

UNIT – 4 : INCOME RECOGNITION, CLASSIFICATION OF ASSETS AND PROVISIONS

LEARNING OUTCOMES

In this unit, you will be able to:

- Determine the profit/loss of a bank which is determined by the income recognition policy. Learn the technique of income recognition followed by a bank.
- Classify advances of a Bank according to the riskiness i.e. standard assets, sub-standard assets, doubtful assets, and loss assets. Try to understand the definitions of various categories and also follow Illustration given in the chapter to learn.
- Create adequate provision against sub-standard, doubtful and loss assets. This helps to find out the bank profit in a conservative manner. Reserve Bank (RBI) has issued guidelines stating the rates to be followed for making such provision.
- Make provision for depreciation on their current investments. Learn how to classify investments into permanent and current and also follow the

4.1 INCOME RECOGNITION

Bulk of a banks' income is from two sources:-

1. Interest earned on Loans & Advances extended to its customers.
2. Discount and commission earned handling Bills of Exchange and Non-Funded

advances like Letter of Credit (LC), Letter of Guarantee (LG) etc.

In this unit Income recognition from Loans & Advances will be dealt with and in the next unit Income from Bills/LCs'/LGs' will be taken up.

Income recognition for interest earned is a function of classification of the Bank loans & advances (i.e. its Assets into Performing & Non-Performing Assets (NPA's)). For Performing assets income is recognised as it is earned i.e. accrued. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. For Non-Performing assets interest income is not considered on accrual basis and it is recognised only when it is actually received. Basically an NPA is a bad and doubtful debt.

An asset becomes non-performing when the bank does not receive income from it for a certain period. In concept, any credit facility (assets) becomes non-performing "when it ceases to generate income for a bank."

Note: Bank should classify an account as NPA if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter-

Income from non-performing assets can only be accounted for as and when it is actually received. The Accounting Standard 9 (AS 9) on 'Revenue Recognition' issued by the Institute of Chartered Accountants of India (ICAI) requires that the revenue that arises from the use, by others, of enterprise resources yielding interest should be recognized only when there is no significant uncertainty as to its measurability or collectability.

Illustration 1

Given below interest on advances of a commercial bank (₹ in lakhs)

	Performing Assets		NPA	
	Interest earned	Interest received	Interest earned	Interest received
Term Loans	120	80	75	5
Cash credits and overdrafts	750	620	150	12
Bills purchased and discounted	150	150	100	20

Find out the income to be recognized for the year ended 31st March, 201X1.

Solution

Interest on performing assets should be recognised on accrual basis, but interest on NPA should be recognised on cash basis.

		₹ in lakhs
Interest on Term Loan :	(120 + 5) =	125
Interest on cash credits and overdraft :	(750 + 12) =	762
Income from bills purchased and discounted :	(150 + 20) =	<u>170</u>
		<u>1,057</u>

Illustration 2

KC Bank Statement of interest on advances in respect of Performing assets and Non Performing Assets are as follows:-

		(in lakhs)			
		<i>Performing Assets</i>		<i>Non Performing Assets</i>	
		<i>Interest earned</i>	<i>Interest received</i>	<i>Interest earned</i>	<i>Interest received</i>
<i>Cash credits and overdrafts</i>	1800	1060	450	70	
<i>Term Loan</i>	480	320	300	40	
<i>Bills purchased and discounted</i>	700	550	350	36	

Find out the income to be recognized for the year ended 31st March, 20X1.

Solution

Interest on performing assets should be recognised on accrual basis, but interest on NPA should be recognised on cash basis.

		₹ in lakhs
Interest on cash credits and overdraft :	(1800+70) =	1,870
Interest on Term Loan	(480+40) =	520
Income from bills purchased and discounted :	(700+36) =	<u>736</u>
		<u>3,126</u>

Illustration 3

Find out the income to be recognized in the case of SS Bank for the year ended 31st March, 20X1:

(₹ in lakhs)

	Performing Assets		Non-performing Assets	
	Interest accrued	Interest received	Interest accrued	Interest received
Term loans	240	160	150	10
Cash credits and overdrafts	1,500	1,240	300	24

Solution

Calculation of interest income of SS Bank to be recognized for the year ended 31.3.20X1

	(₹ in	lacs)
Term Loan		
Interest accrued on Performing Assets	240	
Interest received on Non - Performing Assets	<u>10</u>	250
Cash credit and overdraft		
Interest accrued on Performing Assets	1,500	
Interest received on Non - Performing Assets	<u>24</u>	<u>1,524</u>
Total interest to be recognized		<u>1,774</u>

Identification of NPA

The Reserve Bank of India has issued detailed guidelines to banks regarding the classification of advances between performing and non-performing assets which are revised from time to time. The latest guidelines for identifying an NPA's are:

- 1. Bills purchased and discounted** become NPA if interest and / or instalment of principal remain overdue for a period exceeding 90 days.
- 2. Term Loans:** become NPA if their amount (interest or principal) remain overdue wholly or partly for a period exceeding 90 days.
- 3. A cash credit / overdraft** account is treated as NPA if it becomes out of order. An account is deemed to be out of order if the outstanding balance remains continuously in excess of the sanctioned borrowing power or though the outstanding balance remains below the sanctioned borrowing power, there have been no credits in the account for a continuous period of more than 90 days prior to the Balance Sheet date or where the credits have not been enough to cover the

interest debited during the same period. Therefore, an account is treated as '**out of order**' if **any** of the following conditions are satisfied:

- (a) The outstanding balance remains continuously in excess of the sanctioned limit/drawing power for a continuous period of 90 days prior to the Balance Sheet date
- (b) Though the outstanding balance is less than the sanctioned limit/drawing power –
 - (i) there have been no credits for a continuous period of more than 90 days prior to the date of balance sheet; or
 - (ii) credits during the aforesaid period are not enough to cover the interest debited during the same period.
- (c) Further 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.

Example of OUT OF ORDER

Sanctioned limit	₹60,00,000
Drawing power	₹55,00,000
Amount outstanding continuously from 1.01.20X1 to 31.03.20X1	₹ 47,00,000
Total interest debited	₹3,42,000
Total credits	₹1,25,000

Since the credit in the account is not sufficient to cover the interest debited during the period account will be said as NPA.

4. Agricultural Advances: Advances granted for agriculture purposes becomes NPA **if interest and/or installment of principal remains overdue for two crop seasons** in case of **short duration crops** and a loan granted for **long duration crops will be treated as NPA**, if the installment of principal or interest thereon remains **overdue for one crop season**. *Crops having crop season of more than one year i.e. upto the period of harvesting the crops raised will be termed as 'long duration' crops and other crops will be treated as "short duration" crops.*

5. Securitisation transactions: Such transactions become NPA when the amount of liquidity facility remains overdue for more than 90 days.

6. Derivative transactions: Such transactions become NPA when 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.

7. 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.

8. Advances to Staff: As in the case of project finance, in respect of housing loans or similar advances granted to staff members where interest is payable after recovery of principal, the overdue status (in respect of payment of interest) should be reckoned from the date when there is default in payment of interest or repayment of installment of principal on due date of payment.

9. Take-out Finance: In the case of take-out finance arrangement, the lending bank should apply the prudential norms in the usual manner so long as the account remains on its banks.

* Take-out finance is a product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, the institution/bank financing the infrastructure projects ('the lending institution') has an arrangement with a financial institution ('the taking-over institution') for transferring to the latter the outstanding in respect of such financing on a pre-determined basis. There are several variants of take-out finance, but basically, they are either in the nature of unconditional take-out finance or conditional take-out finance. In the latter case, the taking-over institution stipulates certain conditions to be satisfied by the borrower before it is taken over from the lending institution. Thus, in this variant of take-over arrangements, there is an inherent element of uncertainty over the ultimate transfer of the outstanding amount to the taking-over institution. For a take-out finance arrangement to take effect, the borrower should also recognize the arrangement by way of inter-creditor arrangement.

10. Advances Guaranteed by EXIM Bank: In the case of advances covered under the guarantee-cum-refinance programme of EXIM Bank, to the extent payment has been received by the bank from the EXIM Bank, **the advance may not be treated as NPA. The balance should, however, be treated as NPA** (if the conditions for treating it as NPA are satisfied).

11. Consortium Advances: 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.

12. Advances Secured Against Certain Instruments: Advances secured against term deposits, national savings certificates (NSCs) eligible for surrender, Indira Vikas Patras, Kisan Vikas Patras and life insurance policies have been exempted from the above guidelines. Thus, interest on such advances may be taken to income account on due dates provided adequate margin is available in the respective accounts. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

4.1.1 Regularisation of Account by year-end: The identification of NPA is to be done on the basis of the position as on the balance sheet date. If an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources (and not by sanction of additional facilities or transfer of funds between accounts), the account need not be treated as NPA. The bank should, however, ensure that the account remains in order subsequently. Also, a solitary credit entry made in the account on or before the balance sheet date which extinguished the overdue amount of interest or instalment of principal is not reckoned as the sole criterion for determining the status of the account as non-performing or otherwise.

Certain other important RBI guidelines with reference to NPA's are given below:-

(i) 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. In the matter of classification of accounts with such deficiencies banks may follow the following guidelines:

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. Drawing power is required to be arrived based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

A working capital borrower account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

b) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc 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/ 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.

(ii) Net Worth of Borrower/Guarantor or Availability of Security: Since income recognition is based on recoveries from an advance account, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security is not relevant for determining whether an account is NPA or not (this is, however, subject to certain exceptions).

(iii) Determination of NPAs: Borrower-wise, Not Facility-wise: If any of the credit facilities granted to a borrower becomes non-performing, all the facilities granted to the borrower will have to be treated as NPA without any regard to performing status of other facilities.

(iv) Partial Recoveries in NPAs: Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credits facilities sanctioned to borrowers concerned.

4.1.2 Interest Application : On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record

amount on account of customer's bankruptcy. Show how the transactions would be recorded in the books of the Sona bank.

Solution

**Journal Entries
Books of Sona Bank**

Date	Particulars	Debit ₹	Credit ₹
20X1 31 March	Pankaj Loan Account Dr. To Interest Suspense Account (Interest due on doubtful debt credited to interest suspense account)	80,000	80,000
20X1-X2	Bank Account Dr. To Pankaj Loan Account (Recovery of 80% of the total loan amount and interest accrued i.e. (8,00,000+80,000))	7,04,000	7,04,000
	Interest Suspense Account Dr. To Interest Account (Amount received against the suspense account)	64,000	64,000
	Interest Suspense Account Dr. Bad Debts Account Dr. To Pankaj Loan Account (Unrecovered portion of the interest reversed and the balance transferred to bad debts account)	16,000 1,60,000	1,76,000

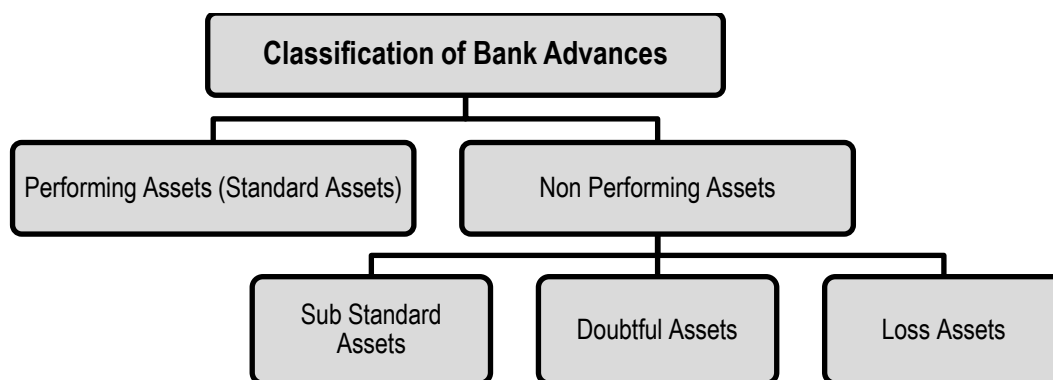
Treatment of interest suspense account: Amounts held in Interest Suspense Account should not be reckoned as part of provisions for NPA. Amounts lying in the Interest Suspense Account should be deducted from the relative advances and thereafter NPA, provisioning as per the norms, should be made on the balances after such deduction.

4.2 CLASSIFICATION OF BANK ADVANCES ON BASIS OF PERFORMANCE

The Banks have to classify their advances into two broad groups:

1. Performing Assets
2. Non-Performing Assets

Performing assets are also called as Standard Assets. The Non-Performing Assets is again classified into three groups and they are (i) sub-standard Assets (ii) doubtful assets & (iii) Loss Assets.



Performing Assets:

Standard Assets - Standard assets are those which do not disclose any problems and which does not carry more than normal risk attached to the business.

Non-Performing Assets (NPA):

- (i) **Sub-standard Assets** – A Sub-standard asset is one which has been classified as an NPA for a period not exceeding 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 bank in full. In other words, such an asset will have well-defined credit weaknesses that jeopardise the repayment of the debt and are characterised by the possibility that the bank would sustain some loss, if deficiencies are not corrected.

- (ii) **Doubtful Assets** - An asset would be classified as doubtful if it has remained in the substandard category for a period of at least 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.

As per RBI guideline, loan upon becoming an NPA would first be classified as sub-standard for a period not exceeding 12 months and beyond that it would have to be classified as DOUBTFUL.

- (iii) **Loss Assets** - A loss asset is one where loss has been identified by the **bank or internal or external auditors or the RBI inspectors** but the amount has not been written off, wholly or partly. In other words, such an asset is considered uncollectible or if collected of such little value that its continuance as a bank asset is not warranted although there may be some salvage or recovery value.

It may be noted that the above classification is meant for the purpose of computing the amount of provision to be made in respect of advances and not for the purpose of presentation of advances in the balance sheet. The balance sheet presentation of advances is governed by the Third Schedule to the Banking Regulation Act, 1949, which requires classification of advances altogether differently.

Important Points for Provisions:

1. Threats to Recovery: As per the guidelines, upon becoming NPA, a credit facility would be classified first as sub-standard for a period not exceeding 12 months and then as doubtful. It has been clarified, however, that in respect of accounts where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to classify them first as sub-standard and thereafter as doubtful. Banks have been advised to classify such accounts **straightway** as doubtful or loss assets, as appropriate irrespective of the period for which the account has remained NPA.

2. Security having Significant Realisable Value: It has been clarified that where the realisable value of security is significant, the credit facility should not be treated as loss assets.

To illustrate, suppose, as on March 31, 2012, the bank or the internal/external auditor or the RBI inspectors identifies a particular credit facility as a loss asset where the amount outstanding is ₹ 100 lakh and the salvage value of the security is ₹ 10 lakh. In such a case, the facility should be treated as a loss asset and provision should be made for ₹ 100 lakh (and not ₹ 90.00 lakh). If, on the other hand, the realisable value of the security is ₹ 80 lakh (i.e) the realisable value of security is significant then the bank can treat the credit facility only as doubtful and not as a loss asset.

3. Reschedulement / Restructuring /Renegotiation of Advances: Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories. However, Banks can not reschedule / restructure /renegotiate any of the borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re- classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation.

No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis.

The stages at which the restructuring/rescheduling/ renegotiation of the terms of loan agreement can take place are as under:

- (a) Before commencement of commercial production/operation;
- (b) After commencement of commercial production/operation but before the asset has been classified as sub-standard; and
- (c) After commencement of commercial production/operation and after the asset has been classified as sub-standard or doubtful.

The accounts classified as 'standard assets' should be immediately reclassified as 'sub-standard assets' upon restructuring (except for in certain cases). The non-performing assets, upon restructuring, 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 (except for in certain cases). Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package. However, in case of accounts where the pre-restructuring facility was classified as "sub-standard" and "doubtful", interest income on the additional finance should be recognized on cash basis only. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

While reviewing the prudential guidelines on restructuring of advances by banks/ financial institutions, Reserve Bank of India has decided the following*:

- i) To enhance the provisioning requirement for restructured accounts classified as standard advances from the existing 2.00 per cent to 2.75 per cent in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2.75 per cent for the period covering moratorium and two years thereafter; and that
- ii) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2.75 per cent in the first year from the date of upgradation instead of the existing 2.00 per cent.

In accordance with the above, loans to projects under implementation, when restructured due to change in the date of commencement of commercial operations (DCCO) beyond the original DCCO as envisaged at the time of financial closure and classified as standard advances in terms of guidelines contained in RBI circular DBOD.No.BP.BC.85 /21.04.048/2009-10 dated March 31, 2010, would attract higher provisioning at 2.75 per cent as against the present requirement of 2.00 per cent as per the details given below:

Infrastructure projects

<i>Particulars</i>	<i>Provisioning Requirement</i>
If the revised DCCO is within two years from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond two years and upto four years or three years from the original DCCO, as the case may be, depending upon the reasons for such delay (Ref.: DBOD.No.BP.BC.85 /21.04.048/2009-10 dated March 31, 2010)	2.75 per cent from the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later.

Non-infrastructure projects

<i>Particulars</i>	<i>Provisioning Requirement</i>
If the revised DCCO is within six months from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond six months and upto one year from the original DCCO prescribed at the time of financial closure (Ref.:DBOD.No.BP.BC.85 /21.04.048/2009-10 dated March 31, 2010)	2.75 per cent from the date of such restructuring for 2 years.

* vide circular no.DBOD.No.BP.BC.63/21.04.048/2012-13 dated November 26, 2012.

These norms are applicable for all scheduled commercial banks excluding RRBs.

Circular No. DBOD.No.BP.BC.33/21.04.048/2014-15 dated 14 August, 2014, states that: revisions of the date of commencement of commercial operations (DCCO) and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will not be treated as restructuring provided that:

- (a) The revised DCCO falls within the period of two years and one year from the original DCCO stipulated at the time of financial closure for infrastructure projects and non-infrastructure projects respectively; and
- (b) All other terms and conditions of the loan remain unchanged.

4.3 PROVISIONS

Taking into account the time lag between an asset becoming substandard/doubtful turning into loss asset, RBI has directed that bank should make provision against all assets (i.e) Loans & advances as follows:

Rates of Provisioning for Non-Performing Assets*

Standard Assets

- (i) The bank requires to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. The general provision towards standard assets as per Master circular is as follows:
 - (1) direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;

- (2) advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;
- (3) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent;
- (4) Housing loans extended at lesser rates – 2.00%. The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain 'standard';
- (5) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under:

3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)

4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)

5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

- (6) All other loans and advances not included above - 0.40%
- (ii) It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular on Lending to Micro, Small & Medium Enterprises (MSME) Sector.
 - (iii) While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning,

vis-a-vis the position as on any previous date, should be determined on an aggregate basis.

- (iv) The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but included as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

Rates of Provisioning for Sub- standard, Doubtful and Loss Advances are as follows:

Category of Advances-	Revised Rate (%)
Sub- standard Advances	
• Secured Exposures	15
• Unsecured Exposures	25
• Unsecured Exposures in respect of Infrastructure loan accounts where certain safeguards such as escrow accounts are available.	20
Doubtful Advances – Unsecured Portion	100
Doubtful Advances – Secured Portion	
• For Doubtful upto 1 year	25
• For Doubtful > 1 year and upto 3 years	40
• For Doubtful > 3 years	100
Loss Advances	100

Accounting and Provisioning Norms for Equipment Leasing Activity: While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities. The bank should follow the Accounting Standard 19 on "Leases" in accounting for lease transactions.

Note: -

1. The provisions on standard assets should not be reckoned for arriving at net NPAs.
2. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions' in Schedule 5 of the balance sheet.

***As per Master Circular DBOD.No.BP.BC.1/21.04.048/2014-15 dated July 1, 2014.**

General Note: Since no bank is likely to extend any loans or advances without adequate security, it is prudent to assume in the questions that even in the case of substandard or doubtful or loss assets, the same are secured unless the question specifically mentions otherwise.

Illustration 1

The outstanding amount (funded as well as unfunded) as on 31st March, 20X1 was: ₹ 10,000. The realizable value of security of the same was ₹ 8,000.

Period for which the advance has remained in 'doubtful' category as on 31st March, 20X1 was: 2.5 years.

Solution

Provisioning requirement:

As on...	Asset Classification	Provisions on secured portion		Provisions on unsecured portion		Total (₹)
		%	Amount	%	Amount	
31 March, 20X1	Doubtful 1 to 3 years	40	3,200	100	2,000	5,200
31 March, 20X2	Doubtful more than 3 years	100	8,000	100	2,000	10,000

Note: The secured portion of the outstanding loan is ₹ 8,000 and unsecured portion is ₹ 2,000.

Illustration 2

From the following information, find out the amount of provisions to be shown in the Profit and Loss Account of AG bank.

	₹ in lakhs
Assets	
Standard	5000
Sub-standard	4000
Doubtful	
: for one year	800
: for three years	600
: for more than three years	200
Loss Assets	1000

Solution**Computation of provisions for AG Bank**

Assets	Amount ₹ in lakhs	% of provision	Provision ₹ in lakhs
Standard	50,00	0.4	20
Substandard*	40,00	15	600
Doubtful for one year*	8,00	25	200
Doubtful for three years*	6,00	40	240
Doubtful for more than three years	2,00	100	200
Loss	10,00	100	<u>1,000</u>
Total Provision required			<u>2,260</u>

* All the marked sub-standard and doubtful assets are assumed as fully secured.

Illustration 3

From the following information of AY Limited, compute the provisions to be made in the Profit and Loss account:

	₹ in lakhs
Assets	
Standard	20,000
Substandard	16,000
Doubtful	
For one year (secured)	6,000
For two years and three years (secured)	4,000
For more than three years (secured by mortgage of plant and machinery ₹ 600 lakhs)	2,000
Loss Assets	1,500

Solution**Calculation of amount of provision to be made in the Profit and Loss Account**

<i>Classification of Assets</i>	<i>Amount of Advances</i>	<i>% age of provision</i>	<i>Amount of provision</i>
	<i>(₹ in lakhs)</i>		<i>(₹ in lakhs)</i>
Standard assets	20,000	0.40	80
Sub-standard assets	16,000	15	2,400
Doubtful assets:			
For one year (secured)	6,000	25	1,500
For two to three years (secured)	4,000	40	1,600
For more than three years (unsecured)	1,400	100	1,400
(secured)	600	100	600
Non-recoverable assets (Loss assets)	1,500	100	<u>1,500</u>
Total provision required			<u>9,080</u>

4.3.1 Provisioning for advances covered by ECGC/DICGC guarantee

In the case of advances guaranteed by Export Credit Guarantee Corporation (ECGC), Deposit Insurance & Credit Guarantee Corporation (DICGC) provision is required to be made only for the balance amount of advance outstanding in excess of the amount guaranteed by the corporations. In case the bank also holds a security in respect of an advance guaranteed by ECGC/DICGC, the realisable value of the security should be deducted from the outstanding balance before the ECGC/DICGC guarantee is off-set. The Reserve Bank of India has also clarified that if the banks are following more stringent method of provisioning in respect of advances guaranteed by ECGC/DICGC, such banks may continue to do so.

The manner of determining the amount of provision in respect of ECGC/DICGC guaranteed advances in accordance with the above guidelines is illustrated below. (It may be noted that these illustrations are merely intended to facilitate understanding of the RBI guidelines; they have not been issued by the RBI.)

Illustration 4

<i>Outstanding Balance</i>	<i>₹ 4 lakhs</i>
<i>ECGC Cover</i>	<i>50%</i>

<i>Period for which the advance has remained doubtful</i>	<i>More than 3 years remained doubtful (as on March 31, 20X1)</i>
<i>Value of security held</i>	<i>₹ 1.50 lakhs</i>

You are required to calculate provisions.

Solution

Provision required to be made as on 31.03.20X1

Outstanding balance	₹ 4.00 lakhs
Less: Value of security held (Secured Portion)	<u>₹ 1.50 lakhs</u>
Unrealised balance	₹ 2.50 lakhs
Less: ECGC Cover (50% of unrealizable balance)	<u>₹ 1.25 lakhs</u>
Net unsecured balance	<u>₹ 1.25 lakhs</u>
Provision for unsecured portion of advance	₹ 1.25 lakhs (@ 100% of unsecured portion)
Provision for secured portion of advance	<u>₹ 1.50 lakhs</u> (@ 100% of the secured portion as advance has remained doubtful for over 3 years)
Total provision to be made	<u>₹ 2.75 lakhs</u>

Illustration 5

<i>Outstanding Balance</i>	<i>₹ 4 lakhs</i>
<i>ECGC Cover</i>	<i>50%</i>
<i>Period for which the advance has remained doubtful</i>	<i>More than 3 years remained doubtful (as on March 31, 20X1)</i>
<i>Value of security held (realizable value only 80%)</i>	<i>₹ 1.50 lakhs</i>

You are required to calculate provisions as per applicable rates.

Solution

Provision required to be made as on 31.03.20X1

Outstanding balance	₹ 4.00 lakhs
Less: Value of security held (80% of 1.5 lacs)	<u>₹ 1.20 lakhs</u>
Unrealised balance	₹ 2.80 lakhs

Less: ECGC Cover (50% of unrealizable balance)	<u>₹ 1.40 lakhs</u>
Net unsecured balance	₹ 1.40 lakhs
Provision for unsecured portion of advance	₹ 1.40 lakhs (@ 100% of unsecured portion)
Provision for secured portion of advance	<u>₹ 1.20 lakhs</u> (@ 100% of the secured portion)
Total provision to be made	<u>₹ 2.60 lakhs</u>

Illustration 6

In KR Bank, the doubtful assets (more than 3 years) as on 31.3.20X1 is ₹ 1,000 lakhs. The value of security (including DICGC 100% cover of ₹ 100 lakhs) is ascertained at ₹ 500 lakhs. How much provision must be made in the books of the Bank towards doubtful assets?

Solution

	(₹ in lakhs)
Doubtful Assets (more than 3 years)	1,000
Less: Value of security (excluding DICGC cover)	<u>(400)</u>
	600
Less: DICGC cover	<u>(100)</u>
Unsecured portion	<u>500</u>
Provision:	
for unsecured portion @100%	500 lakhs
for secured portion @ 100%	<u>400 lakhs</u>
Total provision to be made in the books of KR Bank	<u>900 lakhs</u>

Illustration 7

A loan outstanding of ₹ 50,00,000 has DICGC cover. The loan guaranteed by DICGC is assigned a risk weight of 50%. What is the value of Risk-adjusted asset?

Solution

Loan outstanding	₹ 50,00,000
Guaranteed by DICGC – Risk weight	50%
Value of risk adjusted asset ₹.50,00,000 × 50% =	₹ 25,00,000

Principle for creation of floating provisions

The Master Circular dated July 1, 2013 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, requires the bank's board of directors to lay down a policy regarding the level to which the floating provisions can be created. The bank should hold floating provisions for 'advances' and 'investments' separately.

The floating provisions should not be used for making specific provisions as per the extant prudential guidelines in respect of nonperforming assets or for making regulatory provisions for standard assets. The floating provisions can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI. The boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary.

In terms of the Agricultural Debt Waiver and Debt Relief Scheme, 2008, lending institutions shall neither claim from the Central Government, nor recover from the farmer, interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges and miscellaneous charges, etc. All such interest/charges will be borne by the lending institutions. In view of the extraordinary circumstances in which the banks are required to bear such interest/charges, banks are allowed, as a one time measure, to utilise, at their discretion, the Floating Provisions held for 'advances' portfolio, only to the extent of meeting the interest / charges referred to above.

Floating provisions cannot be reversed by credit to the profit and loss account. They can only be utilised for making specific provisions in extraordinary circumstances as mentioned above. Until such utilisation, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs. Alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 % of total risk weighted assets.

Disclosures: Banks should make comprehensive disclosures on floating provisions in the "notes on accounts" to the balance sheet on (a) opening balance in the floating provisions account, (b) the quantum of floating provisions made in the accounting year, (c) purpose and amount of draw down made during the accounting year, and (d) closing balance in the floating provisions account.

Write-off of NPAs: Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of

loss assets 100% provision shall be made. There can be partial write off relating to the borrower's account in head office.

Interest Suspense Account: As mentioned earlier, the guidelines prohibit recognition of income on non-performing assets until it is actually realised. In order to comply with guidelines while ensuring at the same time that legal remedies against defaulting borrowers are not adversely affected and that proper control is exercised over non-performing advances, many banks adopted the practice of recording interest on non-performing advances to a separate account which is usually styled as 'Interest Suspense Account'. The balance in this account represents interest on non-performing advances debited to the respective borrowers' accounts in accordance with the terms of the agreement but not recognised as income. For purposes of balance sheet presentation, the gross advances portfolio is arrived at after deducting the credit balance in Interest Suspense Account from the total advances as per the ledgers. When the advances are identified as NPAs and banks chooses not to further debit the borrower in the manner aforesaid, the interest on contractual basis is to be computed and recorded as unapplied interest in the memoranda records.

The amounts held in Interest Suspense Account should not be reckoned as part of provisions for the purpose of computing the provision for NPAs. Amounts lying in the Interest Suspense Account should be deducted from the advances concerned and provisions should be made on the balances remaining after such deduction.

4.4 CLASSIFICATION OF INVESTMENTS

A unique feature of investments of a bank is that a large proportion of the investments is made in pursuance of the requirement to maintain a certain minimum level of liquid assets¹. The directions issued by RBI from time to time affect the methods of classification of investments. The entire investment portfolio of a bank (including SLR securities and non- SLR securities) should be classified under three categories:

Held-to-Maturity, (HTM): Securities acquired by banks with the intention to hold them upto maturity should be classified as 'held-to-maturity'. Investments under 'held-to-maturity' category should not exceed 25 per cent of the total investments of the bank though a bank can at its discretion hold less than the aforesaid percentage under this category. Certain securities specified in this behalf are not

¹ To maintain SLR

to be reckoned while applying the ceiling of 25 per cent in respect of 'held-to-maturity' securities.

In order to further develop the government securities market and enhance liquidity, it has been decided to bring down the ceiling on SLR securities under the HTM category from 24 per cent of NDTL to 22 per cent* in a graduated manner. Accordingly it is advised that Banks are permitted to exceed the limit of 25 per cent of total investments under HTM category provided:

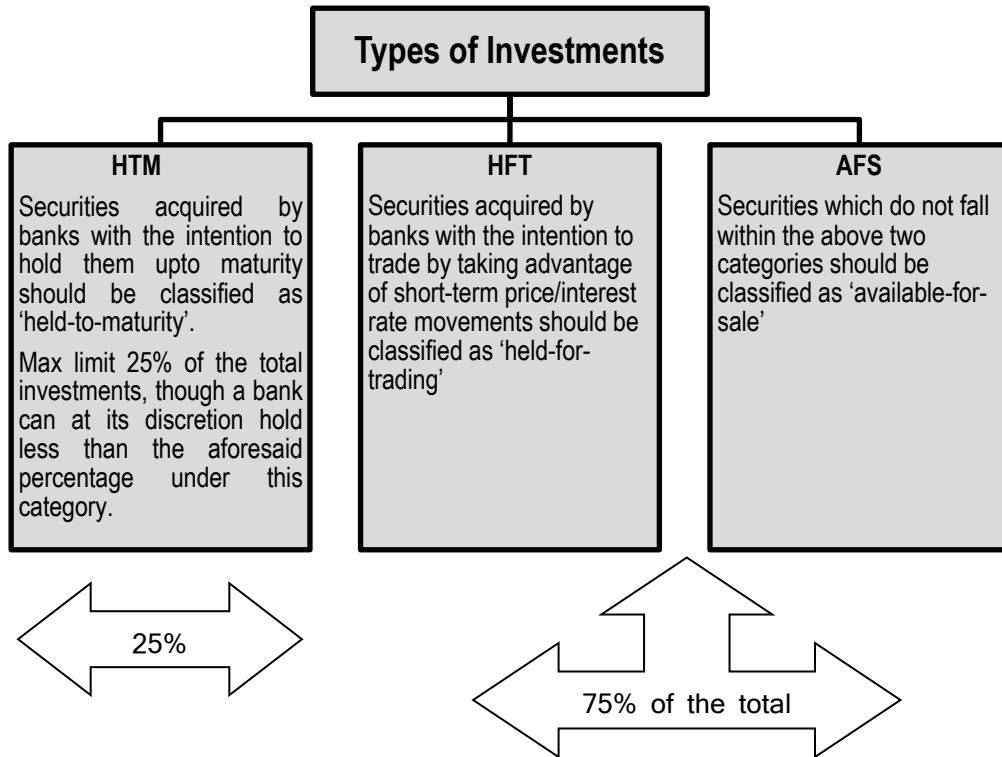
- a. the excess comprises only of SLR securities, and
- b. the total SLR securities held in the HTM category is not more than 23.50 per cent with effect from January 10, 2015, 23.0 per cent with effect from April 4, 2015, 22.5 per cent with effect from July 11, 2015 and 22.0 per cent with effect from September 19, 2015, of their Demand And Time Liability (DTL) as on the last Friday of the second preceding fortnight.

* As per DBOD.No.BP.BC.42/21.04.141/2014-15 dated 7 October, 2014

Held-for-Trading.(HFT): Securities acquired by banks with the intention to trade by taking advantage of short-term price/interest rate movements should be classified as 'held-for-trading'.

Available-for-Sale (AFS): Securities which do not fall within the above two categories should be classified as 'available-for-sale'.

The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills or capital position. The investment classified under HFT would be those from which the bank expects to make again by the movement in the interest rates/market rates. These securities are to be sold within 90 days. Profit or loss on sale of investments in both the categories will be taken to the Profit and Loss Account.



4.5 SHIFTING AMONG CATEGORIES OF INVESTMENTS

- i) Banks may shift investments to/from HTM with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from HTM will be allowed during the remaining part of that accounting year, except when explicitly permitted by RBI.
- ii) If the value of sales and transfers of securities to/from HTM category exceeds 5 per cent of 31 Prudential Norms on Investments - 2015 the book value of investments held in HTM category at the beginning of the year, banks should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. This disclosure is required to be made in 'Notes to Accounts' in banks' audited Annual Financial Statements. However, the one-time transfer of securities to/from HTM category with the approval of Board of Directors permitted to be undertaken by banks at the beginning of the accounting year. Further, additional shifting of securities explicitly permitted by the Reserve Bank from time to time, direct sales from HTM for bringing down SLR holdings in HTM category, sales to the Reserve Bank of India under pre-announced OMO auctions and repurchase of

Government securities by Government of India from banks will be excluded from the 5 per cent cap.

- iii)** Banks may shift investments from AFS to HFT with the approval of their Board of Directors/ ALCO/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/Head of the ALCO, but should be ratified by the Board of Directors/ ALCO.
- iv)** Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.
- v)** Transfer of scrips from AFS / HFT category to HTM category should be made at the lower of book value or market value. In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value.

In the case of transfer of securities from HTM to AFS / HFT category,

- (a) If the security was originally placed under the HTM category at a discount, it may be transferred to AFS / HFT category at the acquisition price / book value. (It may be noted that as per existing instructions banks are not allowed to accrue the discount on the securities held under HTM category and, therefore, such securities would continue to be held at the acquisition cost till maturity). After transfer, these securities should be immediately re-valued and resultant depreciation, if any, may be provided.
- (b) If the security was originally placed in the HTM category at a premium, it may be transferred to the AFS / HFT category at the amortised cost. After transfer, these securities should be immediately re-valued and resultant depreciation, if any, may be provided.

In the case of transfer of securities from AFS to HFT category or vice-versa, the securities need not be re-valued on the date of transfer and the provisions for the accumulated depreciation, if any, held may be transferred to the provisions for depreciation against the HFT securities and vice-versa.

4.6 VALUATION OF INVESTMENTS

The Banks are required to classify investments into three categories:

(a) Held-to-Maturity,

- (i) Investments classified under held-to-maturity category need not be marked to market. They should be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.
- (ii) The bank should reflect the amortised amount in Schedule 13: Interest Earned – Item II 'Income on Investments' as a deduction. However, the deduction need not be disclosed separately. The book value of the securities should continue to be reduced to the extent of the amount amortised during the relevant accounting period.
- (iii) As per AS 13- only permanent diminution in the value of such investments under held-to-maturity category should be provided for. Such diminution should be determined and provided for each investment individually

(b) Available-for-sale: The individual scrips in the available-for-sale category should be marked to market quarterly or at more frequent intervals.

While the net depreciation under each of the categories (required by third schedule to Banking Regulation Act, 1949 – refer Unit 1) should be recognised and fully provided for, the net appreciation under any of the aforesaid categories above should be ignored. Thus, banks can offset gains in respect of some investments marked-to-market within a category against losses in respect of other investments marked-to-market in that category.

The guidelines however, do not permit offsetting of gains and losses across different categories. The book value of the individual securities would not have undergone any change after the marking to market. In other words, the depreciation or appreciation in value of individual scrips in accordance with the above methodology would not be credited to individual scrip accounts but would be held collectively in a separate account.

(c) Held-for-trading: The individual scrips in the 'held-for-trading' category should be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the 'Available for sale' category.

Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.

Banks are required to follow AS 13 'Accounting for Investments' issued by the ICAI relating to long-term investments for valuation of investments in subsidiaries. In terms of AS 13, long term investments should be arrived in the financial statements at carrying cost. However, provision for diminution shall be made to recognise a decline other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

4.7 INVESTMENT FLUCTUATION RESERVE

- (i) With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, banks were advised to build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years.
- (ii) To ensure smooth transition to Basel II norms, banks are advised to maintain capital charge for market risk in a phased manner over a two year period, as under:
 - (a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book , and
 - (b) In respect of securities included in the AFS category.
- (iii) With a view to encourage banks for early compliance with the guidelines for maintenance of capital charge for market risks, banks which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category may treat the balance in excess of 5 per cent of securities included under HFT and AFS categories, in the IFR, as Tier I capital. Banks satisfying the above were allowed to transfer the amount in excess of the said 5 per cent in the IFR to Statutory Reserve.
- (iv) Banks maintaining capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category would be permitted to treat the entire balance in the IFR as Tier I capital. For this purpose, banks may transfer the balance in the Investment Fluctuation Reserve 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account.
- (v) **Investment Reserve Account (IRA)**

In the event, provisions created on account of depreciation in the 'AFS' or 'HFT' categories are found to be in excess of the required amount in any year, the

excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an IRA Account in Schedule 2 – “Reserves & Surplus” under the head “Revenue and other Reserves”, and would be eligible for inclusion under Tier-II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

(vi) Banks may utilise IRA as follows:

The provisions required to be created on account of depreciation in the AFS and HFT categories should be debited to the P&L Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve), may be transferred from the IRA to the P&L Account.

Illustratively, banks may draw down from the IRA to the extent of provision made during the year towards depreciation in investment in AFS and HFT categories (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision). In other words, a bank which pays a tax of 30% and should appropriate 25% of the net profits to Statutory Reserves, can draw down ₹52.50 from the IRA, if the provision made for depreciation in investments included in the AFS and HFT categories is ₹100.

(vii) The amounts debited to the P&L Account for provision should be debited under the head ‘Expenditure - Provisions & Contingencies’. The amount transferred from the IRA to the P&L Account, should be shown as ‘below the line’ item in the Profit and Loss Appropriation Account, after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account, and hence should appear in that account before arriving at the profit for the accounting period.

(viii) In terms of our guidelines on payment of dividend by banks, dividends should be payable only out of current year's profit. The amount drawn down from the IRA will, therefore, not be available to a bank for payment of dividend among the shareholders. However, the balance in the IRA transferred ‘below the line’ in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account would be eligible to be reckoned as Tier I capital.

4.8 DISCLOSURE REQUIREMENTS ON ADVANCES RESTRUCTURED BY BANKS AND FINANCIAL INSTITUTIONS

Reserve of India has framed Disclosure Requirements on Advances Restructured by Banks and Financial Institutions vide Circular DBOD.BP.BC.No.80/21.04.132/2012-13 dated January 31, 2013. These disclosure requirements will be effective from the financial year 2012-13.

Paragraph 16 of Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 2, 2012 states manner in terms of which banks should disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances under the categories-Standard; Sub-Standard; and Doubtful Advances. Under each category, advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories of restructuring are required to be shown separately.

The Working Group (WG) constituted by RBI to review the existing Prudential Guidelines on Restructuring of Advances had recommended that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either abinitio or on upgradation from NPA category) revert back to the normal level on account of satisfactory performance during the prescribed period, such advances should no longer be required to be disclosed by banks as restructured accounts in the "Notes on Accounts" in their Annual Balance Sheets. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions. The WG also recommended that banks may be required to disclose: (i) Details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable); (ii) Provisions made on restructured accounts under various categories; and (iii) Details of movement of restructured accounts.

This recommendation has been accepted in view of the fact that in terms of present guidelines, banks are required to disclose annually all accounts restructured in their books on a cumulative basis even though many of them would have subsequently shown satisfactory performance over a sufficiently long period. As such the present position of disclosures do not take into account the fact that in many of these accounts the inherent weaknesses have disappeared and the accounts are in fact

standard in all respects, but continue to be disclosed as restructured advances. Accordingly, banks should henceforth disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the prescribed format. Detailed instructions relating to the disclosure are also given in the format.