Nepal Rastra Bank

Guideline on Recognition of Interest Income, 2019

Bank and Financial Institutions Regulation Department

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1. Introduction

1.1 Background

Prior to 16 July 2004, there were no any accounting standards in Nepal. The Institute of the Chartered Accountants of Nepal first time pronounced six accounting standards and made effective from 16 July 2004. The pronounced standards were not complete enough to cover all transactions and events of the bank and financial institutions. The full set of accounting standards (named as NFRSs) was issued in 2013 and it was effective for commercial banks from fiscal year 2015/16. However, commercial banks implemented NFRSs from fiscal year 2017/18 and development bank and finance companies are required to implement NFRSs from fiscal year 2018/19. Before implementation of NFRSs, banks and financial institutions were required to prepare their financial statements as per the regulations issued by Nepal Rastra Bank. One of the major changes required by NFRSs is recognition of interest income on loan and advances from cash basis to effective interest rate method.

Before fiscal year 2001/02, bank and financial institutions were allowed to recognize interest income on accrual basis. However, development banks and finance companies were required to debit interest income account if the accrued interest were not received within 6 months and 3 months from due period respectively.

The accrual basis of accounting of interest income on loan and advances impacted severely on capital adequacy and non performing loans of bank and financial institutions especially state owned banks. During the fiscal year 2001/02, capital adequacy ratio of commercial banks was negative by 9.88% whereas such ratio for state owned three banks was negative by 28.92%. Similarly, the non performing loans of commercial banks were also statistically high during that period. NPL level of commercial banks stood at 30.41% whereas of state owned banks were at 55.56%[1]. Considering the above scenario, Nepal Rastra Bank, under Financial Sector Reform Programme, changed its directive on interest income recognition from accrual basis to cash basis.

However, after implementation of NFRSs in bank and financial institutions, the basis of accounting of interest income has been changed from cash basis to effective interest method. This has hazardous impact on the health of bank and financial institutions. Due to this reason, Nepal Rastra Bank has made a provision to allocate the differential interest income between two bases of accounting to Regulatory Reserve Account and retain it until the accrued interest is actually received. The effective interest method is a method of allocating the interest income over the relevant period of the loans.

The financial condition and performance of a bank depends critically on the realistic valuation of its assets and the prudent recognition of its income. NAS 18 on Revenue prescribed the rule to recognize the interest earned on loans as per effective interest method (i.e. as it accrues), provided that its collectability is not subject to significant doubt.

[1] Source : Nepal Rastra Bank, Supervision Department, Annual Report 2001-02.

Doubtful interest should not be recognized as income. For loans where there is still some prospect of ultimate recovery of interest, this is normally done by crediting the interest to a suspense account rather than recognizing it as income. For loans where it is considered that there is no prospect of ultimate recovery of interest, interest should cease to be accrued altogether. If such action is not taken, the profits of the bank and its capital will be overstated. Any interest income previously credited to the profit or loss account on loans whose collectability subsequently becomes doubtful should be tested for impairment rather than reversing the interest income. Any decision to cease interest accrual from an accounting perspective does not preclude continuing to accrue interest on a memorandum basis for legal enforcement purposes.

The problem is to identify the point at which the collectability of interest becomes doubtful. To a large extent this must be a matter of judgment. However, it may be possible to use certain objective indicators such as the length of time that interest or principal is overdue to assist in arriving at the judgment.

Since, there is divergence in practice of bank and financial institutions to identify the point at which the collectability of interest becomes doubtful, it is necessary to issue a guideline to provide guidance to standarise the practices adopted by bank and financial institutions.

1.2 Current practice of income recognition

Bank and financial institutions recognize interest income as per the provision of NAS 18 on Revenue. However, banks and financial institutions have been taking the benefits of carve out regarding the deduction of service fee while calculating the effective interest rate. Although, the basis for recognition of interest income is same across all bank and financial institutions, the judgment made by these institutions to identify the point at which the collectability of accrued interest is significantly doubtful is divergent. Some banks and financial institutions adopted their accounting policies as to suspend the recognition of interest income on loans and advances which are due for more than 180 days whereas others for more than 365 days.

In view of diversity of approach in identification of significant doubtful in collectability of interest, Nepal Rastra Bank considers it necessary to achieve greater standardization in the approach in this regard. This will further enhance the transparency of the banking system and help to reduce market uncertainty. It will enable investors and other users of financial statements to make more meaningful comparisons of the published figures for interest income, loans and advances; and ultimately profit or loss.

1.3 Objective of the guideline

This guideline aims to achieve greater standardization of the practices on recognition of interest income on loan and advances of bank and financial institutions that have adopted NFRSs in preparation of their financial statements. This guideline shall provide a baseline for interest income recognition by all bank and financial institutions adopting NFRSs. This guideline shall be adopted by bank and financial institutions for the purposes of reporting of their financial statements as well as reporting of regulatory reports to the Nepal Rastra Bank.

These guidelines shall not override the provisions of NFRSs and accounting policies adopted by bank and financial institutions for the recognition of interest income but it only intend to provide guidance for making judgment regarding significant doubt on collectability of interest. Further, it is not intended to prevent individual institutions from adopting more stringent and objective triggers for identification of significant doubtful if they consider that to be appropriate, e.g. in terms of the choice of time period and treatment of collateral.

2. The guideline

2.1 Criteria for determining loans on which interest no longer be recognized to the profit or loss account but shall be suspended

The criteria set out below combine a mixture of subjective and objective factors. It is recognized that the decision to suspend the recognition of interest must be largely judgmental, based on whether there is reasonable doubt about the collectability of the interest. However, there are number of objective criteria that can assist in arriving at this judgment, relating in particular to the extent to which payments of principal and/or interest are in arrears. While the length of the period of arrears must inevitably be somewhat arbitrary, because of undue cost and effort involved, it is international best practice to use arrears period.

For example paragraph 5.5.11 of IFRS 9 Financial Instruments prescribe that there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. Similarly, paragraph B5.5.37 prescribe that there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. Above provisions in IFRS uses the past due period as a trigger point to identify as the credit risk on a financial asset has been increased significantly or identify as the party of the financial instrument has been defaulted.

Based on the above principles, the criteria for determining when interest income recognition should be suspended or cease to accrue it are as follows:

(a) Loans where there is reasonable doubt about the ultimate collectability of principal or interest;

(b) Loans against which individual impairment as per NAS 39 or life time impairment as per NFRS 9 has been made;

(c) Loans where contractual payments of principal and/or interest are more than 3 months in arrears and where the "net realizable value" of security is insufficient to cover payment of principal and accrued interest;

(d) Loans where contractual payments of principal and/or interest are more than

12 months in arrears, irrespective of the net realizable value of collateral;

(e) Overdrafts and other short term facilities which have not been settled after the expiry of the loan and even not renewed within 3 months of the expiry, and where the net realizable value of security is insufficient to cover payment of principal and accrued interest;

(f) Overdrafts and other short term facilities which have not been settled after the expiry of the loan and even not renewed within 12 months of the expiry, irrespective of the net realizable value of collateral;.

It should be noted that the first of these criteria establishes the overriding principle. This means, for example, a decision may be made to suspend to recognize interest income on a loan or cease to accrue it because there is significant doubt about the ultimate collectability of principal or interest, even if it is not yet in breach of contractual requirements or if the period of arrears is not more than 3 months.

Notwithstanding anything contained in this paragraph, the suspended interest shall be recognized as income in profit or loss when the interest is receipt by bank or financial institution.

2.2 Criteria to cease the accrual of interest

Bank and financial institutions shall accrue the interest on loan although it has been decided to suspend the recognition of income. However, BFIs shall cease to accrue interest on loan, in case where contractual payments of principal and/or interest of the loan are due for more than 12 months and the "net realizable value" of security is insufficient to cover payment of principal and accrued interest. Cessation of accrual of interest for accounting purpose shall not preclude an entity to continue to accrue interest on a memorandum basis for legal enforcement purposes unless the loan is written off.

2.3 Treatment of the collateral

Given the legal system of Nepal enables lenders to take possession of, and realize, security within a reasonable time-frame, it is appropriate to take the value of security into account in determining whether to suspend the recognition of interest income or cease to accrue it. However, the longer the loan is in arrears, the more "collateral dependent" it will become. That is, it will become increasingly clear that repayment of the debt will depend solely on realization of the underlying collateral. Moreover, recognising interest on non-performing loans for too long could progressively overstate the revenue of the institution. This is why there is a cut-off point of 12 months of arrears beyond which interest should be suspended to recognize or cease to be accrued, regardless of the value of the collateral held.

In the absence of active, efficient and transparent market of real estate in Nepal and considering the force sale event of the collateral, it is necessary to make hair cut to some extent to current market value of the collateral.

In determining whether the value of collateral is sufficient to cover payment of principal and accrued interest, reference should be made to the "net realizable value" of the collateral concerned. This is the current fair value less any realization costs and necessary haircuts. Fair value should be measured on the basis of market price of assets whose active market is available. In case of assets which are not dealt with in active market, up-to-date valuations shall be taken for measurement. Fair value is defined in terms of the price at which an asset might be sold in an orderly transaction between market participants at the valuation date. Following bases shall be taken for determination of net realizable value of different kind of collateral.

a) Net realizable value of collateral of land or land and building shall be calculated as current fair value less 5 % of the value as realization cost (brokerage charges, documentation charges, legal charges, capital gain taxes etc.) less 25% hair cut for possible down fall in price due to force sale transaction of the collateral.

b) Net realizable value of collateral of shares and debenture shall be determined as current fair value less 5% of the value as realization cost (brokerage charges, legal charges, capital gain taxes etc.) less 10% hair cut for possible down fall in price due to immature and volatile share and debenture market.

c) Net realizable value of collateral of inventories and fixed assets other than land or land and building shall be determined as current fair value less 5% of the value as realization cost less 25% hair cut for possible down fall in price due to force sale transaction of the collateral. In case, the fair value of such asset is not determinable at the valuation date, the net realizable value of the assets shall be taken as book value of such assets less 50% flat hair cut on such value.

d) Net realizable value of collateral of debtors/receivables shall be determined as fair value of non due and debtors due for 3 months less 5% of the value as realization cost less 25% as hair cut of fair value of due debtors. Value of the debtors/receivables which are due for more than 3 months shall not be taken in to account.

e) Net realizable value of collateral of gold, silver and other precious metals shall be determined as current fair value less 10% as realization cost.

f) Net realizable value of collateral of Government Bonds and Nepal Rastra Bank's securities shall be determined as current fair value less 2% as realization cost.

g) Net realizable value of all other collateral shall be determined as current fair value less 25% hair cut.

h) Other forms of recognized collateral such as guarantee of top 1000 banks, multilateral development banks, third party collateral may be taken into account for the purpose of determining whether interest should continue to be accrued to the profit or loss account provided that the value of such collateral can be determined with reasonable certainty and the entity shall make 25% hair cut on the value determined.

2.4 Multiple extensions of credit to one borrower and loans to related companies

As a general principle, whether interest on an individual loan is suspended to recognise or ceases to be accrued will depend on the application of the criteria set out in paragraph 2.1 to that particular loan. Thus, even if interest on one or more loans to a particular borrower is no longer accrued to the profit or loss account, this does not necessarily mean that all other outstanding loans to that borrower or to other related companies should be treated in the same manner. In particular, whether individual loans should be treated separately or collectively for interest accrual purposes will depend on how they are collateralised or guaranteed. If it is clear that there is sufficient security dedicated to a particular loan to cover payments of principal and interest on that loan, the criteria for recognition of interest income or suspend it shall apply to individual loan.

In case, the single collateral is used for multiple loans, the criteria suspension of interest income recognition shall be applied on following basis.

a) Interest income shall not be recognized on all loans where contractual payments of principal and/or interest are more than 3 months in arrears even for a single loan where the “net realizable value” of security is insufficient to cover payment of principal and accrued interest

b) Interest income shall not be recognized on all loans where contractual payments of principal and/or interest are more than 12 months in arrears even for a single loan irrespective of the net realizable value of collateral

However, notwithstanding anything contained in clause (a) and (b) above, bank and financial institutions shall recognize interest income on a particular loan if payment of interest is received by the bank/financial institution.

2.5 Resuming accrual in the profit or loss account

Where interest has been suspended to recognize in profit of loss or has ceased to be accrued, the recognition of interest in profit or loss account may be resumed if arrears of principal and interest from the borrower have been cleared and it is probable that the customer is capable of fully servicing his obligations under the terms of the loan for the foreseeable future. This should be supported by a well-documented credit evaluation of the borrower's financial position and prospects for repayment. A loan which has been rescheduled/restructured may be restored to income recognition status if there is reasonable assurance that the borrowers will be able to service all future principal and interest payments on the loan in accordance with the revised repayment terms and the borrower has serviced all principal and interest payments on the loan in accordance with the revised repayment terms continuously for a reasonable period. The period of continuing repayments of 12 months would be considered as reasonable. Receipt of additional collateral should not, by itself, be sufficient to restore a loan to income recognition status.

2.6 Suggested accounting entries

The suggested accounting entries for recognition of interest income, accrual of interest on loan and advances as well as receipt of interest are as follows:

a) For loans and advances which are classified as interest income recognizable category for interest income recognition purpose.

<u>For accrual of interest</u>

Interest Receivable Account	Dr
Interest Income Account	Cr

<u>For receipt of interest</u>

Customer Account	Dr
Interest Receivable Account	Cr

b) For loans and advances on which interest income are suspended to recognize

<u>For accrual of interest</u>

Accrued Interest Account	Dr
Interest Suspense Account	Cr

(The above entry shall be made in memorandum account only)

<u>For receipt of interest</u>

i)	Customer Account	Dr
	Accrued Interest	Cr
ii)	Interest Suspense	Dr
	Interest Income	Cr

3. Implementation of the guideline

This guideline should be adopted by bank and financial institutions for the purpose of financial as well as regulatory reporting. Bank and financial institutions are expected to apply the criteria set out in this guideline for identification of loans on which interest income recognition should be suspended or ceased to be accrued for the reporting of financial statement of fiscal year 2018/19 and thereafter.