Ref DBS.FID No. C-../01.02.00/2001-02

January 2002

To

The CEOs of all-India term lending and refinancing institutions

Dear Sir,

<u>Treatment of Restructured accounts – clarifications</u>

Please refer to our Circular DBS.FID.No. C-19/01.02.00/2000-01 dated 28 Mach 2001 on the captioned subject.

2. In this context, certain points have since been raised by some of the financial institutions seeking clarifications thereon. We have examined the issues and the clarifications are furnished in the Annexure.

3. Please acknowledge receipt.

Yours faithfully,

(K. C. Bandyopadhyay)
Chief General Manager

ANNEXURE

Treatment of restructured accounts – clarifications on the issues raised

S. No.	Issue raised	Clarification
1.	**Projects under Implementation** Whether the instructions contained in the Circular no. C-19 dated 28 March 2001, would also apply to the "Projects under Implementation"?	Yes. The guidelines clearly stipulate that a standard asset could be restructured either **before or after** commencement of commercial production. A sub-standard asset subjected to restructuring could also arise either **before or after** commencement of commercial production and could also be one that has been upgraded to the sub-standard category. Since the "projects under implementation" would come under the category of "before commencement of commercial production", the guidelines would apply to the projects under implementation.
2.	**Tax implications** The write off / provision envisaged in the aforesaid Circular is not an allowable deduction under the Income Tax Act, 1961. Only such debt or part thereof is allowed which has been taken into account in computing income or which represents money lent in the ordinary course of business.	The applicable tax provisions will have to be complied with.
3.	**Problems in accounting** The RBI guidelines do not fit into the "**Matching Concept" of accounting** and the guidelines provide for write off / provision of revenue that will never be realised by FIs. The question of making provision or rather 'reversal' should arise only in case of interest already booked on accrual basis but not realised / realisable. Making of provision / write off in respect of future interest, as described in the Circular, may not be appropriate nor in conformity with the accounting principles.	There is no provision being made for future interest. What is being done is to value the advance at its fair value. Where interest earned on an advance is at a rate which is less than the (PLR as on the date of restructuring + risk factor), the fair value of the advance is diminished and the provision has to be made for the same. Thus, a comparison between the present values of the cash flows under the original loan agreement and under the restructuring package would no longer be necessary. For the purpose, the amount of provision should be calculated as follows: (a) Determine what would be the amount of future interest for the balance period of the loan if interest had been charged at PLR or

		its equivalent (as on the date of restructuring) plus the original risk factor. The 'equivalent of PLR as on the date of restructuring' would be the rate charged to a 'AAA' rated borrower, immediately preceding the date of restructuring, **if** such rate was different from the announced PLR and the 'original risk factor' would mean the risk factor applicable to the borrower at the time of **initial** sanction of the loan. (b) Discount the interest cash flows at (a) above at PLR or its equivalent (as on the date of restructuring) plus original risk factor, to arrive at present value of future interest; (c) Determine future interest on the balance period of the loan on the basis of the interest rate as restructured; (d) Discount the cash flows at (c) above at PLR or its equivalent (as on the date of restructuring) plus original risk factor to arrive at the present value of future interest cash flows. (e) The provisioning needed would be (b) minus (d).
4.	**<u>Write back of provision / write off</u>** The guidelines do not permit reversal of provisions / write off made for the sacrifice incurred in the process of restructuring which leads to accounting ambiguity of holding the provision after the account has been squared off.	The provision should be recalculated at each balance sheet date following the procedure enumerated at item 3 above and excess provision, if any, could be reversed. A hypothetical simplified illustration of the calculation of the amount of provision that would be eligible for reversal after recalculation of the provisioning requirement at the year-end, is furnished in the **Exhibit**.
5(a)	**<u>Security</u>** The treatment of assets which are not fully secured, is not clear in the guidelines.	It is one of the conditions of restructuring / rescheduling / renegotiation of term that the asset must be fully secured. In case an asset, in the standard or the sub-standard category, which is not fully secured is subjected to restructuring, etc., then a provision to the extent of shortfall in security available, should also be made while restructuring the asset, apart from the provision required on present value basis and as per prudential norms.

5(b)	**<u>Treatment of guarantees</u>** Treatment of Corporate and Personal Guarantees for the purpose of security is not clear.	For calculation of provisioning requirement in respect of doubtful assets, the amount of corporate / personal guarantees available is not reckoned at present. The same practice may be followed in the context of the restructuring, etc., of the standard and sub-standard accounts also.
6.	**<u>Reduction in interest rates</u>** The reduction in interest rate on account of declining interest rate regime, **without any rehabilitation being involved** but done with a view to retaining good accounts in the books, to the level of current PLR + risk premium, should not attract the stipulations of the Circular dated 28 March 2001. **In a restructuring package**, the sacrifice on account of reduction in interest rates due to market-related factors need not be reckoned in computation of sacrifice. However, in case the reduction in interest rates is on account of **inability of the borrower to pay**, the sacrifice should be calculated where the interest rate as per the restructuring package is below the "normative rate" i.e., PLR+ risk premium, as specified in the new guidelines.	Please refer to the clarification at serial number 3 and 4 above.
7.	**Income recognition for the amount of funded interest <u>under restructuring</u>** Whether it is in order to recognise the amount of funded interest in the non-performing accounts?	No. 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.
8.	**<u>Conversion of debt into equity or other instruments</u>**	The amount outstanding converted into other instruments would normally comprise principal

	What should be the regulatory treatment for income recognised pursuant to conversion of the outstanding dues of a borrower into equity, debentures or any other instrument?	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.

EXHIBIT

An illustration of re-computation of the amount of provision required at each balance sheet date

Assume the following parameters for a loan account:

- Amount of loan outstanding – Rs. 1000 crore;
- Contracted rate of interest as per original loan agreement : 18% p.a.
- Repayable in five annual instalments of Rs 200 crore each;
- Rate of interest on the date of restructuring 14% p.a., (12% PLR + 2% risk premium) applied/ payable only annually at the end of the year;
- The account was restructured and the new contracted intt. rate was 10% p.a.

A. Computation of provision required at the time of restructuring

Year	0	1	2	3	4	5	Total
O/s amount at the year-end	1000	800	600	400	200	Nil	
Interest due @ 14%	-	140	112	84	56	28	-
Present value of interest cash flows at a discount rate of 14%	-	122.81	86.18	56.70	33.16	14.54	313.39
Interest due @10% (the restructured rate)	-	100	80	60	40	20	-
Present value of the restructured interest cash flows at a discount rate of 14%	-	87.72	61.56	40.50	23.68	10.39	223.85
Provision required to be made pursuant to restructuring exercise (A) (313.89 – 223.85)							**89.54**

B. Re-calculation of the provision required after 1 year at the next balance sheet date

(i.e., when only four interest cash flows from 2nd year onwards remain to be received)

Year	1	2	3	4	Total
Interest due @ 14%	112	84	56	28	-
Present value of interest cash flows at a discount rate of 14%	98.25	64.64	37.80	16.58	217.27
Interest due @10% (the restructured rate)	80	60	40	20	-
Present value of the restructured interest cash flows at a discount rate of 14%	70.18	46.17	26.99	11.84	155.18
Provision required after one year at the date of next balance sheet (B) (217.27- 155.18)					**62.09**

C. Since the provision of Rs. 89.54 crore, made at the time of restructuring of the account, is more than the provision needed at the next balance sheet date (Rs. 62.09 crore), the excess provision amounting to Rs. 27.45 crore can be reversed as at that date.