Reserve Bank of India

Discussion Paper

Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy

Introduction

1.1 With the slowdown of the Indian economy, a number of companies/projects are under stress. As a result, the Indian banking system has seen increase in NPAs and restructured accounts during the recent years. Not only do financially distressed assets produce less than economically possible, they also deteriorate quickly in value. Therefore, there is a need to ensure that the banking system recognises financial distress early, takes prompt steps to resolve it, and ensures fair recovery for lenders and investors. This Paper outlines a corrective action plan that will incentivize early identification of problem cases, timely restructuring of accounts which are considered to be viable, and taking prompt steps by banks for recovery or sale of unviable accounts.

1.2 The main proposals are:

(i) Early formation of a lenders' committee with timelines to agree to a plan for resolution.

(ii) Incentives for lenders to agree collectively and quickly to a plan – better regulatory treatment of stressed assets if a resolution plan is underway, accelerated provisioning if no agreement can be reached.

(iii) Improvement in current restructuring process: Independent evaluation of large value restructurings mandated, with a focus on viable plans and a fair sharing of losses (and future possible upside) between promoters and creditors.

(iv) More expensive future borrowing for borrowers who do not co-operate with lenders in resolution.

(v) More liberal regulatory treatment of asset sales.

a. Lenders can spread loss on sale over two years provided loss is fully disclosed.

b. Takeout financing/refinancing possible over a longer period and will not be construed as restructuring.

c. Leveraged buyouts will be allowed for specialised entities for acquisition of 'stressed companies'.

d. Steps to enable better functioning of Asset Reconstruction Companies mooted.

e. Sector-specific Companies/Private equity firms encouraged to play active role in stressed assets market.

1.3 Going forward, while some regulatory and governmental measures may be required to address the factors that are leading to deteriorating asset quality, there is an equal need for proper credit discipline among lenders. That is, however, not the focus of this Paper.

2. Corrective Action Plan to Arrest Increasing NPAs

2.1 Early Recognition of Stress and Setting up of Central Repository of Information on Large Credits (CRILC)

2.1.1 Before a loan account turns into an NPA, banks should identify incipient stress in the account by creating a new sub-asset category viz. 'Special Mention Accounts' (SMA) in line with instructions issued vide RBI Circular DBS.CO.OSMOS/B.C./4/33.04.006/2002-2003 dated September 12, 2002. Further, within SMA category there should be three sub-categories as given in the table below:

SMA Sub-category	Basis for classification
SMA-NF	Non-financial (NF) signals of incipient stress (Please see Annex)
SMA-1	Principal or interest payment overdue between 31-60 days
SMA-2	Principal or interest payment overdue between 61-90 days

2.1.2 The Reserve Bank of India will set up a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders. The credit information would also include all types of exposures as defined under RBI Circular on Exposure Norms and will therefore, inter alia, include data on lenders' investments in bonds/debentures issued by the borrower/obligor.

2.1.3 Banks will have to furnish credit information to CRILC on all their borrowers having aggregate fund-based and non-fund based exposure of Rs.50 million and above. While all scheduled commercial banks will mandatorily contribute their credit information on their borrowers/customers as above, systemically important non-banking financial companies (NBFC-SI) will also be asked to furnish such information. In addition, banks will have to furnish details of all current accounts of their customers with outstanding balance (debit or credit) of Rs.10 million and above.

2.1.4 Banks will be required to report, among others, the SMA status of the borrower to the CRILC. Individual banks will have to closely monitor the accounts reported as SMA-1 or SMA-NF as these are the early warning signs of weaknesses in the account. They should take up the issue with the borrower with a view to rectifying the deficiencies at the earliest. However, to start with, reporting of an account as SMA-2 by one or more lending banks/NBFC-SIs will trigger the mandatory formation of a Joint Lenders' Forum and formulation of Corrective Action Plan (CAP) as envisioned in the subsequent paragraphs. Banks must put in place a proper Management Information and Reporting System so that any account having principal or interest overdue for more than 60 days gets reported as SMA-2 on the 61st day itself.

2.1.5 It is the intention of the RBI that banks recognise warning signs of weakness in a borrowal account early and in due course would require banks to mandatorily form Joint Lenders' Forum (JLF) and formulate CAP if an account is reported as SMA-NF for three quarters during a year to date or SMA-1 for any two quarters during a year to date, in addition to reporting as SMA-2 during any time. Banks should, therefore, prepare themselves for this development.

2.2 Formation of Joint Lenders' Forum

2.2.1 As soon as an account is reported to CRILC as SMA-2, all lenders, including NBFC-SIs, should form a lenders' committee to be called Joint Lenders' Forum (JLF) under a convener and formulate a joint corrective action plan (CAP) for early resolution of the stress in the account. While the existing Consortium Arrangement for consortium accounts will serve as JLF and the Consortium Leader as convener, for accounts under Multiple Banking Arrangements (MBA), the lender with the highest exposure (fund-based plus non-fund based) will convene JLF at the earliest and facilitate exchange of credit information on the account.

2.2.2 Alternatively, the borrower may request its lender/s, with substantiated grounds, for formation of a JLF if it senses imminent stress. When such a request is received by a bank, the account may be reported as SMA-NF under CRILC. The lenders may then form the JLF immediately.

2.2.3 With a view to limiting the number of JLFs to be formed, it is proposed that JLF formation would be made mandatory for distressed corporate borrowers, engaged in any type of activity, with aggregate fund based and non-fund based exposure of Rs.1000 million and above. Lenders, however, have the option of formation of JLFs even when the aggregate fund-based and non-fund based exposures in an account are less than Rs.1000 million.

2.2.4 All the lenders' should formulate and sign an Agreement (which may be called JLF agreement) incorporating the broad rules for the functioning of the JLF. The JLF should explore the possibility of the borrower setting right the irregularities/weaknesses in the account. The JLF will have the capability/option to invite representatives of the Central/State Government/Project authorities/Local authorities, if they have a role in the implementation of the project financed.

2.2.5 JLF formation and subsequent corrective actions will be mandatory in accounts having aggregate fund-based and non-fund based exposures of Rs.1000 million and above. Even in other cases lenders have to monitor the asset quality and take corrective actions for effective resolution as deemed appropriate, under our extant guidelines.

2.3 Corrective Action Plan (CAP) by JLF

2.3.1 JLF may explore various options to resolve the stress in the account. The intention of this Framework is not to encourage a particular resolution option, e.g. restructuring or recovery, but to arrive at an early and feasible resolution to preserve the economic value of the underlying assets as well as the lenders' loans. The options under Corrective Action Plan (CAP) by the JLF would generally include:

(a) Rectification - Obtaining a specific commitment from the borrower to regularise the account so that the account comes out of SMA status or does not slip into the NPA category, within a specific time period acceptable to the JLF without involving any loss or sacrifice on the part of the existing lenders. If the existing promoters are not in a position to bring in additional money or take any measures to regularise the account, the possibility of getting some other investors to the company may be explored by the JLF in consultation with the borrower. These measures are intended to turn-around the company without any change in terms and conditions of the loan.

(b) Restructuring - Consider the possibility of restructuring the account if it is prima facie viable and the borrower is not a wilful defaulter, i.e., there is no diversion of funds, fraud or malfeasance, etc. At this stage, commitment from promoters for extending their personal guarantees along with their net worth statement supported by copies of legal titles to assets may be obtained along with a declaration that they would not undertake any transaction that would alienate assets without the permission of the JLF. Any deviation from the commitment by the borrowers affecting the security/recoverability of the loans may be treated as a valid factor for initiating recovery process. For this action to be sustainable, the lenders in the JLF may sign an Inter Creditor Agreement (ICA) and also require the borrower to sign the Debtor Creditor Agreement (DCA) which would provide the legal basis for any restructuring process. The formats used by the CDR mechanism for ICA and DCA could be considered, if necessary with appropriate changes. Further, a 'stand still' clause as in the case of CDR mechanism could be stipulated in the agreement to enable a smooth process of restructuring. The ICA may also stipulate that both secured and unsecured creditors need to agree to the final resolution.

(c) Recovery - Once the first two options at (a) and (b) above are seen as not feasible, due recovery process may be resorted to. The JLF may decide the best recovery process to be followed among the various legal and other recovery options available with a view to optimising the efforts and results.

2.3.2 The decisions agreed upon by a minimum of 75% of creditors by value and 60% of creditors by number in the JLF would be considered as the basis for proceeding with the restructuring or recovery action of the account, and will be binding on the lenders under the terms of the ICA.

2.3.3 The JLF is required to arrive at an agreement on the option to be adopted for CAP within 30 days from (i) the date of an account being reported as SMA-2 by one or more lending banks/NBFC-SIs, or (ii) receipt of request from the borrower to form a JLF, with substantiated grounds, if it senses imminent stress. The JLF should sign off the detailed final CAP within the next 30 days from the date of arriving at such an agreement.

2.3.4 If the JLF decides on options (a) or (b), but the account fails to perform as per the agreed terms under option (a) or (b), JLF should initiate recovery under option (c) and accelerated provisioning [as indicated in para 6.3.1] will be applicable in these accounts depending on the asset classification.

3. Restructuring Process

3.1 RBI's extant prudential guidelines on restructuring of advances lay down detailed methodology and norms for restructuring of advances under sole banking as well as multiple/ consortium arrangements. Corporate Debt Restructuring (CDR) mechanism is an institutional but voluntary framework for restructuring of multiple/ consortium advances of banks where even creditors who are not part of CDR system can join by signing transaction to transaction based agreements.

3.2 If the JLF decides on restructuring the account as a CAP, it will refer the account to CDR Cell for restructuring after preliminary viability study.

3.3 In cases of accounts referred to CDR Cell by JLF, lenders who are not members of CDR mechanism will be required to sign transaction to transaction agreement under CDR mechanism for restructuring of a particular account.

3.4 Under extant instructions, CDR Cell is required to make the initial scrutiny of the restructuring proposals. As the preliminary viability of account has already been decided by

JLF, CDR Cell need not duplicate this process and should directly prepare the Techno-Economic Viability (TEV) study and restructuring plan in consultation with JLF within 30 days from the date of reference to it by JLF.

3.5 For accounts with aggregate exposure of less than Rs.5000 million, the above-mentioned restructuring package should be submitted to CDR Empowered Group (EG) for approval. Under extant instructions, CDR EG can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days, which can be extended up to a maximum of 180 days from the date of reference to CDR Cell. However, the cases referred to CDR Cell by JLF will have to be finally decided by the CDR EG within the next 30 days. If approved by CDR EG, the restructuring package should be approved by all lenders and conveyed to the borrower within the next 15 days for implementation.

3.6 For accounts with aggregate exposure of Rs.5000 million and above, the TEV study and restructuring package prepared by CDR Cell will have to be subjected to an evaluation by an Independent Evaluation Committee (IEC)[1] of experts fulfilling certain eligibility conditions. The IEC will look into the viability aspects after ensuring that the terms of restructuring are fair to the lenders. The IEC will be required to give their recommendation in these aspects to the CDR Cell under advice to JLF within a period of 30 days. Thereafter, considering the views of IEC if the JLF decides to go ahead with the restructuring, the same should be communicated to CDR Cell. Thereafter, CDR EG should decide on the approval/modification/rejection within the next 30 days. If approved by CDR EG, the restructuring package should be approved by all lenders and conveyed to the borrower within the next 15 days for implementation.

3.7 Restructuring cases will be taken up by JLF only in respect of assets reported as Standard, SMA or Sub-Standard by one or more lenders of the JLF.

3.8 Wilful defaulters will normally not be eligible for restructuring. However, the JLF may review the reasons for classification of the borrower as a wilful defaulter and satisfy itself that the borrower is in a position to rectify the wilful default. The decision to restructure such cases should however also have the approval of the board/s of individual bank/s within the JLF who have classified the borrower as wilful defaulter.

[1] The constitution of the IEC and the funding needs for payment of fees for independent experts would be decided by Indian Banks' Association (IBA) in consultation with RBI.

3.9 The viability of the account should be determined by the JLF based on acceptable viability benchmarks determined by them. Illustratively, the parameters may include the Debt Equity Ratio, Debt Service Coverage Ratio, Liquidity/Current Ratio and the amount of provision required in lieu of the diminution in the fair value of the restructured advance, etc. Further, the JLF may consider the benchmarks for the viability parameters adopted by the CDR mechanism and adopt the same with suitable adjustments taking into account the fact that different sectors of the economy have different performance indicators.

4. Other Issues/Conditions Relating to Restructuring

4.1 The general principle of restructuring should be that the equity holders bear the first loss rather than the debt holders. With this principle in view and also to ensure more 'skin in the game' of promoters, JLF/CDR may consider the following options when a loan is restructured:

- Possibility of transferring equity of the company by promoters to the lenders to compensate for their sacrifices;
- Promoters infusing more equity into their companies;
- Transfer of the promoters' holdings to a security trustee or an escrow arrangement till turnaround of company. This will enable a change in management control, should lenders favour it.

4.2 In case a corporate has undertaken diversification or expansion of the activities which has resulted in the stress on the core-business of the group, a clause for sale of non-core assets or other assets may be stipulated as a condition for restructuring the account if under the TEV study, the account is likely to become viable on hiving-off of non-core activities and assets.

4.3 For restructuring of dues in respect of listed companies, lenders may be ab-initio compensated for their loss/sacrifice (diminution in fair value of account in net present value terms) by way of issuance of equities of the company upfront, subject to the extant regulations and statutory requirements. In such cases, the restructuring agreement shall not incorporate any right of recompense clause. For unlisted companies, the JLF will have option of either getting equities issued or incorporate suitable 'right to recompense' clause.

4.4 In order to safeguard promoters' control over companies, the equity so issued may bestow 'call' option/'right of first refusal' to the promoters group before the banks sell the same. However, such call option/right of first refusal can only be exercised, after the entire loan and the recompense has been repaid. Further, the price of shares under such call has to be equal to the fair value of the shares at the time of exercise.

4.5 If acquisition of such equity shares results in breaching the extant regulatory Capital Market Exposure (CME) limit, RBI will give exemption to the lenders from the CME limit on a case-by-case basis.

4.6 In order to distinguish the differential security interest available to secured lenders, partially secured lenders and unsecured lenders, the JLF/CDR could consider various options like:

- Prior agreement in the ICA among the above classes of lenders regarding repayments, say, as per an agreed waterfall mechanism;
- A structured agreement stipulating priority of secured creditors;
- Appropriation of repayment proceeds among secured, partially secured and unsecured lenders in certain proportion, say, 50%, 30% and 20%.

The above is only an illustrative list and the JLF may decide on a mutually agreed option. It also needs to be emphasised that while one bank may have a better security interest when it comes to one borrower, the case may be vice versa in the case of another borrower. So, it would be beneficial if lenders appreciate the concerns of fellow lenders and arrive at a mutually agreed option with a view to preserving the economic value of assets. Once an option is agreed upon, the bank having the largest exposure may take the lead in ensuring distribution according to agreed terms once the restructuring package is implemented.

4.7 As regards prudential norms and operational details, RBI's guidelines on CDR Mechanism, including OTS, will be applicable to the extent that they are not inconsistent with this proposed Framework. RBI will also further examine measures to strengthen the capacity under CDR Mechanism.

5. Refinancing of Project Loans

In terms of extant instructions (circular DBOD.No.BP.BC.144/21.04.048-2000 dated February 29, 2000 on 'Income Recognition, Asset Classification, Provisioning and other related matters and Capital Adequacy Standards - Takeout Finance'), banks can refinance their existing infrastructure project loans by entering into take-out financing agreements with any financial institution on a pre-determined basis. Henceforth, RBI may allow infrastructure and other project loans to be refinanced by other institutions which substantially (60% or more of the outstanding loan by value) take over the loan from the existing set of financing banks of the borrowers and the refinancing institution(s) can fix a repayment period by taking into account the life cycle of the project and cash flows from the project. In such cases, even if the revised repayment period is longer than the residual repayment period in the earlier bank's books the account will not be considered as restructured, as long as a proper due diligence has been done by the refinancing bank/institution.

6. Prudential Norms on Asset Classification and Provisioning

6.1 While a restructuring proposal is under consideration by the JLF/CDR, the usual asset classification norm would continue to apply. The process of re- classification of an asset should not stop merely because restructuring proposal is under consideration by the JLF/CDR.

6.2 However, as an incentive for quick implementation of a restructuring package, the special asset classification benefit on restructuring of accounts as per extant instructions would be available for accounts undertaken for restructuring under the JLF framework, subject to adherence to the overall timeframe for approval of restructuring package detailed in paragraphs 3.4 to 3.6 above and implementation of the approved package within 120 days from the date of approval. The asset classification status as on the date of formation of JLF would be the relevant date to decide the asset classification status of the account after implementation of the final restructuring package. As advised to banks vide RBI circular dated May 30, 2013, the special asset classification benefit as above will however be withdrawn for all restructurings with effect from April 1, 2015 with the exception of provisions related to changes in Date of Commencement of Commercial Operations (DCCO) in respect of infrastructure and non-infrastructure project loans.

6.3 Penal Measures for non-adherence

6.3.1 In cases where banks/NBFCs-SIs fail to report SMA status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts e.g., sanctioning additional facilities without genuine reasons, and the accounts subsequently turn into NPAs, RBI may prescribe accelerated provisioning as appended below for these accounts and/or other supervisory actions. The current provisioning requirement and the proposed accelerated provisioning in respect of such non performing accounts are as under:

Asset Classification	**Period as NPA**	**Current provisioning (percentage)**	**Proposed accelerated provisioning (percentage)**
Sub- standard (secured)	Up to 6 months	15	No change
	6 months to 1 year	15	30
Sub-standard (unsecured ab-initio)	Up to 6 months	25 (other than infrastructure loans)	25
		20 (infrastructure loans)	
	6 months to 1 year	25 (other than infrastructure loans)	50
		20 (infrastructure loans)	
Doubtful I	2nd year	25 (secured portion)	50 (secured portion)
		100 (unsecured portion)	100 (unsecured portion)
Doubtful II	3rd & 4th year	40 (secured portion)	100 for both secured and unsecured portions
		100 (unsecured portion)	
Doubtful III	5th year onwards	100	100

6.3.2 Any of the lenders who has agreed to the restructuring decision under the CAP by JLF and is a signatory to the ICA and DCA, but changes their stance later on, or delays/refuses to implement the package, may also be subjected to accelerated provisioning requirement as indicated at para 6.3.1 above, on their exposure to this borrower i.e., if it is classified as an NPA. If the account is standard in those lenders' books, the provisioning requirement will be

5%. Further, any such backtracking by a lender might attract negative supervisory view during Supervisory Review and Evaluation Process.

6.3.3 Presently, asset classification is based on record of recovery at individual banks and provisioning is based on asset classification status at the level of each bank. However, if lenders fail to convene the JLF or fail to agree upon a common CAP within the stipulated time frame, the account will be subjected to accelerated provisioning as indicated at para 6.3.1 above.

6.3.4 If the escrow maintaining bank under JLF/CDR Mechanism does not appropriate proceeds of repayment by the borrower among the lenders as per agreed terms resulting into downgradation of asset classification of the account in books of other lenders, the account with the escrow maintaining bank would attract the asset classification which is lowest among the lending member banks.

7. Wilful Defaulters, Accountability of Promoters / Directors / Auditors

7.1 With a view to ensuring better corporate governance structure in companies and ensuring accountability of independent/professional directors, promoters, auditors, etc. henceforth, the following prudential measures will be applicable:

(a) The provisioning in respect of existing loans/exposures of banks to companies having director/s (other than nominee directors of government/financial institutions brought on board at the time of distress), whose name/s appear more than once in the list of wilful defaulters, will be 5% in cases of standard accounts; if such account is classified as NPA, it will attract accelerated provisioning as indicated at para 6.3.1 above. (In terms of paragraph 2.5 (a) of Master Circular on Wilful Defaulters dated July 1, 2013, no additional facilities should be granted by any bank/FI to the listed wilful defaulters.) This is a prudential measure since the expected losses on exposures to such borrowers are likely to be higher.

(b) With a view to discouraging borrowers/defaulters from being unreasonable and non-cooperative with lenders in their bonafide resolution/recovery efforts, banks may classify such borrowers as non-cooperative borrowers[2], after giving them due notice if satisfactory

[2] *A non-cooperative borrower is broadly one who does not provide necessary information required by a lender to assess its financial health even after 2 reminders; or denies access to securities etc. as per terms of sanction*

clarifications are not furnished. Banks will be required to make higher/accelerated provisioning in respect of new loans/exposures to such borrowers as also new loans/exposures to any other company promoted by such promoters/ directors or to a company on whose board any of the promoter / directors of this non-cooperative borrower is a director. The provisioning applicable in such cases will be at the rate of 5% if it is a standard account and accelerated provisioning as per para 6.3.1 if it is an NPA. This is a prudential measure since the expected losses on exposures to such non-cooperative borrowers are likely to be higher.

(c) RBI will create a database of directors on the boards of companies classified as non-cooperative borrowers for dissemination to lenders.

(d) At present, the list of Suit filed accounts of Wilful Defaulters (Rs.2.5 million and above) is submitted by banks to the Credit Information Companies (CICs) of which they are member(s), who display the same on their respective websites as and when received. The list of non-suit filed accounts of Wilful Defaulters (Rs.2.5 million and above) is confidential and is disseminated by RBI among banks and FIs only for their own use. The current system of banks/FIs reporting names of suit filed accounts of Wilful Defaulters and its availability to the market by CICs/RBI will be enhanced to make it as current as possible, as against the current 3-4 months' time lag from the date of reporting by a bank.

7.2 Banks will have to strictly comply with the existing instructions about formal lodging of complaints with ICAI against company auditors in case of observance of falsification of accounts/wrong certification of stock statement/end-use certificate etc. Pending disciplinary action by ICAI, the complaints will also be received in the RBI for records. The names of the CA firms against whom many complaints have been received from different banks may be flagged for information of all banks. Banks should consider this aspect before assigning any work to them. The names may also be shared with other regulators/MCA/CAG for information.

7.3 Further, banks may seek explanation from advocates who wrongly certify as to clear legal titles in respect of assets or valuers who overstate the security value, by negligence or

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or does not comply with other terms of loan agreements within stipulated period; or is hostile / indifferent / in denial mode to negotiate with the bank on repayment issues; or plays for time by giving false impression that some solution is on horizon; or resorts to vexatious tactics such as litigation to thwart timely resolution of the interest of the lender/s. The borrowers will be given 30 days' notice to clarify their stand before their names are reported as non-cooperative borrowers.

connivance, and if no reply/satisfactory clarification is received from them within one month, they may report their names to IBA for record and necessary action. IBA may circulate the names of such advocates/valuers among its members for consideration before availing of their services in future.

8. Credit Risk Management

8.1 Lenders should carry out their independent and objective credit appraisal in all cases and must not depend on credit appraisal reports prepared by outside consultants, especially the in-house consultants of the borrower company.

8.2 Banks/lenders should carry out sensitivity tests/scenario analysis, especially for infrastructure projects, which should inter alia include project delays and cost overruns. This will aid in taking a view on viability of the project at the time of deciding CAP.

8.3 Lenders should ascertain the source and quality of equity capital brought in by the promoters /shareholders. Multiple leveraging, especially, in infrastructure projects, is a matter of concern as it effectively camouflages the financial ratios such as Debt/Equity ratio, leading to adverse selection of the borrowers. Therefore, lenders should ensure at the time of credit appraisal that debt of the parent company is not infused as equity capital of the subsidiary/SPV.

8.4 While carrying out the credit appraisal, banks should verify as to whether the names of any of the directors of the companies appear in the list of defaulters/ wilful defaulters by way of reference to DIN / PAN etc. Further, in case of any doubt arising on account of identical names, banks should use independent sources for confirmation of the identity of directors rather than seeking declaration from the borrowing company.

8.5 With a view to ensuring proper end-use of funds and preventing diversion/siphoning of funds by the borrowers, lenders could consider engaging auditors for specific certification purpose without relying on certification given by borrower’s auditors. However, this cannot substitute bank’s basic minimum own diligence in the matter.

9. Reinforcement of Regulatory Instructions

9.1 RBI reiterates instructions regarding restrictions placed on banks on extending credit facilities including non-fund based limits, opening of current accounts, etc. to constituents who are not their regular borrowers. Banks must take necessary corrective action in case the above instructions have not been strictly followed. Further, RBI will ensure strict adherence by banks to these instructions. As any breaches of RBI regulations in this regard are likely to vitiate credit discipline, RBI would consider penalising the banks in case of breaches.

9.2 Banks are custodians of public deposits and are therefore expected to make all efforts to protect the value of their assets. Banks are required to extinguish all available means of recovery before writing off any account fully or partly. It is observed that many banks are resorting to technical write off of accounts, which reduces incentives to recover. Banks resorting to partial and technical write-offs should not show the remaining part of the loan as standard asset. With a view to bring in more transparency, henceforth banks would be required to disclose full details of write offs including separate details about technical write offs.

10. Sale of NPAs and ARCs

10.1 ARCs should be construed as a supportive system for stressed asset rather than the last resort to dispose of NPAs by banks. Sale of assets to ARCs at a stage when the assets have good chance of revival and fair amount of realizable value, for rehabilitation and reconstruction is encouraged.

10.2 According to current instructions on sale of financial asset by a bank to ARCs, if the sale is for a value higher than the Net Book Value (NBV), the excess provision is not allowed to be reversed but banks will have to utilise the same to meet the shortfall / loss on account of sale of other financial assets to Securitisation Company (SC) / Reconstruction Company (RC). However, banks are required to provide for any shortfall if the sale value is lower than the NBV. With a view to bringing in uniformity as also incentivising banks to recover appropriate value in respect of their NPAs promptly, the Reserve Bank will allow banks to reverse the excess provision on sale of NPA if the sale is for a value higher than the NBV to its P&L account in the year the amounts are received. Further, as an incentive for early sale of NPAs, the Reserve Bank will allow banks to spread over any shortfall, i.e., if the sale value is lower than the NBV, over a period of two years. This facility of spreading over the shortfall would however be available for NPAs sold up to March 31, 2015 and will be subject to necessary disclosures.

10.3 In terms of extant instructions, floating provisions can be used by banks only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI. The Reserve Bank will allow banks to use floating provisions towards accelerated provisioning /additional provisions incurred at the time of sale of NPAs as per their approved internal policy without obtaining prior permission of RBI.

10.4 The promoters of the company/defaulting borrowers shall be barred from directly/ indirectly buying back the asset from the ARCs. Legal issues involved, if any, would be examined by RBI.

10.5 Current restrictions of Government of India (GOI)/Central Vigilance Commission (CVC) on bilateral sale of assets (by way of private treaty) would be taken up with the Government by suggesting controls as follows:

- Price being not less than the Reserve Price fixed for the asset and after price discovery through one auction.
- Public advertisements of sale in at least 2 leading newspapers inviting offers from anyone who is willing to offer a higher amount.
- If the bilateral sale covers the entire dues to the bank and is with the consent of the borrower, the auction process may be dispensed with.

10.6 Sale of assets between ARCs is not permitted under the SARFAESI Act provisions. In order to encourage liquidity and price discovery of stressed assets, sale of assets between ARCs may be permitted. The issue will be taken up with the Government.

10.7 The ability of the ARCs to raise limited debt funds to rehabilitate units will be considered. This will be accompanied by increasing their minimum level of capitalisation in view of recent liberalisation of FDI ceilings and enhancement of working funds. The ARCs will be encouraged to reach certain minimum level of AUM targets.

10.8 Banks using ARCs as a price discovery vehicle should be more transparent, including by disclosing the Reserve Price and specifying clauses for non-acceptance of bids, etc. If a bid received is above the Reserve Price and also fulfils the other conditions specified, acceptance of that bid would be mandatory.

10.9 Methodologies for Independent Valuation of NAVs of Security Receipts (SRs) will be examined / considered. Further work on this will be done by looking at the valuation methodologies used in this regard and discussion with SEBI, Institution of Valuers, etc.

10.10 Large designated NBFCs could be allowed to assign stressed assets to ARCs. If any of these designated NBFCs are not notified under the SARFAESI Act, the issue of their notification will be taken up with the Government. However, a bank /NBFC cannot sell assets to its own promoted ARC or an ARC where it owns at least 10% equity.

10.11 PE firms and large NBFCs with proven expertise in resolution/recovery may be allowed to participate in auctions through explicit regulatory affirmation. Such entities will have to be provided authority under SARFAESI Act on selective basis to deal with specific assets.

10.12 Appropriate incentive structures (e.g. please see para 10.13 and 11.3) may be built so as to provide greater role to PE firms and other institutions in restructuring of troubled company accounts. These institutions can be expected not only to bring additional funds for restructuring but also bring in expertise for management of the business unit in question.

10.13 In terms of extant instructions, banks are generally not allowed to finance acquisition of promoters' stake in Indian companies. The underlying reasoning being promoters should acquire equity stake from their own sources and not through borrowings. The Reserve Bank would allow banks to extend finance to 'specialized' entities put together for acquisition of troubled companies. The lenders should however ensure that these entities are adequately capitalised.

10.14 Alternatively (or additionally), a specialized institution may be created with equity/ quasi-equity participation of the above entities or international institutions with the Government of India holding a part of the stake. This institution may participate in restructuring of borrowal accounts along with banks and other lenders. Government may take a view on this matter.

10.15 In terms of extant instructions, an NPA in the books of a bank is eligible for sale to other banks only if it has remained as NPA for at least two years in the books of the selling bank. The Reserve Bank will withdraw this minimum holding period for any initial loan sale. However, the bank purchasing the NPA will, have to hold the asset in its books for at least one year before selling the asset.

11. DRTs and Other Recovery Infrastructure

11.1 The issues of large scale vacancies in DRTs and creating of special cadre of officers will be taken up with the Government. The post of Presiding Officers (POs) can be sought to be filled through experienced ex-bankers fulfilling certain eligibility norms.

11.2 Additional DRT benches at centres with large backlogs may be created. A separate bench for speedy disposal of SARFAESI related cases may be established in DRTs. Further, adequate staffing of Recovery Officers may have to be ensured by the Government.

11.3 It is learnt that certain issues relating to acquisition/restructuring of stressed companies where CLB involvement may help have been taken up by IBA. In cases of companies involved in / potentially involved in frauds etc., special privileges by CLB may be considered to protect the new management. The issue will be taken with the Government.

11.4 Recommendation will be made to the Government for establishing Special Courts/ Tribunals to deal with cases involving Section 138 of Negotiable Instruments Act, 1881. Recommendation may also be made to the Government to expedite setting up of special benches in every High Court for corporate cases.

11.5 Currently security registration, especially registered mortgages, is done at district level and Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) is generally used to register equitable mortgages. The Government mandate to register all types of mortgages with CERSAI will have to be strictly enforced among banks and NBFCs.

11.6 To address resource issues of CERSAI, RBI will take up the issue of funding with GOI for enhancing its human resource and technology upgradation.

11.7 The issue of tax claims and other authorities, workers claims etc. getting raised at the last moment and seeking ‘priority’ over secured creditors or getting ‘stay’ order distort the recovery measures initiated by the lenders. The matter will be taken up with Government for fixing ‘limits’ to such claims.

11.8 In case of default in infrastructure project loans, where termination notice is issued to the project authority calling for payment of Debt Due, the termination payment is received after a lengthy procedure.The Government may be requested to review the procedure.

12. Board oversight

12.1 The Board of Directors should take all necessary steps to arrest the deteriorating asset quality in banks and should focus on improving the credit risk management system. Early recognition of problems in asset quality and resolution envisaged in this paper requires the lenders to be proactive and make use of CRILC as soon as it becomes functional.

12.2 Boards should put in place a policy for timely providing of credit information to and access of credit information from CRILC, prompt formation of JLFs, monitoring the progress of JLFs and periodical review of the above policy.

12.3 The boards of banks should put in place a system for proper and timely classification of borrowers as wilful or/and non-cooperative. Further, boards should review the accounts classified as such.

Annex

Non-financial Signals of Stress

Illustrative list of any one of the following signals that may lead to categorise an account as SMA-NF:

1. Delay of 90 days or more in (a) submission of stock statement / other stipulated operating control statements or (b) credit monitoring or financial statements or (c) non-renewal of facilities based on audited financials.

2. Actual sales / operating profits falling short of projections accepted for loan sanction by 40% or more; or a single event of non-cooperation / prevention from conduct of stock audits by banks; or reduction of Drawing Power (DP) by 20% or more after a stock audit; or evidence of diversion of funds for unapproved purpose; or drop in internal risk rating by 2 or more notches in a single review.

3. Return of 3 or more cheques (or electronic debit instructions) issued by borrowers in 30 days, on grounds of non-availability of balance / DP in the account or return of 3 or more bills / cheques discounted or sent under collection by the borrower.

4. Devolvement of Deferred Payment Guarantee (DPG) instalments or LCs or invocation of BGs and its non-payment within 15 days.

5. Third request for extension of time either for creation or perfection of securities as against time specified in original sanction terms or compliance with any other terms and conditions of sanction.

6. Increase in frequency of overdrafts in current accounts.

7. The borrower reporting stress in the business and financials.