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Interpreting the 2 months relaxation for asset classification: Soothing demonetisation pangs for banks and NBFCs

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The demonetisation of high value notes on 8th November, 2016 by the Indian government had a direct impact on availability and circulation of cash in the economy. A direct repercussion was on the timely repayment of credit to banks and NBFCs especially for the small borrowers.

Financial institutions were already struggling with rising NPAs and any more delays in repayment caused due to the demonetisation would strain the book size further. To address this issue, several NBFCs were issuing directive policies offering relaxation in repayment of monthly instalment to its borrowers to deal with the demonetisation of high value notes. Looking at the stress on currency circulation and exchange, RBI also issued a circular¹ on 21st November, 2016 wherein a 60 day relaxation was offered to small borrowers accounts for recognition of an asset as sub-standard. This circular was followed by another circular issued by RBI on 28th December, 2016², whereby the original relaxation of 60 days was extended by another 30 days for some categories of credit facilities. The circular also clarifies one issue which was missing under the earlier circular, with respect to the asset classification of the accounts held as standard before 1st November, 2016.

This note is trying to interpret the circular, ask some pertinent questions, analyse the essence of the circular and how it would help the banks and NBFCs and their borrowers to deal with the issue.

Essence of the circular

The circular takes cognizance of the difficulty in repayment of loans by small borrowers consequent to the withdrawal of the legal tender status of Rs. 500 and Rs. 1000 notes and ***provides an additional 60 days beyond what is applicable for the concerned regulated entity (RE) for recognition of a loan account as substandard.***

In essence, if there was delay in payment caused due to discontinuation of the legal tender, which causes the account to be classified as substandard by the Regulated Entity, such downgrading of the account shall be delayed by a period of 90 days and 60 days in some cases.

Who is a Regulated Entity?

The circular does not define what regulated entities are. However the Master Direction on Know Your Customer (KYC) Directions, 2016 defines Regulated Entities³ as:

“Regulated Entities” (REs) means

- a. *all Scheduled Commercial Banks (SCBs)/ Regional Rural Banks (RRBs)/ Local Area Banks (LABs)/ All Primary (Urban) Co-operative Banks (UCBs) /State and Central Co-operative Banks (StCBs / CCBs) and any other entity which has been licenced under Section 22 of Banking Regulation Act, 1949, which as a group shall be referred as ‘banks,*
- b. *All India Financial Institutions (AIFIs)*

¹ <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10723&Mode=0>

² <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=10801&Mode=0>

³ https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10292

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- c. *All Non-Banking Finance Companies (NBFC)s, Miscellaneous Non-Banking Companies (MNBCs) and Residuary Non-Banking Companies (RNBCs).*
- d. *All Payment System Providers (PSPs)/ System Participants (SPs) and Prepaid Payment Instrument Issuers (PPI Issuers)*
- e. *All authorised persons (APs) including those who are agents of Money Transfer Service Scheme (MTSS), regulated by the Regulator.*

How to determine the qualifying loan accounts for relaxation under this circular?

The circular states that the following loan accounts shall qualify for the relaxation:

- a. Working capital loan accounts (OD/CC)/crop loans, with any bank, wherein the sanctioned limit is Rs. 1 crore or less;
- b. Term loan whether business or personal, secured or otherwise, the original sanctioned amount whereof is ₹ 1 crore or less, on the books of any bank or any NBFC, including NBFC (MFI). This shall include housing loans and agriculture loans;
- c. Loans sanctioned by banks to NBFC (MFI), NBFCs, Housing Finance Companies, and PACs and by State Cooperative Banks to DCCBs;
- d. The above guidelines will also be applicable to loans extended by DCCBs.

The circular clarifies that the limits mentioned in (a) and (b) above shall be mutually exclusive limits applicable to respective category of loans.

This would mean that if a borrower has a term loan with a bank and working capital limit with a bank, the threshold of Rs. 1 crore of loan amount shall be seen for each individual loan and not as a consolidated exposure on the borrower.

Here it is important to mention that the relaxation of further 30 days was extended to only working capital loan accounts (OD/CC)/crop loans, term loans for business purpose only and agricultural loans only. Personal loans and housing loans have been kept out of the purview of the 28th December circular.

Therefore, it can be concluded that following is the standing after reading both the circulars together:

- a. Relaxation of 90 days will be applicable to working capital accounts (OD/CC)/crop loans extended by banks and term loans for business purposes, which shall include agriculture loans extended by banks, NBFCs and NBFC MFIs.
- b. Relaxation of 60 days will be applicable to term loans for personal purpose, which shall include housing loans extended by banks, NBFCs, MFIs, HFCs, PACs and State Co-operative Banks.

The small borrower qualifying threshold is based on the exposure on the borrower or loan facility amount?

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The qualifying threshold is based on each facility limit. This means that a Regulated Entity may have a borrower exposure greater than Rs. 1 crore across various facilities made available to the borrower, however each loan facility amount should be lower than or Rs. 1 crore.

How will the asset classification be carried out?

The asset classification relaxation is provided only if the account was to move from standard to sub-standard category during November-December, 2016. However, if the account was within NPA category already, the benefit of the relaxation will not be available.

Effectively the circular stalls the dip in the asset classification by 2 months/ 3 months.

To what instalment dues does the relaxation apply?

Para 2 of the circular provides for the conditions for the relaxation. The relaxation applies:

- a. To the dues payable between 1st November, 2016 and 31st December, 2016.
- b. Dues payable before November 1 and after December 31, 2016, will be covered by the existing instructions with regard to NPA recognition.
- c. For deferment of classification is only from standard to sub-standard account and not migration of an account within NPA categories.

Conditions in Essence:

- a. All instalments falling due between 1st November, 2016 and 31st December, 2016 will be given a deferment of 60 days/ 90 days for asset classification norms.
- b. For accounts classified as standard before 1st November, 2016 which are due for downgrading during the period between 1st November, 2016 and 31st December, 2016, will be deferred by a period of 90 days.
- c. This deferment however, does not mean that an able borrower will not pay the instalments in November or December. The obligation to pay has not been altered. This means that the borrowers will be required to pay as per the scheduled repayment schedule.
- d. The standard to NPA classification will be deferred by two months. However if the account was already in NPA category then movement within NPA category will be undertaken as per the extant asset classification norms. **To further clarify the issue in essence:**
 - i. Where the account was 90 days past due on October, 2016 and where the borrower has been unable to pay the instalment falling due in November, 2016 the account in normal circumstance would have moved into NPA category. However owing to this circular, the NPA recognition in November would be deferred by 60 days and will be recognised in January, 2017.
 - ii. Therefore the circular intends to not strain the loan portfolio of the Regulated Entities that is likely because of a macro-economic factor.



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The essence of the circular is also apparent from the introductory lines of the circular that are as follows:

“It has been represented to us that consequent upon withdrawal of the legal tender status of the existing ₹ 500 and ₹ 1,000 notes (SBN) small borrowers may need some more time to repay their loan dues. Taking these representations into consideration, it has been decided to provide an additional 60 days beyond what is applicable for the concerned regulated entity (RE) for recognition of a loan account as substandard...”

Conditions in Literal Interpretation:

The earlier circular stated that dues payable before or after the November-December period shall be subject to the existing asset classification norms and therefore, the wordings were very counter-intuitive to the letters of the law.

If one had to take a literal interpretation of the 21st November circular, it would mean that dues till October will continue to provide for asset classification under extant regulations.

In effect, if the instalment due of November was not paid timely, the NPA recognition for an NBFC will be 120 days later with the counting of 120 days starting from January, 2017. Post the circular, the NPA for a 1st November, 2016 instalment due will be classified as an NPA on 1st April, 2017.

However, if the instalment was 90 days past due as on 31st October, 2016 it would fall into 120 days past due bucket in November 2016 and will be classified as NPA, as per the circular, because the dues prior to November will be following the extant classification norms.

To summarise, if an account was even 1 day past due on October 2016 it would have been classified as NPA within 120 days without the 60 day deferment, defeating the objective of deferment of the NPA classification proposed by the 21st November circular.

This position has now been made clear vide the 28th December circular and the accounts classified as standard before 1st November will also be able to enjoy this benefit.

The following questions are addressed, considering the essence and the literal interpretation.

An NBFC has the following borrower accounts with DPDs marked, how will the NPA classification be impacted?

| DPD as on 31st October, 2016 (in days) | NPA declaration (interpretation by language) | NPA declaration (interpretation by essence of circular) |
|--|---|--|
| 0 | February, 2017 | April, 2017/ May, 2017 |



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| | | |
|-----|----------------|----------------------------------|
| 30 | January, 2017 | March, 2017/ April, 2017 |
| 90 | November, 2016 | January, 2017/ February, 2017 |
| 120 | Already NPA | Already NPA |

Is the circular offering relaxation in repayment by the borrower?

The circular is an arrangement offered by RBI to the Regulated Entities. It is not a guidance for the borrowers to delay or defer the repayment of the loans.

The circular is merely a relief for asset classification by Regulated Entities. It does not affect either the right of the lender to collect as per the agreement, or the obligation of the borrower to pay

Will the delayed instalments accrue in the books of accounts?

The accounting entries with regard to accrual of the instalments will continue as was in case the circular was not published. The circular provides relaxation with asset classification and not for income recognition. The circular is an understanding between RBI and the Regulated Entities, it no way directs the borrowers to defer repayment in any manner.

Will the NBFCs be charging delayed interest charges on the loan accounts?

The relaxation in asset classification is a regulatory relaxation offered to Regulated Entities. There is no relaxation offered to borrowers in repayment. Therefore as per the contractual terms of the loans extended, the Regulated Entities will have the right to charge delayed interest charges on such delayed payouts.

Will the loan tenure be extended by two/ three months?

The circular does not seek to amend the terms of lending between the borrower and the Regulated Entities. It only facilitates the deferment of the asset classification norms. Therefore there is no question of extension of the loan tenure.

Will the borrowers be required to pay 2 instalments as on January, 2017 and February, 2017?

As discussed above, the borrower will pay the dues as per the agreed repayment schedule. The loan terms will continue as is.

Can a lender take enforcement action on account of non-payments during the breather period?



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Yes. However, lenders may take a practical stand in recognition of the fact that there may be genuine difficulties the borrower may have during the period, on account of financial dislocation.

In case the NBFCs had already provided a relaxation policy for borrower accounts can that still prevail?

If the lender had provided for a relaxation in repayment of instalment owing to the demonetisation issue as a matter of policy decision, it will in no way get impacted by this circular. Both can co-exist.