CHAPTER 3

Non-performing assets and Provisioning

This article aims to:

Explicate the regulations pertaining to provisioning of assets in the financial statements and as per the regulatory requirements, and disclosures thereon.

Background

As per the regulations issued by RBI, provisioning of assets is critical for all entities in the financial services sector. Currently, the SI-NBFC Master Directions[1], NSI-NBFC Master Directions[2] and HFC Master Directions[3] (collectively termed as Master Directions) provide norms for asset classification and provisioning for NBFCs. As per the Master Directions every NBFC shall, after considering the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes, namely:

(i) Standard assets;

(ii) Sub-standard assets;

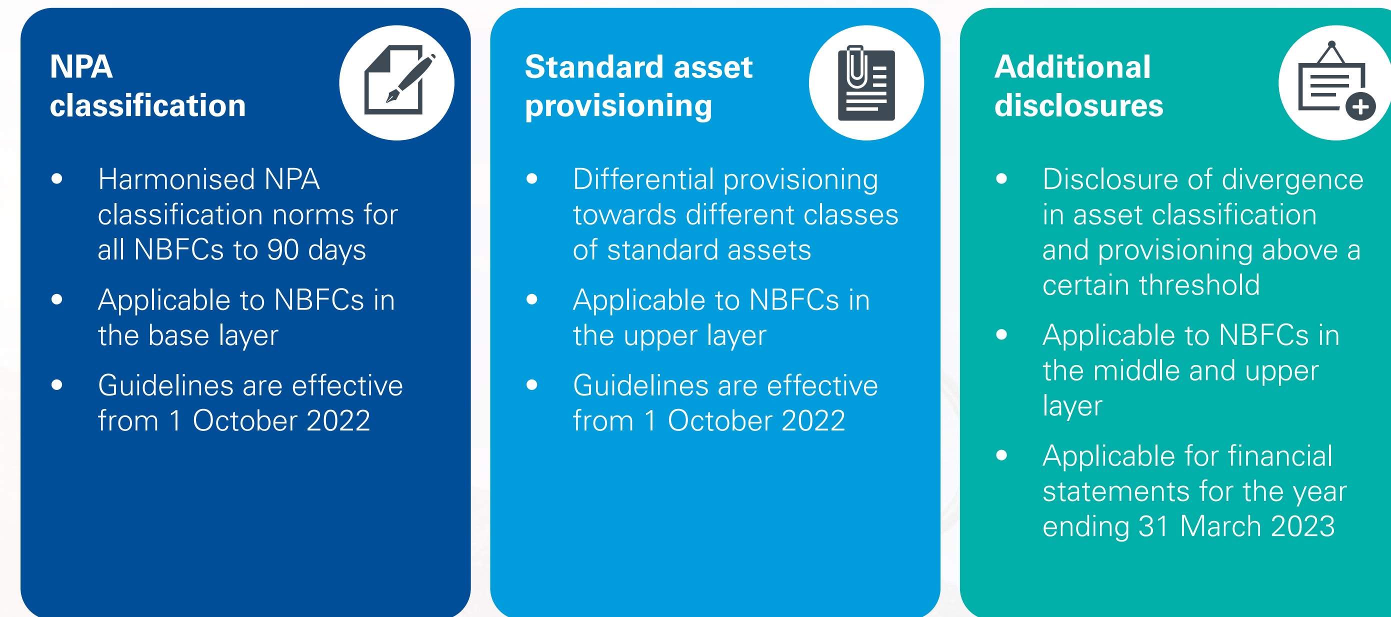
(iii) Doubtful assets; and

(iv) Loss assets.

Provisioning is required for each of these assets at the rates prescribed by RBI. Additionally, NBFCs are required to disclose provisions made as per the RBI regulations in their financial statements.

The RBI, vide the SBR has prescribed certain additional regulations pertaining to provisioning and disclosures of provisions for certain layers of the NBFCs, as given in figure 1 below:

Figure 1: Additional regulations pertaining to provisioning issued under SBR



(Source: KPMG in India's analysis,2022, read with RBI circulars, Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs issued on 22 October 2021, Disclosure in Financial Statements- Notes to Account issued on 19 April 2022 and Provisioning for Standard assets by Non-Banking Financial Company – Upper Layer, issued on 6 June 2022)

In this article, we aim to provide an overview of the current requirements pertaining to NPA classification and provisioning under the RBI regulations and under the Ind AS and explicate the amendments issued under the SBR.

1. Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.
2. Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016.
3. Master Direction – Non-Banking Financial Company – Housing Finance Company (Reserve Bank) Directions, 2021.

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Non-Performing Assets (NPA) classification

Currently, the NBFCs-ND with an asset size of less than INR500 crore (i.e. non-systemically important, non-deposit taking NBFCs) classify assets with an overdue period of more than 180 days as NPA (NPA norm). All other NBFCs have an NPA norm of 90 days.

The RBI has now harmonised the NPA norms for all NBFCs to 90 days. This amendment will impact the NBFCs in the base layer, which includes the NBFC-ND (i.e. the non-systemically important, non-deposit taking NBFCs). Accordingly, a glide path has been provided to NBFCs in the base layer to adhere to the 90 days NPA norm, as given below:

NPA norm	Timeline
> 150 days	By 31 March 2024
> 120 days	By 31 March 2025
> 90 days	By 31 March 2026

Clarifications issued by RBI on NPA classifications

On 1 October 2021, RBI issued a Master Circular on Prudential Norms on Income Recognition Asset Classification and Provisioning (IRACP) which is applicable to all commercial banks (excluding regional rural banks). Subsequently, on 12 November 2021 and 15 February 2022, RBI issued circulars providing certain clarifications on IRACP norms to ensure uniformity in its implementation and harmonising certain requirements for all lending institutions[4]. Some clarifications that will impact NPA classification for NBFCs with effect from 1 October 2022 include:

- **SMA classification applicable to NBFC-ND:** Currently, the requirement to classify overdue borrower accounts as SMA as prescribed in the 'Prudential Framework for Resolution of Stressed Assets' is applicable to NBFC-ND-SI and NBFC-D (i.e. all systemically important, non-deposit taking NBFCs and all deposit taking NBFCs), however, it is not applicable to NBFC-ND (i.e. non-systemically important, non-deposit taking NBFCs).

  With the clarifications issued by RBI, these provisions will now apply even to NBFC-ND. However, references to '90 days' for SMA-2/NPA classification may be read as per the NPA norms applicable to NBFC-ND (non-systemically important, non-deposit taking NBFCs).

- **Upgradation of accounts classified as NPAs**: The IRACP norms state that accounts classified as NPA can be upgraded to 'standard account' category if arrears of interest and principal are paid by the borrower. RBI observed that many lending institutions upgrade NPA accounts to 'standard' category upon payment of only interest overdues, partial overdues, etc.

  The RBI 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. Circular dated 15 February 2022 has provided NBFCs time till 30 September 2022 to put in place the necessary systems to implement this.

4. This includes all commercial banks, co-operative banks, All-India Financial Institutions and all NBFCs (including HFCs).

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Provisioning requirements and computation of a prudential floor

While dealing with provisioning for assets, NBFCs should look at two aspects i.e. the regulatory aspect and the accounting aspect. The Master Directions instruct NBFCs that are required to implement Ind AS to prepare their financial statements in accordance with the principles enunciated in Ind AS. NBFCs that are not required to adopt Ind AS, should comply with the requirements of the notified Accounting Standards (AS) insofar as they are not inconsistent with the Master Directions.

It is expected that most NBFCs in the middle and upper layer of the SBR will have a net worth of INR250 crore or more, hence they would be within the purview of Ind AS. Such NBFCs would need to refer to the principles of Ind AS 109, *Financial Instruments* while provisioning for assets in the financial statements.

In parallel NBFCs/Asset Reconstruction Companies (ARCs) should also maintain the asset classification and compute provisions as per extant prudential norms on Income Recognition, Asset Classification and Provisioning (IRACP) including borrower/ beneficiary wise classification, provisioning for standard as well as restructured assets, NPA ageing, etc. (termed as Prudential floor)[5]. A comparison between provisions required under IRACP and impairment allowances made under Ind AS 109 should be disclosed in the prescribed format by NBFCs/ARCs in the notes to their financial statements to provide a benchmark to their BoD, RBI supervisors and other stakeholders, on the adequacy of provisioning for credit losses.

Where impairment allowance under Ind AS 109 (which is recorded in the financial statements) is lower than the provisioning required under IRACP (including standard asset provisioning), NBFCs/ARCs should appropriate the difference from their net profit or loss after tax to a separate 'Impairment Reserve'.

Some of the key requirements prescribed by Ind AS and the provisioning requirements applicable to NBFCs are discussed below.

Accounting as per Ind AS

Requirements of Ind AS 109 with regard to provisioning of assets is given below:

A. Classification and measurement of financial assets

An entity should classify financial assets as subsequently measured at amortised cost, Fair Value through Other Comprehensive Income (FVOCI) or at Fair Value Through Profit or loss (FVTPL) on the basis of both:

- The business model for managing the financial assets; and
- The contractual cash flow characteristics of the financial assets

B. Expected credit losses (ECL)

The impairment model in Ind AS 109 is an expected credit loss model, which means that it is not necessary for a loss event to occur before an impairment loss is recognised. As a result,all financial assets generally carry a loss allowance, however, there are some exceptions from recognising a loss allowance. ECLs are a probability-weighted estimate of credit losses – i.e. the present value of cash shortfalls over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because ECL consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

<u>Significant increases in credit risk</u>

Entities should initially recognise a 12-month ECL on all financial assets, and subsequently, on every reporting date test whether there has been a significant increase in credit risk of that asset, in which case, a lifetime ECL is recognised on such asset.

Generally, for assessing whether there has been a significant increase in credit risk, entities compare the probability of defaults on the financial asset at the reporting date with the probability of default on the financial asset at the date of initial recognition.

Ind AS 109 also provides a rebuttable presumption, wherein the credit risk of a financial asset is presumed to have increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.

<u>Default</u>

Ind AS 109 does not define the term 'default', but instead requires each entity to do so. The definition has to be consistent with that used for internal credit risk management purposes for the relevant financial instrument and has to consider qualitative indicators - e.g. breaches of covenants - when appropriate. The definition of default is applied consistently, unless information that becomes available indicates that another default definition is more appropriate for a particular financial instrument.

There is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to corroborate a more lagging default criterion.

5. This is in accordance with RBI circular dated 13 March 2020 on 'Implementation of Indian Accounting Standards'

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Provisioning requirements under the Master Directions

The Master Directions prescribe the provisioning requirements for standard assets, sub-standard assets, loss assets and doubtful assets for NBFCs and HFCs as given below:

Asset classification[6]	Provisioning for NBFCs	Provisioning for HFCs
Loss assets	Entire asset to be written off Or 100 per cent provision on outstanding amount	Entire asset to be written off Or 100 per cent provision on outstanding amount
Doubtful assets	A. Unsecured portion 100 per cent provision B. Secured portion 20 per cent to 50 per cent provision on the basis of period for which asset is considered doubtful	A. Unsecured portion 100 per cent provision B. Secured portion 25 per cent to 100 per cent provision on the basis of period for which asset is considered doubtful
Sub-standard assets	Provision of 10 per cent on outstanding amount	Provision of 15 per cent on outstanding amount
Standard assets	A. For all NBFCs MFI and IFC and for Factors with asset size less than INR500 crore 0.25 per cent of standard asset B. For other NBFCs, including Factors with asset size greater than INR500 crore 0.4 per cent of standard asset (This provision has been amended for NBFCs in the upper layer of the SBR framework, see the section below.)	Differential standard asset provisioning based on category of assets.

(Source: KPMG in India's analysis, 2022 read with SI-NBFC-Master Directions, NSI-NBFC-Master Directions and HFC-Master Directions)

6. Additional rates and provisions have been given for lease and hire purchase assets. These are not covered in this article

Amendments issued by the scale based regulations (effective 1 October 2022)

The RBI has issued detailed guidelines for NBFCs falling in the upper layer of SBR to adopt **'differential standard asset provisioning norms'**[7] while computing the provisions on standard assets. These norms are in line with those prescribed for banks:

Category of standard assets	Rate of provision on standard assets
Individual housing loans and loans to Small and Micro Enterprises (SMEs)[8]	0.25 per cent
Housing loans extended at teaser rates[9]	2 per cent, which will decreae to 0.4 per cent after one year from the date on which the rates are reset at higher rates (if accounts remain standard)
Advances to Commercial Real Estate[10] – Residential Housing (CRE-RH)[11] sector	0.75 per cent
Advances to Commercial Real Estate (CRE) sector (other than CRE-RH)	1 per cent
Restructured advances	As stipulated in the applicable prudential norms for resturcturing of advances
All other loans and advances not included above, including loans to Medium Enterprises[8]	0.4 per cent

(Source: RBI circular, Provisioning for Standard assets by Non-Banking Financial Company – Upper Layer, issued on 6 June 2022)

7. Detailed guidelines on differential standard asset provisioning have been issued vide circular dated 6 June 2022.
8. Definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be as per the circular FIDD.MSME & NFS.BC.No.3/06.02.31/2020-21 dated July 2, 2020 on 'Credit flow to Micro, Small and Medium Enterprises Sector' as updated from time to time.
9. Housing loans extended at teaser rates shall mean housing loans having comparatively lower rates of interest in the first few years after which the rates of interest are reset at higher rates.
10. Commercial Real Estate (CRE) would consist of loans to builders/ developers/ others for creation/acquisition of commercial real estate (such as office building, retail space, multi-purpose commercial premises, multi- tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction etc.) where the prospects for repayment, or recovery in case of default, would depend primarily on the cash flows generated by the asset by way of lease/rental payments, sale etc. Further, loans for third dwelling unit onwards to an individual will be treated as CRE exposure.
11. Commercial Real Estate – Residential Housing (CRE–RH) is a sub-category of CRE that consist of loans to builders/ developers for residential housing projects (except for captive consumption). Such projects should ordinarily not include non-residential commercial real estate. However integrated housing project comprising of some commercial spaces (e.g. shopping complex, school etc.) can also be specified under CRE-RH, provided that the commercial area in the residential housing project does not exceed 10 per cent of the total Floor Space Index (FSI) of the project. In case the FSI of the commercial area in the predominantly residential housing complex exceed the ceiling of 10 per cent, the entire loan should be classified as CRE and not CRE-RH.

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Further, current credit exposures[12] arising on account of the permitted derivative transacitons would also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for permitted derivative transactions.

Since these provisions are in line with the existing provisions pertainig to differential standard asset provisioning applicable to HFCs, the HFCs that are classified in the upper layer of the SBR will not be impacted by this amendment.

It is to be noted, these revised provisions will be applied while computing the prudential floor with effect from 1 October 2022.

Additional disclosure requirements

Currently, the Master Directions prescribe the disclosure requirements pertaining to asset classification and provisioning, which includes an analysis of the NPAs and comparison of provisions computed as per Ind AS and with the provisions computed in accordance with RBI regulations (this is for NBFCs that have adopted Ind AS)[13].

In addition to the existing requirements, the SBR requires NBFCs in the middle and upper layer to disclose divergences in asset classification and provisioning between those computed by the NBFCs, by following the RBI regulations, and those computed by RBI (as part of its evaluation of the NBFC's asset classification and provision for assets computation). The disclosure of divergence in asset classification and provisioning is required to be provided in accordance with the format (table 1) as given below. Disclosures of divergence would be required if either or both of the following conditions are satisfied:

- The additional provisioning requirements assessed by RBI (or National Housing Bank (NHB) in the case of Housing Finance Companies) exceeds five per cent of the reported profits before tax and impairment loss on financial instruments for the reference period, or
- The additional Gross NPAs identified by RBI/ NHB exceeds five per cent of the reported Gross NPAs for the reference period

Table 1: Format for reporting divergence in asset classification and provisioning

Sr.	Particulars	Amount
1	Gross NPAs as on March 31, 20XX* as reported by the NBFC	
2	Gross NPAs as on March 31, 20XX as assessed by the Reserve Bank of India/ NHB	
3	Divergence in Gross NPAs (2-1)	
4	Net NPAs as on March 31, 20XX as reported by the NBFC	
5	Net NPAs as on March 31, 20XX as assessed by Reserve Bank of India/ NHB	
6	Divergence in Net NPAs (5-4)	
7	Provisions for NPAs as on March 31, 20XX as reported by the NBFC	
8	Provisions for NPAs as on March 31, 20XX as assessed by Reserve Bank of India/ NHB	
9	Divergence in provisioning (8-7)	
10	Reported Profit before tax and impairment loss on financial instruments for the year ended March 31, 20XX	
11	Reported Net Profit after Tax (PAT) for the year ended March 31, 20XX	
12	Adjusted (notional) Net Profit after Tax (PAT) for the year ended March 31, 20XX after considering the divergence in provisioning	

* March 31, 20XX is the close of the reference period in respect of which divergences were assessed

12. Current credit exposure is defined as the sum of the gross positive mark-to-market value of all derivative contracts with respect to a single counterparty, without adjusting against any negative marked-to-market values of contracts with the same counterparty.
13. NBFCs that are preparing financial statements as per Ind AS would additionally be required to provide disclosures prescribed in Ind AS 107, *Financial Statements: Disclosures*

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