

# Article



## NHB implements wilful defaulter guidelines for HFCs

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6<sup>th</sup> January, 2015

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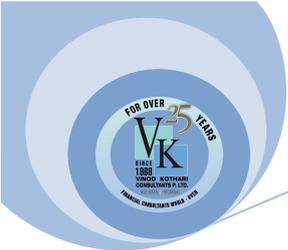
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The “Committee to Recommend Data Format for Furnishing of Credit Information to Credit Information Companies”, constituted under the chairmanship of Mr. Aditya Puri, had made several recommendations in its report to the Reserve Bank of India on January 2014<sup>1</sup>, of which a separate section dealt with reporting of wilful defaulters. The concept of reporting of wilful defaulters existed in India since 1990, but it was only for the banks, until the said committee made recommendations with respect to reporting requirement by all financial institutions, including housing finance companies (HFC), as well. It is in furtherance to this particular recommendation that the NHB has introduced the concept of reporting wilful defaulter by HFCs<sup>2</sup>.

In this write up we intend to analyse the impact of the new set of guidelines on the HFCs, which are in line with the ones issued by the RBI for banks<sup>3</sup>, and summarising the list of compliance checks to be taken care off.

### 1. Scope of these Guidelines

The Guidelines are applicable to all the HFCs with respect to the credit extended by them to borrowers who can either be individuals, juristic persons or other forms of business enterprise where the amount involved is Rs. 25 lakhs or more.

While it is relatively easier to identify and control the wilful defaults caused by non corporate borrower, corporate borrowers require special attention owing to the complexities involved in its operations and this is the reason why the instant Guidelines has focussed more on wilful defaults by corporate borrowers.

### 2. Definition of key terms

The Guidelines define a few key terms and they are exactly same as that used in the Guidelines for the banks. The Guidelines define the term “wilful default” in the following manner:

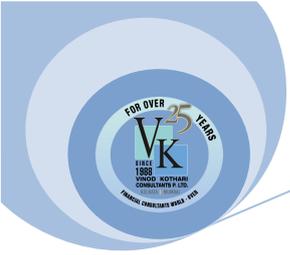
*2.1.3 Wilful Default: A ‘wilful default’ would be deemed to have occurred if any of the following events is noted:*

- (a) The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.*
- (b) The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised 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 utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.*
- (d) The unit has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property*

<sup>1</sup> <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/APR220314FS.pdf>

<sup>2</sup> [http://www.nhb.org.in/Regulation/NHB\(ND\)-DRS-Policy-Circular-74-2015-16.pdf](http://www.nhb.org.in/Regulation/NHB(ND)-DRS-Policy-Circular-74-2015-16.pdf)

<sup>3</sup> [https://www.rbi.org.in/Scripts/BS\\_ViewMasCirculardetails.aspx?id=9907](https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9907)



*given for the purpose of securing a term loan without the knowledge of the HFC / lender.*

*The identification of the wilful default should be made keeping in view the track record of the borrowers and should not be decided on the basis of isolated transactions / incidents. The default to be categorised as wilful must be intentional, deliberate and calculated.*

The terms “*diversion of funds*” have been defined in the Guidelines in the following manner:

*2.2.1. Diversion of Funds: The term ‘diversion of funds’ referred to at paragraph 2.1.3(b) above, should be construed to include any one of the undernoted occurrences:*

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

The above definition holds good for banks and but not for HFCs, as some of the instances mentioned above may not happen ever in the lifetime of an HFC. HFCs primarily extend loans for purchase and modification of house properties or extend loans to builders for construction of houses, so the concept of working capital loan does not hold good for HFCs at all.

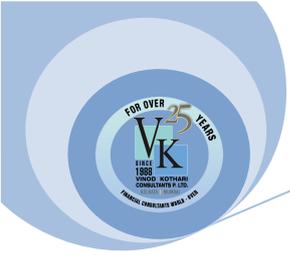
Again, the term “*siphoning of funds*” have been defined in the following manner:

*2.2.2 Siphoning of Funds: The term ‘siphoning of funds’, referred to in paragraph 2.1.3(c) above, should be construed to occur if any funds borrowed from HFCs are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be a judgment of the lenders based on objective facts and circumstances of the case.*

The outcome of the above definition is that the HFCs will now have an upper hand as they will have the ultimate say on whether a particular instance is a case of wilful default or not.

### **3. Identification of wilful defaulters**

As per the Guidelines, the identification of wilful defaulters has to be carried out by a committee constituted for this purpose, by the name of “Identification Committee”, in the following manner:



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- a. The Committee should have at least one Executive Director of the Company, who shall also act as the Chairperson of the Committee; and
- b. There should at least two senior officers of the Company, preferably of the stature of General Manager/ Deputy General Manager of the Company.

The Identification Committee, after giving the defaulting party reasonable opportunity of being heard will decide on whether the party is a wilful defaulter. The order passed by the Identification Committee will be subject to review by another committee called the “Review Committee” which has to be constituted in the following manner:

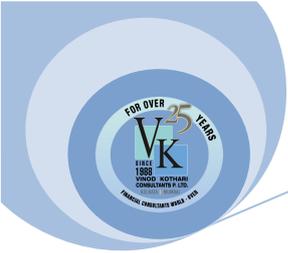
- a. The Committee should be headed by the Chairman / Chairman & Managing Director or the Managing Director & Chief Executive Officer / CEOs; and
- b. There should at least two independent directors of the Company

The order passed by the Identification Committee will be final only once the same is confirmed by the Review Committee. The Review Committee, however, will come into picture only where the Identification Committee declares a defaulting party as a wilful defaulter and not when it does not.

The detailed procedure of the identification has been presented graphically below:



### 3.1. Non-whole time directors/ Non promoters not to be reckoned as wilful defaulters



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The Guidelines are also clear about whom to catch hold off on happening of a wilful default by a corporate borrower. It has been stated that “*officers in default*” should be caught hold off and the definition of “officers in default” has been adopted from section 2(60) of the Companies Act, 2013. The Guidelines have also clarified that persons other than non-whole time directors/ non promoters should not be named as wilful defaulters unless where it has been established that –

- a. Such person was aware of the wilful default;
- b. The wilful default has taken place with his consent.

### 3.2. Guarantors to be reckoned as wilful defaulters

Further, the Guidelines have also clarified that in case of a financial assistance involving guarantee by a company in the same group for the wilfully defaulting party, where upon invocation of guarantee by the HFC, the guarantor does not honour the liability, then such guarantors shall also have to be reckoned as wilful defaulters.

## 4. Penal measures

Once an account is identified by a lender/ HFC as a “*wilful defaulter*”, the account so identified shall be subject to the following penal measures:

- a. Such wilful defaulters **shall not be eligible for additional financing facilities**. Additionally, where instances like siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions have been identified, such defaulter shall be **blacklisted for a period of 5 years** and shall not be eligible to obtain institutional finance from the HFCs, SCBs, FIs, NBFCs.
- b. The lender shall **initiate legal proceedings** against the borrowers/ guarantors immediately, which includes criminal proceedings, wherever necessary.
- c. The lender may initiate a **change of management** of the defaulting party;
- d. The lender may **cause non-induction of such persons on corporate boards** whose names appear in the wilful defaulter list.
- e. **Initiate criminal proceedings** for cheating, dishonest misappropriation of property, and criminal breach of trust against wilful defaulters.

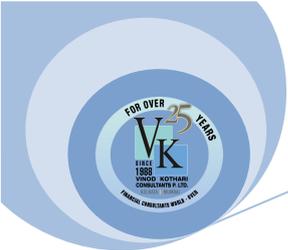
## 5. Reporting requirement

6.

The HFCs shall have to report to all the Credit Information Companies (CIC)<sup>4</sup>, the details of the suit-filed accounts and non- suit filed accounts of wilful defaulters of Rs.25 lakh and above on a monthly or more frequent basis in such manner prescribed in the Guidelines.

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<sup>4</sup> As per NHB’s Circular No. NHB(ND/DRS/Misc. Circular No.15/2015-16 dated July 17, 2015 all Housing Finance Companies (HFCs) that they shall become members of all CICs and submit requisite data to CIC - [http://www.nhb.org.in/Regulation/NHB\(ND\)-DRS-Misc.Circular-17-2015-16%20dated%20July%2017,%202015.pdf](http://www.nhb.org.in/Regulation/NHB(ND)-DRS-Misc.Circular-17-2015-16%20dated%20July%2017,%202015.pdf)



It has also been clarified that the HFCs need not report cases the following cases with the CICs:

- a. Those involving outstanding amount falls below Rs.25 lakh; and
- b. Those where HFCs have agreed for a compromise settlement and the borrower has fully paid the compromised amount.

Further, CICs shall also have to disseminate the information pertaining to suit filed accounts of wilful defaulters on their respective websites.

### **7. Monitoring of end use of funds**

Throughout the entire Guidelines, a lot of emphasis has been given on monitoring of end use of funds, as the same would help the HFCs to keep a check on the activities of the borrowers. In fact, a list of illustrative measures on the part of the HFCs has been provided in the Guidelines and the same goes on in the following manner:

- a. Meaningful scrutiny of quarterly progress reports / operating statements / balance sheets of the borrowers;
- b. Regular inspection of borrowers' assets charged to the lenders as security;
- c. Periodical scrutiny of borrowers' books of accounts and the 'no-lien' accounts maintained with other banks;
- d. Periodical visits to the assisted units;
- e. System of periodical stock audit, in case of working capital finance;
- f. Periodical comprehensive management audit of the 'credit' function of the lenders, so as to identify the systemic-weaknesses in their credit administration.

### **8. Responsibility of professionals**

The Guidelines have also laid down liabilities for the auditors of the wilfully defaulting borrowers. Where a HFC has a reason to believe that there has been a falsification of accounts and there has been a negligence or deficiency on the part of the auditor, the HFC must lodge a complaint with the Institute of Chartered Accountants of India to fix the accountability of the auditors and where the disciplinary actions are pending on the part of the ICAI, the same should be reported to RBI, NHB and IBA for record keeping.

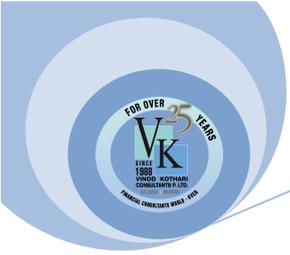
This is a welcome measure, as this is would act as motivation for the auditors to act as a whistle blower in the event of a wilful default.

Further, the Guidelines have also recommended the HFCs to mandate a separate certification with respect to the end use of funds by either the auditors of the borrower or the auditor of the HFCs.

#### **8.1. Role of internal auditors**

The internal auditors of the wilfully defaulting borrowers should inspect whether there is a diversion of funds while carrying out an internal audit/ inspection.

Further, the internal auditors of the HFCs are also required to periodically review the cases of wilful default and report the same to the Audit Committee of the company.



### 9. Compliance checks

Now that the Guidelines have come into effect, there are several compliance checks that the HFCs shall have to take care off with immediate effect. A list of such compliances has been provided below:

- a. Constitution of Identification Committee and Review Committee;
- b. Put in a place mechanism of identification of wilful defaulters;
- c. Make sure that the company has obtained membership of all the CICs;
- d. Make necessary arrangements for timely reporting of wilful defaulters;
- e. Make necessary amendments in the loan documents so as to mandate the certification of end use of funds by the auditors of the borrowers;
- f. Make other necessary arrangements so as to monitor the end use of funds by the borrower;
- g. Put in place a transparent mechanism, with the approval of the Board of Directors, for initiating criminal proceedings against the wilfully defaulting borrowers.

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