Credit Information Review

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Policy

Preventing Slippage of NPA Accounts

AReserve Bank conducted a study by scanning relevant t the behest of Board for Financial Supervision (BFS) the information/data obtained from a select group of banks The Reserve Bank also held discussions with bank officials, who manage non-performing accounts (NPAs) at the policy level as well as those who look after actual recovery, rehabilitation/revival, restructuring of accounts at the implementing level. On the basis of the study, the Reserve Bank had suggested a framework of recommendations for preventing slippage of non-performing accounts from sub-standard to doubtful/loss category which had been circulated among banks for feedback and comments. The final recommendations for tackling the problem of slippage of NPAs were sent to banks with an advice to place these guidelines before their Board of Directors in their next meeting and work out their strategic response in keeping with the broad thrust of these guidelines.

Guidelines

Signals

Recognise the Problem Early : Invariably, by the time banks start their efforts to get involved in a revival process, it is too late to retrieve the situation - both in terms of rehabilitation of the project and recovery of bank's dues. Identification of weakness in the very beginning (i.e., when the account starts showing first signs of weakness regardless of the fact that it may not have become NPA) is imperative. Assessment of the potential of revival may be done on the basis of a techno-economic viability study. Restructuring should be attempted where, after an objective assessment of the viability and promoter's intention (and his stake), banks are convinced of a turnaround within a scheduled timeframe. In respect of totally unviable units as decided by the bank/consortium, it is better to facilitate winding up/selling of the unit early, so as to recover whatever is possible through legal means before the security position becomes worse.

Recourse to the New Ordinance : The Government of India has promulgated an ordinance on June 21, 2002, called "The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002" to facilitate foreclosure of financial assets. In respect of totally unviable units as decided by the bank/consortium, action under this ordinance may be initiated without any loss of time. Banks may take immediate recourse to this legal remedy where they encounter malfeasance on the part of promoters/borrowers.

Early Alert System : The strategy for management of NPAs may be governed by the circumstances connected to each individual case. The NPA is more likely to be resolved in terms of recovery if the company is in operation. For this to be effective there must be a system of identifying the weakness in accounts at an early stage. Banks may put in place an "Early Alert" system that captures early warning signals in respect of accounts showing first signs of weakness. This system may be an integral part of the risk management process of the bank. Depending upon the identified weaknesses, one may go back (rather than with reference to current period) to a prior or earlier period in determining the rehabilitation response.
Under the "Early Alert" system, for internal monitoring purpose, banks may designate a time limit for overdue accounts to determine the threshold for a proactive intervention - well before the account becomes NPA. This is to enable a bank to assess whether the default is due to some inherent weakness or due to a temporary liquidity or cash flow problem and accordingly calibrate its response. For example, where there is a default in an account for 30 days, it may be shifted to a special category. Out of the accounts, ones that show promise may be considered for granting incremental facility for specific purposes, such as for capital expenditure, by ensuring strictest possible end use of the money. All the accounts displaying unsatisfactory features/early warning signals should be put under potential NPA list for follow up and time bound action to prevent their slippage. Even though an account may be regular, it may be classified as potential NPA in the event of the following :

- Delay in submission of stock/financial/other control statements.
- Return of cheques issued by borrowers.
- Devolvement of deferred payment guarantee (DPG) instalments and non-payment within a reasonable period.
- Frequent devolvement of letter of credit (LC) and non-payment within a reasonable period.
- Frequent invocation of bank guarantees (BGs) and non-repayment within a reasonable period.
- Return of bills/cheques discounted.
- Non-payment of bills discounted or under collection.
- Poor financial performance in terms of declining sales and profits, cash losses, net losses, erosion of net worth, etc.
- Incomplete documentation relating to creation/registration of charge/mortgage.
- Non-compliance of terms and conditions of sanction.

Special Mention Accounts :. It is suggested that banks introduce a new asset category between 'standard' and 'sub-standard' for their own internal monitoring and follow up. This asset

category may be in line with international practice of ‘Special Mention Assets’ used by FDIC, U.S.A., MAS, Singapore, etc., while keeping in view the local requirements. An asset may be transferred to this category once the earliest signs of sickness/irregularities are identified. This will help banks to look at accounts with potential problems in a focused manner right from the onset of the problem, so that monitoring and remedial actions can be more effective. Under off-site reporting, data on potential NPAs in terms of overdue position such as (i) loans and advances overdue for less than two quarters and (ii) loans and advances overdue for less than one quarter, are required to be submitted by banks on a quarterly basis. Introduction of a ‘Special Mention’ category of assets should be on the basis of not only overdue position in the account but also other factors which reflect sickness/irregularities in the account. Banks which already have ‘special mention’ category may continue the same on the basis of their internal norms.
A special mention account may briefly have main characteristics as follows :

- The asset has potential weaknesses which deserves close management attention and which can be resolved through timely remedial action.
- If left un-corrected, the potential weaknesses in special mention assets may result in deterioration of the repayment prospects and subsequent adverse asset classification.
- Often a bank’s weak origination/servicing policies are the reason behind classification of an asset under the special mention category though there may be cases where technical or other factors may also be responsible.
- Apart from continuing irregularities, special mention accounts may also be categorised on the basis of factors such as inadequate cash flows and management integrity.
- Special mention assets would not require provisioning, as they are not classified as NPAs. Nor are these proposed to be brought under regulatory oversight and prudential reporting immediately.
- The Reserve Bank would consider, in due course, regarding introducing a ‘special mention’ category as part of the ‘income recognition and asset classification (IRAC) norms’ .

Identifying Borrowers with Genuine Intent

Based on the promoters’ sincerity, wherewithal, and capability to achieve a turnaround, banks should quickly decide whether it would be worthwhile to commit additional finance. Banks may consider having ‘special investigative audit’ of all financial transactions/ business transactions, books of accounts in order to ascertain real factors that contributed to sickness of the borrower. Banks may have a panel of technical experts with proven expertise and track record for preparation of techno-economic viability study of the projects of the borrowers.

Borrowers having genuine problems due to temporary mismatch in funds flow or sudden requirements of additional funds may be entertained at the branch level and for this purpose a special limit to tide over such contingencies may be built into the sanction process itself. This will obviate the need to route the additional funding request through the controlling offices in deserving cases, and help avert many accounts slipping into NPA category.

Timeliness and Adequacy of Response

Longer the delay in response (in fact, sometimes branch officials may have to act suo-moto), greater the injury to the account and the asset. Time is a crucial element in any restructuring/rehabilitation strategy. Further, the response decided on the basis of techno-economic study and promoter's commitment, has to be adequate in terms of extent of additional funding, relaxations, etc., under the restructuring exercise. The package of assistance may be flexible, and where required, the bank may also look at the exit option.

Focus on Cash Flows

While financing, at the time of restructuring, banks may not be guided by the conventional funds flow analysis only, which could yield a potentially misleading picture. Appraisal for fresh credit requirements may be done by analysing funds flow in conjunction with cash flows rather than only on the basis of funds flow.

Management Effectiveness

Management effectiveness in tackling adverse business conditions is a very important aspect that affects a borrowing unit's fortunes. Additional finance to an ailing unit may be committed by a bank only after basic viability of the enterprise also in the context of quality of management is examined and confirmed. Where the default is due to deeper malady, viability study or investigative audit should be done

Consortium/Multiple Financing

a) While assessing viability and restructuring, a pragmatic and unified approach by all the lending banks/financial institutions(FIs)as also sharing of all relevant information on the borrower would go a long way toward overall success of rehabilitation effort.

b) In some default cases, where the unit is still working, the bank should make sure that it captures the cash flows (there is a tendency on the part of the borrowers to switch bankers once they default, for fear of getting their cash flows forfeited), and ensure that such cash flows are used for working capital purposes. There should be regular flow of information among consortium members. A bank, which is not part of the consortium may not be allowed to offer credit facilities to such defaulting clients. Current account facilities may also be denied at non-consortium banks to such clients and violation may attract penal action. The Credit Information Bureau of India Ltd., (CIBIL) may be very useful for meaningful information exchange on defaulting borrowers once the setup becomes fully operational,

c) In a forum of lenders, the priority of each lender will be different. While one set of lenders may be willing to wait for a longer time to recover its dues, another lender may have a much shorter timeframe in mind. So it is possible that the latter category of lenders may be willing to exit, even at a cost, i.e., by a discounted settlement of the exposure. Therefore, any plan for restructuring/rehabilitation may take this aspect into account.

d) Corporate Debt Restructuring mechanism has been institutionalised in 2001 to provide a timely and transparent system for restructuring of corporate debts of Rs.20 crore and above with banks and FIs on a voluntary basis and outside the legal framework. Under this system, banks may greatly benefit in terms of restructuring of large standard accounts (potential NPAs) and viable sub-standard accounts with consortium/multiple banking arrangements.

Legal and Related Issues

Legal action may be initiated once the Banks/FIs are convinced and have reached the conclusion that rehabilitation is not possible and there is no other way out. This will put pressure on the borrowers and will reduce the chances of depletion in the value of the security. In this context, the new securities ordinance, as mentioned earlier, will go a long way in developing the culture of prompt repayment of banks'/FIs' dues. Under this ordinance, substantial powers have been granted to banks/FIs for enforcement of securities without the intervention of courts/tribunals. Similarly powers have been given to Banks/FIs to take over the management of business of defaulting borrowers.

Banks may take recourse to criminal proceedings along with civil suit where misleading information has been furnished influencing the bank's credit decision. Also in case of value-less guarantees and diversion of funds, bank may not hesitate to initiate criminal proceedings. Borrowers may be asked to declare on oath their borrowings, assets and all other material facts, which can be the basis for criminal action in future if details are not found to be correct.

When considering a plan for the revival/rehabilitation, the lenders should retain the right to exercise control over the ownership/ management. This can be done by ensuring pledge of promoter's shareholding to the lenders with a right to change ownership if certain covenants/stipulations are not met.

Auditor's Responsibility

In case any falsification of accounts on the part of the borrowers is observed by banks/FIs, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) if it is observed that the auditors were negligent or deficient in conducting the audit to enable the ICAI to examine and fix accountability of the auditors.

With a view to monitoring end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion/siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors, banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers/auditors.

Government Relief

State Government relief (state tax waiver, subsidy, etc.) in respect of accounts enjoying the same takes long time to come, thus worsening the overdue position. Closer monitoring is needed to work in the direction of cutting down/reducing the time lag.

Risk Based Supervision

In August 2001 the Reserve Bank had forwarded to banks, a discussion paper on ‘Move towards Risk Based Supervision of Banks’. While forwarding it, the Reserve Bank had advised to take specific steps for (a) setting up risk management architecture (b) adoption of risk focused internal audit, (c) strengthening of management information system and information technology support (d) addressing HRD issues and, (e) setting up compliance units to monitor regulatory and supervisory compliance. Banks were required to set up in-house change management teams to monitor the progress of preparation in these five areas.

A recent review of the progress made by banks in risk based supervision (RBS) has revealed that they are yet to put in place effective institutional mechanisms to deal with risk management and RBS. Banks have, therefore, been advised to take action as follows :

(i) To set up a comprehensive risk management system including asset liability management system as advised in the Reserve Bank’s circular of October 7, 1999. Some of the banks have set up risk management functions. It is essential for banks to have such an institutional mechanism in the organizational structure to exclusively deal with risk management functions. The principle of segregation of risk management functions from the business line functions should be observed in formation of this institutional mechanism.

(iii) Put in place an institutional mechanism to direct and monitor the progress in implementing the action points advised in the discussion paper. An officer of sufficiently senior rank may act as head of this institutional mechanism. The institutional mechanism set up to attend to the requirements of RBS should be kept separate and distinct from the institutional mechanism attending to risk management functions.

(iii) Review at quarterly intervals, the efficacy of the institutional mechanisms in attending to these two distinct functions of risk management and risk based supervision requirements and the progress made therein. The quarterly review reports should be placed before the Board of Directors. The review reports on progress of action points on RBS should be sent to the concerned Regional Offices of the Department of Banking Supervision of the Reserve Bank along with the progress report on risk management systems now being sent at quarterly intervals.

(iv) To build up an inventory of skilled and trained personnel to attend to risk management and RBS functions. Banks may ensure that persons trained in risk management, risk based supervision and risk focused internal audit are positioned in appropriate places. Banks should maintain a record of training and placement of such officials.

BRANCH BANKING

Time Schedule for Disposal of SSI Loans

With a view to providing better customer service and ensuring that applications for loans up to Rs.5 lakh received from all categories of small scale industries (SSI) borrowers are expeditiously disposed off, the Reserve Bank has revised the time schedule for disposal of loans. If the loan applications received are complete in all respects and are duly accompanied by a check list, banks should dispose them off within the time frame indicated below :

a) Applications for loans up to Rs.25,000 within two weeks.
b) Applications for loans up to Rs.5 lakh within four weeks.

Bank branches have been advised to acknowledge all loan applications which are complete in all respects and accompanied by a check list, on the same day, i.e., on the day the application is received by them.

Earlier, loan applications up to credit limit of Rs.25000 were required to be disposed off within a fortnight and those over Rs.25,000 within 8 to 9 weeks.

Closure of Foreign Bank Branches

All foreign banks operating in India have been advised to invariably inform the Reserve Bank well in advance of their intention of closing any of their branches including those in metropolitan areas. They have also been advised to furnish a detailed plan of closure to ensure that their customers' interests and convenience are addressed adequately.

It had been observed that foreign banks close their branches without giving adequate notice of such closure to their depositors, borrowers and other customers, causing avoidable inconvenience to them.

COOP BANKS

UCBs not to act as Agents for Money Transfer Service Schemes

The Reserve Bank has advised all primary (urban) co-operative banks (UCBs) not to act as agents/sub-agents of money transfer service schemes. Those UCBs which are already acting as agents/ sub-agents of such schemes have been advised to withdraw/ disengage themselves from such activities forthwith.

EXCHANGE CONTROL

FCNR (B) Deposits

Forex Loans

Authorised dealers (ADs) have been permitted to grant foreign currency loans in India against the security of funds held in foreign currency non-resident (banks) [FCNR (B)] deposit accounts to the account holders subject to the guidelines as follows :

(a) Loans should be against own FCNR (B) deposits and not against the deposits of third parties.
(b) Loans should be granted only to the deposit holder and not to any third party/ies. The documents should be executed by the deposit holders themselves and not by their Power of Attorney holders.
(c) The maturity of the loan should not exceed the maturity of the deposit under any circumstances.
(d) Loans should be sanctioned to the account holders for purposes other than investments in India.
(e) Advances should be fully secured by the deposit and regulations, if any, relating to margin should be complied with.
(f) Repayment should be effected by fresh remittances in foreign exchange or by adjustment of the deposit.
(g) Banks should put in place adequate monitoring system for the purpose.
(h) Extension of this facility should have the approval of the Board of the bank.

Further, ADs should also comply with the instructions for grant of loans against non-resident deposits contained in the Reserve Bank's circular of May 21, 2002 prescribing inter alia, precautions to be taken by banks while granting loans against non-resident deposits.

Interest Rates

The Reserve Bank had advised banks on April 29, 2002 that for foreign currency non-resident accounts (banks) [FCNR(B)] deposits of a maturity of 1-3 years, fixed and floating rates of interest within the ceiling rate of LIBOR/SWAPS rates for the respective currency/ corresponding maturities minus 25 basis points may be offered. Reviewing the matter in the context of difficulties experienced by banks in charging interest at 25 basis points lower than LIBOR on Yen deposits, the Reserve Bank has now given banks the freedom to set the FCNR(B) deposit rates which may be equal or less than LIBOR in respect of Yen deposits.

Short Term Credit for Imports

With a view to simplifying the procedure for imports into India, the Reserve Bank has decided to make uniform regulations and procedures applicable to both categories of short term credit, i.e., suppliers' credit as well as buyers' credit, with immediate effect till further notice.
Accordingly, ADs may approve proposals received in Form ECB for short term credit for financing, (by way of either suppliers' credit or buyers' credit) import of goods into India, provided :

(a) The credit is extended for a period of less than three years.
(b) The amount of credit does not exceed USD 20 million, per import transaction.
(c) The 'all-in-cost' per annum, payable for the credit does not exceed LIBOR +50 basis points for credit upto one year and LIBOR + 125 basis points for credits for periods beyond one year but less than three years, for the currency of credit.

ADs should furnish the details of approvals granted by all their branches during the month, to the Chief General Manager, Exchange Control Department, Reserve Bank of India, Central Office, External Commercial Borrowing (ECB) Division, Mumbai - 400 001. The details should reach the Reserve Bank not later than 5th of the following month. Each credit should be given a unique Identification number which should invariably be quoted in all references made to the Reserve Bank. All applications for short term credit for amount exceeding USD 20 million for any import transaction may be forwarded in form ECB to the Reserve Bank.

Earlier, suppliers' credit , viz., short term loans where the credit for imports into India is extended by the overseas supplier for a period of more than six months, required the Reserve Bank's prior approval. Similarly, buyers' credit, viz., where short term loans for payment of imports into India is arranged by the importer from a bank or financial institution outside India for maturity of less than three years, also required the Reserve Bank's prior approval.

Interest on Rupee Export Credit

The validity of the reduction in interest rates charged by scheduled commercial banks for rupee export credit has been extended upto April 30, 2003.

The ceiling on interest rates charged by scheduled commercial banks on rupee export credit was reduced by one percentage point from September 26, 2001 to March 31, 2002. The reduction was applicable to both pre-shipment and post-shipment credits. The concession was subsequently extended till September 30, 2002.

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