Regd. No. MH/MR/South-30/2004-05

Volume I ◆ Issue 7

April 2005

MONETARY AND CREDIT INFORMATION REVIEW

DRAFT GUIDELINES

Purchase/Sale of NPAs

With a view to increasing the options available to banks to resolve their non-performing assets (NPAs), the Reserve Bank has formulated draft guidelines on sale/purchase of NPAs. The guidelines have been formulated with a view to developing a healthy secondary market for NPAs where securitisation companies and reconstruction companies are not involved.

These guidelines would be applicable to banks, financial institutions (FIs) and non-banking financial companies (NBFCs) purchasing/selling NPAs from/to other banks/FIs/NBFCs (excluding securitisation companies/reconstruction companies). A financial asset, including assets under multiple/consortium banking arrangements, would be eligible for purchase/sale if it is an NPA/ non performing investment in the books of the selling bank.

Procedure for Purchase/Sale

a) The purchasing/selling of NPAs should be conducted in accordance with a policy approved by the bank's Board. The Board should lay down policies and guidelines covering, *inter alia* -
   - NPAs that may be purchased/sold.
   - Norms and procedure for purchase/sale of such financial assets.
   - Valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the estimated cash flows arising out of repayments and recovery prospects.
   - Delegation of powers of various functionaries for taking decision on the purchase/sale of the financial assets.
   - Accounting policy.

b) While laying down the policy, the Board should satisfy itself that the bank has adequate skills to purchase NPAs and deal with them in an efficient manner which would result in value addition. The Board should also ensure that appropriate systems and procedures are in place to effectively address the risks that a purchasing bank would assume while engaging in this activity.

c) A bank may purchase/sell NPAs from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the NPAs should be transferred to the purchasing bank. The selling bank should ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank and after the sale, there should not be any known liability devolving on the selling bank.

d) Banks should ensure that subsequent to the sale of the NPAs to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancement/liquidity facilities in any form or manner.

e) Each bank should make its own assessment of the value offered by the purchasing bank for the financial asset and decide whether to accept or reject the offer.

f) Under no circumstances should a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing bank, the selling bank would have to bear a part of the shortfall.

g) An NPA in a bank's books would be eligible for sale to other banks only if it has remained as NPA for at least two years in the books of the selling bank.

CONTENTS

	Page
DRAFT GUIDELINES	
Purchase/Sale of NPAs	1
Securitisation of Standard Assets	2
BANKING	
RIDF IV to VII - Rates of Interest	2
SGSY - Interest Rates on Group Loans	3
Reporting of CP Issuance on NDS Platform	3
Customer Service	
Monitoring Implementation of the Banking Ombudsman Scheme	3
Standing Committee on Customer Service	3
Compensation for Delayed Credit of Funds	3
UCBS	
Donations for Charitable Purposes	3
Directors as Surety/Guarantors - Clarification	3
Credit Exposure Limits to Individuals/Group of Borrowers Revised	4
UCBs - Definitions of Tier I Capital and Tier II Capital	4

h) Banks shall sell NPAs to other banks only on cash basis.

i) An NPA should be held by the purchasing bank in its books at least for a period of 15 months before it is sold.

j) An asset would be deemed to have demonstrated its performing status with reference to cash flows estimated while purchasing the asset.

k) Selling banks should pursue the staff accountability aspects as per the existing instructions in respect of NPAs sold to other banks.

Asset Classification

- Purchasing banks may classify the NPA as 'standard' in their books for a period of 90 days from the date of purchase. The asset classification status of an existing exposure to the same obligor in the books of the purchasing bank would continue to be governed by the record of recovery of that exposure and hence may be different. Thereafter, the asset classification status of the account should be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset.
- Where the purchase/sale does not satisfy any of the prudential requirements prescribed in these guidelines, the asset classification status of the financial asset in the books of the purchasing bank at the time of purchase should be the same as in the books of the selling bank. Thereafter, the asset classification status would continue to be determined with reference to the date of NPA in the selling bank.
- Any restructure/reschedule/rephase of the repayment schedule of the NPA would render the account as NPA.

Provisioning

For selling bank

- When a bank sells its NPAs to other banks, the bank should remove the NPAs from its books on transfer.
- If the sale is at a price below the net book value (NBV) i.e., book value less provisions held, the shortfall should be debited to the profit and loss account of that year.
- If the sale is for a value higher than the NBV, the excess provision should not be reversed but should be utilised to meet the shortfall/loss on account of sale of other NPAs.

For purchasing bank

The asset would attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank.

Accounting of Recoveries

Any recovery in respect of an NPA purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost may be recognised as profit.

Capital Adequacy

For the purpose of capital adequacy, banks should assign 100 per cent risk weights to the NPAs purchased from other banks. In case the NPA purchased is an investment, then it would attract capital charge for market risks. For NBFCs, the relevant instructions on capital adequacy would be applicable.

Exposure Norms

The purchasing bank should reckon exposure on the obligor of the specific financial asset. Hence, purchasing banks should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase. For NBFCs, the relevant instructions on exposure norms would be applicable.

Disclosure Requirements

Banks which purchase NPAs from other banks would be required to disclose details of NPAs purchased/sold in the Notes on Accounts to their balance sheets.

Securitisation of Standard Assets

The Reserve Bank has issued guidelines for securitisation of standard assets to ensure healthy development of the securitisation market. The guidelines are applicable to banks, financial institutions and NBFCs. The regulatory framework provided in the guidelines prescribes that -

- For a transaction to be treated as securitisation, it must follow a two-stage process. In the first stage there should be pooling and transferring of assets to a bankruptcy remote vehicle (SPV) and in the second stage, repackaging and selling the security interests representing claims on incoming cash flows from the pool of assets to the third party investors should be effected.
- To enable the transferred assets to be removed from the balance sheet of the seller in a securitisation structure, it is essential to isolate the assets or 'true sale' from the seller or originator to the SPV. In the event of transferred assets not meeting the true-sale criteria, the assets would be deemed to be an on-balance sheet asset of the seller who would be required to comply with all applicable accounting and prudential requirements in respect of those assets.
- Arms length relationship between the originator/seller and the SPV should be maintained.
- The SPV should meet the prescribed criteria to enable originators to avail the off balance sheet treatment for the assets transferred by them to the SPV and also to enable the service providers and investors in the pass through certificates to avail of the regulatory treatment prescribed under these guidelines for their respective exposures in a securitisation structure. In all cases of securitisation, the securities issued by the SPV should be independently rated by an external credit rating agency and such ratings should be updated at least every 6 months.

The details of regulatory norms for capital adequacy, valuation, profit/loss on sale of assets, income recognition and provisioning for originators and service providers like credit enhancers, liquidity support providers as well as investors as also the accounting treatment for securitisation transactions and disclosure norms are given on the RBI website www.rbi.org.in

BANKING

RIDF IV to VII - Rates of Interest

It has been decided, with the approval of the Government of India, to restructure the lending and deposit rates in respect of the amounts disbursed on or before October 31, 2003 out of Rural Infrastructure Development Fund (RIDF IV to VII). The revised rates which are effective from April 16, 2005 are as under:

RIDF	Deposit rates payable to banks (per cent per annum)	
	Existing	Revised
IV	11.5	8.0
V	11.5	8.0
VI	11.0	8.0
VII	Interest rate linked to shortfall in agricultural lending (varying between 10 and 7 per cent)	7.5

SGSY - Interest Rates on Group Loans

The Reserve Bank has clarified to all scheduled commercial banks that the rate of interest to be charged on group loans under the swarnjayanti gram swarozgar yojana (SGSY) should be linked to per capita size of the loans so as to mitigate the burden on the below poverty line beneficiaries on the analogy of integrated rural development programme (IRDP) group loans.

The SGSY is a major poverty alleviation and employment generation programme of the Government of India, implemented in the rural areas of the country which focuses on group approach. The Government of India, Ministry of Rural Development had observed certain anomalies in the rate of interest charged by banks on group loans and individual loans under SGSY.

Reporting of CP Issuance on NDS Platform

It has been decided that with effect from April 16, 2005, all scheduled banks, which are negotiated dealing system (NDS) members and acting as issuing and paying agents (IPA) for commercial paper (CP) issuance, should report details of CP issue on NDS platform within two days from the date of completion of the issue.

A module for reporting of CP issuance on the NDS platform by IPAs has been released to NDS members on April 2, 2005 in the PDO-NDS Version 3.0 software.

All scheduled banks should, however, continue to report CP issuance details as hitherto, to the Adviser-in-Charge, Monetary Policy Department, Reserve Bank of India, Central Office, Mumbai till NDS reporting stabilizes to the Reserve Bank's satisfaction.

CUSTOMER SERVICE

Monitoring Implementation of the Banking Ombudsman Scheme

The Reserve Bank has advised all scheduled commercial banks that their Customer Service Committee of the Board should play a more pro-active role with regard to complaints/grievances resolved by Banking Ombudsmen.

With a view to enhancing the effectiveness of the Customer Service Committee, banks have also been advised to place all the awards issued by the Banking Ombudsmen before the Customer Service Committee -

- to enable it to address issues of systemic deficiencies existing in banks, if any, brought out by the awards; and
- which have remained unimplemented for more than three months with the reasons therefore, to enable it to report to the Board such delays in implementation and for initiating necessary remedial action.

The Scheme of Banking Ombudsman was introduced with the objective of enabling resolution of complaints relating to provision of banking services and resolving disputes between a bank and its constituent as well as between one bank and another bank through the process of conciliation, mediation and arbitration in respect of deficiencies in customer service. After detailed examination of the complaints/grievances of customers of banks and after perusal of the comments of banks, the Banking Ombudsmen issue their awards in respect of individual complaints to redress the grievances.

Standing Committee on Customer Service

Having examined the issues relating to the continuance or otherwise of the Ad hoc Committees set up in banks to undertake procedures and performance audit on public services rendered by them and having observed that there should be a dedicated focal point for customer service in banks, the Committee on Procedures and Performance Audit of Public Services (CPPAPS) has recommended that the Ad hoc Committees should be converted into Standing Committees on Customer Service.

Accordingly, the Reserve Bank has advised all scheduled commercial banks to take necessary action to convert the existing Ad hoc Committees into a Standing Committee on Customer Service. It has also advised that the constitution and functions of the Standing Committee should be on the lines indicated in its letter of August 17, 2004. While the Standing Committee would serve as the micro level executive committee driving the implementation process and providing relevant feedback, the Customer Service Committee of the Board would oversee and review/modify the initiatives.

Compensation for Delayed Credit of Funds

The Reserve Bank has reiterated to all commercial banks that the compensation for delayed credit of electronic clearing service (ECS) funds to the beneficiaries/customers should be paid *suo moto* instead of waiting for a claim by the customers.

UCBs

Donations for Charitable Purposes

The Reserve Bank has advised urban co-operative banks (UCBs) that the normal donations made by them during a year, should, in aggregate, be restricted to a ceiling of 1 per cent of their published profits for the previous year. The Reserve Bank has also advised that such normal donations, together with those made to national funds and other funds recognized/sponsored by the central/state government, during a year, should not exceed 2 per cent of the UCBs' published profits for the previous year.

It had come to the notice of the Reserve Bank that large donations are being made by UCBs for various purposes from out of their charity fund which adversely affect the interest of banks' depositors. The matter was examined and it was considered necessary, in public interest and in the interest of the depositors, that donations made by UCBs should be regulated.

Directors as Surety/Guarantors - Clarification

The Reserve Bank has clarified that UCBs which have granted loans and advances against the guarantee/surety of the directors and/or their relatives prior to October 1, 2003 may not unwind the position and may continue with the guarantee/surety of the directors and/or their relatives till the maturity of the facility. No fresh borrowal arrangements should, however, be allowed with the guarantees/ surety of their directors and/or their relatives.

It may be recalled that in August 2004, UCBs were advised that their directors and relatives could not stand as surety/guarantor to the loans and advances (both secured and unsecured) sanctioned by them.

Corrigendum

It is clarified that the item on 'Prudential Norms for State Government guaranteed Advances' published in the March 2005 issue of the Monetary and Credit Information Review pertains to all state and district central co-operative banks.

Licensed to post without prepayment - Licence No. South - 20/2004-05 **Regd. No. MH/MR/South-30/2004-05**
Posted on 29th and 30th April 2005 at MUMBAI PATRIKA CHANNEL SORTING OFFICE - GPO

Credit Exposure Limits to Individuals/Group of Borrowers Revised

The Reserve Bank has advised UCBs that the prudential exposure ceiling in case of individual borrower and group of borrowers has been revised and fixed at 15 per cent and 40 per cent of the 'capital funds' in case of a single borrower and group of borrowers, respectively. For the purpose of prudential exposure norm, UCBs may fix 'capital funds' in relation to their Tier I and Tier II capital as defined in the box below.

UCBs have been further advised that the exposure should henceforth include both credit exposure and investment exposure (non-SLR) as indicated below :

(i) Funded and non-funded credit limits, underwriting and similar commitments. The sanctioned limit or outstanding, whichever is higher, should be reckoned for arriving at credit exposure limit.

(ii) In respect of non-funded credit limits, 100 per cent of such limits or outstanding, whichever is higher, should be taken into account.

(iii) Non-SLR investments indicated in the Reserve Bank's circular of April 2004.

The revised prudential exposure limits for individual/group of borrowers should be computed from April 1, 2005. In the case of existing borrowers, however, where the outstanding or the sanctioned exposure limit exceeds the revised limit, it should be brought down within the revised limits in a maximum period of 2 years, i.e., by March 31, 2007.

Earlier, the prudential exposure ceiling was 20 per cent and 50 per cent of the capital funds in case of individual borrower and group of borrowers respectively.

UCBs - Definitions of Tier I Capital and Tier II Capital

Tier I Capital includes -

(i) Paid-up share capital collected from regular members of a bank having voting powers.

(ii) Free reserves as per the audited accounts. Reserves, if any, created out of revaluation of fixed assets or those created to meet outside liabilities should not be included in the Tier I capital. Free Reserves should exclude all reserves/provisions which are created to meet anticipated loan losses, losses on account of fraud etc., depreciation in investments and other assets and other outside liabilities. While the amounts held under the head "Building Fund" are eligible to be treated as part of free reserves, "Bad and Doubtful Reserves" should be excluded.

(iii) Capital Reserve representing surplus arising out of sale proceeds of assets.

(iv) Any surplus (net) in profit and loss account i.e., balance after appropriation towards dividend payable, education fund, other funds whose utilisation is defined, asset loss, if any, etc.

Note : Amount of intangible assets, losses in current year and those brought forward from previous periods, deficit in non-performing assets (NPA) provisions, income wrongly recognised on, provision required for liability devolved on bank, etc., should be deducted from Tier I Capital.

Tier II Capital

Undisclosed Reserves

They have the capacity to absorb unexpected losses and can be included in capital, if they represent accumulation of profits and not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses.

Revaluation Reserves

Revaluation reserves arise from revaluation of assets that are undervalued in the bank's books. The typical example in this regard is bank premises and marketable securities. The extent to which the revaluation reserves can be relied upon as a cushion for unexpected losses depends mainly upon the level of certainty that can be placed on estimates of the market value of the relevant assets, the subsequent deterioration in values under difficult market conditions or in a forced sale, potential for actual liquidation of those values, tax consequences of revaluation, etc. It is, therefore, prudent to consider revaluation reserves at a discount of 55 per cent when determining their value for inclusion in Tier II Capital i.e., only 45 per cent of revaluation reserve should be taken for inclusion in Tier II Capital. Such reserves should be reflected on the face of the balance sheet as revaluation reserves.

General Provisions and Loss Reserves

These include such provisions of general nature appearing in the books of the bank which are not attributed to any identified potential loss or a diminution in value of an asset or a known liability. Adequate care must be taken to ensure that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering any amount of general provision as part of Tier II capital as indicated above. To illustrate : excess provision in respect of bad and doubtful debts, general provision for standard assets etc. could be considered for inclusion under this category. Such provisions which are considered for inclusion in Tier II capital would be admitted up to 1.25 per cent of total weighted risk assets.

Investment Fluctuation Reserve

Balance, if any, in the investment fluctuation reserve fund of the bank.

Hybrid Debt Capital Instruments

Under this category, there are a number of capital instruments, which combine certain characteristics of equity and certain characteristics of debt. Where these instruments have close similarities to equity, in particular, when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital.

Subordinated Debt

To be eligible for inclusion in Tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and should not be redeemable at the initiative of the holder or without the consent of the bank's supervisory authorities. They often carry a fixed maturity and as they approach maturity, they should be subjected to progressive discount for inclusion in Tier II capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier II capital. Subordinated debt instruments would be limited to 50 per cent of Tier I capital.

Note : (a) At present UCBs do not issue hybrid debt capital instruments and subordinated debt instruments. There is, however, no bar on issuing such instruments subject to provisions of the respective State Co-operative Societies Act/Multi State Co-operative Societies Act. Issue of such instruments would be subject to the Reserve Bank's prior approval. (b) The total of Tier II elements would be limited to a maximum of 100 per cent of total Tier I elements for the purpose of compliance with the norms.

Edited and published by **Alpana Killawala** for the **Reserve Bank of India,** Press Relations Division, Central Office, Shahid Bhagat Singh Marg, Mumbai-400 001 and printed by her at **Alco Corporation**, A-2, 72, Shah & Nahar Ind. Estate, Lower Parel (West), Mumbai - 400 013. **Readers may write to the Director, DRRP (Sales Section), DEAP, Reserve Bank of India, Amar Building, Sir P. M. Road, P. B. No. 1036, Mumbai - 400 001 for renewal and change of address. MCIR is also available on Internet at www.cir.rbi.org.in**