

CREDIT INFORMATION REVIEW



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POLICY

Wilful Defaulters

An In House Working Group was constituted by the Reserve Bank for further examining some of the recommendations of the Working Group on Wilful Defaulters (Chairman : Shri S. S. Kohli). Based on the Group's recommendations, the Reserve Bank advised banks and notified financial institutions (FIs) as under :

Definitions

Certain terms/definitions contained in the Reserve Bank's circular of February 20, 1999, have been redefined as follows :

Wilful Default : a wilful default would be deemed to have occurred if any of the following events is noted :

- A unit has defaulted in meeting its payment/repayment obligations to the lender even when it has the capacity to honour the obligations.
- A unit has defaulted in meeting its payment/repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- A unit has defaulted in meeting its payment/repayment obligations to the lender and has siphoned off the funds. When the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.

Diversion of Funds : diversion of funds should be construed to include any one of the undernoted occurrences :

- Utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction.
- Deploying borrowed funds for purposes/activities or creation of assets other than those for which the loan was sanctioned.
- Transferring funds to subsidiaries/group companies or other corporates by whatever modalities.

- Routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender.
- Investment in other companies by way of acquiring equities/debt instruments without approval of lenders.
- Shortfall in deployment of funds vis-à-vis the amounts disbursed/drawn and the difference not being accounted for.

Siphoning of funds : should be construed to have occurred if funds borrowed from banks/FIs are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be a judgement of the lenders based on objective facts and circumstances of the case.

End-use of Funds

In cases of project financing, banks/FIs, *inter alia*, obtain certification from chartered accountants to ensure end-use of

CONTENTS

POLICY

	Page
Wilful Defaulters	1
Swarnjayanti Gram Swarozgar Yojana	2
Prudential Norms on Asset Classification	3
Corporate Debt Restructuring	3
Transactions in Government Securities	3

BRANCH BANKING

Charging of Interest at Monthly Rests	4
Updating of Passbooks	4
Investment Fluctuation Reserve	4
Collateral Free Loans for SSI	4

FOREX

Advertisement on Foreign TV	4
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funds. In case of short-term corporate/clean loans, lenders should observe due diligence and to the extent possible, such loans should be limited to only those borrowers whose integrity and reliability is above board. Banks and FIs, therefore, should not depend entirely on the certificates issued by chartered accountants but strengthen their internal controls and credit risk management system to enhance the quality of their loan portfolio. Ensuring end-use of funds by banks and FIs should form a part of their loan policy document for which appropriate measures should be put in place. Some illustrative measures that could be taken by the lenders for monitoring and ensuring end-use of funds are :

- (a) Meaningful scrutiny of quarterly progress reports/operating statements/balance sheets of the borrowers.
- (b) Regular inspection of borrowers' assets charged to the lenders as security.
- (c) Periodical scrutiny of borrowers' books of accounts and the no-lien accounts maintained with other banks.
- (d) Periodical visits to the assisted units.
- (e) System of periodical stock audit, in case of working capital finance.
- (f) Periodical comprehensive management audit of the 'credit' function of the lenders, so as to identify the systemic-weaknesses in credit-administration.

Penal Measures

In order to prevent wilful defaulters from accessing capital markets, a copy of the list of wilful defaulters would henceforth be forwarded by the Reserve Bank to the Securities and Exchange Board of India (SEBI). Banks and FIs should initiate penal measures against wilful defaulters as follows :

- a) No additional facilities should be granted by any bank/FI to listed wilful defaulters. In addition, entrepreneurs/promoters of companies where banks/FIs have identified siphoning/diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions, should be debarred from institutional finance from scheduled commercial banks, development financial institutions (DFIs), government owned non-banking financial companies (NBFCs), investment institutions, etc., for floating new ventures for a period of 5 years from the date the name of the wilful defaulter is published in the list of wilful defaulters by the Reserve Bank.
- b) Legal process, wherever warranted, against the borrowers/guarantors and foreclosure of recovery of dues should be initiated expeditiously. The lenders may initiate criminal proceedings against wilful defaulters, wherever necessary.
- c) Wherever possible, banks and FIs should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit.
- d) A covenant in the loan agreements with the companies in which the notified FIs have significant stake, should be incorporated by the FIs to the effect that the borrowing company should not induct a person who is a director on

the Board of a company which has been identified as a wilful defaulter. In case, such a person is found to be on the Board of the borrower company, it would take expeditious and effective steps for removal of the person from its Board.

It is imperative on the part of banks and FIs to put in place a transparent mechanism for the entire process so that the penal provisions are not misused and the scope of such discretionary powers is kept to the barest minimum. It should also be ensured that a solitary or isolated instance is not made the basis for imposing penal action.

While dealing with wilful default of a single borrowing company in a group, banks/FIs should consider the track record of the individual company, with reference to its repayment performance to its lenders. However, in cases where a letter of comfort and/or guarantees furnished by the companies within the group on behalf of the wilfully defaulting units are not honoured when invoked by banks/FIs, such group companies should also be reckoned as wilful defaulters.

Cut-off Limits

Any wilful defaulter with an outstanding balance of Rs. 25 lakh or more, henceforth, would attract the penal measures. The limit of Rs. 25 lakh is also to be applied for taking cognisance of instances of siphoning/diversion of funds.

Role of Auditors

In case any falsification of accounts by borrowers or negligence/deficiency in conducting audit by auditors is observed by banks/FIs, they should lodge a formal complaint against the auditors with the Institute of Chartered Accountants of India (ICAI) to enable ICAI to examine and fix accountability of the auditors.

With a view to monitoring the end-use of funds, if the lenders desire specific certification from the borrowers' auditors regarding diversion/siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors, banks and FIs should ensure that appropriate covenants in the loan agreements are incorporated.

Reporting

Consequent to the change in the definition, banks and notified FIs have been advised to compile the list of wilful defaulters as on March 31, 2002 and submit it to the Reserve Bank.

Swarnjayanti Gram Swarozgar Yojana

The Ministry of Rural Development has brought to the notice of the Reserve Bank that some states have reported instances where relatives of defaulters were debarred from benefits under the Swarnjayanti Gram Swarozgar Yojana (SGSY). The terms family and defaulter for the purpose of SGSY guidelines have been defined by the central government as under :

BPL family : would be treated as a unit for the purpose of giving income generating assets. Family would consist of members of a household and united by ties of marriage, blood and adoption. The family would consist of husband, wife,

dependent parents/sons/daughters/brothers/sisters. The moment a parent/son/daughter/brother/sister is no longer dependent and has a separate household, he will no longer be a member of the same BPL family.

Wilful defaulter : is defined as one who is capable of repaying the loan, but has been defaulting intentionally and not repaying the loan deliberately and wilfully.

Prudential Norms on Asset Classification

Consistent with the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II) and with a view to moving closer to international best practices regarding provisioning norms, the Reserve Bank has advised all commercial banks that from March 31, 2005, an asset should be classified as doubtful if it remained in the sub-standard category for 12 months. Banks are permitted to phase the consequent additional provisioning over a four-year period, commencing from the year ending March 31, 2005, with a minimum of 20 per cent each year.

Earlier, an asset was treated as doubtful if it remained in the sub-standard category for 18 months.

Corporate Debt Restructuring

A High Level Group on Corporate Debt Restructuring (CDR) was constituted by the Reserve Bank under the Chairmanship of Shri Vepa Kamesam, Deputy Governor to review the operations of the CDR scheme, to identify the operational difficulties, if any, in smooth implementation of the scheme and to suggest measures to make the scheme even more effective. As an interim measure, it has been decided that permission for corporate debt restructuring would be made available by the Reserve Bank on the basis of specific recommendations of CDR "Core-Group", if a minimum of 75 per cent (by value) of the lenders constituting banks and FIs consent for CDR, irrespective of differences in asset classification status in banks/FIs.

Earlier in August 2001, Guidelines on Corporate Debt Restructuring were issued to banks for putting in place a framework outside the purview of Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunal (DRT) and other legal procedures for restructuring debts of viable corporate entities facing financial problems.

Transactions in Government Securities

The Reserve Bank, has been, over a period of time, encouraging holding of government securities in dematerialised mode in the following manner :

- All entities having a subsidiary general ledger (SGL) account with the Reserve Bank are allowed to open constituent subsidiary general ledger (CSGL) accounts on behalf of their clients.
- Although being non-banks, depositories [(National Securities Depository Limited (NSDL)/Central Depository Services (India) Limited (CDSL)] and organisations such as Stock Holding Corporation of India Limited (SHCIL) have been provided an additional SGL account to open CSGL accounts on behalf of their clients.

- The cost of postage incurred by the depositories on remitting interest and redemption proceeds is being reimbursed by the Reserve Bank so as to encourage dematerialised holding and retail participation in gilts.
- Guidelines have been issued to banks prescribing the safeguards to be adopted for maintenance of CSGL accounts.
- To impart transparency in government securities traded by clients (through CSGL accounts), a special feature has been incorporated in the negotiated dealing system (NDS) for reporting and settlement of such trades. Provision has also been made in the NDS for giving quotes on behalf of clients, i.e., CSGL account holders.

As a result of these measures 99 per cent of the trading in government securities presently takes place through SGL accounts with the Reserve Bank. The delivery versus payment (DVP) system ensures simultaneous transfer of securities against funds.

In the light of recent fraudulent transactions in the guise of government securities transactions in physical format by a few co-operative banks with the help of some broker entities, it is now proposed to accelerate the measures under contemplation for further reducing the scope for trading in physical form. The measures are :

All entities regulated by the Reserve Bank [including FIs, primary dealers (PDs), co-operative banks, regional rural banks (RRBs), local area banks (LABs), non-banking financial companies (NBFCs)] should necessarily hold their investments in government securities portfolio in either SGL (with the Reserve Bank) or CSGL [with a scheduled commercial bank/state co-operative bank/PD/FI/sponsor bank (in case of RRBs) and SHCIL] or in a dematerialised account with depositories (NSDL/CDSL).

- Only one CSGL or dematerialised account can be opened by any such entity.
- In case the CSGL accounts are opened with a scheduled commercial bank or state co-operative bank, the account holder has to open a designated funds account (for all CSGL related transactions) with the same bank.
- In case a CSGL account is opened with any non-banking institutions the particulars of the designated funds account (with a bank) should be intimated to that institution.
- Entities maintaining CSGL/designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the CSGL account for sales before putting through the transactions.
- Entities regulated by the Reserve Bank should not undertake transactions in physical form with any broker with immediate effect.

Branch Banking**Charging of Interest at Monthly Rests**

Reserve Bank has clarified to all commercial banks that its instructions of March 9, 2002 regarding charging of interest on monthly rests are not applicable to agricultural advances. Banks may continue with the existing practice of charging/compounding of interest on agricultural advances linked to crop seasons. Banks are required to charge interest at monthly rests in respect of other advances.

It is further clarified that the move over to charging of interest at monthly rests from April 1, 2002 was envisaged in the context of adopting 90 days' norm for recognition of loan impairment from the year ending March 31, 2004 and consequential need for close monitoring of borrowers' accounts. Banks are, therefore, advised not to compound interest at monthly rests till March 31, 2003 and to move over to monthly compounding from April 1, 2003.

While compounding interest at monthly rests from April 1, 2003 banks may ensure that for advances where administered interest rates are applicable, the rates are re-aligned suitably. In all other cases also, banks should ensure that the effective rate does not go up merely on account of the switchover to the system of charging interest on monthly rests.

Earlier, banks were advised to switch over to the system of charging interest on advances at monthly rests from April 1, 2002.

Updating of Passbooks

The Reserve Bank has advised all commercial banks to provide full particulars of each transaction while updating passbooks of customers maintaining savings/current accounts with them, irrespective of whether the withdrawal is effected by issue of cheques by the customer and presented through Bankers' Clearing Houses or entries have emanated from usage of Electronic Clearing Service.

Accordingly, banks have been advised to remodel their software packages to provide full particulars of each transaction while updating passbooks through computers.

It had been brought to the notice of the Reserve Bank that in some banks where passbooks are updated through computers, entries do not include cheque/warrant number, name of the party from whom the proceeds have been received, etc. The indication "by clg" or "to clg" is very ambiguous particularly when the same figures appear on different dates.

Investment Fluctuation Reserve

The Reserve Bank has advised all commercial banks that investment fluctuation reserve (IFR) should be computed with reference to investments in two categories, viz., "held for trading" and "available for sale". It would not be necessary to include the investment under "held to maturity" category, which is not meant to be traded for computation of IFR.

With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, banks were advised in January, 2002, to build up an IFR of a minimum 5.0 per cent of the investment portfolio within a period of 5 years. Banks were given the freedom to build up IFR to a maximum of 10.0 per cent of the portfolio depending on the size and composition of their portfolio, with the approval of their Board.

Collateral Free Loans for SSI

In order to further improve the flow of credit to small scale industries (SSIs), the Reserve Bank has advised all scheduled commercial banks (including RRBs and LABs) that they may, on the basis of good track record and financial position of the units, increase the limit of dispensation of collateral requirement for loans from the existing level of Rs. 5 lakh to Rs.15 lakh.

Earlier in April 2000, the Reserve Bank had announced dispensation of collateral requirement for loans up to Rs.5 lakh for tiny sector. This dispensation was extended subsequently to all SSI units in January 2002.

Forex**Advertisement on Foreign TV**

Authorised dealers have been advised to obtain a certificate from a chartered accountant on behalf of residents who do not require the Reserve Bank's prior permission for remitting foreign exchange for advertisement on foreign television. The chartered accountant should certify that -

- the applicant exporter has export earnings of more than Rs. 10 lakhs during each of the preceding two years, and
- the advertisement for which the foreign exchange is being remitted would be broadcast by the foreign television company in foreign countries and not in India alone.

Exporters whose export earnings are less than Rs.10 lakhs during each of the preceding two years, require the Reserve Bank's prior approval for remitting foreign exchange for advertisement on foreign television unless the payment is made from their exchange earners' foreign currency (EEFC) account.