Journal Homepage: -www.journalijar.com
INTERNATIONAL JOURNAL OF ADVANCED RESEARCH (IJAR)
Article DOI:10.21474/IJAR01/3686
DOI URL: http://dx.doi.org/10.21474/IJAR01/3686
ISSN NO. 2320-5407

RESEARCH ARTICLE

EVOLUTION OF "WILFUL DEFAULTS" MANAGEMENT IN INDIA: COMPENDIUM OF INSTRUCTIONS

Lakshmi Karthik[1],* and M. Subramanyam[2].

1. Research Scholar, Gitam School of International Business, Gitam University, Visakhapatnam, India.
2. Professor, Corporate Finance, Gitam School of International Business, Gitam University, Visakhapatnam, India.

Manuscript Info

Manuscript History

Received: 13 January 2017
Final Accepted: 02 February 2017
Published: March 2017

Key words:-
Suit-filed Wilful Defaults, Regulation, Credit Risk Management, Credit Information, India.

Abstract

India is a country which discerns between "wilful" and other defaulters. The issue of wilful default by a large number of borrowers had been receiving the attention of Government of India, Reserve Bank of India, and credit institutions since 1986. This study is an attempt to critically examine the regulatory framework on "wilful defaults".

This paper has been divided into three phases. Phase I introduces the concept of wilful defaults and the scheme framed for disclosure of such information. Phase II was during 2001 to 2005, when the monitoring tools were strengthened and penal measures were framed. During Phase III greater transparency and accountability was brought in the process of identification of a "wilful" defaulter. A centralized mechanism of credit information and dissemination was put in place to alert the lenders against the borrowers who abuse the public funds and jeopardize the health of the institutions.

The relevance of this study at this juncture, is very crucial for credit risk management of the financial institutions in India. A thorough understanding of the policy prescriptions would enable these institutions to employ an ex-ante approach to detect early stages of strategic defaults and thus avert high costs associated with it.

Introduction:-

"If you owe your bank manager a thousand pounds, you are at his mercy. If you owe him a million pounds, he is at your mercy" -- J.M. Keynes

Genesis:-

The issue of "wilful default" and withholding of credit facilities to defaulting borrowers, to enforce credit discipline had been receiving the attention of the regulatory authorities in India for more than three decades now. Reserve Bank of India (RBI), the central bank of the country, in 1986 had noticed that the credit institutions are sanctioning term loans to borrowers for setting up of new units or expansion of their existing businesses even when such borrowers had not respected the repayment commitments of their existing debts. Reserve Bank had, therefore, issued guidelines to all scheduled commercial banks to ascertain the cause of such defaults and delay in repayment of the principal or the interest. The guidelines further stated that the same may be condoned only if these have been due to genuine factors which were beyond the control of the defaulters. Otherwise, not meeting the financial obligations for a prolonged period indicates some serious lacunae in the financial management of the borrowing company. In such cases, it is expected that the borrower resolves the issues of the existing unit rather than

Corresponding Author:-Lakshmi Karthik.
Address:-Research Scholar, Gitam School of International Business, Gitam University, Visakhapatnam, India.

considering expansion or enlarging his business by setting up new ones. Banks were directed not to consider fresh loans in respect of such borrowers either exclusively or jointly with other banks / financial institutions. To overcome this, banks were directed to ascertain the overdue position from other credit institutions before sanctioning fresh term finance.

With respect to working capital finance, as stoppage or withdrawal of such facility may lead to closure of the business and adversely affect the workers, the banks were directed to withheld such credits and not sanction fresh loans only when it could be established that the management of the defaulting borrowers are indulging in siphoning off the company's funds or such other malpractices. The guideline states that the banks may even freeze the operations of the account, if warranted, for bringing round the management of the company to comply with the required financial discipline. Credit institutions were also required to assess whether there is need to consider change in management of such recalcitrant borrowers.

Introduction of a reporting mechanism to Reserve Bank:-

To assess the overall position in respect of these persistent defaulters in the banking system, the Reserve Bank introduced a reporting mechanism in the year 1986. The details of the same are as under:

Table 1:-Details of annual report to be submitted by the banks.

S. No.	Periodicity	Amount and nature of the loan	Description of the report to be submitted
1.	Annually by 31 January of the following year. (First such report for the calendar year 1986 to be submitted not later than January 31, 1987).	Borrowers enjoying aggregate working capital limits of Rs.50 lakhs and above from the banking system.	From banks to Reserve Bank Action taken on: (i) the persistent defaulters in repayment of principal / interest on terms loans and deferred payment guarantees. (ii) Management of the defaulting companies who have siphoned off funds from the companies. (iii) Impact of such action on the units. (If it is a consortium arrangement, leader to furnish the report) Report to indicate: (i) nature of offence / default (ii) name of the promoter group (iii) the period of default (iv) steps taken by the bank.
2.	Annually	Borrowers enjoying aggregate working capital limits of Rs.10 lakhs and over, and up to Rs.50 lakhs	From banks to its Board of Directors In order to strengthen their internal management, the report as detailed at point number 1 above for Rs.10 lakhs and above, to be submitted annually by the banks to its Board members.
3.	Quarterly - to be submitted within fifteen days after the close of the quarter. (beginning from the quarter ending March 1987)	Borrowers enjoying aggregate working capital limits of Rs.50 lakhs and above from the banking system.	From banks to Reserve Bank At shorter interval (quarterly), report to contain snapshot of the defaults: (i) names of the defaulting borrowers (ii) nature of action taken in each case.

The lending institutions were directed to inculcate the necessary financial discipline with regard to the borrowers who abhorrently exploit the system with impunity. The impacts of such action wereanalyzed by these reports.

Evolution of wilful default management:-

Phase I – 1990 to 2000

The journey of the wilful defaults management can be divided into three phases. In the first phase i.e., the period from 1990 to 2000, the Reserve Bank introduced the definition of "wilful defaults" and also framed a scheme of disclosure of information on defaulting borrowers.

Definition of a "Wilful Default":-

RBI (1990) defined "wilful" defaults as *"defaults other than those caused by genuine factors beyond the control of the borrowers"*. During that period there was a rapid increase in number of wilful defaulters and also it was brought to the notice of the central bank that such borrowers do not co-operate with the lending institutions when appropriate corrective measures are initiated by these institutions. Reserve Bank attached considerable importance to the feed-back received on the subject and reviewed the matter.

With a view to strengthen the existing monitoring mechanism, it was decided to increase the frequency of reporting from annually to half-yearly and also enlarge the scope by including the other borrowers belonging to the same group which had wilfully defaulted. With the introduction of the revised reporting arrangement, RBI advised the banks to discontinue the then existing yearly reporting. The details of the revised reporting mechanism are as under:

Table 2:-Details of the half-yearly report to be submitted by the banks.

S. No.	Periodicity	Amount and nature of the loan	Description of the report to be submitted
1.	Half-yearly reports as on March 31 and September 30 of every year. To reach RBI within a month from the end date. (First such report for March 1990 to be submitted by end of April 1990)	Borrowers enjoying fund based aggregate credit facilities (term loans and working capital) of Rs.2 crores and above from the banking system.	From banks to Reserve Bank The details of each borrower have to be submitted separately along with a summary sheet on the number of cases and names of the wilful defaulters. The details of each of the borrower had to be reported in a prescribed format with complete particulars such as name, health code, nature of the business, constitution of the company, credit facilities enjoyed by the same group, with brief remarks indicating the circumstances for becoming irregular and the measures proposed to be taken to regularise it.

RBI framed a Scheme of Disclosure of information on defaulting borrowers:-

In 1994, the issue of defaulting borrowers again came to the fore with the rapid increase of non-performing assets of the banks and financial institutions. The Honourable Union Finance Minister in his Budget Speech on February 28, 1994, announced that RBI will put in place an arrangement for circulating the names of the defaulting borrowers amongst lending institutions. This mechanism would alert and guard these institutions against borrowers who have defaulted in their dues to other lenders. Government further mentioned that RBI would also publish a list of defaulting borrowers in cases where suits have been filed by these institutions.

Accordingly, RBI framed a Scheme of Disclosure of information on defaulting borrowers of banks and financial institutions for collection / dissemination of information from / to the banking companies. RBI issued a circular under the powers vested to it by the provisions of Chapter IIIA of the Reserve Bank of India Act, 1934. Under the scheme all the commercial banks and all India financial institutions were advised on April 23, 1994 to furnish to RBI the prescribed details of defaulting borrowers with outstanding amount (both funded and non-funded) of Rs.1 crore and above which were classified as "doubtful" and / or "loss" and suit filed accounts on half-yearly basis (March 31 and September 30).

This scheme had the following objectives:-

(a) to alert banks and financial institutions and to put them on guard against borrowers who have defaulted in their dues to other lending institutions.
(b) to make public the names of the defaulting borrowers against whom suits have been filed by the banks and financial institutions.

As stated in the budget, RBI had started publishing such information in a booklet form for use of these institutions since 1994.

Establishment of Central Vigilance Commission by Government of India:-
The matter of "wilful default" received further impetus with the establishment of Central Vigilance Commission (CVC) by the Government of India in 1998. The Central Vigilance Commission Ordinance 1998 under Section 8(1)(h) directs that the power and function of the CVC will be the following:
(a) "Exercise superintendence over the vigilance administration of the various Ministries of the Central Government or Corporations established by or under any Central Act, Government companies, societies and local authorities owned or controlled by that Government".
(b) "Improving vigilance administration is possible only if system improvements are made to prevent the possibilities of corruption and also encourage a culture of honesty."

Directions issued by the Central Vigilance Commission on "wilful defaults":-
In exercise of the above powers conferred on the CVC, it issued instructions on November 27, 1998 on "Improving vigilance administration in Banks" which *inter alia*, included directions on "Lack of communication between banks" and directed banks, financial institutions and RBI on the following for compliance:
(a) "all cases of wilful default of Rs.25 lakh and above will be reported by banks and RBI as and when they occur or are detected.
(b) whether a matter is a case of "wilful default" will be decided in each bank by a Committee of Officers.
(c) RBI will circulate the information received from the banks of wilful default every three months. The data with the RBI will also be accessible directly by the banks concerned.
(d) there should be greater intra-bank communication about wilful default, frauds, cheating cases, etc., so that the same bank does not get exploited in different branches by the same defaulting parties."

Scheme framed by RBI for reporting the names of the "wilful defaulters":-
Pursuant to the instructions of the Central Vigilance Commission, a scheme was framed by RBI under which all the scheduled commercial banks and all notified All India financial institutions were required to submit the details of the wilful defaulters to RBI. The scheme came into effect from April 1, 1999.

Objective of the Scheme:-
Dissemination of information in respect of wilful defaulters, amongst the credit institutions would make them more vigilant while considering requests for new or additional loans from these defaulters. The risk of plundering of public money can thus be mitigated.

Definition of "wilful default" revised by RBI:-
Hitherto the definition of "wilful default" given by RBI only indicated that if the defaults are caused other than by genuine factors, it would deem to have been "wilful". However, in 1999, RBI expanded the scope of the definition of a "wilful default".

The revised definition broadly covers the following:-
1. "Deliberate non-payment of the dues despite adequate cash flow and good net worth.
2. Siphoning off of funds to the detriment of the defaulting unit.
3. Assets financed have either not been purchased or have been sold and proceeds have been misutilised.
4. Misrepresentation / falsification of records.
5. Disposal / removal of securities without bank's knowledge.
6. Fraudulent transactions by the borrower."

Mechanism prescribed for identification of "wilful default":-
The Reserve Bank had advised the credit institutions that prima facie for a default to be categorized as "wilful" it must be intentional, deliberate and calculated. Further, for the purpose of identifying the cases of wilful default, the banks and financial institutions were advised to form a Committee consisting of three General Managers / Deputy General Managers or equivalent to them. However, it was made amply clear that the wilful defaulters should be identified based on their track record and the decision of the credit institutions should not be based on isolated transactions or incidents. Further, these credit institutions need to report the cases of wilful defaults at their overseas branches also, if such disclosure is permitted under the laws of the host country. RBI also instructed that names of the "Professional Directors" and "Nominee Directors" of the financial institutions, Central or State Governments need not be reported. It was further clarified that names of the directors who are stakeholders only should be reported in the list. In case of consortium / multiple banking arrangements, the credit institutions will report wilful

defaults to other participating / financing institutions also. Further, any fresh limit / renewal or enhancement of the loan in respect of wilful defaulters can be considered only by the Board of Directors of the credit institutions.

Reporting mechanism on wilful defaulters strengthened:-
The reporting mechanism in respect of "wilful defaulters" was further strengthened by the Reserve Bank in the year 1999. The periodicity of the reporting was reduced from half-yearly to quarterly and also the threshold amount was brought to Rs.25 lakhs from the earlier figure of Rs.2 crores.
Table 3:-Details of the quarterly report to be submitted by the banks.

S. No.	Periodicity	Amount and nature of the loan	Description of the report to be submitted
1.	Quarterly – detected after March 31, 1999	All non-performing borrowal accounts with outstanding (funded facilities and such non-funded facilities which are converted into funded facilities) aggregating to Rs.25 lakhs and above.	The data has to be reported by the credit institutions to RBI in a prescribed format. The format contains all details of the borrower viz., name, address, amount outstanding, names of the directors and details of the reporting bank and branch etc.

Inclusion of "Consent Clause" in the loan agreements:-
As banks were under an obligation to maintain secrecy of their customers' accounts, Reserve Bank (October 1999) under section 21 and 35A of the Banking Regulation Act, 1949 issued directions to all commercial banks and the notified all India financial institutions to obtain consent from the borrowers for publicizing their names if they commit default in repayment of their dues. Therefore, the circular had directed the credit institutions to include a condition to that effect in the loan agreement.However, after enactment of CICRA, this clause was withdrawn in July 2013.

Phase II – 2001 to 2005
Review of wilful default management:-

Report of the Parliament's Standing Committee:-
The Parliament's Standing Committee on Financial Institutions - Objectives, Performance and Future Prospects, in its Eighth Report submitted to the Parliament on December 20, 2000 had underlined the need for effective action by the credit institutions' against the entrepreneurs who exploit the public funds and thereby jeopardize the health of the institutions. This Committee had *inter-alia* also made certain recommendations relating to wilful defaulters, diversion and siphoning of funds, change of management of borrowing companies and other related issues. The following are some of the major conclusions / recommendations of the Committee in respect of wilful defaults:

Comprehensive system of credit information:-
The Committee was of the view that all the credit institutions should have access to an efficient system of credit information. This would prevent the headstrong defaulters from availing fresh credit from other lenders despite their deplorable past. This database of credit information should be a comprehensive system and should include details of the defaulters, wilful defaulters including the information on the promoters and the group companies who have abused the public funds with impunity. Further, the Committee recommended that the ambit of credit institutions sharing the said information should also be enlarged and more institutions should be made eligible for this purpose. Further, these institutions should also adhere to the directions issued by the RBI on wilful defaulters so that uniformity in interpretation, identification, classification and reporting is ensured in the system. This would also facilitate in having a standardized format for compilation of the data in respect of these defaulters.

Strengthen the process of recovery:-
The Committee had noticed that the procedure for recovering the dues from the "wilful" defaulters is similar to that of the "genuine" defaulters. The data revealed that recovery of dues from the wilful defaulters was not very encouraging and it showed that only a small percentage had been brought back. It had to be noted that lenient view taken on such defaulters who are robbing public money would jeopardize the health of the credit institutions and would also adversely affect the economy. Hence, the committee concluded that the process of recovery and the action taken against such persistent defaulters should be strengthened.

Recommendation of penal measures:-
The Committee recommended stringent penal measures including filing of criminal cases against the companies which have siphoned off bank funds, have resorted to falsification of accounts, misrepresented and fraudulently processed their transactions. Further, it stated that promoters of such companies should be debarred from availing the institutional finance for floating new ventures for at least a period of 15 years. The report further states that wilful defaulters should not be allowed to become directors on the Board of any Government controlled or owned companies / corporations. The Committee recommends that if such defaulter is already on the Boards of these companies or corporations, immediate steps should be taken for removal of such director. Also, the credit institutions should take proactive steps to change the management of the companies which have wilfully defaulted.

Deny access to capital markets:-
The Committee has recommended that if a company is accessing the primary market for raising funds through equity or debt issue and has in its Board a wilful defaulter/s then it would be mandatory on the part of the company to mention this fact in their prospectus and offer documents. This would enable the investors to factor this point while considering investment on such issues. These steps were felt necessary to have a deterrent effect on the wilful defaulters who enter the capital market.

Recommendation on Guarantees:-
With regard to guarantees the Committee recommended that the entrepreneurs, who had the capacity to honor the guarantees but were delinquent in meeting their commitments when invoked, should also be debarred from becoming directors on the Board of Government owned and controlled companies / corporations. Further, such entrepreneurs should also be debarred from financial assistance from credit institutions for a period of 15 years.

Constitution of a working group by RBI in 2001:-
Government of India, Ministry of Finance, had desired RBI to examine the recommendations of the above report and furnish comments thereon to the Government. Hence, in May 2001, RBI in consultation with Government of India, constituted a "Working Group on Wilful Defaulters". The said group was chaired by Shri S.S. Kohli, the then Chairman of the Indian Banks' Association. After receiving the recommendations of this working group in November 2001, RBI constituted another in-house Working Group. This group examined the recommendations of Shri Kohli's Committee report and thereafter, various directions and guidelines on "wilful defaulters" were issued by the Reserve Bank to the credit institutions, by way of Circulars.

Filing of suits to recover dues from Wilful Defaulters:-
RBI in the year 2001 reviewed the information received in respect of wilful defaulters. They had observed that though there were large amounts of outstanding against these defaulters, yet the credit institutions had not initiated any legal action against them. Hence, RBI issued the following directions in May 2001:
Table 4:-Details of legal action to be taken up by the banks.

S. No.	Details and Amount outstanding	Action to be taken
1.	Cases of wilful default having outstanding amount of Rs. One crore and above	Examine each case and file suits if not already done by the institution.
2.	Cases of cheating / fraud by the defaulting borrowers having outstanding of Rs. One crore and above.	Examine each case and file criminal cases against the borrowers.
3.	Cases of defaulting borrowers having outstanding of less than Rs. One crore	Examine each case and take appropriate action including legal action.

Definition of "Wilful Default" redefined:-
RBI (2002) issued the landmark circular on wilful defaulters and action there-against on May 30, 2002. The definition of "wilful default" was redefined and it superseded the earlier definition given in 1999. RBI stated that "*A wilful default would be deemed to have occurred if any of the following events is noted":*

(a) "the unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honor the said obligations.
(b) the unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilized the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.

(c) the unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilized for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets."

"Diversion of funds" and "siphoning of funds" – meaning of the terms:-
In the year 2002, the meaning to be construed for the terms "diversion of funds" and "siphoning of funds" was also framed by RBI as hereunder:
"Diversion of funds" would be construed to include any one of the undernoted occurrences:

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

"Siphoning of funds" *would be construed to have occurred if any funds borrowed from banks / FIs are utilized for purposes un-related to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. But RBI in its circular has stated that the decision as to whether a particular instance amounts to "siphoning of funds" or not, would be the judgement of the credit institutions, based on the objective facts and circumstances of the case.*

Directions on monitoring the end use of funds:-
In 2002, RBI further directed the credit institutions to strengthen their monitoring mechanism and credit risk management. RBI had stated in its circular that these lending institutions should enhance the quality of their loan portfolio by strengthening their internal controls. The institutions in addition to obtaining certificates from the chartered accountants with regard to utilization of the loan funds, should put in place an independent monitoring mechanism with due diligence, to verify the end use of funds. The said mechanism should form part of the loan policy document and appropriate systems and procedures should be laid down by the lending institutions. Some of the illustrative measures that could be followed by the credit institutions were also indicated in this circular, for example, undertaking periodical in depth scrutiny of borrowers' books of accounts, balance sheets and other reports. Regular inspection of his assets, periodical visits to the site, stock audit and comprehensive management audit should be taken up to detect systemic flaw, if any, on the credit administration.

Introduction of penal measures and access denied to capital market:-
To deter the growth of wilful defaults in the financial sector, RBI directed certain penal measures to be applied on the defaulters identified as "wilful". However, the credit institutions were directed to ensure that there is no misuse and also that an isolated case is not made as a basis for imposing these provisions. RBI emphasized on putting in place a transparent mechanism for the whole process and also stated that the discretionary powers should be kept at, the bare minimum.

RBI also decided to share the list of wilful defaulters with Securities and Exchange Board of India which is the regulatory authority of the capital market to enable them to deny access of the same to such defaulters. This measure was a major step as it closed the other channel of raising funds by the wilful defaulters. These steps were applicable for all the borrowers who were identified and declared as "wilful" with an outstanding balance of Rs.25 lakhs and above.

The other penal measures which need to be initiated by the institutions were:

- Wilful defaulters to be debarred from any kind of institutional finance for a period of five years from the date of publication in the list of RBI.
- Institutions may initiate legal process or criminal proceedings wherever necessary.
- Adopt proactive approach for change of management.

- Companies not to induct wilful defaulters on its board and if such person is already a member on the Board, effective steps to be initiated immediately for removal of such member from the Board.
- Guarantees not honored when invoked by a company of the same group, such group company will also be reckoned as wilful defaulter by the lender.

The Role of Auditors:-

In order to strengthen the role of audit, RBI had directed the credit institutions to lodge a complaint with the Institute of Chartered Accountants of India, where it is observed that the auditor was negligent or deficient in conducting the audit of the wilfully defaulted company.

Introduction of Grievance Redressal Mechanism:-

Till 2003 the credit institutions did not have a grievance redressal mechanism in respect of wilful defaulters. Hence, RBI in July 2003 reviewed the position and directed the institutions as under:

- Higher functionaries of the credit institutions to constitute the identification committee to impart more objectivity to the process. Hitherto the identification committee consisted of three General Managers / Deputy General Managers or equivalent to them. In 2003, RBI revised the constitution of the said Committee and directed that the same should be headed by an Executive Director and two General Managers / Deputy General Managers should form part of the Committee, as members.
- Identification committee should specify the reasons for classifying a borrower as a "wilful" defaulter and advise the borrower accordingly. The borrower should also be provided reasonable time of say around 15 days, to represent his case, if he desires to do so.
- A system of "hearing" to the borrowers who represented that they have been wrongly classified as "wilful" was also put in place by creating a grievance redressal mechanism. The redressal team was headed by the Chairman and Managing Director of the institution and included two other senior officials as its members. Final view to be taken by this Committee. RBI (2004)
- RBI reiterated that the credit institutions should identify and declare a borrower as "wilful" defaulter with requisite evidence and support the same with proper documentation.

Observations and Recommendations of the Joint Parliamentary Committee:-

The Joint Parliamentary Committee (JPC) on Stock Market Scam and matters relating thereto was constituted on April 27, 2001, which presented its report to both the houses of Parliament on December 19, 2002. This Committee in the course of their examination *inter alia* observed that in a number of cases the funds taken from banks / financial institutions was not used for the purposes for which the funds were lent but had been diverted by the borrowing entities. In this context, the Committee examined the extant legal provisions and following were the observations:

- Banking Regulation Act, 1949 does not include any provision as to the rights and responsibilities of borrowers or depositors.
- Loan funds are governed by the agreements, contracts and other documents entered into between the banks and their customers. Thus, it is the responsibility of the lending institutions to ensure the proper end-use of funds by periodical monitoring of the borrowal accounts.
- Diversion of funds has to be considered as per the provisions of the Contract Act for civil remedy and as per the Indian Penal Code 1860 for penal recourse, if any. However, criminal law rests on the principle of *mens-rea* which requires the proof of certain degree of malafide intention at the time of commission of the alleged crime (dishonest intention, fraudulent intention).
- Sections 405 and 415 of the Indian Penal Code (IPC) relating to criminal breach of trust and cheating needs to be considered whether relevant in cases of diversion of funds.

Interpretation of Sections 405 and 415 of IPC:-

As per the judicial interpretation of implications of diversion of funds vis-a-vis provisions of Section 405, the Courts have observed that, *"If a sum of money is advanced by way of loan no criminal breach of trust is committed even if the borrower uses it for a purpose other than that for which the advance was made".*

As regards Section 415 of IPC, in order to make an offence of cheating, the presence of dishonest intention from the beginning is necessary. In case of borrowing of funds from the bank, the proposal submitted before the bank depicts a genuine purpose for borrowing. It is only at the subsequent stage that the borrowed funds are utilized for some other purpose. Thus it would be difficult to prove the presence of dishonest intention on the part of the borrower

from the beginning and in the absence of such proof the offence of cheating as provided under section 415 of IPC cannot be made out.

Therefore, unless the provisions of IPC are suitably amended as to make such acts on the part of borrowers as an offence punishable under IPC, there is no recourse available for penalizing the borrowers.

Recommendations of the JPC Report:-
The JPC suggested exploring the possibility of (i) criminal action against wilful defaulters and (ii) obtaining a certificate from the borrower certifying that the funds have been used for the purpose for which it was borrowed.

The JPC concluded that as the activity of diversion of funds is not culpable either under the Banking Regulation Act or under the Indian Penal Code, "*it is essential that such offences are clearly defined under the existing statutes governing the banks, providing for criminal action in all such cases where the borrowers divert the funds with malafide intention. However, the Committee agreed that such penal provisions should be used sparingly and after due diligence and caution, at the same time it is also essential that banks closely monitor the end use of the funds and obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained. Wrong certification, should attract criminal action against the borrower."*

Recommendations of the Standing Technical Advisory Committee on Financial Regulation:-
RBI (2004) in consultation with the Standing Technical Advisory Committee on Financial Regulation examined the recommendations of the Joint Parliamentary Committee report of 2002. Guidelines were issued to the credit institutions on "Checking of wilful defaults and measures against wilful defaulters" and on the need for initiating criminal action against the concerned borrowers. They are:

- it is essential that offences of breach of trust or cheating construed to have been committed in the case of loans should be clearly defined under the existing statutes governing the banks, providing for criminal action in all cases where the borrowers divert the funds with malafide intentions.
- it is essential that banks closely monitor the end-use of funds and obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained.
- wrong certification should attract criminal action against the borrower.

RBI further advised the credit institutions to:-

- put in place a transparent mechanism for initiating criminal proceedings.
- based on the facts and circumstances of the case, consider initiating criminal action against wilful defaulters, under the provisions of Sections 403 and 415 of the Indian Penal Code (IPC) 1860.
- With due approval of their Board, and after careful consideration and due caution, use these penal provisions effectively and determinedly.

Enactment of the Credit Information Companies (Regulation) Act, 2005:-
RBI in 1999 constituted a Working Group under the chairmanship of Shri N.H. Siddiqui to examine the possibilities of setting up of a Credit Information Bureau in India. It was recognized that in order to arrest the growth of the non-performing advances of the credit institutions, it is necessary to put in place an institutional mechanism for collecting and furnishing information on the borrowers of these institutions.

Formation of Credit Information Bureau (India) Ltd. (CIBIL):-
Based on the recommendations of Shri Siddiqui's Committee, Credit Information Bureau (India) Ltd. (CIBIL), being a company, was formed and registered under the Companies Act, 1956. CIBIL was set up by the State Bank of India in association with Housing Development Financial Corporation in January 2001. The Working Group, however, observed that it would not be possible to set up a credit information company within the existing legal framework. Therefore, with a view to provide the necessary legislative support to the business of credit information, it was proposed to enact legislation for regulation of credit information companies and to facilitate efficient distribution of credit.

The 15th report of the Standing Committee on Finance on the Credit Information Companies (Regulation) Bill 2004 was presented to the Parliament on February 25, 2005. *This Act would provide for regulation of credit information companies and facilitate efficient distribution of credit and for matters connected therewith or incidental thereto.*On

June 23, 2005 the Government of India had notified the Credit Information Companies (Regulation) Act, 2005 and the Act came into force with effect from December 14, 2006.

Reporting to Credit Information Bureau (India) Ltd. (**CIBIL):-**
Credit institutions had to submit the list of suit-filed accounts on wilful defaulters of Rs.25 lakhs and above as at end March, June, September and December every year only to Credit Information Bureau (India) Ltd. (CIBIL) from the quarter ended on March 31, 2003. However, they had to submit the quarterly lists of wilful defaulters where suits have not been filed only to RBI in the prescribed format.

Phase III – 2006 to 2015
Introduction of Master Circular on "Wilful Defaulters":-
Till July 1, 2006 RBI had been issuing circulars to credit institutions from time to time, containing instructions on matters relating to wilful defaulters. Master Circular on Wilful Defaulters incorporating all the instructions and guidelines on the subject is being issued annually in the month of July since 2006.

The scope of the definition of wilful defaulters expanded by RBI in 2008:-
Pursuant to the Hon'ble Supreme Court's Order relating to writ petition Civil No.291 of 1998 titled Common Cause (A registered Society) Vs. Union of India &Anr., RBI had received a suggestion to expand the scope of definition of "wilful default". The suggestion was examined by RBI and it was decided to expand the scope of definition of "Wilful Defaulter". The additional criterion is as indicated below:

"The unit has defaulted in meeting its payment / repayment obligation to the lender and has also disposed of or removed the movable fixed assets or immovable property given by it for the purpose of securing a term loan without the knowledge of the bank / lender."

Issuance of Certificate of Registration to four Credit Information Companies:-
Four companies were granted Certificate of Registration by RBI to carry on the business of credit information in terms of Para 5 of the Credit Information Companies (Regulations) Act, 2005 (CICRA).

1. Experian Credit Information Company of India Pvt. Ltd. (Date of Registration: February 17, 2010)
2. Equifax Credit Information Services Pvt. Ltd. (Date of Registration : March 26, 2010)
3. CRIF High Mark Credit Information Services Pvt. Ltd. (Date of Registration: November 25, 2010)
4. Credit Information Bureau (India) Ltd.(Date of Registration: March 5, 2012)

Credit Information Bureau of India Ltd. (CIBIL) has been functioning as a Credit Information Company (CIC) from January 2001 onwards and credit institutions have been reporting data to CIBIL as per the instructions of RBI.

Reporting of credit information to Credit Information Companies:-
With issuance of Certificate of Registration to four Credit Information Companies by RBI, credit institutions were instructed in 2010 to submit the list of suit-filed accounts of wilful defaulters of Rs.25 lakh and above as at the end of March, June, September and December every year to CIBIL and / or any other credit information company which has obtained certificate of registration from RBI in terms of Section 5 of the Credit Information Companies (Regulation) Act, 2005 and of which it is a member. It was further clarified that if outstanding amount falls below Rs. 25 lakhs the banks / financial institutions need not report and also in respect of cases where banks have agreed for a compromise settlement and the borrower has fully paid the compromised amount, the same need not be reported.

Dissemination of Suit filed accounts by CICs on their websites:-
In order to have a system of wider dissemination, RBI in 2011 advised the Credit Information Companies to disseminate credit information covering data supplied by credit institutions on suit-filed accounts on their respective websites.

Withdrawal of "Consent Clause"
Section 17 of the CICRA, 2005 provides for collection and furnishing of the credit information by Credit Information Companies. Hence, RBI (2013) states that CIC Act now provides statutory backing for sharing of the credit information by credit institutions to the credit information companies. Therefore, with CIC Act coming into force, the consent clause becomes redundant and hence the same need not be insisted upon by the institutions.

Reporting of data to Credit Information Companies and not to RBI:-
Till September 2014, RBI was collecting the data on non-suit filed wilful defaulters of Rs.25 lakh and above and the same was being disseminated by RBI to the credit institutions to enable them to take credit decisions after factoring in the details of this list in their credit appraisal. However, this system predates the enactment of Credit Information Companies Act, 2005 (CICRA), when there was no system of centralized credit information on borrowers. With the establishment of these four Credit Information Companies in India, such a system was now put in place. Therefore, the credit institutions were advised to furnish the requisite data to these Companies, and not to RBI. Further, the periodicity was also made monthly or more frequent basis instead of quarterly hitherto, as this would enable such information to be available to the institutions on a real time basis.

Modifications / clarifications issued in the guidelines – 2015:-
As the reporting and dissemination of the names of the wilful defaulters started strengthening and consequences of the same was felt in the economy, it also gave rise to many references / queries from the banking sector and other agencies. RBI examined all such references and the issues emanating from them, made suitable modifications in the guidelines and issued a detailed circular on the same on January 7, 2015.

Objective:-
To put in place a systematic mechanism of all the credit information available in respect of wilful defaulters and disseminate the same periodically amongst the credit institutions in order to alert and caution them from further lending to these borrowers.

Clarification on term "lender" and "Unit" in the definition of "Wilful Default"
Table 5:-Description of the term "lender" and "Unit"

Lender	• Covers all banks and financial institutions • To which amount is due on account of banking transactions • Includes off balance sheet transactions.
Unit	• Individuals • Juristic persons • Any type of business enterprise • Persons responsible or In-charge for the management of the affairs in case of business enterprise.

"Grievances Redressal Mechanism" now titled as "Mechanism for identification of Wilful Defaulters"
With a view to bring in accountability and greater transparency the process put in place by the credit institutions for identifying, declaring and reporting a borrower as "wilful" defaulter, has been revised. The title of the mechanism has also been reformed from "Grievances Redressal Mechanism" to "Mechanism for identification of wilful defaulters".

The changes brought are as under:
Table 6:- Procedure for identification of "wilful defaulters" – old and new.

Step-wise procedure of "Grievances Redressal Mechanism"	**Step-wise procedure of "Mechanism for identification of wilful defaulters"**
With a view to imparting more objectivity in identifying cases of wilful default, decisions to classify the borrower as wilful defaulter should be entrusted to a Committee of higher functionaries headed by the Executive Director and consisting of two GMs/DGMs as decided by the Board of the concerned bank / financial institution.	The evidence of wilful default on the part of the borrowing company and its promoter/whole-time director at the relevant time should be examined by a Committee headed by an Executive Director and consisting of two other senior officers of the rank of GM/DGM.
The decision taken on classification of wilful defaulters should be well documented and supported by requisite evidence. The decision should clearly spell out the reasons for which	If the Committee concludes that an event of wilful default has occurred, it shall issue a Show Cause Notice to the concerned borrower and the promoter/whole-time director and call for their submissions and after considering their submissions issue an

the borrower has been declared as wilful defaulter vis-à-vis RBI guidelines.	order recording the fact of wilful default and the reasons for the same. An opportunity should be given to the borrower and the promoter/whole-time director for a personal hearing if the Committee feels such an opportunity is necessary.
The borrower should thereafter be suitably advised about the proposal to classify him as wilful defaulter along with the reasons therefor. The concerned borrower should be provided reasonable time (say 15 days) for making representation against such decision, if he so desires, to a Grievance Redressal Committee headed by the Chairman and Managing Director and consisting of two other senior officials.	The Order of the Committee should be reviewed by another Committee headed by the Chairman / CEO and MD and consisting, in addition, of two independent directors of the Bank and the Order shall become final only after it is confirmed by the said Review Committee.
Further, the above Grievance Redressal Committee should also give a hearing to the borrower if he represents that he has been wrongly classified as wilful defaulter.	As regard a non-promoter/non-whole time director, it should be kept in mind that Section 2(60) of the Companies Act, 2013 defines an officer who is in default to mean only the following categories of directors: (i) Whole-time director (ii) where there is no key managerial personnel, such director or directors as specified by the Board in this behalf and who has or have given his or their consent in writing to the Board to such specification, or all the directors, if no director is so specified; (iii) every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings and who has not objected to the same, or where such contravention had taken place with his consent or connivance. Therefore, except in very rare cases, a non-whole time director should not be considered as a wilful defaulter unless it is conclusively established that i) he was aware of the fact of wilful default by the borrower by virtue of any proceedings recorded in the Minutes of the Board or a Committee of the Board and has not recorded his objection to the same in the Minutes, or, ii) the wilful default had taken place with his consent or connivance. A similar process should be followed when identifying a non-promoter/non-whole time director as a wilful defaulter.
A final declaration as 'wilful defaulter' should be made after a view is taken by the Committee and the borrower should be suitably advised.	

The major changes which have been brought about in the mechanism are:

1. In addition to the borrowing company, the evidence of wilful default is being examined in respect of its promoter / whole-time director as they represent the core management of the company who are responsible for such default.
2. The reviewing committee which takes the final decision on the borrower being wilful has in addition to the Chairman / CEO and MD of the bank two independent directors of the bank now. Inclusion of independent directors in the committee makes the process more fair and unbiased.

3. In view of the limited role of non-promoter / non-whole time directors (Nominee and Independent directors) in the management of a company's debt contracts, their names shall now be excluded from the list of wilful defaulters, except in the rarest circumstances.

Clarifications issued on guarantees furnished:-
As there were references received from the credit institutions with regard to guarantees issued by individuals, group companies and non-group companies in respect of the wilfully defaulted company, hence clarifications on the same were issued by Reserve Bank in its circular of 2015.

RBI had advised that in terms of Section 128 of the Indian Contract Act, 1872, "*The liability of the surety is coextensive with that of the principal debtor unless it is otherwise provided by the contract*." It is therefore, clarified that the credit institutions can go ahead with invoking the guarantee against the guarantor / surety even without exhausting the available remedies against the wilful defaulter, who is the principal debtor. Further, it states that when the credit institution makes a claim on the guarantor, the liability of the guarantor is immediate.

The major instructions on this aspect are as under:
Table 7:-Action to be taken by banks on guarantees

Type of Guarantee	Action to be taken by credit institution
Wilful default of a single borrowing company in a Group.	Institution to consider track record of the individual company with reference to its repayment performance to its lenders.
Guarantees furnished by the companies within the Group on behalf of the wilfully defaulting units.	If the guarantee is not honoured when invoked, such group companies should also be reckoned as "wilful defaulters"
Claim made on the guarantor on account of the default made by the wilful defaulter.	As the liability of the guarantor is immediate, in case he refuses to pay in spite of having means to make payment, such guarantor would also be treated as a "wilful defaulter".

Strengthened the role of auditors:-
Hitherto, whenever the credit institutions observed that the auditors of the borrowers were negligent or deficient in conducting the audit of the wilfully defaulted company they were instructed to lodge a formal complaint against such auditors with the Institute of Chartered Accountants (ICAI).

In 2015, RBI had further strengthened the mechanism of audits. The credit institutions have been directed that in addition to the complaint being filed with the ICAI, they should also forward the same to the Department of Banking Supervision, Central Office of RBI and the Indian Banks' Association (IBA) for records. IBA in turn, would circulate the names of these Chartered Accountant firms amongst the credit institutions, who should consider this aspect before assigning further task to these firms. RBI would also share such information with other financial sector regulators / Ministry of Corporate Affairs (MCA) / Comptroller and Auditor General (CAG).

Specific Certificate from auditors on end-use of funds:-
The credit institutions should award a separate mandate to the auditors if they desire to have a specific certificate from them regarding diversion / siphoning of funds. However, if such a certificate is called for from the auditors, the credit institution should ensure that an appropriate covenant exists in the loan agreement which enables them to award such a mandate from the borrowing company or its auditors. Credit institutions may also engage their own auditors for obtaining specific certificate on the end use of funds, in addition to their own "due diligence" in monitoring the end use of funds lent.

Role of Internal Audit / Inspection spelt out:-
The credit institutions were also directed that while conducting their internal inspection or audit of their branches periodically, they should look into the defaulters' accounts exhaustively and scrutinize carefully to check whether there are diversion and / or siphoning of funds. The cases where "wilful" defaults are found, it should be reported to the Audit Committee of the bank.

Directors' to be identified by "Director Identification Number" (DIN):-
Ministry of Corporate Affairs (MCA), Government of India has introduced the concept of Director Identification Number (DIN) with insertion of Section 266A and 266G of Companies (Amendment) Act, 2006. Hence, as per the

extant notification all the existing and intending Directors have to obtain DIN within the prescribed time-frame from the MCA.

RBI (2015) had directed all the credit institutions to include the DIN against the names of the directors so that directors are correctly identified and names of the directors who do not appear in the list of wilful defaulters are not denied credit due to the similarity in the names with that of the person who is in the said list. The institutions should carefully examine this issue while scrutinizing the credit proposals and in case of doubt should independently verify the names from other sources.

Way Forward:-

The twenty-seventh Standing Committee Report on "Non-performing assets of Financial Institutions" presented by the Ministry of Finance, Government of India to both the houses of Parliament on February 24, 2016 *inter alia* states that the "wilful defaulters owe public sector banks a total of Rs.64,335 crore, which constitutes 21% of the total non-performing assets." As a measure of public accountability the said Committee has recommended that as a deterrent measure, credit institutions must pay attention to their top 30 wilful defaulters and make their names public. Such measure will help in recovering the existing debt from such defaulters and also prohibit these borrowers from availing further credit from the system. The report also states that to facilitate publishing of names of the wilful defaulters, if need be, the provisions of RBI Act or any other extant law governing prohibiting the same should be amended. There is need to examine the recommendations / conclusions of this report and mitigate the huge credit risk and stressed assets piled up in respect of "wilful defaults".

A thorough understanding of the above policies and regulatory prescriptions would enable credit institutions to employ an ex-ante approach to detect early stages of wilful defaults and thus avert high costs associated with identification, classification, reporting and legal recourse undertaken by filing a suit.

References:-

1. Central Vigilance Commission (1998) Circular No. 8(1)9(h)/98(2) dated November 27, 1998. http://cvc.gov.in/ins2.pdf (accessed on 10/03/2017)
2. Fifteenth report of the Standing Committee on Finance on the Credit Information Companies (Regulation) Bill 2004 http://164.100.24.208/ls/CommitteeR/finance/15rep.pdf (accessed on 07/03/2017)
3. Report of the Joint Committee on Stock Market Scam and matters relating thereto http://www.prsindia.org/administrator/uploads/general/1292845141JPC (accessed on 07/03/2017)
4. Reserve Bank of India (1986) Circular IECD.No.PMS.145/C. 446(PL)-86/87 dated August 20, 1986.
5. Reserve Bank of India (1990) Circular IECD.No.PMD.25/ C.446 (PL)-89/90 dated April 5, 1990.
6. Reserve Bank of India (1994) Circular DBOD No. BC.CIS.47/20:16:002/94 dated April 23, 1994.
7. Reserve Bank of India (1999) Circular DBOD No. BC. DL(W) 12/20.16.002/ 98-99 dated February 20, 1999.
8. Reserve Bank of India (1999) Circular DBOD No. BC. DL.4/20.16.002/ 99-2000 dated October 21, 1999.
9. Reserve Bank of India (2001) Circular DBOD No. BP.BC.115/21/03/038/ 2000-01 dated May 2, 2001.
10. Reserve Bank of India (2002) Circular DBOD No. DL (W).BC.110/20.16.003/ 2001-02 dated May 30, 2002.
11. Reserve Bank of India (2003) Circular DBOD No. BC.DL 7/20.16.003/ 2003-04 dated July 29, 2003.
12. Reserve Bank of India (2004) Circular DBOD No. DL.BC 94/20.16.003/ 2003-04 dated June 17, 2004.
13. Reserve Bank of India (2004) Circular DBOD No. DL.BC.16/20.16.003/ 2004-05 dated July 23, 2004.
14. Reserve Bank of India (2008) Circular DBOD No. DL. (W).BC.87/20.16.003/ 2007-08 dated May 28, 2008.
15. Reserve Bank of India (2010) Circular DBOD No. DL.BC.20/20.16.003/ 2010-11 dated July 1, 2010.
16. Reserve Bank of India (2011) Circular DBOD No. CID.BC.30/20.16.042/ 2011-12 dated September 5, 2011.
17. Reserve Bank of India (2013) Circular DBOD No. CID.BC.27/20.16.042/ 2013-14 dated July 1, 2013.
18. Reserve Bank of India (2014) Circular DBOD No. CID.BC.128/20.16.003/ 2013-14 dated June 27, 2014.
19. Reserve Bank of India (2014) Circular DBOD No. CID.41/20.16.003/ 2014-15 dated September 9, 2014.
20. Reserve Bank of India (2015) Circular DBOD No. CID.BC.57/20.16.003/ 2014-15 dated January 07, 2015.
21. The Parliament's Standing Committee Eighth Report on Financial Institutions – Objectives, Performance and Future Prospects http://164.100.24.208 /ls/committeeR/finance/8.pdf (accessed on 05/03/2017)
22. Twenty seventh report of the Standing Committee on Finance, Ministry of Finance (Department of Financial Services) on "Non-Performing Assets of Financial Institutions presented in the Lok Sabha on the February 24 2016 http://164.100.47.193/lsscommittee/Finance/16_Finance_27.pdf (accessed on 10/03/2017)