

The Chief Executive Officers of
Insurance & Re-insurance Companies

Dear Sir,

Prudential norms for Income Recognition, asset classification and provisioning and other related matters

As you are aware, Clause 7 of Part I of Schedule A and B of the IRDA (Preparation of Financial Statements and Auditor's Report) Regulations 2002 require:

"Loans shall be measured at historical cost subject to impairment. Insurers shall assess the quality of its loan assets and shall provide for impairment.

The impairment provision shall not be lower than the amount derived on the basis of guidelines prescribed from time to time by Reserve Bank of India (RBI) that apply to companies and financial institutions".

We observe that the insurers have already adopted the RBI guidelines in this regard as stipulated by the Authority, and that the statutory auditors examine the compliance in this regard while finalizing the audit of annual financial statements of insurers.

The Authority has now formalized the "Prudential norms for income recognition, asset classification and provisioning and other related matters" in respect of debt portfolio (placed at Annexure). The guidelines for provisioning for the debt portfolio are based on the RBI guidelines issued in this regard which are duly updated. However some modifications have been made keeping in view the industry specific requirements.

All insurers are requested to ensure compliance with the stipulations w.e.f the financial year 2006-07.

Yours faithfully,

(C. R. Muraildharan)

Annexure

INCOME RECOGNITION, ASSET CLASSIFICATION, PROVISIONING AND OTHER RELATED MATTERS

I. ASSET CLASSIFICATION:

Every insurer shall make adequate provision for estimated loss arising on account from/under recovery of loans and advances (other than loans and advances granted against insurance policies issued by the insurer) outstanding at the balance sheet date. **These guidelines are intended to provide the basis for determination of minimum provisions of loss on account of loans and advances.** Insurers shall classify their loans/advances into four categories, viz., (i) standard assets, (ii) sub-standard assets, (iii) doubtful assets and (iv) loss assets. Classification of assets into these categories shall be done taking into account ability of the borrower to repay and the extent of value and realizability of security.

(i) Standard assets

Standard asset is one which does not disclose any problem and which does not carry more than normal risk attached to the business. Such an asset is not an NPA. The insurer should make a general provision on Standard Assets of a minimum of 0.40 per cent of the value of the asset.

In respect of loans extended directly by insurers to sick units taken over by borrowers falling under the "standard" classification, the facilities of the transferee and merged units may continue to be classified separately, for a period not exceeding 24 months from the date of the take over of the sick unit, after which the performance of the loans sanctioned to the borrower as a whole should determine their classification. In cases of reverse merger (i.e., take-over of a healthy unit by a sick unit) as well, the facilities of both the units may continue to be classified separately for a period of 24 months after which the combined performance may be taken for asset classification.

(ii) Sub-standard assets

Sub-standard asset is one which has been classified as NPA for a period not exceeding 12 months, e.g., an asset which has been treated as a NPA on 1st April, 2004, would be treated as a sub-standard asset only up to 31st March 2005.

In case of time overrun for completion of project directly financed by insurers, the Boards of Insurers should decide based on valid grounds, whether the advance should be treated as standard asset.

An asset where the terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production, should be classified as sub-standard and should remain in this category for at least two years of continually satisfactory performance under the revised terms. The classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of the above condition.

(iii) Doubtful assets

A doubtful asset is one which has remained as NPA for a period exceeding 12 months, e.g., a loan facility to a borrower which is treated as NPA on 1st April 2004, would be treated as 'doubtful' from 1st April, 2005.

A loan classified as doubtful has besides the weakness inherent in that classified as sub-standard, with the continuing default makes the recovery in full, to be improbable. Here too, as in the case of sub-standard assets, rescheduling does not lead upgradation of the category of the asset automatically. Similarly a doubtful asset which is subject to rehabilitation and where the asset has been subsequently continually satisfactorily serviced for one year shall be graduated to a standard asset.

(iv) Loss assets

A loss asset is one where loss has been identified by the insurer or its internal or statutory auditors or by IRDA, but the amount has not been written off wholly. In other words, such an asset is considered un-collectible and as such its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

II. OVERDUE AMOUNTS INTEREST/PRINCIPAL:

An amount, whether interest or principal is said to be over due if it is not paid to the insurer on the specified date.

An asset is classified as an NPA if the interest and/ or installment of principal remain overdue for more than 90 days (i.e., one quarter).

III. PROVISIONING FOR LOANS AND ADVANCES:

General

Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion in the value of security charged to the insurers, it is necessary that insurers make adequate provisions against sub-standard assets, doubtful assets and loss assets, as per the procedure outlined below:

(i) Loss assets:

The entire asset should be written off. If the assets are to remain in the books for any reason, 100 per cent of the outstandings should be provided for.

(ii) Doubtful assets:

- (a) 100 percent provision of the extent to which the asset is not covered by the realisable value of the security to which the insurer has a valid recourse and the realisable value is estimated on a realistic basis.
- (b) Over and above item (a) above, depending upon the period for which the asset has remained doubtful, 20% to 100% provision of the secured portion (i.e., estimated realisable value of the outstandings) should be made on the following basis :

Period for which the asset has been considered as doubtful	% of provision
Up to one year	20%
One to three years	30%
More than three years	100%

(iii) Sub-standard assets

- 1. A general provision of 10% of total value outstanding remaining substandard is required to be made including loans granted by the Central/State government.
- 2. Loans granted under rehabilitation packages

In case of nursing finance granted by an insurer, the additional loan facilities sanctioned under the rehabilitation programme may be treated as a separate account and the performance assessed separately. Asset classification and provisioning in respect of such loan facilities as per the prescribed guidelines may be made only if the interest /principal payments remain due beyond 90 days.

It is clarified that the proviso has been included to take care of the existing portfolio of the insurers.

IV. DEFAULTS IN REPAYMENT OF PRINCIPAL:

On account of various reasons, such as delays in project implementation, getting adequate working capital facilities, etc., repayment of principal may be delayed beyond the stipulated one quarter. The asset may continue to be considered as standard if the installments of the principal amount are rescheduled with the approval of the Board of the concerned insurer. This is subject to the condition that there can be only a one time re-schedulement and that the interest continues to be paid regularly.

V. TIME OVERRUN:

In case of time overrun for completion of project directly financed by insurers, the Boards of Insurers should decide based on valid grounds, whether the advance should be treated as standard asset.

VI. ONE TIME SETTLEMENT (OTS):

(a) In respect of loan facilities extended to sick units (under nursing programmes or otherwise) taken over by borrowers falling under the “standard” classification, the facilities of the transferee and the merged units may continue to be classified separately for a period not exceeding 2 years from the date of take over of the sick unit, after which the performance of the loan facility sanctioned to the borrower as a whole should determine their classification.

(b) Sometimes insurers enter into one time settlement (OTS) of their dues with a new owner. In cases where a sick unit has been merged with a healthy and strong unit and where payments are being made as per the OTS scheme, the asset in respect of the merged unit may be considered as standard without waiting for a period of 2 years for upgradation from sub-standard to standard asset. However, such cases should be approved by the Board of the concerned insurer.

It is clarified that the said relaxation is allowed only in OTS cases.

VII. UNITS ENJOYING MORE THAN ONE LOAN FACILITY:

In case of borrowers who have been granted more than one loan facility by the insurer, all the dues from them will have to be treated as NPAs if 50 per cent of its total interest and/or principal dues from all loans extended to it remain overdue for more than one quarter.

VIII. GOVERNMENT GUARANTEED LOANS:

Loans or other credit facilities backed by Central/State Government guarantees should be treated on par with other assets for income recognition and provisioning. However, in respect of loans backed by Central Government guarantee, such loans shall be treated as NPA only when the Government repudiates its guarantee when invoked.

IX. INCOME RECOGNITION:

Income in respect of any asset classified as NPA shall not be recognized unless realized. However, any adjustment towards overdue interest against any fresh/additional loan shall not be considered as realized.