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FIRST NOTES
KPMG in INDIA

25 March 2014

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- 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 month**
- Post 3 month but within 6 month
- Post 6 months

Introduction

The Reserve Bank of India (RBI) on 30 January 2014, had 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 attempting to ensure fair recovery for lending institutions. With the above background, the RBI has on 21 March 2014, released similar guidelines, to the extent it is applicable, to non-banking financial companies (NBFCs.)

Early recognition of stressed assets

Under the new Framework, before a loan account turns into a non-performing asset (NPA), NBFCs would be required to identify incipient stress in the account by creating a sub-asset category viz 'Special Mention Accounts' (SMA) as follows:

SMA sub-categories	Basis for classification
SMA - 0	Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress
SMA - 1	Principal or interest payment overdue between 31-60 days
SMA - 2	Principal or interest payment overdue between 61-180 days

The Framework consists of an illustrative list of signs of stress for categorising an account as SMA-0, which includes, amongst others, shortfall in projections accepted for loan sanction by 40 per cent or more; delay of 90 days or more in submission of stipulated control statements/financial statements, non-renewal of facilities based on audited financials; return of three or more cheques/debit instructions issued by borrowers in 30 days on grounds of non-availability of balance/drawing power in the account; promoters pledging/selling shares in the borrower company due to financial stress, etc.

RBI has set up a Central Repository of Information on Large Credits (CRILC) to collect, store and disseminate credit data to lenders. All systemically important non-banking financial companies (NBFC-ND-SI), NBFCs-D, and all NBFC-Factors, shall be required to furnish credit information to CRILC on all their borrowers having an aggregate fund and non-fund based exposure of INR 50 million and above.

Individual notified NBFCs would have to monitor accounts reported as SMA-0 or SMA-1 and take up the issues with the borrower for their rectification. However, reporting of an account as SMA-2 by one or more lending banks/notified NBFCs will trigger the mandatory formation of a Joint Lenders' Forum (JLF) and formulation of Corrective Action Plan (CAP).

Formation of JLF and CAP

The Framework lays down guidelines on formation of JLF based on the extent of aggregate exposure of the lenders. The CAP by JLF may explore various options to resolve the stress in the account including rectification of the signs of stress, restructuring the account, and in case these measures are not considered feasible, resorting to due recovery process. Detailed guidance has been provided on the restructuring process to be followed. The Framework prescribes a time limit depending on the aggregate exposure to be approved by the Corporate Debt Restructuring (CDR) Cell and JLF.

Penal measures

In case where NBFCs fail to report the SMA status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts, those NBFCs would be subject to accelerated provisioning, as prescribed below for these accounts and/or other supervisory actions as deemed appropriate by the RBI.

Asset Classification	Period as NPA	Current Provisioning %	Revised accelerated provisioning %
Sub-standard (secured)	6 month to 1 and half year	For secured and unsecured 10	25
Sub-standard (unsecured ab-initio)	6 month to 1 and half year	10	40
Doubtful I	Upto 1 year (secured portion)	20	40
	Upto 1 year (unsecured portion)	100	100
	1-3 years	30 (secured portion) and 100 (unsecured portion)	40 (secured portion) and 100 (unsecured portion)
Doubtful II	More than 3 years	50 (secured portion)	100 for both secured and unsecured portions
		100 (unsecured portion)	
Doubtful III	5th year onward		100

Any of the lenders who has agreed to the restructuring decision under the CAP by JLF, and is a signatory to the Inter Creditor Agreement and Debtor Creditor Agreement, but changes their stance later on, or delays/refuses to implement the package, will also be subjected to accelerated provisioning requirement as indicated above, on their exposure to this borrower i.e., if it is classified as an NPA. If the account is standard in those lenders' books, the provisioning requirement will be 5%. Further, any such backtracking by a lender might attract negative supervisory view during Supervisory Review and Evaluation Process.

Presently, asset classification is based on record of recovery at individual NBFCs, and provisioning is based on asset classification status at the level of each NBFCs. However, the framework prescribes that, if lenders fail to convene the JLF or fail to agree upon a common CAP within the stipulated time frame, the account will be subjected to accelerated provisioning as indicated above, if it is classified as an NPA. If the account is standard in those lenders' books, the provisioning requirement would be 5%.

Sale of NPAs

In partial modification to the current applicable guidelines on sale of NPAs, it is mentioned that NBFCs will be permitted to sell their NPAs to other banks/FIs/NBFCs (excluding Securitisation Company (SC)/ Reconstruction Company (RCs) without any initial holding period. However, the non-performing financial asset should be held by the purchasing bank/FI/NBFC in its books at least for a period of 12 months before it is sold to other banks/financial institutions/NBFCs (excluding SCs/RCs). The extant prudential norms on asset classification of such assets in the books of purchasing banks/FIs/NBFCs will remain unchanged.

Non-Cooperative borrowers

A 'non-co-operative borrower' is defined as one who does not provide necessary information required by a lender to assess its financial health even after two reminders; or denies access to securities etc. as per terms of sanction; or does not comply with other terms of loan agreements within stipulated period; or is hostile / indifferent / in denial mode to negotiate with the NBFC on repayment issues; or plays for time by giving false impression that some solution is on horizon; or resorts to vexatious tactics such as litigation to thwart timely resolution of the interest of the lenders.

The framework requires notified NBFCs to report classification of such borrowers to CRILC. Further, NBFCs will be required to make higher/accelerated provisioning in respect of new loans/exposures to such borrowers, as also new loans/exposures to any other company promoted by such promoters/ directors or to a company on whose board any of the promoter / directors of this non-cooperative borrower is a director. The provisioning applicable in such cases will be at the rate of 5% if it is a standard account and accelerated provisioning, if it is an NPA. This is a prudential measure since the expected losses on exposures to such non-cooperative borrowers are likely to be higher.

Other aspects

The Framework also gives guidance on credit risk management, board oversight, registration of transactions with central registry.

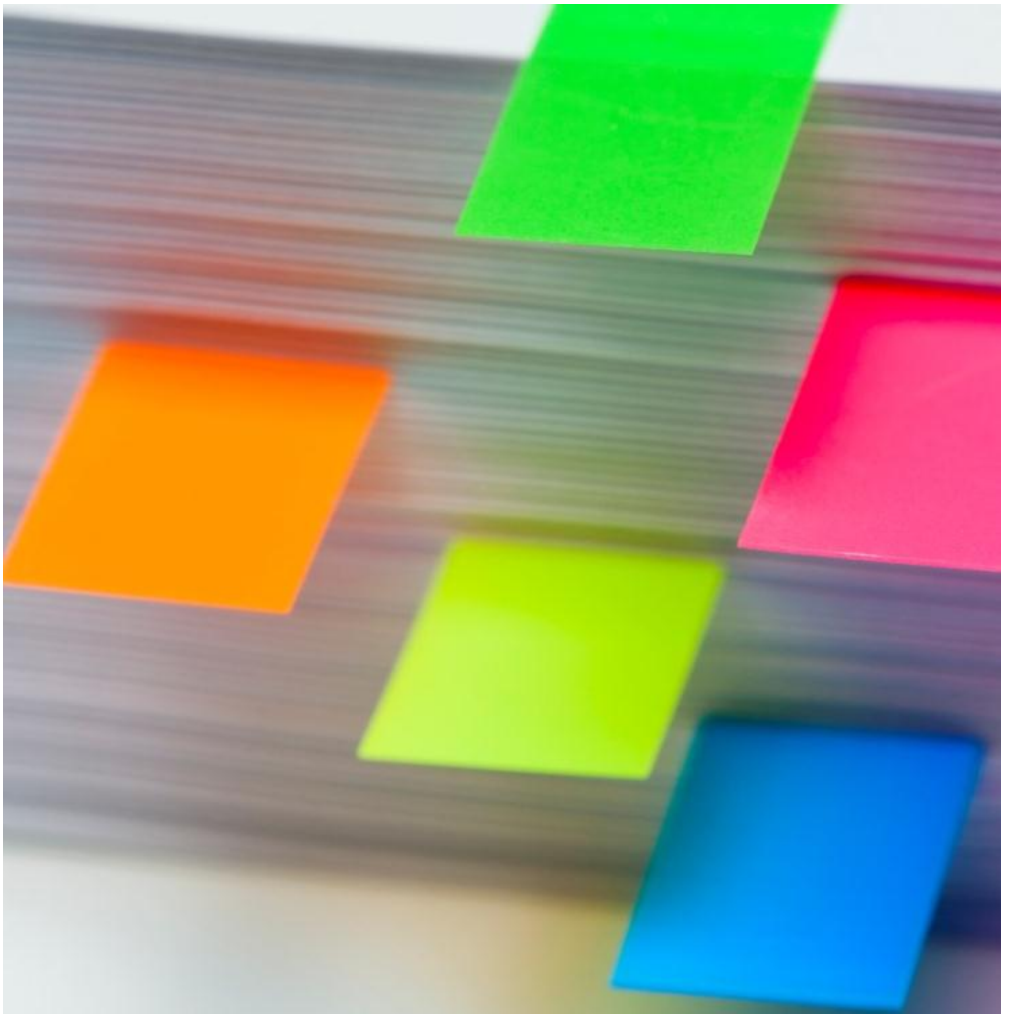
Our comments

The Framework released by the RBI is expected to have a potentially significant effect on how lenders operate in India, and look to tackle and resolve their NPAs or near NPA exposures.

- NBFCs may need to institute an inclusive monitoring mechanism to identify and categorise SMAs.
- Reporting requirements to the newly established Central Repository could have implications both for lenders and borrowers who dealt with a situation of information asymmetry till recently.
- Joint efforts and co-ordination between lenders on resolution and restructuring could change the ground rules and also be a challenge for more nimble NBFCs that tended to follow a bilateral approach towards resolution.
- Penal consequences in terms of provisioning and supervisory reviews could create a powerful incentive for compliance.

The bottom line

- The RBI continues to be serious about its efforts to resolve the rising NPAs issue in the Indian banking system.
- A lot of work and co-ordination is required for NBFCs to comply with the new framework.
- Both, incentives for compliance and disincentives for non adherence are significant enough to help ensure traction on the ground.



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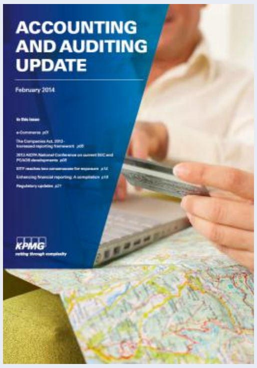

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