CHAPTER III

Performance review relating to Statutory corporation

Karnataka State Financial Corporation

3.1 One Time Settlement (OTS) Schemes

Highlights

The implementation of the OTS scheme reduced the NPAs from 64 per cent to 35 per cent.

(Paragraph 3.1.10)

The OTS guidelines provided for write off of principal which is not permissible as per RBI guidelines. The on-line OTS did not take into account the value of security and had the effect of extending undue favour of waiver of dues to defaulters.

(Paragraphs 3.1.12 and 3.1.13)

An examination of OTS scheme relating to 305 cases out of 1,462 cases (loans above Rupees five lakh only) settled during 2003-08 revealed that the Corporation suffered a total loss of Rs. 332.75 crore. Of the 305 cases test checked, audit observed that in 78 cases there were various deficiencies resulting in a loss of Rs. 182.28 crore.

(Paragraphs 3.1.14 and 3.1.15)

Pre-audit was not conducted for OTS approvals and only on-line cases were subject to pre-audit.

(Paragraph 3.1.40)

Introduction

3.1.1 Karnataka State Financial Corporation was established in March 1959 under Section 3(1) of the State Financial Corporations (SFC) Act, 1951 with the main objective of promoting and developing industrial growth in the State of Karnataka by providing financial assistance to small and medium enterprises in the State. The Corporation has its Head Office in Bangalore and is headed by a Chairman and Managing Director appointed by the State Government, who is assisted by two Executive Directors and six General Managers. The Corporation has seven Zonal Offices and 29 Branch Offices in different locations in the State.

One Time Settlement (OTS)

3.1.2 The Corporation implemented the settlement of outstanding loans under One Time Settlement (OTS) Scheme from the year 1993-94 onwards when the recovery through normal procedure was difficult. It introduced (August 2005) the on-line OTS scheme which provided for settlement of overdues arrived at on the basis of outstanding balance of principal on any day and simple interest thereon.

3.1.3 The main objectives of OTS Scheme were

- to bail out the entrepreneur in distress by recovering maximum amount of the outstanding dues;
- to improve the liquidity position of the Corporation;
- to reduce the quantum of Non Performing Assets (NPA); and
- to improve the recovery rate *vis-à-vis* demand so that the funds can be recycled to earn interest income.

3.1.4 Guidelines for OTS scheme / on-line OTS scheme

The eligibility criteria for considering OTS / on-line OTS were as under:

- the loan account should be under doubtful / loss asset categories and in extraordinary circumstances under sub-standard category;
- cases pending before Courts, Debt Recovery Tribunal (DRT), Board for Industrial and Financial Reconstruction (BIFR) *etc*.,
- cases coming under Section 29 of the SFC Act where assets have been taken over by the Corporation.

Willful defaulters, profit making units, defaulters who have resorted to fraudulent means like submission of fake documents and diversion of funds for other purposes were not eligible for OTS. The guidelines, *inter alia*, further provided for a settlement formula according to various situations. The Corporation constituted committees at Branch and Head Office level to finalise OTS cases prescribing time limits for each category of loans.

During 2003-08, the Corporation settled 7,134 loans under OTS, which resulted in recovery of Rs. 352.05 crore and a sacrifice of Rs. 633.36 crore.

During the last five years ended 2007-08, the Corporation settled 7,134 cases which resulted in recovery of Rs. 352.05 crore and a sacrifice of Rs. 633.36 crore (Rs. 12.84 crore by way of write off of principal and Rs. 620.52 crore by way of waiver of interest).

Scope of audit

3.1.5 The performance review conducted during the period from October 2007 to January 2008 covered the performance of OTS schemes implemented during 2003-08. OTS schemes involved sacrifices by way of 'write off'' of principal and / or 'waiver' of interest. The Company had settled 7,134 OTS cases[64] during the period 2003-08. Of these 1,462 cases pertained to loans above Rupees five lakh each. Audit selected a sample of 305 cases involving write off / waiver of Rs. 332.75 crore (53 *per cent*) as against total write off / waiver of Rs. 633.36 crore. The sample based on financial materiality was selected from the loan categories as detailed below:

- all 115 cases (overdue amount Rs. 82.15 crore) which involved write off of principal where loan sanctioned was more than Rs. 5 lakh;
- all 133 cases of waiver of interest (overdue amount Rs. 384.30 crore) where loan sanctioned was above Rs. 50 lakh;
- 57 cases of waiver of interest amounting to Rs. 65.67 crore (33 *per cent* of 171) which involved sanctioned amount between Rs. 25 lakh to Rs. 50 lakh;

The records relating to the sample selected under OTS were scrutinised in the Head Office and eight[65] Branch Offices, to assess the overall economy, efficiency and effectiveness of the scheme.

Audit objectives

3.1.6 The performance review was conducted to ascertain whether:

- the objectives of the OTS of decreasing NPAs and improving liquidity were achieved;
- the guidelines approved for implementation of OTS were followed;
- the schemes were not extended to willful defaulters; value of securities was properly assessed for determining the OTS amount;
- OTS was not extended without adopting normal recovery procedures like take over and sale of securities, invoking of personal guarantees *etc*.,
- the OTS amounts were recovered within the stipulated period; and
- the internal audit of the Corporation was effective to highlight the lapses and irregularities in the implementation of OTS Scheme.

Audit criteria

3.1.7 The audit criteria adopted for assessing the achievement of audit objectives were:

- guidelines issued by RBI / other financial institutions;
- the eligibility conditions prescribed for settlement of loan under OTS.

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[64] included 5,672 cases below Rupees five lakh category.
[65] Kolar, Mysore, Chitradurga, Hubli, MG Road, Jaynagar, Peenya and Tumkur.

- the procedure for valuation of properties obtained as security and collateral securities; and
- the method fixed for investigation of personal properties of promoters and guarantors.

Audit methodology

3.1.8 The following methodology was adopted for attaining the audit objectives with reference to the audit criteria:

- review of Board Minutes and scrutiny of proceedings of Default Review Committee / Executive Committee for finalisation of OTS;
- review of circulars and guidelines issued by the Corporation, RBI / Small Industries Development Bank of India (SIDBI);
- scrutiny of loan files relating to monitoring, recovery and finalisation of OTS;
- examination of correspondence with the State Government on OTS matters; and
- issue of audit enquiries and interaction with the Management.

Implementation of OTS

3.1.9 The details of cases settled under OTS in various categories during 2003-08 are given below:

Loan category	No. of OTS approved (both write off of principal and waiver of interest)	No. of cases of write off of principal[66]		waiver of interest
		cases	Amount Rs. in crore	Amount Rs. in crore
Up to Rs. 5 lakh	5,672	3,222	5.70	78.31
Rs. 5 lakh - 10 lakh	551	37	1.08	48.68
Rs. 10 lakh - 25 lakh	574	45	1.38	110.04
Rs. 25 lakh - 50 lakh	190	19	1.34	104.40
Above Rs. 50 lakh	147	14	3.34	279.09
Total	7,134	3,337	12.84	620.52

It may be seen from the above table that the Corporation settled 6,223 cases[67] under loan category up to Rs. 10 lakh (small loan sector). The Corporation had written off Rs. 133.77 crore towards write off of principal and waiver of interest based on the Government instructions during 2003-08. The Government has provided budgetary support of Rs. 68 crore during 2007-08.

In respect of other category of loans (911 cases) the Corporation had written off principal and waived interest of Rs. 499.59 crore during 2003-08.

[66] **the cases of write off of principal involve waiver of interest also.**
[67] **5,672 cases (up to Rs. 5 lakh) and 551 cases (Rs. 5 lakh to Rs.10 lakh).**

Status of NPAs

3.1.10 As per the guidelines issued by SIDBI, assets are classified as standard, sub-standard, doubtful and loss assets based on the period from which the loans are outstanding. Assets which are not standard and remained outstanding for a period more than 91 days are termed as Non-performing Assets (NPAs). The position of NPAs and the movement of NPAs during the last five years is given below:

(Rupees in crore)

Year	OTS sanctioned		Loan out-standing (Amount)	NPA (Amount)	NPA *per cent*	Movement in NPAs		Percentage of addition to collection
	Number	Amount				Addition	Collection	
2003-04	3,473	68.31	1,259.60	808.57	64	283.79	378.16	75
2004-05	988	52.75	1,131.47	714.20	63	186.06	302.71	61
2005-06	953	65.82	988.24	597.55	60	172.14	324.16	53
2006-07	1,498	119.10	976.90	445.53	46	156.46	264.60	59
2007-08	222	46.07	976.34	337.39	35	82.27	186.88	44

It can be observed that due to implementation of OTS schemes, there was reduction in NPAs (64 *per cent* to 35 *per cent*), which bailed out a large number of entrepreneurs during the last five years. While there was a declining trend in addition to NPAs, there was an increase in the percentage of addition to NPA during 2006-07 which subsequently reduced in 2007-08. While the Corporation had the details of collection under NPA, it did not have separate details of the recoveries under OTS scheme.

Audit findings

3.1.11 Audit findings arising from the performance review were reported (May 2008) to the Government / Management and were discussed (22 July 2008) in the meeting of Audit Review Committee on Public Sector Enterprises (ARCPSE). The meeting was attended by the Managing Director of the Company. The replies furnished by Management (May / July 2008), the views expressed by the representatives of the Management in ARCPSE meeting and confirmation of minutes furnished (August 2008) by the Management have been taken into consideration while finalising the review. The Management stated in the ARCPSE meeting that it has discontinued the OTS with effect from 31 March 2008.

The audit findings are discussed in the succeeding paragraphs:

Deficiencies in the OTS guidelines

3.1.12 A review of the OTS guidelines issued for implementation of OTS revealed the following deficiencies:

OTS guidelines provided for write off of principal, which is not permissible as per RBI guidelines.

- the guidelines allowed write off of principal whereas the guidelines issued by RBI for implementation of OTS by commercial banks did not permit write off of principal;

- there was no system of notifying the names of the parties to other financial institutions under the State Government so that credit worthiness is made known;

The Management stated (May 2008) that RBI had not categorically prohibited the write-off. The reply is not acceptable as the minimum amount to be recovered in case of RBI guidelines was 100 *per cent* of the outstanding balance of principal as on the date on which the account was categorised as doubtful NPA.

Deficiencies in on-line OTS scheme

On-line OTS did not take into account the value of security and had the effect of extending undue favour of waiver of dues to defaulters.

3.1.13 The on-line OTS scheme had the following deficiencies:

- the on-line OTS scheme did not take into account the value of security. This was more relevant where the value of security was more than the dues. The Corporation would have been able to recover the dues in the normal course.

- the operation of on-line scheme had the effect of extending undue favour of waiver of dues to defaulters who were capable of making full repayment which may encourage willful default.

- though an internal rate of return of 15 *per cent* was fixed as the norm for on-line scheme, there was no system to ensure this yield. The thrust of the scheme was on reduction of NPA alone without concern for the consequent losses.

The Corporation settled 794 cases during 2005-08 under on-line OTS which involved a total collection of Rs. 31.88 crore and a total waiver of Rs. 39.15 crore.

Deficiencies in the implementation of OTS

3.1.14 An examination of OTS scheme and other records relating to 305 cases out of 1,462 cases (loans above Rupees five lakh only) settled during 2003-08 revealed that the Corporation suffered a loss of Rs. 332.75 crore[68].

There were deficiencies in the implementation of OTS scheme as summarised below:

Nature of violation of OTS guidelines	No of cases
Sanction of OTS to ineligible defaulters where the realisable value of security was more than the dues, willful defaulters and fraud cases	25
Incorrect application of settlement formula	16
Settlement below the value of securities	48

[68] **Rs. 7.46 crore by way of write off and Rs. 325.29 crore by waiver of interest.**

Downward revision of OTS amount fixed	14
OTS due to inadequate security and failure to obtain collateral security resulting in write off / waiver.	12

Note : A case may appear under more than one category.

Of the 305 cases test checked audit observed that in 78 cases, the Corporation suffered a loss of Rs. 182.28 crore.

3.1.15 Of the 305 cases test checked involving loss of Rs. 332.75 crore, 60 cases having various deficiencies, involving losses of Rs. 106.60 crore[69] are given in the **Annexure 12**. In addition, 18 interesting cases involving a loss of Rs. 75.68 crore[70] are discussed below:

Sanction of OTS to ineligible and willful defaulters

3.1.16 As per the guidelines, profit making units, cases where the value of securities was more than 1.5 to 2 times of the dues and where assets financed were sold without the permission of the Corporation were not eligible for OTS. Defaulters who resorted to fraudulent means were also not eligible for OTS. Instances where OTS was extended to such ineligible defaulters are discussed below.

3.1.17 The Corporation disbursed (January 1996) Rs. 1.72 crore to Neeladri Amusement Parks Private Limited for setting up an amusement park in Bangalore under joint financing with KSIIDC[71]. The loan was secured by primary and collateral securities (residential properties) valued at Rs. 9.08 crore. The unit defaulted in payment from the beginning and in June 2002 the Corporation approved OTS on lump-sum basis for Rupees two crore as against the value of securities of Rs. 9.08 crore. As the unit failed to pay the OTS amount within the time limit (30 days), the OTS was cancelled and the unit was taken over by the Corporation in June 2005. In November 2005, the unit paid the OTS fixed three years ago but the Corporation did not re-validate the OTS, which was cancelled earlier. The securities were subsequently valued (March 2007) at Rs. 72.78 crore. Though the unit was not eligible for OTS as the value of securities were very high as compared to the total dues of Rs. 6.22 crore, the amount was reduced to Rs. 4.39 crore. The unit paid the amount in September 2007.

Thus, the settlement of dues under OTS to an ineligible party and the unjustified reduction of OTS amount when the value of security was higher than the dues resulted in a loss of Rs. 1.83 crore.

The Management stated (July 2008) that the unit had represented for revalidation of the earlier OTS and the OTS amount was reduced to fall in line with KSIIDC, which also sanctioned OTS, for early realisation of the dues. The reply is not acceptable as the unit was not eligible for OTS as the value of security was higher than the amount due.

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[69] **write off Rs. 1.50 crore and waiver of Rs. 105.10 crore.**
[70] **Rs. 2.20 crore by way of write off and Rs. 73.48 crore by way of waiver.**
[71] **another State Government Company.**

3.1.18 The Corporation disbursed (1986-1991) loan amounting to Rs. 32.13 lakh to Foto Fact, Mysore after obtaining security valued at Rs. 24 lakh. The unit defaulted in payments and when the unit was taken over it was found that the collateral security had been sold (1999). The promoter approached (August 2007) the Corporation for OTS for an amount of Rs. 20 lakh. The Corporation approved (February 2008) OTS for Rs. 62.88 lakh resulting in a waiver of Rs. 1.62 crore.

As the collateral security was sold without the permission of the Corporation, the unit was not eligible for OTS. Thus, sanctioning of loans without adequate security and granting OTS to an ineligible defaulter resulted in a loss of Rs. 1.62 crore.

3.1.19 The Corporation disbursed (July 1996) a term loan of Rs. 58.50 lakh to Glamour Poultry Farms for establishment of a poultry unit. The firm did not implement the project, diverted the funds and failed to make any payment towards the loan. The loan was recalled in October 1998 and it was noticed that the title deeds of collateral properties were not genuine.

When the Corporation took over (February 2006) the unit, it was found that plant and machinery worth Rs. 16 lakh were removed. The primary assets were brought for sale and the highest offer of Rs. 1.86 crore was approved (October 2006) by the Corporation. The promoters offered to settle the account on on-line OTS basis. The Corporation approved (March 2007) OTS at Rs. 1.57 crore as against security valued at Rs. 3.37 crore and overdue amount of Rs 4.68 crore. The unit had become ineligible for OTS as the assets financed were removed without the permission of the Corporation and extension of OTS was in violation of guidelines resulting in loss of interest of Rs. 3.11 crore.

The Management stated (July 2008) that OTS was granted considering the nature of activity and the problems associated with the unit and on-line OTS scheme did not have any bearing on the value of security. The reply is not acceptable as the Corporation should have safeguarded its financial interest while granting OTS in view of availability of security.

3.1.20 Thirupathi Thimmappa Granites Private Limited was disbursed (1992) Rs. 50.75 lakh to setup Granite Unit on the security valued at Rs. 55.25 lakh and personal guarantee of promoters. Collateral security was not obtained. The unit stopped functioning from June 2000 and applied (September 2002) for OTS. The Corporation approved (January 2003) OTS for Rs. 60.62 lakh with waiver of Rs. 24.58 lakh. The unit paid Rs. 1.50 lakh and requested for reduction of OTS amount to Rs. 35 lakh. The Corporation noticed (October 2003) that the machinery was missing. The promoters could not pay the OTS amount and OTS was cancelled in November 2004. The Corporation sanctioned (March 2005) OTS for Rs. 70.40 lakh on the basis of value of security with a waiver of Rs. 52.29 lakh. The unit did not make any payment towards the second offer also but was later allowed (August 2006) on-line OTS for Rs. 64.02 lakh with a waiver of Rs. 83.82 lakh when the value of security was Rs. 1.65 crore.

The unit was a willful defaulter and not eligible for OTS but OTS was extended three times. The settlement of the loan under the on-line scheme below the value of security resulted in loss of interest of Rs. 83.82 lakh.

The Management stated (July 2008) that on-line OTS was extended to resolve a chronic case and the settlement yielded return of 13.3 *per cent* which was reasonable. The reply is not acceptable as extending OTS to a willful defaulter / ineligible unit resulted in a loss of Rs. 83.82 lakh.

Incorrect application of settlement formula

3.1.21 The OTS guidelines formulated by the Corporation had laid down the settlement formula for determination of OTS amount. The formula had been devised by linking the dues to be collected and the value of security available under various situations with the objective of maximizing the recovery. Audit noticed that there were deviations from the approved settlement formula, which resulted in lesser recovery and additional losses. Some illustrative cases are discussed below:

3.1.22 The Corporation sanctioned (July 1993) a term loan of Rs. 67.70 lakh to Kadur Stampings Private Limited (KSPL) with the primary security valued at Rs. 1.74 crore. Collateral security was not obtained. A corporate loan of Rs. 90 lakh was also disbursed (November 1994) to Kadur Engineering Private Limited (KEPL) owned by the same promoters secured by a collateral security valued at Rs. 53 lakh. The accounts of KSPL and KEPL became NPAs in June 1996 and September 1996 respectively. Based on the request of the promoters, the Corporation offered (January 2007) OTS at Rs. 1.87 crore with an initial payment of Rs. 37 lakh. As the initial amount was paid only in March 2007 *i.e.,* after 30 days, OTS was not sanctioned. The Corporation subsequently extended (March 2008) OTS for Rs. 5.52 crore which was worked out based on simple interest basis for KEPL and on on-line basis for KSPL which resulted in a waiver of Rs. 11.16 crore.

Audit observed that as per the revised guidelines for 2007-08**,** the OTS amount was to be fixed at Rs. 9.94 crore on simple interest plus 50 *per cent* basis for both the entities together. Thus, extending OTS for a lesser amount in violation of the guidelines resulted in an avoidable loss of Rs. 4.42 crore.

3.1.23 The Corporation extended (December 1999) financial assistance of Rs. 1.15 crore by way of subscription to Non Convertible Debentures (NCD) of Chitradurga Sunflower Oil Complex Limited. The NCD were secured by first charge on fixed assets, second charge on current assets (aggregate value Rs. 2.50 crore) and personal guarantee of Directors.

The unit became sick and proposed (December 2006) to settle dues under OTS for Rs. 95 lakh as against overdue amount of Rs. 3.54 crore. As per the policy, the OTS amount worked out to Rs. 2.25 crore on simple interest (at 15 *per cent* basis) with waiver of Rs. 1.28 crore and the value of security was Rs. 4.87 crore. The Corporation, however, approved (January 2007) OTS for

Rs. 1.15 crore on principal plus other debits basis, in violation of the OTS policy, with a waiver of interest of Rs. 1.10 crore.

The Management stated (July 2008) that the saleability of the unit was doubtful and BIFR approval was necessary to initiate action against the personal properties identified. The reply is not acceptable as sufficient securities were available and the Corporation should have obtained the approval of BIFR to sell the securities.

3.1.24 The Corporation disbursed (1982-89) a term loan of Rs. 59.80 lakh to Nav Bharat Flange & Allied Corporation Limited. The loan was secured by a *pari passu* charge with KSSIDC[72] on land and building valued at Rs. 34.39 lakh, plant and machinery worth Rs. 75.72 lakh and personal guarantee of promoters. As the unit failed due to delay in implementation of the project, the Corporation offered (October 1996) OTS for Rupees one crore on simple interest basis but the proposal was not accepted by unit. Instead of canceling the OTS and proceeding against the securities, the corporation revived (February 2004) the OTS after seven years and reduced the OTS amount to Rs. 70 lakh with waiver of Rs. 4.45 crore. The amount was further reduced (April 2004) to Rs. 65 lakh. The unit paid the amount and the account was closed.

As per the OTS policy and considering the value of the assets available (Rs. 2.34 crore as on November 2002) OTS amount should have been fixed on principal *plus* simple interest basis at a minimum of Rs. 1.46 crore. Thus, settlement of the loan under OTS on lump-sum basis at Rs. 65 lakh in violation of the guidelines resulted in additional waiver of Rs. 81 lakh. The Management stated (July 2008) that OTS amount fixed was more than the value of securities. The reply is not acceptable as the Corporation applied incorrect settlement formula and the total value of securities was more than the value considered by the Corporation.

Settlement below value of securities

3.1.25 As per the OTS guidelines, the amount at which the account was to be settled depended on the value of primary, collateral and personal securities obtained. Audit noticed that in many cases the value of securities was not assessed properly for the finalisation of the OTS amount and the personal properties were not investigated and taken into account. Some illustrative cases are given below:

3.1.26 The Corporation disbursed (1998-2002) term loans and corporate loans to the extent of Rs. 2.13 crore to Digantha Mudrana Private Limited, Mangalore to set up an offset printing unit. The loan was secured by primary and collateral security valued at Rs. 2.61 crore. The account became **'**doubtful asset' from April 2005. The Corporation, in February 2007, settled the account under OTS at Rs. 1.30 crore on lump-sum basis on the ground that recovery was difficult as the unit was losing business due to stiff competition

[72] **Karnataka State Small Industries Development Corporation Limited, a State Government Company.**

and making losses for the previous three years. The settlement based on 12 *per cent* return, resulted in a write off of Rs. 43.39 lakh and waiver of Rs. 87.87 lakh.

Audit scrutiny revealed that:

- the value of primary and collateral securities at the time of finalising OTS was Rs. 1.93 crore, which was more than the dues of Rs. 1.73 crore on principal and other debits basis (October 2006);
- the amount of OTS as per on-line scheme worked out to Rs. 1.87 crore (October 2006), which would have yielded a return of 14 *per cent*;
- the unencumbered value of personal properties of the promoters (net worth) as per latest valuation was Rs. 1.33 crore;
- during the visit of the Executive Director (Operations) of the Corporation in November 2006, the unit was having orders for the next 18 months;
- as per the annual accounts of the unit, the turnover had steadily risen from Rs. 2.02 crore in 2003-04 to Rs. 2.62 crore in 2005-06 and the unit was not incurring any cash losses.

The Management stated (July 2008) that the loan was settled at 12 *per cent* return. The reply is not acceptable, as the value of securities was more than the principal and other debits. The settlement of the loan below value of securities in violation of the guidelines resulted in avoidable write off of Rs. 43.39 lakh apart from waiver of interest of Rs. 87.87 lakh.

3.1.27 The Corporation disbursed (November 1995) a term loan of Rs. 2.34 crore to Hotel Sandesh Private Limited, Mysore with the primary security valuing Rs. 6.03 crore and personal guarantee of promoters. The unit defaulted in payments and the loan was rescheduled (March 1999). The Corporation ceded *pari passu* charge (August 2001) on secured assets to KSIIDC to enable the unit to avail further loan of Rs. 3.18 crore, in spite of continuing default. The unit, however, did not make any repayment.

The Management approved (November 2004) OTS on simple interest basis at 17 *per cent* calculated up to November 2004 for Rs. 4.72 crore, which resulted in waiver of Rs. 3.91 crore while the value of security was Rs. 8.34 crore in 2003. The account was closed (August 2005). Ceding the *pari passu* charge while the default continued resulted in erosion in value of security available to the corporation and resulted in settlement of the loan at a much lower level and consequent loss of Rs. 3.91 crore.

The Management stated (July 2008) that the project was facing funds crunch and *pari passu* charge was ceded to avail finance from KSIIDC. While confirming to minutes of ARCPSE meeting the Management further stated (August 2008) that loan was sanctioned (1995) to the Company with a condition to take over the firm after the commercialisation of operations, but the Company had not commenced operations till 2002-03 and as such OTS was approved. The reply is not acceptable as the unit was already in default and the Corporation should not have diluted its hold on the security.

3.1.28 The Corporation disbursed (1992-94) term loans aggregating Rs. 1.45 crore to Madhu Art Studios Private Limited to establish a film studio on leased land with the primary security and collateral security (leased land) valued at Rs. 21 lakh and personal guarantees of the Directors. Due to default in repayments, the Corporation obtained attachment order (May 1999) and offered the property in public auction in December 1999 and September 2000 but received no offers.

The Corporation approved (March 2003) OTS for Rs. 2.75 crore with waiver of Rs. 4.55 crore. As the value of the assets at the time of OTS was Rs. 5.81 crore, the account should have been settled on simple interest basis at Rs. 3.59 crore. Settlement at lower value resulted in avoidable additional waiver of Rs. 83.69 lakh.

The Management stated (July 2008) the collateral property was under litigation and hence OTS was considered. The reply indicated that the legal scrutiny of the security was not made properly resulting in settlement under OTS.

3.1.29 The Corporation sanctioned term loans (November 1995 and February 1997) of Rs. 90 lakh and Rs. 57 lakh to Sri Lakshmi Venkateshwara Industrial Complex (SVIC) and Sri Govardhan Industrial Complex (SGIC) respectively. These loans were secured against the primary assets and land of one acre nine guntas situated in Bangalore. No collateral securities were obtained. Due to default, the Corporation took over (April 2001) the units and subsequently (March 2005) approved OTS to SVIC for Rs. 3.48 crore and to SGIC for Rs. 1.82 crore waiving interest of Rs. 1.21 crore and Rs. 63.46 lakh respectively. The OTS amount was worked out on the basis of simple interest plus 50 *per cent* considering the value of security of Rs. 7.26 crore as against the total dues of Rs. 7.15 crore (March 2005).

The value of personal properties of promoters was not considered while assessing the value of securities available for the purpose of OTS. Had the Corporation taken into account the value of all the personal properties[73] (identified in August 2000), it would have been possible to recover the entire dues of Rs. 6.14 crore considering that the properties were in prime industrial / residential areas of Bangalore City and avoid loss of Rs. 1.84 crore.

The Management stated (July 2008) that according to the OTS Policy prevailing in 2003-04, value of personal property was not needed to be considered if the OTS amount was more than on simple interest basis. The reply of the Corporation confirms the lacuna in the OTS policy.

[73] land in the suburbs of Bangalore City (31 guntas in Begur and 14 guntas in Bommanahalli) and two residential sites within the city (BTM layout and HSR layout) measuring 30,000 square feet.

Downward revision of OTS amount fixed

3.1.30 According to the OTS guidelines, if the promoters fail to pay a minimum of 25 *per cent* of approved amount within a period of 30 days from the date of communication of OTS, the OTS was to be withdrawn. Cases observed in audit where the promoters failed to pay the stipulated amount and yet the Corporation reduced the OTS amount without any justification are discussed below:

3.1.31 The Corporation sanctioned (1996-97) Rs. 1.95 crore to Orient Select Granites under three accounts *viz.,* Deferred Payment Guarantee (DPG), subscription to Non Convertible Debentures and Corporate loan. The assistance was sanctioned on the security of *pari passu* charge with Lakshmi Vilas Bank on the assets valued at Rs. 2.83 crore and personal guarantee of promoters.

Due to changes in the Government policy, all the three accounts turned into NPA during May-September 1999 and the Corporation took over the equipments financed under DPG and disposed off an excavator for Rs. 8.15 lakh. The unit was taken over in June 2002 and the assets were brought for sale twice in 2004. Sale agreements could not be executed due to stay order obtained (December 2005) by the promoters. The stay was vacated in December 2006 and the Corporation accepted (February 2007) OTS proposal for Rs. 4.50 crore against the outstanding of Rs. 7.36 crore. The amount was reduced (March 2007) to Rupees four crore and the settlement resulted in a loss of Rs. 3.36 crore (interest).

Audit observed that the value of the secured assets was assessed (February 2007) at Rs. 14.21 crore. Though a *pari passu* charge existed on the securities, there was no justification for downward revision of the OTS as the loanee had not honoured the OTS earlier (February 2007).

The Management stated (July 2008) that OTS fixed at Rs. 4.50 crore was in excess as per the policy guidelines and hence, it was revised to Rupees four crore. The reply is not tenable as the Board had fixed OTS at Rs. 4.50 crore taking into account the security available which is also to be considered as per OTS policy.

3.1.32 Saven Engineering Private Ltd. (SEPL) was sanctioned (August 1994), term loan, corporate loan, hire purchase assistance and equipment lease assistance aggregating Rs. 2.07 crore. The loans were secured (Rs. 2.51 crore) by primary security and personal guarantee of Directors. SEPL became defaulter and the unit was taken over (March 1998). The promoter sold (December 2001) the plant and machinery without the consent of Corporation.

The Corporation approved (March 2003) OTS for Rs. 2.17 crore with waiver of Rs. 3.39 crore on the basis of principal dues *plus* other debits for term loans and on principal dues *plus* simple interest for other loans. The OTS amount was however revised (March 2004) to Rs. 1.86 crore with waiver of Rs. 5.05 crore on the ground that personal assets were under attachment by

Banks. SEPL paid Rs. 1.88 crore (including delay period interest) and the settlement resulted in a loss of Rs. 5.05 crore.

The securities were valued at Rs. 1.51 crore in February 2002 and land which was originally valued at Rs. 21.78 lakh was valued at Rs. 20 lakh even after eight years, indicating undervaluation for purpose of OTS**.** The original OTS amount approved in March 2003 for Rs. 2.17 crore was reduced to Rs. 1.86 crore after keeping the OTS open for one year, which was in violation of the OTS policy.

The Management stated (July 2008) that as the promoters could not pay the originally approved OTS amount and based on their request, the OTS amount was reduced. The reply is not acceptable as the Corporation had fixed the OTS amount based on its own guidelines and reduction of OTS amount lacked justification.

3.1.33 The Corporation disbursed (1996) a term loan of Rs. 1.20 crore and bridge loan of Rs. 19.20 lakh to Gowri Oil Refinery (P) Limited, Kolar on the primary security valued at Rs. 1.60 crore and collateral security of land valued at Rs. 15 lakh. Due to default, the unit was taken over (August 1999) and the primary assets were sold for Rs. 66.50 lakh.

The Corporation approved (February 2006) OTS on simple interest basis for Rs. 2.65 crore which was not accepted by the unit. The Corporation permitted the unit to sell the collateral security valuing Rs. 35.22 lakh for Rs. 23 lakh and received the sale consideration. The OTS amount was revised (January 2007) to Rs. 2.12 crore which was further revised (April 2007) to Rupees two crore while the value of collateral security and personal property was Rs. 11.12 crore. Reducing the OTS amount from Rs. 2.65 crore to Rs. 2 crore resulted in additional waiver of Rs. 65 lakh.

OTS due to inadequate security / non-obtaining of collateral security

3.1.34 Lending Policy of the Corporation specified the quantum of primary security and collateral security to be obtained for each type of loan. Some illustrative cases noticed in audit where the Corporation failed to obtain the required quantum of security, which culminated in OTS are discussed below.

3.1.35 The Corporation sanctioned (March 1996) Deferred Payment Guarantee (DPG) assistance of Rupees two crore to Vaishnovi Engineers and Constructions Private Limited (VECL), for purchase of 25 Tata Tippers on the condition that the tippers should be hypothecated to the Corporation. VECL, instead purchased three Hydraulic Excavators at a total cost of Rs. 1.83 crore which was approved by the Corporation. VECL defaulted from the beginning and as the bill was discounted with IDBI under DPG scheme, the entire liability was devolved on the Corporation from May 1997, which was duly discharged by the Corporation during 1998-2003.

VECL did not pay the installments and hence the excavators were seized (November 2004) and sold (November 2005) for Rs. 14 lakh. The Fixed Deposit of Rs. 16.74 lakh was also realised. The total recovery, however, was only Rs. 1.09 crore (including repayment of Rs. 78 lakh) as against the dues of Rs. 5.15 crore. In the absence of any other security, the account was settled under OTS in November 2006 at Rs. 1.61 crore (on principal *plus* other debits basis), ten years after default. OTS guidelines for DPG cases did not provide for settlement on principal plus other debits basis. According to the policy, the OTS amount should have been fixed on the basis of principal plus 15 *per cent* simple interest, which worked out to Rs. 2.37 crore instead of Rs. 1.61 crore. Thus, the sanction of financial assistance without adequate security and approval of OTS in violation of guidelines resulted to a loss of Rs. 2.45 crore due to waiver of interest.

The Management stated (July 2008) that it has since discontinued the DPG scheme.

3.1.36 The Corporation disbursed (1994-1996) term loans aggregating to Rs. 1.38 crore to Kamal Precision Profiles Private Limited (KPPL). The loan was secured by plant and machinery valued at Rs. 1.58 crore, which included installation charges of Rs. 1.02 crore and land and building valued at Rs. 35 lakh. Collateral securities of a flat and a site (both in Bangalore) were obtained but the same were released (November 1997) by the Corporation after installation of the machinery. KPPL defaulted in repayment since inception and the unit was taken over in September 2000. The plant and machinery could not be sold as these were imported / second hand and were more than 15 years old. The Corporation approved (March 2002) OTS for Rs. 80 lakh. This involved a write off of Rs. 40.48 lakh and waiver of Rs. 2.16 crore. The OTS amount which was to be paid by September 2002 was paid only by March 2004.

Audit observed that due to premature release of collateral security the Corporation had no recourse, as the primary security was old machinery, which resulted in a loss of Rs. 2.56 crore. The Management stated (July 2008) that the matter of pre-mature release of collateral security was being looked into.

Improper appraisal culminating in OTS

3.1.37 The loan applications were evaluated with special reference to viability of the project, capability of the promoter, *etc.* Cases where the viability of the projects was not assessed properly resulting in failure of the unit and settlements under OTS are given below.

3.1.38 The Corporation disbursed (1990-97) financial assistance to Mesh Trans Gears (India) Private Limited and group companies aggregating to Rs. 4.47 crore. The loans were secured by imported second-hand machinery valued at Rs. 8.01 crore (taken under export obligation with risk of seizure by Customs authorities) and a collateral security of an industrial shed valued at Rs. 99.04 lakh. All the four group units defaulted and the Corporation took over the units in May 2002.

The Corporation approved (May 2004) OTS for Rs 2.35 crore on the basis of value of securities with write off of Rs 1.36 crore and waiver of Rs 12.58 crore and directed (June 2004) the parties to pay 25 *per cent* of the amount within 30 days and balance within three months. Though no payment was received within the time limit, the Corporation cancelled the OTS only in September 2006. Thus, the loan of Rs. 1.36 crore disbursed more than 10 years ago and interest thereon of about Rs. 16.29 crore remained uncollected so far (June 2008). The Corporation should have taken action to sell the assets immediately after the party failed to pay the OTS amount within the stipulated period. The securities valued by the Corporation at Rs. 8.99 crore were subsequently valued (October 2003) by TECSOK[74], at Rs. 2.18 crore for the purpose of OTS.

Thus, improper appraisal of the viability of the assisted units and over-valuation / inadequacy of securities forced the corporation to extend OTS and failure to sell the securities after expiry of OTS offer resulted in heavy loss of interest.

The Management stated (July 2008) that the OTS was not revalidated in view of appreciation in the value of the collateral security. The fact remained that there was failure in appraisal of the project and OTS approved in May 2004 was cancelled only in September 2006 indicated that there was no follow-up before and after approval of OTS.

3.1.39 The Corporation subscribed (October 1995 / June 1996) to Non Convertible Debentures (NCD) of Karnataka Malladi Biotics Limited (KMBL) a newly promoted unit for Rs. 1.50 crore. The debentures were to be redeemed in three years and secured by charges on inventories, book debts, personal guarantee of directors and corporate guarantee of Malladi Group Companies. This NCD assistance was extended to a newly promoted unit in violation of the norm of the Corporation that such assistance should be sanctioned to units which were in existence for more than three years. KMBL defaulted in repayment from July 1997 and was referred (August 1999) to BIFR. BIFR ordered (June 2003) OTS at the principal dues of Rs. 1.50 crore in 12 quarterly instalments from August 2003, which was paid by KMBL.

The Corporation had received only Rs. 36.07 lakh as interest for the subscription of Rs. 1.50 crore over six years as against Rs. 90 lakh[75] due over a period of six years. Thus, improper appraisal to the subscription to the NCD resulted in loss of interest.

Internal control and Internal audit

Pre-audit was not conducted for OTS approvals and only on line cases were subject to pre-audit.

3.1.40 The Corporation obtained ISO 9001:2000 certification for its systems and procedures. The OTS amount is worked out by the accounts department as per the guidelines in vogue and intimated to the recovery wing.

Audit observed that OTS approvals were not subjected to pre-audit. Only on-line cases were subjected to pre-audit up to the end of 2006-07. The

[74] **Technical Consultancy Services of Karnataka, a State Government Agency.**
[75] **at 10 *per cent* return per annum.**

internal audit covered the OTS cases sanctioned on a selective basis. Internal audit reports were submitted to the Managing Director and placed before the audit committee of the corporation.

The absence of sufficient controls in the area of valuation of securities and over-riding of controls at different stages of finalisation of OTS and inept usage of discretionary powers at the time of sanction resulted in various violation of guidelines leading to avoidable losses as pointed out in the earlier paragraphs. There was no system to fix the accountability for lapses and extension of undue favour to the loanees. The Management while confirming (August 2008) to the minutes of the ARCPSE meeting accepted that all OTS should have been pre-audited and stated that instructions have been now issued to pre-audit all OTS proposals in pipeline. The Management also assured to look into any nexus between officials of Corporation and defaulters.

Acknowledgement

Audit acknowledges the co-operation and assistance extended by the staff and the Management of the Corporation at various stages of conducting the performance review.

Conclusion

During 2003-08, the Corporation settled 7,134 cases, which resulted in recovery of Rs. 352.05 crore and a loss of Rs. 633.36 crore due to write off of principal and waiver of interest. This helped in improving the liquidity position of the Corporation and reducing the NPAs from 64 *per cent* in 2003-04 to 35 *per cent* in 2007-08. Audit, however, noticed deficiencies in framing of OTS guidelines and in implementation of OTS schemes. This resulted in loss of Rs. 182.28 crore from controllable factors to the Corporation. OTS schemes were kept open almost on a permanent basis from 2002-03 which allowed write off of principal in cases where there was erosion in the value of securities and it was not possible to collect even the principal. Though OTS amount used to be worked out with reference to financial position and realisable value of securities on a case to case basis, the on-line Scheme introduced in August 2005 did not take into account the realisable value of securities. This resulted in settlement of dues below the value of securities and heavy waiver of interest. OTS was extended to many ineligible parties and willful defaulters. There were instances where OTS was settled below the value of securities available, incorrect application of settlement formula, unjustified downward revision of OTS amount, failure to obtain collateral securities, lapses in enforcing personal guarantees / attaching personal properties. There was no system to fix staff accountability for lapses and undue favour shown to loanees, leading to write off of principal and other avoidable losses caused to the Corporation.

Recommendations

The appraisal norms of the Corporation for sanction of loans need to be strengthened as it was found that many cases culminated in OTS due to improper assessment of feasibility, inadequate securities and lapses in legal scrutiny. While formulating any OTS policy, the Corporation needs to take into account the following:

- **Evolve a policy of offering settlement to cases, which had a genuine business failure and recovery became difficult with the available securities.**
- **As the on-line OTS scheme did not take into account the value of security at the time of settlement, the scheme was detrimental to the interest of the Corporation; therefore the necessity for continuance of the scheme may be reviewed.**
- **To collect the entire outstanding amount where the securities are of high value and adequate.**
- **To maintain a data bank for primary and collateral security and of promoters / guarantors.**
- **A system for fixing accountability of staff needs to be evolved.**