

PART A: HIGHLIGHTS OF THE ORDINANCE

Context

Non-performing assets (NPAs) are loans given by banks, where the borrower defaults on repayment. According to the Reserve Bank of India (RBI), loans are classified as NPAs 90 days after default.¹ Over the last decade, NPAs as a proportion of total loans extended by banks have increased from 2.3% in 2008 to 7.5% in 2016 (Rs 6.11 lakh crore or 4.5% of GDP).² At these levels, India's NPAs are higher than other emerging markets.³ A rise in NPAs adversely affects the lending capacity of banks, thereby impacting credit availability, investment and economic growth.⁴

To recover the outstanding amount, banks may restructure loans (such as change the repayment schedule) or choose to initiate action under RBI schemes. These schemes allow for various options including: (i) conversion of debt into equity, (ii) takeover a company's management, and (iii) collective decision making by banks on a recovery plan. There may be cases where the defaulter is unable to repay the loan despite restructuring.

Banks may also take legal action by: (i) approaching Debt Recovery Tribunals, (ii) taking possession of the collateral (SARFAESI Act), or (iii) taking action under the Insolvency and Bankruptcy Code, 2016. In case banks cannot recover a part of the loan, the unrecovered amount will have to be written off as a loss. Figure 1 depicts the process of loans turning into NPAs, and the options available for recovery.

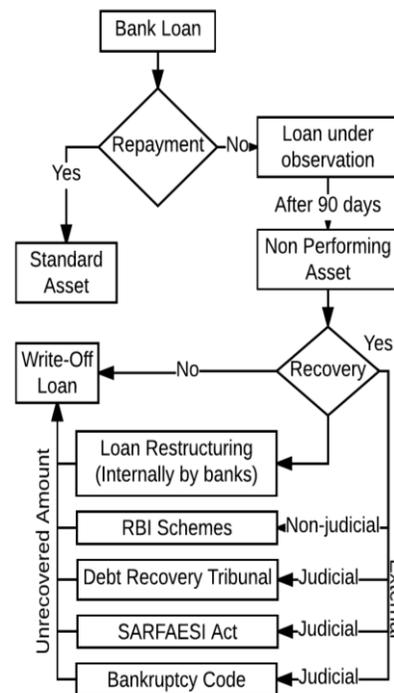
The Banking Regulation (Amendment) Ordinance, 2017 promulgated on May 4, 2017 allows the centre to authorise the RBI to direct banks to initiate recovery proceedings against loan defaulters.⁵ These proceedings will be under the Insolvency and Bankruptcy Code, 2016.⁶ Subsequent to the promulgation of the Ordinance, the Finance Ministry authorised the RBI to issue directions to banks that it considers necessary, to initiate insolvency proceedings.⁷ RBI has used these powers to identify 12 defaulters, each having an outstanding amount of over Rs 5,000 crore.⁸ Subsequently, one of these companies has challenged RBI's directions.⁹

Key Features

The Banking Regulation (Amendment) Ordinance, 2017 amends the Banking Regulation Act, 1949.¹⁰ The 1949 Act regulates the functioning of banks and provides details on aspects such as licensing, management, and operations of banks. Key features of the Ordinance are:

- **Insolvency proceedings:** The central government may authorise the RBI to issue directions to banks for initiating proceedings in case of a default in loan repayment. These proceedings will be under the Insolvency and Bankruptcy Code, 2016.
- **Issuing directions to banks on stressed assets:** The RBI may issue directions to banks for resolution of stressed assets (stressed assets include NPAs, and loans that have been restructured.) Further, the RBI may specify authorities or committees to advise banks on resolution of these assets. Members on such committees will be appointed or approved by the RBI.

Figure 1: NPAs and their recovery



Recovery process under the Insolvency and Bankruptcy Code, 2016:⁶

- Specialised insolvency professional appointed to manage the defaulter's assets and constitute a committee of creditors.
- Creditors committee decides to either: (i) formulate a resolution plan to restructure the defaulter's loans, or (ii) liquidate (sell) his assets to recover outstanding amount.
- If no decision is taken within 180 days (extendable by 90 days), the defaulter's assets will be liquidated.
- Proceeds from the sale will be distributed in an order of priority, with secured creditors and workmen getting preference over others.

PART B: KEY ISSUES AND ANALYSIS

Necessity of the Ordinance unclear

The Ordinance allows the RBI to issue directions to banks for initiating recovery proceedings against loan defaulters. These proceedings will be under the Insolvency and Bankruptcy Code, 2016. In this context, we discuss the purpose of the Ordinance, and if the objectives could have been achieved through existing mechanisms.

Powers given to RBI under the Ordinance similar to existing powers under the 1949 Act

Act: Section 35A
Ordinance: Clause 2

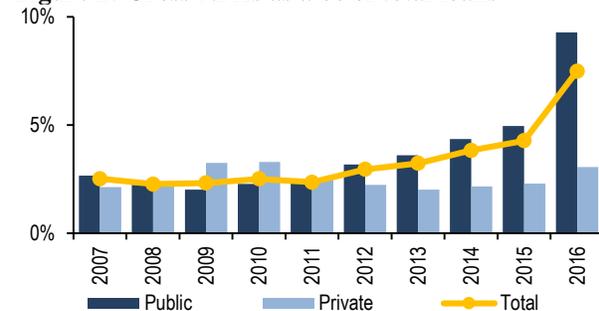
The Ordinance inserts a provision in the Banking Regulation Act, 1949, allowing RBI to direct banks for initiating recovery proceedings against defaulters. The question is whether the existing powers of RBI under that Act enable it to issue such directions.

The above provision is in addition to Section 35A of the 1949 Act which allows RBI to issue binding directions to banks in 'public interest' or where the functioning of a bank is detrimental to its interests, among others.¹⁰ It could be argued that a high level of NPAs impact credit availability in the country and has implications for the broader economy.⁴ The question is whether this situation qualifies as 'public interest' and allows the RBI to use powers under Section 35A to direct banks to initiate recovery proceedings under the Insolvency and Bankruptcy Code, 2016.¹¹

Centre as a majority shareholder in public sector banks could have decided to initiate proceedings

The Ordinance empowers the centre to authorise the RBI to direct banks to initiate recovery proceedings against loan defaulters. According to the RBI, loans extended by public sector banks account for 88% of the NPAs in the country.² This implies that a majority of the NPAs are in banks where the government is the majority shareholder. Therefore, the government had the power to direct public sector banks to initiate recovery of NPAs under various RBI schemes and laws such as the Insolvency and Bankruptcy Code, 2016 (see Annexure for details). In this context, it could be argued that the government had the authority to initiate recovery of 88% of NPAs without having to authorise the RBI under the Ordinance.

Figure 2: Gross NPAs as a % of total loans



Note: Figures for public and private sector banks is a % of loans advanced by them, respectively.
Sources: RBI; PRS.

Appropriateness of RBI as regulator to issue directions on recoveries

The Ordinance allows the RBI to issue directions to banks for initiating recovery proceedings against loan defaulters. The question is whether it is appropriate for the RBI, as a banking regulator, to direct banks on business decisions such as recovery of loans from specific defaulters.

It may be argued that a banking regulator is responsible for ensuring stability of the banking system and thereby preventing risks to the financial system.¹² Therefore its role should be restricted to formulating broad guidelines to be followed by all banks, and it should not issue directions related to specific loans.¹³ Banks should have the independence to take business decisions such as criteria for extending loans, risk profile of borrowers, lending rates, and recovery in case of loan default. Banks are best placed to assess the likelihood of recovery; for example, a bank may judge that a higher amount may be recovered if it waited for an improvement in the business cycle.¹¹ Furthermore, a specific direction by RBI exposes it to being challenged in court. This has happened in one of the defaults identified recently.⁹

On the other hand, the power of the RBI to issue directions to banks for recovery of loans may be justified on grounds that NPAs impact economic stability. A rising trend in loan defaults affects the lending capacity of banks, investment potential in the country and may have wider economic implications.⁴ In this situation, it could be argued that the RBI's intervention is required to resolve the situation and recover the outstanding amount. While there may be an argument for the RBI to issue directions, it may be considered whether such powers should continue to be a part of the law after achieving the desired objective, or cease to be in force after a limited period of time?¹¹

Issues faced by banks in recovery of NPAs

Currently, banks have the option of initiating recovery proceedings under the Insolvency and Bankruptcy Code, 2016, among other laws. The Ordinance allows the RBI to direct banks to initiate these proceedings. It could be argued that the Ordinance may not address challenges faced by banks in the recovery process.

As part of the recovery proceedings, banks have to decide on whether to: (i) restructure the loan, or (ii) liquidate the assets for recovery, and estimate the losses they are willing to accept as part of the recovery process. The Economic Survey 2016-17 notes that the challenges faced by banks during the recovery process include: (i) lack of incentives for public sector bankers to recognise losses, (ii) fear of investigation by anti-corruption agencies in case of low recoveries, and (iii) insufficient capital to absorb losses due to unrecovered loans.³

Annexure: Existing mechanisms to recover outstanding loans

Over the years, several mechanisms have been introduced to recover NPAs. We summarise these in Table 1 below.

Table 1: Various options available for the recovery of NPAs

	Year	Action/Scheme	Features
	2002	Corporate Debt Restructuring	▪ Allows for restructuring of a borrower's outstanding loans from more than one bank.
	2014	Joint Lender's Forum	▪ All lenders evolve an action plan to resolve the NPA of a defaulter. A plan will be implemented if 60% of the creditors by value, and 50% of the creditors by number agree.
RBI Schemes	2014	5:25 scheme	▪ Banks can extend the loan term to 25 years based on cash flow of projects for which the loan was given. Interest rates and other terms of the loans may be readjusted every five years.
	2015	Asset Quality Review	▪ Sought to ensure that banks are conforming to RBI guidelines on classification of loans. Banks were given six quarters to rectify any deviations in the categorisation of loans in their accounts.
	2015	Strategic Debt Restructuring	▪ Banks convert their debt into equity to hold a majority of shares in a company. This allows banks to change the management of the defaulting company.
	2016	Sustainable Structuring of Stressed Assets	▪ Allows for conversion of a part of the outstanding debt to equity or preference shares if (i) project for which loan was taken has commenced operations, and (ii) borrower can repay over 50% of the loan.
Legal Options	1993	RDDBFI Act, 1993	▪ Banks and certain financial institutions initiate proceedings in specialised Debt Recovery Tribunals. This option is available for both secured and unsecured lenders.
	2002	SARFAESI Act, 2002	▪ Enables secured creditors to take possession of collateral without the involvement of a court or a tribunal. It also regulates the functioning of Asset Reconstruction Companies.
	2016	Insolvency and Bankruptcy Code, 2016	▪ Provides a 180-day time limit for creditors to agree on: (i) restructuring the defaulter's loans, or (ii) liquidate the assets to recover outstanding dues.

Sources: RBI scheme guidelines; Economic Survey 2016-17; Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI Act); Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act); Insolvency and Bankruptcy Code, 2016; PRS.

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