Wilful Defaulters and Non- Cooperative Borrowers

Financially distressed assets pose a systemic risk to the integrity of the banking system. The slowdown of the Indian economy in the recent past has repeatedly brought the problem of NPAs and restructured accounts to the forefront. RBI, in order to curb the menace of deliberate non-payment of dues, siphoning off of funds, falsification of records, unilateral disposal of collateral and other fraudulent transactions in relation to credit facilities advanced by banks, introduced the concept of *"wilful defaulter"* in 1999. As defined in the *Master Circular on Wilful Defaulters* issued by RBI, banks and financial institutions are under an obligation to maintain strict vigil on wilful defaulters and adhere to timely reporting requirements prescribed by RBI. Broadly, a wilful defaulter is a borrower who intentionally, deliberately and in a calculated manner, defaults in meeting its payment/repayment obligations despite having the capacity to honour the said obligations or diverts/siphons of funds for other purposes. The classification as *"wilful defaulter"* not only leads to the tarnishing of the borrower's credit history but also restricts access to further capital. Further, wilful defaulters may be met with penal proceedings under section 403 and 415 of the IPC.

Considering the harshness of the implications associated with the tag of a *"wilful defaulter"* and laying faith in the doctrine of *prevention is better than cure,* RBI introduced the concept of a *"non-cooperative borrower"* through its *Framework for Revitalising Distressed Assets in the Economy* on January 30, 2014. RBI had through this framework, sought to address the issues related to growing NPAs with the three-pronged objective of a) recognising financial distress early, b) taking prompt steps to resolve it, and c) ensuring fair recovery for lenders and investors.

On February 26, 2014, RBI had come out with detailed guidelines on the formation of a Joint Lenders' Forum and adoption of a Corrective Action Plan which provide elaborate provisions for identifying and dealing with incipient stress in different accounts. However, the process of classification as a *"non-cooperative borrower"* under the framework was rudimentary in nature and RBI by its notification dated December 22, 2014 has provided further clarity regarding the classification of "non-cooperative borrower". The notification defines a *"non-cooperative borrower"* as *"a defaulter who deliberately stone walls legitimate efforts of the lenders to recover their dues"* by, among other things, not providing necessary information or denying access to collateral or obstructing sale of securities etc. Further, it provides a numerical threshold of Rs. 5 Crores (Rs. 50 million) of aggregate fund-based and non-fund based facilities as a cut off limit for classifying borrowers as non-cooperative and provides a structured mechanism for dealing with *"non-cooperative borrower".*

Classification as a *"non-cooperative borrower"*, as opposed to *"wilful defaulter"*, would not entirely restrict a borrower's access to capital. However, it would impose higher provisioning requirements on banks willing to provide fresh loans to such a borrower; which would indirectly make it difficult for non-cooperative borrowers to source capital. Although the tag of a *"non-cooperative borrower"* may act as a clarion call for high risk borrowers and a red flag for new lenders, the direct benefit of this development to the recovery efforts of banks is debatable as the non-cooperative borrower regime would primarily hurt the banks and financial institutions through higher provisioning and reporting requirements.

Overseas Investments by Alternative Investment Funds (AIF)

RBI, under section 6(3)(c) of FEMA 1999, has the power to prohibit, restrict or regulate the *transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India*. In furtherance of this power, RBI has framed the FEMA (Transfer or Issue of any Foreign Security) Regulations, 2004 for regulating the issuance and transfer of foreign securities. RBI through its circulars dated, April 30, 2007 and May 04, 2007, had permitted Venture Capital Funds (VCFs), registered with SEBI to invest in equity and equity-linked instruments of off-shore venture capital undertakings, subject to an overall limit of ***USD 500 million*** with the prior approval of SEBI. With the SEBI (VCF) Regulations, 1996 now repealed, new VCFs are required to be registered with SEBI as Category I AIFs under the SEBI (AIF) Regulations, 2012. Regulation 15(a) of the AIF Regulations permits AIFs to invest in foreign securities; however, until now, there was no provision in the FEMA (Transfer or Issue of any Foreign Security) Regulations, 2004 enabling AIFs to invest in securities issued by foreign entities.

Recently, RBI, through its circular dated December 09, 2014, has permitted AIFs to invest in equity and equity-linked instruments of off-shore venture capital undertakings, subject to an overall limit of ***USD 500 million*** with the prior approval of SEBI. However, the latest circular appears to be a mere reproduction of the permission that was granted to VCFs in 2007.

This raises several concerns. First, the scope of investments by AIFs is much broader than that of the erstwhile VCFs; AIFs include infrastructure funds, private equity funds, hedge funds, etc. Therefore, restricting foreign investments of such funds only to off-shore venture capital undertakings seems illogical; second, an overall investment limit of USD 500 million is excessively small for a class of investment funds, i.e. AIFs, which is much larger in scope than the erstwhile VCFs; third, the RBI notification prescribes a requirement of obtaining the prior approval of SEBI before AIFs invest in securities of off-shore venture capital undertakings. In light of regulation 15(a) of the AIF Regulations and in view of SEBI's regulatory responsibility, such a prior approval may lead to unnecessary delays. As regards the apportioning of the overall limit, it may be done on a first-come, first-served basis; and fourth, there is no clear definition of an *"off-shore venture capital undertaking"* under the AIF Regulations.

A revised notification addressing the aforementioned concerns and highlighting the regulatory rationale may be helpful in providing certainty to AIFs which are considering investing abroad.

Improving Liquidity in the Corporate Bond Market

The high level expert committee, headed by Dr. R. H. Patil, on Corporate Bonds and Securitization (CoBoSAC) was set up in 2008 with the task of recommending measures for the development of the market for corporate bonds and securitized debt instruments. While observing that the corporate bond market is highly fragmented due to multiple issuances of privately placed bonds, one of the committee's latest recommendations was to permit consolidation and re-issuance of these fragmented units. A similar experiment was attempted in 1999 wherein consolidation was permitted in the G-sec market which resulted in both larger stock size and improved market liquidity. The objective behind the current proposal is to have a similar outcome in the corporate bond market.

Based on the above recommendation, SEBI has proposed to amend the SEBI (Issue and Listing of Debt Securities) Regulations, 2008, by adding a new sub-regulation to regulation 18. This sub-regulation will enable an issuer to carry out consolidation and re-issuance of its debt securities through private placement as long as its articles of association contain a provision permitting the same. The issuer will also be required to obtain and disclose a credit rating from a registered credit rating agency and should ensure that it is periodically revalidated.

If the G-sec market is anything to go by, the proposed change is sure to have a positive outcome on the corporate bond market.

Lok Sabha clears the Companies Amendment Bill, 2014

With the larger aim to smoothen the path for doing business in India, the Lok Sabha has given its nod to the Companies (Amendment) Bill, 2014 on December 17, 2014. The notable changes included in the Bill are as follows:

Related Party Transactions: The Companies Act, 2013 which came into effect from April 1, 2014 had made it difficult for companies to undertake RPTs in their ordinary course of business as it had introduced the requirement of passing a special resolution for all RPTs. It was felt that these restrictions were too onerous and affected the smooth functioning of business, especially for large conglomerates. Under the Bill, it is proposed that all RPTs will require only an ordinary resolution of the shareholders, and the Audit Committee will be empowered to provide omnibus annual approvals for RPTs subject to prescribed conditions. However, it may be noted that listed companies may still have to comply with the more stringent requirements under Clause 49 of the Listing Agreement.

Public Inspection of Board Resolutions: Public inspection of board resolutions filed with the Registrar of Companies would now be prohibited. This is a step in the right direction as it would ensure that business strategies of companies are not made known to competitors.

Loans to Subsidiaries: Loans/guarantees /security provided against loans by a holding company to its subsidiaries would be exempted from the general prohibition imposed on companies from giving loans to directors/persons in which directors are interested, provided such loans are utilized by the subsidiaries for their principal activities.

Minimum Paid-up Capital: The requirement of having a minimum paid-up capital for incorporating companies would be done away with. However, concerns have been raised that this may open flood gates by making it easier to set up shell companies that may facilitate money laundering.

Further, the Bill makes amendments in relation to payment of dividends, fraud reporting, establishment of special courts, punishment for violation of deposit rules, optional requirement to have a common seal etc.

SEBI Discussion Paper on "Issuance of partly paid shares and warrants by Indian companies"

Following the decision of the Ministry of Finance to permit the issuance of partly paid shares and warrants by Indian companies to foreign investors, RBI has now classified partly paid shares and warrants of Indian companies as eligible instruments for the purpose of FDI and FPI. Towards this objective, SEBI released a Discussion Paper on *"Issuance of partly paid shares and warrants by Indian companies"* on December 2, 2014, seeking to harmonize the requirements relating to a) upfront payment of consideration, and b) tenure of partly paid shares and warrants, for different modes of issuance of these instruments under the ICDR Regulations, 2009 and FEMA.

The Discussion Paper proposes the upfront payment of 25% of the total consideration at the time of issuance of partly paid shares and warrants, with the balance consideration being payable within 12 and 18 months, respectively. Prescribing a minimum upfront payment will ensure certainty regarding the receipt of funds by the issuer company. Keeping a time-frame for making the payment, even if in a staggered manner, will help prevent misuse of the instrument. However, concerns have been raised regarding issuance through preferential allotment. Although, RBI does not prohibit the issuance of these instruments through preferential allotment, the proposed SEBI amendments do not provide for the same. Further clarity in this regard would benefit issuers willing to raise capital through these instruments.