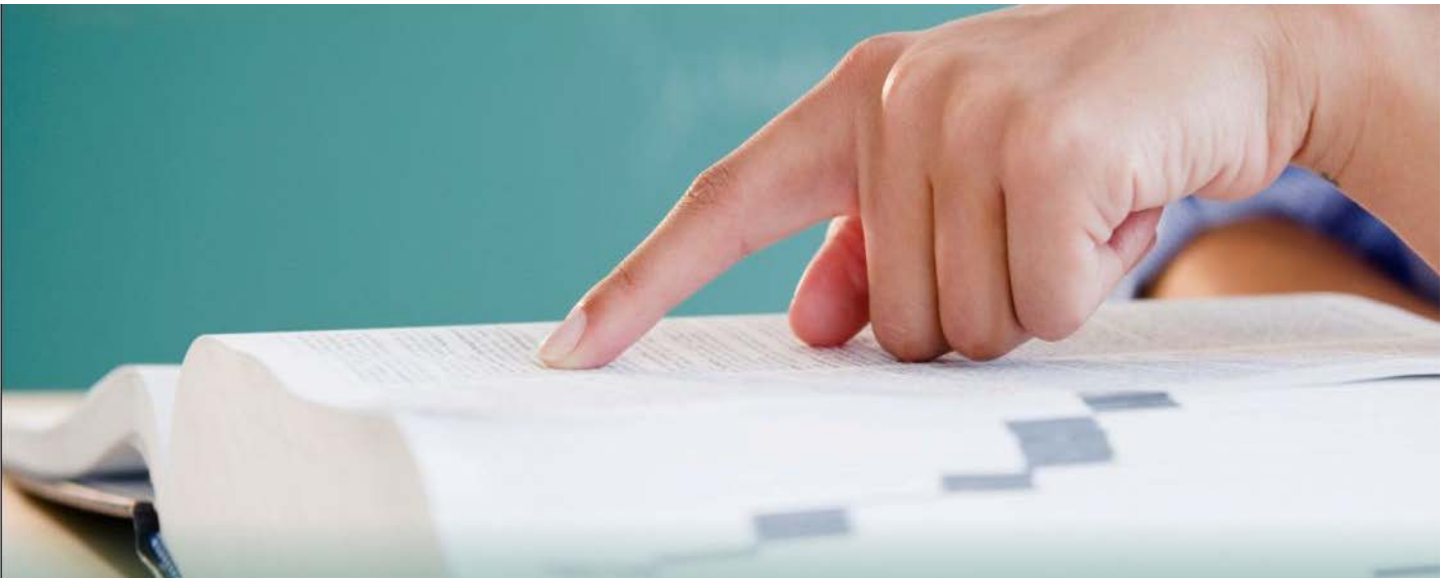
KPMG
cutting through complexity

FIRST NOTES
KPMG IN INDIA

RBI framework on stressed asset resolution

31 January 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 month but within 6 months
Post 6 months

Introduction

The Reserve Bank of India (RBI) has released a 'Framework for Revitalising Distressed Assets in the Economy' effective from 1 April 2014, which lays down guidelines for early recognition of financial distress, taking prompt steps for resolution and, thereby ensuring fair recovery for lending institutions.

Early recognition of stressed assets

As per a 2002 RBI circular, before a loan account becomes NPA, banks are required to identify incipient stress in the account by creating a sub-asset category of 'Special Mention Accounts' (SMA). Under the new Framework, banks would, henceforth, be required to have three sub-categories under 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 61-90 days

The Framework lists down illustrative list of signs of stress for categorizing 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; increase in frequency of overdrafts in current accounts; promoters pledging/ selling shares in the borrower company due to financial stress etc.

The RBI will set up a Central Repository of Information on Large Credits (CRILC) to collect, store and disseminate credit data to lenders. All commercial banks and notified systemically important non-banking financial companies (NBFC-SI) and NBFC-Factors would be required to furnish credit information to CRILC on all their borrowers who have an aggregate fund and non-fund based exposure of INR 50 million and above, and also report External Commercial Borrowing extended by their overseas branches/ offices to the Indian borrowers. Additionally, banks will have to furnish details of all current accounts of their customers with debit/ credit balance of Rs 10 million and above.

Individual banks 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 lenders will trigger the mandatory formation of a Joint Lenders' Forum (JLF) and formulation of Corrective Action Plan (CAP). Additionally, formation of a JLF and CAP would be required if an account is reported as SMA-0 for three quarters during a year to date or SMA-1 for any two quarters during a year to date.

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 of 30 days from the date of reporting, to agree on the option to be adopted by the CAP, and further 30 days to sign off the final CAP.

Penal measures

In case the notified lenders 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 lenders 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)	Upto 6 month	15	No change
	6 month to 1 year	15	25
Sub-standard (unsecured ab-initio)	Upto 6 month	25 (other than infrastructure loans)	25
		20 (infrastructure loans)	25
	6 month to 1 year	25 (other than infrastructure loans)	40
		20 (infrastructure loans)	40
Doubtful I	2nd year	25 (secured portion)	40 (secured portion)
		100 (unsecured portion)	100 (unsecured portion)
Doubtful II	3rd and 4th year	40 (secured portion)	100 for both secured and unsecured portions
		100 (unsecured portion)	
Doubtful III	5th year onwards	100	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 the Supervisory Review and Evaluation Process.

Sale of NPAs

With regards to sale of NPAs, amongst other matters, the Framework also permits banks to sell assets reported as SMA-2 to Asset reconstruction Companies (ARCs) for which necessary guidelines would be issued by the RBI. According to current instructions on sale of financial asset by a bank to ARCs, if the sale is for a value higher than the Net Book Value (NBV), the excess provision is not allowed to be reversed but banks will have to utilise the same to meet the shortfall/loss on account of sale of other financial assets to Securitisation Company (SC)/Reconstruction Company (RC). However, banks are required to provide for any shortfall if the sale value is lower than the NBV. With a view to bringing in uniformity and incentivising banks to recover appropriate value in respect of their NPAs promptly, the RBI would allow banks to reverse the excess provision on sale of NPA if the sale is for a value higher than the NBV to its P&L account in the year the amounts are received. Further, as an incentive for early sale of NPAs, the RBI would allow banks to spread over any shortfall, i.e., if the sale value is lower than the NBV, over a period of two years – this incentive would be available for NPAs sold up to 31 March 2015 and will be subject to necessary disclosures in the financial statements. The Framework also allows banks to use floating provisions towards accelerated provisioning /additional provisions incurred at the time of sale of NPAs as per their approved internal policy. without obtaining prior permission of the RBI, for which necessary instructions would be issued.

Accountability

The Framework also prescribes prudential measures for ensuring better corporate governance in companies and accountability of independent directors, auditors, valuers, lawyers etc.

Other aspects

The Framework also gives guidance on Credit risk management and reinforcement of regulatory instructions on extending credit facilities. It also mentions measures being taken up by the RBI towards putting in place the infrastructure required for implementation and Board oversight to be put in place by the lenders for implementation of the Framework.

Our comments

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

- Lenders would need to institute a comprehensive monitoring mechanism to identify and categorize SMAs.
- Reporting requirements to the newly established Central Repository would have implications, both for lenders and borrowers who have dealt with a situation of information asymmetry till recently.
- Joint efforts and co-ordination between lenders on resolution and restructuring can change the ground rules and also can be a challenge for more nimble banks that had the tendency to follow a bilateral approach towards resolution.
- Penal consequences in terms of provisioning and supervisory reviews can create a powerful incentive for compliance.
- The leeway offered by the RBI on recognition of gains and deferral of losses on sales of assets can pose accounting / auditing challenges, but represents the seriousness of the RBI to push through more timely resolution of SMA exposures.

The Bottom Line

- The RBI is very serious about its efforts to resolve the issue of rising NPAs in the Indian banking system.
- A lot of work and co-ordination will be required for lenders 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.

KPMG in India

Ahmedabad
Safal Profitaire
B4 3rd Floor, Corporate Road,
Opp. Auda Garden, Prahlad Nagar
Ahmedabad – 380 015
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bangalore
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
4/F, Palal Towers
M. G. Road, Ravipuram,
Kochi 682 016
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Infinity Benchmark, Plot No. G-1
10th Floor, Block – EP & GP, Sector V,
Salt Lake City, Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3058 5764/65
Fax: +91 20 3058 5775

Useful Links

Back issues are available to download from: www.kpmg.com/in

www.kpmg.com/in