NIBM WORKING PAPER SERIES

(Policy Research Notes)

Improving Asset Quality Data through Divergence Disclosures

Dipali Krishnakumar

Working Paper

(WP23/2022)

NATIONAL INSTITUTE OF BANK MANAGEMENT
Pune, Maharashtra, 411048
INDIA
November 2022

Citation Guideline:

Krishnakumar, Dipali (2022), "Improving Asset Quality Data through Divergence Disclosures". NIBM Working Paper Series: Policy Research Notes WP23/November.

https://www.nibmindia.org/static/working_paper/NIBM_WP23_DK.pdf

Improving Asset Quality Data through Divergence Disclosures

Dipali Krishnakumar
NIBM Working Paper No. 23
November 2022

ABSTRACT

The Reserve Bank of India has tightened the norms for disclosure of divergence on asset classification and provisioning by commercial banks and also made disclosure norms applicable to Primary (Urban) Co-operative Banks (UCBs). This article describes the concept of divergence, discusses typical reasons for divergence, provides an analysis on divergence reported by large public and private sector commercial banks in the past few years and deliberates upon the implications of the circular. The findings of the study indicate that there has been a decline in the reported divergence by commercial banks in the past few years, indicating an improvement in published asset quality data.

Dipali Krishnakumar (*Corresponding Author*)
k.dipali@nibmindia.org

Improving Asset Quality Data through Divergence Disclosures

Background

The Reserve Bank of India (RBI), vide its notification number RBI/2022-23/130 DOR.ACC.REC.No.74/21.04.018/2022-23 dated October 11, 2022 has tightened the norms for disclosure of divergence on asset classification and provisioning by commercial banks and also made disclosure norms applicable to Primary (Urban) Co-operative Banks (UCBs). This article describes the concept of divergence, discusses typical reasons for divergence, provides an analysis on divergence reported by large public and private sector commercial banks in the past few years and deliberates upon the implications/impact of the circular.

What is Divergence?

The Reserve Bank of India as part of its supervisory process, assess compliance by banks with the norms for income recognition, asset classification and provisioning (IRACP). The reports from the Risk Based Supervision (RBS) on-site and off-site reviews carried out by RBI are largely confidential and not privy to the general public. However, in April 2017, the RBI issued a notification[1] requiring all commercial banks to disclose in the next published annual report of the bank; information about difference in the Gross Non-Performing (GNPA) Assets; Net Non-Performing Assets (NNPA) and the Adjusted (notional) Net Profit after Tax (PAT) for differences in the numbers reported by the bank for a particular year and that assessed during the RBS review. This difference in GNPA, Net NPA and provisioning between a banks reported number and the numbers assessed during the RBS process is referred to as divergence. Hence, for the first time as a result of this notification, information on a crucial outcome of the supervisory review process was made transparently available to external stakeholders.

The significance of this information can be assessed from the fact that the Securities and Exchange Board of India (SEBI) in 2017[2] mandated that divergence data should be made a part of the Annual Financial Statement filings by all banks having listed securities as an annexure to the annual financial results filed with the stock exchanges. Recognizing the value of the divergence data, SEBI issued a circular[3] in 2019 stating that the divergence is a material event, which contains price sensitive information and requires to be disclosed as soon as reasonably possible and not later than 24 hours within receipt of the Reserve Bank's Final Risk Assessment Report ('RAR'). Thus, expediting the disclosure of divergence information instead of delaying the disclosure until the publishing of the bank's annual financial statement.

[1] RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 dated April 18, 2017
[2] CIR/CFD/CMD/80/2017 July 18, 2017
[3] CIR/CFD/CMD1/120/2019, dated October 31, 2019

Disclosure Requirements

For commercial banks, the requirement for disclosure of divergence existed since 2017. The threshold and the applicability for divergence disclosures are tabulated in Table 1. Two Thresholds are considered; in case either conditions are met the bank would be required to report the divergence data. The first threshold is related to additional provisioning as percentage of the banks profits, the second threshold considers the percent of additional GNPA assessed during the supervisory review over the incremental GNPA reported by the bank during the year.

What is new in the current circular?

We observe from Table 1 that not all divergence is reported, but only if it meets any one of the threshold criteria. In the October 2022 circular the divergence reporting threshold for incremental GNPA reported by commercial bank has been reduced from 15% to 10%. With a mandate to reduce both thresholds (provision as % of PBPC and % incremental GNPA) at the 5% level for the financial year 2024. Thus making the reporting requirements more stringent.

While UCBs were not required to disclose divergence data, they too are being brought under the requirement for divergence disclosures from the reporting year 2023. Initially with higher threshold levels of 10 % provision as percentage of PBPC and 15% incremental GNPA in the financial year 2023, with a guidance to reduce the threshold for PBPC to 5% in 2024. It is envisaged the threshold for incremental GNPA currently set at 15% would be reviewed and may be revised downwards in future.

Reason for Divergence

There could be multiple reasons for divergence between reported numbers by a bank/UCB and the numbers assessed by RBI. A divergence disclosure is not only dampening to the reputation of the Bank/UCB but also to the auditors who have reviewed the financial statements. The Institute of Chartered Accountants of India have been enumerating multiple reasons for divergence between asset classifications and provisioning to alert the auditors of banks. A few of these reasons are listed providing a perspective on the possible causes of divergence[4].

1. Instances of failure of multiple restructurings – In case an account is subject to multiple restructuring rounds that fail, the Non-Performing Asset (NPA) date needs to be set to when the account first turned NPA. In some instances the supervisors found that the NPA date was revised to a more recent restructuring date. Though the account would be correctly classified as NPA, the date of NPA being incorrect, the provision amount would be miscalculated as provisioning is based on the period for which the account has been non performing.

2. Account upgraded in the absence of satisfactory performance - After an account is downgraded to NPA, all instalments of principal and interest need to be repaid before an account is upgraded. However, accounts are upgraded without adhering to these requirements.

[4] Based on ICAI Guidance Notes on Audit of Banks

3. Non updating of Drawing Power by Lead Bank in consortium lending of working capital – There may be instances of failure of lead banks to intimate the latest stock position as submitted by the borrower, resulting in incorrect drawing power computations and hence classifications of working capital facilities.
4. Ever greening – New loans being sanctioned to the borrower or to group entities which are then round tripped to repay old outstanding loans
5. Security Valuation – Banks need to carry out stock audits at annual intervals when security is in the form of stock in NPA accounts and once in three years when collateral is in the form of immovable assets. A failure to consider the latest security valuation would lead to an error in classification of NPA accounts. For instance an erosion of security value by 50% would lead to an account being required to be classified as doubtful. If the realisable value of the security is less than 10 percent of the outstanding in the account, the account needs to be classified as Loss Asset.
6. Failure to implement the resolution plan as per the June 7, 2019 circular on Prudential Framework for Resolution of Stressed Assets'. In case of failure to implement the Resolution Plan as per the June 7, 2019 circular, the bank needs to make additional provisions on both the funded and non-funded portion. However, in some instances they have missed making the additional provisions on the total outstanding including the non-funded limits.
7. Computation of Drawing Power (DP) based on expired stock statements. In such instances the account needs to be treated as irregular and marked as NPA.
8. Upgradation of account without complance to conditions in the Resolution Plan as per the June 7, 2019 circular, until 10% of the pricipal debt and inerest capitalized is repaid. In such cases the bank may have also reversed additional provisions required as per the circular before the conditions for upgrade are met.
9. In some instances when a borrower availed resolution as per the August 6, 2020 circular for covid-19 related sress, the account has been upgraded to standard before implementation of the resolution plan.
10. Asset classifiation is required to be done by borrower, and not by facility. In some instances Banks have failed to down grade some of the facilities availed by a defaulting borrower.

Reported Divergence Data

We examine divergence reported by five large public and five private sector to understand the experience with reported divergence data since the introduction of the disclosure requirement. The banks selected for the analysis include State Bank of India, Bank of Baroda, Punjab National Bank, Canara Bank and Union Bank from the Public Sector. HDFC Bank, ICICI Bank, Axis Bank, Kotak Mahindra Bank and IDFC Bank were selected from the Private Sector. These banks were selected as they represent the five largest banks in the Public and Private sector based on advances as per RBI Data Tables for the year ended 2021.

We observe that the GNPA divergence reported by banks in the study is the highest in the year 2016-17. While the Private Sector Banks in our study reported GNPA divergence in the initial years 2015-16 and 2016-17; they have not reported any divergence in subsequent years. Public Sector Banks in our study reported the largest divergence in 2016-17, after which the supervisory review continued to observe some divergence beyond threshold levels during 2017-18 and 2018-19 and subsequently the divergence assessed has reduced to below the threshold levels for the years 2019-20 and 2020-21.

Next we examine the divergence in provisioning of Public and Private Sector Banks in our study in figure 2.

We observe in figure 2 that the divergence in provisioning is larger for Public Sector Banks v/s Private Sector Banks. Since, this data may be impacted by the size of the loan portfolio, Table 2, displays the same information in percentage of assessed numbers for the public and private sector banks in our study that have reported a divergence.

The incremental GNPA, Net NPA and incremental provision assessed as a percent of reported numbers are highest for Axis Bank for the year 2016, followed by Indusind bank in 2017. The impact on profitability is highest for State Bank of India for the assessment year 2019.

Policy Implications

The divergence data from 2016 to 2021 as reported by the ten banks in the study is provided in Appendix 1. It is interesting to note that Kotak Mahindra Bank has not reported any divergence in their Asset Quality during the period of study (Refer Appendix 1). As noted earlier, none of the banks reported a divergence for the years 2020 and 2021. The decline in reported divergence in the recent years, indicates an improvement in the quality of reported numbers by commercial banks over the past few years.

The improved transparency on divergence information provides insights to the general public, institutional investors and other stakeholders on true and fair view of the financial position of banks. The requirement to disclose divergence also possibly disincentives' divergence practices by commercial banks, given the potential loss of face in case of a public disclosure of large divergence data.

While, it is not possible to prove a causal relationship between disclosure requirements and an improvement in the quality of financial data reported by Banks. The data indicates that asset quality divergence for commercial banks has reduced. A further strengthening through tighter norms for commercial banks and also introducing these norms for UCBs is a step in the right direction towards further strengthening the quality of banks reported numbers.

References

ICAI Guidance Note on Audit of Banks (2022 Edition)

Published Annual Reports of Banks

RBI Data Tables Database on Indian Economy

RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 dated April 18, 2017, Disclosure in the "Notes to Accounts" to the Financial Statements- Divergence in the asset classification and provisioning

RBI/2022-23/130 DOR.ACC.REC.No.74/21.04.018/2022-23 dated October 11, 2022, Reserve Bank of India (Financial Statements - Presentation and Disclosures) Directions, 2021 - Disclosure of Divergence in Asset Classification and Provisioning

RBI/CIR/CFD/CMD1/120/2019, dated October 31, 2019, Disclosure in the "Notes to Accounts" to the Financial Statements - Divergence in the asset classification and provisioning

SEBI CIR/CFD/CMD/80/2017 dated July 18, Disclosure of divergence in the asset classification and provisioning by banks

SEBI CIR/CFD/CMD1/120/2019 dated October 31, 2019, Disclosure of divergence in the asset classification and provisioning by banks

Table 1: Divergence Threshold Requirements

Circular year	*Applicable to financial statements for the year ended*	*Entity*	*Additional provisioning requirements Assessed for reference period*		*Additional Gross NPA assessed for reference period over GNPA reported by the Bank*
2017	2018	Commercial Banks	exceeds 15 % of banks reported **PAT**	and/or	exceeds 15 % over incremental GNPA
2019[$]	2019	Commercial Banks	exceeds 10 % of the banks reported profit before provisions and contingencies (**PBPC**)	and/or	exceeds 15 % over incremental GNPA
2022 (current circular)	2023	Commercial Banks	exceeds 10 % over reported PBPC	and/or	exceeds 10 % over incremental GNPA
	2024	Commercial Banks	exceeds 5 % over reported PBPC	and/or	exceeds 5 % over incremental GNPA
	2023	UCBs	exceeds 10 % over reported PBPC	and/or	exceeds 15 % over incremental GNPA
	2024	UCBs	exceeds 5 % over reported PBPC	and/or	exceeds 15[@] % over incremental GNPA

(Authors workings based on RBI notifications)

Note: [$] In 2019, RBI changed the disclosure threshold by comparing additional assessed provisions with reported profit before provisions and contingencies instead of a percentage of PAT. The reasoning was that a number of banks were reporting low or negative profits after tax, requiring disclosures of divergence when based on PAT, even if the actual provision divergence in value terms were not very large.

[@] may be reduced

Table 2: Percentage of Divergence in Reported Numbers v/s Assessed Numbers during Supervisory Review

Name of Bank	*Year Assessed*	*Public/ Private*	*% Inc. GNPA*	*% Inc. NNPA*	*% Inc. provision*	*Impact on profitability*
Axis Bank	2016	Private	156%	284%	68%	-19%
ICICI Bank	2016	Private	19%	31%	8%	-7%
Indusind Bank	2016	Private	72%	98%	54%	-7%
Canara Bank	2016	Public	2%	0%	5%	19%
Axis Bank	2017	Private	26%	50%	11%	-24%
HDFC Bank	2017	Private	35%	68%	20%	-4%
Indusind Bank	2017	Private	128%	228%	57%	-8%
State Bank of India	2017	Public	21%	30%	11%	-36%
Canara Bank	2017	Public	9%	9%	11%	-125%
Bank of Baroda	2017	Public	7%	13%	3%	-31%
Punjab National Bank	2017	Public	4%	4%	4%	-60%
Punjab National Bank	2018	Public	1%	-6%	10%	31%
Union Bank of India	2018	Public	2%	-6%	9%	29%
State Bank of India	2019	Public	7%	18%	11%	-908%
Punjab National Bank	2019	Public	3%	9%	4%	14%
Bank of Baroda	2019	Public	3%	11%	8%	28%
Union Bank of India	2019	Public	1%	3%	6%	35%

(Authors workings based on Published Annual Report Data)

Figure 1: GNPA Divergence for banks in study
(Authors workings based on Annual Report Data)

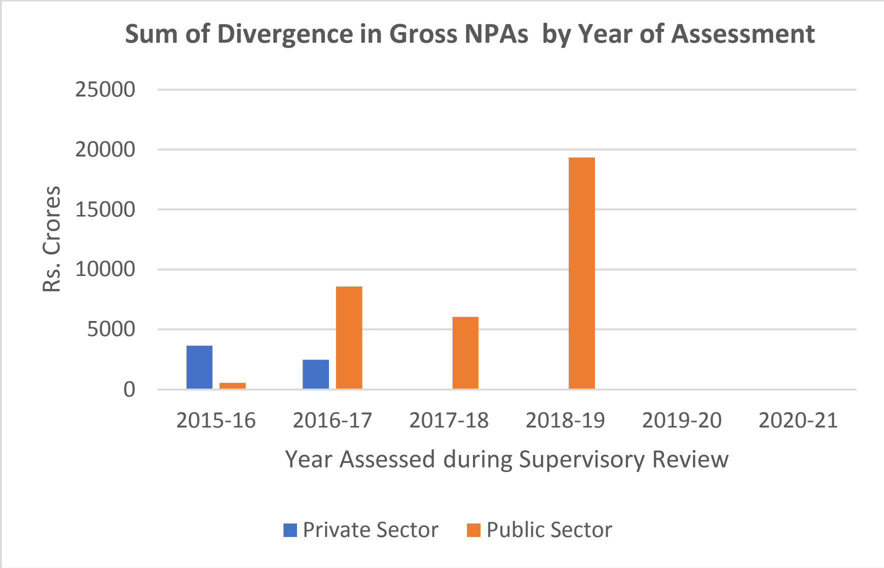
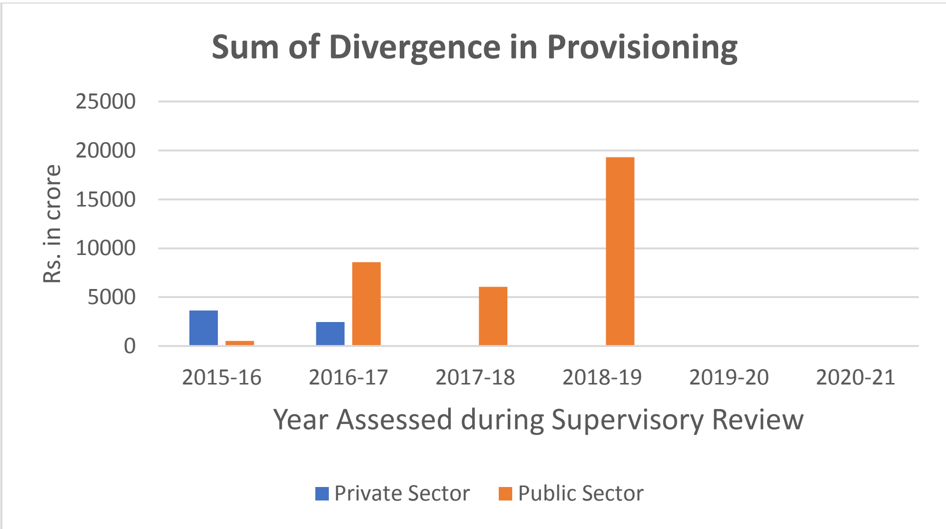


Figure 2 Divergence in provisioning for banks in study
(Authors workings based on Annual Report Data)



Appendix 1: Divergence Data Reported by Banks in Study

Name of Bank	*Year Assessed*	*Gross NPAs as reported by the bank (1)*	*Gross NPAs as assessed by RBI (2)*	*Divergence in Gross NPAs (2-1)*	*Net NPAs as reported by the bank (4)*	*Net NPAs as assessed by RBI (5)*	*Divergence in Net NPAs (5-4)*	*Provisions for NPAs as reported by the bank (7)*	*Provisions for NPAs as assessed by RBI (8)*	*Divergence in provisioning (8-7)*	*Reported Net Profit after Tax (PAT) for the year*	*Adjusted (notional) Net Profit after Tax (PAT) for the year*
State Bank of India	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
State Bank of India	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
State Bank of India	2019	172,750	184,682	11,932	65,895	77,827	11,932	106,856	118,892	12,036	862	(6,968)
State Bank of India	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
State Bank of India	2017	112,343	135,582	23,239	58,277	75,796	17,519	54,066	59,786	5,720	10,484	6,743
State Bank of India	2016	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Bank of Baroda	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Bank of Baroda	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Bank of Baroda	2019	69,924	71,972	2,048	23,795	26,323	2,528	46,001	49,611	3,610	(8,339)	(10,686)
Bank of Baroda	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Bank of Baroda	2017	42,719	45,637	2,919	18,080	20,341	2,261	24,639	25,296	658	1,383	953
Bank of Baroda	2016	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Punjab National Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Punjab National Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Punjab National Bank	2019	78,473	81,090	2,617	30,038	32,655	2,617	48,151	50,242	2,091	(9,975)	(11,336)
Punjab National Bank	2018	86,620	87,516	896	48,684	45,813	(2,871)	37,612	41,379	3,767	(12,283)	(16,050)
Punjab National Bank	2017	55,370	57,578	2,207	32,702	34,117	1,415	22,043	22,836	792	1,325	533

Name of Bank	*Year Assessed*	*Gross NPAs as reported by the bank (1)*	*Gross NPAs as assessed by RBI (2)*	*Divergence in Gross NPAs (2-1)*	*Net NPAs as reported by the bank (4)*	*Net NPAs as assessed by RBI (5)*	*Divergence in Net NPAs (5-4)*	*Provisions for NPAs as reported by the bank (7)*	*Provisions for NPAs as assessed by RBI (8)*	*Divergence in provisioning (8-7)*	*Reported Net Profit after Tax (PAT) for the year*	*Adjusted (notional) Net Profit after Tax (PAT) for the year*
Punjab National Bank	2016	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Canara Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Canara Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Canara Bank	2019	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Canara Bank	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Canara Bank	2017	34,202	37,451	3,249	21,649	23,496	1,847	12,553	13,954	1,401	1,122	(279)
Canara Bank	2016	31,638	32,145	507	20,833	20,863	30	10,745	11,282	537	(2,813)	(3,350)
Union Bank of India	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Union Bank of India	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Union Bank of India	2019	48,729	49,318	589	20,332	20,921	589	28,397	29,984	1,587	(2,947)	(3,978)
Union Bank of India	2018	49,370	50,237	867	24,326	22,912	(1,414)	25,044	27,324	2,280	(5,247)	(6,770)
Union Bank of India	2017	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Union Bank of India	2016	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
HDFC Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
HDFC Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
HDFC Bank	2019	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
HDFC Bank	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
HDFC Bank	2017	5,886	7,937	2,052	1,844	3,102	1,258	4,042	4,835	793	14,550	14,028
HDFC Bank	2016	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

Name of Bank	*Year Assessed*	*Gross NPAs as reported by the bank (1)*	*Gross NPAs as assessed by RBI (2)*	*Divergence in Gross NPAs (2-1)*	*Net NPAs as reported by the bank (4)*	*Net NPAs as assessed by RBI (5)*	*Divergence in Net NPAs (5-4)*	*Provisions for NPAs as reported by the bank (7)*	*Provisions for NPAs as assessed by RBI (8)*	*Divergence in provisioning (8-7)*	*Reported Net Profit after Tax (PAT) for the year*	*Adjusted (notional) Net Profit after Tax (PAT) for the year*
ICICI Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
ICICI Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
ICICI Bank	2019	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
ICICI Bank	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
ICICI Bank	2017	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
ICICI Bank	2016	26,221	31,326	5,105	12,963	16,997	4,034	13,258	14,329	1,071	9,726	9,026
Axis Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Axis Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Axis Bank	2019	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Axis Bank	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Axis Bank	2017	21,280	26,913	5,633	8,627	12,944	4,317	12,206	13,521	1,316	3,679	2,794
Axis Bank	2016	6,088	15,565	9,478	2,522	9,685	7,163	3,393	5,708	2,315	8,224	6,688
Kotak Mahindra Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Kotak Mahindra Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Kotak Mahindra Bank	2019	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Kotak Mahindra Bank	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Kotak Mahindra Bank	2017	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Kotak Mahindra Bank	2016	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Indusind Bank	2021	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

Name of Bank	*Year Assessed*	*Gross NPAs as reported by the bank (1)*	*Gross NPAs as assessed by RBI (2)*	*Divergence in Gross NPAs (2-1)*	*Net NPAs as reported by the bank (4)*	*Net NPAs as assessed by RBI (5)*	*Divergence in Net NPAs (5-4)*	*Provisions for NPAs as reported by the bank (7)*	*Provisions for NPAs as assessed by RBI (8)*	*Divergence in provisioning (8-7)*	*Reported Net Profit after Tax (PAT) for the year*	*Adjusted (notional) Net Profit after Tax (PAT) for the year*
Indusind Bank	2020	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Indusind Bank	2019	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Indusind Bank	2018	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Indusind Bank	2017	1,055	2,405	1,350	439	1,440	1,001	616	965	349	2,868	2,640
Indusind Bank	2016	777	1,337	560	322	638	316	455	699	244	2,286	2,137

(The divergence data is disclosed in the notes to accounts of Annual Reports of Banks. While, these data fields are included in the Prowess IQ data base; a few mismatches were observed between the Annual Report data and Prowess database. As to the best of information available, no other data base currently provides the divergence information. Thus hand collection of data was done for this article.)

NA- the assessed divergence if any for the Bank did not meet the threshold criteria for disclosure