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प्लैटिनम जयंती
PLATINUM JUBILEE

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The Chairman and Managing Directors/
Chief Executive Officers of
All Scheduled Commercial Banks
(excluding RRBs & LABs)

Dear Sir,

Prudential Guidelines on Restructuring of Advance by Banks

Please refer to our circular RBI/2008-09/143 DBOD No.BP.BC.No.37/21.04.132/ 2008-09 dated August 27, 2008 on the captioned subject.

2. As mentioned in paragraph 3.4.2 of the circular, reduction in the rate of interest and / or re-schedulement of the repayment of principal amount, as part of restructuring, results in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and has impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution and make provisions for it by debit to Profit & Loss Account. This approach is based on recognition of the fact that grant of financial concessions in a loan results in permanent impairment of the asset value which needs to be recognised in the accounts. Similar accounting practices are followed in many countries including USA and are also consistent with the International Accounting Standards (mainly IAS 39) and AS 30 issued by Institute of Chartered Accountants of India.

3. It is further stated in para 3.4.2 that the erosion in the fair value of the advance should be computed as the difference between the "the present value of future cash flows (principal and interest) reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring", and 'the present value of future cash flows' (principal and interest) based on rate charged as per the restructuring package. For computing the present value, the discount rate to be applied should be equivalent to the current BPLR as on the date of restructuring + appropriate term premium + credit risk premium applicable to the borrower as on the date of restructuring.

4. In this connection, it has been represented to RBI that while computing the diminution in fair value of restructured loans, the cash flows representing principal should not be taken into account. It has also been represented that the existing methodology results in making provisions even for that part of the diminution which is attributed to general rise in the interest rates in the economy, because it computes the diminution with reference to the existing book value of the loan. (It may be seen from para 3 above that the present value of the pre-restructured loan comes to its book value). The formula has particularly resulted in higher provisioning due to rise in the rate of interest during last few years which is adding to the financial difficulties when banks' margin are already stressed due to the current downturn. It has, therefore, been suggested that the existing formula may be modified in such a way that the changes in fair value of the loan attributed to the changes in market interest rates are not taken into account while computing the diminution.

5. <u>Inclusion of cash flows representing principal of the loan</u>

5.1 It may be recalled that the concept of measurement of diminution in fair value of a loan consequent upon the restructuring and making provision for such diminution was introduced, in principle, vide Circular DBOD.No.BP.BC.98/21.048/2000-01 dated March 30, 2001. In terms of this circular, only the diminution in the present value of interest cash flows was reckoned for the purpose of provisioning. Any diminution in the present value of principal cash flows due to elongation of the repayment period or increase in weighted average maturity of the loan due to reschedulement of some of the installments while leaving the final maturity unchanged, was not captured. This issue was examined by the Working Group to review the functioning of CDR Mechanism constituted by RBI in September, 2004. In its report, the Group recognized the need for taking into account the principal cash flows also in computation of diminution of the fair value of the loan. However, considering that the implementation of even the framework for computation of diminution in the fair value of interest cash flows had not yet stabilized in the banking system, owing mainly to technical difficulties experienced by the banks, it was decided to defer this for some more time.

5.2 In August 2008, while carrying out a comprehensive review of the prudential norms governing the restructuring of advances so as to align the general prudential framework with that prescribed for CDR Mechanism, it was considered appropriate to modify the framework for computation of diminution in the fair value of the restructured loans to make it fully consistent with the international practices. It was recognized that the 'interest – only' methodology was deficient in as much as it was based only on part of the cash flow of the loan. Besides, in some cases where there was substantial elongation in the repayment period, the present value of interest cash flows as per terms of restructuring even exceeded the present value of interest cash flows as per terms of the loan before restructuring, resulting in negative diminution. This observation highlighted the inadequacy of the 'interest – only' approach to properly compute the diminution in the fair value of the restructured loans.

5.3. In view of the above, RBI has not accepted the request that while computing the diminution in fair value of restructured loans, the cash flows representing principal should not be taken into account.

6. Formula for computation of diminution in fair value of a restructured loan

6.1 In this context, it may be mentioned that prior to revision of the guidelines on restructuring of advances under CDR Mechanism issued vide circular dated November 10, 2005, the methodologies prescribed by the RBI for the computation of sacrifice by the banks and FIs differed. Banks discounted the future interest due as per the original loan agreement to the present value at a rate appropriate to the risk category of the borrower (i.e. current PLR plus the appropriate credit risk premium for the borrower category) and compared with the present value of the dues expected to be received under the restructuring package discounted on the same basis. FIs, however, reckoned the future interest due, based on the PLR or its equivalent (rate charged to a AAA rated borrower immediately preceding the date of restructuring, if such rate was different from the announced PLR) as on the date of restructuring plus the original risk factor (risk factor applicable to the borrower at the time of initial sanction of the loan). During the course of the discussions which the members of the Working Group to review the CDR Mechanism had with representatives of banks as part of their work, it was represented that methodology for computation of sacrifice(diminution) for banks should be aligned with that for FIs in order to ensure a level playing field and also in view of the fact that the difference in the present value of the interest cash flows as per the terms of pre-restructured loan and the post-restructured loan was substantial because the interest rates had declined during the last 4 to 5 years at that time. The Working Group agreed to the suggestion, *in principle*, with the understanding that so long as the approach was followed consistently from year to year over the entire interest rate cycle, it would not raise any prudential issues. Accordingly, the Group recommended to compute the diminution in the present value of the interest cash flows with reference to the "current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring" which was much lower than the interest rate charged on the pre-restructured loan at that time.

6.2 We have examined the request now made by the banks. The existing treatment, in effect, compares the post-restructuring fair value of the loan with the book value. In a falling interest rate scenario, the difference is too low while in a rising interest rate the difference is too high. One of the ways in which the issue raised by the banks can be addressed is to fair value the loan both before and after restructuring and make provisions for the difference. It has been decided to modify the formula for computing diminution in the fair value of restructured loan as per this approach, in respect of all accounts which were restructured in terms of circular dated August 27, 2008 referred to above and the subsequent circulars issued on the subject. Accordingly, para 4.3.2 of Circular dated August 27, 2008 is amended as under :

“The erosion in the fair value of the advance should be computed as the difference between the fair value of the loan ***before*** and ***after*** restructuring. ***Fair value of the loan before restructuring*** will be computed as the present value of cash flows representing the interest at the <u>existing rate charged on the advance before restructuring</u> and the principal, discounted at a rate equal to the bank’s BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring". ***Fair value of the loan after restructuring*** will be computed as the present value of cash flows representing the interest at the <u>rate charged on the advance on restructuring</u> and the principal, discounted at a rate equal to the bank’s BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring".

7. It may please be noted that the above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to followed consistently in future. No request for changing the same, particularly for reversion to the present formula, will be entertained in future.

8. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

9. It is also re-emphasised that all the modifications effected to the guidelines on restructuring of advances by RBI since December 2008 are aimed at providing an opportunity to banks and borrowers to preserve the economic value of the units and should not be looked at as a means to evergreen the advances.

10. In their published annual Balance Sheets for the year ending March 2009, in addition to the disclosures regarding restructured loans required in terms of paragraph 8 of the circular dated August 27, 2008 referred to above, banks should also disclose the amount and number of accounts in respect of which applications for restructuring are under process, but the restructuring packages have not yet been approved.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge