Co-ordination between banks and financial institutions

BP. BC. 82 /21.04.048/00-01

February 26, 2001

All Commercial Banks
(excluding RRBs and LABs)

Dear Sirs

Co-ordination between banks and financial institutions

In the context of transition of the banks and the all-India financial institutions (FIs) from a regulated to a deregulated regime, the issue of more effective co-ordination among the banks and the FIs has been engaging the attention of the financial institutions, banks and Reserve Bank for sometime past, particularly in respect of large value projects jointly financed by the banks and the FIs, with a view to avoiding delays and facilitate better solutions to the common problems. In this regard, informal meetings of the Heads of select banks and the FIs, including the Chairman, IBA, were convened by the Governor to identify and deliberate upon the issues of common interest to the banks and the FIs. The following seven issues emerged at the meetings:

a) Timeframe for sanction of facilities;
b) Asset classification across consortium members;
c) Disciplining borrowers – change in management;
d) Levy of charges in the problem accounts;
e) Group approach for borrowers;
f) Sharing of securities and cash flows; and
g) Treatment of restructured accounts for the asset classification purposes.

An Informal Note indicating the consensus arrived at the aforesaid meetings on the first six issues was forwarded to the CMD, IDBI, for circulation/discussion among the participants of the meeting, with a view to evolving a consensus which should serve as the Ground Rules on the said six issues. We forward herewith a copy of the minutes of the meeting of the select banks and financial institutions convened by IDBI on 24 January 2001, indicating the Ground Rules agreed to by the participants on the aforesaid six issues. A copy of the Informal Note forwarded by us to IDBI in the matter is also enclosed for your information.

2. We shall, therefore, be glad if you will please place the minutes indicating the agreed Ground Rules before the Board of Directors of your bank for adoption and ensure implementation thereof thereafter except item at (b) viz. "asset classification across consortium members" (para 2 of the minutes of the meeting held on January 24, 2001) in respect of which banks will continue to follow the current instructions. As these Ground Rules have been arrived at after intensive consultation and discussions among banks/FIs and represent a consensus which is in the interest of all the banks/institutions and the economy, it will be appreciated if the Rules are implemented in letter and spirit at different levels of management.

3. As regards the issue relating to the 'regulatory treatment of restructured accounts for the purpose of asset classification', the matter is under our examination and the instructions would be conveyed shortly.

4. Please acknowledge receipt.

Yours faithfully

(M. R. Srinivasan)
Chief General Manager-in-Charge

Encls: As above

Informal note for discussion on "Co-ordination issues between banks and FIs"

1. Introduction

The level of NPAs in the Indian Financial System which has recorded an up-ward trend in the recent past has been an area of concern among the lenders as well as for the supervisors and the Government. As on 31st March 2000 the NPAs for the Indian Banking System aggregated Rs.60,841 crore ## and those for the select all-India FIs it stood at Rs. 18,146.00 crore ##. In this context, a view has been expressed that at least a part of the reason for phenomenal rise in NPAs has been a lack of the requisite co-ordination between the banks and FIs particularly where they are joint financiers of large value projects. (It is recognised in this regard that pursuant to the recommendations of the Working Group on Harmonizing the role and operations of DFIs and Banks [Chairman Shri S.H. Khan], a **Standing Co-ordination Committee** has become operational since October 1999 under the aegis of IDBI and select FIs and banks are represented on the Committee). Such jointly financed projects also give rise to certain operational issues which, it is felt, can be better addressed through a more effective and closer co-ordination between the two sets of lenders viz., the banks and the FIs.

In this background, the Governor, Reserve Bank of India, had taken two meetings of select FIs and banks, the latter one on 7 November 2000; the minutes of the meeting were sent to the participants on 24 November 2000. It was decided at the meeting that while the matter of treatment of restructured accounts for asset classification purposes would be examined by RBI as a regulator, on certain other issues of mutual interest to the FIs and banks, a draft "non paper" would be prepared to facilitate further discussion in the matter among the banks and the FIs. Accordingly, this paper seeks to raise the following issues for comments from the select banks and the FIs:

- Delay in sanction of various credit facilities
- Asset classification across consortium members
- Disciplining borrowers - change in management
- Levy of charges in problem / restructured accounts
- Implementation of Group Approach for borrowers
- Sharing of securities and cash flows - Trust & Retention Account (TRA) mechanism

2. Various aspects of each of the foregoing issues are briefly discussed in the following paragraphs in order to facilitate the formulation of "ground rules" or a code of conduct by banks / institutions.

(a) <u>Delay in sanction of various credit facilities</u>

One of the reasons for the mounting NPAs in the Indian financial sector is stated to be the inordinate delays in sanctioning credit facilities, particularly, under project financing,
where substantial quantum of cost overrun needs to be financed by the members of the consortium in respect of "last mile" projects or in other cases involving restructuring or rehabilitation of accounts. The delay arises generally on account of lack of co-ordination and consensus among lenders on financing the amount of cost overrun or restructuring or rehabilitation. At times the delays also arise for want of commitment for working capital facilities from the bankers though the term lending for the project might have been fully tied up. This in turn delays the operationalisation of the project.

The issues raised in this regard are : (a) the introduction of the concept of super majority whose decision should be binding on all the members of the consortium, and (b) the time frame within which the entire credit processing for new as well as the existing projects including overrun financing should be completed. The various ramifications of these issues are discussed below.

A view has been expressed that to obviate delay in financing, the decision should be taken as per the "super majority" of lenders that should be binding on all the members of the consortium. Super majority in such cases is suggested to be the secured creditors with more than 70 per cent share in total lending. It is also suggested that inter creditor agreement might also be necessary in such cases to make the super majority decision legally binding on all the members. A contrary view has also been expressed that the concept of "super-majority" should not be imposed on the dissenting minority in the consortium since in project financing the banks, as working capital providers, would always be in minority and, therefore, would not be able to safeguard their interests. Further, it was suggested that in case of overrun financing, the share of the dissenting minority should be frozen at the existing levels and any further contribution required from the minority in the overrun financing, should be contributed by the majority itself. As a variation to this view, it was suggested that in consortia where a single lender holds more than 30 per cent share of the total lending, the decision by a simple majority comprising 51% share in total lending, should suffice and should be treated as binding on all the members of the consortium.

On examining the above views, the following approach may be appropriate:

(a) As regards the time-frame for sanction of facilities, it is felt that in the case of accounts where only two lenders are involved, any issues relating to sanction of facilities should be expeditiously resolved by mutual discussions between them.

(b) In case where more than two lenders were involved, their agreement or disagreement for sanction of facilities must be conveyed within a maximum period of 90 days from the date of receiving loan applications, complete in all respects.

(c) In case of fresh loan proposals involving more than two lenders, the sanction or rejection should be conveyed within a period of two months from the date of the appraisal note by the lenders which had initially agreed in-principle to participate in the financing.

(d) In case of accounts involving restructuring, the lead institutions should complete the restructuring process within three months while the other participating lenders should convey their decision within two months from the date of receipt of appraisal note

(b) Asset classification across consortium members

In the days prior to the deregulation of the Indian financial system, the Reserve Bank had prescribed detailed guidelines for financing of borrowers under consortium arrangement. One of the prescriptions of those guidelines was that all the members should follow the asset classification of the leader of the consortium regardless of the performance of the account in their own respective books. However, with progressive deregulation and liberalisation of the banking sector and realising certain anomalies in the aforesaid dispensation, Reserve Bank stipulated that in consortium financing each lender could classify the asset according to the record of recovery in its own books regardless of asset classification in the books of the leader of the consortium. It is now contended that such liberalisation has given rise to certain unhealthy and unethical practices on the part of the borrowers.

There were broadly two streams of thought regarding asset classification of consortium accounts. While one view is that uniform asset classification across all the members of the consortium should be reintroduced by Reserve Bank to pre-empt the possibility of the borrower playing one lender against the other, a counter-view is that the asset classification should continue to be lender- specific as at present and should not be guided by the classification of the lead lender. It is argued in this regard that such a system is necessarily to create the right incentives for the lenders for effective follow up and recovery and for rewarding the recovery efforts of the lenders by way of better asset classification. It is further averred that lender-specific classification is all the more necessary for reflecting true and fair picture of the asset quality in accordance with the performance of the account in the books of each of the lender rather than being distorted by imposition lead classification across all the lenders. *Prima facie*, there appears to be some merit in this line of argument.

A practical difficulty in following the classification of the lead institution / super majority of lenders / lead and second lead institution is the likelihood of change in the asset classification by the auditors of the lead, etc., institution subsequent to such classification having been adopted by other members of the consortium. A suggestion, therefore, made in this context is to put in place a mechanism to ensure that where the lead classification is already adopted by the members of the consortium, the auditors of the lead institution do not subsequently effect a change in the asset classification since it creates a system-wide repurcussion for all the lenders. While this practical constraint is understood and recognised, it may not be feasible in practice to place an embargo on the auditors of the lead institution from changing the asset classification in the books of a lender as per their own best judgement.
Majority view would seem to be in favour of continuing the existing dispensation of lender-specific asset classification of a consortium account.

(c) Disciplining borrowers - change in management

A view has been expressed that the recalcitrant attitude of certain defaulting borrowers and their deliberate non-cooperation with the lenders for turning around the unit, have also significantly contributed to the burgeoning levels of NPAs in the system. In such circumstances, lenders are at times constrained to adopt the extreme measure of effecting a change in the management of borrowing unit with a view to inducing an element of credit discipline and improving the health and viability of the borrowing unit. Since changing the management of the borrowing unit is an extreme measure, to be adopted only exceptionally, a question arises as to what should be the specific criteria for resorting to the extreme remedy of changing the management of the defaulting borrowing unit.

There is divergence in the views held in this regard. While some of the criteria suggested for the purpose are listed in the **Annexure I**, it has also been indicated that continuance of an account in the NPA category for a period of 18 months should be ground enough for effecting a change in the management of the unit. The modality suggested in this case is the invocation of the "convertibility clause" in the loan agreements and creation of a pool of professional managers for running the unit on behalf of the lenders after the change in the management is effected. Certain other criteria suggested for the purpose are diversion of funds, unapproved investments in the associate firms, more than 50 per cent erosion in the networth and inability of the promoters to infuse fresh funds equal to losses of the unit. It has also suggested in the same breath that BIFR has outlived its utility and needs to be wound up since it has in effect become a shelter and resort for the sick units and wilful defaulters.

As a variant of the aforesaid approach it has also been suggested that once an account becomes NPA, the promoters should be asked to pledge their entire stake (shareholding) in favour of the lender. The lenders thereafter should prescribe specific milestones to be achieved by the borrowers within the specified time frame. The progress in achieving the milestones should be closely monitored and if the promoters / borrowers are unable to comply with the prescribed benchmarks and time schedule, the lending institution should effect a change in the management of the borrowing unit on the strength of its majority shareholding in the borrowing company.

Yet another view expressed in this regard is that the case-specific decision for change in management of a particular borrowing unit should be left to the discretion of the members of the consortium on a case to case basis and no uniform approach should be mandated for the purpose.

As regards the concept of change in the management for disciplining the borrowers, it is pointed out that the success rate for banks in cases of change in management of the borrowing unit, has been very low and this approach, therefore, does not inspire much confidence as a solution to turning around sick / defaulting unit.

Besides, it is also mentioned that the extant provisions of Banking Regulation Act do not permit the banks to have a majority stake in a company unlike the FIs, which are not subject to any such restriction. It is, therefore, indicated that if a change in management by the banks is to be a practicable option for turning around the sick units, necessary amendments to provisions of B. R. Act would be a pre-requisite for the purpose.

A reference is also made in this regard to the provisions of the Negotiable Instruments Act which do not provide any legal protection to the nominee directors nominated by the banks on the Boards of the borrowing companies whereas the nominee directors of FIs on the Board of borrowing companies do enjoy certain legal protection. This anomally too needs to be resolved before change in management of units could emerge as viable option.

A related issue raised in this regard is whether while effecting any change in management of a company within a group, the change in the management of even the healthy units of the group should also be considered, especially if several units within the group are in the non-performing category.

Furthermore, it is pointed out that mere change of management of the defaulting unit is not the solution to the underlying fundamental problems and hence, there is a need to provide for deterrent punishment to the wilful defaulters through appropriate statutory enactments.

Reckoning the divergence of views in respect of uniform criteria for effecting change in management of defaulting unit, the practicable solution appears to be to follow the views of the majority of lenders in a consortium (say 70 per cent of total funded exposure), on a consortium-specific basis. It may also be worthwhile to effect the change in management in a few extreme cases expeditiously, which could create deterrent example for the borrowing community.

(d) <u>Levy of charges in problem accounts</u>

A view has been expressed that one of the reasons for high level of NPAs in the Indian financial system is the application of not only high rate of interest applicable at the time of sanction of loan but also levy of various other charges, such as, penal interest, overdue interest, liquidated damages, etc., at very high rates by the lenders. Such levies have resulted in inflating the amount of NPAs especially when viewed in the current low interest rate regime. A question, therefore, arises whether it would prudentially be desirable to evolve a ceiling on levy of such penal, etc., charges from the defaulters in respect of problem accounts so that the level of NPAs is not unduly distorted.

Divergent views have been expressed in this regard. On the one hand it has been suggested that the concept of penal interest, liquidated damages, etc., should be dispensed with altogether as it has failed to serve the purpose of disciplining the borrowers. On the other hand a suggestion has also emanated from certain quarters for placing a ceiling of 18 per cent on all levies taken together as it is expected to adequately cover the cost of funds even in the erstwhile high interest rate regime.

In another variant of the proposed ceiling it has been suggested that instead of prescribing an absolute ceiling on total charges, the ceiling on penal charges should be fixed at 2 to 3 per cent above the contracted rate of interest regardless of what the contracted rate was.

It is also contended that reckoning very high rates at which various levies and charges have been debited to the borrowers in the past, if any concession is considered desirable for recovery of dues, it should be extended only as a part of overall restructuring / rehabilitation package and not otherwise. However, such concession should be extended subject to the **right of recompense** being reserved by the lenders. This suggestion is, however, countered by stating that the right to recompense clause has proved to be ineffective since BIFR and the borrowers have not agreed to such a clause and even though such a clause was included in the rehabilitation package, recoveries have not been possible.

Reckoning divergent views and suggestions made in the matter, majority felt that while the consortium members should decide the rate of interest to be charged on such accounts, penal interest or other charges, if any, should not exceed two percentage points above the contracted rate.

(e) <u>Group approach for borrowers</u>

It has been a common experience that within a borrower group, while some of the units might be facing difficulties and may be defaulters to the lenders, certain other units of the same Group might be quite healthy and prosperous. The issues have been raised whether in such a situation it would be feasible or desirable to grant additional credit facilities to the healthy units of the group with a condition that such facilities be used only for repaying the dues of the defaulting unit. It is contended in this context that even in cases where such possibilities might exist, there is a lack of requisite cooperation between the banks and FIs. Certain basic issues have also been raised in this regard regarding the definition of Group. It is contended before adopting a "group approach", a clarity in definition of "Group" was a pre-requisite which needed to be studied in depth by an expert group.

The adoption of the group approach on the foregoing lines with a view to recovering the dues of the non-performing units by granting fresh facilities to the healthy units of the group has generally not been well received. It has been pointed out that such an approach would be neither legally tenable nor workable in practice besides amounting to a tacit approval for diversion of funds. Such an approach is also contended to be contrary to the principles of good corporate governance since it would not be in the interest of the minority shareholders of the healthy companies of the group and could also undermine the financials of such healthy units in the long run. Moreover, every company in a group being a separate legal entity, such a linkage in lending to the healthy units of a group, might not stand the legal scrutiny. As a counter argument, however, it has been mentioned that such an approach could possibly be considered in cases where non-performing unit had diverted the funds to the healthy units of the group and the non-performing unit was considered to be financially viable.

On the other hand, a view has been expressed that, regardless of the legal tenability of the aforesaid approach, there should not be a blanket prohibition on adopting such a practice and the decision to adopt this approach, if found feasible in certain cases, should be left to the discretion and commercial judgement of the lenders concerned. This was particularly necessary since there could be circumstances where such an approach was considered appropriate on account of genuine difficulties of the non-performing unit or where the owners / shareholders of the healthy units were willing to borrow for meeting the dues of the non-performing units. It was also pointed out that the aforesaid group approach could possibly be considered as a part of overall restructuring package in respect of a defaulting unit. Hence, no uniform approach or rules should be laid down in this regard.

Reckoning the various practical difficulties in operationalising the group approach, a pragmatic solution which emerges is to exercise due circumspection in extending fresh credit facilities to the units of a group where certain other units have been in default with the lenders. However, it would also need to be ensured that the normal funding requirements of the healthy performing units do not get hampered in the process. It was, however, felt that if 70 % majority of lenders (in terms of their funded exposures) agree to effect a change in the management of the defaulting borrowal unit, or to convert the loans to equity for subsequent off-loading of the same to the highest bidder through auction, they should take such decisions on a consortium-specific basis. Such action should be taken in certain specific circumstances (e.g., where sickness was induced by the same promoters in several units) in at least **a few cases** expeditiously in order to set a **deterrent example** in this regard.

(f) <u>Sharing of securities and cash flows - Trust & Retention Account (TRA) mechanism</u>

In the joint financing of large value projects by banks and FIs, the sharing of securities as also of the cash flows of the borrowers has been a contentious issue. A general view is expressed that while the banks are reluctant to create pari passu or second charge over the current assets in favour of the FIs, the FIs try to delay the creation of pari passu or second charge on the fixed assets of the borrowers in favour of the banks. Likewise, in the problem accounts when the cash flows of the borrowers are not sufficient to service the dues of the banks as well as of the FIs, well defined mechanism does not exist for equitable sharing of cash flows between the two sets of lenders. Hence, it is felt that there is a need to evolve an effective and smooth mechanism for safeguarding the interests of both classes of lenders in jointly financed large projects.

A view has emerged in this regard that all the assets of the borrowers available as security (current or fixed) should be pooled together and shared by term lenders (FIs) as also the working capital providers (banks) as per their weighted average share in the total exposure to the borrower. It is, however, stated in this regard that such an approach of pooling and sharing of securities while perhaps feasible in respect of fresh loans, would not be workable in respect of old / existing stock of NPAs since the charges of the lenders would have already been registered and would, therefore, have chronological priority. As regards creation of a second charge over the assets of the borrowers, while a view is expressed that it should not be a problem at all since creation of second charge does not dilute the security available to the first charge holder, apprehensions are also expressed that creation of second charge might result in withholding of consent by the second charge holders for creation of pari passu charge for additional facilities subsequently granted by the first charge holders.

As regards *pro rata* sharing of securities among the lenders in consortium, a view has also been expressed that at times the FIs hold certain securities by way of pledge of promoters' shares or the real estate, etc., in the project company but such a security is not shared by them with the other lenders in the consortium. Such FIs subsequently enter into undisclosed arrangements with the borrowers / promoters for disposal of such securities at attractive prices but do not involve the banks in the exercise and also do not share the proceeds with the other members of the consortium. There was, therefore, a need to curb such practices in the system.

As regards the system of Trust and Retention Account (TRA - a brief write up furnished at **Annexure II**), it has been opined that TRA mechanism would be possible to adopt only if the banks and FIs share the charge over the entire assets of the borrower and only if such sharing is made a part of the terms and conditions of sanction of limits. On the other hand, adoption of TRA mechanism is strongly advocated since it is stated to be a healthy practice, is expected to bring about greater discipline among the borrowers and would be fair and transparent to all the members of the consortium. It has also been argued in this regard that since the TRA concept has been successful in case of infrastructure financing, it could be suitably adapted for project financing as well. However, a technical point has been raised in operationalising the TRA mechanism that all the cash flows of borrower (such as proceeds of the bill discounted for a manufacturing project) cannot be shared with the FIs since the bill financing by definition is meant to be self liquidating in nature and proceeds must be fully appropriated by the discounting bank only. Certain apprehensions have also been expressed that the TRA mechanism is biased in favour of the FIs and is not fair to the banks, the procedure is quite cumbersome and is not practicable in all the cases.

There is, therefore, a need to take a view that where TRA mechanism is not feasible, what should the alternative mechanism be to safeguard the interest of all the lenders.

: Source : Report on Trend and Progress of Banking in India, 1999-2000

ANNEXURE I

Suggested criteria for effecting change in management of defaulting units

1) Chronic wilful default of the borrower;
2) Loss of confidence in the management of the borrowing unit by the lenders - to be decided by the majority of lenders;
3) Non-compliance with the time frame and quantum of committed contribution from the promoters;
4) Non-commencement of commercial production within one year from the date originally planned without assigning any unavoidable reasons.
5) Any fraudulent action / convictions under any law;
6) Any major penal action by any regulatory authority against the management of the company evidencing fraudulent intentions of the management;

ANNEXURE II

Trust and Retention Account (TRA) mechanism

TRA mechanism has been a common feature in financing of infrastructure projects. It seeks to protect the project lenders against the credit risk (the risk of debt service default) by insulating the cash flows of the project company. This is done through shifting the control over future cash flows from the hands of the borrowers (project company) to an independent agent, called **TRA agent**, duly mandated by the lenders.

2. The infrastructure projects are executed through a separate company created for the purpose (called 'Special Purpose Vehicle' - SPV) and the shares of the SPV would normally be held, among others, by the sponsors of the project. The cash flows of the **SPV** (project company) are subjected to a TRA arrangement. Under this arrangement, the **lenders**, the **borrower** and the **TRA agent** enter into a **tri-partite agreement**, which provides for all revenues of the project to be directed into a single account, maintained with the designated TRA agent. The lenders, in consultation with the borrower, draw up a **detailed mandate** for the TRA agent as to periodic transfer and utilisation of funds available in the TRA. The mandate basically spells out the manner and purpose of various payments including the debt service to the lenders. The payment to the lenders is to be made directly by the TRA agent, as per its mandate, without any intervention by the borrower. For operational convenience, the TRA could be sub-divided into several **sub-TRAs** dedicated to separate heads of expenses / purposes. In case of multi currency cash flows, there could also be separate TRAs with the same agent or different TRA agents for handling the cash flows in various currencies. Thus, the TRA agent acts as a trustee on behalf of the lenders and ensures that the cash flows are accessible to the borrower / project company, strictly as per the mandate. Thus, the TRA mechanism could be viewed as a sophisticated version of the traditional 'No Lien' accounts, on which the concerned bank could not exercise its right of general lien.

3. **Illustratively**, the mandate to the TRA agent by the lenders for appropriation of cash flows could prescribe the following sequence for end use of funds:

- All operation and maintenance expenses of the project;
- Monthly dues / accruals of net principal and interest payments to lenders;
- A debt service reserve equal to, say, six months' dues - which could also be backed by a letter of credit to be arranged by the sponsors of the project company;
- A cash reserve equal to, say, four months' operating expenses;
- After meeting all the foregoing obligations, either through L/C or out of project cash flows, the residual funds, if any, would be available to the project company for disposal as per their discretion or as pre-determined by the mandate given to the TRA agent. .

4. A Trust and Retention Account mechanism needs to be distinguished from an **Escrow Account arrangement,** though the two are somewhat similar. An Escrow Account is an arrangement for safeguarding the borrower against its customers from the payment risk for the goods or services sold by the former to the latter. This is achieved by removing the control over the cash flows from the hands of the customer to an independent agent, who in turn could ensure appropriation of cash flows as per the its mandate. The Escrow arrangement provides for directing a pre-determined payment stream from the customers of the borrower to a special account maintained with a designated agent. Payment / deposit by the user / buyer into such an account is assumed to be a valid discharge of his liability to the supplier of the goods / services. An Escrow arrangement involves parties different from the parties in a TRA mechanism. The Escrow arrangement would involve usually four parties: the lender, the borrower, the customers of the borrower and the Escrow Agent. The mandate to the Escrow Agent would normally be finalised by the lenders in consultation with the borrower and its customers.

5. Thus, for instance, in financing of a power plant which sells its power generated to a SEB, the Escrow arrangement would involve the power producer (borrower), the SEB concerned (customer), the bank / FI (lenders) and the Escrow Agent (a designated bank). The SEB would agree to direct its collection centres to deposit the electricity charges received from retail consumers, into a designated account with the designated bank (Escrow agent) and to direct its bulk consumers to deposit their payments directly with the Escrow Agent in the specified account. The Escrow Agent would then appropriate the funds in the Escrow account as per the priority laid down in the Escrow Agreement.