Income Recognition and Provisioning Norms

Credit Risk and Loan Losses

- Credit risk is most simply defined as the probability that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.
- In evaluating credit risk, banks should assess the likely downside scenarios and their possible impact on borrowers and their debt servicing capacity.
- Two types of losses are possible in respect of any borrower or borrower class – expected and unexpected losses.
- Expected losses can be budgeted for, and provisions held to offset their adverse effects on the bank's balance sheet.
- Unexpected losses, being unpredictable, have to be cushioned by holding adequate capital.

Expected versus Unexpected Loss

- Though credit losses are typically dependent on time & economic conditions, it is theoretically possible to arrive at a statistically measured, long run average loss level.
- Bank's Expected Loss (EL) = PD x EAD x LGD, where
- PD = probability of default over the specified time period,
- EAD = exposure at default, i.e. the amount owned by the counterparty at the time of default,
- LGD = loss given default, i.e. the fraction of the exposure, net of recoveries which will be lost following a default event
- E.g.: A bank's Expected Loss for a credit portfolio of Rs.1000 cr (EAD), with a default probability of 1% (PD), and average recovery rate of 50% (LGD). Therefore,
- EL = Rs. 1000 crores x 0.50 x 0.01 = Rs. 5 crores.
- EL can be aggregated at the level of individual loans and or the entire credit portfolio.

Income Recognition

- The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, 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.
- Further, 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.

Income Recognition and Asset Classification of Banks

- *Definition of a non-performing asset (NPA) as per RBI:*

- An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.
- A NPA is a loan or an advance 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’ as indicated below, in respect of an Overdraft/Cash Credit (OD/CC),
- (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.

Definitions

- 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.
- 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'**.
- 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 Policy

- The policy of income recognition has to be objective and based on the record of recovery. Internationally income from non-performing assets (NPAs) 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

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:
- a) Sub-standard Assets

- b) Doubtful Assets
- c) Loss Assets
- **With effect from 31 March 2005, a sub-standard asset would be one, which has remained NPA for a period less than or equal to 12 months**. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected**.**

- **With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months**. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, 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.
- **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. 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.
- 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.

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.
- The requirement of invocation of guarantee has been delinked for deciding the asset classification and provisioning requirements in respect of State Government guaranteed exposures. With effect from the year ending 31 March 2006 State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms if interest and/or

principal or any other amount due to the bank remains overdue for more than 90 days.

Upgradation of restructured accounts

- The sub-standard accounts which have been subjected to restructuring etc., whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after the specified period i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory performance during the period.
- Based on the experience in other countries of putting in place institutional mechanism for restructuring of corporate debt and need for a similar mechanism in India, a Corporate Debt Restructuring System was evolved, and detailed guidelines were issued in August 2001 for implementation by banks.

Provisioning for Standard assets

- The provisioning requirements for all types of standard assets stands as below. Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:
- (a) direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;
- (b) advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;
- (c) housing loans extended at teaser rates and restructured advances between 0.40 per cent and 2.00 per cent;
- (d) all other loans and advances not included in (a) (b) and (c) above at 0.40 per cent

Provisioning for Substandard assets

- (i) A general provision of 15 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and **securities available.**
- (ii) The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance.

Provisioning Norms: Doubtful Assets

- 100 percent 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 percent to 100 percent 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

Provisioning Norms: Loss Assets

- The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors.
- *Loss assets:*
- Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

Provisioning Coverage Ratio (PCR)

- i. PCR is the ratio of provisioning to gross NPAs and indicates the extent of funds a bank has kept aside to cover loan losses.
- ii. To enhance soundness of banks and financial sector, banks 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. It was, therefore, decided by RBI 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 not later than end-September 2010.

Based on Presentation by Prof Abhijit Roy in Pre Examination Training for RBI Officers.