

ANALYSIS OF MASTER DIRECTION ON TREATMENT OF WILFUL AND LARGE DEFAULTERS

I. INTRODUCTION AND BACKGROUND:

Reserve Bank of India ("**RBI**") vide its Master Direction on 'Treatment of Wilful Defaulters and Large Defaulters' dated July 30, 2024, bearing reference number RBI/DoR/2024-25/122 ("**said Direction**") released a comprehensive guideline delineating the regulatory framework and procedures for classification of borrowers as wilful defaulters. The said Direction plays a crucial role in maintaining the financial system's integrity by outlining the measures and consequences for borrowers who deliberately default on their financial obligations.

The principal aim of the said Direction is to establish an equitable and transparent process, while adhering to the principles of natural justice, for the Lenders to identify a borrower as a wilful defaulter. The guidelines therein also seek to establish a mechanism for sharing credit data regarding wilful defaulters in order to alert Lenders and prevent them from receiving additional institutional financing.

With these directions, coming into force, the instructions/ guidelines contained in a total of 60 circulars, issued by the RBI stand repealed.

II. APPLICABILITY:

The said Direction is applicable to-

- **Lender** i.e. all India financial institutions, banks or non-banking financial companies that have granted a credit facility to a borrower.
- '**Asset Reconstruction Companies**' and 'Credit Information Companies' only with regard to their reporting requirements.
- All '**Regulated Entities**' with regards to the restrictions on further financial accommodation to wilful defaulters and the provisions relating to large defaulters (who have an outstanding amount of Rs. 1 crore or above including the unapplied interest, if any).

III. COMMENCEMENT:

The said Direction will come into force after 90 days from July 30, 2024.

IV. SALIENT FEATURES

- **Identification & Classification of Wilful Defaulters**
 - a. A wilful default shall be deemed to have occurred when the borrower defaults in meeting payment/ repayment obligations to the Lender whilst a wilful defaulter is a borrower or a guarantor who has committed wilful default with the outstanding amount being ₹25 lakh or above. The said Direction

empowers the Lenders to identify and classify a person as a 'Wilful Defaulter' keeping in view the track record of the borrowers who shall not be classified merely on the basis of isolated transactions/ incidents.

- b. An '**Identification Committee**' shall be constituted by the Lender and shall examine the evidence to determine if the default was wilful and if satisfied, it shall issue a show-cause notice stating out all the relevant information, to borrower/ guarantor/ promoter/ director/ persons who are in charge and responsible for the management of the affairs of the entity ("**Person**"), and call for the submissions from them within 21 days of issuance of show cause notice.
- c. After reviewing the submission, the 'Identification Committee' shall make a proposal to the 'Review Committee' which shall also be constituted by the Lender, for classification of a Person as a wilful defaulter by explaining the reasons in writing. The Person shall thereafter be suitably advised about the proposal to classify them as wilful defaulter along with the reasons therefor.
- d. The Person shall thereafter make a written representation to the 'Review Committee' within 15 days of such a proposal from the 'Identification Committee'. The 'Review Committee' shall also provide an opportunity for a personal hearing. In a scenario where the opportunity is not availed or if the personal hearing is not attended, the 'Review Committee' shall, after assessing the facts on record, including written representation, if any, consider the proposal of the 'Identification Committee' and take a reasoned decision which shall be communicated to the wilful defaulter.
- e. If the 'Identification Committee' concludes that the Person does not qualify for classification as a wilful defaulter, such cases need not be referred to the 'Review Committee'.
- f. A director other than whole-time director, including an independent director/ nominee director, shall not be considered as wilful defaulter unless it is conclusively established that the wilful default has taken place with their consent or connivance or he/ she was aware of the fact of wilful default by the borrower or the guarantor, as revealed from the proceedings recorded in the minutes of the meeting of the Board or a committee of the board, but has not recorded his/ her objections to the same.
- g. Further, the Lender must periodically review all non-performing asset accounts of ₹25 lakh or more to see if they involve wilful default. If wilful default is observed, the Lender shall complete the process of classification within six months of the account being classified as Non-Performing Asset ("**NPA**").

➤ **Treatment of Wilful Defaulters**

- a. **Criminal Proceedings**- Lender has the discretion to decide whether to initiate criminal proceedings against wilful defaulters based on the facts and circumstances of each case. In cases where criminal proceedings have been initiated, removal of the name of a wilful defaulter from the List of Wilful Defaulters ("**LWD**") shall be without prejudice to the continuation of criminal proceedings against the wilful defaulter.
- b. **Publishing Photographs**- Lender must create a fair policy, approved by their board, that outlines the criteria on which they can publish photographs of people who have been classified as wilful defaulters.
- c. **Penal Measures**- Wilful defaulters and their associated entities are barred from receiving new credit facility from Lenders, with this restriction lasting for a period of 1 year. Further, no credit facility shall be granted by any Lender for floating of new ventures to a wilful defaulter or its associated entity for a period of 5 years after their name is removed from the LWD by the Lender. Wilful

defaulters or its associated entity shall also not be eligible for restructuring of credit facility until the removal of their name from the LWD. The penal provisions mentioned above, shall cease to be applicable on the associated entities when they are no longer associated with the wilful defaulters.

- d. The Lender must include a clause in loan agreements stating that a company cannot have a wilful defaulter on its board or as a manager, and if such a person is found, they must be removed quickly; otherwise, the Lender won't renew or provide new loans to the company as long as the wilful defaulter remains involved.
- e. The Lender shall, wherever warranted, initiate legal action against the borrowers/ guarantors for foreclosure/ recovery of dues expeditiously.
- f. The Lender must have their internal auditors to specifically look into adherence to instructions for classifying a borrower as a wilful defaulter. The audit committee should periodically review wilful default cases, recommend preventive measures, and ensure early detection.

➤ **Liability of a Guarantor**

- a. According to Section 128 of the Indian Contract Act, of 1872, a guarantor's liability is equal to that of the principal debtor unless the contract says otherwise. If the principal debtor defaults, the Lender can act against the guarantor even without first exhausting the remedies against the principal debtor.
- b. Once a Lender has made a claim on the guarantor due to the debtor's default, the guarantor's liability is immediate and where the guarantor refuses to comply, they can also be classified as a wilful defaulter following the set procedure.

➤ **Reporting and Dissemination of Credit Information**

1. On Large Defaulters:-

- a. All 'Regulated Entities' must submit monthly reports to credit information companies with regards to large monthly defaulters including:
 - a list of suit filed accounts of large defaulters; and
 - a list of non-suit filed accounts of large defaulters whose account has been classified as doubtful or loss.
- b. For determining the ₹1 crore threshold, the unapplied interest, if any shall also be included. For suit-filed accounts, the threshold shall relate to the amount for which the suits have been filed. Further, Credit Information Companies ("**CICs**") must provide access to lists of non-suits filed accounts of large defaulters to credit institutions. CICs shall also publish list of suit-filed accounts of large defaulters on their websites.

2. On Wilful Defaulters:-

- a. All Lender(s) or Asset Recovery Companies ("**ARC**") to which account has been transferred, must report monthly to CICs:
 - A list of wilful defaulters in respect of suit-filed accounts.
 - A list of wilful defaulters in respect of non-suit filed accounts.
- b. When the outstanding amount falls below ₹25 lakh (or as notified by RBI from time to time), Lender

or the ARC must promptly update CICs the removal of the name of the wilful defaulter from the LWD within 30 days and must display both suit-filed and non-suit-filed accounts of LWD on their websites.

- c. In the event an 'NBFC' in the middle layer or above or a 'Non-Scheduled UCB' falling under tier 3 or 4 is reclassified during a subsequent review as 'NBFC-Base Layer' or 'Non-Scheduled UCB' under tier 1 or 2, such 'NBFCs/ UCBs' shall no longer be eligible to classify their borrowers as wilful defaulters. However, these 'NBFCs/ UCB's shall continue to furnish updates pertaining to historical data submitted by them to the CIC.

➤ **Treatment of Compromise Settlements**

- a. An account shall only be removed from LWD after the borrower has fully paid the agreed compromise amount where the Lender/ARC has entered into a compromise settlement with the borrower. If only part of the compromise amount is paid, the borrower's name will remain on the LWD, even if the outstanding amount falls below ₹25 lakh or as notified by RBI from time to time.
- b. Compromise settlements shall not affect the continuation of any ongoing criminal proceedings against the wilful defaulter.

➤ **Treatment of Defaulted Loans sold to other Lender(s)/ARCs**

- a. Before transferring a defaulted loan with an outstanding amount of ₹25 lakh or more to other transferees, regardless of its NPA classification, the Lender shall conduct a comprehensive investigation from a wilful default perspective. This investigation does not need to involve a two-stage committee but must ensure a thorough examination of wilful default aspects for each defaulted loan.
- b. If wilful default is identified, the Lender shall complete the classification process of the borrower as a wilful defaulter and report it to CICs before selling the asset to other Lenders or ARCs.
- c. The Lender shall convey the details of the reporting to the transferee Lenders or ARCs, which shall then be responsible for reporting the information to the CICs.
- d. The "transferee" Lender(s)/ ARCs shall continue to report the account as a wilful defaulter until the balance remaining to be recovered in their account plus the amount written off by the "transferor" lender falls below the threshold of ₹25 lakh or as notified from time to time.

➤ **Treatment of LWD Accounts under Resolution**

- a. If an account listed as a wilful defaulter undergoes liquidation or a resolution (under IBC or under the 'Master Direction of Prudential Framework for Resolution of Stressed Assets' dated June 7, 2019, as amended), and results in a change in management and control of the entity or business, the name of the borrower or guarantor who were classified as a wilful defaulter (including promoters and directors of a company, or those responsible for management in other entities) shall be removed from the LWD after the resolution plan is implemented.
- b. The penal measures under this direction shall not apply to such entities or business enterprises after the above stated resolution plan is implemented but shall continue to apply to the erstwhile promoter(s)/ director(s)/ guarantor(s)/ persons who were in charge and responsible for the management of the affairs of the entity/ business enterprise, and to the entities they are associated as a promoter or director or as one in charge and responsible for its management.

➤ **Reporting**

a. Responsibility for Correct Reporting

- It shall be the responsibility of the Lender to report correct information and to ensure the accuracy of facts and figures.
- When providing information to CICs, the Lender must ensure the accuracy of directors' details by cross-checking with the 'Registrar of Companies' database whenever possible.

b. Reporting of Guarantors

- The Lender or the regulated entities as applicable, must report details of guarantors to CICs who have failed to fulfil their commitments thereunder when invoked, as either large defaulters or wilful defaulters as the case may be.

c. Reporting of Directors

- For business enterprises registered under the Companies Act, 2013, the Lender shall also report the full names of directors to facilitate better identity of persons concerned, subject to the provisions of these directions.
- To prevent wrongful denial of credit due to similar names of the directors, the Lender must also include their 'Director Identification Number' in the data submitted in to CICs.

➤ **Preventive Measures**

1. Credit Appraisal

- a. While carrying out credit appraisal of a borrower, regulated entities must verify if the name of any directors, guarantors, or key management personnel of a company appear on the lists of large defaulters or wilful defaulters by reference to their 'DIN' or 'PAN', etc.
- b. If there is confusion due to identical names, the Lender should use independent sources to confirm the identity of directors instead of relying on declaration from the borrowing company.

2. Monitoring End Use of Funds

- a. Regulated entities must closely monitor how funds are used and obtain certifications from borrowers confirming that funds are used in accordance with the purpose for which they were obtained. If a borrower provides false certifications, regulated entities should consider imitating legal proceedings, including criminal proceedings, if necessary, against the borrowing company.
- b. In cases of project financing, regulated entities should ensure end use of funds by obtaining certification from Chartered Accountants for the same but should not rely solely on these certification. They must enhance their credit risk management systems and internal controls to enhance the quality of their loan portfolio.

➤ **Role of Statutory Auditors**

- a. If a Lender observes that borrowers have falsified accounts and the auditors are found to be negligent or deficient in conducting the audit, the Lender should file a formal complaint against the statutory auditors of the borrowers with the National Financial Reporting Authority ("**NFRA**") or the Institute of Chartered Accountants of India ("**ICAI**"). This allows NFRA or ICAI to investigate and

hold auditors accountable.

- b. Until NFRA/ICAI takes action, the Lender should also report the issue to the 'Department of Supervision, Central Office of the RBI and the Indian Banks' Association ("**IBA**"). Before reporting, the Lender must satisfy themselves and verify the auditors' involvement and give them an opportunity of being heard.
- c. IBA based on this information shall create a caution list of such auditors, which will be shared among Lender to consider before assigning work to them.
- d. If a Lender needs specific certification from auditors regarding diversion/siphoning of funds, they should give a separate mandate to the auditors. The loan agreements shall include covenants allowing such mandates by the Lender to the auditor. The Lender is also free to engage their own auditors for such specific certification without relying on certification given by borrowers' auditor.

➤ **Role of Third Parties**

- a. As provided by the 'Master Direction on Fraud Risk Management in Commercial Banks (including RRBs) and AIFIs/ UCBs, State Cooperative Banks, Central Cooperative Banks/ NBFCs (including Housing Finance Companies)' dated July 15, 2024, a Lender must hold third parties accountable if they played a crucial role in credit sanction or disbursement and were negligent or deficient or facilitated wilful default by the borrower.
- b. The lenders shall forward the details of these third parties to the IBA for their records, even if such lenders are not IBA members.

V. CONCLUSION:

The said Direction (which consolidates/supersedes almost 60 earlier circulars/directions) is a welcome move which comes as a great relief to the lenders and addresses the crisis by providing a proper regulated mechanism to identify, prevent and report such instances of wilful and large defaults to the relevant authorities. The said Direction provides a regulatory structure that places a strong emphasis on accountability, openness, and close oversight and outlines the significance of precise reporting, in-depth credit evaluations, and strict actions to be taken against the wilful defaulters.

The stringent provisions discourage the borrowers to inculcate and incorporate the wrongful practices and strengthens the banking system in the country and at the same time gives access to the lenders to find out the names of the borrowers/guarantors who have been reported as wilful defaulters at the time of credit approval. Further the said Direction also makes the Lender responsible while transferring the loans and puts an obligation on the transferring Lender to complete the investigation process and disclose the details of defaults (if any) to other lenders and/or the ARCs.

Disclaimer:

The contents of this newsletter are intended for information purposes only and have been prepared basis the notifications/circulars available on the online portal/websites and have not been independently verified. The analysis herein is not in the nature of a legal opinion or advice and has been prepared for general guidance. They may not encompass all possible regulations and circumstances applicable to the subject matter and readers are encouraged to seek legal counsel advice prior to acting upon any of the

information provided herein. SDS Advocates neither assumes nor accepts any responsibility for any loss arising to any person as a result of or any direct, indirect, special, or incidental damage resulting from raising out of or in connection with the use of this information or any material contained herein.