

Prudential Norms on Income Recognition and Asset Classification - Changes effective for 31.3.2022

This Article is intended to provide a look into the Prudential Norms on Income Recognition and Asset Classification for Banks with special reference to the changes which are effective for the year ended 31.3.2022. Read on...



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Important RBI notifications

1. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01.005/2020-21 dated September 14, 2020 -Automation of Income Recognition, Asset Classification and Provisioning processes in banks
2. RBI/2021-2022/104 DOR.No.STR. REC.55/21.04.048/2021-22 dated October 1, 2021-Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances
3. RBI/2021-2022/125 DOR.STR.

REC.68/21.04.048/2021-22 dated November 12, 2021-Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Clarifications

4. RBI/2021-2022/158 DOR.STR. REC.85/21.04.048/2021-22 dated February 15, 2022 -Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Clarifications

Automation of IRAC norms – Daily reckoning of NPA

This should be the **most important** change in the IRAC norms going forward from the current year and hence the members are advised to familiarise themselves before the audit is taken up.

As per notification dated September 14, 2020, banks were required to put in place / upgrade their systems to conform to the guidelines in respect of automated Asset



Classification (classification of advances/investments as NPA/ NPI and their upgradation) latest by June 30, 2021.

The banks have submitted compliance of this circular to RBI. It is understood that while the automation is put in place generally, there are specific areas where the same is in progress and hence the members while approaching the audit for the current year may initially confirm the extent to which automation is in place.

All borrowal accounts, including temporary overdrafts, irrespective of size, sector or types of limits, are required to be covered in the automated IT based system (System) for asset classification, upgradation, and provisioning processes along with Banks' investments

Calculation of provisioning requirement shall also be System based as per pre-set rules for various categories of assets, value of security as captured in the System and any other regulatory stipulations issued from time to time on provisioning requirements.

In addition, income recognition/reversal in case of impaired assets (NPAs/NPIs) shall be system driven and amount required to be reversed from the income account should be obtained from the System without any manual intervention.

The System shall handle both down-grade and upgrade of accounts through Straight Through Process (STP) without manual intervention.

The System based asset classification shall be an ongoing exercise for both down-gradation and up-gradation of accounts. Banks are required to ensure that the asset classification status is updated as part of *day end process* which is a significant departure from, which were hitherto, an exercise as on the balance sheet date.

In short, the down grading of borrower accounts as NPA and up grading as standard asset would be a daily exercise instead of being carried out as on the balance sheet date.

Consequential changes – Classification as NPA – Term Loans

As a result of the moving into daily identification of NPA, various clarifications are issued by RBI vide its circular dated 12.11.2021.

As per the circular, the borrower accounts shall be flagged as *overdue* by banks as part of their day-end processes for the due date. Similarly, classification of borrower accounts as SMA as well as NPA shall be done as part of day-end process for the relevant date and the SMA or NPA classification date shall be the *calendar date* for which the day end process is run. In other words, the date of SMA/NPA shall reflect the asset classification status of an account at the day-end of that calendar date.

Example: *If due date of a loan account is March 31, 2021, and full dues are not received before the banks runs the day-end*

process for this date, the date of overdue shall be March 31, 2021. If it continues to remain overdue, then this account shall get tagged as SMA-1 upon running day-end process on April 30, 2021 i.e. upon completion of 30 days of being continuously overdue. Accordingly, the date of SMA-1 classification for that account shall be April 30, 2021.

Similarly, if the account continues to remain overdue, it shall get tagged as SMA-2 upon running day-end process on May 30, 2021 and if continues to remain overdue further, it shall get classified as NPA upon running day-end process on June 29, 2021. (Refer paragraph 11.97 of Guidance Note on Audit of Banks 2022 edition)

The circular further clarifies that in case of interest payments, generally, an account is classified as NPA only if the interest due and charged during *any quarter* is not serviced fully within 90 days from the *end of the quarter*. In order to fully align with the 90 days delinquency norm as well as the requirement to apply interest at monthly rests, the instructions are modified to the effect that in case of interest payments in respect of term loans, an account will be classified as NPA if the interest applied at specified rests remains overdue for more than 90 days. (Refer paragraph 11.99(a) of Guidance Note on Audit of Banks 2022 edition)

The circular also requires that the exact due dates for repayment of a loan, frequency

of repayment, breakup between principal and interest, examples of SMA/NPA classification dates, etc. shall be clearly specified in the loan agreement and the borrower shall be apprised of the same at the time of loan sanction and also at the time of subsequent changes. As a result, the date of debit of interest in the borrower account becomes important. Some banks run the interest application on staggered days during the last week of every month/ quarter. In such cases, the 90 day norm shall be calculated accordingly. Auditors need to ensure that the application of IRAC norms are ensured accordingly, during the audit for the current year.

Consequential changes – CC/OD accounts

In the case of CC/OD accounts, an account was considered as 'out of order' only if there were no credits continuously for 90 days as on the date of Balance Sheet or credits were not enough to cover the interest debited during the same period.

The determination of 'out of order' status of CC/OD accounts would now be on the following basis:

- i. the outstanding balance in the CC/OD account remains continuously in excess of the sanctioned limit/drawing power for 90 days, or
- ii. the outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but there are

no credits continuously for 90 days, or

- iii. the outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but credits are not enough to cover the interest debited during the previous 90 days period.

Accordingly, treatment of CC/OD accounts as 'out of order' on or after the date of this circular shall be based on the above instructions. In other words, the reckoning of NPA in the case of CC/OD accounts by regularisation near to the balance sheet date is no longer possible. (Refer paragraph 11.98 of Guidance Note on Audit of Banks 2022 edition)

The change could be best explained with the following example: Hitherto, if the outstanding balance in any CC/OD account was above the sanctioned limit / drawing power say from 15th December, it would have been possible to retain the account as standard if the remittance is received on or before 31st March to bring the balance outstanding within sanctioned limit / drawing power. In the same manner, even if there are no credits in the account in the months of December, January and February and credit is received by end March, the account would have continued to be standard. Applying the revised norms, the account would turn NPA by end of day on 14th March, being the end of the 90th day.

Since banks have moved into monthly debits towards interest, credits to cover interest debit period should also be reckoned in a 90 day period from each debit. Example for an interest debit on 30th November, if the credits between 30th November to 27th February are not enough to cover the interest debit, the account will be NPA by end of day on 27th February.

Banks have come out with exquisite and innovate loan products where OD facility is granted against primary security of property, personal guarantee of borrower etc. In all these cases, there is no requirement of furnishing monthly stock statements, yearly audited accounts etc. and consequently the computation of drawing power is not required. Monitoring of end use of funds is also not required as per the internal circular issued to branches. In some cases, borrowers are required to service only the interest debited. Doubts had arisen whether under such circumstances the revised 90 days norm as above would be attracted. RBI vide its clarification dated 15.2.2022, has made it clear beyond any doubt that:

- i. *The definition of 'out of order', as clarified in the Circular, shall be applicable to all loan products being offered as an overdraft facility, including those not meant for business purposes and/or which entail interest repayments as the only credits.*

- ii. *The 'previous 90 days period' for determination of 'out of order' status of a CC/OD account shall be inclusive of the day for which the day-end process is being run.*

The members while carrying out the branch audit, need to closely look at the above changes mandated as it is quite doubtful whether the system updation to capture all such circumstances are in place.

Standard Assets under Securitisation

Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated 24.9.2021 explains Securitisation as those transactions where credit risk in assets are redistributed by repackaging them into tradeable securities with different risk profiles which may give investors of various classes access to exposures which they otherwise might be unable to access directly. While complicated and opaque securitisation structures could be undesirable from the point of view of financial stability, prudentially structured securitisation transactions can be an important facilitator in a well-functioning financial market in that it improves risk distribution and liquidity of lenders in originating fresh loan exposures. As per paragraph 55 of the said directions, the asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days in respect of

a securitisation transaction undertaken in terms of the said directions (Refer paragraph 11.99(d) of Guidance Note on Audit of Banks 2022 edition).

Agricultural Advances

The IRAC norms in the case of agricultural advances would be based on whether such advances are for 'long duration' or 'short duration' crops. The crop season for each crop would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by the borrower.

The above norms should be made applicable only to Farm Credit extended to agricultural activities as listed at Annexure – 2 to RBI circular no. RBI/2021-2022/104 DOR.No.STR. REC.55/21.04.048/2021-22 dated October 1, 2021. In respect of agricultural loans, other than those specified in the Annexure - 2, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm. (Refer paragraph 11.101 of Guidance Note on Audit of Banks 2022 edition)

Upgradation of accounts classified as NPA

With the alignment of classification of borrower accounts as NPA on a 90 days norm, there are consequential changes in the upgrading of accounts that are classified as

NPA. Due to the percolator effect, once one facility of a borrower is classified as NPA, all other facilities are also treated as NPA though the other facilities could be only in SMA category. RBI circular of 12.11.2021 makes it categorical that: *It has been observed that some lending institutions upgrade accounts classified as NPAs to 'standard' asset category upon payment of only interest overdue, partial overdue, etc. In order to avoid any ambiguity in this regard, it is clarified that loan accounts classified as NPAs may be upgraded as 'standard' asset only if entire arrears of interest and principal are paid by the borrower.*

Hence, upgradation is allowed only if the account reaches "no over dues" status. This should not be misunderstood with "overdues brought within 90 days". Further, in case of borrowers wherein the bank has multiple exposures, it would be pertinent to note that the 'no overdue' status needs to



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be achieved with reference to all exposures of the bank as on the date of upgradation of the account. (Refer paragraph 11.135 (i) of Guidance Note on Audit of Banks 2022 edition).

For example, if a term loan account is classified as NPA and if the borrower has a home loan which may be standard, that too would be classified as NPA. Suppose the home loan account slips to SMA when the term loan irregularity is removed, the borrower continues to be an NPA until the home loan account also moves from SMA to Standard, *with no overdues*.

Auditors may bear in mind the guidance given in Page 396 of the Guidance Note on Audit of Banks 2022 edition where it is cautioned that in case of advances upgraded during the year, the auditor needs to review such upgradation in the light of the criteria specified for upgradation of NPA accounts, considering the possibility of incorrect upgradation of account on the basis of partial recoveries made in the account wherein the overdue portion is not extinguished in entirety, recoveries made

in the account subsequent to the cut-off date, (i.e., date of financial statements) and non-identification of NPAs on on-going basis resulting in an account being considered as standard though overdue portion of such unidentified NPAs is not recovered in entirety.

This aspect is once again reiterated in the clarification circular issued by RBI on 15.2.2022 which reads as under:

In case of borrowers having more than one credit facility from a lending institution, loan accounts shall be upgraded from NPA to standard asset category only upon repayment of entire arrears of interest and principal pertaining to all the credit facilities.

Here again, the members need to exercise caution as it is understood that the system upgradation in this regard is not complete in many banks and there are possibilities of errors in identification.

It may be borne in mind that upgradation of accounts classified as NPA due to restructuring, non-achievement of date of commencement of commercial operations (DCCO), etc., the instructions specified for such cases shall continue to be applicable.

Income recognition policy for loans with moratorium on payment of interest

There have been lot of discussions and debates on accrual of interest during moratorium period as well as

reversal of interest when such interest during moratorium period is allowed to be converted into FITL, especially during COVID period. RBI circular of 12.11.2021 has issued necessary clarification in such cases.

In cases of loans where moratorium has been granted for repayment of interest, banks may recognize interest income on accrual basis for accounts which continue to be classified as 'standard'. This shall be followed only in the case of borrower accounts falling within the definition of 'restructuring' provided in paragraph 1 of the Annexure -1 of RBI circular - 'Prudential Framework for Resolution of Stressed Assets' dated June 7, 2019. Income recognition norms for loans towards projects under implementation involving deferment of DCCO and gold loans for non-agricultural purposes shall continue to be governed as per the existing instructions issued in this regard. For DCCO cases reference may be made to Para 4.2.15 of Master Circular dated 1.10.2021 and in the case of agricultural advances



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RBI circular DBOD.No.BP. BC.27/21.04.048/2014-15 dated July 22, 2014 as updated from time to time may be referred to.

Paragraph 3.2 of the Master Circular on Prudential norms dated October 1, 2021 requires that once an account is classified as NPA, the interest accrued and credited to income account in the past periods, must be reversed to the extent it remains unrealised. However, if loans with moratorium on payment of interest (permitted at the time of sanction of the loan) become NPA after the moratorium period is over, the capitalized interest corresponding to the interest accrued during such moratorium period need not be reversed

In the case of interest during the period of COVID moratorium (March 2020 to August 2020) converted into FITL, they were required to be repaid before 31.3.2021. In case of failure to pay the same, the FITL need not be reversed, but should be considered as NPA applying the normal 90 days norm. This is because of specific direction contained in RBI circular dated 17.4.2020 on Covid 19 which specified that the conversion of accumulated interest into FITL as permitted under this circular was not to be treated as concession granted due to financial difficulty of the borrower and consequently will not result in asset classification downgrade, thereby granting relief in the form of retention of class of asset to such accounts (Refer paragraph 11.185 of Guidance Note on Audit of Banks 2022 edition)

Appropriation of recovery in NPA accounts

Many banks were following the accounting policy of appropriation of recoveries in NPA accounts first towards principal and balance if any towards interest and other charges. This was adopted to bring down the Gross NPA which was significant till recently. Some of the banks have changed the accounting policy in the last two years. As per changed policy, recoveries in NPA accounts, except in cases like OTS or in cases where there is a clear agreement for appropriation towards principal, are appropriated towards interest and charges first and balance only towards principal. Auditors are advised to go through the significant accounting policies as well as published quarterly results for the current year to ascertain if there was any change in accounting policy and ensure that the appropriation is done according to the changed policy. (Refer paragraph 11.131 of Guidance Note on Audit of Banks 2022 edition)

Provisioning for Loans and Advances

RBI Master Circular dated October 1, 2021 on Prudential Norms on IRAC contains the principles to be followed by banks in calculating the provisions required for the NPAs. In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the



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banks' balance sheet RBI has stipulated various requirements.

Attention of the members is drawn to the disclosure requirement of advances for which *intangible securities* such as charge over the rights, licenses, authority, etc., have been taken as also the estimated value of such intangible collateral. The disclosure is to be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

As per the existing instructions of RBI, in the Balance Sheet of banks, the advances against book debts (though not tangible assets), charged as security are grouped as "secured by tangible assets" and disclosure is made with a remark in parenthesis in Schedule 9, without any quantification of the advances covered by security of book debts.

However, as per Master Circular dated 1.10.2021, the amounts comprising the

intangibles (such as charge over the rights, licenses, authority, etc.) will need to be culled out of the secured exposures and quantified to be reflected as unsecured advances; which would also require corresponding reclassification of advances for the earlier year. More importantly, in case of NPAs, the unsecured portion would attract a higher provision, when segregated from the secured portion. (Refer paragraph 11.138 of Guidance Note on Audit of Banks 2022 edition)

Advances covered by certain types of guarantee

In case the advance covered by Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the existing guidelines on provisioning norms. Illustrative examples of provisioning in case of advances covered by CGTSE guarantee is given under



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Paragraph 5.9.4 of the RBI Master Circular dated October 1, 2021 on Prudential Norms (Refer paragraph 11.151 of Guidance Note on Audit of Banks 2022 edition).

Restructured Advances

Over the last two years different guidelines have been issued on restructuring of advances and guidelines to be followed in complying with IRAC norms. Part B1 of RBI Master Circular dated October 1, 2021 explains the Framework for resolution of stressed assets while Part B2 of RBI Master Circular dated October 1, 2021 explains the prudential norms applicable for restructured advances. Para 15.3 of the above said Master Circular gives the special dispensation granted to specific categories of borrowers on account of COVID 19. Accounts restructured under the revised framework shall attract provisioning as per the asset classification category as laid out in Part A of the above said Master Circular. The members may go through the guidelines explained in detail in paragraphs 11.159 to 11.209 of the Guidance Note on Audit of Banks 2022 edition since restructuring as well as provisioning guidelines are distinct and different across categories of borrowers. This is besides the disclosure requirement of such advances in the Notes on Accounts.

Conclusion

Verification of advances and application of IRAC norms continues to be the most important area in the case of



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bank audits. The identification and classification of accounts as NPA would be the challenge continued to be faced in the audit of branches while ensuring the provisioning requirements are taken care would be the responsibility of the central statutory auditors. The changed 90 day norms both for classification and upgrading of NPA which is reiterated by RBI through two clarification circulars shows the intention of the regulator in ensuring compliance. The auditors, both branch and central, are required to continue to keep vigil in ensuring compliances and not to be carried away by the fact that the number of divergences observed by RBI in asset classification have come down over the period of time. The members, especially those who are presently carrying out only branch audits, should familiarise themselves with the guidance given in the Guidance Note on Audit of Banks issued by ICAI which is updated every year and published much before the audit process is expected to commence. ■■■