful category. Accordingly, in the present scenario the bank should classify the advance as doubtful instead of substandard as there is erosion in value of security by more than 50% from 40 lakhs as on last valuation to 19 lakhs present valuation and accordingly provisioning norms will be applied.

4.2) As per the RBI Guidelines, the security should be valued at least once in 3 years. The valuation report older than 3 years is not considered for valuation of security for IRAC norms. If the valuation report of the security is more than 3 years old, then such valuation is to be ignored and value of security is to be taken as NIL. This criteria needs to be seen critically in case of accounts which are already classified as NPA by the bank and especially in case of doubtful advances as the provisioning will increase substantially.

5) Restructured Accounts

A restructured account is one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/repayable amount/the amount of instalments/rate of interest (due to reasons other than competitive reasons).

As per Para 17.2 of master circular on IRAC norms, accounts classified as standard assets are to be classified as substandard immediately upon restructuring. Further, if NPA account is restructured, then, upon restructuring, the account 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.

However, extension in repayment tenor of a floating rate loan on reset of interest rate, so as to keep the EMI unchanged provided it is applied to a class of accounts uniformly will not render the account to be classified as 'Restructured account'.

In other words, extension or deferment of EMIs to individual borrowers as against to an entire class, would render the accounts to be classified as 'restructured accounts'.

Case Study

The borrower had a cash credit limit of ₹ 40 crores and NFB of ₹ 100 crores. One June 17, 2016 two BGs totaling ₹ 25 crores were invoked, which were paid by overdrawing the cash credit account. Hence, the account turned SMA-2 on 31/08/2016 and would have turned NPA on 30th September, 2016. On 21st September, 2016, the bank sanctioned an increase in cash credit limit of ₹ 10 crores, increase in Bank Guarantee Limit of ₹ 30 crores, a new corporate loan of ₹ 6 crores for a period of more than six months and a onetime interchangeability of ₹ 25 crores from NFB to FB. It effectively increased the CC Limit to ₹ 75 crores. The corporate loan was disbursed on September 29, 2016 and was utilised for repayment of interest dues of cash credit account. This tantamounts to restructuring/ever greening as the borrower was granted concession in the form of grant of one time interchangeability of NFB to FB which was not to the entire class of advances, but only to the borrower owing to his financial stress. Hence, the account is to be classified as substandard immediately upon restructuring.

6) The NPAs are to be identified borrower wise and not facility wise

The borrower was availing cash credit facility, term loan facility and vehicle loan from the bank. The cash credit account of the borrower became NPA due to non-servicing of interest. All the other accounts were standard and regular. The bank treated the cash credit account as substandard and all the other accounts as standard. As per the IRAC Master circular para 4.2.7, all the facilities granted to the borrower will be treated as NPA even though there is default in only one facility. Hence, in the given instance all the cash credit, term loan and vehicle loan accounts will be classified as NPA and appropriate provisions need to be made as per the classification. ■