Income recognition, asset classification, provisioning and other related matters and capital adequacy standards – Take out finance

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The Chairman & Managing Director,
All Financial Institutions.

Dear Sir,

Income recognition, asset classification, provisioning and other related matters and capital adequacy standards – Take out finance

In order to meet long term financing requirements of infrastructure projects, financial institutions/banks are taking recourse to new products. Take out finance is the product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, institution/bank financing the infrastructure projects will have an arrangement with any financial institution for transferring to the latter outstandings in respect of such financing in their books on a pre-determined basis. The proposals for take-out finance also help the banks in asset liability management since the financing of infrastructure is long term in nature against their short-term resources. There are several variants of the Take-out-finance but basically they are either in the nature of unconditional take-out finance or conditional take-out finance though it may involve assuming full credit risk or part of the same. The take-out-finance products will involve three parties viz., the project company, taking over institution and the lending banks/FI. Moreover, the company should also recognise the aforesaid arrangement by way of inter creditor agreement. The issues pertaining to criteria for assigning risk weight and applying other prudential norms in respect of take out finance have since been examined and we advise as under :-

The risk weight to be assigned for these finances will be as follows :

A. Unconditional take out finance

The unconditional take out finance involves the assumption of partial / full credit risk by the institution agreeing to take over the finance from the original lender. In such a case the credit facility extended to the borrower will be borne on the books of the original lender till it is taken over. The institution agreeing to take over would have to reflect in its books this obligation as a contingent liability till it actually takes over with partial or full credit risk as agreed upon.

Consequently,

(a) The lending institution should assign a risk weight of 20 per cent on the asset to the extent to which risk will be assumed by taking over financial institution as the counter party is the financial institution. The portion, which will not be taken over by the taking over institution, will have to be assigned 100 per cent risk weight.

(b) Contingent liability on the books of the taking over institution would have to be converted at a credit conversion factor of 100 per cent. As the counter party exposure will determine the risk weight it will be 100 per cent in respect of all borrowers or zero per cent if covered by Government guarantee.

B. Conditional take over:

In this scenario, the taking over institution would have stipulated certain conditions to be satisfied by the borrower before it is taken over from the lending institution. There is, therefore, an element of uncertainty over the ultimate transfer of the assets to the taking over institution. The risk weight and other prescription would therefore have to be different.

(a) The assets on the books of the lending institution would carry 100 per cent risk weight as the take over is not automatic.

(b) The obligation to take over the assets, though conditional needs to be reflected on the books of the taking over institution by way of a contingent liability. However, since the take over is conditional, the credit conversion factor will be 50 percent only as against 100 percent in the case of unconditional take over. As regards the assignment of risk weight no distinction is required and irrespective of the actual take over, the risk weight will be 100 per cent in the case of all borrowers and zero per cent in respect of those backed by a Government guarantee.

2. Income Recognition and Provisioning

In view of the time period involved in taking over, the possibility of a default in the meantime can not be ruled out. The norms of income recognition and provisioning will have to be followed by the concerned bank / FI in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not also recognise income on accrual basis and account for the same only when it is paid by the borrower / taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

The summary of guidelines in respect of assigning risk weight, asset classification, income recognition and provisioning in respect of take-out finance are listed in the Annexure.

Please acknowledge receipt.

Yours faithfully,

(K. C. Bandyopadhyay)
Chief General Manager

ANNEXURE

Risk Weight

Unconditional takeover	Credit conversion factor	Risk Weight
(i) Lending Institution (a) Where the full credit Risk is assumed by the taking over institution (b) Where only partial credit risk is assumed by taking over institution (ii) Taking over institution	 Not applicable since it is not an off balance sheet item -do- 100%	 20% 20% on the amount to be taken over 100% on the amount not to be taken over 100% on the amount to be taken over
Conditional takeover (i) Lending institution (ii) Taking over institution	 Not applicable since it will not be off balance sheet item 50%	 100% 100%

Note : In the above cases where the counter party risk is guaranteed by Government the risk weight will be zero.

Income Recognition & Provisioning under unconditional & conditional take overs

Where the credit facility becomes NPA before take over by the taking over institution:

(1) **Lending institution**

(i) Should be classified as NPA
(ii) Income not to be recognised on accrual basis
(iii) Provision to be made appropriate to the asset classification.

(2) **Taking over institution**

(i) No obligations would arise till the asset is actually taken over.

(ii) On taking over such assets should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books on that date.