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EMERGING TRENDS IN REVIVAL OF NON PERFORMING ASSETS IN THE INDIAN BANKING SYSTEM[1]

ABSTRACT

Non Performing Assets manifest a clear threat to the Indian banking system. While the problem of NPAs has perennially affected the banking sector, the slowdown of the global economy has caused an exponential increase in number of companies under stress. While the government has continually taken steps to improve efficiency and bring down the volume of bad loans, most existing laws have indirectly aided in sheltering of weak entities. However, recent regulations in this regards show a lot of promise. Therefore, the article attempts to show the ineffectiveness of existing mechanisms like SICA, DRTs, CDR, etc to deal with the rapid growth of NPAs. The article critically analyses the recent step taken by RBI in limiting their rise by early identification of distress and formation of a Corrective Action Plan by lenders and also the RBI's effort to resolve financial institutions by means of certain tools. The article also gives recommendations, which may help in containing the magnitude of NPAs in India to some extent.

KEY WORDS

Banks, Non-Performing Assets (NPAs), Corporate Debt Restructuring (CDR), Joint Lenders' Forum (JLF), Financial Resolution Authority (FRA), Reserve Bank of India (RBI).

INTRODUCTION

Banks are considered to be mirrors of health of an economy and are a pre-requisite for the overall stability and financial development of the economy. Escalating non-performing assets[2], especially of state-owned banks, weaken the stability of such entities and have thus become a major concern for the Indian financial system. In addition to affecting the strength of a bank, NPAs reflect a distress in the economy. They destruct the whole credit distribution structure and even lead to major financial disturbances. Statistics reveal that the magnitude of stressed assets

[1] Ankita Sharma, Vth year, B.A. LL.B., National Law Institute University, Bhopal.
[2] Hereinafter referred to as "NPAs".

by the end of December, 2013 was about 10.13 per cent of the gross advances of the banks. [3] Lessons are to be learnt from the lenient banking norms of the US which resulted in bankruptcy of big banks and ultimately in the subprime mortgage crisis. Thus, it is essential to deal with NPAs seriously, without any further delay.

Combating the menace of NPAs has now become one of the chief goals of the regulatory authorities[4]. There are three primary reasons for the rise of NPAs in India: negligence of bankers, willful defaults by borrowers and weak recovery, rehabilitation and insolvency laws. Recently, Mr. Raghuram Rajan, the current Governor, RBI described '*improving the system's ability to deal with corporate distress and financial institution distress by strengthening real and financial restructuring as well as debt recovery*' as a prime agenda for RBI to improve the overall stability of our financial system.[5] Consequently, the RBI came up with a framework for early recognition of stressed assets, which in long run is expected to contain this mammoth problem of rising NPAs. Further, creation of a nodal agency for resolution of troubled financial institutions has also been suggested.

In order to see the effectiveness of such upcoming reforms *inter alia*, this Paper analyses the effectiveness of existing laws in Indian banking sector in respect of NPAs. For convenience, the Paper has been divided into three parts. The 1st part deals with laws which instead to serving banks, protect failed entities. The 2nd part outlines the legal framework created in response to these ineffective laws for benefit of both creditors and debtors. The 3rd part discusses the recent emerging regulatory and legislative trends to contain burgeoning NPAs and concludes by giving certain recommendations to scale down their volume to some extent.

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[3] The Economic Times, "*Steps to address issue of rising bad loans likely in budget*", June 2, 2014, available at: http://economictimes.indiatimes.com/news/economy/policy/steps-to-address-issue-of-rising-bad-loans-likely-in-budget/articleshow/35958490.cms. (Last visited on June 3, 2014).

[4] Hereinafter referred to as "RBI".

[5] Press Release, Reserve Bank of India, "*RBI releases Framework for Revitalising Distressed Assets in the Economy*" (30 January, 2014), available at: http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30519. (Last visited on June 2, 2014).

PART - I: INEFFECTIVENESS OF EXISTING LAWS

1. Rehabilitation under Sick Industrial Companies (Special Provisions) Act, 1985:

The Sick Industrial Companies (Special Provisions) Act, 1985[6] was enacted for the purpose of timely recognition, revival and rehabilitation of potentially viable sick industrial companies within a reasonable time frame with the help of measures (such as moratorium, providing financial assistance etc) given in the Act itself. The Act thus intended to give an opportunity to recover NPAs by making the defaulting entities economically viable again.

SICA covers within its ambit Sick Industrial Companies (whose net worth has completely eroded) and potentially Sick Industrial Companies (net worth fallen below 50%) as defined in the Act.[7] Under §§ 15 and 23 of SICA, if a Company qualifies to be a Sick or potentially Sick Industrial Company as per the provisions of the SICA, within sixty days from the date of finalization of the duly audited accounts, it has to mandatorily forward a report of such erosion to the Board for Industrial and Financial Reconstruction[8]. BIFR, after making an inquiry, either formulates a scheme for rehabilitation of the sick unit[9] or order winding up if it is of opinion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time[10].

Further, § 22 of SICA suspends certain legal proceedings and contractual obligations in respect of a Sick Company after a reference has been made to BIFR and such legal proceedings shall continue only with the consent of BIFR or Appellate Authority for Industrial and Financial Reconstruction (AAIFR).

LACUNAE IN SICA:

SICA, with a general consensus, is regarded as a failed legislation due to latches involved in the procedure laid down in the Act and delays it causes in the recovery of dues of creditors, defeating the very purpose with which it was enacted. Companies misuse its provisions by

[6] Hereinafter referred to as "SICA".
[7] § 2(e) of SICA.
[8] Hereinafter referred to as "BIFR".
[9] § 18 of SICA.
[10] § 20 of SICA.

registering themselves in BIFR for postponing the recovery proceedings indefinitely. This is evident by the fact that of 5644 cases registered with BIFR since its inception, there was a successful revival only in 801 cases, whereas 1227 companies were ordered to be wound up.

Owing to these difficulties, SICA is often described as a "*debtor's haven*".[11] In fact, SICA was attempted to be repealed by the Sick Industrial Companies (Special Provisions) Repeal Act, 2003. However this Act could not see light of the day in absence of notification in the official gazette.

However, recently, the Hon'ble Supreme Court, explaining the scope of § 22 in ***Inderjeet Arya v. ICICI Bank Ltd***.[12], held that the Section covers only those legal proceedings which are in nature of a "suit" and since proceedings before DRT are out of purview of a "suit", protection under § 22 cannot be availed by directors and guarantors of a sick company against whom recovery proceedings are initiated before a DRT. This judgment can be expected to cure loopholes in the procedure given in the SICA.

2. <u>Debt Recovery Tribunals:</u>

Prior to the establishment of Debt Recovery Tribunals, in order to recover loans, banks had to file a civil suit involving usual, time-consuming procedure to be followed. Burdening of civil courts further delayed the course of recovery for the banks. This led to blocking of significant amount of funds of the economy.

After financial crisis of late 1980's, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993[13] was enacted on June 24th, 1993. The Act allowed setting up of Debt Recovery Tribunals (DRTs) and Debt Recovery Appellate Tribunals (DRATs) with powers of adjudication and expeditious recovery of debt (Rs. 10 lakh or more) due to banks and Financial Institutions[14]. The Act embodied a summary procedure for recovery of debts and a time limit of 180 days was prescribed for the disposal of an application.

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[11] Mr. Sumant Batra, "*Proposal for Reforms- The Indian Position*" (The Second Forum for Asian Insolvency Reform (FAIR), 2002), p. 10, available at: http://siteresources.worldbank.org/GILD/Resources/Batra.pdf (Last visited on June 5, 2014).
[12] Inderjeet Arya v. ICICI Bank Ltd. (2014) 2 SCC 229.
[13] Hereinafter referred as "the RDBF Act".
[14] Hereinafter referred to as "FIs".

PROBLEMS WITH DRTs:

Although the RDBF Act seemed stringent on paper, practical difficulties in its enforcement resulted in delayed recovery. In the year 2012-13, out of the total claims worth Rs. 310 billion which were referred to DRTs, the amount that could be recovered was only Rs. 41 billion.[15]

An example of practical hindrances in its implementation can be gauged by the fact that big and powerful debtors were able to interrupt recovery process by initiating separate civil proceedings on the ground that attachment or sale of property would result in an irreparable damage. The problem was further aggravated because of conflicting jurisdiction of an Official Liquidator appointed by High Court and a Recovery Officer under the RDBF Act.

3. <u>Winding Up under Companies Act:</u>

§ 433 of the Companies Act, 1956 (corresponding to § 271 of the Companies Act, 2013 which is yet to be notified) allows winding up of a company by a High Court if the company is unable to pay its debts. Any creditor may initiate winding up proceedings after serving a 21 days demand notice in writing on the indebted company at its registered office.[16] However, receiving an acknowledgement of liability from the debtor is a *sine qua non* for commencing winding up. Further, it is essential that the company owes a minimum sum of Rs. 500 (Rs. 1lakh under Companies Act, 2013) to such a creditor.

It is to be noted that winding up proceedings are not recovery proceedings and a separate civil suit in case of ordinary creditors and an application in a Debt Recovery Tribunal in case of creditor bank has to be filed for recovery of dues from the company.

PROBLEMS WITH § 433:

Winding up is a time consuming and expensive affair in India. It must be kept in mind that the multiplicity of laws arose in the first place since § 433 had become time consuming and the government felt the need for other agencies to handle NPAs. Unfortunately, multiplicity of authorities (Central Government, High Court, CLB, BIFR, etc) makes the process even more complicated. In fact, a weak insolvency laws regime, taking on an average 10 years to close

[15] Reserve Bank of India, "*Operation and Performance of Commercial Banks*", (November 21, 2013), available at: http://www.rbi.org.in/scripts/PublicationsView.aspx?id=15440 (Last visited on June 8, 2014).
[16] § 434 of the Companies Act 1956.

down, is often blamed for massive volume of NPAs in India.[17] Consequently, the World Bank has ranked India 121st out of 189 economies in '*resolving insolvency*'.

PART – II: GOVERNMENTAL RESPONSES TO EXISTING INEFFECTIVE LAWS

1. SARFAESI Act, 2002:

In consequence of the above mentioned difficulties faced by banks in realizing the NPAs, a more rigorous statute, namely Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002[18] was enacted. This new legislation provides following three alternatives to the lending banks and FIs for recovering NPAs:

a) **Securitization**- It is a process under which stressed assets of a bank are acquired by a specialized company (securitization companies), then converted in the form of marketable securities and finally, sold to investors.

b) **Asset Reconstruction**- Reconstruction is transferring NPAs to specialized reconstruction companies for the purpose of their timely recovery.

   The Act empowers securitization companies and asset reconstruction companies to purchase NPAs from the creditor banks and financial institutions at a discounted rate so as to clear them from the accounting books of these creditors and consequently, to enter into the shoes of these secured creditors in order to recover such assets.

c) **Direct enforcement of security interests without intervention of the courts, by serving a demand notice in writing to borrowers**- It is the most frequently used option as it allows lending banks and institutions to directly take possession of secured assets, transfer them by way of sale, lease or otherwise and take over the management of the borrowing company as soon as account is classified as an NPA without undergoing any legal process. However, if there are more than one secured creditors and in consortium lending, consent of 75% of the lenders is required for initiating the aforesaid measures.

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[17] Rajesh Chakrabarti et al, "*Corporate governance in India*", Econstor, (December 8, 2007), available at: http://www.econstor.eu/bitstream/10419/41393/1/582127289.pdf. (Last visited on June 9, 2014).
[18] Hereinafter referred to as "SARFAESI Act".

IMPLICATIONS OF THE ACT:

The SARFAESI Act was enacted keeping in mind lacunae in existing legislations. Therefore the machinery under this Act has proven to be most effective and relied upon one since it allows a lending bank to take possession of the secured assets of defaulting borrowers without rigorous, expensive and lengthy court proceedings as soon as an asset is classified as an NPA, by merely making a demand on the borrower. According to a recent RBI report, the amount recovered through this recourse constituted over 80% of the total NPAs in 2012-13.[19]

Further, § 15 of the SICA makes it apparent that the procedure under SARFAESI Act has been given priority over the procedure under SICA and that the right of a lending bank to invoke provisions of the SARFAESI Act does not get defeated by the application of the provision of SICA. The second proviso of § 15(1) provides that no reference shall be made to the BIFR where financial assets have been acquired by any securitization company or reconstruction company. Also, the third proviso to § 15(1) states that where a reference is pending before BIFR, then such reference shall abate if the secured creditors take any measures under SARFAESI Act.

SARFAESI Act is still being altered to better aid the recovery of NPAs. Due to rapid rise in quantum of NPAs, lately, the Confederation of Indian industries (CII) has recommended to integrate Non Banking Financial Companies (NBFCs) with core financial sector and to extend the application of the Act to such companies so as to allow them to recover distressed assets without strict legal proceedings.[20]

2. Corporate Debt Restructuring:

In India, though there is no legislation dealing with Corporate Debt Restructuring[21], the RBI guidelines dated August 23, 2001, based on the institutional frameworks of countries like UK, Korea, Thailand etc, enunciated an outline for the CDR mechanism for Indian Banking Sector. Since then, these guidelines are regularly updated.

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[19] Supra n. 15.
[20] The Economic Times "*CII suggests action plan for revival of NBFCs*", June 15, 2014, available at: http://economictimes.indiatimes.com/news/economy/finance/cii-suggests-action-plan-for-revival-of-nbfcs/articleshow/36592250.cms. (Last visited on June 11, 2014).
[21] Hereinafter referred to as "CDR".

CDR is a voluntary and non statutory mechanism for domestic banks and FIs which aims at ensuring "*timely and transparent restructuring of corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned"*.[22] It aims at reviving the companies facing financial difficulties due to certain factors beyond their control and simultaneously safeguarding the interests of creditor banks and FIs. Existence of such machinery is necessary for ensuring healthy functioning of an economy and its absence will reduce the role of banks from advancing "developmental finances" for industries to mere money lending.

The CDR system has a three tier structure, comprising of **CDR Standing Forum and its Core Group** (the general body consisting of all participants of CDR scheme), **CDR Empowered Group** and **CDR Cell**. A preliminary inquiry of proposals of restructuring is conducted by the CDR Cell. If the proposal is approved by the Empowered Group, then the Cell formulates a detailed plan for restructuring and if not, the lenders are free to initiate recovery proceedings.

The CDR scheme is applicable only to syndication, consortium and multiple banking accounts of corporate borrowers with outstanding exposure (fund and non-fund based) of Rs.10 crore and above.[23] Corporate houses indulging in fraud, malfeasance, willful defaults and those which have made reference to BIFR are not eligible for restructuring under CDR. The CDR mechanism offers flexibility to lenders in deciding whether to make reference to CDR.

The CDR mechanism gets the legal basis from the Debtor-Creditor Agreement and the Inter-Creditor Agreement, with necessary enforcement and penal clauses. Reference to CDR has to be approved by minimum 75% of the creditors by value and 60% of creditors by number, irrespective of differences in asset classification status by the creditors.

If the asset is classified as 'standard' or 'sub-standard' in the books of 90% of the lenders and minimum 75% of the creditors (by value) and 60% of creditors (by number) consent to the scheme, then the CDR scheme, including agreement of bringing additional finances, would be binding on all the creditors. Such an arrangement is **Category 1 CDR system**. On the other

[22] Reserve Bank of India, "*Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances*" (DBOD.No.BP.BC.20/21.04.048/2008-09, July 1, 2008),, available at: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?Id=4313&Mode=0. (Last visited on June 12, 2014).
[23] Id Para 4.2.16.D.

hand, **Category 2 CDR system** is applicable if the asset is classified as doubtful in the books of creditors and at least 75% of the creditors by value and 60% of creditors by number agree to restructuring via CDR mechanism. Here except the clause requiring pooling in of additional finances, all other clauses equally apply on all creditors.

For the smooth functioning of CDR scheme, every Debtor-Creditor Agreement has a 'stand-still clause' which restricts both the parties from initiating any civil proceeding so as to avoid any outside interference hampering the implementation of scheme.

IMPLICATIONS OF CDR:

The CDR scheme envisages an informal, out-of-court mechanism to recover NPAs from large, medium and small corporations facing temporary liquidity issues, where taking the above mentioned harsh statutory measures is not justified. But at the same time, such a system is being used as leverage for causing delays and for 'evergreening' of the defaulting assets. Due to the lack of a time bound procedure, defaulting companies circumvent recovery of dues by resorting to restructuring. Further, CDR Cell, while conducting preliminary inquiry, often ignores performances and operations of the borrowing company. In fact, from April to June 2013 itself, restructuring via CDR scheme of 415 companies, with aggregate debt of Rs 2,50,279 crore was approved.[24] Thus there is an urgent need for stricter norms so as to ensure the advantage of CDR scheme is not available both perpetually and to every entity.

PART - III: NEW APPROACHES

With the recent global recession, a slowdown has been witnessed by all the major economies, and the Indian economy is no exception. The recession has indirectly aided the shoot up of NPAs and restructured accounts which, despite innovative recourses by the government continue to flourish. In wake of deteriorating value of assets, both the RBI and the parliament have continued to make certain efforts for revamping the existing legal regime for supporting the Indian banking sector in dealing with the issue.

[24] Business Standard, "*Corporate debt restructuring cases to come under scanner*", September 7, 2013, available at: http://www.business-standard.com/article/companies/corporate-debt-restructuring-cases-to-come-under-scanner-113090600859_1.html. (Last visited on June 15, 2014).

REGULATORY EFFORTS:

1. Joint Lenders' Forum:

The most recent and the most significant move to curb the mammoth NPA problem faced by the banking sector was the issuance of a '*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy*[25]' by RBI on 30 January 2014, which came into force from 1 April 2014. For operationalising this framework, the RBI issued detailed guidelines on February 26, 2014 via a notification, namely '*Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum and Corrective Action Plan*'[26]. This notification is applicable only to Scheduled Commercial Banks (excluding RRBs) and All-India Term-lending and Refinancing Institutions (like Exim Bank, NABARD, NHB and SIDBI). By another notification dated March 21, 2014 (*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy*), these guidelines were made equally applicable to certain notified NBFCs, i.e. systemically important non-banking financial companies.[27] Only multiple banking and consortium lending is covered under the ambit of these recent guidelines.

The guidelines reiterates that promoters of a borrowing company have no inherent right to manage the company, despite high level of mismanagement and that financial institutions cannot be allowed to be used as a device to recapitalize failed businesses. Some of the key proposals of these guidelines are as follows:

1. Before an asset turns into an NPA, identification of incipient stress as **Special Mention Account** (SMA) by the lenders and its classification into three sub categories, as given below:

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[25] Reserve Bank of India, "*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy*", (Press Release : 2013-2014/1533, January 30, 2014), available at: http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30519. (Last visited on June 17, 2014).

[26] Reserve Bank of India, "*Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum and Corrective Action Plan*", (DBOD.BP.BC.No.97/ 21.04.132 / 2013-14, February 26, 2014), available at: http://rbi.org.in/scripts/NotificationUser.aspx?Id=8754&Mode=0. (Last visited on June 17, 2014).

[27] Reserve Bank of India, "*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy*" (DNBS (PD) C.No.371/03.05.02/2013-14, March 21, 2014), available at: http://rbidocs.rbi.org.in/rdocs/notification/PDFs/DNBSF21032014.pdf. (Last visited on June 15, 2014).

S. No.	SMA Sub-Categories	Basis of Classification
1	SMA-0	Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress
2	SMA-1	Principal or interest payment overdue between 31-60 days
3	SMA-2	Principal or interest payment overdue between 61-90 days

2. Formation of **Central Repository of Information on Large Credits** (CRILC) for the purpose of collection and dissemination of information regarding all the credit that has been extended to all the lenders including the External Commercial Borrowing (ECB) advanced by their overseas branches to the Indian borrowers. Additionally, these lenders are required to report CRILC as soon as an asset turns SMA if total exposure exceeds Rs.50 million.
3. Mandatory formation of a **Joint Lenders' Forum** (JLF) if an account is reported as SMA-2 and the aggregate exposure is Rs. 100 crore and above. However if the total exposure is below Rs.100 crore or if account is reported as SMA-0 or SMA-1, formation of JLF is optional for the lenders. Further, a borrowing company may also request formation of JLF by the lenders.
4. Adoption of one of the several **Corrective Action Plans** (CAP) suggested in the guidelines by the JLF within 30 days of account being described as SMA-2. The guidelines offer flexibility to the lenders in choosing the most appropriate CAP for an account.
5. The CAP can be one of the following:
   a) **Rectification** wherein an undertaking is given by the borrowing company to check the account from turning into SMA or NPA. This includes arrangement for additional funds by promoters or by some strategic or equity investor and if necessary, by the JLF itself.
   b) Restructuring where borrower is not a willful defaulter and restructuring is considered prima facie feasible by atleast 75% of creditors by value and 60% of creditors by number in the JLF. Here promoters of the borrowing company may be required to extend their personal guarantees with an undertaking of not disposing of their assets without prior approval of the JLF. Any departure from these commitments may lead to initiation of recovery proceedings. The lenders may choose to restructure as per CDR mechanism (as described above) or independently of CDR mechanism. In both the cases, a Techno-

Economic Viability (TEV) is required to be conducted and if the average exposure exceeds Rs. 500 crore, then TEV and restructuring scheme would be appraised by an **Independent Evaluation Committee** (IEC) of experts. For smooth restructuring, promoters may be asked to infuse additional finances and further, services of an escrow agent or a security trustee may be availed to hold promoters' shares in the borrower.

c) **Recovery** where recourse to first two options is not practical.

6. Even if an account is not reported as SMA-2, then also, it is compulsory for creditors to **closely observe all the accounts** and take suitable actions wherever necessary.
7. **Accelerated provisioning** will be attracted if a lender:
   a) Does not report SMA-2 account to CRILC with an object to evergreen it or to hide its real character.
   b) Does not organize a JLF or agree upon a CAP.
   c) Deliberately hinders timely implementation of restructuring scheme and the account turns into an NPA.
8. Certain **prudential measures** are provided, such as:
   a) Lender may also categorize and report to CRILC a borrower as a **Non Cooperative Borrower** after serving them with a due notice if such a borrower is unreasonably hampering and not cooperating with the creditor in implementing CAPs. Future loans and advances for these borrowers would be expensive and accelerated provisioning will be attracted if the account is classified as NPA.
   b) Accelerated provisioning if loan extended to a company with a director who has been declared as **willful defaulter** more than once, becomes an NPA.
9. **Sale of NPAs:**
   a) The RBI has withdrawn the requirement of minimum holding period for lenders before selling NPAs to other banks, financial institutions and NBFCs. However the purchasing bank has to hold such assets for minimum 12 months.
   b) Further, the guidelines allow banks and financial institutions to sell standard financial assets to a Securitization Company or Asset Reconstruction Company[28] as soon as it is reported as SMA-2 to CRILC, which is not permitted hitherto.

[28] Hereinafter referred to as "ARC".

c) Promoters of a company are now allowed to enter into settlement with ARCs for purchasing back their assets if it has been arrived at after "*proper due diligence under well laid down principles*". This will reduce time consuming and expensive litigations.

d) ARCs are permitted to purchase NPAs of their sponsor banks through transparent auction at prevailing market prices.[29]

10. It has been stipulated that if promoters of the borrowing company cannot provide additional funds, then the prospects of supplementary finances through **Private Equity (PE) firms** investors may be discovered by the JLF. Further, such entities will be permitted to purchase NPAs by partaking in auction through *explicit regulatory affirmation*.[30] In order to encourage their participation, certain incentives are proposed, e.g. empowering such entities to take measures provided under SARFAESI Act *on a selective basis.*
11. Liability of **auditors**, **legal professionals** and **valuers** has been clearly specified.

IMPLICATIONS OF THE FRAMEWORK:

1. The Circular can be best portrayed as a carrot and stick as it offers both rewards for compliance and penalties for non compliance, especially to borrowers.
2. The guidelines will promote identification of developing stress on assets at the earliest so that appropriate measures could be taken before these stressed assets become non-performing ones.
3. All the accounts, irrespective of their classification, will have to be closely monitored by lending institutions. Also, certain Corrective Action Plans (CAP) offering case-specific solution will have to be prepared and implemented *before* resorting to measures like DRTs and SARFAESI Act and *before* writing off an account, fully or partly.
4. In a way, considering restructuring of stressed assets, which hitherto was discretionary for lenders, has been made obligatory before they resort to formal legal proceedings. However restructuring may no longer be a life-saver to the borrower due to inclusion of stringent

[29] Supra n. 25, Para 10.10.
[30] Supra n. 25, Para 10.11.

covenants like 'convertibility cause'[31], which will have an impact of diluting promoters' stake in the borrowing company. Further, all the improvements suggested in the restructuring mechanism (like independent evaluation by experts) indicate that the procedure provided by the guidelines is an improvement over the existing restructuring process and provides for just division of losses among lenders and promoters.

5. Establishment of CRILC will encourage disclosures of all advances made, outstanding exposures and total amount of NPAs not only for domestic banks and financial institution but also for their overseas branches. This will promote transparency and help in formulation of policies for the Indian banking sector, thus avoiding US like recession and bailouts.
6. Definite time limits have been prescribed for every step. This will ensure expeditious measures being taken to prevent accumulation of NPAs.
7. PE firms are now accepted as part of restructuring mechanism as they can offer both additional finances and managerial expertise. The guidelines will promote participation of PE investors in asset financing business by affording them adequate opportunity to recover dues in case of defaults. Further, opening up of such a whole new vista for PE firms will attract foreign investments in India and at the same will demand simultaneous liberalizations in other aspects like FDI/FPI sectoral caps, tax laws, etc.
8. The framework provided will prevent borrowers from being non-cooperative and unreasonable with creditors in their efforts to recover dues as there is a provision of expensive loans to non-cooperative borrowers.
9. Leveraged buyouts[32] are now permitted by the RBI as banks are now allowed to advance loans to specialized entities acquiring 'stressed companies'.
10. Obligation of promoters in CAPs has been clearly indicated. They may be required to provide personal guarantees and title documents of their assets to the lenders. Promoters may also be restrained from disposing of their shares during restructuring by transferring their holding to an escrow or security trustee account.
11. The guidelines put forth both incentives (like allowing of PE investors and leverage buyouts) and deterrents (like accelerated provisioning) to ensure strict compliance by both lenders and borrowers.

[31] The "convertibility clause" gives right to creditors to convert restructured amount into equity investment in borrowing company.
[32] Leveraged buyout is acquisition of a company with the help of borrowed finances.

12. Prescription of penalty for auditors, valuers and lawyers will ensure greater accountability on their parts.

APPRAISAL OF THE FRAMEWORK:

The guidelines admit a significant swelling in the volume of NPAs and also mark a considerable change in the regulatory outlook towards this problem. Such a move may be expected to strengthen other measures taken to tackle the NPA issue and to help financial sector in long run.

However, owing to expensive and time consuming procedure involved for taking such steps, this mechanism cannot be said to be a fool-proof solution for growing NPAs. It would tend to give willful defaulters more time to dodge their creditors. Further, under the guidelines, banks neither need to exercise due diligence and discipline while advancing credit nor required to restrain from giving loans to borrowers with doubtful creditworthiness. Moreover, though the liability of auditors has been clearly defined in the guideline, there is no penal provision pertaining to the liability of directors of the borrowing companies who are principal reasons for creation of NPAs.

2. <u>Resolution Regime for Financial Institutions:</u>

A working group of the RBI has recently proposed a separate framework for specifically addressing bankruptcy of financial institutions in India, which may come into force in 2015.[33] Till date Indian banks have been compulsorily amalgamated or merged, but never been allowed to become insolvent. Following the lessons learnt from the recent financial crisis and continuous rise in volume of NPAs leading to pressure on financial institutions, such a framework has been initiated. Such a structure will facilitate not only early detection of weakening, but also organized resolution of financial institutions (both banks and non-banks).

Based on the recommendations of Financial Sector Legislative Reforms Commission (FSLRC), the framework proposes to establish of a single, independent **Financial Resolution Authority** (FRA), similar to Federal Deposit Insurance Corporation of the US. The FRA will have power to resolve troubled financial institutions, regardless of their ownership and will endeavor to ensure

[33] Press Release, Reserve Bank of India, "*Report of the High Level Working Group on Resolution Regime for Financial Institutions*", (May 2, 2014), available at: http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767. (Last visited on June 16, 2014).

overall stability in Indian financial market. It will also be empowered to impose moratorium, transfer NPAs to specialized entities, etc.

For effective resolution of troubled financial institutions, the Report suggests the following instruments[34]:

a) closing of such an institution and selling of its performing assets to a private sector purchaser;
b) declaration of such an entity as insolvent, thus closing it permanently;
c) establishment of a "*bridge bank*" where assets of such a failing entity may be transferred so as to bridge the time-lag between an institution's failure and finding of purchaser;
d) division of troubled financial institutions into "*good bank*" consisting of its performing assets and "*bad bank*" comprising of stressed assets of such an institutions and the subsequent sale of "*good bank*" to a third party and winding up of "*bad bank*". Here business of the financial institution is continued by the purchaser;
e) bail-in, which involves recapitalizing the failed entities by way of conversion of existing creditors into shareholders, for systemically important financial institutions;
f) temporary acquisition of control of systemically important financial institutions by the government and its eventual sale to a private entity, where special circumstances warrants state intervention.

IMPLICATIONS:

The framework attempts to address a major problem with all existing legislations i.e. the lack of a comprehensive solution for rehabilitation of financial institutions themselves. A single framework avoids differential treatment on basis of ownership, capital structure and manner of registration and allows failed financial institutions to sell off only their viable venture, while winding up the stressed part. The proposal, if implemented, would also align Indian laws with global standards. Further, it would pave way for strengthening our weak insolvency laws, a major reason for poor recovery of NPAs in India.

[34] Id p. 96.

REFORMS IN OTHER INCIDENTAL LEGISLATION:

In addition to the above mentioned regulatory efforts, legislature has also made certain endeavors to control growth of NPAs by introducing necessary provisions in other incidental legislations. Setting up of a **special purpose infrastructure fund and/or development financial institution** as lately recommended by CII, for lending finances to companies which are troubled but require capital to finish their projects, is one such example.[35]

The most vital change has been made under the new Companies Act, 2013, which seeks to modify the available structure of debt recovery. Some of the key changes to be introduced by the new Companies Act, 2013 are as follows:

1. **Constitution of National Company Law Tribunal (NCLT) and National Company Law Appellate Tribunal (NCLAT)[36]**: All the powers and jurisdiction which were hitherto exercised by different authorities, *viz* the High Court, the Company Law Board (CLB) and the BIFR, will now be consolidated and vested in the NCLT. This will avoid multiplicity of proceedings before various quasi-judicial bodies. After its establishment, all the 'arrangements', including *corporate debt restructuring, rehabilitation and winding up of a company* shall be approved by the NCLT.
2. Objection to a scheme of arrangement can be made only by persons holding at least 10% shares or at least 5% of the total debt outstanding in the company, as against any shareholder, creditor or other "interested person" who can presently object the scheme. This will reduce hindrances in the process of reconstruction and arrangement.[37]
3. The pecuniary limit for filing winding up petition has been increased from Rs. 500 to Rs. 1,00,000.[38]
4. **Rehabilitation of Sick Companies**: Chapter XIX of the new Act embodies the circumstances in which a company can be declared sick and prescribes a rehabilitation procedure for such companies. Unlike SICA, this chapter is not confined to Industrial Companies. In contrast to the present requirement of erosion in net worth to below 50%, the 2013 Act provides that a company shall be declared sick on the basis of its inability to pay

[35] The Hindu: Business Line, "*CII moots 5-point action plan to improve asset quality of banks*", May 5, 2014, available at: www.thehindubusinessline.com/.../cii...banks/article5979280.ece. (Last visited on June 19, 2014).
[36] § 408 and 410 of the Companies Act, 2013.
[37] Proviso to § 230(4) of the Companies Act, 2013.
[38] § 271(2) of the Companies Act, 2013.

debt within 30 days of making of demand by secured creditors representing fifty per cent or more of outstanding amount of debt.[39] The entire procedure has been made time bound and the rehabilitation scheme is to be finalized within one year, failing which winding up order shall be made.[40]

IMPLICATIONS:

The modifications introduced in the procedure will bring Indian laws at par with international standards suggested by the United Nations Commission on International Trade Law (UNCITRAL). The time limits and limitations on power to object prescribed will fasten the procedure and will avoid deliberate attempts to delay. Further, the Act takes active steps in removing the multitude of authorities that exist currently in the entire process of winding up and reconstruction, instead providing for a centralized authority to carry out all the functions. Thus this new Act will fill in most of the lacunae present in the existing system.

CONCLUSION and RECOMMENDATIONS

Given the rate of rise in NPAs and the attitude of banks in advancing loans, mere regulatory efforts are not sufficient to check the growth of ever increasing NPAs. Policy making by the government with respect to such distressed assets also need to change. The trend of providing subsidy to failing banks will only burden the state and tax payers and will never help the economy. Therefore, the need of a self administering mechanism for banks under the supervision of RBI cannot be ignored for long. Such a mechanism will require both banks and borrowers to develop a sound credit profile and levy strict punishments for lapses.

Further, in light of the above mentioned observations regarding the existing and emerging trends in the Indian banking sector, the following recommendations are put forth:

1. Public Sector Undertaking Banks (PSU Banks) should be given more autonomy in their operations, particularly independence from political pressures. PSU banks should explore the possibility of raising finances through capital market, especially via Qualified Institutional Placement (QIP) by issuing shares to Qualified Institutional Buyers (QIB). This will facilitate

[39] Section 253(1) of the Companies Act, 2013.
[40] Section 258 of the Companies Act, 2013.

in their privatization and diversification of ownership and consequently, be expected to bring better managerial and technical expertise in these banks in a regulated environment.

2. Banks granting loans with no due diligence and proper inquiry of credit worthiness of borrowers should be penalized. In fact, carrying out a credit risk management before granting finances should be made mandatory for them.
3. Earlier governmental attempts in establishing a single agency to regulate NPAs have failed. Therefore, there is an urgent need of establishment of a central agency to purchase strained loans from banks at a discounted rate, thus supporting DRTs in recovering NPAs. Such a step would aid in keeping NPAs off balance sheets of banks and would also improve their share prices. In fact, the new government has recently proposed setting up of a **National Asset Management Company** (NAMCO) which will act as a nodal agency in reviving companies with voluminous bad debts.[41]
4. After the recent RBI guidelines to form JLF, restructuring via CDR mechanism for viable corporate entities has already been made indispensable before resorting to legal proceedings. Thus there is an urgent need for revamping the existing CDR scheme. Endeavors must be made for bringing more transparency in CDR by displaying in public domain full details about restructuring, continuous monitoring and appraisal of entities under restructuring, allowing participation of shareholders, and increasing promoters' accountability in the restructuring process. RBI should clearly lay down criteria to determine what amounts to a '*viable corporate entity'*, where restructuring will be prima facie feasible.
5. RBI has already identified role of ARCs and PE firms in recovery of NPAs. Such special entities assist in curing strains on assets, rather than merely writing off them in balance sheets. Thus, their participation of should be encouraged by giving them certain incentives such as liberal capital requirements, finances through banks at a cheaper rate, permission to foreign investors to hold more than 49% of stake in ARCs, etc.
6. As already stated above, Indian laws neither provides an opportunity for effective rehabilitation nor for an efficient exit. Thus, there is a need for remodeling the legal framework for both revival and insolvency of companies and bringing about a single

[41] The Financial Express, "*Bankers meet Arun Jaitley, pitch for National Asset Management Company"*, June 22, 2014, available at: http://indianexpress.com/article/business/economy/bankers-meet-jaitley-pitch-for-national-asset-management-company/ (Last visited on June 20, 2014).

mechanism for recovery for all financial institutions (banks and non banks) so as to improve their overall effectiveness.

7. There is a need of greater coordination among different regulatory authorities like RBI, SEBI, IRDA, etc for combating the issue of escalating NPAs and improving insolvency laws in India.