Restructuring of Accounts by Banks

Restructuring of advances in the banks, under both CDR and non-CDR mechanism, has posed many challenges for the auditor at the branch level. Procedures and instructions relating to restructuring are somewhat intricate, therefore, it is necessary for the branch auditor to know the guidelines issued by the regulator on Restructuring of Accounts to prepare proper audit checks for audit of these restructured accounts. Moreover, special regulatory treatment for restructured advances expired on 31st March 2015. Thus, the verification of restructured accounts has to be done keeping in mind the strictures given by the regulators prior to 31st March 2015 and post 1st April 2015. The author in this article summarises the provision for restructuring of advances contained in the master circular of Reserve Bank of India of 1st July 2015. Read on…

During bank branch statutory audit, most of the branch auditors come across cases of *restructuring/ rescheduling* of accounts which were mostly done by the branch suo moto near to balance sheet date to save these accounts from slipping into *sub-standard* category. Arguments furnished by the officers of the bank that necessary compliance of guidelines issued in this regard are in progress or could not be met with due to paucity of time or work overload. Let us get to know these guidelines and understand how their compilation works.

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BACKGROUND

The Reserve Bank of India has given autonomy to all the banks to restructure the loans of borrowers vide

Circular No. DBOD.No.BP.BC.9/21.04.048/2012-13 dated 2nd July 2012, Part- B Para 9 to 18. However, rules and regulations of each bank must be in line or rather within the guidelines issued by RBI.

Restructured Accounts

Key Concepts in Annex 5 of the master circular defines a restructured account as *one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/repayable amount/ the amount of installments/rate of interest (due to reasons other than competitive reasons).*

Thus, any change in repayment schedule of a loan will render it as restructured account. However, extension in repayment tenor of a floating rate loan on reset of interest rate, so as to keep the EMI unchanged provided it is applied to a class of accounts uniformly will not render the account to be classified as 'Restructured account'. In other words, extension or deferment of EMIs to individual borrowers as against to an entire class, would render the accounts to be classified as 'restructured accounts'.

In the cases of roll-over of short term loans, where proper pre-sanction assessment has been made, and the roll-over is allowed based on the actual requirement of the borrower and no concession has been provided due to credit weakness of the borrower, then these might not be considered as restructured accounts. However, if such accounts are rolled-over more than two times, then third roll-over onwards the account would have to be treated as a restructured account. Besides, banks should be circumspect while granting such facilities as the borrower may be availing similar facilities from other banks in the consortium or under multiple banking. Further, Short Term Loans for the purpose of this provision do not include properly assessed regular Working Capital Loans like revolving Cash Credit or Working Capital Demand Loans.

Repeatedly Restructured Accounts

As per the definition of a repeated restructured account as given under 'Key Concepts' in Annex 5 of the master circular, *When a bank restructures an account a second (or more) time(s), the account will be considered as a 'repeatedly restructured account'. However, if the second restructuring takes place after the period upto which the concessions were extended under the terms of the first restructuring, that account shall not be reckoned as a 'repeatedly restructured account'.*

PRUDENTIAL GUIDELINES ON RESTRUCTURING OF ADVANCES BY BANKS

RBI guidelines (given in Part B of the master circular) issued on restructuring of advances (other than those restructured under a separate set of guidelines issued by the Rural Planning and Credit Department (RPCD) of the RBI on restructuring of advances on account of natural calamities) are divided into the following four categories :

(i) Guidelines on restructuring of advances extended to industrial units.

(ii) Guidelines on restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism

(iii) Guidelines on restructuring of advances extended to Small and Medium Enterprises (SME)

(iv) Guidelines on restructuring of all other advances.

In these four sets of guidelines on restructuring of advances, the differentiations were broadly made based on whether a borrower is engaged in an industrial activity or a non-industrial activity. In addition, an elaborate institutional mechanism was laid down for accounts restructured under Corporate Debt Restructuring (CDR) Mechanism. (Annex -4 of master circular).

The major difference in the prudential regulations was in the stipulation that subject to certain conditions, the accounts of borrowers engaged in industrial activities (under CDR Mechanism, SME Debt Restructuring Mechanism and outside these mechanisms) continued to be classified in the existing asset classification category upon restructuring. This benefit of retention of asset classification on

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restructuring was not made available to the accounts of borrowers engaged in non-industrial activities except to SME borrowers.

Another difference was that the prudential regulations covering the CDR Mechanism and restructuring of advances extended to SMEs were more detailed and comprehensive than that covering the restructuring of the rest of the advances including the advances extended to the industrial units, outside CDR Mechanism. Further, the CDR Mechanism was made available only to the borrowers engaged in industrial activities.

These guidelines are not for those accounts which are restructured on account of natural calamities which will continue to be covered by the extant guidelines issued by the RPCD.

General Principles and Prudential Norms for Restructured Advances

The principles and prudential norms are applicable to all advances including the borrowers, who are eligible for special regulatory treatment for asset classification as specified in para 20 of the master circular.

Special Regulatory Treatment

The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated for Conversion of Principal into Debt/ Equity, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 20.2 of the master circular. Such treatment is not extended to the following categories of advances:

i. Consumer and personal advances;
ii. Advances classified as Capital market exposures;
iii. Advances classified as commercial real estate exposures.

The asset classification of these three categories accounts as well as that of other accounts which do not comply with the conditions enumerated in para 20.2 of master circular, will be governed by these prudential norms.

The special regulatory treatment has the following two components:

(i) Incentive for quick implementation of the restructuring package.
(ii) Retention of the asset classification of the restructured account in the pre-restructuring asset classification category.

The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated for Conversion of Principal into Debt/ Equity, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 20.2 of the master circular.

In line with the recommendation of the Working Group (Chairman: Shri B. Mahapatra) to review the existing prudential guidelines on restructuring of advances by banks/financial institutions, the extant incentive for quick implementation of restructuring package and asset classification benefits (para 20.2.1 and 20.2.2 of master circular) available on restructuring on fulfilling the conditions have been withdrawn for all restructurings effective from 1st April 2015 with the exception of provisions related to changes in DCCO (Date of Commencement of Commercial Operation) in respect of infrastructure as well as non-infrastructure project loans (please see paragraph 4.2.15 of master circular). It implies that with effect from 1st April 2015, a standard account on restructuring (for reasons other than change in DCCO and) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

Eligibility Criteria for Restructuring of Advances

- Banks may restructure the accounts classified under 'standard', 'sub- standard' and 'doubtful' categories.
- Banks cannot reschedule/restructure/ renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re-classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring/rescheduling/

renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

- Normally, restructuring cannot take place unless alteration/changes in the original loan agreement are made with the formal consent/ application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.
- No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects/activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns/action. Banks should accelerate the recovery measures in respect of such accounts. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include the return on capital employed, debt service coverage ratio, gap between the internal rate of return and cost of funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance. As different sectors of economy have different performance indicators, it will be desirable that banks adopt these broad benchmarks with suitable modifications. Therefore, it has been decided that the viability should be determined by the banks based on the acceptable viability parameters and benchmarks for each parameter determined by them. The benchmarks for the viability parameters adopted by the CDR Mechanism are given in the Appendix to Part–B of the master circular and individual banks may suitably adopt them with appropriate adjustments, if any, for specific sectors while restructuring of accounts in non-CDR cases.
- While the borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring, banks may review the reasons for classification of the borrowers as wilful defaulters, specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent, and satisfy itself that the borrower is in a position to rectify the wilful default. The restructuring of such cases may be done with Board's approval, while for such accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group only.
- BIFR cases are not eligible for restructuring without their express approval. CDR Core Group in the case of advances restructured under CDR Mechanism, the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

Stage of Restructuring of Advances

Restructuring of advances could take place in the following stages:

(a) before commencement of commercial production/operation;

(b) after commencement of commercial production/ operation but before the asset has been classified as 'sub-standard';

(c) after commencement of commercial production/ operation and the asset has been classified as 'sub-standard' or 'doubtful'.

Asset Classification Norms

- The accounts classified as 'standard assets' should be immediately re- classified as 'sub-standard assets' upon restructuring.
- The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories

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Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

as per extant asset classification norms with reference to the pre-restructuring repayment schedule.

- Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the bank should be upgraded only when all the outstanding loan/facilities in the account perform satisfactorily during the 'specified period,' i.e. principal and interest on all facilities in the account are serviced as per terms of payment during that period.
- In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.
- Any additional finance may be treated as 'standard asset' during the specified period under the approved restructuring package. However, in the case of accounts where the pre-restructuring facilities were classified as 'sub-standard' and 'doubtful', interest income on the additional finance should be recognised only on cash basis. If the restructured asset does not qualify for upgradation at the end of the above specified period, the additional finance shall be placed in the same asset classification category as the restructured debt.
- If a restructured asset, which is a standard asset on restructuring in terms of para 20.2 of master circular, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion. However, such advances restructured on second or more occasions may be allowed to be upgraded to standard category after the specified period in terms of the current restructuring package, subject to satisfactory performance.

Income Recognition Norms

Subject to provisions for additional finance (para 17.2.5 of master circular), conversion of principal into debt/equity (para 18.2 of master circular) and conversion of unpaid interest into 'funded interest term loan' (FITL), debt or equity instruments (para 19.2 of master circular), interest income in respect of restructured accounts classified as 'standard assets' will be recognised on accrual basis and that in respect of the accounts classified as 'non-performing assets' will be recognised on cash basis.

Provisioning Norms

Provision on restructured advances

(i) Banks will hold provision against the restructured advances as per the extant provisioning norms.

(ii) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

(iii) Restructured accounts classified as non-performing assets, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

(iv) The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated 26th November 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from 1st June 2013 and increase in a phased manner for the stock of restructured standard accounts as on 31st May 2013 as under :

- 3.50 per cent- with effect from 31st March 2014 (spread over the four quarters of 2013-14)
- 4.25 per cent- with effect from 31st March 2015 (spread over the four quarters of 2014-15)
- 5.00 per cent- with effect from 31st March 2016 (spread over the four quarters of 2015-16)

Provision for diminution in the fair value of restructured advances

(i) Reduction in the rate of interest and/ or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to profit & loss account. Such provision should be held in addition to the provisions as per existing provisioning norms as indicated above, and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR or base rate5 (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR or base rate (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to be followed consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

ii) It was observed that on a few occasions, there were divergences in the calculation of diminution of fair value of accounts by banks. Illustratively, divergences could occur if banks are not appropriately factoring in the term premium on account of elongation of repayment period on restructuring. In such a case the term premium used while calculating the present value of cash flows after restructuring would be higher than the term premium used while calculating the present value of cash flows before restructuring. Further, the amount of principal converted into debt/equity instruments on restructuring would need to be held under AFS and valued as per usual valuation norms. Since these instruments are getting marked to market, the erosion in fair value gets captured on such valuation. Therefore, for the purpose of arriving at the erosion in the fair value, the NPV calculation of the portion of principal not converted into debt/equity has to be carried out separately. However, the total sacrifice involved for the bank would be NPV of the above portion plus valuation loss on account of conversion into debt/equity instruments.

Banks are therefore advised that they should correctly capture the diminution in fair value of restructured accounts as it will have a bearing not only on the provisioning required to be made by them but also on the amount of sacrifice required from the promoters (Ref. para 20.2.2.iv). Further, there should not be any effort on the part of banks to artificially reduce the net present value of cash flows by resorting to any sort of financial engineering. Banks are also advised to put in place a proper mechanism of checks and balances to ensure accurate calculation of erosion in the fair value of restructured accounts.

(iii) In the case of working capital facilities, the diminution in the fair value of the cash credit/ overdraft component may be computed as indicated in para (i) above, reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

(iv) In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at ₹1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

(v) The diminution in the fair value may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR or base rate (whichever is applicable to the borrower), term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

(vi) If due to lack of expertise/ appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor, at five per cent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore.

The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

Risk-Weights

a. Restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points.

b. With a view to reflecting a higher element of inherent risk which may be latent in entities whose obligations have been subjected to restructuring/rescheduling either by banks on their own or along with other bankers/creditors, the unrated standard/performing claims on corporates should be assigned a higher risk weight of 125% until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest/principal falls due under the revised schedule.

c. For details on risk weights, Master Circular DBR. No.BP.BC.1/21.06.201/2015-16 dated 1st July 2015 on 'Basel III Capital Regulations' may be referred.

With effect from the financial year 2012-13, banks should disclose in their published annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the format given in Annex – 6 of master circular. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately.

Disclosures

With effect from the financial year 2012-13, banks should disclose in their published annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the format given in Annex– 6 of master circular. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately. Banks must disclose the total amount outstanding in all the accounts/facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means even if only one of the facilities/accounts of a borrower has been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities/accounts of that particular borrower.

It has been reiterated that the basic objective of restructuring is to preserve economic value of units, not ever-greening of problem accounts. This can be achieved by banks and the borrowers only by careful assessment of the viability, quick detection of weaknesses in accounts and a time-bound implementation of restructuring packages.

Thus challenges for the auditors are manifold in verification and validation of restructured accounts. The central statutory auditors as well as the branch auditors have their own role to play to consolidate the efforts to ensure a true and fair presentation of the financial statements. ■

Who looks outside, dreams; who looks inside, awakes. - Carl Gustav Jung