

## **Wilful defaulters and action thereagainst**

DBOD. No..DL(W).BC ./110 /20.16.003(1)/2001-02

May 30, 2002

### **All Scheduled Commercial Banks and All Notified All-India Financial Institutions**

Dear Sir,

#### **Wilful defaulters and action thereagainst**

Please refer to our Circular DBOD.No.BC.DL(W)12/20.16.002(1)/98-99 dated February 20, 1999 (copy enclosed) which, *inter alia*, defines the term "wilful default" and also lays down the system for the banks and the notified financial institutions to identify and report periodically certain particulars of the wilful defaulters to RBI.

2. Considering the concerns expressed over the persistence of wilful default in the financial system in the 8<sup>th</sup> Report of the Parliament's Standing Committee on Finance on Financial Institutions, the Reserve Bank of India had, in consultation with the Government of India, constituted in May 2001 a Working Group on Wilful Defaulters (WGWD) under the Chairmanship of Shri S. S. Kohli, the then Chairman of the Indian Banks' Association, for examining some of the recommendations of the Committee. The Group submitted its report in November 2001. The recommendations of the WGWD were further examined by an In House Working Group constituted by the Reserve Bank and we now advise, for implementation, with immediate effect, as under.

#### **Definitions**

3. It has been decided to redefine the term "wilful default", in supersession of the definition / illustrations contained in the Circular DBOD.No.BC.DL(W)12/ 20.16.002(1)/ 98-99 dated February 20, 1999, as follows:

“A wilful default would be deemed to have occurred if any of the following events is noted :-

- (a) the unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.

- (b) The 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.
- (c) The unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that 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 and siphoning of funds**

4. It has also been decided that the terms “diversion of funds” and “siphoning of funds” should be construed to mean the following:-

4.1 **Diversion of funds**, referred to at para 3(b) above, would be construed to include any one of the undernoted occurrences:

- (a) utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
- (b) deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;
- (c) transferring funds to the subsidiaries / Group companies or other corporates by whatever modalities;
- (d) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
- (e) investment in other companies by way of acquiring equities / debt instruments without approval of lenders;
- (f) shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

4.2 **Siphoning of funds**, referred to at para 3(c) above, should be construed to occur if any funds borrowed from banks / Fis are utilised for purposes un-related 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.

### **Cut-off limits**

5. While the penal measures indicated at para 7 below would normally be attracted by all the borrowers identified as wilful defaulters or the promoters involved in diversion / siphoning of funds, keeping in view the present limit of Rs. 25 lakh fixed by the Central Vigilance Commission for reporting of cases of wilful default by the banks/FIs to RBI, any wilful

defaulter with an outstanding balance of Rs. 25 lakh or more, as on the date of this circular, would attract the penal measures stipulated at para 7 below. This limit of Rs. 25 lakh may also be applied for the purpose of taking cognisance of the instances of 'siphoning' / 'diversion' of funds.

### **End-use of Funds**

6. In cases of project financing, the banks / FIs seek to ensure end use of funds by, *inter alia*, obtaining certification from the Chartered Accountants for the purpose. In case of short-term corporate / clean loans, such an approach ought to be supplemented by 'due diligence' on the part of lenders themselves, and to the extent possible, such loans should be limited to only those borrowers whose integrity and reliability were above board. The banks and FIs, therefore, should not depend entirely on the certificates issued by the Chartered Accountants but strengthen their internal controls and the credit risk management system to enhance the quality of their loan portfolio. Needless to say, ensuring end-use of funds by the banks and the FIs should form a part of their loan policy document for which appropriate measures should be put in place. The following are some of the **illustrative measures** that could be taken by the lenders for monitoring and ensuring end-use of funds:

- (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 the credit-administration.

**(This list of measures is only illustrative and by no means exhaustive.)**

### **Penal measures**

7. In order to prevent the access to the capital markets by the wilful defaulters, a copy of the list of wilful defaulters would henceforth be forwarded by RBI to SEBI as well. It has also been decided that the following measures should be initiated by the banks and FIs against the wilful defaulters identified as per the definition indicated at paragraph 3 above:

- a) No additional facilities should be granted by any bank / FI to the listed wilful defaulters. In addition, the **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 the scheduled commercial banks, Development Financial Institutions, Government owned 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 RBI.
- b) The 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, the 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 as per the definition at paragraph 3 above and that 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 would be imperative on the part of the 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 the penal action.

**8.** While dealing with wilful default of a single borrowing company in a Group, the 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 the guarantees furnished by the companies within the Group on behalf of the wilfully defaulting units are not honoured when invoked by the banks / FIs, such Group companies should also be reckoned as wilful defaulters.

### **Role of auditors**

**9.** In case any falsification of accounts on the part of the borrowers is observed by the banks / FIs, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) if it is observed that the auditors were negligent or deficient in conducting the audit to enable the ICAI to examine and fix accountability of the auditors.

**10.** With a view to monitoring the end-use of funds, if the lenders desire a 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 the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers / auditors.

**Reporting to RBI**

**11.** Consequent to the change in the definition of wilful defaulters vide para 3 above, the banks and the notified FIs are advised to compile the list of wilful defaulters, to be submitted to RBI as per extant instructions, as on 31 March 2002, as per the revised definition.

**12.** Please acknowledge receipt.

Yours faithfully,

(C. R. Muralidharan)  
Chief General Manager