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FIRST NOTES
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RBI releases guidelines relating to framework on stressed asset resolution

28 February 2014

First Notes on:

- Financial Reporting
- Corporate law updates
- **Regulatory and Other Information**
- Disclosures

Sector:

- All
- **Banking and Insurance**
- Information, Communication, Entertainment
- Consumer and Industrial Markets
- Infrastructure and Government

Relevant to:

- **All**
- Audit committee
- CFO
- Others

Transition:

- Immediately
- **Within the next 3 months**
- Post 3 months but within 6 months
- Post 6 months

Introduction

The Reserve Bank of India (RBI) had on 30 January 2014, released a 'Framework for Revitalising Distressed Assets in the Economy' effective from 1 April 2014, which laid down guidelines for early recognition of financial distress, taking prompt steps for resolution and thereby, ensuring fair recovery for lending institutions (refer First Notes edition dated 31 January 2014).

For operationalising the above framework, the RBI has vide notification dated 26 February 2014, released detailed guidelines on refinancing of project loans, sale of NPAs by banks and other regulatory measures. Also, another notification dated 26 February 2014, provides further guidelines on formation of joint lenders' forum (JLF) and adoption of corrective action plan (CAP).

Refinancing of project loans

In partial modification to the August 2008 circular on restructuring of advances by banks and the February 2000 circular on takeout finance, the new guidelines mention that in case banks refinance any existing infrastructure and other project loans by way of take-out financing, even without a pre-determined agreement with other banks/FIs, and fix a longer repayment period, the same would not be considered as restructuring if the following conditions are satisfied:

- Such loans should be 'standard' in the books of the existing banks, and should have not been restructured in the past.
- Such loans should be substantially taken over (more than 50 per cent of the outstanding loan by value) from the existing financing banks/financial institutions.
- The repayment period should be fixed by taking into account the life cycle of the project and cash flows from the project.

Purchase/ sale of non-performing financial assets to other banks

In partial modification to the July 2005 circular on purchase/sale of non-performing financial assets, the new guidelines permit banks to sell their NPAs to other banks/FIs/NBFCs (excluding SCs/RCs) without any initial holding period. However, the non-performing financial asset should be held by the purchasing bank in its books at least for a period of 12 months before it is sold to other banks/financial institutions/NBFCs (excluding SCs/RCs). It is clarified that the extant prudential norms on asset classification of such assets in the books of purchasing banks/FIs/NBFCs will remain unchanged.

Use of counter-cyclical/floating provision

In addition to utilisation of countercyclical/floating provision for up to 33 per cent of such provisions held by banks as on 31 March 2013 as per the recent RBI circular (refer First Notes edition dated 10 February 2014), the new guidelines permit banks to use countercyclical/floating provisions for meeting any shortfall on sale of NPA i.e. when the sale is at a price below the net book value (NBV) [i.e., book value less provision held], which presently requires debit to the profit and loss account.

Credit risk management

The guidelines advise banks to strictly follow the credit risk management guidelines and reiterate/prescribe the following:

- Banks/lenders should carry out sensitivity tests/scenario analysis, especially for infrastructure projects, which should inter alia include project delays and cost overruns. This will aid in taking a view on the viability of the project at the time of deciding corrective action plan.
- Lenders should ascertain the source and quality of equity capital brought in by the promoters /shareholders.
- Lenders could consider engaging their own auditors for certification related to end-use of funds without relying on certification given by borrower's auditors. However, this cannot substitute the bank's basic minimum own diligence in the matter.

Reinforcement of regulatory instructions

The guidelines reiterate that banks are required to extinguish all available means of recovery before writing off any account fully or partly. It mentions that some banks are resorting to technical write off of accounts, which reduces incentives to recover. Banks resorting to partial and technical write-offs should not show the remaining part of the loan as standard asset. With a view to bring in more transparency, the guidelines prescribes a format in which banks should disclose full details of write offs, including separate details about technical write offs, in their annual financial statements. For details of the format prescribed, please refer the 'Annex' to the notification on the link provided.

Board oversight

The new guidelines specify periodic review by the Board to be on a half yearly basis, with regard to the oversight measures to be put in place by the lenders, which were prescribed in the framework released on 30 January 2014, and have been reiterated in these guidelines.

Guidelines on JLF and CAP

The new guidelines reiterate the details specified in the framework released on 30 January 2014, and provide further guidance on those.

Our comments

The guidelines released by the RBI further strengthen the measures introduced by it to tackle the challenges posed by NPAs in India.

The additional concessions offered by the RBI on provisioning will likely require changes from an accounting/ auditing perspective.

The bottom line

- The RBI has provided some relief from the higher levels of provisioning being witnessed in the banking industry.
- The RBI is also focussing on strengthening the credit risk management and effectiveness of the policy approved by the Board, by prescribing half yearly review by the Board of the policy framed, pursuant to the RBI guidelines.

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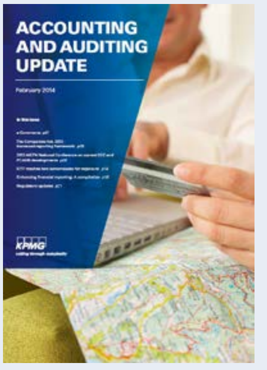

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