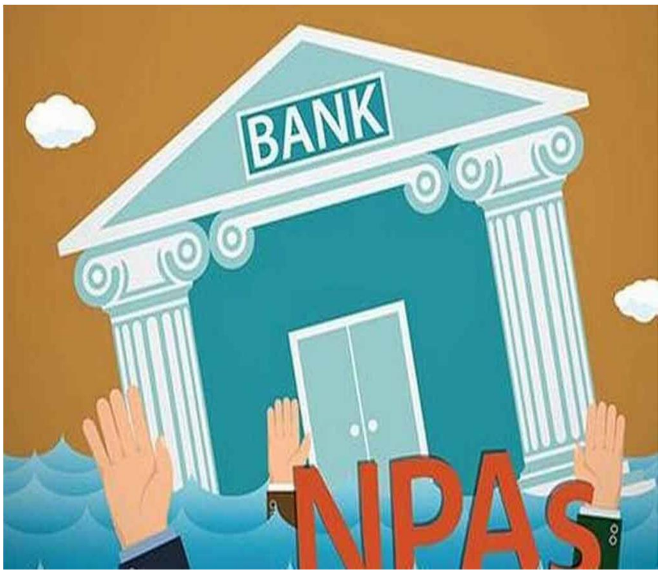
# RBI'S 12TH FEBRUARY CIRCULAR: THE LAST WORD BECOMES THE LOST WORLD

- ***Abhirup Ghosh***

***Editor's Notes:*** *The fact that the deep-rooted presence of bad-loans is at an ever rising high in India, is no new news. Though the most essential element of the Code is its timeliness, it does not take away the basic rights of a Corporate Debtor. However, the infamous RBI circular on treatment of stressed assets proved to be in the contrary. More colloquially referred to as the "12th February Circular", it happens to be one of the sternest measures against insolvent companies, now annulled by the Hon'ble Supreme Court. In the note below we take you through the entire episode of the 12th February Circular from its rise to its fall.*

The 12th February 2018 circular of the Reserve Bank of India (RBI) (Circular), arguably one of the sternest of measures requiring banks to stop ever-greening bad loans, and resolve them once for all, with a hard timeline of 6 months, or mandatorily push the matter into insolvency resolution, was aimed at being the last word, overriding several of the previous measures such as CDR, JLF, SSSS-A, etc. However, with the Supreme Court striking it down, in the case of *Dharani Sugars and Chemicals Limited vs Union of India and Ors*, the mandate of the RBI in directing banks with how to deal with stressed loans has fallen apart. While the SCI has used very technical grounds to quash the 12th Feb circular, the major question for the RBI is whether it should continue to micro-manage banks' handling of bad loans, and the major question for the banks is when will they grow up into big boys and stop expecting RBI to tell them how to clean up the mess on their balance sheet.




The judgment has received mixed reactions from various parts of the economy. This write-up will take you through how it started, and how it ended and what the way forward is.

## How it started?

The inception of the entire trail dates back to 5th May, 2017 when the Banking Regulation (Amendment) Ordinance, 2017 was notified. The Ordinance was passed with the intention to empower the Central Government (CG) to authorise the RBI to issue directions to banking companies to initiate insolvency resolution process (IRP) under the provisions of Insolvency and Bankruptcy Code, 2017 (IBC). Two new sections were introduced in the Banking Regulation Act, 1949, namely, sections 35AA and 35AB. While section 35AA empowered the CG to authorise RBI to direct banks to initiate IRP proceedings, section 35AB empowered the RBI to issue directions to the banking companies for resolution of stressed assets.

Soon after the Ordinance was notified, the Ministry of Finance empowered the RBI to issue directions under section 35AA on 5th May, 2017.

The Ordinance was replaced by the Banking Regulation (Amendment) Act, 2017 on 25th August, 2017. However, before the Ordinance could turn into an Act, the RBI issued a press release conveying the following:

1. That it has constituted an Internal Advisory Committee that will help identifying accounts for which IRP must be launched;
2. That it is laying down criterion for referring accounts for resolution under IBC among top 500 exposures in the banking system which are either wholly or partially NPA; and that 12 accounts satisfy the conditions;
3. That for the accounts which do not satisfy the criterion laid down by IAC, the banks must prepare a resolution plan within six months and where a valid resolution plan is not agreed upon IRP must be launched after the expiry of six months;
4. That the RBI will issue directions, based on the recommendations of the IAC, to banks to initiate insolvency proceedings under IBC;
5. That the RBI will subsequently issue framework for dealing with other NPAs.

Subsequently, the RBI came out with a framework for dealing with other NPAs on 12th February, 2018. The framework was notified by RBI, purportedly, deriving powers from four sections – sections 35A, 35AA and 35AB of the BR Act and section 45L of the RBI Act.

The central theme of this framework revolved around identification of stress in large ticket sized accounts, implementing a resolution plan within 180 days from the date of default and in case of failure to implement, IRP action must be initiated against the borrower under IBC, within 15 days from the date of expiry of the timeline. Large accounts for this purpose means accounts where the aggregate exposure of the lenders exceed ₹ 2,000 crores.

The salient features of the framework are as follows:

- Identification of early signs of stress in accounts with outstanding of Rs. 5 crores or above, through SMA account classifications and filing of relevant information with the Central Repository of Information on Large Credits (CRILC).
- Resolution plans must be worked upon for all cases of default and must be implemented within a period of 180 days from the date of default or from the reference date, that is 1st March, 2019, in case the default was subsisting as on the date of reference date. This timeline is however applicable for accounts with outstanding debt of Rs. 2000 crores. However, the reference date was accounts with outstanding of debt of less than the specified amount but more than Rs. 100 crores, for the purpose of debt resolution, has not been notified yet.

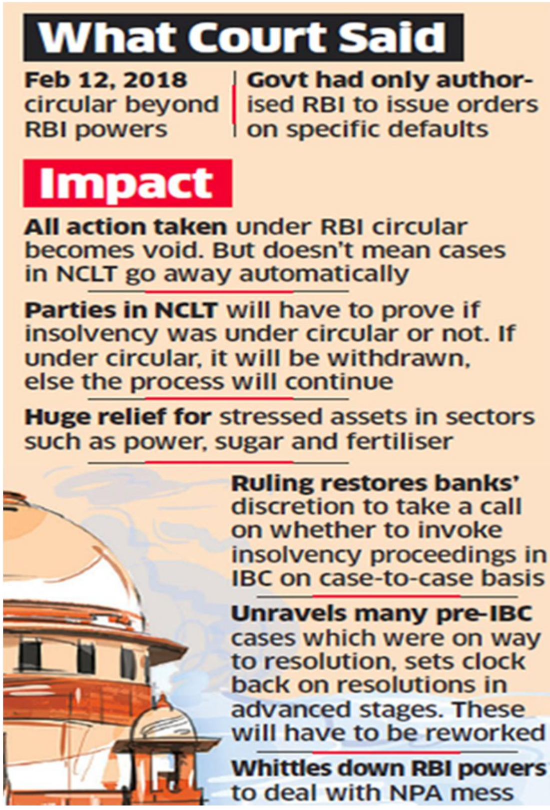
- Independent credit rating to be obtained before implementing the RP.

- In case of failure to implement the RP within the specified timeline, the account must be dragged into IRP under the IBC within a period of 15 days from the expiry of the time period. The reference under IBC can be made by the banks either singly or jointly.

- In case of timely implementation of RP, if the account faces any default during the specified period, then the same must be referred for IRP under IBC by the lenders singly or jointly, within 15 days from the date of default. Specified period, in this regard means period within which at least 20 percent of the outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is supposed to be repaid.

- Sale and leaseback transactions of any asset of the borrower will be treated as a case of restructuring for the purpose of the framework and be subject to asset classification norms applicable to restructured accounts.

- The framework repealed all the other frameworks for dealing with stressed assets, issued earlier by the RBI, namely, Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, Scheme for Sustainable Structuring of Stressed Assets (S4A), and Joint Lenders' Forum (JLF) as an institutional mechanism for resolution of stressed accounts.




## How it ended?

The framework raised several eyebrows as some felt that the RBI had categorised all defaulted accounts into one single bucket, irrespective of the kind of stress they are facing. Other felt that the framework becoming applicable even on a single day default is an unreasonable measure. However, the most important issue of contention that dragged the matter to the court was questioning the authority of RBI to issue the framework on the first place.

The ruling passed by the SCI is result of this contention and the SCI has ruled it against the RBI. The SCI declared that the issuance of the framework *ultra vires* the powers granted to the RBI under various statutes and that the framework shall be of no effect in law.

While building up this ruling the SCI considered the following:

- **Sections 35A, 35AA and 35AB of the BR Act –** The SCI stated that the stressed assets can be resolved through the provisions of IBC or otherwise. When the measure intended is IBC, section 35AA is the only resort. However, if the RBI wishes to resolved stressed accounts other than through IBC, then it can use general powers under section 35A and 35AB. While section 35A grants wide powers to RBI to give directions when it comes to the matters specified therein, section 35AA calls for an additional requirement of "authorisation" from CG to give directions to banks to proceed under IBC.

Therefore, for exercising powers under the 35AA, the RBI requires specific authorisation from the Central Government, however, for enforcing powers granted under sections 35A and 35AB, no specific authorisation is required. Had there been no section 35AA, RBI would have needed no authorisation to give such directions, as such power could be derived from the existing section 35A, which is wide and expansive enough.

To quote SCI –

*"30. The corollary of this is that prior to the enactment of Section 35AA, it may have been possible to say that when it comes to the RBI issuing directions to a banking company to initiate insolvency resolution process under the Insolvency Code, it could have issued such directions under Sections 21 and 35A. But after Section 35AA, it may do so only within the four corners of Section 35AA.*

31. *The matter can be looked at from a slightly different angle. If a statute confers power to do a particular act and has laid down the method in which that power has to be exercised, it necessarily prohibits the doing of the act in any manner other than that which has been prescribed. . ."*

The court pointed out that if the RBI had the power under sections 35A or 35AB of the BR Act to direct the banks to initiate proceedings under the IBC, it would obviate the necessity of the Central Government authorisation under section 35AA to do so. It noted the following:

*"40. Stressed assets can be resolved either through the Insolvency Code or otherwise. When resolution through the Code is to be effected, the specific power granted by Section 35AA can alone be availed by the RBI. When resolution de hors the Code is to be effected, the general powers under Sections 35A and 35AB are to be used. Any other interpretation would make Section 35AA otiose. In fact, Shri Dwivedi's argument that the RBI can issue directions to a banking company in respect of initiating insolvency resolution process under the Insolvency Code under Sections 21, 35A, and 35AB of the Banking Regulation Act, would obviate the necessity of a Central Government authorisation to do so. Absent the Central Government authorisation under Section 35AA, it is clear that the RBI would have no such power."*

Therefore, it becomes important to understand if the RBI acted well within its powers under section 35AA while issuing the circular. Section 35AA states the following:

*'35AA. The Central Government may, by order, authorise the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of* ***a default****, under the provisions of the Insolvency and Bankruptcy Code, 2016.*

*Explanation.—For the purposes of this section, "default" has the same meaning assigned to it in clause (12) of section 3 of the Insolvency and Bankruptcy Code, 2016.*

## Stress Factor

**February 12, 2018**
RBI issues a circular revising the resolution mechanism for stressed assets; puts pressure on banks and India Inc

**August 27, 2018**
Allahabad High Court refuses to grant interim relief to power companies seeking stay on RBI circular

As noted above, section 35AA allows the RBI to issue directions to banks to initiate IRP in respect of "a default". The meaning of term default has been drawn from the IBC, as per which a default is non-payment of a debt when it has become due and payable by the corporate debtor. All this indicates that the default in the present context refers to a specific default and not defaults in general.

Further, the SCI also took note of the press note of the Ordinance of 5th May, 2017 which indicated that the intention of deal with resolution of "specific" stressed assets which will empower the RBI to intervene in "specific" cases of resolution of NPAs. The same was also the understanding of the Central Government when it issued the notification on 5th May, 2017 to authorise the RBI to issue directions to the banks to act against "a default" under IBC. Therefore, this made it conclusive that directions issued in relation to debtors in general, is *ultra vires* the powers under section 35AA.

- **Section 45L of the RBI Act –** The RBI stated in the framework that it drew one of its powers from section 45L of the RBI Act. The section grants power to direct non-banking financial institutions. However, section 45(3) of the RBI Act states the following:

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*(3) In issuing directions to any financial institution under clause (b) of sub-section (1), the Bank shall have due regard to the conditions in which, and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect the business of such financial institution is likely to have on trends in the money and capital markets.*

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It was emphasised that in order to issue any direction under this section, the RBI must have due regard to the conditions in which, and the objects for which, the institutions have been established, their statutory responsibilities, and the effect the business of such financial institutions is likely to have on trends in the money and capital markets. However, the framework did not discuss anything as such. Further, since, the very intention of bringing in NBIs under this framework was to deal with cases which had joint lending arrangements between banks and NBIs, the SCI found it difficult to separate banks and NBIs and make the circular applicable on NBIs even though *ultra vires* for the banks.

Therefore, the entire circular was declared *ultra vires* as a whole.

## What is the way forward?

The ruling has created an awkward situation, as the banks have already acted upon the directions issued by the RBI. They have either implemented an RP or dragged the borrower to NCLT to proceed under IBC. Now that the circular is gone, following are the probable outcomes:

1. For cases where RPs have been implemented – the lenders may decide to go ahead as per the RP and treat the same as restructured account.

2. For cases where the corporate debtor has been taken to the NCLT – now that the very basis for taking the account to NCLT is gone, the lenders will have to take a call whether they want to pursue the proceedings under the Code without making references to RBI Circular.

Another apparent question that arises here is what will happen to the various frameworks which were withdrawn vide the 12th February circular. As stated by the SCI, the Circular will have no effect in law, therefore, the "withdrawal" clause too has been nullified. Therefore, the old restructuring frameworks can be said to be existing as on date.

Nevertheless, the Circular played the role of a game-changer by inducing a certain degree of credit discipline or at least the fear of being dragged into IBC. Now, as the Circular goes away, RBI may have to think of new restructuring frameworks – if that is through IBC, it would surely need CG's authorisation.

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***On 7th June, 2019, the RBI brought a new set of directions titled Prudential Regulations for Resolution of Stressed Assets. These regulations give substantia liberty to the lenders, and while the lenders will still be required to carry out a review of a defaulter's exposure, form an inter-creditor forum and agree on the measures for resolution within a period of 30 days, there is no mandatory reference to IBC. Instead, there is a range of options available to the lenders – IBC being only one. The lenders are required to implement the resolution within 6 months of the end of the review period. For a discussion by Vinod Kothari Consultants on the revised framework, see here: http://vinodkothari.com/2019/06/fresa/***