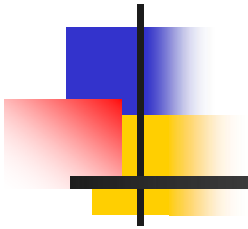


# **ADVANCES,ASSETS & NPA NORMS**

## **-IMPORTANT ISSUES**



**ICAI SEMINAR Nagpur Dt. 29<sup>th</sup> March 2013**

**By  
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## Major Policy Guidelines related to Audit of Advances

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- RBI Guidelines (Master Circulars)
- Loan Policy
- Recovery Policy
- Guidelines on Documentation
- Books of Instructions of the Bank supplemented by circulars/guidelines from time to time.



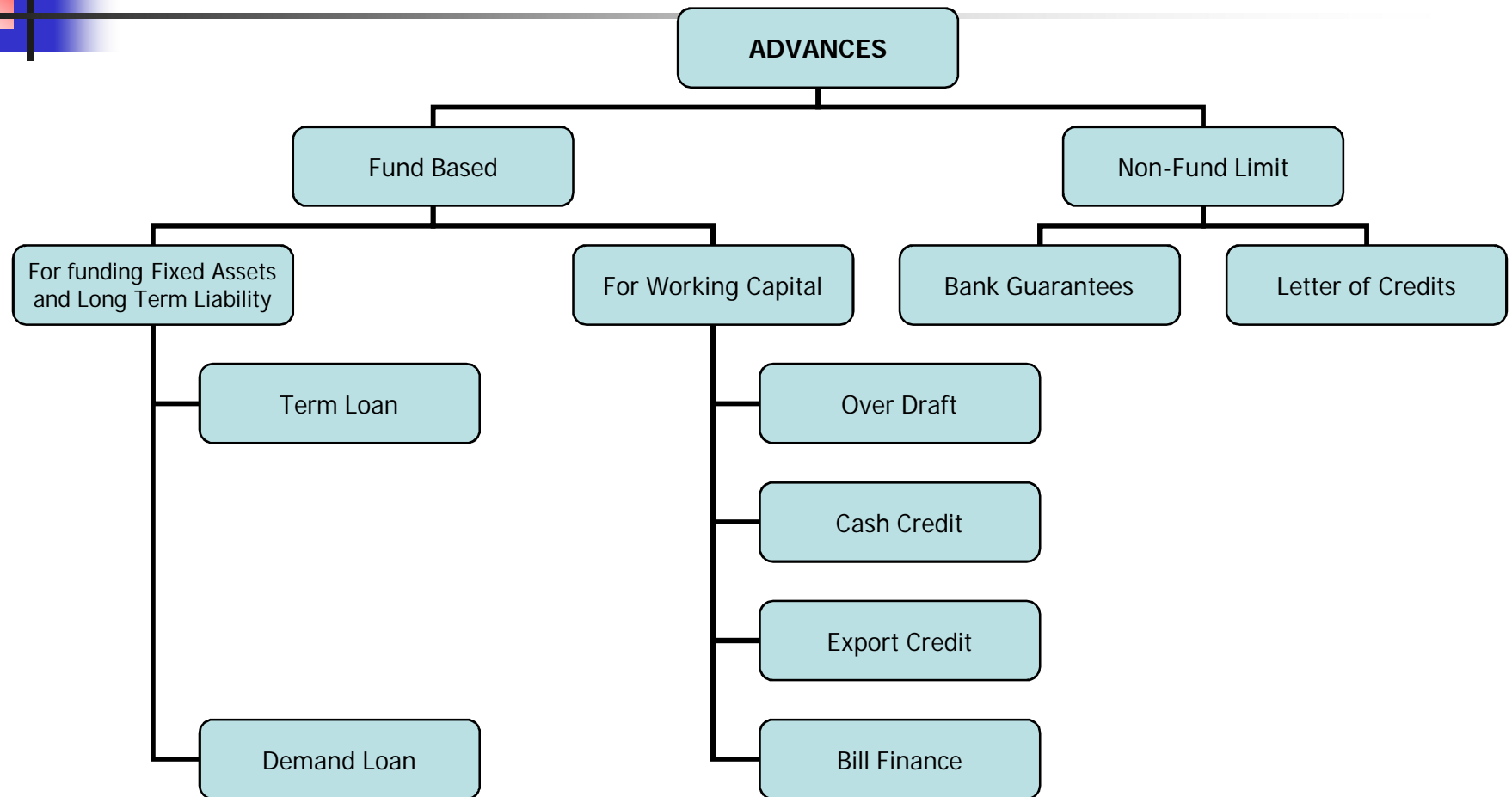
## Audit Pre-Requisites

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- Previous year audit report & Long Form Audit Report
- Monthly concurrent audit report
- Stock audit report
- CIBIL Report
- RBI Inspection Reports
- Awareness about the Credit Policy of the Bank



# Types of Advances





## Auditors Concerns

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- Whether asset is stated at its fair value
- Whether it is recoverable as expected
- Whether it's classification is correct.
- Whether the necessary guidelines & procedure were followed in exercising the powers
- Whether proper disclosure have taken place.

Auditors should exercise his judgment over there questions and arrive at the conclusion



## At the beginning

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- Please read audit instruction carefully
- Carefully read concurrent audit report & preferably follow the trail through out the year. This will help you reset your mind & focus on the critical area.
- Obtain Trial Balance
- Assess the various types of advances given by the branch



## Audit Sampling

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- Generally ensure that at least 75% of the value under each category is covered.
- Ensure that connected advances under same company/group are selected simultaneously.
- All large advances whose year end balance is in excess of Rs.2 crores or 5% of the aggregate year end advances of branch whichever is less have to be verified and reported.



## Term Loans

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- Usually term loans will not be standalone unless they are retail in nature .
- Standalone industrial term loans, if any may require grater degree of vigilance.
- Simply calculate DP based on installments from the disbursement date.
- Any difference in the value so arrive may have to be look into.
- Based on checking the classification may be confirmed.





## Term Loan Monitoring

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- Periodical Inspection of Assets (1 or 2 times in a year)
- Adequacy of Insurance with Bank's clause
- Valuation of Assets at stipulated intervals. (Normally, once in a period of 3 years)
- Follow up for recovery of Interest & Installments.



## Working Capital

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- Checking of working capital requires grater degree of skills owing to the multiple facets involved.
- Unlike term loan where fresh term loans require detailed checking, there is no distinction to be made among the fresh and old advances for working capital since they are expected to renewed every year.



## Cash Credit & Overdraft

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- Timely Submission Of Stock/Book Debt Statement. Latest stock/book statement should be on record.
- The system should be in place to scrutinize the stock / book debt statements by Bank Officials for calculating Drawing Power. (Due to current melt-down, extra care should be taken to look after position of long outstanding debtors and volume of creditors and its effect on DP)
- Drawings should be within limit or D.P, whichever is low.
- Periodical Inspection Of Stocks & Book Debts.
- Stock Audit
- Forward rates contract
- Review of Limits.



## Export Credit

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The following check points are for conducting the audit from "Credit angle". It is also required to conduct the audit of export credit from "Forex angle" for which separate set of guidelines are available.

### **Pre Shipment (Packing Credit):**

- Normally disbursed on order to order basis. In few cases allowed as running account facility.
- To be released against confirmed Export Orders or L/Cs (except running account).
- Pre shipment credit should be adjusted from Export proceeds.
- If adjusted from local funds, commercial rate of interest to be charged.
- Interest Subvention, if any to be claimed.
- ECGC covered (Policy / guarantee)
- Special approval list



## ....Export Credit

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### **Post Shipment Credit**

(Four major products)

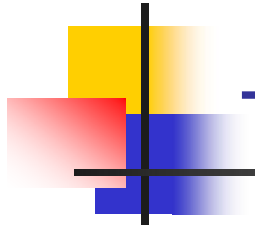
- Negotiation of Bills under L/C
- Purchase or discounting of Export Bills
- Post Shipment Demand Loan (Advance against Bill for collection)
- Advance against Duty Drawback receivable from Government
  
- **Auditor should satisfy –**
  - The advance to be granted against the genuine trade transaction.
  - Proof of Export should be on record.
  - Post shipment credit to be first utilized for liquidating the pre-shipment credit, if any, outstanding against the same export order.
  - Proper system should be in place for follow-up the realization of export bills.
  - Reporting of Overdue Export Bills in XOS statements.



## Bill Finance

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- Clean Bill & Documentary Bill
- Demand Bill & Usance Bill
- Bills to be related to genuine trade transactions & should not be an Accommodation Bill.
- Drawee - wise Sub-limit
- Payment history of the Drawee.
- System in place for follow up of realization of discounted Bills.
  - Bills drawn under L/C: Documents should be L/C compliant.
  - If Bills discounted/ purchased are adjusted by allowing excess drawings or adhoc or TODs, the same should be commented upon by the Auditor.



## The Audit Process

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- The audit process of checking of advances involves the following broad stages of verification:
  - Credit Appraisal
  - Documentation
  - Sanction & disbursement
  - Review of Operations, Monitoring & Renewals



## Credit Appraisal

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- Before sanctioning a loan, bank has to undertake Credit Appraisal.
- Generally there are 4 broad principles used for appraisal.
  - Borrowers financials
  - Borrowers commercials
  - Management quality
  - Industry segment
- Application should be in prescribed format with all information and details.
- KYC compliance as per RBI Guidelines.





## ....Credit Appraisals

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- Analysis of important financial ratios.
- Copy of necessary resolutions in case of Company.
- All relevant documents should be attached like Borrower's Financials, IT Returns, Project report, quotations, Net Worth report on Borrower and Guarantor, etc.



## Documentation

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- Documents are required for :
  - To legally establish borrowers liability towards the Bank
  - To create legal charge on various securities in favor of the Bank like pledge, hypothecation, mortgage, assignment, lien, etc.
- The documents should be duly filled in & properly executed and adequately stamped.
- The charges should be properly recorded (ROC,RTO,Sub Registrar ,etc.)
- Vetting of Documents
- Safe keeping of the documents



## Sanctions

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- Sanctions should be within delegated powers.
- The discretionary powers to be judiciously exercised.
- All the required terms and conditions should be properly mentioned and there should not be any ambiguity.
- Sanctions to be properly recorded & reported to various authorities as per Bank's guidelines.
- Sanctions are properly communicated to the Borrower and unqualified acceptance to be on record.



## Disbursements

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- End use of Bank's funds to be satisfied upon.
- All invoices, stamped receipts related to loan disbursements & Post Disbursement inspections to be on record.
- Required margin is raised as per terms of sanction.
- Working Capital Limits are disbursed after satisfying that necessary infrastructure including Plant & Machinery, etc is in place.
- Withdrawal in Working capital Limits should be related to business activities of the borrowers.



## Review of Operations, Monitoring and Renewals

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- Check for the flow of debit/credit transaction in the accounts.
- Summations of debit/credit.
- Overall conduct of the account.
- Stock valuation of previous year v/s stock statement.
- Any adhoc/enhancement during the year.
- Check for the correspondence with the client to assess management quality.



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- Servicing of interest.
- Check whether advances are renewed at year end.
- Checking of Balance Confirmation- "Letter of acknowledgement of debt" or "Debit balance Confirmation Certificate" from the borrower.
- Verify Balance outstanding under Sundry Deposits/or debits which are not cleared within 90 days on 31st March.



# Non Fund Limits

## Letter of Credit

- L/Cs to be issued within sanctioned limits.
- L/Cs to be in conformity with the Borrower's Application and advised to the beneficiary's Bank immediately.
- For Import L/ Cs, the UCPDC of ICC, FEMA Stipulations, RBI directives & FEDAI guidelines to be adhered to.
- Liability entries passed in the books of Bank.
- The Bills are in conformity with L/ C terms & to be paid on due date by the borrower.
- Care in case of devolved L/Cs.
- Devolved amounts adjusted by allowing excess drawings or adhoc or TODs, should be commented upon by the Auditor.



## .... Non Fund Limits

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### **Bank Guarantee:**

- Issued within the sanctioned limit.
- Proper Liability Entries are passed
- Should not have any onerous clause.
- The limitation Clause, in regard to amount and time, to be incorporated in each guarantee.
- Repeated extensions of guarantee should be carefully looked into.
- Payment of Invoked Guarantees
- Non-reversal of Expired Guarantees to be looked into carefully.





# Master Data

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- The major areas which auditor should satisfy about proper creation of master data through test checks are -
  - Repayment schedule (Demand Loan / Term Loan)
  - Rate of interest (income leakage)
  - Drawing Power (Monitoring of drawing in Cash credit/ overdraft account)
  - Customer ID (Same customer ID to be allotted for different accounts of the same client)
  - Classification of advance (Sectoral classification, secured / unsecured classification, etc.)
  - Master data directly affect the calculations of overdues, classification of advances as well as the income of the Bank and also the BASEL-II statement.



## Identification of Account as NPA

Loans or Advance	<ul style="list-style-type: none"><li>■ Interest and/or installment remains overdue for a period of more than 90 days in respect of a term loan.</li><li>■ <b>As per Para 2.1.3, an account is classified as NPA only if interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.</b></li></ul>
Exceptions	<ul style="list-style-type: none"><li>■ Loans with moratorium for payment of interest .</li><li>■ Housing Loan or similar advance to staff.</li></ul>



## Identification of Account as NPA ...

Bills Purchased and discounted	Bill remains overdue for a Discounted period of more than 90 days.
Agricultural Advances	Interest or installment remains overdue for more than two crop seasons for short duration crop, one crop season for long duration crop.
Derivative Transaction	Overdue receivables representing positive mark to market value of a derivative contract remaining unpaid for a period of 90 days from specified due date.
Liquidity facility	Remains outstanding for more than 90 days in respect of Securitisation transaction.



## Identification of Account as NPA ...

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- **Cash Credit / Overdrafts**  $\Rightarrow$  Account remains 'out of order'

**The account is treated as 'out of order' if :**

- Outstanding Balance remains continuously in excess of sanctioned limit/drawing power (for how many days?) or
- No credit continuously for 90 days as on the date of Balance Sheet or
- Credits in the account are not sufficient to cover interest debited during the same period.



## Income Recognition

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- For NPA accounts income should be recognised on realisation basis.
- When an account becomes non-performing, unrealised interest of the previous periods should be reversed or provided.
- Interest income on additional finance in NPA account should be recognised on cash basis.
- In project loan, funding of interest in respect of NPA if recognised as income, should be fully provided.
- If interest due is converted into equity or any other instrument, income recognised should be fully provided.



## ...Income Recognition

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### Adjustment of Recoveries - *Priority*

Unrealised Expenses

Unrealised Interest

Amount of Principal Outstanding

Clarification vide Master Circular - in the absence of clear agreement between the Bank and the Borrower, an appropriate policy to be followed in uniform and consistent manner.



## Classification Norms

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- **Standard Asset**  
The account is not non-performing.
- **Sub-Standard Asset**  
A sub standard Asset is one which has remained NPA for a period of less than or equal to 12 months.
- **Loss Assets**  
These are accounts, identified by the bank or internal or external auditors or by RBI Inspectors as wholly irrecoverable but the amount for which has not been written off.



## Classification Norms...

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- Doubtful Asset – Remained NPA for a period exceeding 12 months.

### Three Categories

Category	Period
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Doubtful - I	up to One Year
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Doubtful – II	One to Three Years
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Doubtful - III	More than Three Years
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# Provisioning Norms

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## Standard Asset

- Agricultural and SMEs Sectors .25%
- Commercial Real Estate (CRE) Section 1%
- Others .40%
- Vide circular dated 23rd December 2010, provision on housing loan accounts has been increased to 2% with immediate effect.

## Sub-standard Asset

- 15% of total outstanding
- 25% of total outstanding if loan is unsecured



## Provisioning Norms...

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### **Doubtful Assets:**

Period	Provision	(Secured + Unsecured)
Up to 1 year	25%	+ 100%
1to 3 years	40%	+ 100%
More than 3 years	100%	+ 100%

### **Loss Asset:**

100% should be provided for written off.

Banks should have total provisioning coverage ratio of not less than 70%.



## Restructuring of Advances Accounts

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RBI has issued several guidelines on restructuring of the advances from time to time. Such guidelines (other than those restructured under a separate set of guidelines issued by RPCD of the RBI on restructuring of advances on account of natural calamities) are divided into four categories :

- Guidelines on restructuring of advances extended to industrial units
- Guidelines on restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism
- Guidelines on restructuring of advances extended to Small and Medium Enterprises (SME)
- Guidelines on restructuring of all other advances



## .....Restructuring

The guidelines are divided into four parts :

- General Principles and Prudential Norms for Restructured Advances
  - Eligibility Criteria for restructuring of advances
  - Asset Classification norms
  - Income Recognition norms
  - Provisioning Norms
- Prudential Norms for Conversion of Principal into Debt/Equity
- Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments
- Special Regulatory Treatment for Asset Classification.



## Special Regulatory Treatment

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- RBI has stipulated Special Regulatory Treatment for Asset Classification. It is available to borrower engaged in important business activities.
- Under these guidelines benefit of classification would apply to the eligible accounts. However it cannot be extended to the following categories of accounts:
  - Consumer and personal advances
  - Advances classified as capital market exposure.
  - Advances classified as commercial real estate exposures



## Special Regulatory Treatment - Conditions

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- It is applicable for fully secured accounts, however following exceptions are permitted :
  - SSI borrowers where outstanding is up to Rs.25/- lacs.
  - Infrastructure project :
    - Cash flow is adequate for repayment of advance
    - Escrow mechanism is in place
    - Bank has clear and legal first claim on this cash flows.
  - Unsecured portion of WCTL (subject to additional provision)
- Promoter to contribute 15% of the bank's sacrifice
- Personal guarantee of promoters
- Restructuring only once.



## Special Regulatory Treatment - Conditions

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- The accounts which were standard accounts would be treated as standard accounts on restructuring provided the restructuring is done within 120 days for CDR & 90 days for others from the date of application.
- The unit should become viable in 10 years if it is infrastructure activity and 7 years in other cases.
- Repayment period of restructured advance including moratorium period if any should not exceed 15 years in case of infrastructure advance and 10 years in other advance.
- The ceiling of 10 years repayment period is not applicable for housing loan.



## Eligibility Criteria for restructuring of advances

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- Accounts classified under 'standard', 'sub-standard' and 'doubtful' categories can be restructured.
- Borrowers indulging into fraud and malfeasance will not be eligible.
- Willful defaulter will be eligible if willful default is rectified.
- BIFR cases will be eligible with express approval of BIFR.

### ***Proviso.....***

- **The financial viability is to be established and there should be reasonable certainty of repayment as per terms of restructuring package.**
- **Any restructuring done without looking into cash flows of the borrowers and assessing the viability of the project / activity would be treated as an attempt of 'evergreening' a weak credit facility and would invite supervisory concerns / action.**





## Provisioning Norms (Restructured Assets)

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- Normal provision as per existing provisional norms.
- Additional provision for **diminution in the fair value of restructured advances** which is to be recomputed on each balance sheet date till satisfactory completion of all repayment obligations.
- Additional provision for unsecured portion of WCTL.



## CAR under BASEL -II

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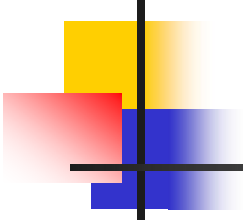
- The banks are expected to calculate Capital Adequacy Ratio(CAR) or Capital to Risk(weighted) Assets Ratio(CRAR) under BASEL-II as well.
- The credit rating must be obtained from rating agency under following criteria
  - Average last 3 years turn over of Rs. 50. cr.
  - Sanctioned facility above Rs. 5 Cr.



## Disclosure norms

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- Exposure to real estate sector
- Exceeded prudential exposure limit.
- Unsecured advances.
- Letters of comfort issued
- Sector wise NPAs



***THANK YOU***