● DILIGENCE DUE

KEEPING TABS ON A BORROWER'S GOVERNANCE WOULD HELP THE BANK GAUGE THE NEED FOR TIMELY ACTION TO MANAGE RECOVERY BETTER

Banks and borrowers' governance

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THERE ARE LAYERS of governance norms for banks. Being a company, a bank complies with the basic corporate governance norms prescribed under the company laws. Being a listed company, it complies with advanced governance norms required under the securities laws. It often voluntarily adopts additional/higher norms arising from peer pressure and best practices. It may, for example, adopt NSE Prime, which prescribes higher standards of corporate governance for listed companies than those required by laws.

From a governance perspective, a bank is different from a real sector company. The latter carries on business primarily with funds sourced from investors through debt and equity. The investors have some control over its management and are entitled to market-related returns. The former carries on business primarily with the funds sourced from customers through deposits. The customers do not have any say in its management, but are entitled to get back the full amount of deposits, along with interest, as per agreed terms. Further, the operations of a bank have the potential to create systemic instability. A listed bank is, therefore, subject to further governance norms in terms of risk management, capital adequacy, and prompt corrective action.

Adherence to the aforesaid governance norms, though an absolute necessity, is not sufficient for a bank. A real sector company, which sources resources from investors, has full control over the resources so sourced and its utilisation. However, a bank sources resources from customers, but loses control over the resources so sourced as soon as it places the same, through loans, at the disposal and under the control of the borrowers. Its ability to return deposits to customers depends on the borrowers' ability to deploy the loan efficiently in the business, and willingness to use the surplus generated to repay the loan. Its health (including reputation) is inextricably linked to that of borrowers, which, in turn, depends on their governance practices. A bank must, therefore, worry about the governance practices of the borrowers, while deciding to sanction a loan, and till the loan is fully repaid.

While processing a loan proposal, a bank usually does a background check and due diligence on the promoters and key managerial personnel of the borrower company. It also considers company disclosures, audit report qualifications, and market reports from gatekeepers like credit rating agencies and proxy advisory services. These provide a fair idea about the conduct and performance of the borrower at the time of sanction of the loan. A bank, however, needs to explicitly consider the governance practices (including environmental, social and governance concerns) of the borrower, as required by law and even beyond, to have a clear understanding of the likelihood of slippage in terms of conduct and performance of the borrower during the currency of the loan and consequently, default.

For example, a bank may consider if the borrower has a sustainable business that will continue to generate surplus at least till the loan is fully repaid. The business must not lose steam either because it is in the decline stage of the product cycle or it fails to withstand the onslaught of competition and innovation in the marketplace. For this purpose, the bank may ask questions such as if the borrower lives too much in the present, which may jeopardise its future and vice versa; does it have a comprehensive risk management programme; does it have resilience and adaptation to tide over unforeseen contingencies; does it have visionary leadership to deal with unknown unknowns and so on.

Banks have experimented with different remedies in case of default against the borrower and/or its property. Their reliance on collateral and personal guarantees and on the ability of the borrower, represented by business potential and management capability, to recover the loan has not been very inspiring; limited, at best, to the liquidation value of the assets available with the borrower. With the availability of insolvency option, banks are exploring the possibility of resolution, whereby the company survives while they realise on average 175% of the liquidation value towards their dues. The possibility of resolution and consequently, realisations, is higher, if the borrower is resolvable. It is resolvable if the borrower has value, and such value is free from encumbrances, is visible to a discerning eye, and is easily realisable by any resolution applicant. For example, it would be difficult to get resolution plans where the borrower company has factory on the promoter's premises. A bank may, therefore, consider while advancing a loan if the borrower and its business is resolvable, should a need arise.

Banks must keep track of loss of value through irregular transactions, depletion of value of secured assets, and transfer of assets by promoters, to ensure that the loan remains backed by assets

After a loan is sanctioned, the bank needs to keep a tab on the slippage of governance. For example, it needs to have a mechanism to detect and prevent loss of value which may compromise the recovery of a loan. Value is siphoned off, transferred, or lost through irregular transactions (preferential transactions, undervalued transactions, extortionate transactions, and fraudulent transactions). In a landmark judgement in the matter of *Anuj Jain Vs. Axis Bank Ltd.*, the apex court upheld the recovery of 758 acres of land valued over ₹5,300 crore, which was lost through irregular transactions. Till December 2022, 847 applications have been filed to claw back ₹2.8 trillion allegedly lost through irregular transactions by companies undergoing insolvency process. If this value was not alienated, many of them probably would not have got into the insolvency process in the first place.

A bank often has guarantees from promoters and security interests to secure the loan. The promoters may transfer assets or the borrower may transfer the secured assets clandestinely, making the guarantee and security infructuous. One of the reasons for huge haircuts for creditors in some insolvency proceedings is the negligible value of the secured assets vis-à-vis the loan amount. A bank needs to keep track of loss of value through irregular transactions, depletion of value of secured assets, and transfer of assets by promoters, to ensure that the loan remains backed by assets.

A tab on governance of borrowers would alert the bank to take timely remedial action to manage recovery better. It would incentivise the borrower to have healthy governance practices, which is a positive-sum game for the credit market.