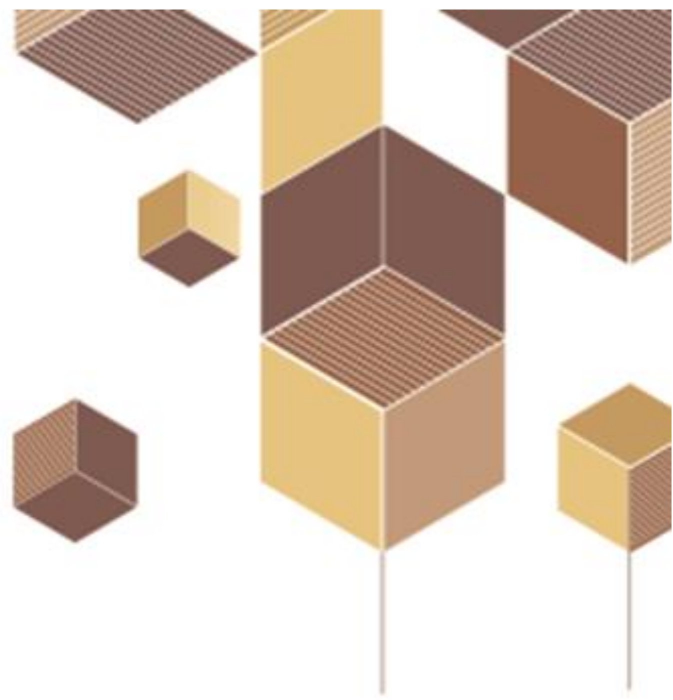

RESOLVING THE NPA CRISIS – SOME ACTION POINTS FOR REFORM

A BRIEFING REPORT SUBMITTED TO THE RESERVE BANK OF INDIA

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October 2014 www.vidhilegalpolicy.in

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Anjali Anchayil, Yashaswini Mittal, Shubhangi Bhadada, Faiza Rahman and Sowjhanya Shankar provided research assistance on parts of this report.

Acknowledgments

We wish to thank Mr. M. Damodaran, Dr. P.J. Nayak, Mr. Ashwin Ramanathan, and Dr. Kristin van Zwieten for several invaluable discussions.

All views expressed in this report (including any errors and omissions) are the Authors' alone.

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1. INTRODUCTORY NOTE

The prevalence of non-performing assets ("**NPAs**") in the Indian banking sector may be attributable to several factors.[1] According to neoclassical economists, non-payment of loans is largely motivated by financial difficulty of the firm in question.[2] This view suggests that NPAs can be minimised by 'enforcing punishments and strengthening the assessment of credit risk'[3]. However, if banks don't have good incentives to correctly evaluate a debtor's prospects of success *ex ante*, monitor the company effectively through-out the existence of the loan and swiftly exercise enforcement/liquidation rights when required, the law is unlikely to work as predicted, even if it is well-drafted.[4] The 'normalisation perspective' suggests that when deviant behaviour becomes the norm in a business community (which may partially be attributable to the manner in which the law operates in practice), the tendency of players to engage in such behaviour increases.[5] In the context of the NPA problem, when non-payment of debt becomes an 'institutional routine' in the community (due to ineffective enforcement rights of the creditors, weak liquidation regime, etc.) more and more players tend to engage in such behaviour. Similarly, when certain banks benefit from implicit and explicit guarantees from the State (in the form of bail-outs, tax exemptions, regulatory interventions that may inadvertently promote forbearance, etc.), loan performance may not be as much of a focus in the management practices of those banks (especially, when the economic environment is good). While the Reserve Bank of India ("**RBI**") has initiated several reform measures over the last year or so to address the situation, anecdotal evidence suggests that several practices of the banks and debtors which may have contributed to the crisis remain widespread.

While suggesting measures to counter all factors responsible for such 'normalisation' may be outside the scope of this Report, we adopt a multi-pronged approach to address a host of demand-side and supply-side issues, which may have directly or indirectly contributed to the problem. Such issues include weak monitoring by banks, delayed intervention, inefficient attempts at restructuring, regulatory arbitrage, and the legal bottlenecks affecting the recovery mechanisms. In Section 2 of the Report, we discuss some monitoring and compensation models which may be implemented by Indian banks, complemented by appropriate sanctions

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[1] RBI Annual Report 2013-14 notes that although there has been an increase in NPAs in the recent years, the health of the banking sector remains satisfactory (August 21, 2014), pp.81-84. It may be noted that anecdotal evidence suggests that the total amount of distressed debt (as against just NPAs) in the banking sector may be at far greater levels.

[2] Jintao Li & Carmen K. Ng., The Normalisation of Deviant Organisational Practices: The Non-performing Loans Problem in China, Journal of Business Ethics 114 (2013) 643–653, p. 645.

[3] *Id.*

[4] NPAs may be influenced by macroeconomic conditions as well. Berger and Young note that "loan quality problems may be caused by events exogenous to the bank, such as regional economic downturns, in which case extra expenses associated with the non-performing loans (e.g. monitoring, negotiating workout arrangements, seizing and disposing of collateral, diverted senior managerial focus) can create the appearance, if not the reality, of low cost efficiency" at banks. Allen N. Berger and Robert DeYoung, Problem Loans and Cost Efficiency in Commercial Banks, Journal of Banking and Finance (1997).

[5] *Id.*

by the RBI in cases of non-compliance. In Section 3, we examine the out-of-court mechanisms for reconstruction and suggest measures for making them more effective (in line with certain international approaches). In Section 4, we discuss issues relating to recovery and asset reconstruction under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI Act**") and provide recommendations for making the system more robust and less prone to regulatory arbitrage. In Section 5, we examine the functioning of the Debt Recovery tribunals under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ("**RDDBI Act**") and suggest measures for improving their functioning and maximising recoveries. Finally, in Section 6 of the Report, we analyse issues, which albeit not directly linked to the NPA problem, offer some opportunities for mitigating the situation and preventing reoccurrences in the future (for instance, issues like the manner in which the debt bias of the taxation regime may be influencing the funding decisions of businesses).

The Report attempts to highlight a wide range of issues at a broad level and makes several recommendations for reform. It is submitted that in order to translate those recommendations into concrete policies and regulations, far greater work may be required. While some of our recommendations may be implemented by RBI on its own, several others will require legislative changes.

2. Early Detection, Supervision and Intervention

One of the primary theoretical rationales advanced for the existence of banks emphasises the economies of scale and scope banks are able to achieve in monitoring and screening borrowers.[6] Theory also predicts that it is in the interests of a bank to effectively monitor its debtors in order to meet the extremely liquid obligations it creates on the liabilities side - retail deposits drawable on demand.[7] To the extent these theoretical predictions do not bear out in reality, there is a market failure in play –the negative externality arising out of the fact that the bank (and its shareholders) do not absorb (some or all) the costs of its failing. While the gains of increased debt creation are appropriated privately by bank equity-holders in the form of increased P&L, the cost of failed loans and subsequent bank failure is collectivised – the most egregious example of such collectivisation being the public bailout of a privately held bank.

There have been several different approaches taken internationally in order to bolster the screening/monitoring function performed by banks. At the heart of all these approaches has been the issue of how this externality can be addressed in the most effective manner. Direct approaches aim at directly enhancing the quality and intensity of screening and monitoring of borrowers performed by banks by stipulating minimum standards, sanctions for breach and incentives for complying with enhanced standards. Indirect approaches seek to address the issues/incentives, which underlie the negative externality and/or try to ameliorate its effects.

[6] Douglas W. Diamond, Financial Intermediation and Delegated Monitoring, Review of Economic Studies (July 1984).

[7] Douglas W. Diamond and Raghuram Rajan, Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking, Journal of Political Economy (April 2001).

2.1. Bolstering Internal Systems/Process Requirements

Subsequent to the financial crisis in 2008, there has been an increased focus by regulators internationally on the internal risk processes and controls employed by Banks. This global regulatory effort has gone hand in hand with the efforts at bolstering and standardising the internal risk weights assigned by banks to the exposures they undertake. As part of the Basel III reforms, changes have been made to the way banks determine the riskiness of an asset – both on the banking book (which is more directly related to the NPA issue) and the trading book. Changes to the banking book mean that in order to obtain the most favorable capital treatment, banks have to migrate to using sophisticated formulae for measuring credit risk and determine measures for Probability of Default (PD), Loss Given Default (LGD), Earnings and Default (EAD) and Marturity (M). In addition to requiring these measures at the threshold stage, Basel III also mandates that only coupled with robust internal risk management systems and data will banks be afforded the maximum capital benefit.[8]

As an active participant in the Basel III reform process, the RBI needs no introduction to the content of the minimum capital requirements –"Pillar I" of Basel III. However, what may be useful to adapt from other jurisdictions in this context is the practices and policies developed as part of the "Pillar II" of Basel III which relates to the qualitative supervision by regulators of internal bank risk procedures, including, as outcomes to such supervision, the ability to require the provision of more capital. Regulators have developed several measures in order to bolster Pillar II of Basel III including in depth regulatory visits and detailed audit of bank risk control systems, ongoing monitoring of bank compliance with internal risk requirements and cross sector consistency checks in order to ensure that consistent risk weightings are used by banks while dealing with similar risks. Regulators in the United States ("**US**") and the United Kingdom ("**UK**") in particular have been extremely pro-active in obtaining increased data from banks and conducting periodic reviews of the information received.[9] Banks have beefed up their internal risk systems keeping in mind the regulatory push and in order to gain a competitive advantage and management consultancy firms have developed best practices in this regard in order to respond to this client demand.[10] The means of adopting these international best practices could be by way of stipulating minimum conditions for internal bank systems or a combination of carrots and sticks for adhering to higher standards or falling below minimum acceptable thresholds.

One of the techniques developed in this regard is a rules based "early warning system" to monitor the outstanding credit exposure of banks. The system (the details of which will obviously vary from bank to bank) involves setting up a sophisticated IT/operational system to aggregate and monitor all important data in relation to an individual customer and a set of "soft" factors such as establishing processes within the bank to appropriately monitor the information and take swift remedial action. The early warning system identifies and selects-

[8] Latham and Watkins, Understanding Basel III, <www.lw.com/presentations/understanding-basel-III-2014

[9] UK, see: http://www.bankofengland.co.uk/pra/pages/crdiv/default.aspx and USA, see: http://www.federalreserve.gov/bankinforeg/basel/USImplementation.htm

[10] McKinsey and Company, Working Papers on Risk, Number 37, First-mover Matters: Building credit monitoring for competitive advantage, (2012)

on the basis of pre-defined and non-discretionary rules - potential clients who may be liable to default purely based on statistical and empirical triggers. The statistical system is updated constantly to reflect good and bad news about the relevant credit. Once selected by early warning system, the cases are closely monitored by a specially constituted monitoring committee which is given independence and discretion within the bank's decision making process to take swift remedial actions it deems necessary. The crucial advantage of such an early warning system is that it is based on an IT/statistical systems and an independent monitoring committee – both of which are less prone to manipulation by interested officers and both of which are susceptible to easier review and audit by the regulator. Clearly, the details of a system such as this are beyond the scope of the present briefing paper.

The RBI has recently laid down guidelines for early recognition of financial distress, taking prompt steps for resolution, and ensuring fair recovery for lending institutions.[11] Before a loan account turns into an NPA, banks are required to identify incipient stress in the account by creating three sub-categories under the Special Mention Account ("**SMA**") category. Banks are also required to report certain credit information pertaining to a class of borrowers to the 'Central Repository of Information on Large Credits' ("**CRILC**"). These guidelines envisage the mandatory setting up of a Joint Lenders' Forum ("**JLF**") by lending banks if the principal or interest payment on the loan account is overdue for 31- 60 days and the aggregate exposure of lenders in that account is Rs. 1000 million and above.[12]

Recommendations: The CRILC mechanism should be strengthened further by requiring banks to implement the IT/statistical systems discussed above. More specifically, the criteria for identifying non-financial signals of stress (for SMA-0) should be reviewed periodically and more factors may be added (for instance, information about pending court cases, regulatory issues which may expose the borrower to huge downside risks, macroeconomic factors which may affect borrowers operating in particular sectors). Given that the borrowers may underestimate the risks associated with some of their actions and may not notify in time, a reporting obligation on the auditors of the borrowers may also be considered. Further, the RBI may consider conducting periodic audits of the implementation of the system to address failings in individual banks, and impose penalties on the banks and the concerned officials in appropriate cases (see Section 2.3 below). The RBI could also link the implementation and effectiveness of such systems to regulatory capital benefits/burdens in order to incentivise the banks appropriately.

2.2. Risk based Compensation Arrangements for Senior Management

Another regulatory response to the financial crisis has been the introduction of risk sensitive compensation structures for senior management members in banks. Indeed, several jurisdictions now require such risk based incentive schemes to be introduced for even lower

[11] Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lender's Forum (JLF) and Corrective Action Plan (CAP) – RBI Circular No. DBOD.BP.BC.No.97/21.04.132/2013-14 dated February 26, 2014.

[12] Please note that lenders can also form a JLF even when the AE in an account is less than Rs. 1000 million and/or when the account is reported as SMA-0 or SMA-1.

ranking business functions within a bank. The regulatory efforts arose from the widely held view post-crisis that the existing incentive structures in banks greatly incentivised short term risk taking and did not adequately factor in the potential costs of such risk taking in determining the quantum of executive compensation. This, coupled with high executive turnover meant that individuals in banks were able to reap the benefits of the increased P&L arising from additional exposure in the short term but were not required to bear any downside in respect of losses which only crystallised several years down the line. Arguably, such practices may be prevalent in India as well.

Regulatory measures have been introduced in several developed countries in order to address this issue. Measures include the requirement that incentive- aligning stock option packages paid to bank managers be “risk adjusted”. Compensation Committees have been made mandatory on the boards of large banks and directors are held responsible for breaches of bank compensation policy. The EU has imposed several stringent requirements around the bonus percentage payable to certain key bank functions. The US and the UK, while not adopting the EU’s strict bonus rules have enhanced the disclosure requirements, mandated that compensation be risk adjusted (using some measure of VaR), introduced clawback mechanisms which permit bank management/regulators to claw back bonuses paid in earlier years which turn out to have been improperly risk adjusted.[13] All of these measures, in combination, it is hoped will boost the screening and monitoring function performed by bank functionaries and restrict the short termism of such individuals.

In the Indian context, while all the international regulatory developments may not be relevant, certain useful lessons can certainly be learnt from them.

Recommendations: The NPA crisis could be attributable to some form of short termism among bank officials in India – although the cause of such short termism may not solely lie in the compensation structures faced by such officials- issues such as the tenure of senior bank officials, the absence of any downside risks faced by officials for lending decisions which ultimately end up as NPAs need to be analysed and if applicable, the relevant international regulatory responses can be adapted to work in the Indian context. The two-year chairmanship model existing in public sector banks may create perverse incentives for management decisions of ‘providing and holding’. This problem can be countered by either extending the tenure of the chairman position in public sector banks or by providing performance incentives to management upon reduction in non-performing loan levels of the bank. This of course would have to be coupled with robust accounting and provisioning norms, which prevent potential bad assets from being repackaged into standard assets without proper risk assessment and provisions.

2.3. RBI’s Powers to Impose Penalties

Subsequent to the financial crisis in 2008, most countries, including the US and the UK, have been in the process of revamping their financial sector laws to ensure that it is better regulated and the mistakes of the pre-recession era are not repeated. In 2013, the Parliamentary

[13]http://www.bloomberg.com/news/2014-09-07/eu-banks-sidestepping-bonus-limits-face-regulatory-crackdown.html

Commission on Banking Standards in the UK published a report "Changing Banking for Good", (the "**Report**") which examined the professional standards and culture of the UK banking sector and made recommendations for legislative reforms. It specifically dealt with the role that sanctions and enforcement mechanisms can play in deterring wrongful behaviour in the banking sector. The Report looked at the previous practises related to enforcement against banks and their senior officers, pointing out the shortcomings in the regulatory regime and suggested changes for making the enforcement mechanism more effective.

The Report concluded that effective enforcement action against banks represents an important pillar of the overall approach to enforcement and also serves as the gateway to enforcement action against responsible individuals. It noted that effective enforcement action can also draw wider attention to a failure, providing incentives for banks to strive to maintain high standards, and establish penalties when a bank violates these standards. Specifically, looking at the level of fines previously imposed on banks by regulators, it was noted *that "the level of fines historically have done little to dent bank balance sheets"* and that *"[i]f the penalty were only monetary and only on the firm, the great danger is that the firm will simply see this as a cost of doing business"*.

In addition, the Report looked at the issue of enforcement action against responsible individuals, who hold senior positions in the financial institutions. Issues such as the range of individuals who should be covered under the penal provisions, including how complex decisions would be traced back to the responsible individuals; the possible punitive actions that could be taken against such individuals, including interim prohibition to work in the industry; the standard of evidence required for prosecuting such individuals; etc., were also discussed in the Report.

Lack of effective sanctions gives purchase to the idea that banks or other financial institutions are too big or complex to sanction. Arguably, this is against public interest and reduces public confidence in the financial sector as a whole. The UK Report on Banking Standards has also acknowledged that failure to impose sanctions on "too big to fail" institutions is against public interest.[14]

In the context of the NPA crisis, enforcement powers of the RBI may be used to prevent indiscriminate lending, and ineffective 'monitoring and intervention' by bank officials. However, RBI's enforcement powers under the Reserve Bank of India Act, 1934 ("**RBI Act**") and the Banking Regulation Act, 1949 ("**Banking Regulation Act**") are not robust enough to enable a calibrated response. Although RBI has the power to cancel licenses, initiate prosecutions, etc. such measures may be difficult to implement in practice (due to several externalities). Further, the enforcement powers of the RBI should lead to such consequences that financial institutions are not able to set them off as a 'business cost'. This not only requires higher levels of fines (ideally linked to the profits, so that the cost of non-compliance is not passed on to outsiders) than those currently prescribed, but also greater flexibility for the regulator to impose those fines, taking into account both aggravating and mitigating factors. Further, a protracted process of enforcement against the banks may defeat the process of

[14]See Chapter 10, Sanctions and Enforcement, "Changing Banking for Good", Parliamentary Commission on Banking Standards, Vol. II (12 June 2013), *available at* http://www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf.

holding individuals responsible, which would normally take place only after the completion of enforcement action against the institution. Thus, swift resolution of enforcement action is also crucial for ensuring deterrence.[15]

Recommendations: There is considerable scope to amend the RBI Act and the Banking Regulation Act to bring RBI's enforcement powers in line with international best practices to deter violations (especially in relation to actions/inaction of senior officials).[16] Such measures may go a long way in preventing practices which may have contributed to the present NPA crisis.

3. Restructuring Mechanisms

3.1. Joint Lenders' Forum

The JLF mechanism allows lenders to explore various options to resolve the stress in the account with the intention of arriving at an early and feasible solution to preserve the economic value of the underlying assets as well as the lenders' loans. Such options include restructuring of the account if it is prima facie viable and the borrower is not a wilful defaulter, and recovery if the restructuring procedure does not appear feasible to the participating lenders.

The JLF is similar to the London Approach, an informal solution developed in the 1970s under the aegis of the Bank of England, which provides for multi-bank support for financially troubled companies.[17] The London Approach relied on complete information sharing, consensus building and coordinated action between banks and other creditors to reach a solution (Finch). The London Approach has been criticised for: (a) its extremely high implementation costs; (b) lack of formal moratorium[18]; (c) need for unanimous support from the affected creditors; and (d) difficulties in coordination with creditors, particularly with the fragmentation of the financing in later years. The London Approach worked because it dealt with debtors with relatively concentrated debt owed to institutional lenders, where those lenders had relatively homogeneous incentives (Armour and Deakin). Such creditors could coordinate a solution for financial distress without any need to have recourse to a formal insolvency or restructuring procedure (assuming, that non-institutional creditors were

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[15]Similar suggestions have also been made in the Sanctions and Enforcement section of the UK Parliamentary Commission on Banking Standards Report. For further details, see *id.*, at pp. 495-497.

[16] It may be noted that the level and details of such penalties is outside the scope of this Report. We shall address them in a separate report.

[17] It must be noted that the JLF, unlike the London Approach is not an informal solution, but an out-of-court restructuring framework developed by the RBI.

[18] Although, a moratorium should not be required if the affected lenders agreed a standstill between themselves, and debts to other creditors (e.g. trade creditors) were paid as and when they fell due: so there may be no need to stay enforcement action by those other creditors (Armour and Deakin).

unaffected). This model may not work in case of fragmented debt or where the incentives of the creditors are different. Coordination between creditors in such cases is much harder.

However, this approach has been successful in providing a means of rescue that avoids delays, expenses of formal actions and gives the necessary flexibility to both creditors and the debtor company (Finch). The London Approach has been adopted in a modified form in many countries.[19] In the countries where the London approach has been adopted, modifications have provided for a structured framework that incentivises restructurings, including measures such as regulatory suasion, arbitration of disputes, and penalties for failures to meet deadlines for the workout process (IMF Staff Note).

The UK experience with the London Approach, holds some lessons which the JLF approach should consider. Banks have cooperated in a London Approach rescue, largely due to informal pressures exerted by the Bank of England[20] and the reputational harm for banks themselves from non-cooperation. The Bank of England has been known to act as a "neutral intermediary" and "Chairman", often using its good offices to drive discussions through banks and exert pressure on dissenting banks (Finch). Finch notes that if the dissenting banks are foreign banks, the Bank of England has been prepared to talk to their national regulators in order to convince them. Further, she says that, *"Individual banks may fear that if they act obstructively, the banking community will exclude them from further profitable deals or deny them future co-operation."*[21]

Recommendation: It is submitted that the RBI could play a role similar to that played by the Bank of England, to ensure that: (i) banks are discouraged from enforcing debts and precipitating the debtor's insolvency and consequent liquidation, where the business is viable; (ii) banks co-operate to share information and act in coordination to rescue the debtor's business; (iii) where rescue is not feasible, the recovery process maximises returns to all creditors. Further, informal pressures placed on banks from the banking community itself could prevent hold-out strategies by lenders in the JLF. In this regard, RBI should consider requiring the banking community to develop a 'Statement of Principles' or a 'Code of Best Practices' for efficient functioning of the JLF system and back them up with appropriate sanctions for breach. The RBI may also consider consulting the Bank of England and the Financial Services Authority to ensure that the JLF model is informed by the regulator's experience with the London Approach over the years.

3.1.1. Turnaround Specialists

Company Doctors/Turnaround Specialists have become increasingly popular in international restructuring and recovery processes. They are essentially professionals skilled in the

[19] Examples include Indonesia, Korea, Malaysia and Thailand (Thomas Laryea, Approaches to Corporate Debt Restructuring in the Wake of Financial Crises, IMF Staff Note, January 2010, SPN/10/02, available at http://www.imf.org/external/pubs/ft/spn/2010/spn1002.pdf).

[20] The Bank of England's role as the banking regulator was transferred to the Financial Services Authority in June 1998.

[21] V Finch, Corporate Insolvency Law: Perspectives and Principles (Cambridge University Press, 2nd edn., 2009).

mechanics of turning around a struggling business. The key for the success of a company doctor or a turnaround specialist is that they are brought in early enough in the process such that their efforts can salvage the economic value in the company. They may either be appointed by the lending banks or by the incumbent management itself. Although, where the company's debt structure is highly leveraged, it is more likely that the lending banks appoint the turnaround specialists who act on behalf of the banks rather than the incumbent management. Turnaround Specialists are particularly useful in the context of companies suffering from idiosyncratic rather than systemic issues. Since they are essentially generalists adept at dealing with companies in distress, they may not have the level of in depth knowledge of the distressed company's particular area of operation. In this context, it is crucial to note, that turnaround specialists are generally more successful when they operate with the advice and guidance of the incumbent management. Since they are external parties, they are able to bring in a fresh perspective to the issues faced by the distressed company and since they operate across sectors, they also have the benefit of being able to look at broader "macro" issues and trends which often entrenched incumbent management fails to perceive.

Recommendation: (a) In the context of the JLF mechanism, banks participating in a particular JLF may, as part of the CAP for the company, consider appointing turnaround specialists to run the company on behalf of the banking consortium with a view to turning the distressed business around. Again, as noted above, some of the key ingredients needed for a successful turn include - the turnaround specialist being appointed sufficiently early, she being given maximum flexibility and discretion to take decisions in respect of the business, being able to obtain the advice and input of the incumbent management in respect of the industry specific aspects of the distressed company and also get some upside benefit in the event of a successful turnaround. (b) Turnaround specialists may also be utilised for restructuring alternatives discussed in Section 4.1.4 below. (c) RBI may consider consulting international agencies like INSOL (an international association of restructuring, insolvency and bankruptcy professionals) and the OECD to advise the Government in developing a market for such specialists in India.

3.1.2. 'Loan to Own' Strategies – Distressed Debt Trading in US and Europe

A strategy which has proved popular recently in the US and Europe, in the context of companies with a significant amount of traded debt is the "loan to own" or "distressed debt trading" strategy. This involves the acquisition of the debt of a distressed company in the secondary loan or bond market by the distressed debt trading firm – which is essentially a type of Private Equity ("**PE**") firm. Once the distressed debt trading firm acquires a sufficient majority in the outstanding debt of the distressed company, the firm utilises one of several legal techniques (which could range from an out of court creditor meeting, consensual agreement with the incumbent equity-holders and management or a court orchestrated "Scheme of Arrangement") to convert their majority debt holding into equity in the distressed business thereby acquiring control of the business. Hence the name "loan to own". Once in control, the turnaround process works similar to a PE investment, except that the capital structure of the business is relatively free of debt, the free cash flow status of the company is much better and the acquiring firm is able to re-invest substantial portions of the retained earnings back into the business.

In order for this strategy to be successful, the distressed debt trading firm needs to believe that there is economic value in the distressed company which is being unutilised as a result of either the overleveraged capital structure of the company or the inefficient incumbent management of the company. In such 'Loan to Own' strategies it is very uncommon for the incumbent management to stay and be a part of the turnaround process. This is because, the operating philosophy of the distressed trading company is fundamentally different to the incumbent management and the former firmly believes that it brings an advantage in running the distressed company which the incumbent management was not able to deliver. Further, the legal regime applicable to the distressed company needs to be able to support this high risk strategy of the distressed debt trading firm. The legal and extra-legal processes by which it converts its debt position into equity need to be robust, certain and not subject to excessive delay or judicial discretion. Court approved "Schemes of Arrangements" and out of court creditor agreements have been the most popular legal techniques utilised internationally.

Recommendation: The RBI may consider permitting such 'Loan to Own' trading through the JLF, as long as the debtor company's interests are also adequately protected.[22]

3.1.3. Chapter XI DIP Financing in the US

Though not technically a process by which the creditor acquires control of the management of the distressed company, the DIP financing technique utilised in the US may be of interest in this context given the similar underlying issues. One of the primary issues which lead to the breakup of economically valuable businesses is the debt overhang problem which entails that any fresh capital (which is needed to bolster the working capital needs of the distressed company and kick start its recovery) is not forthcoming as it will almost entirely be siphoned off in debt payments to the existing creditors. In order to address this issue, the Bankruptcy Code of the United States contains provisions which provides "super priority" to creditors who provide finance to companies in distress (in the US, context, companies which have filed for Chapter XI protection) – i.e., the rescue finance providers will rank ahead of all existing creditors[23]. Any free cash flows generated as a result of the injection of fresh capital will first go toward the DIP financiers and not the existing creditors thereby avoiding the debt overhang problem. The buy-in of the existing creditors is achieved by allowing them to participate in the DIP financing or with equity positions in the distressed companies. This regime has proven reasonably robust in practice in the US (although several lessons need to be learnt from the US experience) and some of the biggest bankruptcies in the recent past including those of Chrysler and General Motors included portions of DIP financing in their structures.

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[22] This kind of strategy assumes the existence of publicly issued debt. Given the underdevelopment of the Indian corporate bond market this strategy may therefore be of limited use in the present climate.

[23] The crucial issue is whether such financier can get priority over existing secured crediotrs, given that the company may have no unencumbered assets. This is possible under the US regime (cf the UK, where fixed charge holders cannot be subjected to such a super priority result without their consent), but the US rules are subject to significant safeguards for existing secured creditors.

Recommendation: As part of the JLF mechanism, consideration could be given as to whether the inclusion of super priority provisions for institutions willing to provide rescue finance to the distressed business is desirable. Inclusion of such mechanisms has the potential to alleviate one of the key failings of the current system - that economically valuable businesses are being unnecessarily dismantled in many cases.

3.2. The CDR Mechanism

The Corporate Debt Restructuring (CDR) mechanism was introduced in 2001 to provide for timely and transparent restructuring of corporate debts outside the formal processes involving courts and tribunals. It aims to preserve viable corporates distressed by certain external and internal aspects as well as minimise losses to creditors and other stakeholders.[24] The CDR mechanism comprises of the CDR Standing Forum, a representative general body of all financial institutions and banks in the CDR mechanism; the CDR Empowered Group, which decides individual cases referred to the mechanism; and the CDR Cell, which carries out the initial scrutiny of the proposals from borrowers or creditors.[25]

Over the past few years the number of cases referred to the CDR Cell has increased from 365 cases, with an aggregate debt of Rs. 182611 crore on December 31, 2011, to 624 cases, with an aggregate debt of Rs. 432843 crore on June 30, 2014; resulting in several concerns being raised regarding the current mechanism in place.[26]

These concerns can be classified into two categories - concerns in the packaging of cases and wider regulatory concerns. Packaging concerns include concerns in the monitoring mechanism, appraisal errors and limited promoter guarantees. Such concerns have resulted in 130 cases with an aggregate debt of Rs. 38686 crore being withdrawn from the CDR Cell as of June 30, 2014. Wider regulatory concerns include sectoral concerns, particularly in the infrastructure sector, stress on public sector banks and delays in exit from the mechanism. These concerns are discussed below with some recommendations provided for addressing the same.

3.2.1. Packaging Issues

A. Monitoring Mechanism

One of the key contributory factors in relation to the monitoring mechanism is the lack of a centralised database to provide information across clients, projects, industries and sectors. This lack of an overall information database allows banks to evade prudential norms issued by the

[24] RBI Master Circular, Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, Annex 4- Organisational Framework for Restructuring of Advances under Consortium/ Multiple Baking/ Syndication Arrangements, July 1, 2014, p. 85.

[25] RBI Master Circular, Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, Annex 4- Organisational Framework for Restructuring of Advances under Consortium/ Multiple Baking/ Syndication Arrangements, July 1, 2014, pp.85 – 89.

[26] CDR Cell Progress Report, June 30, 2014.

RBI resulting in the concealing of inherent credit weakness of accounts, which in turn affects their safeguards against expected losses. Anecdotal evidence suggests that in many cases, the CDR platform is being misused to protect the company without making any efforts to revive payments and in such cases the restructured capital structure is not supported by cash flows.[27] The lack of a centralised database also affects the mechanism's capability to monitor borrowers in order to ensure that they meet their restructuring commitments. Together, these factors result in the failure of the restructuring process, as well as decrease the overall efficiency of the financial industry and increase the industry's susceptibility to external shocks.[28]

Currently, the monitoring mechanism comprises a monitoring institution which monitors all aspects of package implementation; a monitoring committee which is a company specific body that provides recommendations; and external agencies of repute to complement the monitoring activities and carry out a concurrent audit or valuation.[29] Additionally, the RBI initiates Monitorable Action Plans (MAP) to provide risk based supervision of banks for ensuring that corrective action is undertaken in time to mitigate risks and improve the areas identified in the supervisory process.[30]

Recommendation: In order to strengthen the monitoring mechanism currently in place, we recommend the appointment of a team of professionals to regularly populate the centralised database across clients, projects and sectors. We also recommend the facilitation of an independent evaluation committee to conduct post restructuring monitoring, overlook the activities of the three monitoring institutions prevalent under the CDR mechanism and oversee the regular population of the database. Further, we suggest the tightening of norms governing the CDR mechanism in order to address the circumvention of norms together with the rising trends in gross NPAs and net NPAs. Additionally, there should be a defined time frame within which proposals are required to be cleared by participating banks, failing which the package would be deemed approved except in cases of further disbursement.

B. Appraisal Errors

Appraisal errors involved in CDR also contribute significantly towards packaging failures. Statutory requirements necessitate that lenders rely on due diligence at the time of disbursement of loans carried out by professionals and financial service companies. However, the performance and operations of cases are overlooked as due diligence proceedings involved in the assessment of eligibility criteria are subject to Type I and Type II errors of statistics i.e. false negatives and false positives, resulting in *bona fide* projects not being taken in or *mala fide* projects being admitted into the Cell.[31] Additionally, cash flow analyses are prepared with

[27] S. Ravi, 'Why Corporate Debt Restructuring Needs a Revamp', Economic Times (online), April 4, 2014.

[28] Addressed by Dr. K.C. Chakrabarty, Deputy Governor, RBI at the Corporate Debt Restructuring Conference on August 11, 2012, p. 15.

[29] CDR India, 'Monitoring Mechanism', www.cdrindia.org/monitoring.htm

[30] RBI Discussion paper, 'Move Toward Risk Based Supervision of Banks', August 2011.

[31] Addressed by Dr. K.C. Chakrabarty, Deputy Governor, RBI at the Corporate Debt Restructuring Conference on August 11, 2012, pp. 2-3.

the objective of the restructuring plan being acceptable to creditors instead of being based on achievable objective assumptions. Determination of project completion dates are also subject to appraisal errors as uncertainties involved in projects are raised in cases of project delays instead of at the time of appraisal.[32]

Recommendation: We recommend that due diligence for such projects is carried out on a case to case basis to suit the borrower's specific situation by taking into account industry fundamentals and risk, time frames for projects as well as the borrower's projected cash flow. This ensures an objective assessment of each borrower's ability to meet their obligations. Further, reports carried out by industry experts for assessing restructuring proposals should be relied upon for validation purposes.

C. Promoters' Guarantee

A key issue faced by banks in the restructuring of NPAs is the limited enforceability of promoter discipline caused due to the lack of credibility of promoters and disagreement on terms of restructuring. Even after the restructuring process, there are limited steps that banks can undertake to ensure commitment by promoters to revive the company. The Working Group, in its report dated July 18, 2012 prescribed that corporate guarantees cannot be substituted for personal guarantees and recommended the personal guarantees of promoters be made mandatory for all cases of restructuring, including instances where restructuring resulted from external factors pertaining to the economy and industry.[33] Thus, the Working Group's recommendations sought to ensure the promoters' commitment to the restructuring package and increase the promoters' "skin in the game".[34]Although the RBI, vide its circular dated May 20, 2013, has mandated that personal guarantees are obtained in all cases of restructuring,[35] in most cases these guarantees are not supported by the adequate net worth of promoters.[36] As a result, large value frauds arising from the diversion of funds by promoters are continue to take place.[37]

Recommendation: In order to address these cases of fraud, we recommend that the provisions in relation to promoters support should be strengthened. This can be implemented by banks requiring additional security/non-disposal undertakings in relation to personal assets from the promoters, thereby ensuring that the personal guarantees of promoters continue to remain valuable. In case CDR restructuring is unsuccessful, banks should have the ability to enforce and change ownership and management. This would also incentivise

[32] Alvarez and Marsal, 'Outlook for Stressed Assets Market in India', 2014, p. 19 (hereinafter, A&M)

[33] Report of the Working Group Committee to Review the Existing Prudential Guidelines on Restructuring of Advances by Banks and Financial Institutions, July 2012, p. 101.

[34] *Id.*

[35] RBI, Review of Prudential Guidelines on Restructuring of Advances by Banks and Financial Institutions, May 30, 2013, p. 14.

[36] A&M, p. 25.

[37] *Id.*, p. 18.

the promoter to ensure that the mechanism is complied with.[38] It may be noted that being too aggressive on this recommendation may have the effect of diluting the concept of limited liability of companies, which may in turn have a chilling effect on the cases being referred to the CDR.

3.2.2. Regulatory Issues

A. Infrastructure Sector

The infrastructure sector contributes 23.01% of aggregate debt in the CDR Cell. As of June 30, 2014, 26 cases with an aggregate debt of Rs. 57906 crore stemmed from this sector.[39] The reason for the large number of infrastructure cases undergoing restructuring can be attributed to the long gestation period of loans, problems in land acquisition and environmental and governmental clearances. [40] These factors raise the overall project costs and increase the indebtedness of developers, resulting in the concentration of credit growth in segments with higher levels of stressed assets.[41]

The budget for the financial year 2014-15 provided the infrastructure sector with approximately Rs. 62,000 crore and the government seeks to finance this by way of the 5:25 proposal. The proposal seeks to provide a more flexible structure for loans by extending the amortisation period to 25 years, compared with the previous tenure of 15 years, with periodic refinancing every 5 years. However, there seems to be an asset- liability mismatch as the banking industry does not look at the proposal in a favourable light. Public sector banks, which chiefly finance infrastructure projects, have seen an increase in bad loans for infrastructure projects over the past few years and in their view, this proposal will only serve to increase the number of bad loans. Additionally, gross non-performing assets due to these bad loans have increased threefold since March 2011 and stood at Rs. 216739 crore as of March 2014.[42]

Recommendation: In order to address these concerns we recommend the setting up of a fund/DFI for the infrastructure sector by the government to provide an option to transfer stressed assets from banks. This will also provide assistance with the difficult decision making process in the banking system, credit risk and exposure limitation in the infrastructure sector, which in turn will facilitate faster turnaround of projects. Moreover, the DFI could also look at liberal NPA norms in order to address projects with longer gestation periods.

[38] *Id.*, p.26.

[39] CDR Cell Progress Report, June 30, 2014

[40] PR Sanjai and Madhura Karnik, ‘Banks wary of budget’s 5:25 plan for infra projects’, Live Mint and the Wall Street Journal (online), July 15, 2014.

[41] A&M, p.17.

[42] Amit Bhandari, ‘How India’s Private Banks Duck NPAs’, India Spend (online), July 22, 2014.

In relation to the infrastructure exposure of banks, the RBI has mandated certain relaxations (as far as conditions specify) for deriving asset classification benefits with respect to repayment period of restructuring advantages. In such cases, existing standard assets are not downgraded to sub-standard assets upon restructuring and asset classification of sub-standard / doubtful accounts do not deteriorate upon restructuring if a satisfactory performance is demonstrated during the specified period.[43] These relaxations have encouraged flow of credit in this sector within India. The Working Group, in its report of 2012, discussed whether these relaxations should be applicable for infrastructure financing taking place for projects within India as well as for overseas projects and had recommended that such relaxations only be applicable in the case of infrastructure financing undertaken by banks in India.[44]

Recommendation: Therefore, we recommend that the RBI, by way of a notification, clarify that such relaxations are applicable only in the case of infrastructure financing undertaken by banks only in India and not overseas.

B. Public Sector Banks

Another concern in the CDR mechanism is the disproportionate burden faced by public sector banks which in turn affects their profitability, credit management and asset quality. Data gathered over the last few years indicates that the impact on profitability caused by contribution of public banks to total stressed advances in the system has been disproportionately high and has been on the rise for the past four years. The contribution of public sector banks to the total stressed advances has risen from 5.9% in March 2010 to 10.8 % in March 2013, whereas the total stressed advances for private sector banks has reduced from 4.7% in March 2010 to 3.9% in March 2013.[45] Further, public sector banks have been unable to assiduously manage their credit portfolios due to poor credit appraisal prior to sanctioning, unfamiliarity in deterioration of asset quality indicators, lack of granular data on slippages, lack of detailed evaluation of restructuring, slow policies on decision making and tight liquidity.[46]

As a result, public sector banks have shown a steady decline in their asset quality while private sector banks with fewer restructured advances have managed their stressed asset portfolio more efficiently. For the first half of the financial year 2014-15, public sector banks saw an increase of NPAs at 41.41 % while that of private sector banks was much lower at 12.91 %, highlighting the importance of effective credit evaluation and policies in private banks.[47]

Recommendation: Thus, due to the high exposure suffered by public sector banks, we recommend that these banks should be given greater autonomy regarding the decision making process in the CDR mechanism. This can be complemented by the implementation of reforms

[43] RBI, Prudential Guidelines on Restructuring of Advances by Banks, August 27, 2008, p. 10.

[44] Report of the Working Group Committee to Review the Existing Prudential Guidelines on Restructuring of Advances by Banks and Financial Institutions, July 2012, pp. 92-93.

[45] RBI Database of the Indian Economy, December 2013 from Alvarez and Marsal, 'Outlook for Stressed Assets Market in India', 2014, p.9.

[46] Alvarez and Marsal, 'Outlook for Stressed Assets Market in India', 2014, pp.9, 17.

[47] CARE Ratings, 'Banking Sector Performance Study H1FY14', p. 2

to strengthen the performance of public sector banks in order to ensure that banks that benefit from both implicit and explicit guarantees from the State do not continue to roll over / postpone rather than exit where economically efficient to do so. This in turn will also improve the asset quality of public sector banks thereby aiding their ability to restructure NPAs and debt in the CDR mechanism.

C. Exit Mechanism

Anecdotal evidence suggests that the CDR mechanism has been grossly misused by banks and debtor companies in many cases leading to an extraordinary number of cases referred to the CDR Cell. With several companies receiving CDR protection for years and without having any incentive to exit, the RBI implemented strict norms to ensure the sincerity of cases referred to the CDR Cell. Additionally, several viable cases have been unable to exit the mechanism owing to the inability to meet the assumptions of the viability criteria, non-implementation due to environmental reasons and promoters' lack of adherence to the necessary terms and conditions.[48] Thus, out of a total of 486 cases with an aggregate debt of Rs. 348502 crore approved by the CDR Cell since its inception, only 75 cases with an aggregate debt of Rs. 58205 crore have successfully exited the mechanism.[49]

Recommendation: In order to address these concerns, we recommend that the accessibility to the CDR mechanism is restricted and a detailed appraisal of each existing case in the Cell is carried out. Moreover, we recommend an increased incentivisation and disincentivisation scheme is set out in the restructuring process. Incentives should be provided for companies to adhere to their restructuring commitments in order to facilitate projects moving out of the Cell and not remaining for perpetuity. Similarly, there should be disincentives for non-adherence to the restructuring commitments and under- performance. In instances where viable cases have not exited the mechanism due to non-materialisation of viability, environmental or promoter concerns, banks should be advised to assess the situation early and use the exit option with a view to minimise losses.

The CDR mechanism is a valuable debt restructuring mechanism in a developing economy such as India. However, it seems that the mechanism still suffers from certain shortcomings in relation to its monitoring and appraisals standards and guarantees from promoters regarding their contribution towards the viability of their companies. The mechanism is also affected by high debt in the infrastructure sector, an overburdening of public sector banks and exit delays. These issues need to be addressed at the earliest in order to improve the mechanism, which in turn will improve the asset quality of the economy and the banking and financial industries as a whole.

[48] Report of the Working Group Committee to Review the Existing Prudential Guidelines on Restructuring of Advances by Banks and Financial Institutions, July 2012, p. 98.

[49] CDR Cell Progress Report, June 30, 2014.

3.3. Other Measures

3.3.1. Debt-Equity Conversion by Banks and other approaches for taking over the Management

Debt to equity conversions are another mode of informal rescue, where the creditor agrees to exchange his debt for equity shares in the debtor company. In the UK, such debt/equity conversions have been used in a significant number of cases to restructure debt.[50]

For a debtor company, such conversions have the advantage of avoiding interest payments on debt, cleaning up the company's balance sheet, raising the company's financial profile, allowing access to new credit lines, attracting new business and reassuring current customers (Finch). They may be attractive to creditors as well, especially unsecured lenders, due to the possibility of greater recovery through future returns on investments (Finch). Such conversions may also serve the purpose of deterring intentional defaults. However, there are significant downsides to such conversions for creditors: (a) loss of priority in subsequent liquidations, as being shareholders, they will be residual claimants; (b) sale of shares after conversions may be difficult due to decreased liquidity for the debtor company's shares (Finch). Further, it must also be noted that secured creditors who are over-collateralised may have weak or no incentives to cooperate in rescue through such conversions.

Though most loan documents in India include measures for conversion of debt into equity in the event of default, for reasons discussed below, banks are not been very keen to exercise the option in practice. The Banking Regulation Act prescribes investment limits for banking companies. The investment limit for banking companies in non-financial services companies as per the Banking Regulation Act read with the Master Circular – Para-banking Activities dated July 1, 2014 is 10% of the paid-up share capital of the investee company or 10% of the banks' own paid-up share capital and reserves, whichever is less.[51] Further, the investment in a non-financial services company by a banking company together with its subsidiaries, associates, joint ventures, entities directly or indirectly controlled by the bank and mutual funds managed by asset management companies controlled by the banking company cannot exceed 20% of the investee company's paid-up share capital.

The 30% limit pursuant to section 19(2) of the Banking Regulation Act is only permitted with the prior approval of the RBI provided that the investee company is engaged in non-financial activities in which banking companies are permitted to engage under the Banking Regulation Act. These activities, pursuant to section 6(1) of the Banking Regulation Act, include those which are allied to the business of banking such as carrying on or transacting guarantee and indemnity businesses, executing trusts, acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company etc. Equity

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[50] Examples include Groupe Eurotunnel (creditors took on 87% of shares in GE), Saatchi and Saatchi plc, Brent Walker plc, Signet, Queens Moat (Finch, 321).

[51] The new restrictions on investments by banks in non-financial services companies were made applicable through the RBI Guidelines on Section 19 of the Banking Regulation Act, 1949 dated December 12, 2011, available at http://rbiadocs.rbi.org.in/rdocs/Notification/PDFs/CIFSF12122011.pdf

holding by a bank in excess of 10% of the non-financial services investee company's paid up capital would be permissible without RBI's prior approval (subject to the statutory limit of 30% in terms of Section 19 (2) of the Banking Regulation Act) if the additional acquisition is through restructuring/corporate debt restructuring, or acquired by the bank to protect its interest on loans/investments made in a company. The equity investment in excess of 10% of the investee company's paid up share capital in such cases would be exempted from the 20% limit referred to above. However, banks will have to submit to RBI a time bound action plan for disposal of such shares within a specified period.

Further, banking companies can *form* subsidiaries with prior RBI and Central Government approval which carry on activities that are considered to be conducive to the spread of banking in India or otherwise useful or necessary in public interest. Banks are permitted to form a subsidiary company for the purpose of undertaking any of the business activities provided by section 6 of the Banking Regulation Act without the permission of the RBI. As a result of these provisions the banks can either hold shares in a non-financial services company up to 10% or form such company a subsidiary by holding 51% or more of the shares of such company.

The rationale for such investment limits is to ensure that banks do not exercise control on or have significant influence over non-financial companies and thus, engage in activities directly or indirectly not permitted to banks as it would be against the spirit of the provisions of the Banking Regulation Act and is not considered appropriate from a prudential perspective.[52]

The objectives of the Banking Regulation Act, *inter alia*, include (i) to safeguard interest of depositors, (ii) to develop banking institutions on sound lines and (iii) to attune the monetary and credit system to the larger interests and priorities of the nation. Under *status quo* since banks are permitted to own subsidiaries that undertake non-financial activities, there seems to be no rationale for why banks should not be permitted to hold higher percentage of shares exceeding 10% without having controlling interest in such subsidiary company. To mitigate risks, such holding can be made subject to the approval of the RBI.

Secondly, corporate financing by way of pledge of companies' shares as collateral is extremely common. In project finance, the pledge of shares is a method for banks to ensure that promoters of companies continue to be involved in the project and to deter them from transferring interest in the company without the consent of the banking company. The restrictions in section 19(2) of the Banking Regulation Act do not apply to financial institutions like IDFC and IRDA. Given the objective of the Banking Regulation Act, and since there is significant project financing through banks there may be significant interest for banks to be permitted to hold a controlling interest in non-financial companies.

Pursuant to section 13(4)(b) of the SARFAESI Act, the right of the creditor to take-over the management of the defaulting borrower is for the *express purpose* of realisation of the secured debt. This is to be construed as permission for sale of the assets for the purpose of realisation of cash, which would go toward the liquidation of the liability/part liability incurred by the borrower although the secured creditor will not be the owner of the assets.[53] The taking over of the management of the borrower is operationally difficult for the creditor as it may not have

[52] Paragraph 3.2 of the Master Circular on Para-banking Activities issued by the RBI dated July 1, 2014.

[53] *Disco Electronics Limited (in liquidation)* v. *Micromix India*, AIR 1997 Del 251.

the expertise for management of the assets. Further, if the borrower is a running unit the management of the secured assets may have legal implications and may render the secured creditor liable to the borrower for the losses which may be sustained on account of the creditor running operations of the borrower.[54] Hence, the purport of the section is effectively limited to *management of the assets* unlike Section 9 of the SARFAESI Act which deals with asset reconstruction and allows for the ARC to take over the *management of the business* of the borrower whilst taking into consideration RBI guidelines prescribed in this regard. However, if the creditors are given the authority to acquire controlling interest in the company, they may be in a position to exercise their management rights under the SARFAESI Act more effectively.

Recommendations: (a) The RBI should consider allowing the banks to acquire controlling interest in the debtor companies in appropriate cases of default involving viable businesses (and suggest suitable amendments to the Banking Regulation Act). In order to mitigate the exposure to the downside risks, it may be made mandatory to appoint a turnaround specialist (see section 3.1.1. above) who may be given a 'right of first refusal' on the bank's shareholding in the event of a successful turnaround. Alternatively, banks may be allowed to hold such shares through a trust, whereby the banking companies are the ultimate beneficiaries of the post-conversion equity interest held by the trustee company. The trustee company appointed by the banks can be specialised companies, which understand the nature of the businesses of the borrowers. It is important to note that the interest of both the borrower and the bank is to ensure growth of the company in a manner so as to not have a potential for default in the future. The specialised trustee company while acting for the benefit of the banks will also be in a position to determine better growth strategies of the company. Given that such a measure may lead to availability of more credit, it should be complemented by better enforcement of rules relating to credit discipline by banks (to prevent indiscriminate lending to unviable projects).To the extent, debt-equity conversions can lead to change in control of the company, the possibility of such conversion itself may serve as an effective deterrent against wilful defaults.

(b) An alternative approach (with or without exercising such conversion rights) would be the use of a receiver – a professional person (typically an accountant) or a turnaround specialist (discussed above) appointed on behalf of the bank to realise the assets or manage the business. The effect is that the bank is not itself taking control of assets. This model could also be used to sell the business as a going-concern. The rights and obligations of such receiver should ideally be laid out in the SARFAESI Act. The SARFAESI Act provisions relating to handing back of the management (after realisation of dues) may also need to be reconsidered for such a mechanism to work.

Such an approach may be considered within the JLF and the CDR frameworks as well.

[54] H.P.S. Pahwa, *Law & Practice of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest*, 604 (New Delhi: Modern Law Publications, 2006).

4. Sarfaesi Act Processes

4.1. Asset Reconstruction under the SARFAESI Act

Specialised resolution agencies in the form of Asset Reconstruction Companies ("**ARCs**") with sole purpose of resolving bad loans were created under the SARFAESI Act. They were seen as vehicles to increase the liquidity of banks which could divest themselves of bad loans by transferring them to the ARCs which in turn could recover the value underlying those loans in their role as specialised agencies. The bank could hold exposure in the sold loans through subscription to security receipts issued by the special purpose vehicle holding these assets. These offloaded assets are generally held in trusts that issue security receipts and are managed by the ARCs in their capacity as trustees.

However, the model did not meet with much success after the initial response.[55] There are a number of reasons contributing to the low supply of bad loans from bank's side in spite of high NPA levels and the growing demand for business by the ARCs (which have grown in numbers in the last decade). With the NPA levels in the banking sector rising steadily, even more ARCs have cropped up in the recent past in expectation of further offloading of NPAs by banks.

The policy discussion on the structure of ARC and bad loan resolution has been going on for a while. The RBI has implemented a number of suggestions[56] made by the Key Advisory Group[57], yet the sector seems to be plagued with inertia and remains prone to failure due to several underlying risks.

The changes implemented by the RBI have, in the recent past relaxed the process for ARCs while at the same time increased the pressure on banks to offload their bad loans resulting in a sudden flurry of activity in 2014.[58] However, whether this is a one-off response or whether the market for ARC's has actually improved is yet to be seen. Nevertheless, there are several gaps in the structure that need to be dealt with.

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[55] Report of the Key Advisory Group on the ARCs, Ministry of Finance, Dept. of Fin. Services, 30th November 2011, p. 8 (hereinafter referred to as ARC Report)

[56] *See*, RBI, Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy, dated 30th January 2014; *Also see*, RBI Notification bearing RBI/2014-2015/164 DNBS (PD) CC. No. 41/ SCRC / 26.03.001/ 2014-2015 dated 5th August 2014.

[57] *See,* ARC Report.

[58] Ajay Shah, Anjali Sharma, Susan Thomas., "NPAs processed by asset reconstruction companies -- where did we go wrong?", *available at* http://ajayshahblog.blogspot.in/2014/08/npas-processed-by-asset-reconstruction.html

4.1.1. Perverse Incentives

A significant reason for the failure of the ARC mechanism has been the perverse incentives inadvertently created by the structures envisaged in the legal regime, adversely affecting the outcomes predicted by the law.

4.1.1.1. For Banks

A. Provisioning Norms

The provisioning norms were responsible, to some extent, for the bank's strategies of "provide and hold" because of its "gradient" effect in writing off bad loans, while selling those loans had an immediate impact on the books depending on the discount value. The provisioning norms allowed the banks to 'write off' the losses over a longer period by 'providing' for them. Whereas, in case of sale of NPAs, the losses had to be absorbed by the bank at once. This generated a perverse incentive to not sell the non-performing loans. Now, the RBI has increased the amortisation period for writing off losses after sale of NPAs to two years but it is still less than the four year period allowed by the bank provisioning norms. In addition, under the present structure, since most sales to ARCs do not result in immediate cash gains for the banks, the incentive to sell is diminished. Similar problems have been faced due to accounting norms in European nations too. Keeping the distressed assets on the books and improving the state of business by financial window dressing became the dominant strategy of many banks during the financial crisis, especially for the hard-hit public banks.[59] In India, the banks often restructured accounts only to avoid classification of these assets as substandard and incur provisioning. It also led to the unrealistic values ascribed to the security receipts in instances where such NPAs were sold to the ARCs and the banks themselves subscribed to the security receipts, leading to the risk being transferred back to the bank.

Recommendation: We recommend that equivalent amortisation period for writing-off sale of non- performing assets be prescribed as is prescribed for similar assets being held by the banks in their books. The period for writing off losses on NPAs on books of the banks and losses on sale of NPAs should be aligned.

B. Risk Transference and Ever-greening of books

Many banks found a way around having to book immediate losses on sales of non-performing assets and instead found a way to evergreen their books. Firstly, such banks sold their non-performing assets to the ARCs against security receipts for the book value or at a very little discount to the ARCs in spite of the market value of those assets being highly diminished. The trust buying and holding these assets then issued security receipts up to 95% of the value of the assets which the same banks subscribed to. In effect, this led to window dressing and ever-greening of books. Before the amendment which increased the minimum holding requirement

[59] Ulrich van Suntum & Cordelius Ilgmann, *Bad banks: a proposal based on German financial history,* Eur J Law Econ (2013) 35:367–384 at 374. (hereinafter "Suntum &Ilgmann")

for ARCs to 15%[60], the ARCs had to put up only 5% of the SRs and could sustain their business on management fee earnings in spite of delays in resolution. However, the situation became unsustainable later when the security receipts came up for redemption. In effect, the banks still held the same risk in respect of the bad loans with the only difference being that they were now categorised as investments and the banks did not have to provide for them. It led to an abuse of the system. Even now, it is unclear if the 15% minimum holding requirement will tackle these perverse incentives successfully.

If the assets have to be truly dissociated from the banks, there has to be a true sale after proper pricing of the assets. The cash will incentivise the banks to sell and will also bring discipline for their risk assessment and lending policies when they are forced to confront the real value of these onerous assets as a result of only being able to obtain highly discounted prices for the assets. The higher stakes for ARCs will incentivise resolution on their behalf and make resolution a desirable proposition for them.

The other option can be to prohibit subscription by a bank to the SRs of its own portfolios that it sells to ARCs. This will stop the risk transference of the same accounts back to the bank and bring more transparency to the system. The banks may be allowed to hold other SRs as investments after such SRs have been appropriately rated by external credit rating agencies.

Recommendation: We recommend that sale of non-performing loans should be allowed only by way of cash payments. It may be prescribed that the seller bank of such loans cannot subscribe to security receipts arising out of the same portfolios. If it is desired that banks be allowed to invest in security receipts from a purely investment and earning perspective, then they may be allowed to subscribe to other bank's portfolios transferred to the SPVs (after appropriate ratings).

4.1.1.2. For ARCs

A. Management Fees

Since, the ARC's were required to hold only 5% of a single issuance of security receipts, till the recent changes in policy[61], their incentives for seeking resolution were questionable. The management fees they received for handling these assets were in the range of 1.5 to 2% of book value of assets. For the ARCs, the returns on any capital or human resource investment towards resolution was too low in view of their low stake and management fee earnings. Arguably, the management fee model created perverse incentives for them to prolong resolution and earn more management fee each year.

[60] RBI Notification dated 5th August 2014, RBI/2014-2015/164 DNBS (PD) CC. No. 41/ SCRC / 26.03.001/ 2014-2015.

[61] *Id.* As per this notification, minimum holding requirement was increased to 15% for ARCS, debt aggregation was permitted inter se ARCs and various other changes suggested in the ARC Report were implemented.

Recommendation: We believe it is advisable to cap the management fee earned by ARCs on both time and value factors. The management fee should be linked to the market value of assets and should be earned for a limited period from the date of first assignment of an asset. Further, management fee should be ascertained asset wise so that transfer of assets between ARCs does not lead to abuse of the system by new management fee claims by each transferee ARC.

B. More "skin in the game"

The low stakes held by ARCs has been the bane of the entire reconstruction model. The low minimum holding requirements did not require much capital investment from ARCs, which in any case required little capital to be set up. To stir the ARCs into action their minimum holding requirements need to be significantly increased. Even the hike from 5% to 15% is not enough to incentive the ARCs to increase resolution efficacy.[62] They need to have more skin in the game.

Recommendation: We recommend that the minimum holding requirement of ARCs should be reconsidered. The RBI may consider creating separate categories in this regard. In a case where the company is viable (as certified by a third party expert), ARCs may be permitted to bring in a smaller amount of money. In cases where the company does not seem viable, the ARCs should be required to bring in more money.

C. Security Receipts Extension

The possibility of extension of time for redemption of security receipts combined with the above factors has added to the lethargy in resolution efforts by ARCs. In addition, during the period of extension, the ARC continues to earn management fees. There should be a strict redemption date for SRs without any scope for extension. In the event of a resolution being unsuccessful or delayed, the ARCs should be required to redeem the SRs and transfer the assets on their own books.

Recommendation: We recommend that there should be no scope of extensions on SR redemption dates except at the choice of the SR holder who may be allowed to choose pursuant to a due diligence on his behalf. In the event that SR holder chooses to redeem, the ARC should be made to redeem the SR and transfer the underlying assets on its own books and bear the risk. In the event, the SR holder prefers extension to partial extension that should be laid out in clear terms.

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[62] *Id.*

D. Capital Issues

The low capital requirements to set up an ARC have led to mushrooming into of ARCs without there being enough business for all of them. Further, it is questionable if such an approach has so far facilitated a balanced growth. There is a possibility that such requirements may further fragment the sector where debt aggregation remains a valuable aim. It may give rise to holdouts and opportunistic behaviour by ARCs. Therefore, the sector needs some consolidation. The suggested measure in the Budget of 2014[63] of setting up one ARC for bad loans of public sector banks may be a solution but will raise the risk of complacency in public sector banks and inherent pricing risks.[64] Further, prevention of risk transference would again be obfuscated if public sector banks are allowed to be significant shareholders of ARCs. The hand-in-glove behaviour of ARCs with their promoter shareholder banks can defeat the purpose of the entire asset reconstruction exercise.

Recommendation: We recommend that complete dissociation should be effected between banks and ARCs. Banks should not to be allowed to be a promoter shareholders or a significant shareholders in any ARC. Secondly, the minimum capital requirement to set up an ARC or sustain the ones already in existence should be increased substantially to attract only serious players to the market (who are genuinely interested in resolution and recovery).

The aforementioned measure and earlier recommendation for buying assets for cash, raises the question of availability of funds for the ARCs to adopt this model. This can be facilitated by a two-way approach. Firstly, by broadening the category of SR participants who are eligible to invest in these securities. A secondary market for these securities will further add to their flexibility.[65] Enabling the issuance of derivative securities from repackaged portfolios with balanced risk averages will attract more investors. Secondly, the ARCs can tap into the funds at the disposal of distressed debt funds on the investor side. Since, ARCs are now allowed to convert debt into equity, this route can be attractive for the distressed asset investors as well. If implemented efficiently, it could build cohesive institutions which could restructure and turnaround viable assets and liquidate and recover underlying value of unviable assets. However, risks inherent with equity ownership remain and will have to be ameliorated to some extent to provide impetus to such ventures. If distressed asset funds join hands with ARCs and invest in debt portfolios then similar rights (as available to the ARCs) in terms of RDDBI Act and SARFAESI Act should be extended to them.

[63] Mint, Govt plans to set up asset reconstruction firms for power, road sectors dated July 11, 2014 *available at http://www.livemint.com/Politics/VFAHss3kTsNXVQwJ4FJZAI/Government-planning-ARCs-for-power-and-road-sectors.html*

[64] John P. Bonina & Yiping Huang, *Dealing with the bad loans of the Chinese banks,* Journal of Asian Economics 12 (2001) 197–214, p. 205-208 (hereinafter Bonina & Huang).

[65] ARC Report *at* p. 20.

Recommendations: We recommend that definition of eligible investors in SRs should be significantly broadened. Portfolios should be allowed to be repackaged by pooling several assets together in order to attain diversification of benefits. We further recommend facilitation of a secondary market for security receipts. Joint ventures between distressed asset funds and ARCs should be encouraged to fuse the capital and expertise. If such ventures are facilitated, the debt portfolios of distressed asset funds should be extended rights as "other creditors" under SARFAESI Act and RDDBI Act.

4.1.2. Pricing Mechanism

The biggest challenge faced in almost all economies where such resolution strategies have been adopted has been the pricing of the assets being sold by the banks and financial institutions.[66] The market for sale of non-performing assets is plagued by information asymmetry. The originators enjoy an informational advantage over the purchasers and hence, attempt to extract price above the true value of the asset creating a moral hazard problem.[67] The ARCs on the other hand are buying assets that are delinquent and wish to adopt a higher discount rate to set off the risk to some extent being employed by them.[68] The Indian scenario is no different. The difference between seller and purchaser expectation of discount rate on these assets can be up to 20%.[69] The RBI has introduced certain measures to restrict the usage of non-performing loan auctions as price discovery mechanisms but the larger problem still persists.

Internationally the advocates of a bad bank structure in the form of an AMC or ARC have identified three key challenges that an effective bad bank solution must meet: (1) transparent removal of toxic assets, (2) minimum costs to the public, and (3) curtailing moral hazard.[70]

Too low a price can force banks to write off larger losses, which in turn may affect the availability of credit. Too high a price can put pressure on the ARCs and make their investment more susceptible to risks. However, a pricing policy towards a lower end in the short run can help discipline the lending policies of banks and induce better risk assessment procedures.

Mark to market approach: A mark-to-market approach employed through empanelled independent valuers can be an option. These valuers will have to be independent and the structure put in place by the Companies Act, 2013 can be utilised for this purpose. However, in spite of the support from ARCs to the mark to market approach, the banks and FIs resist this model because of the earlier discussed "provide and hold" approach induced by the perverse incentives generated by the provisioning norms. Some international economists are of the view that if banks are forced to account for their assets according to their current market value during

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[66] *Supra* 59 at p. 368-370.

[67] *Id.*

[68] *Id.*

[69] A&M, p. 19.

[70] The first global financial crisis of the 21st century (pp. 17–19). Zimmermann, K. F., & Scha¨fer, D. (2009) referred to in *Supra* 59 at p. 371.

a systemic financial crisis[71], minimum risk-adjusted capital requirements and fair value accounting may even force the closure of sound banks, thereby contributing to the drying up of markets.[72] Bank to banks sale of non-performing loans has finally cleared itself of the legality issues raised before various courts.[73] It may be a very lucrative option for the public sector banks with their high level of non-performing assets which can be bought by other banks interested in purchasing them. Such choices will only be made by banks if they see it as a good business opportunity and do not anticipate any hazard to their own non-performing loan levels. In such circumstances, where such sales can result in immediate cash earnings for banks, they should be encouraged and actively pursued. However, one area of concern remains the twelve month holding period required to be maintained by a purchaser bank compared with the debt aggregation aim. The holding period can at times be an encumbrance to aggregation and expedited resolution. The initial years are crucial to both recovery or restructuring and the twelve month holding period can seriously affect the restructuring and recovery. In such a period, there can be circumstances where a relatively small but crucial percentage of debt can be held by an ARC that can hold out against the recovery or restructuring process. Further, the diminishing value of the assets is a serious concern and time is of the essence for salvaging any residual value. Reducing this period to six months could be a strategy to prevent pure debt trading while facilitating debt aggregation.

Hence, if this mark to market pricing policy were to be adopted, it will have to be in conjunction with appropriate changes in provisioning norms to encourage offloading of bad loans.

Recommendation: We recommend a hybrid model that employs mark to market price as the base price with limited scope for additional bids where ARCs can compete on incremental purchase price as per their risk profiles. The need would be to ensure that the additional risk be borne by the ARCs and not be transferred back to the Banks and FIs, so as to avoid ever-greening.

4.1.3. Centralised Single Institution Model

Certain countries have successfully implemented a state sponsored single agency model that deals with the bad loans of all banks. Some of these institutions came with a sunset clause while others have persisted longer.[74] To analyse the *pros and cons* of such an approach may be a step too late in the Indian market where a number of ARCs have already been operating. It may lead to serious backlash and elicit hostile response from the market. Further, the case for a central agency in the Indian scenario would come with efficiency risks that has been running upon publicly owned enterprises and the moral hazard problems that come with continuous government support at the cost of public funds. The non-performing loan levels at public sector

[71] *Supra* 59 at p. 368.

[72] *Id.*

[73] ICICI v. OL. of APS Star Industries, (2010) 10 SCC 1.

[74] *See,* Bonina & Huang.

banks is a case in point.[75] The persistent need for capital infusion costs public money and is a serious cause of complacent behaviour of these banks. A reconstruction institution model with a government backing may further facilitate bad lending practices of public sector banks. Further, in view of the lack of a tried and tested efficient pricing mechanism, competition in the sector will actually help real value discovery. The Czech experience indicates that transferring bad loans from all banks to a single centralised institution does not solve the incentive problem if the client remains attached to the original public sector bank.[76]

Recommendation: We recommend that a single institution model is not advisable under current circumstances in India. However, increasing minimum capital requirements and facilitation of consolidation of the sector to reduce the number of small and opportunistic players may be considered.

4.1.4. Restructuring and Turnaround

Early stage resolution has the benefit of allowing extraction of going concern value from an asset.[77] Further, it encourages industrial and economic confidence. Therefore financial and business restructurings with operational overhauls, mergers and acquisitions, and 'change in management' are preferable modes of workouts.[78] The Corporate Debt Restructuring model or the Sick (Industrial) Companies Act, 1986 are examples in case of policy efforts in this direction. However, these have not been particularly successful in terms of efficiency or preventing depreciation of non-standard assets.

A. Debt to Equity Conversion & Change of Management

Even though debt to equity conversion has been allowed for ARCs as per the 2012 amendment[79], relaxations from the Securities and Exchange Board of India ("**SEBI**") on lock-in period and open-offer requirements in certain cases which are available to banks have not been extended to them.

Further, the associated risks arising from equity ownership have not been dealt with by the legislature to encourage these conversions particularly in relation to the liabilities contingent upon takeover of management or holding a post of director in a company. Shareholder directors who are appointed by ARCs have not been given specific protections under the new Companies Act, 2013 as given to Independent Directors who are liable only in cases of offences committed with their knowledge, connivance or negligence.[80]

[75] A&M at p. 9.

[76] Bonina & Huang at pp. 203-4.

[77] ARC Report at p. 5

[78] ARC Report at p. 24.

[79] *See,* The Enforcement of Security Interest (Amendment) Act 2012.

[80] Section 149 (12) of the Companies Act, 2013.

As regards, change of management, even though this method has been available for a while, the ARCs have hardly utilised it. This is attributable to lack of clear guidelines on the risks borne by key managerial personnel appointed by such methods. Various legislations in India implicate directors and managers for offences committed by companies. These legislations do not differentiate between original management and management that may come in place as part of a restructuring exercise. Therefore, clearly delineated protections need to be laid down for the directors and key managerial personnel that occupy such posts.

Recommendation: It is submitted that SEBI should consider extending some relaxations to ARCs upon conversion of debt to equity (as is currently provided to banks for such purposes). Risks borne by ARC nominated directors in its capacity as shareholder should be mitigated by special provisions being included for such directors under the Companies Act, 2013 along with concomitant amendments in other enactments which contemplate criminal/civil liability on directors. Similar protections should be introduced in the SARFAESI Act in relation to the change in management actions and resulting director and key managerial personnel appointments. Having said that, care must be taken to ensure that such relaxations in protection do not come at the expense of other investors and shareholders of the company. RBI may consider making appropriate recommendations to SEBI and the Ministry of Corporate Affairs in this regard.

B. Restructuring Finance

Restructuring often requires fresh infusion of funds, which is exactly where ARCs face the paucity. As discussed above, the minimum capital requirements for an ARC to be set up is quite low[81] and does not ensure a well-capitalised institution equipped to carry out the restructuring. As suggested earlier, ARCs should be allowed wider access to sources of funds from distressed asset investors or wider group of SR subscribers. The distressed asset investors can effectively tackle the liquidity shortage by infusing funds into the viable company for restructuring.

However, the passive investor mechanism cannot be employed here and the distressed asset investors will have to actively seek turnarounds. This, in turn calls for skilled human resources who are conversant and experienced in operational, financial and business turnaround and restructurings. Active investing with a strong resolution team and turnaround expertise is the trifecta that can ensure maximum value extraction from the stressed assets sector. Another crucial factor is to stop the supply of funds to stressed debtors from the banks which have already borne the brunt of their failure. The primary aim of extricating banks from bad borrowers remains a priority, hence, the restructuring finance mechanism through ARCs should be encouraged. As far as distressed debt investors are concerned, they could be afforded the protections of the SARFAESI Act through the 'enforcement of security interest mechanism' if their debt is secured (by introducing an amendment to Section 2 (zd) of the SARFAESI Act). Similarly, they could also be allowed access to DRTs by amendment to Section 2(h) or Section 17 of the RDDBI Act.

[81] See Owned Fund requirements in the Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions as amended up to July 1, 2014.

Recommendation: We recommend that ARCs should be allowed a wider access to capital. Further, distressed debt investors/funds (both Indian and foreign) may also be recognised as a separate category of entities allowed to purchase debt receivables directly, and should be allowed access to recovery mechanisms under SARFAESI Act and DRT by appropriate amendments to the Acts in question.

4.2. Clarity on Assignment Transactions and Stamp Duty

While the stamp duty rates on few items such as transfer of shares are reserved for the Centre, most others are in the domain of the State legislatures. The differential rates of stamp duties across various States contributes to an additional layer of complication, as is explained below.

The agreement by which the receivables / assets are transferred or assigned from the originator to a special purpose vehicle is liable to the stamp duty. An instrument of transfer of immovable properties typically requires payment of stamp duty at an ad valorem rate such as 11% in Rajasthan and 5% in Maharashtra along with an additional registration fee.

Some States have legislated specific entries lowering the stamp duty payable upon transactions involving assignment of receivables. To cite an example, the entry in Karnataka stipulates that Rs.1 would be payable for every Rs.1,000 subject to a maximum of Rs.100,000. However, the specific entry relating to the assignment of a debt in Madhya Pradesh stipulates the rate at 0.5% of the amount of the debt assigned, with no maximum cap specified.

Securitisation of assets may involve parties situated in more than one State owing to the originator, the asset reconstruction company and the assets being spread across States which may entail that an assignment agreement is brought into more than one State. When an instrument on which stamp duty has been paid in one State is received in another State, the difference in stamp duty may be payable in the latter State.

Recommendation: In order to address the problem caused by the multiple state specific rates, we recommend that the stamp duty applicable on assignment of receivables be reduced to a nominal duty capped at a stipulated amount. The rates should also be made uniform so that an agreement which is required to be brought into more than one State need not be stamped with differential stamp duty in each such State. RBI should consider making an appropriate recommendation to the Government for setting up a Centre-State committee to rationalize this.

4.3. Preferential Status of the Secured Creditor Undermined

The secured creditors can enforce their security under the SARFAESI Act and sell the assets as long as the proceeds are distributed in accordance with the priority rules under company law. The preferential status of the secured creditor is subject to certain overriding preferential

payments- the security of every secured creditor is deemed to be subject to a pari passu charge in favour of the 'workmen'[82] to the extent of the workmen's portion therein.[83] Further, while in general, dues of the Government get priority over debts owed to unsecured creditors only, where the tax or revenue payable to the Government is by virtue of a specific statutory provision (Sales Tax legislations in certain States etc.), it gets priority over the secured creditors as well. This is different from the position in the UK and the US.[84] In the UK, fixed charge holders are entitled to claim first, even over liquidator's fees and expenses, whereas there are certain carve-outs made from the assets available for distribution to floating charge holders (but this no longer includes debts owed to the Crown, like taxes). In the US, secured creditors are entitled to claim first, even over the liquidator's fees and expenses.

Allowing for carve-outs from the priority of secured creditors is problematic for several reasons- (a) it leads to uncertainty for secured creditors regarding the sums that would be payable to them in the event of a company's insolvency; (b) it may slow or otherwise complicate the exercise of out-of-court enforcement rights by secured creditors, to the extent that they are required to associate the official liquidator with the sale to protect such claims; (c) it may increase costs and lead to delays; (d) secured creditors may ultimately pass on the risks arising from these to the debtor through higher interest rates; and (e) it may reduce the attractiveness of certain kinds of security interests that would otherwise generate positive externalities, as where they encourage monitoring *ex ante*.

Workmen:

While the claims of employees do require special attention, there are several questions that need to be addressed. To what extent should employee claims be treated in priority to other non-adjusting creditors such as tort creditors, judgment creditors etc, consumer pre-paying creditors? Should employee entitlements be addressed by labour laws rather than insolvency legislation? Would not the increased risk to secured creditors and trade creditors from the preferential status given to employees be passed on to the debtor in the form of higher lending rates and higher priced goods and services?

While countries like India, the US have given preferential status to employees in the event of the employer's insolvency, several other countries have used insurance funds or a combination of insurance funds and limited priority to address the issue of employee entitlements in winding up. For example, the UK gives limited priority to employees in relation to unpaid wages (four months of unpaid wages up to a prescribed maximum limit of £800 per employee). The Employment Rights Act 1996 offers further protection to employees by permitting payment out of the National Insurance Fund up to eight weeks of pay arrears during the statutory minimum period, six weeks of holiday pay and a basic award for unfair dismissal (Finch). Denmark takes the Guarantee Fund approach whereby employees are given the highest priority

[82] As defined in the Industrial Disputes Act 1947

[83] S 325, 326, Companies Act 2013 (not yet notified, but similar to the provisions of the 1956 Act). Such workmen's 'portion' is equal to the percentage of the value of the security that is equal to the percentage that the workmen's dues constitute of the sum total of both (a) the total debts due to all the secured creditors and (b) the workmen's dues.S 325(3)(c), Companies Act 2013.

[84] SS 59, 60, 61, IA 1986; Chapter V, VII, US Bankruptcy Code.

amongst unsecured creditors in relation to claims for salaries, wages and other employment benefits, while a Guarantee Fund acts as a safety net, out of which such payments are made in case the assets are insufficient to satisfy claims (Johnson). Germany takes the view that employee rights are to be protected outside of insolvency legislation. Thus, unsecured creditors including employees are entitled to a pari passu distribution of assets. Employee claims which are not satisfied out of the company's assets are paid out of a National Insolvency Fund (Johnson).

All the jurisdictions discussed above all give protection to employee claims in the event of insolvency; however, Germany's approach is preferable in that it strikes the right balance between encouraging commercial confidence and social protection. By treating employees on par with other unsecured creditors, it resolves the issue of fairness between classes of non-adjusting or mal-adjusting creditors. However, the particularly vulnerable position of employees in an insolvency is recognised by providing for satisfaction of employee claims out of the National Insolvency Fund where assets of the company are insufficient to satisfy such claims. In the Indian scenario, rather than giving preferential status to workmen's dues, the possibility of protecting workers in an insolvency through such insurance funds should be explored.

Crown Debts:

The preferential status given to dues of the Government/Crown has been a controversial issue in many jurisdictions. The origins of the preference for Crown debt can be traced back to England, where the Crown was entitled to an absolute priority for revenue-related debts in the event of the insolvency of a subject (Morgan). This common law doctrine was later exported to other countries, including India, to grant preferential status over other debts to the government in the absence of a monarch (Morgan).

The main reasons behind giving preferential status to the Crown are: (a) unlike the claims of private creditors, revenue-related claims of the government are for the benefit of the community- granting priority usually prevents the costs of insolvency from being borne by taxpayers; (b) the Crown is a non-adjusting creditor in that they cannot choose the debtor or obtain security for their dues; (c) in cases where the debtor collects taxes on behalf of the Crown (sales tax, value added tax etc), if no priority is given to the Crown, the moneys so collected will result in a windfall for other unsecured creditors; (d) if the Crown is not given some security through preferential status, the Crown may not negotiate repayments with debtors, thus precipitating unnecessary business failures (Morgan). However, these arguments have been countered by critics of the Crown preference. The Crown is often able to adjust tax levels in a manner that anticipates the risk of default. Further, the dues payable to the Crown are unlikely to be significant when compared to total government receipts, whereas the impact of non-payment on private commercial creditors is likely to be substantial and may even lead to their insolvency (Morgan). It has also been argued that the Crown has other means of enforcing its debts, which private creditors do not have recourse to, such as imposition of penalties, higher interest rates, statutory liens and levies (Morgan). Thus, it seems clear that the arguments for granting Crown preference are tenuous.

Taking these arguments into consideration, many jurisdictions have moved towards abolishing or limiting the status of the Crown as a preferential creditor. In the UK, after the enactment of the Enterprise Act 2002, Crown preference has been abolished- the Crown now takes in pari

passu with ordinary unsecured creditors. In Germany, a flat priority system is followed with the Crown being treated on par with other unsecured creditors (Morgan). Australia has also abolished priority for tax claims, while strengthening the powers of taxing authorities through statutory liens, personal liability of directors etc (Morgan).

It is submitted that the preferential status given to the Crown in on shaky ground. Therefore, there is a strong case to be made for abolishing the priority given to Government debts and bringing the Indian law in line with international practices.

Recommendation: It is recommended that that the priority given to secured creditors be not eroded through exceptions. In this regard, the RBI may consider making appropriate recommendations to the Bankruptcy Law Reform Committee appointed by the Ministry of Finance to bring out appropriate changes to the law on priority rights.

4.4. Reinterpreting the Mardia Chemicals Judgment for Wilful Defaulters

Section 17 of the SARFAESI Act embodies the right of borrowers to file an appeal against actions undertaken by secured creditors and their authorised agents for the recovery of their dues. Prior to the implementation of the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Act, 2004 that amended the SARFAESI Act, Section 17 contained a necessary precondition wherein 75% of the amount claimed by the creditor had to be deposited by the borrower before his appeal could be entertained by the DRT. This precondition was in addition to the possession/management of the borrower's property by the creditors as a measure to recover his dues in instances involving default under Section 13 of the SARFAESI Act. On account of the simultaneous application of Section 13 and Section 17 under the SARFEASI Act, the borrower not only had to part with his secured assets but also had to deposit an additional 75% of the demand amount in order to exercise his right to appeal.

These measures were analysed by the Supreme Court in the case *of Mardia Chemicals Ltd. v. Union of India (UOI)*[85] wherein the validity of Section 17 of the SARFAESI Act was challenged by the petitioners for being excessively unreasonable. The Court observed in its judgement that proceedings under Section 17 were in fact not appellate in nature but rather in the nature of an action in the first instance wherein the borrower exercised his right to put forward his grievances against the measures undertaken by the creditor before a prescribed forum. It further observed that such an action in the first instance is an inherent right of every person and requires no authority of law unless there is an express bar on such a right under a Statute. In the opinion of the Court, the requirement of depositing 75% of the demand amount was an unreasonable condition for initiating action in the first instance before the start of adjudication of the dispute. It stated that such a condition made the measures undertaken under the SARFAESI Act to lean in favour of the creditor, to the detriment of the borrower, as in most instances, the borrower would be unable to raise 75% of the demand amount, given that

[85] AIR 2004 SC 2371

his secured assets were already under the control of his creditors. The Court however also noted that the condition regarding pre-deposit for the filing of an appeal was not a new concept but observed that it was feasible only in instances where the deposit amount was meagre or where the power to waive or reduce the said amount was conferred upon the requisite appellate authority. Given that neither of these conditions were satisfied under Section 17 of the SARFAESI Act, the Court accepted the contentions of the petitioners and held Section 17 to be in violation of Article 14 of the Constitution on account of unreasonableness and arbitrariness in its application to the borrower. The appeal amount was subsequently reduced.

Recommendation: The RBI may consider recommending the Ministry of Finance to bring an amendment requiring a deposit of 75% of the amount for cases where the appellant is a wilful defaulter. Since it will not be unreasonable to require such payment from a person who has the resources to make such payment, it may be argued that such an amendment will not go against the broad principles on the basis of which the original provision was struck down. The Ministry of Finance may also be requested to obtain a legal opinion on this issue.

5. DEBT RECOVERY TRIBUNALS

5.1. Introduction

The RDDBFI Act set up the framework for the establishment of DRTs and DRATs in India. The primary objective of RDDBFI Act was to ensure speedy adjudication of cases concerning recovery of debts due to banks and notified financial institutions. Cases pending before the civil courts where the debt amount exceeded Rs 10,00,000 were automatically transferred to DRTs. There are some key differences between DRTs and ordinary civil courts. First, differences in procedure: ordinary civil courts are bound to follow the procedural rules set out in the Code of Civil Procedure, 1908 ("**CPC**"), whereas DRTs adopt a summary procedure based on the rules of natural justice.[86] Second, in DRTs, there is a more restricted scope for hearing arguments over the procedural lapses of the creditor.[87] Third, DRTs fall within the purview of the Ministry of Finance, unlike civil courts, which are part of the judicial hierarchy under the supervision of the respective High Court. Appeals from orders of the DRT lie to the relevant DRAT.

[86] RDDBFI Act, section 22(1).

[87] H Jayesh, Fraser M Alexander, Rashmi Grover, Ashish Banga, 'Multi-Jurisdictional Survey: India: Enforcement of Security Interests in Banking Transactions' available at < http://www.ibanet.org/Document/Default.aspx?DocumentUid=A4360664-F298-491F-AA48-BCAAFC5B45FF>.

DRTs were introduced in a staggered fashion, but by 1999, all states in India had access to a DRT.[88] There are presently five DRATs and thirty-three DRTs in India.[89] Six cities (Delhi, Mumbai, Chennai, Kolkata, Chandigarh and Ahmedabad) have two or more DRTs each, whereas each of the five DRATs, located in different cities, cover a wide geographical zone encompassing several DRTs.

5.2. Impact of DRTs

There is limited empirical evidence detailing the performance of the DRTs since the enactment of RDDBFI Act. However, available evidence suggests that the establishment of DRTs has prompted a considerable improvement in rates of loan repayment. Based on a sample of forty-nine cases, Visaria established that there have been significant reductions in the duration of legal proceedings after DRTs came into being.[90] Further, the probability that a loan repayment would be made on time increased by twenty eight per cent after the DRTs were established.[91] The establishment of DRTs represented a successful attempt to improve channels for loan recovery 'without incurring the costs of overhauling the entire judicial system'.[92] Similarly, research conducted at the DRT Ernakulum indicates that rates of recovery increased over a consecutive three-year period between 2006 and 2009.[93]

All of this evidence should, however, be tempered with two qualifications. First, research suggests that DRTs have had less of an impact than expected on bank lending in the long run, as opposed to in the short run, because of high case pendency in the DRTs and the erstwhile practice of borrowers bypassing DRTs by relying on the Sick Industrial Companies (Special Provisions) Act 1985.[94] In other words, although DRTs have prompted greater bank lending in the short run, the effects of DRTs on long run bank lending have been far more modest. Second,

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[88] Sujata Visaria, 'Legal Reform and Loan Repayment: The Microeconomic Impact of Debt Recovery Tribunals in India' (2009) 1(3) American Economic Journal 59.

[89] In July 2014, the Union Finance Minister proposed the establishment of six new debt recovery tribunals (Maulik Vyas, 'Budget 2014: Government to set up additional six new debt recovery tribunals' *The Economic Times* (Mumbai, 10 July 2014)).

[90] Sujata Visaria, 'Legal Reform and Loan Repayment: The Microeconomic Impact of Debt Recovery Tribunals in India' (2009) 1(3) American Economic Journal 59.

[91] *Id*.

[92] *Id*.

[93] Mukund P Unny, 'A Study on the Effectiveness of Remedies Available For Banks in a Debt Recovery Tribunal - A Case Study on Ernakulam DRT' Centre for Public Policy Research Working Paper Series (February 2011). The author notes that although there was a decrease in recoveries in the financial year 2009-2010, this mirrored the general trend of the fall in the recovery of secured assets using all methods of recovery available to banks and financial institutions during that period.

[94] Francis Xavier Rathinam, 'Procedural Law and Bank Lending to the Private Sector: Evidence from India' Paper Presented at the World Bank Conference on Doing Business (February 2014). The Sick Industrial Companies (Special Provisions) Act 1985 was repealed by the Sick Industrial Companies (Special Provisions) Repeal Act 2003.

DRTs have reduced credit availability for smaller borrowers, and increased credit availability for larger borrowers. The position of lenders improved because of more robust credit enforcement, but a large proportion of small firms experienced contractions in credit and fixed assets.[95]

In spite of improved rates of loan recovery, DRTs have become increasingly burdened in recent years and have been unable to dispose of cases expeditiously. As of 31 March 2013, there were 42,819 cases pending before the DRTs, averaging about 1,297 pending cases per DRT and involving loans worth Rs. 1.43 lakh crore.[96] There are significant variations in case pendency and total loan amounts amongst different DRTs. For instance, whereas 3,632 cases were pending before the three tribunals in Mumbai (with a total loan amount of Rs. 43,400 crore), 11,212 cases were pending before the three tribunals in Kolkata (with a total loan amount of Rs. 20,600 crore). The recommended statutory timeline[97] - six months - is rarely complied with, with cases often running into years before they reach their logical conclusion, particularly if there is an appeal to the DRAT.

5.3. Specific Recommendations

D. Infrastructure and Training

(i) Measuring the efficiency of DRTs and adjusting the monetary threshold under the RDDBFI Act

One of the major problems plaguing the functioning of the DRTs at present is that their performance is not grounded in carefully evaluated statistical data.[98] Most of the evidence concerning the functioning of DRTs and the time taken for loan recovery in specific cases is based on anecdotal evidence. Statistical data can be usefully fed into parameters of efficiency to appraise the functioning of DRTs across the country.

The absence of sophisticated statistical data and established efficiency parameters also makes it difficult to determine whether the monetary threshold for approaching DRTs – currently Rs. 10,00,000 – is set at an appropriate level. There may also be a case to reduce the threshold if DRTs are able to deal with the existing caseload more efficiently.[99] Conversely, there may also be a case to increase the existing threshold in order to enable DRTs to sustain a manageable caseload.

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[95] Ulf Von Lilienfeld-Toal, Dilip Mookherjee, Sujata Visaria, 'The Distributive Impact of Reforms in Credit Enforcement: Evidence from Indian Debt Recovery Tribunals' (2012) 80(2) Econometrica 497.

[96] Vishwanath Nair, 'Rs. 1.44 Trillion Stuck as Cases Pile up at Debt Recovery Tribunals' *Live Mint* (Mumbai, 22 August 2014).

[97] RDDBFI Act, Section 17(24).

[98] Report of the Financial Sector Legislative Reforms Commission (22 March 2013).

[99] Report of the Working Group on Banking - Financial Sector Legislative Reforms Commission (1 March 2013).

Presently, the monetary threshold for invoking the jurisdiction of the DRTs is set out in the RDDBFI Act. Several reports have suggested amendment to the RDDBFI Act in order to promote flexibility by enabling the thresholds to be adjusted through delegated legislation.[100] However, such an amendment is not strictly necessary, because the existing statutory provision permits increases or decreases in the threshold through central government notifications, subject to a minimum of Rs. 1,00,000. Given the current caseload of DRTs, it is highly unlikely that the efficiency parameters will justify a reduction in the threshold below Rs.1,00,000 in the foreseeable future.

Recommendation: Every DRT should be required to record annual statistical data on matters such as the number of pending cases, the number of cases disposed, the total loan amounts, and the time taken for disposal of cases. This data may be passed on to the relevant DRAT, which can evaluate the data based on standard efficiency parameters. The monetary threshold for invoking the jurisdiction of DRTs may be adjusted (upwards or downwards) based on efficiency through central government notifications.

(ii) Training of judicial officers and recovery officers

Arguably, the judicial officers and recovery officers in DRT lack the requisite knowledge of banking, finance (including valuation) and associated rules and regulations.[101] This may be a major cause for delays on account of the fact that such officers find it difficult to grapple with the complex issues that arise before them. The absence of specialised knowledge may also result in unsustainable orders that are open to challenge for being beyond the jurisdiction of DRTs.[102] Therefore, providing specialised training to judicial officers and recovery officers forms an important part of the project of ensuring effective recovery of loans.[103]

Judicial training provided by the Judicial College in the UK may be relied upon as a model for training judicial officers and recovery officers.[104] In this context, the following points may be borne in mind.

(a) Overriding objective: The overriding objective should be to provide training of the highest professional standards which satisfies the business requirements of judicial leaders, promotes (as far as practicable) the professional development of officers, strengthens the capacity of officers to discharge their judicial functions effectively and enhances public confidence in the system.

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[100] Report of the Financial Sector Legislative Reforms Commission (22 March 2013); Report of the Working Group on Banking - Financial Sector Legislative Reforms Commission (1 March 2013).

[101] Report of the Working Group on Banking - Financial Sector Legislative Reforms Commission (1 March 2013).

[102] See, for eg, the discussion in *Standard Chartered Bank v Dharminder Bhohi* (2013) 12 SCALE 124.

[103] In *Union of India v Debts Recovery Tribunal Bar Association* (2013) 2 SCC 574, the Supreme Court directed the Government of India to hold regular training programs recovery officers/assistant registrars/registrars.

[104] Strategy of the Judicial College in the UK (2011-2014), available at < http://www.judiciary.gov.uk/about-the-judiciary/training-support/judicial-college/strategy-2011-14/>.

(b) Components: Judicial training should comprise the following elements: (a) substantive law, evidence and procedure, including 'subject expertise' – i.e., a thorough understanding of banking, finance (including valuation) and associated regulations (b) the acquisition and improvement of judicial skills, including leadership and management skills (c) the social context within which judging occurs (including knowledge about the delaying strategies of defaulters, etc.) (d) information technology training (which is discussed subsequently in further detail).

(c) Programme Design and Delivery: Judicial training should be designed and delivered by experienced judicial officers or by distinguished members of the academic community (including business-school professors). Judicial officers who design and deliver judicial training should themselves receive training and advice for that purpose and attend international conferences, as may be necessary and subject to resource constraints, to learn from prevailing global best practices. The training should focus on active participation by judicial officers and recovery officers in a supportive environment that gives them the opportunity to practise and develop their skills.[105]

(d) Monitoring and Evaluation: Judicial training should be reviewed and evaluated to ensure its continuous development and improvement and in order to ensure value for money. Anonymous feedback should be secured from participants at the end of each training programme in order to ensure that the programme develops based on the requirements of the judicial officers and recovery officers.

Recommendation: Judicial officers and recovery officers should receive sufficient training in banking, finance and associated regulations. The training component should be continuous, requiring such officers to participate in stated minimum training requirements annually.

(iii) Encouraging the use of Information Technology

As the Working Group on Banking noted, the use of information technology in the management of DRT cases, including on matters such as digitisation of court records and computerisation of registries, forms an important part of equipping the DRTs to cope with their increasing caseload.[106] Some steps have already been taken in this vein. The government of India's 'e-DRT' project, which is being undertaken with the assistance of the National Institute for Smart Government, seeks to provide DRT officials with relevant technology enablers and efficiently manage case records, amongst other things.[107]

As stated earlier, the training provided to judicial officers and recovery officers should include a component on information technology. They should be imparted sufficient training to ensure that they are able to make effective use of the equipment, software and online resources that

[105] For examples of the kind of active participation encouraged by the UK Judicial College, see Joshua Rozenberg, 'Wigs off, jeans on at the Judicial College' *The Guardian* (London, 8 February 2012).

[106] Report of the Working Group on Banking - Financial Sector Legislative Reforms Commission (1 March 2013).

[107] See website of the National Institute for Smart Government, available at <http://nisg.org/project/37>.

are available to them.[108] Presently, judicial officers and recovery officers may have different levels of knowledge and experience in dealing with information technology. The training that is imparted should ensure that all officers acquire knowledge to a minimum standard. In addition to collective training, judges may also be given individual support to address gaps in their personal computer skills.[109]

It may also be beneficial to appoint 'IT Liaison Judges' (ITLJs) for groups of DRTs in every region. ITLJs should be well versed with information technology and should be willing to assist colleagues with basic computer problems in their spare time.[110] On appointment, each presiding officer and recovery officer should be given the identity and contact details of the relevant ITLJ for the region. The concept of ITLJs seems to have worked well in the UK, with some of them even pro-actively arranging small informal courses to enable judges to keep abreast of recent developments.[111]

Recommendation: The 'e-DRT' project should be implemented in a time-bound fashion so as to ensure that presiding officers and recovery officers are swiftly equipped with adequate access to information technology and records. Training imparted to presiding officers and recovery officers should include an information technology component. 'IT Liaison Judges' may be appointed for DRTs on a regional basis.

E. Procedure

(i) Establishing uniform procedures for the functioning of DRTs across the country

One of the primary objectives behind the setting up of DRTs was to enable the speedy recovery of loans in tribunals that do not need to comply with the procedural rules set out by the Code of Civil Procedure. As stated earlier, the RDDBFI Act only requires DRTs to comply with the principles of natural justice. However, a consensus is emerging that the lack of uniformity in procedural rules across DRTs has produced significant ad-hocism and confusion in matters such as the serving of summons, filing of documents and evidence, and cross-examination of creditors.[112] This confusion produces greater delays and frequent adjournments. There is also an apprehension that the absence of uniform procedures contributes to uncertainty of DRT members about the kind of procedures that will be considered sufficient and fair to all parties.

[108] See Prospectus of the UK Judicial College, available at <http://www.judiciary.gov.uk/wp-content/uploads/JCO/Documents /eLetters/764964+Judicial+College+final +proof.pdf>

[109] *Id.*

[110] *Id.*

[111] *Id.*

[112] 'A Hundred Small Steps': Report of the Working Committee on Financial Sector Reforms, Planning Commission, Government of India (2009). Advocates have often complained about the lack of uniform procedures across DRTs – see, for eg, 'Kolkata DRT Lawyers' Strike' *Business Line* (Chennai, 1 August 2002).

In the past, some DRTs have been known to follow the full set of procedures laid down in the Code, resulting in significant delays.[113]

It should be made clear that the establishment of uniform procedures across DRTs need not be tantamount to the adoption of elaborate procedural rules resembling those set out in the CPC – in fact, that would go against a fundamental purpose of the RDDBFI Act. The objective should be to develop a set of basic procedures that comply with the rules of natural justice without being so elaborate that they contribute to delays in recovery.

Recommendation: Uniform procedural rules that comply with the principles of natural justice should be developed in consultation with DRTs and DRATs. These rules should comply with basic requirements of natural justice without sliding into an elaborate procedural regime resembling that set out in the CPC. Procedures should be designed with the ultimate aim of the tribunal (facilitating expedited resolution on default for undisputed debts) in mind. DRTs and DRATs across India should be required to comply with these rules in all cases.

(ii) Restricting stay petitions and adjournments

It is well known that adjournments and stay orders on recovery applications are secured easily before the DRTs and DRATs.[114] This contributes to the time lags in decision-making and results in an increased caseload. The Supreme Court has pointed out that DRTs and DRATs should grant adjournments as an exception rather than as the rule.[115] Enabling regular adjournments to stifle proceedings before the tribunals would frustrate the fundamental purpose of the RDDBFI.[116]

Recommendation: A requirement that DRTs and DRATs should grant adjournments only where absolutely necessary should be introduced and a ceiling for the maximum number of adjournments allowed should be introduced. The training programs for judicial officers should include a component on the nature of cases that warrant adjournments and stay orders.

Having said this, it should be noted that adjournments are often prompted by the other institutional problems plaguing the DRTs, for example, the lack of uniform procedures and absence of adequate information technology infrastructure. Tackling these problems will eradicate to a significant extent the causes of frequent adjournments in DRTs.

[113] *S Ravichandra v Debt Recovery Tribunal* (1998) 5 Kar LJ 162.

[114] Mukund P Unny, 'A Study on the Effectiveness of Remedies Available For Banks in a Debt Recovery Tribunal - A Case Study on Ernakulam DRT' Centre for Public Policy Research Working Paper Series (February 2011).

[115] *Standard Chartered Bank v Dharminder Bhohi* (2013) 12 SCALE 124.

[116] *Id*.

(iii) Disallowing simultaneous action under RDDBFI Act, SARFAESI Act

In *Transcore v Union of India*[117], the Supreme Court was called upon to interpret the first proviso to section 19 of the RDDBFI Act to determine whether banks and financial institutions were required to seek prior leave of DRTs before bringing proceedings under the SARFAESI Act. The Court held that withdrawal of an application before the DRT is not a pre-condition for bringing proceedings under the SARFAESI Act. The relevant bank or financial institution would be left to exercise its discretion as to cases in which it would apply for leave and cases in which it need not apply for leave to withdraw. This judgment opened the door to simultaneous proceedings under SARFAESI Act and RDDBFI Act on the same subject matters, resulting in the clogging of the DRTs.

Recommendation: The RDDBFI Act could be suitably amended so as to require banks and financial institutions to obtain the leave of DRTs before bringing proceedings under the SARFAESI Act. However, it is possible that banks file in the DRT as a backstop if they fear delays / unexpected hurdles using out-of-court rights under the SARFAESI Act, which does not appear unreasonable. An alternative solution might be to have an automatic stay on DRT proceedings until the resolution of the SARFAESI Act proceedings, but at least this would mean the DRT proceedings could be immediately restored by the bank if necessary

The RBI may consider making appropriate recommendations to the Ministry of Finance for implementing the recommendations made in this section.

6. Other Issues

6.1. RBI directors in Public Sector Banks

Pursuant to section 9(3)(c) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80, as amended, the appointment of the RBI nominee director on the boards of public sector banks (PSBs) is to use the expertise and experience of such directors in regulating and supervising commercial banks. Such directors are nominated by the Central Government on the recommendation of the RBI and their tenure is at the discretion of the RBI. Pursuant to the Nationalised Banks (Management and Miscellaneous Provisions) Scheme, 1970 the object of section 9 was to reflect the genuine interests of various persons manning or dealing with the bank as an industry and commercial enterprise.[118] The broad guidelines issued by the RBI to their nominees on the boards of banks include the following:

- The director is expected to regularly attend board meetings and take an active part in its deliberations;

[117] AIR 2007 SC 712

[118] *All India Banks Officer's Confederation* v. *Union of India*, AIR 1989 SC 2045

- Members of the board do not exercise any executive authority individually, but are collectively responsible for the superintendence, direction and management of the bank;
- While directors can delegate certain powers to any committees, executives or other officers, they cannot absolve themselves of their responsibility of ensuring that the bank operates on sound and prudent lines;
- Directors are responsible for safeguarding the interests of the depositors and owners through efficient and well informed administration of the bank;
- Directors are expected to critically and thoroughly study agenda papers; and
- Directors should pay adequate attention to the state of non-performing assets, recovery performance and write-off of large debts (say Rs. 1 crore or more)[119]

There have been several criticisms of the appointment of RBI nominee directors to the boards of PSBs. There is arguably a conflict of interest in a representative of the regulator being present on the board of a regulated entity. Further, despite the presence of such nominees, there have been instances of widespread inefficiency due to the power being exercised by the CMDs of these banks.[120] The Narasimhan Committee on Banking Sector Reforms had also suggested certain amendments in this regard. However, the counter view suggests that the presence of an RBI nominee director is useful to counter the oft-seen misuse of power by the CMDs of PSBs. Further, since the depositors are the most important stakeholders in PSBs (rather than shareholders), the RBI (as the parent company of the Deposits Insurance and Credit Guarantee Corporation which insures deposits in PSBs) has an important function to safeguard the interests of both its subsidiary and the depositors.

Recommendations:

(a) There is certainly an argument for the RBI to retain certain control over the functioning of PSBs since the criteria prescribed for the "fit and proper" constitution of the board of directors in private sector banks has not been extended to public sector banks. Other inherent safeguards are present such as the requirement to appoint a certain number of independent directors to the board of PSBs pursuant to Clause 49 of the Listing Agreement entered into by the listed PSBs and the stock exchanges. One way in which the RBI could still contribute its expertise to the boards of PSBs while minimising conflict, is to appoint retired RBI officials as nominee directors to the boards. Further, the tenure of such directors should be in consonance with provisions of the Companies Act, 2013 (which is inapplicable to banking companies currently) and not at the discretion of the Central Government. Further, such directors (in keeping with the distinction drawn between nominee directors and independent directors under the Companies Act, 2013) should be classified as independent directors since there is no pecuniary relationship or shareholding of such directors in the PSBs. The directors will be required under law to provide a declaration of independence at the first meeting of the board and should be governed by guidelines to be made applicable to independent directors. As suggested by the RBI report dated May 13, 2014 for Governance of Boards of

[119] Report of the Consultative Group of Directors of Banks / Financial Institutions issued by the RBI dated April 2002 available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/27762.pdf

[120] RBI has moved a proposal dated September 17, 2014 to segregate the post of Chairman and Managing Director of PSBs.

Banks in India, till a Bank Investment Company is constituted to which the government transfers its holdings in PSBs, the Bank Boards Bureau should comprise of RBI nominees who will advise on all board appointments of PSBs.

(b)Alternately, the RBI directors can be appointed as observer/advisory directors, in which case either they do not have voting rights, but can participate in board meetings to forward proposals and suggestions for the course of action to be undertaken by such banks while focusing on their regulatory functions. A way to ensure effectiveness is to require the board to table the suggestions forwarded by the observer director and to provide cogent reasons for consideration/non-consideration of such suggestions, which will be recorded in the minutes of the meetings of the board. In certain exceptional situations, to be decided by a majority of the board, such suggestions will have to be tabled before the shareholders of the banks for consideration.

(c)Until such time that there is clarity on the status of Central Government and RBI nominee directors being classified as independent directors or with the implementation of the suggestions of the RBI Committee in 2014, the presence of RBI nominee directors on the boards of PSBs is advisable.

6.2. Tax Issues

6.2.1. Differential Treatment Accorded to Debt and Equity Finance under Indian Tax Laws

The Indian corporate income tax regime treats debt and equity finance with some difference, with the former being accorded a preferential treatment. This phenomenon of debt bias is prevalent in the taxation laws of many other countries.[121]

In the Indian context, the Income Tax Act, 1961 ("**Income Tax Act**") stipulates that a company is liable to pay corporate income tax at the rate of 30% on the total income earned by it during a relevant previous year. Over and above this tax, when a company distributes dividends to the shareholders, the distributed amount is subject to an additional levy by the name of dividend distribution tax[122]. As a corollary, the dividend income when received by a shareholder is exempt in his hands[123]. When a shareholder ultimately sells his shareholding, the accruing gains

[121] Wolfgang Schon, Tobias Beuchart, et.al., 'Debt and Equity: What's the difference? A Comparative View', Max Planck Institute for Intellectual Property, Competition & Tax Law Research Paper Series No. 09-09, pp.9-99.

[122] Section 115-O, inserted by the Finance Act, 2007, introduced the concept of Dividend Distribution Tax which levies an additional tax of 15% on a company when it distributes dividends. The ultimate burden of this tax is on shareholders though and the rationale for introducing the dividend distribution tax was to simplify the administration of the tax collection. Prior to 2007, tax on dividends was collected from the shareholders directly.

[123] Section 10(33) and 10(34), Income Tax Act, 1961.

are subject to short or long term capital gains tax, depending on the period for which the shares were held.

On the other hand, when a company raises debt finance, the resulting interest payments it makes on the borrowed capital, can be claimed by it as a deduction[124] from its taxable profit. The lender of the debt finance is required to pay tax on the interest income[125].

Hence, in effect, the returns on equity finance (being dividends and capital gains) is not deductible while returns on debt finance (interest income) is deductible. This leads to an apparent bias towards debt finance.[126] The problem with the bias is that it may lead to funding decisions being driven by the mere need to avail tax incentives rather than economic grounds, defeating the principle of fiscal neutrality that tax policies should aspire for. This may lead to over indebtedness in companies (which can translate into large scale defaults during an economic downturn).

Empirical studies of the impact of the debt bias under taxation laws, though in the setting of developed countries, have demonstrated that the ramifications of the preferential treatment accorded to debt cannot be ignored altogether.[127] The debt bias induces firms to raise increased finance through debt instruments distorting the debt-equity ratios of corporations.[128] Within the financial sector, the negative externalities and the welfare costs flowing out of the collapse of a bank are enhanced because of the associated systematic risk. While it has been opined that the debt bias was not the primary cause of the recent financial crisis, it may have worsened the impact of the crisis.[129]

A number of rationales have been provided to justify the debt bias. The difference in the legal rights between lenders of debt and equity finance has been often quoted as one basis. A debt financier has a right to receive a fixed return irrespective of the financial position of the creditor, unlike a shareholder who receives a variable return linked to the profits earned. In a situation of insolvency, a debt financier assumes priority. A shareholder exercises voting rights

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[124] Section 36(1)(iii), Income Tax Act, 1961.

[125] Section 56(2)(id), Income Tax Act, 1961.

[126] Having said that, it must be said that the actual benefit of the debt bias depends on a number of circumstances including the rate of corporate tax, source of funding – whether, external or internal, and the availability of profits from which interest can be deducted. See John Vella, 'The Asymmetrical Treatment of Debt and Equity Finance Under UK Tax Law' in A Reisberg and D Prentice (eds), Corporate Finance Law: UK and EU Perspectives, OUP, (2011).

[127] 'Growth – Friendly Tax Policies in Member States and Better Tax Co-ordination in the EU', Vol.5/5, Annex IV, November 2011, pp.7-8.

[128] M A Desai, C F Foley, and J R Hines Jr, 'A Multinational Perspective on Capital Structure Choice and Internal Capital Markets', (2004) 59 (6) Journal of Finance 2451.

[129] Ruud A de Mooji, 'Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions', IMF Staff Discussion Note, May 2011, pp.12-14.

while a debt financier typically does not. It has also been argued that interest payments are expenses incurred in earning income while dividends are a distribution of the profits earned.[130]

The problem with the rights based reasoning is that the traditional lines delineating the distinction between debt and equity have been blurred which is borne out by the advent of hybrid instruments. In the context of a company both debt and equity finance represent an obligation to another party (the debt financier or the shareholder) and in essence, perform the similar function of financing the company.

Efforts are being made, at the domestic and multilateral level to find a solution to the problem posed by such debt bias. For example, United Kingdom has come up with a detailed provision defining a distribution[131] and has attempted at framing a principle-based legislation[132] to tackle debt disguised as equity. The country also has in place thin capitalisation rules which seek to limit interest deductibility if the borrowing exceeds a certain limit. OECD has noted that the use of hybrid mismatch instruments in cross border situations have led to a number of policy issues[133] and in its Base Erosion and Profit Shifting Report, it has dedicated Action 2 for developing recommendations to prevent base erosion arising out of the interest deductions.

Recommendation: It is submitted that while it may not be correct to deduce that the debt-bias of the taxation regime has necessarily contributed to the NPA crisis, the RBI may consider recommending the Ministry of Finance to study the negative externalities and attendant welfare costs caused by the differential tax treatment of debt and equity. Such study may consider emerging alternatives such as Allowance for Corporate Equity[134], Comprehensive Business Income Tax[135].

[130] Ruud A de Mooji, 'Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions', IMF Staff Discussion Note, May 2011, pp.10-11.

[131] Part 23 of the UK Corporation Tax Act, 2010.

[132] Section 468B, UK Corporation Tax Act, 2009 which uses the test of whether the return is '*economically equivalent to interest*'.

[133] OECD, 'Hybrid Mismatch Arrangements Tax Policy and Compliance Issues', March 2012, pp.11.12.

[134] The Allowance for Corporate Equity proposal, which was made popular by the IFS Capital Tax Group in 1991, provides for a deduction on equity based on a normal rate of return. Thus, the corporate income tax would be a tax on 'economic rents'. The proposal is being or was implemented in a number of countries including Austria, Italy, Croatia, Belgium and Brazil. See OECD Tax Policy Studies No.16, *Fundamental Reform of Corporate Income Tax*, pp.130-132.

[135] Comprehensive Business Income Tax was proposed by the US Department of Treasury in 1992 and it sought to integrate the corporate and personal income tax systems by taxing returns on equity (normal and economic) and debt in the hands of the company. The debt financier and shareholder would no longer be taxed and a company would be neutral in choosing between debt and equity.

6.2.2. Deduction Regime for Bad Debts

Tax incentives often operate in a counterproductive and inequitable manner, provide a greater incentive to undertake tax avoidance behavior, entail higher compliance costs for the taxpayer and the authorities while also adding to the already complex regime.[136] It has been noted that some deductions including those relating to bad debts are being allowed to banks without adequate scrutiny which is problematic.[137]

Section 36(1)(vii) of the Income Tax Act provides that in respect of any amount of bad debt or part thereof which has been written off[138] as irrecoverable for the previous year the assesse may claim a deduction. In the case of a banking business, the assessee is entitled to a deduction in respect of irrecoverable bad debts advanced in the ordinary course of business irrespective of the method of accounting employed. The section does not stipulate any cap on the amount that may be written off as irrecoverable by a creditor.

Prior to the assessment year 1989-1990, for an assessee to claim deduction he was required to *establish* that the debt or part thereof became bad *in the previous year*.[139] An assessee is now at an advantageous position as he can write off and claim the debt in a subsequent year when the debt continues to remain bad. The amended language[140] has been interpreted to mean that once the assessee writes off the amount as irrecoverable the requirement to establish that the debt has become bad has been dispensed with.[141] The assessing officer may disallow a claim only if the assessee's conclusion was not *bona fide*[142] or based merely on convenience[143]. Once the transaction is proved to have taken place, the presumption is that the write off was honest and justified on grounds of commercial expediency[144]. One of the high courts has held that the

[136] Report of the Task Force on Direct Taxes, December 2002, pp.120-127.

[137] CBDT Instruction No. 17/2008.

[138] Until the Finance Act, 2001 a mere debit to the profit and loss account by the assessee was taken to constitute a write off. In order to rectify this situation an explanation was added to Sec. 36(1)(vii) in 2001, with effect from 1st April, 1989. This explanatory provision was added to clarify the distinction between a write off and a provision for bad and doubtful debts. An assessee is now required to debit the profit and loss account simultaneous with a reduction in the loans and advances or the debtors from the asset side of the balance sheet per *Vijaya Bank v Commissioner of Income Tax*, (2010)5SCC416. *Southern Technologies* Ltd.v *Joint Commissioner of Income Tax* (2010) 2 SCC 548 contrasts write off from a provision for non-performing assets in terms of the Prudential Norms (Reserve Bank) Directions, 1998.

[139] Prior to the Direct Tax Laws (Amendment) Act, 1987, w.e.f. 1-4-1989, the clause read as - "*any debt, or part thereof, which is established to have become a bad debt in the previous year*".

[140] Section 36(1)(vii) reads as - "*any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year*".

[141] *TRF (T.R.F.) Limited v Commissioner of Income Tax* (2010) 13 SCC 532.

[142] *Director of Income Tax (International Taxation) v Oman International Bank* 2009 (5) BomCR 416.

[143] *South India Surgical Co. Ltd v Assistant Commissioner of Income Tax* [2006] 287 ITR 62 (Mad).

[144] *Commissioner of Income Tax v Morgan Securities and Credits (P) Ltd.* (2007) 210 CTR (Del) 336.

assessing officer can disallow a claim only if the entire books of accounts are found to be unreliable or there is extreme perversity in the declaration of the debt[145].

The CBDT explained that the amendment was brought in to rationalise the provisions and to end the litigation relating to the *determination of the year* in which a bad debt can be allowed.[146] However, the amendment has been interpreted in a manner that has left hardly any scope for investigation into the facts and whether the debt actually ever became bad by relying primarily on the commercial judgment of the banker.

Substituting the scrutiny by the tax authorities for the commercial judgment of a creditor may potentially lead to a situation where the economic reality is divorced from the representations in the books of accounts. This policy is only made worse by the lack of an upper limit on the permissible deduction that a creditor can avail.

Recommendation: It is submitted that norms be evolved to regulate the permissible levels of deduction for bad debts. This can be done by prescribing an upper threshold for the deduction of bad debts that can be availed. Additionally, to ensure that the books of accounts reflect the true economic position, we recommend that the administration of this section be strengthened. It should be clarified that while a creditor need not adduce infallible proof of the debt becoming bad in a particular year, he or she should be able to reasonably justify the writing off a debt in the books of account and so must maintain records of when the debt was extended, the whereabouts of the debtor, attempts made to recover the debt, etc. The RBI may consider making an appropriate recommendation to the Ministry of Finance in this regard.

6.2.3. Deduction Regime for a Provision for Bad and Doubtful Debts

Deduction in respect of a mere provision for bad and doubtful debts is usually not allowed but in the case of banks (scheduled, non-scheduled and foreign) a provision up to a stipulated limit is deductible under Section 36(1)(viia).[147] As banks are entitled to avail deduction for bad debts as well as for a provision for bad and doubtful debts, there have been concerns about a double deduction. The proviso to Section 36(1)(vii) limits the deduction for bad debts to the amount by which such debt exceeds the credit balance in the provision for bad and doubtful debts account. Yet again, if the amount written off as an irrecoverable bad debt, that amount is available as a deduction irrespective of the amount claimed. The provisio has an effect of limiting the deduction only when the amount written off is less than the deduction for bad and doubtful debts that can be made under the caps stipulated under Section 36(1)(viia).

[145] *Commissioner of Income Tax v Nai Duniya* [2007] 295 ITR 346 (MP).

[146] CBDT Circular No.551, paras 6.6 and 6.7.

[147] In respect of any provision for bad and doubtful debts made by a scheduled bank (not being a foreign bank) or a non-scheduled bank, an amount not exceeding 7.5% of the total income and an amount not exceeding 5% of the aggregate average advances made by the rural branches of such bank. Rural branch means a branch of a scheduled or non-scheduled bank in a place which has a population of not more than 10,000 according to the last preceding census of which the relevant figures have been published before the first day of the previous year.

The Supreme Court[148] had held that the proviso does not apply to urban advances but, an amendment[149] which took effect from April 1, 2014 clarified that it applies to all advances. Due to the expansive reading of the proviso to Section 36(1)(vii), a write off pertaining to urban advances is to be set off against a provision for bad and doubtful debts relating to rural advances. Hence, the scope of claiming a double deduction has been put to an end through the amendment.

Recommendation: In order to address the problems caused by excessive deductions available to banks due to Section 36(1)(vii) and 36(1)(viia) and the fact that the proviso in Section 36(1)(vii) may have a limited effect in some instances, we recommend the stipulation of a maximum cap under Section 36(1)(vii). This recommendation ties in with our immediately preceding recommendation The RBI may consider making an appropriate recommendation to the Ministry of Finance in this regard.

6.3. Raising Capital by Public Sector Banks without Dilution of the Government's Ownership or Control

Company law envisages a mode of raising further capital without dilution of ownership. Section 43 of the Companies Act, 2013 provides for two kinds of equity share capital (i) with voting rights; and (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed. Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014 lays down certain conditions for issuing shares with differential voting rights for example (i) the articles of association of the company should authorize such issuance; (ii) the issue of shares should be authorized by an ordinary resolution passed at a general meeting of the shareholders; (iii) the shares with differential rights should not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time; and (iv) the company should have consistent track record of distributable profits for the last three years.

The Banking Regulation Act states that capital of a banking company can consist of 'equity shares only' or 'equity shares and preference shares'.[150] Further, Section 12(2) of the Banking Regulation Act states that no person holding shares in a banking company shall, in respect of any shares held by him, exercise voting rights on poll in excess of ten percent of the total voting rights of all the shareholders of the banking company. The Reserve Bank has the power to increase the ceiling on voting rights from ten percent to twenty-six percent in a phased manner.

[148] *Catholic Syrian Bank Ltd v Commissioner of Income Tax* (2012) 3 SCC 784.

[149] Explanation 2.—For the removal of doubts, it is hereby clarified that for the purposes of the proviso to clause (vii) of this sub-section and clause (v) of sub-section (2), the account referred to therein shall be only one account in respect of provision for bad and doubtful debts under clause (viia) and such account shall relate to all types of advances, including advances made by rural branches.

[150] Section 12 (1) (ii), Banking Regulation Act, 1949.

Recommendation: It is submitted that the Government may consider diluting its economic interest in public sector banks (which can be achieved without dilution of its ownership and control) through issuance of shares with differential voting rights. This will provide such banks with much needed capital without imposing any additional economic burden on the exchequer or affecting the Government's ownership and control over such banks. Such fundraising may be implemented within the framework of a holding company structure for public sector banks that is currently being considered. This may require certain clarificatory enabling amendments to the Banking Regulation Act. Given that such a measure may substantially increase the availability of funds for lending, it will have to be complemented by strict credit discipline (to prevent indiscriminate lending).