

RBI proposes a revamp on the framework applicable to wilful defaulters

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Last month, the Reserve Bank of India (the “**RBI**”) released a draft Master Direction (the “**Draft Direction**”) proposing revisions to the Master Circular released in 2015 relating to wilful defaulters. The Draft Direction has broadened the definition of “wilful default” and expanded the scope for Regulated Entities (“**REs**”), now covering commercial banks and co-operative banks, to classify borrowers as “wilful defaulters.” The Draft Direction also mandates a review and finalization of the wilful default aspects of a case within six (6) months of an account being classified as a Non-Performing Asset (“**NPA**”).

Background

The RBI released a Master Circular relating to wilful defaulters in 2015. However, major issues arose in 2016 when the RBI issued directions, i.e., the RBI (Frauds Classification and Reporting by Commercial Banks and Select FIs) Directions, 2016 (the “**FCRSF Directions**”), under which borrowers (including promoter directors and whole-time directors) accused of fraud were prevented from accessing the banking system and capital markets. In *State Bank of India v. Rajesh Agarwal* (Civil Appeal No. 7300 of 2022), the Supreme Court held that borrowers must be heard before their accounts are classified as fraudulent on the principle of “audi alteram partem,” i.e., the other party must be heard, and this legal principle must be read into the FCRSF Directions.

Based on the foregoing and other rulings, various stakeholders suggested that borrowers should be given an opportunity to be heard before their accounts are declared as fraudulent. To put this controversy to rest, the RBI decided to revise the 2015 Master Circular and has released the Draft Direction.

Key Changes

Several key changes have been proposed by the RBI in the Draft Direction to increase the comprehensiveness of the framework relating to wilful defaulters.

Identification and classification of wilful defaulters and large defaulters

Lenders have been entrusted with the exclusive power to declare entities as wilful defaulters. The Draft Direction proposes that a “wilful defaulter” must be a borrower or guarantor who has committed wilful default and the outstanding amount is INR 2.5 million or more. Similarly, if the outstanding amount is INR 10 million or more, the borrower will be construed as a large defaulter.

The Draft Direction proposes a twin-tiered structure consisting of an identification committee and a review committee to be constituted for identification of wilful defaulters. The identification committee is tasked with the responsibility of issuing a show-cause notice

against the defaulter and calling for submissions. After receiving submissions, a reasoned order must be passed by the identification committee, which will be considered by the review committee for classification of entities as wilful defaulters.

The RBI has attempted to satisfy the requirements of natural justice by providing an opportunity to defaulters to make written submissions and attend an in person hearing before the review committee, if deemed necessary.

Compromise settlement with defaulters

In case of a settlement between the lender and the borrower, the name of the borrower should be removed from the List of Wilful Defaulters (“LWD”) only when the settlement amount is fully paid by the borrower. In case of part payment, the name should not be removed from the list even if the outstanding amount becomes less than the threshold of INR 2.5 million.

Further, the settlement with the wilful defaulter should be in terms of the board-approved policy of the lender. It is imperative to note that a settlement should not absolve the wilful defaulter from any legal proceedings, including criminal actions. Further, a lender can proceed against a guarantor without exhausting remedies against the principal debtor, in cases of default.

Framework for credit facility

The Draft Direction proposes that no additional facility should be granted by a lender to the wilful defaulter or an entity with which the wilful defaulter is associated for up to one (1) year after the wilful defaulter’s name has been removed from the LWD by the lender. Further, no credit facility should be granted for any new venture of a wilful defaulter or any entity to which a wilful defaulter is associated for a period of five (5) years after the name of wilful defaulter has been removed from the LWD by the lender. Furthermore, wilful defaulters should not be eligible to restructure the credit facility. Additionally, lenders may initiate legal and criminal proceedings and also demand penal charges, where applicable.

Lenders should complete investigations into wilful default cases before transferring credit facilities to other lenders or asset reconstruction companies. The Draft Direction also prescribes that the sale of the defaulted loan should not be considered as a recovery. Further, the Draft Direction outlines the regulatory requirement for monthly reporting by REs to Credit Information Companies (“CIC”) of large and wilful defaulters. The report should include lists categorizing accounts as “suit filed” and “non-suit filed” accounts, indicating whether REs have approached courts or tribunals to recover their dues. Additionally, CICs should display the list of suit-filed accounts of large defaulters on their website. In case, the lender removes the name of the wilful defaulter from the LWD, the lender must communicate to the CIC promptly but no later than thirty (30) days, from the date when the outstanding amount falls below the threshold of INR 2.5 million.

Our comments

The Draft Direction, to a large extent, aims at curbing wilful defaults by companies or individuals on account of the rigorous consequences imposed for such wilful defaults. The Draft Direction provides a deadline for banks to classify a borrower as a wilful defaulter, which will definitely enhance vigilance levels and reduce the siphoning off of funds by borrowers.

Certain options provided to banks under the Draft Direction, such as allowing settlements with wilful defaulters, can lead to tricky situations. In case a bank takes a large 'haircut' on a settlement, this can impact the financial strength of the bank. Moreover, boards of banks are authorized to provide leniency to wilful defaulters as they deem fit without any prescribed norms. If such decisions are not monitored by the government/ RBI vigilantly, the authority may be misused. Moreover, in cases where the government controls the board of public sector banks, the settlement option may be used for political favors at the cost of the commercial interests of such banks.

Although the intent of the framework of Draft Direction is positive, the RBI will have to periodically review the guidelines to curb any misuse of the proposed framework.