



CAIIB PAPER-2

Module-D Unit-3

Bank Financial Management(BFM)



CAIIB Paper 2 (BFM) Module D Unit 3: Asset Classification and Provisioning Norms

Asset Classification

In August 1991, a high-level committee, **headed by M. Narasimham** was appointed to **examine various aspects of financial system**. One of the important recommendations of the Narasimham Committee was that balance sheets of the banks should be transparent and comply with international accounting standards.

The Committee recommended that banks should adopt uniform accounting practices in regard to income recognition and bad debts provisioning. In particular, income recognition of non-performing assets should not be on accrual basis but on record of recovery. The Committee also suggested that provisioning should depend upon a proper classification of assets, which in turn should be based on objective criteria.

Non-performing Assets

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. **A non-performing asset (NPA) is a loan or an advance where:**

- Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- The account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC).
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- The Installment of principal or interest thereon remains overdue for two crop seasons for short duration crops.
- The installment of principal or interest thereon remains overdue for one crop season for long duration crops.
- 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 February 1, 2006.
- In respect of derivative transactions, if the overdue receivables representing positive mark-to market value of a derivative contract, 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 charged during any quarter is not serviced fully within 90 days from the end of the quarter. The classification of an asset as NPA should be based on the record of recovery.

- **'Out of Order' Status:** 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'.
- **'Overdue':** 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.

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.

Reversal of income

- **If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for, if the same is not realised.** This will apply to government guaranteed accounts too.
- 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 too, 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.

Asset Classification

Categories of NPAS

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 realisability of the dues:**

- Substandard Assets
- Doubtful Assets
- Loss Assets

(a) Substandard Assets: With effect from 31 March 2005, a substandard asset would be one, which has remained NPA period less than or equal to 12 months. In such cases, the current net worth of the borrower/guarantor.

(b) Doubtful Assets: With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, 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 (doubtful).

(c) 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 asset is not warranted, although there may be some salvage or recovery value.

Accounts with Temporary Deficiencies

The classification of an asset as NPA should be based on the record of recovery. A Bank should not classify an advance account 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 the due date, etc.

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 may 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 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 an 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.

Asset Classification to be Borrower-wise and not Facility-wise

- It is difficult to envisage a situation when only one facility to a borrower/one investment in any of the securities issued by the borrower becomes a problem credit/investment and not others. Therefore, all the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not the particular facility/ investment or part thereof which has become irregular.

- 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.
- The bills discounted under LC favouring a borrower may not be classified as a Non-performing assets (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA.

Loans with Moratorium for Payment of Interest

- **In the case of bank finance given for industrial projects or for agricultural plantations, etc.** where moratorium period 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 the due date for payment of interest, if the interest remains uncollected.
- **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

- 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.

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.

Project Loans

Project Loan means any term loan which has been extended for the purpose of setting up of an economic venture. There are occasions when the completion of projects is delayed for legal and other extraneous reasons like delays in Government approvals etc. All these factors, which are beyond the control of the promoters, may lead to delay in project implementation and involve restructuring/reschedulement of loans by banks. Accordingly, the following asset classification norms would apply to the project loans before commencement of commercial operations.

For this purpose, all project loans have been divided into the following two categories:

- Project Loans for infrastructure sector
- Project Loans for non-infrastructure sector

Takeout 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 will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis.
- In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out.

Post-shipment Supplier's Credit

- In respect of post-shipment credit extended by the banks covering export of goods to countries for which the Export Credit Guarantee Corporation's (ECGC) cover is available, EXIM Bank has 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.

- Accordingly, to the extent payment has been received from the EXIM Bank, the advance may not be treated as a non performing asset for asset classification and provisioning purposes.

Export Project Finance

- **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.**
- 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.

Provisioning Norms

A non-performing asset (NPA) causes two-fold impact on the profitability of a bank. On one hand, the bank ceases to earn interest on this asset and thus is deprived of its legitimate income from the asset. On the other hand, the bank is required to make provisions for this asset, depending on the classification category of the asset and value of security, if any. This makes a further dent in the profitability of the bank. The Reserve Bank of India introduced the system of asset classification and provisioning in line with international practices for the first time in 1993. The norms have undergone several changes during the last 24 years.

Loss Assets

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

Doubtful Assets

- 100% of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.
- In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25% to 100% of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has remained in 'doubtful' category	Provision Requirement
Up to one year	25%
One to three years	40%
More than three years	100%

Substandard Assets

- **A general provision of 15% on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.** The 'unsecured exposures' which are identified as substandard would attract additional provision of 10%, i.e., a total of 25% on the outstanding balance. The provisioning requirement for unsecured doubtful' assets is 100%.

Standard Assets

Banks are required to make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:

- Farm Credit to agricultural activities and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent.
- Advances to Commercial Real Estate (CRE) Sector at 1.00 per cent.
- Advances to Commercial Real Estate - Residential Housing Sector (CRE - RH) at 0.75 per cent.
- Housing loans extended at teaser rates at 2 per cent in view of the higher risk associated with them. The provisioning rate shall be reduced to 0.40

per cent after 1 year date on which the rates are reset at higher rates if the accounts remain 'standard'.

- All other loans and advances not included in (a) (b) and (c) above at 0.40 per cent.

Provisioning Coverage Ratio

- Provisioning Coverage Ratio (PCR) is essentially the ratio of provisioning to gross non-performing assets and indicates the extent of funds a bank has kept aside to cover loan losses.
- From a macro-prudential perspective, bank should build up provisioning and capital buffers in good times i.e. when the profits are good, which can be used for absorbing losses in a downturn. This will enhance the soundness of individual banks, as also the stability of the financial sector. It was, therefore, decided that banks should augment their provisioning cushions consisting of specific provisions against NPAs as well as floating provisions, and ensure that their total provisioning coverage ratio, including floating provisions, is not less than 70 per cent. Accordingly, banks were advised to achieve this norm by the end of September, 2010.
- Majority of the banks had achieved PCR of 70 percent and had represented to RBI whether the prescribed PCR is required to be maintained on an ongoing basis. The matter was examined and till such time RBI introduces a more comprehensive methodology of countercyclical provisioning taking into account the international standards as are being currently developed by Basel Committee on Banking Supervision (BCBS) and other provisioning norms.

RBI's Strategic Debt Restructuring (SDR)

RBI has given powers and a tool to the Banks vide its Circular of June 2015 to try and clean up their balance sheets through SDR. SDR allows banks to convert their debt or loans into equity holding in a defaulting company, change management if needed and also find a suitable buyer for the company or its assets so that the Bank can recover its dues. As per the reports published in newspapers, Banks have already used the SDR effectively and converted debt into equity in several cases.

Central Repository of Information on Large Credits (CRILC)

RBI has set up a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders. Accordingly, RBI's Department of Banking Supervision (DBS) has advised vide circular of February 13, 2014 on 'Central Repository of Information on Large Credits (CRILC) - Revision in Reporting' that banks will be required to report credit information, including classification of an account as SMA to CRILC on all their borrowers having aggregate fund-based and non-fund based exposure of Rs.50 million and above with them (Rs. 5 crores). However, Crop loans are exempted from such reporting, but, banks should continue to report their other agriculture loans in terms of the above instruction. Banks need not report their interbank exposures to CRILC including exposures to NABARD, SIDBI, EXIM Bank and NHB.

As per RBI norms, before a loan account turns into a NPA, banks are required to identify incipient stress in the account by creating **stress sub-categories under the Special Mention Account category as given below:**

SMA Sub-Categories	Basis for classification
SMA-0	Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress)
SMA-1	Principal or interest payment overdue between 31 -60 days
SMA-2	Principal or interest payment overdue between 61-90 days

In cases where banks fail to report SMA (Special Mention Accounts) status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts or evergreen the account, banks will be subjected to accelerated provisioning for these accounts and/or other supervisory actions as deemed

appropriate by RBI. The current provisioning requirement and the revised accelerated provisioning in respect of such non performing accounts are as under:

Asset Classification	Period as NPA	Current Provisioning (%)	Revised accelerated Provisioning (%)
Sub-standard (secured)	Upto 6 months	15	No Change
	6 months to 1 year	15	25
Sub-standard (unsecured abiinitio)	Upto 6 months	25 (other than infrastructure loans) 20 (Infrastructure loans)	25
	6 months to One year	25 (other than infrastructure loans)	40
		20 (Infrastructure loans)	
Doubtful I	2 nd year	25 (secured portion)	40 (secure portion)
		100 (unsecured portion)	100 (unsecured portion)

Doubtful II	3 rd & 4 th year	40 (secured portion) 100 (unsecured portion)	100 (for both secured and unsecured portion)
Doubtful III	5 th year onwards	100	100

Scheme for Sustainable Structuring of Stressed Assets (shortly known as S4A):

- **S4A is the process of restructuring large ticket loans where the project is up and running. Here the lenders are required to separate a sustainable loan from an unsustainable loan.** The bank would convert the unsustainable debt into equity or equity related instruments.
- As a result, on one hand, the debt burden of the borrower is substantially reduced and on the other hand promoter's equity stake is also reduced. The idea behind the scheme is that banks would get the upside if the company regains its old good form and it also gives the borrower a second chance to revive the company.

Insolvency and Bankruptcy Code, 2016 (IBC):

Government of India has enacted the IBC, which is the most comprehensive law and in the process has consolidated the existing laws and rules through a single legislature to help the banks to enforce insolvency and bankruptcy proceedings of distressed companies. The code includes the best practices following from around the world including USA and UK with regard to insolvency and bankruptcy.

This Code now would permit banks to push for recovery of money from a company within a period of 180 days, with a grace period of a further 90 days, if majority (i.e. 75%) of the creditors agrees. In a situation where the company does not meet the recovery terms, it will be liquidated involuntarily. **This will make it easier for banks**

and other financial institutions to deal with bad debts arising out of failed ventures.

Some of the Key highlights of the Code are given below:

- The Code proposes to cover Insolvency of individuals, unlimited liability partnerships, Limited Liability partnerships (LLPs) and companies. The adjudicating authority for individuals and firms is the present DRTs and for corporates it would be National Company Law Tribunal (NCLT).
 - Bankrupt individuals would be barred from contesting elections.
 - Under the new law, a debtor could be jailed for up to five years for concealing property or defrauding creditors.
 - It will strengthen hands of lenders to recover outstanding debts by setting a deadline of 180 days for companies to pay or face liquidation.
 - To create Insolvency Professionals who will specialize in such cases, assist creditors, manage liquidation process. These professionals will in turn be certified by a newly created Insolvency Professional Agency.
 - It will also create good data base and from this dissemination of information is possible related to the debtors.
 - The entire operation of insolvency and bankruptcy through these various newly created agencies will be overseen by a regulator - Insolvency and Bankruptcy Board of India.
 - Workers' salaries for up to 24 months will get first priority in case of liquidation of assets of a company, ahead of secured creditors.
 - Money due to employees from PPF, gratuity fund will not be included in the estate of the bankrupt company or individual.
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