



F I R M
Forum on Insolvency Risk Management
THE WORLD BANK



FORUM ON ASIAN INSOLVENCY REFORM 2004

INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN ASIA

*New Delhi, India, 3-5 November 2004
The Oberoi Hotel*

**TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK
MANAGEMENT: THE EXPERIENCE OF INDIA**

by

Mr. R. Umarji, Indian Banks' Association

IN PARTNERSHIP WITH
THE GOVERNMENT OF JAPAN

HOSTED BY
**MINISTRY OF FINANCE,
BANKING DIVISION
MINISTRY OF COMPANY AFFAIRS
AND INSOL INDIA**

Trends and Developments in Insolvency Systems and Risk Management

The experience of India

The legal system in India is based on common law of England. The legal system operates on the basis of statutory laws and the Constitution of India which provides the basic structure of the judiciary and powers of judicial review to the High Courts and Supreme Court.

With the judicial system well entrenched the professional expertise in the fields of law, accounting procedures, costing and valuations has also developed very well in the country. Each category of professionals has a Self-Regulatory Organization and the professionals are subject to the code of conduct prescribed by such SROs.

After India embarked upon the process of liberalization and deregulation, reforms have been undertaken in all sectors of the economy including financial sector. Certain specific measures undertaken are as under:

- In the matter of exchange control, number of relaxations have been introduced and Foreign Exchange Regulation Act has been replaced by Foreign Exchange Management Act. In other words, the focus of exchange control which was strict regulation and punishment of any violation of regulation, has been changed to management of the foreign exchange transactions.
- The control, regulation and supervision of the banking system has also been liberalized with full freedom to the banks in conducting the banking business subject to prudential norms and other regulatory requirements of the Reserve Bank of India. Controls on credit have also been relaxed except certain requirements of lending to priority sector. Interest rates are deregulated.
- The private mutual funds are allowed to operate in the market subject to regulation by Securities and Exchange Board of India (SEBI).
- Insurance sector which was totally government owned has been liberalized and private sector is allowed to undertake insurance business, both general insurance as well as life insurance.
- Reforms have been undertaken in the judicial system for the purpose of eliminating delays of the system. For this purpose Civil Procedure Code has been amended and there are many areas for which specialized tribunals have been set up.
- In the financial sector special tribunals have been set up for recovery of defaulted loans of banks and financial institutions.
- Creditor rights have been further strengthened by giving powers of enforcement of securities to the banks and financial institutions.
- The law relating to winding up of companies contained in the Companies Act, 1956 has also been amended for the purpose of setting up National Company Law Tribunals (NCLTs) with powers of amalgamations and mergers and other restructuring of companies and winding up of companies.
- In the amended provisions of the Companies Act, 1956, it is permissible for professionals to be appointed as administrators, managers and liquidators which was not permissible under the earlier law.
- Information Technology Act, 2008 has been enacted for E-commerce.
- Negotiable Instruments Act has been amended for the purpose of providing Truncation of Cheques.
- Foreign Direct Investments and Foreign Institutional Investments have been categorized and various ceilings have been laid down for the purpose of permitting such investments in various sectors of the economy.

- The Capital Market Regulation has been made wider by providing regulations for merchant bankers, debenture trustees, mutual funds, venture capital funds, etc.

As can be seen from the above that India is progressing on the path of liberalization, deregulation and adopting the market economy at a faster pace. Proposals for further reforms are already under consideration in respect of the following matters:

- (1) A new law for Credit Information Bureaus
- (2) New law for Payment and Settlement Systems
- (3) Amendment to the Banking Regulation Law for strengthening regulation of Co-Operative Banking Sector.

Coupled with the above changes introduced in the system, corporate governance norms are also being prescribed for the various participants in the financial markets and disclosure and accounting norms have been revised to make the functioning of various entities doing business with public money more transparent.

Labour Policy and Insolvency Laws:

For any economy generation of employment and prevention of unemployment are major policy considerations and India is no exception. In India the Industrial Policy tilted towards protection of labour and many measures including statutory provisions were undertaken to ensure that an industrial undertaking does not close down and render the labour force employed jobless. Some important steps taken in this direction were as under:

- i) An industrial establishment employing not less than hundred workmen is required to obtain permission of the Government before closing down the establishment (section 25-B of the Industrial Disputes Act, 1947).
- ii) The Industries (Development and Regulation) Act, 1951 empowered Central Government to take-over management or control of any industrial undertaking.
- iii) In cases where action could not be taken under the industries (Development & Regulation) Act, 1951, management take-over was done by passing an Act of Parliament.
- iv) In certain cases where such management take-over could not solve the problems of the ailing industry the industrial undertakings were nationalized and the Government itself started running the industry and the major policy consideration for such a step was to prevent unemployment. This was done in respect of certain large engineering units and composite textile mills having a large work-force.
- v) Some of the State Governments enacted laws for declaring any industrial undertaking as a Relief Undertaking. On such declaration a stand-still provision became operative and no action for recovery of money or any other proceeding could be taken against the industrial undertaking.
- vi) For the purpose of rehabilitation of any ailing industrial unit a special law was enacted namely, Sick Industrial Companies (Special Provisions) Act, 1985 prescribing a detailed procedure for preparing schemes for revival of sick industrial undertakings. Since most of the banks and financial institutions are public sector undertakings controlled by the Government, rehabilitation of sick industrial undertakings by grant of further financial assistance was facilitated.

Implications on Insolvency Law:

A policy heavily loaded in favour of protection of employment of labour, has its implications on the Insolvency Law. Hence in India the process of winding up of companies is regulated by the Companies Act and is under the supervision of the court. Although article 19 (1)(g) of the Constitution of India gives freedom to practice any profession or to carry on any occupation, trade or business to the citizens of India, there are restrictions on closure of any industrial undertaking. Such restriction is justified on the ground that it is in public interest to prevent

unemployment. As a result of such policy there is a freedom to undertake any industrial activity, but there is no freedom to exit.

In the process of deregulation and liberalization number of restrictions on undertaking industrial activity have been withdrawn and relaxed. There is a need to take the process of liberalization a step further and recognize that so long as a company is acting in the interest of shareholders and otherwise observing the law of the land it should have the freedom to manage its affairs, merge, amalgamate, restructure and reorganize or otherwise plan its affairs as it considers best in the interest of the stakeholders. Interference by the Government or court or any tribunal should only be in the event of any detriment to the shareholders or under the Competition Act to prevent monopolies or restrictive trade practices. While undertaking reforms in the Insolvency Laws there is a need to change the focus from strict regulation of the activities of companies to granting freedom to the industry in conducting its business activities and lay down norms for protection of interest of stakeholders.

Risk Assessment and Management Systems:

The mismatch between assets and liabilities has serious implications for interest rate risk, liquidity risk, foreign exchange risk, credit risk etc. To manage these risks properly, risk management skills on the part of the banks need to be enhanced. For this purpose, there is a need to put in place a clear-cut asset-liability management (ALM) practices. The RBI issued ALM guidelines and to complement it on October 21, 1999 issued guidelines on risk management. It is expected that these two guidelines would help banks to establish an integrated risk management system. The RBI guidelines on risk management have placed the primary responsibility of laying down risk parameters and establishing the risk management and control system on the board of directors. The RBI guidelines require that the top management should give priority to credit risk. The banks should put in place the loan policy, approved by the board of directors covering the methodologies for measurement, monitoring and control of credit risk. Banks are expected to evolve comprehensive risk rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions. Taking into consideration the diversity and varying size of balance sheet items between banks, the RBI also indicated that it would be difficult to follow uniform risk management system for all banks. Hence it was suggested that banks could design their risk management framework as per respective banks' requirement dictated by the size and complexity of business, risk philosophy, market perception and the existing level of capital. In other words, banks can evolve their own systems compatible with the type and size of operations as well as risk perception.

With regard to credit risk, the guidance note covers areas pertaining to the policy framework, the types of credit risk models, managing credit risk in inter-bank and off –balance sheet exposures and implications for credit risk management arising from the New Capital Accord.

With regard to market risk, the guidance note encompasses areas of liquidity, interest rate risk and foreign exchange risk management as well as the treatment of market risk in the proposed New Capital Accord. The systems, procedures and tools prescribed in the guidance notes for effective management of credit risk and market risk are merely indicative in nature. The risk management systems in banks should be adaptable to changes in the business size, the market dynamics and the introduction of innovative products by banks in future.

Many banks are now focusing on improving their existing MIS for enhancing their risk management capabilities, for preparation of contingency plans to measure the bank's ability to withstand liquidity crises, to conduct stress tests to estimate future volatility in values of securities due to market movements, for creation of an operational risk management policy and for stipulating prudential limits based on operational risk, and development of internal systems for quantifying and monitoring operational risk.. The RBI is yet to issue guidelines for operational risk management for the banks.

Disclosures in the balance sheets of banks: Since transparency and disclosures are accepted as areas which need to be aligned with international best practices, Indian banks are required to disclose in their balance sheets information such as ownership pattern, NPA ratio, Capital adequacy ratio, Return on assets, Business per employee, Profit per employee, movement of NPA, movement in the depreciation of non-performing assets, depreciation in investments, movement in provision towards non-performing non-SLR investments, issuer composition of non-SLR investments, maturity profiles of assets and liabilities, segment reporting etc.

Deposit Insurance: Deposit insurance is designed to protect small depositors who cannot be expected to monitor the soundness of the bank's asset portfolio. In India deposits upto Rs.1 lac is covered under DICGC Scheme. Uniform risk premium is charged to all the banks irrespective of their size and soundness. With a view to reform the existing set up, the budget 2002-03 announced the conversion of the Deposit Insurance Credit and Guarantee Corporation (DICGC) into the Bank Deposit Insurance Corporation (BDIC). Appropriate legislative changes are to be proposed for this purpose. The proposed BDIC is expected to be an effective instrument for dealing with depositors' risks and for dealing with distressed banks. Efforts are being made to align the present deposit insurance scheme with that of the Federal Deposit Insurance Corporation model. Major difference between Indian Deposit Insurance Scheme with that of the developed nations pertains to lack of re-insurance and absence of risk-adjusted premiums.

Text Box I: The Financial Sector

Types and Number of banks and Financial Institutions	There are 90 Scheduled Commercial Banks operating in the country – 27 Public Sector Banks, 30 private Sector Banks and 33 Foreign Banks. Besides them there are 196 Regional Rural Banks located in the rural areas of the country. 9 Development Financial Institutions, 13,671 Non-Bank Finance Companies (of which 584 NBFCs are permitted to accept/hold public deposits) operating in the country. There are co-operative banks also who have limited geographical presence in their respective areas of operations.
Financial health of major lenders and potential sources of systemic risk	<p>Immediately after introduction of prudential norms based on income recognition principles, balance sheets of some banks went into red. But RBI has adopted a policy to benchmark Indian norms against international best practices and gradually align them with international standards over a period of time. With such a policy Indian banking system is now aligned to international best practices except one or two norms on provisioning if default continues beyond 365 days. Financial health of major lenders continues to be sound.</p> <p>Like in any other market there have been cases of some small banks coming into stress where the RBI as stepped in and taken measures for merger of the stressed banks with healthy banks and there has been no systemic repercussions.</p> <p>There have been few failures of co-operative banks which has adversely affected the business of some other co-operative banks. But RBI is aware of the need for strengthening the co-operative bank supervisory framework and various steps including legislation are initiated to meet the challenges to regulation posed by co-operative banking sector. (Challenges: large number of banks to be regulated, regulatory overlaps among several regulators and high levels of loan delinquency).</p>
Prudential Supervision and regulatory capacity	The RBI regulates commercial and urban co-operative banks, Development Finance Institutions (DFIs) and NBFCs. Life Insurance Corporation and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and Securities and Exchange Board of India (SEBI). The main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. For this purpose RBI evaluates system-wide risks and promotes sound business and financial practices. The Reserve Bank of India is fully aware and is participating in formulation of international norms by Basel Committee. As far as implementation of such norms in India is concerned, RBI is adopting prudent policy of introducing the changes in a phased manner after making an assessment of preparedness of the Indian system to adopt the new norms.
Financial Institutions suspended or closed recently in your country	3 private sector banks were amalgamated with public sector banks over the last two years and 2 co-operative banks were put under moratorium during 2004-05.
Ownership structures of banks-if majority privately	27 banks are state owned. 30 banks are privately owned. 33 foreign banks are working as branches of the foreign banks. All development financial institutions

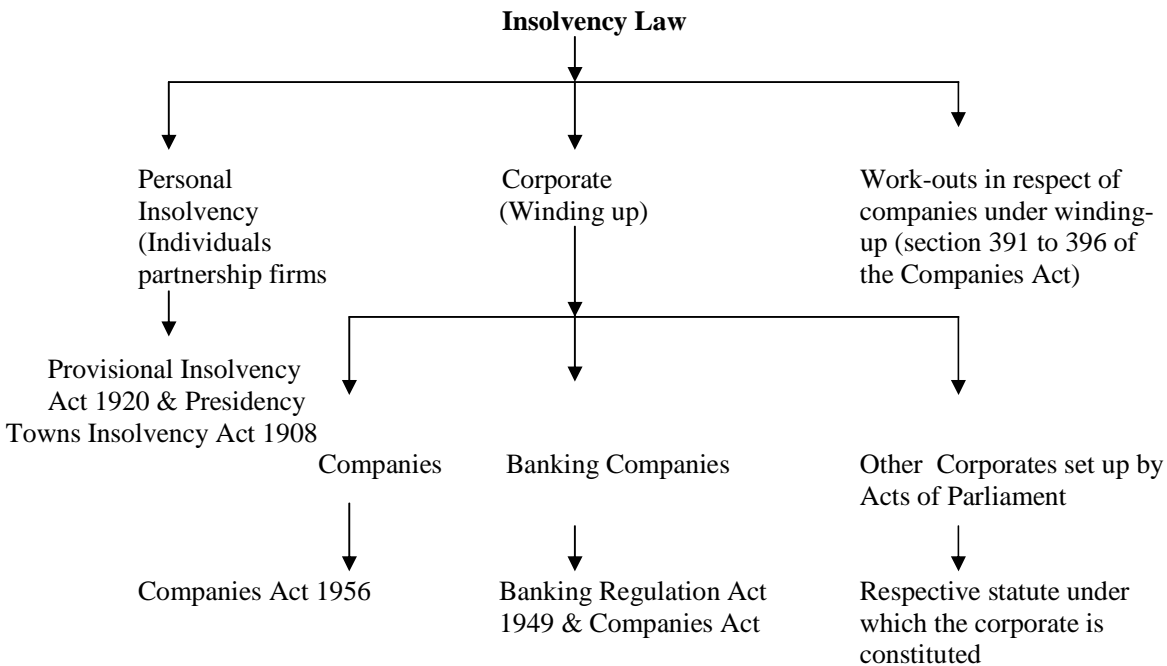
owned or not:	are Government owned. All regional rural banks are jointly sponsored by State owned commercial banks, Central Government and concerned State Government.
Ownership and control of banks and firms by the same share holder, if relevant;	The major shareholder in 27 public sector banks is the government of India. But the RBI regulates the banks. Although Government is the owner in the matter of functioning of the banks, the RBI has the full freedom to point out any regulatory lapses and force correction of the same. As far as the government is concerned the Reserve Bank is always consulted before taking any measures including appointment of government nominees on the Boards of such banks.
State bail-outs of banks, state subsidies to state banks and if relevant, interference in management of banks:	Government has from time to time infused capital to the extent of Rs. 20,000 crore in public sector banks to improve their financial strength. Government has also permitted such banks to raise capital from public investors ensuring that government stake remains 51% of the total capital.
Size, types and volume of credit	
Types of collateral, directed lending and their percentage	Banks are expected to provide 40 per cent of the net bank credit to priority sector comprising Agriculture, SSI and other weaker sections. Such directed lending is more in the form of policy directions. Banks are free to take their own individual loan decisions and there are no penalties for not achieving targets for such lending.
Risk management Capacity Financial market characteristics and role in risk management	Risk Management is recognized as one of the important requirements for a sound banking system. Detailed guidelines have been issued to the banks for Asset Liability Management and Risk Management five years back. RBI has also started risk based supervision of banks. RBI has issued directions for measures for mitigating select risks in money market, debt securities market, equity market and foreign exchange market.

Current Legal and Institutional Developments:

The insolvency laws in India can be segregated into three parts as under:

1. Pre-insolvency workouts
2. Personal insolvencies
3. Corporate insolvencies

The laws applicable to the various insolvencies can be illustrated by the following chart:



Pre-insolvency Work-out Schemes

- Companies Act, 1956 (Sections 391 to 396)
- The Sick Industrial Companies (Special Provisions) Act, 1985
- Corporate Debt Restructuring Scheme
- Asset Reconstruction under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI)
- RBI Guidelines on Special Mention Accounts.

As far as the laws relating to personal insolvencies are concerned, they are relevant only in the context of certain basic principles of insolvency proceedings which are applicable even to winding up of companies. In the process of liberalization, deregulation and adopting market economy, India is experiencing a massive growth of retail loans to individuals, housing loans and credit card users. On account of phenomenal rise in retail lending it will be necessary in the near future to give a re-look at the personal insolvency laws to ensure that any insolvency proceedings against individuals are also expeditiously decided.

Although the statutory provisions in regard to various commercial laws are well defined, in the matter of actual implementation or enforcement of contractual rights and other claims there is a problem of delays of the judicial system. Here again the trial and decision of any suit for enforcement of contract or for a recovery of money or compensation / damages for breach of contract are required to be decided by filing a civil suit in the civil court. There is no jury system applicable in trial and decision of the civil suits. But the Civil Procedure Code and the law of evidence makes detailed provisions about conducting a trial of any suit which is very time consuming and prone to delays on account of appeals against any interim orders and final orders. In the matter of recovery of loans and advances granted by the banks and financial institutions from the defaulting borrowers, the lenders were facing problems of delays in enforcement and realization of securities and recovery of the loans. The unsecured lenders and other claimants against any person or company continue to face the same problem of delays if the recovery of the defaulted loans or claims is to be made in insolvency proceedings. In fact in regard to the winding up proceedings against any company registered under the Companies Act, 1956, on account of rigid system of sale of assets of the company by the official liquidator appointed by the court, the delays are more pronounced. As a result of inordinate delays the lenders do not consider proceeding for insolvency as a viable mode for recovery of defaulted loans.

Insolvency of a borrower and consequent default in repayment of a loan is a risk which any lender takes. The mitigation of such risk has to be provided by promoting secured lending and recognizing the rights of secured lenders to take possession of securities and sell them in the event of default. As far as India is concerned the commercial laws in India recognize the rights of the secured creditors to remain outside the winding up /insolvency proceedings against a borrower and enforce the securities taken for the loan outside such insolvency proceedings. The reforms required in the insolvency laws in India need to be directed towards eliminating delays in concluding such proceedings. There is also a need to streamline statutory provisions in regard to rehabilitation of sick industrial companies and workout schemes for revival of such companies.

Another aspect of insolvency law which again is related to expeditious completion of insolvency proceedings relates to the claims of unsecured creditors and other claimants. On account of strong recognition of rights of secured creditors and statutory provisions for certain preferential payments due to the Government and labour, in many cases there are no assets available for satisfying the claims of unsecured creditors even partially. Reforms are urgently needed for expediting decisions in insolvency proceeding to prevent deterioration of the assets to be sold and for ensuring better realization of the assets and also a possibility of selling the business enterprise as a going concern which can take care of the claims of unsecured creditors to certain extent.

Recent changes in Corporate Insolvency Laws:

Government had appointed a Committee to consider reforms in the provisions relating to winding up of companies in the Companies Act, 1956 under the Chairmanship of Justice V.B. Balakrishana Eradi, Retired Judge of the Supreme Court. Based on the recommendation of the said Committee, the provisions in the Companies Act, 1956 relating to winding up of companies have been amended and the salient features of the amendments are as under:

- (a) The jurisdiction of winding up of any company is conferred on National Company Law Tribunals (NCLTs) to be set up under the amended provisions and such proceeding will no longer be required to be filed before the High Courts.
- (b) Provision has been made for appointment of professionals as liquidators which was earlier not permissible. Payment of remuneration to such liquidators is also statutorily prescribed subject to a maximum of 5% of the value of the debt recovered and realization of sale of assets.
- (c) The amended provisions propose that National Company Law Tribunals (NCLTs) shall substitute the Board for Industrial and Financial Reconstruction (BIFR) constituted under the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) for the purpose of preparing workout schemes for sick industrial companies.
- (d) Amended provisions of the Companies Act are same as the SICA except that there is no stand-still provision like section 22 of SICA and definition of sick industrial company has been revised.
- (e) An Act for repeal of the SICA has also been passed by the Parliament and is yet to be brought into force and the actual abolition of BIFR is yet to take place. It is expected that the new NCLTs will be set up and simultaneously order for abolition of BIFR will also be issued.
- (f) The constitutional validity of the Companies Amendment Act in regard to setting up of NCLTs was challenged before the Madras High Court. The Madras High Court has held that certain provisions in the Amendment Act relating to terms of the office of the NCLT and the powers given to the administrative member of such tribunal are invalid. It is understood that the issue relating to correcting the objected provisions is under consideration of the Government and the stalemate on account of the judgement of the Madras High Court is expected to be resolved shortly.

Pending amendment of the provisions found to be objectionable by the Madras High Court the status quo relating to rehabilitation of sick industrial companies by the BIFR continues and the amended provisions of the Companies Act, 1956 have not yet become effective and operational. As a result of Madras High Court judgement there is a vacuum which needs to be cleared urgently.

Further Reforms:

Entire process of either a work-out or closure of an industrial company is tightly regulated and is done under the supervision of the Court or Tribunal. There is a need for deregulation in this area and permit the company and the creditors to work out reorganization or restructuring or closure of the company with the assistance of expert

professionals. The law should provide necessary environment conducive to such work-outs and access to the Court or Tribunal in the event any stakeholder has a grievance in the matter.

Further reform measures that could be considered are:

- Repeal provisions relating to rehabilitation of sick industrial companies
- Any scheme for rehabilitation should be made in accordance with the provisions contained in sections 391 to 396 of the Companies Act.
- The law may be amended for facilitating work-outs if the shareholders and other stakeholders with a three-fourth majority approve the work-out scheme.
- A suitable provision can be made for protecting the interest of minority stakeholders.

Developments in Creditor Rights:

The judicial system in India has been traditionally functioning in debtor friendly manner and the lenders are always treated as persons having very good means and deep pockets, who can absorb any losses and suffer delays. The scene has undergone a change on adoption of prudential norms based on income recognition principles for the loans and advances of the banks and financial institutions. With the need for provisioning for Non-Performing Assets and non-recognition of income unless actually realized, the debtors are now under pressure for prompt payments of the loans on due dates. The creditor rights have been strengthened by enactment of following Laws:

- (1) The Recovery of Debts due to Banks and Financial Institutions Act, 1993 (DRT Act)
- (2) The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act.).

One of the major problems faced by the lenders in recovery of the defaulted loans was delays of the judicial system, which resulted in the deterioration of the securities and other assets of the defaulting borrower. Since the actual sale of securities or other assets of the borrower took a very long time the lenders rarely recovered the full loan amount. Under the above DRT Act the Government set up specialized Debt Recovery Tribunals for recovery of loans of banks and financial institutions. Such provisions are not required to follow the civil procedure code which is applicable to suits filed in the civil courts and Tribunals are free to determine their own procedure for dealing with the claims of the banks. The Tribunals have adopted a summary procedure for the purpose of enabling speedy recovery of the defaulted loans.

The constitutional validity of the DRT Act was challenged before the High Courts and in appeal to the Supreme Court. With certain changes suggested by the Supreme Court, the law was further amended and has been declared to be constitutionally valid by the Supreme Court. The Government has increased the number of DRTs all over the country and 22 such Tribunals are functioning and the entire process of recovery of bank loans through such Tribunals has now stabilized. As against the average time of 5 to 7 years required for decision in civil suit, the Tribunals are deciding cases of recovery in about an year's time. As on June 30, 2003, out of 57,915 cases (involving Rs.82,266 crore) filed by banks to the DRTs, 22,163 cases (involving Rs.19,633 crore) have been adjudicated and the amount recovered so far stood at Rs.5,787 crore. (source: RBI Report on Trend and Progress of Banking 2002-03).

In the Indian legal system the secured lenders do not have a power of foreclosure. It was not permissible for a secured creditor to take possession of the securities in the event of default and sell such securities for the purpose of recovery of the loan. This power has been conferred on the secured creditors by the SARFAESI Act, 2002. Enactment of the SARFAESI Act has changed the entire environment in regard to recovery of non-performing loans of the banks and financial institutions. With the powers of taking possession of the secured assets given to the secured creditors, the fear of getting dispossessed has resulted in lesser number of defaults and in cases where there are defaults, more and more defaulters approaching the banks for the purpose of out-of-court settlements of the defaulted loans. In the report of the Reserve Bank of India on Trend and Progress of Banking India 2002-2003 it is observed as under:

“The decline in NPAs has also been evidenced across bank groups, except in 2000-01. In line with this declining trend, NPAs declined sharply in 2002-03, reflecting, inter alia, the salutary impact of earlier measures towards NPA reduction and the enactment of the SARFAESI Act ensuring prompter recovery without intervention of court or tribunal. The progress under this Act has been significant, as evidenced by the fact that during 2002-03, reductions outpaced addition, especially for PSBs and reflected in an overall reduction of non-performing loans to 9.4 per cent of gross advances from 14.0 per cent in 1999-2000.”

The constitutional validity of the SARFAESI Act, 2002 was also challenged before the Supreme Court and by its judgement dated 8th April, 2004 in the case of Mardia Chemicals Vs. Union of India, the Supreme Court declared the Act to be constitutionally valid except one provision which required deposit of 75% of the claim amount by the borrower if he files an appeal against the action of the bank in taking possession of the securities. This judgement of the Supreme Court is a significant landmark in the banking law in India because it recognizes contractual right of the secured creditor to take possession of securities in the event of default and sell them for realization of the loan. Under the law prior to the enactment of the SARFAESI Act, 2002, the entire borrower community was used to a system where claims of the lenders were adjudicated by courts and the recovery process by attachment and sale of securities and other assets could be done only after such adjudication. Under the provisions of the Act this system has been replaced by a procedure of bank serving a notice on the defaulting borrower for payment of the defaulted loan and in the event of non-compliance, proceed with the action for taking possession and sale of securities. The Supreme Court read into the existing provisions the requirement of secured creditors acting in a fair and reasonable manner. With the declaration of the SARFAESI Act, 2002 as constitutionally valid the rights of secured creditors have been strengthened and they are in a much better position in regard to recovery of the defaulted loans. Such recognition of security rights mitigates the risk of insolvency.

Text Box II: Non-performing Assets

NPA Management by Banks

In India, the prudential norms, including classification of loan accounts based on income recognition principles were introduced in 1991. Although, initially the norms prescribed by the RBI for classification of accounts were not in conformity with international standards, RBI adopted a policy of benchmarking Indian standards against international prudential norms and gradually aligning Indian system with international standards. This was particularly done taking into consideration the impact of international norms on the banking system in India and the ability of the banking system to absorb the stringent provisioning requirement in their Balance Sheets. The process of alignment of the prudential norms absorbed by the Indian banking system with the international norms has almost been completed.

Concept and Definition of NPAs: With the introduction of income recognition and asset classification norms in the Indian banking sector, the concept of non-performing assets came into being in India. In 1993 “ a non-performing asset was defined as credit facility in respect of which interest has remained “past due” for a period of four quarters ending March 31, 1993, three quarters ending March 31,1994 and two quarters ending March 31, 1995 and onwards. Banks were not permitted to charge and take to income account interest on all non-performing assets. Banks were required to classify their advances into four broad groups : a) standard assets b) sub-standard assets, c) doubtful assets and d) loss assets. With effect from 31st March, 2001, the concept of “past due” was withdrawn and an advance has to be classified as NPA, if interest and/or installment of principal remain overdue for a period of more than 180 days. With a view to move towards international best practices and to ensure greater transparency, the 90 day norm for recognition of loan impairment was introduced with effect from 31st March, 2004.

Provisioning requirement: Banks have to make 100 per cent provision in respect of loss assets and not less than 30 per cent of the total provisioning in respect of sub-standard and doubtful advances. For standard assets, a general provision of 0.25 per cent was to made for global as well as domestic advances effective from October, 2000. RBI has also directed that effective from 31st March,2005 the banks have to classify asset as doubtful, if it had remained in substandard category for 12 months. Additional provision therein would be phased over a four-year period commencing from year ending March 31, 2005 with a minimum of 20 per cent each year. Recently banks were asked to introduce graded higher provisioning according to the age of NPAs, which are included under “doubtful” for more than three years’ category, with effect from 31st March, 2005.

Policy support to deal with NPAs: During 1995-2000 the non-performing assets of the banks were very high. Of late, they have come down both in absolute terms and as percentage to advances. Along with banks' initiative in curtailing the growth of stressed assets by efficient risk management and recovery management practices, various policy supports by the Government and the RBI played a critical role to contain the growth of these stressed assets. Important policy initiatives announced to check the growth of non-performing assets include One-time settlement/ Compromise Schemes announced in July, 2000, Special One-Time Settlement Scheme for loans upto Rs.50,000 to small and marginal farmers by PSBs were issued in March 2002 and extended till March, 2003, Lok Adalats, Debt Recovery Tribunals, CDR Mechanism, formation of Credit Information Bureau to provide information about the defaulters to enable the banks to take informed decisions before extending the line of credit and The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act,2002 which helps the banks to realize the dues without the intervention of courts or tribunals. Asset Reconstruction Companies have also become operational which help the banks to transfer the stressed assets to the ARC and thus clean their balance sheets.

As per the balance sheet data of the banks, for the year ended 31st March, 2004, all the groups viz public, private and foreign banks showed decline in non-performing assets as percentage to advances.

The following table gives the data pertaining to NPAs of SCBs over the last five years.

(Rs crore)						
Year (1)	Gross Adv (2)	Gross NPA (3)	(3) as % (2)	Net Adv (4)	Net NPA (5)	(5) as % (4)
2000	4,75,113	60,408	12.7	4,44,292	30,073	6.8
2001	5,58,766	63,741	11.4	5,26,328	32,461	6.2
2002	6,80,958	70,861	10.4	6,45,859	35,554	5.5
2003	7,78,043	68,714	8.8	7,40,473	32,764	4.4
2004	-	64,811	7.3	8,64,146	24,554	3.0

Additions to non-performing assets during 2003-04 was Rs.24,026 crore as against Rs.21,863 crore during 2002-03 showing an increase of Rs 2,163 crore . But due to good recovery efforts, the reduction of NPA from the system was to the tune of 27,835 crore during 2003-04, which is higher than the Rs.23,302 crore of the previous year.

The following Table gives the recovery and incremental NPA position of SCBS from 2000 to 2004

(Rs crore)		
Year	Additions	Recovery
2000	16234	12376
2001	19118	15668
2002	24826	17515
2003	21863	23302
2004	24026	27835

From 2000 to 2002 though recovery showed improvement over the previous year, incremental non-performing assets were higher than the recovery, leading to upward movement in NPA. Year 2003 saw a decline in additions and impressive recovery performance which resulted in reduction in the non-performing assets. For 2004, though, additions were higher than before, owing to good recovery and higher provisioning made by banks due largely to treasury profits, NPA level was lower than the previous year.

Informal Workouts for Industrial Undertakings:

Corporate Debt Restructuring Scheme:

The salient features of the revised CDR scheme issued in February 2003 are as follows:

- It will cover multiple banking accounts/syndication/consortium accounts with outstanding exposure of Rs.20 crore and above.
- It will be a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA).
- CDR will have a three-tier structure consisting of: (a) CDR Standing Forum and its Core Group (the policy-making body), (b) CDR Empowered Group (the functional group deciding on the restructuring of cases referred to the CDR mechanism), and (c) the CDR Cell (the secretariat to the CDR system).
- The revised guidelines provide exit options for lenders who do not wish to commit additional financing or wish to sell their exiting stake.
- 'Stand-still' agreement binding for 90 days or 180 days by debtors and creditors respectively, under which both sides commit themselves not to take recourse to any legal action during the 'stand-still' period.
- The CDR scheme contemplates a workout in respect of accounts which are classified as sub-standard and is a scheme which is being extensively used by the industry for the purpose of obtaining restructuring of the debts and remain a performing asset in terms of the revised repayment schedules.

The progress under the scheme upto 30th June 2003:

(Source: RBI Report on Trends & Progress of Banking – 2002-2003)

Rs. in crores		
Particulars	No. of cases	Amount involved
1	2	3
Cases referred to CDR Forum	71	53,736
Final schemes approved	41	38,638
Rejected	18	7,252
Pending	12	7,846

Recourse to Reorganization Procedures and out of Court work-outs:

As far as reorganization procedures for industrial companies are concerned, there is a special law enacted viz. Sick Industrial Companies (Special Provisions) Act, (SICA) 1985. This law also contains an automatic stand-still provision which operates on registration of a reference by a sick industrial company with the Board for Industrial and Financial Reconstruction (BIFR). In view of the stand-still provisions applicable to any proceedings against the company, many industrial units abuse the standstill provision for the purpose of stalling any action against the company for recovery of secured and unsecured loans as well as any other claims. Such abuse of the stand-still provisions was noted by the BIFR as well as the courts before whom such matters were agitated. Since the success rate of proceedings filed before BIFR for reorganization or workout was very low, government finally decided to repeal the special law and abolish BIFR. Necessary legislation for repeal of SICA has already been passed but the date for its coming into force is yet to be notified. The BIFR is to be replaced by National Company Law Tribunals to be set up under the amended provisions of the Companies Act, 1956. The amended provisions do not contain a stand-still provision on the lines of Section 22 of the SICA and stay on any proceeding or action against the company is left to the discretion of the National Company Law Tribunals to be dealt with in each particular case.

One other reason for very low success rate of work-outs under SICA was the criteria of total erosion of the networth by accumulated losses for classification of a company as a sick industrial company. In most of the cases,

such companies having lost their entire net-worth were not capable of being reorganized or restructured. Inordinate delays in working out such reorganization also added to making any work-out scheme non-viable.

The amended provisions of the Companies Act has changed the criteria for making an application for work-out to erosion of net-worth to the extent of 50% or failure to repay its debts within any three consecutive quarters. With the changed criteria of classification of a sick industrial company it is expected that the process of preparing a work-out scheme will be started at a much earlier stage making it possible for the company to be reorganized or rehabilitated.

Work-outs for Non-industrial Business Enterprises:

The statutory provisions contained in the SICA relating to reorganisation do not apply to small-scale industrial undertakings and any other non-industrial business enterprises. However, the RBI guidelines prescribing the prudential norms on asset classification and income recognition contain detailed guidelines for prevention and corrective measures from such accounts becoming non-performing assets (NPAs). The guidelines provide for classification of such accounts showing signals of committing default and becoming NPAs as Special Mentioned Accounts. The guidelines provide strategy for early alert system and initiation of special corrective measures to prevent the account becoming non-performing. For any restructuring Companies Act provisions are applicable to corporates who are non-industrial enterprises.

Other Measures for Settlement of Defaulted Accounts – Asset Reconstruction:

Under the provisions of the SARFAESI Act, 2002, the activity of asset reconstruction for the impaired loan accounts of the banks and financial institutions can be undertaken by any company after obtaining registration from the Reserve Bank of India. Such asset reconstruction company has to have a minimum capital of Rs.2 crores and a capital adequacy of 15%. The law provides for acquisition of loans and advances of the banks and financial institutions and issue of debt instruments (security receipts) by such asset reconstruction companies to the investors. The unique feature of this law is that the entire exercise of asset reconstruction is thrown open to the market and there is no government support to the asset reconstruction activity either by way of equity participation or a government guarantee for the debt instruments issued by such asset reconstruction companies. This new concept has been successful and three asset reconstruction companies have obtained registration from RBI and are functional. Foreign investors have evinced interest in setting up such asset reconstruction companies and certain issues relating to the permissible limit of foreign investment in such activity are to be clarified by the Government. Once such clarification is issued it is expected that few more asset reconstruction companies with the foreign investment will be registered. With this development in the financial market the banks and financial institutions will be having additional option of disposal of their financial assets to the asset reconstruction companies.

One-Time Settlements:

The Reserve Bank of India has also formulated one-time settlement schemes for settlement of chronic non-performing assets of the banking system. Originally such schemes were applicable in respect of small loans, but now, has been extended to loans upto Rs.10 crores. Such schemes also provide yardsticks for deciding proposals for settlement of defaulted loans.

Secured Lending Procedures:

In the matter of control over lending activities of the banks, the process of deregulation is complete with full freedom to the banks in the matter of quantum of credit, interest rates, securities and repayment schedules, subject to observance of prudential norms based on income recognition principles. Each Bank is directed to formulate its own credit policy and permit any deviations with the approval of the Board of Directors. The systems and procedures in regard to credit appraisal and assessment of viability of projects is done by the banks themselves and by outside experts in large value accounts. Most of the banks have their own niche areas where they have developed expertise in meeting credit needs of area specific business or industrial or trading or agricultural activity. Broadly the lending procedures observed by banks are as under:

- Lending without security is normally done in respect of Tripple “A” rated borrowers having a very good balance-sheet. Hence chances of defaults in such type of lending are very rare.
- As far as secured lending is concerned, it could be divided into two parts namely, working capital finance and term lending.
- Working capital finance is given against non-possessory security of hypothecation of movables. Indian law recognizes such non-possessory securities by way of hypothecation or floating charge. The recent enactment of SARFAESI Act, 2002 has given further recognition to such securities by introducing the concept of comprehensive security interest which covers all categories of securities given for due repayment of any loan to a bank or financial institution.
- In respect of non-possessory securities, the borrowers are permitted to dispose of such securities during the course of business without the approval or consent of the bank. The working capital finance also includes finance against receivables. Such working capital finance is normally given in running accounts called cash credit or over-draft accounts and the borrowers are required to furnish periodical statements containing the list of movable properties which are hypothecated to the bank. Based on the value of hypothecated movables which are called stock statements, the banks fix the drawing power in the cash credit account and the borrower accounts are accordingly operated subject to such drawing power. The working capital finance is also given by way of discounting or purchase of bills of exchange.

- **Margins for working capital:**

The banks stipulate a margin of 20%- 25% for the working capital finance. Depending on the nature of business such margins may also be higher.

- The lending against possessory securities is normally restricted to pledge of valuables, pledge of shares and securities and holding of documents of title to goods such as bills of lading, motor transport receipts, etc.

- **Term Lending:**

Banks are also engaged in giving finance for purchase of land, construction of building and purchase of plant and machinery. Such loans are usually payable in instalments and are sanctioned after assessment of the viability of the project of the borrower. In respect of small scale industries whether set up by individual, partnership firm or corporates the loan component is ranging between 60% and 80%. The balance coming from the borrower is his contribution. In respect of large projects where the corporates are in a position to access funds from the capital market the loan component is lower than in respect of small and medium enterprises.

- In the past enforcement of securities given for a loan was a time-consuming process on account of delays of the judicial system.
- As a measure of reforms the rights of the secured creditors have been strengthened providing remedy for expeditious recovery through the Debt Recovery Tribunals as well as strengthening the rights of secured creditors by giving them powers to enforce securities in the event of default.

Credit Information System:

Under the existing law the power to call for information and sharing and dissemination of credit information was restricted to the RBI. On account of the enormity of the task of calling information and furnishing it to the prospective lenders, the RBI’s use of the information collected is restricted for statistical purposes. The practice amongst the bankers is therefore to call for specific information in respect of any person maintaining account with any other bank, provided there is a disclosure by the prospective borrower about the existing account with other banks. In order to develop the credit information system, RBI decided to enact a new legislation. Pending such legislation, Reserve Bank of India has directed the banks to obtain consent of the borrowers and other account holders in the loan agreement for sharing information relating to their creditors to Credit Information Bureau. Based on such consent obtained from the constituents, banks have started furnishing credit information to the Credit Information Bureau which has been set up by some banks and financial institutions as a company for doing business of credit information. The Bureau has started collecting credit information from the member banks and financial institutions. The RBI has also directed the banks to furnish information relating to defaulted account and suit-filed accounts to the Central Information Bureau. It is expected that the necessary legislation for Credit

Information Bureaus will be in place shortly giving such bureaus statutory powers to collect information. Such Bureaus will also be taking up credit rating and credit scoring.

Credit Risk Transfer and New Financial Instruments:

In the financial market in India certain housing finance companies, certain banks and financial institutions have started undertaking securitisation transactions by setting up Special Purpose Vehicles (SVP) using the structure of trust and acting themselves as a trustee. The debt instruments issued by such special purpose vehicles are rated by the rating agencies and are in respect of loan assets having very low rates of defaults. One major constraint in undertaking such securitisation transactions in India is the multiple stamp duty laws applicable in various States in the country. In such transactions where the secured loan is transferred by a bank to an SVP, such transfer is coupled with the benefit of the underlying securities. Under the provisions of the stamp laws any assignment of mortgage or other securities attracts Ad valorem stamp duties which makes the transaction of securitisation unviable. Realizing the various difficulties faced by the banks and financial institutions, certain States have reduced the rate of stamp duty to 0.1% and in such States like Maharashtra, Gujarat, Karnataka, Tamil Nadu and West Bengal the securitisation transactions are being undertaken.

An attempt was also made to make statutory provision for securitisation under the SARFAESI Act and in the said law, provisions has been made for securitisation transactions to be undertaken by a securitisation company which should have a minimum capital of Rs.200 lakhs and a capital adequacy of 15%. It is also provided that such securitisation companies should get itself registered with the RBI. On account of such requirement no securitisation transaction have taken place under the said Act. A proposal to segregate securitisation from the provisions of the SARFAESI Act and enact a separate independent law for securitisation with enabling provision for setting up a trust which are bankruptcy proof and pass through structures, is under consideration of the RBI and the government. After such enactment, it is expected that the market for debt instruments will grow further.

Conclusion and Recommendations:

- Recent reforms in the legal system in India have been particularly directed against delays in the system and specific new legislations have been enacted for the purpose of facilitating quick recovery of defaulted loans by the banks and financial institutions. Special mention in this respect needs to be made about two laws enacted for dealing with recovery cases of banks and financial institutions.
 - (i) Recovery of Debts due to Banks & Financial Insitutions Act of 1993.
 - (ii) Securitisation and Reconstruction of Financial Assets & Enforcement of Security Interest Act (SARFAESI) Act.
- Recovery of Debts due to Banks & Financial Institutions do not apply to non-banking financial companies and other lenders who are not banks. It will be necessary to carry the reform process further for the purpose of ensuring that the benefit of speedy recovery is available to all category of lenders.
- There is a need to reform the laws for the purpose of work-out schemes for industrial companies to facilitate formulation of work-outs by the creditors and other stake-holders with the assistance of professionals. Supervision and role of the Court or Tribunal may be restricted to grievance redressal and perhaps final approval of the scheme of work-out. For achieving this object provisions relating to rehabilitation of such units may be repealed and any schemes for revival of sick units should be brought under the provision of sections 391 to 396 of the Companies Act. (Compromise and Arrangement Schemes.)
- Restriction on closure of industrial units contained in section 25-0 of the Industrial Disputes Act, 1947 needs to be repealed.
- It is necessary to devise a system for work-outs of sick units in which professionals can be appointed as liquidators or administrative receivers or managers for the purpose of turning around a stressed industrial unit or speedy disposal of all the assets of the company and completion of the winding-up proceedings within a specified time-frame not exceeding one year, can be achieved.

- The CDR scheme which is at present applicable to large industrial undertakings having borrowing from the banking system of Rs.20 crores and above, needs to be extended to even lower-level industrial undertakings.
- In the matter of CDR there is a need to provide super priority to any lender post work-out scheme. In other words, in case of a stressed or impaired account if any, lender provides any further finance for revival of the account, such finance should have a priority over all other existing secured lenders. Such a statutory provision would encourage lending to such account and improve the prospects of turning around such stressed industrial units.
- The SARFAESI Act, 2002 has made a provision for setting up of a central registry for introducing the registration system for purchase of movable and immovable properties. These provisions have not yet been brought into force. Such a new registration system may have to be devised on the lines of notice filing system prevalent in USA and some other countries. Such registry may also have to adopt the principle of first-to-file to get priority. It will also be necessary to decide how the existing registry systems already operative are to be integrated with the new registry to be set up.
- Although banks are lending against the security of commodities there is no formal recognition of warehouse receipt as a negotiable instrument. There is a need to enact a law for the purpose of giving status of negotiable instruments to the warehouse receipts coupled with a system of grading and valuation of the commodities so that the entire system of lending against warehouse receipts can develop in the market.
- The securitisation of financial assets has already been provided in the SARFAESI Act, 2002 but there are hardly any all transactions of securitisation being undertaken under the new law. This is on account of inability to use the pass through structure of a trust and the requirements of capital as well as other regulations of Reserve Bank of India. There is a need to segregate the concept of securitisation from the security enforcement law and enact separate law for securitisation coupled with other provisions for growth of market in debt instruments.
- Enact a law for Payment and Settlement System for recognition and protection of set-off or netting rights, notwithstanding the commencement of insolvency proceedings.