Income recognition, asset classification and provisioning norms on advances – treatment of projects under implementation involving time overrun

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The Chairman/ Chief Executive
of all scheduled commercial banks

Dear Sir,

Income recognition, asset classification and provisioning norms on advances – treatment of projects under implementation involving time overrun

As you may be aware prudential norms on asset classification as applicable to financial institutions, which were predominantly involved in extending project finance, specifically covered scenarios involving time overrun for completion of industrial projects under implementation. Initially, in terms of the norms issued in March 1994, a time overrun of up to 50% of the time contracted was permitted before downgrading the asset to sub-standard category. Further, in terms of instructions issued in June 1996, a one-time refixing of the time period of the project was allowed with the approval of the Board of the financial institutions even if the time overrun was more than 50% and in that case, the asset was required to be treated as standard till the time so refixed by the Board.

2. In this context, instances were observed where despite substantial time overrun in the projects under implementation, the underlying loan assets remained classified in the standard category merely because the project continued to be under implementation. Recognising that unduly long time overrun in a project adversely affected its viability and the quality of the asset deteriorated, a need was felt to evolve an objective and definite time-frame for completion of projects so as to ensure that the loan assets relating to projects under implementation were appropriately classified and asset quality correctly reflected. In the light of the above background, it has been decided to extend the norms detailed below on income recognition, asset classification and provisioning to banks with respect to industrial projects under implementation, which involve time overrun.

3. It has been decided to group the projects under implementation into three categories for the purpose of determining the date when the project ought to be completed:

Category I:	Projects where financial closure had been achieved and formally documented.
Category II:	Projects sanctioned before 1997 with original project cost of Rs.100 crore or more where financial closure was not formally documented.
Category: III:	Projects sanctioned before 1997 with original project cost of less than Rs.100 crore where financial closure was not formally documented.

Asset classification

3.1 It has been decided that for each of the three categories, the date when the project ought to be completed and the classification of the underlying loan asset should be determined in the following manner:

Category I (Projects where financial closure had been achieved and formally documented): In such cases the date of completion of the project should be as envisaged at the time of original financial closure. In all such cases, the asset may be treated as ***standard asset for a period not exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project***.

In case, however, in respect of a project financed after 1997, the financial closure had not been formally documented, the norms enumerated for category III below, would apply.

Category II (Projects sanctioned before 1997 with original project cost of Rs.100 crore or more where financial closure was not formally documented): For such projects sanctioned prior to 1997, where the date of financial closure had not been formally documented, an **independent Group** was constituted with experts from the term lending institutions as well as outside experts in the field to decide on the deemed date of completion of projects. The Group, based on all material and relevant facts and circumstances, has decided the deemed date of completion of the project, on a project-by-project basis. In such cases, the asset may be treated as ***standard asset for a period***

not exceeding two years beyond the deemed date of completion of the project, as decided by the Group. Banks, which have extended finance towards such projects, may approach the lead financial institutions to which a copy of the independent Group's report has been furnished for obtaining the particulars relating to the deemed date of completion of project concerned.

Category III (Projects sanctioned before 1997 with original project cost of less than Rs.100 crore where financial closure was not formally documented): In these cases, sanctioned prior to 1997, where the financial closure was not formally documented, the date of completion of the project would be as originally envisaged at the time of sanction. In such cases, ***the asset may be treated as standard asset only for a period not exceeding two years beyond the date of completion of the project as originally envisaged at the time of sanction.***

3.2 In all the three foregoing categories, in case of time overruns beyond the aforesaid period of two years, the asset should be classified as sub-standard regardless of the record of recovery and provided for accordingly.

3.3 As regards the **projects to be financed by the FIs/ banks in future**, the date of completion of the project should be clearly spelt out at the time of financial closure of the project. In such cases, if the date of commencement of commercial production extends **beyond a period of six months** after the date of completion of the project, as originally envisaged at the time of initial financial closure of the project, the account should be treated as a sub-standard asset.

Income recognition

3.4 There will be no change in the existing instructions on income recognition. Consequently, banks should not recognise income on accrual basis in respect of the projects even though the asset is classified as a standard asset if the asset is a "non performing asset" in terms of the extant instructions. In other words, while the accounts of the project may be classified as a standard asset, banks shall recognise income in such accounts only on realisation on cash basis if the asset has otherwise become 'non performing' as per the extant delinquency norm of 180 days. The delinquency norm would become 90 days with effect from 31 March 2004.

3.5 Consequently, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s). As regards the regulatory treatment of income recognised as 'funded interest' and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

a) Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

b) Conversion into equity, debentures or any other instrument: The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity **or any other instrument**, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realisation basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognised only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

Provisioning

3.6 While there will be no change in the extant norms on provisioning for NPAs, banks which are already holding provisions against some of the accounts, which may now be classified as 'standard', shall continue to hold the provisions and shall not reverse the same.

4. The revised instructions come into force with immediate effect. Please acknowledge receipt.

Yours faithfully,

Sd/-

(***M.R. Srinivasan***)
Chief General Manager-in-Charge