

**Income recognition, asset classification and
provisioning norms for advances**

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All Commercial Banks (excluding RRBs)

Dear Sir,

**Income recognition, asset classification and
provisioning norms for advances**

As you are aware, the prudential norms on income recognition, asset classification and provisioning introduced in 1992, eliminated the subjective element in these areas and introduced objectivity to a large extent. The identification of a Non Performing Asset (NPA), which is the basis for application of the prudential norms on income recognition, asset classification and provisioning, is based on the record of recovery and was expected to enable the banks to apply the norms in a uniform manner. However, in practice, there are instances of non-compliance with the prudential requirements by banks and also divergence in the assessment of NPAs by banks, Statutory Auditors and RBI Inspecting Officers. The Board for Financial Supervision of RBI, therefore, desired that causes for the persistence of divergences in assessment of NPAs should be examined. As a sequel, a Working Group was constituted by the RBI in March 2000, with Shri P.R. Khanna, Chartered Accountant, as Chairman, to broadly examine the causes for divergence in asset classification and make suitable recommendations to narrow down the divergences.

2. The Working Group has since submitted its recommendations. The Group's analysis shows that the divergence in asset classification and provisioning requirement has been arising primarily due to the following factors:

- i) Non compliance with RBI guidelines.
- ii) Subjectivity arising out of some flexibility in the guidelines issued by RBI on income recognition, asset classification and provisioning.
- iii) Differences in valuation of security by banks, Statutory Auditors and RBI.

3. The recommendations of the Group were recently discussed by RBI with a cross section of banks. The banks generally expressed their agreement with the recommendations and also suggested a few minor changes, with a view to further eliminating the divergences. It has now been decided to make the following modifications to strengthen the systems in banks and issue certain clarifications in a question- answer format on the instructions already issued.

(A) Divergence due to non compliance with RBI guidelines

The periodical inspections of RBI have brought out instances of deviation on income recognition, asset classification and provisioning even where the instructions are clear and unambiguous. Banks should ensure scrupulous compliance with the instructions for recognition of credit impairment and view aberrations by dealing officials seriously. The elimination of divergences in asset classification of larger credit limits should help the banks to institutionalise

conscious efforts towards compliance with prudential guidelines at all levels, for the entire asset portfolio, in due course. It is, therefore, advised that:

- (i) 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 cut off point should be valid for the entire accounting year.
- (ii) Responsibility and validation levels for ensuring proper asset classification may be fixed by the bank.
- (iii) 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.

RBI would continue to identify the divergences arising due to non-compliance, for fixing accountability. Where there is wilful non-compliance by the official responsible for classification and is well documented, RBI would initiate deterrent action including imposition of monetary penalties.

(B) Divergence arising out of flexibility in the instructions issued by RBI on income recognition, asset classification and provisioning

Based on the discussions, the Group identified RBI instructions on prudential norms which lent scope for difference in interpretation between banks, Statutory Auditors and Inspecting Officers of RBI. In the light of the recommendations of the Group, it has been decided to clarify some of the extant guidelines on prudential norms relating to income recognition, asset classification and provisioning issued vide our Circular DBOD.No. BP. BC. 9 / 21.04.048/ 97 dated 29 January 1997.

- (i) Temporary irregularities [para 2 (a) of the Circular]

Q: Whether a working capital account will become a NPA if the stock statements are not submitted regularly? What should be the period for which the stock statements can be in arrears before the account is treated as a NPA?

A: Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Considering the practical difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstandings in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. A working capital borrowal account will become NPA if such irregular drawings are permitted in the account for a continuous period of 180 days even though the unit may be working or the borrower's financial position is satisfactory.

Q: Whether an account will become a NPA if the review/ renewal of regular/ adhoc credit limits are not done when due? What should be the periodicity of review/ renewal to decide the present status of an account?

A: Regular and adhoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of adhoc 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/ adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of adhoc sanction will be treated as NPA.

(ii) Regularisation of the account around the date of balance sheet [para 2 (c) of the Circular]

Q: Whether it will be in order to treat a borrowal account as 'standard' if it has been irregular for a major part of the year, but has been regularised near the balance sheet date?

A: 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.

(iii) Classification of NPAs where there is a threat to recovery
[para 2 (d) of the Circular]

Q: How should the instructions on classification of NPA straightaway as doubtful or a loss asset be interpreted and what can be termed as a 'significant' credit impairment'?

A: The circular provides that a NPA need not go through the various stages of classification in case of serious credit impairment and such assets should be straightaway classified as a doubtful/ loss asset as appropriate. Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(C) Absence of specific guidelines on certain issues

(i) Classification of credit facilities under consortium

Q: In certain cases of consortium accounts, though the record of recovery in the account with a member bank may suggest that the account is a NPA, the banks submit that, at times, the borrower has deposited adequate funds with the consortium leader/ member of the consortium and the bank's share is due for receipt. In such cases, will it be in order for the member bank to classify the account as 'standard' in its books?

A: As already clarified at item 2 (b) of our Circular DBOD. No. BP. BC. 9/ 21.04.048/ 97 dated 29 January 1997, 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. 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 books of the other member banks and therefore, be treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

(ii) Appropriation of Recoveries

Q: What is the practice to be adopted by banks regarding appropriation of recoveries in NPA accounts (i.e. towards principal or interest).

A: In the absence of a clear agreement between the bank and the borrower for the purpose, banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

(iii) Activities allied to agriculture

Q: The guidelines conveyed vide Circular DBOD. No. BP. BC. 17/ 21.04.048/ 98 dated 4 March 1998 stipulate the income recognition/ asset classification norm of two harvest seasons/ two half-years for direct agricultural loans. Whether the same norm can be extended to floriculture and allied agriculture activities like poultry, animal husbandry etc.?

A: It is clarified that the above norms should be made applicable only in respect of short term agricultural loans for production and marketing of seasonal agricultural crops such as paddy, wheat, oilseeds, sugarcane etc. In respect of other activities like horticulture, floriculture or allied activities such as animal husbandry, poultry farming etc., assessment of NPA would be done as in the case of other advances.

(iv) Overdues in other credit facilities

Q: There are instances where banks park the dues from a borrower in respect of devolved letters of credit and invoked guarantees in a separate account, irrespective of whether the borrower's credit facilities are regular or not. How to determine when the account in which such dues are parked has become a NPA?

A: A number of banks adopt the practice of parking the dues of the borrower in respect of devolved letters of credit and invoked guarantees in a separate account which is not a regular sanctioned facility. As a result these are not reflected in the principal operating account of the borrower. This renders application of the prudential norms for identification of NPAs difficult. It is, therefore, advised that 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.

(v) Treatment of loss assets

Q: A NPA account will be classified as a loss asset only when there is no security in the account or where there is considerable erosion in the realisable value of the security in the account. What can be termed as a 'considerable' erosion for the account to be classified as a loss asset?

A: If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstandings in the borrowal accounts, the existence of security should be

ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

(D) Valuation of security

Q: A major source of divergence in provisioning requirement was the realisable value of the primary and collateral security. Can uniform guidelines be prescribed for adoption in this area, at least for large value accounts?

A: With a view to bringing down divergence arising out of difference in assessment of the value of security it has been decided that in cases of NPAs with balance of Rs. 5 crore and above;

a) The current assets and their valuation are looked into at the time of Statutory Audit. However, in order to enhance the reliability on stock valuations, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory.

b) 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.

4. Please acknowledge receipt.

Yours faithfully,

(B. Mahapatra)
General Manager