

PERSONAL GUARANTEES AS THE SOLE BASIS FOR SANCTION OF LOANS

“A signature is powerful. But can it replace security worth crores?”

Recently, while advising one of India’s leading banks, we recently addressed an important question: *Can a large loan be granted solely on the basis of the personal guarantee of the Managing Director, without any tangible security?*

At first glance, this may appear to be a strong commitment as after all, the Managing Director is willing to put his personal wealth on the line. But is this enough to protect the bank? And what happens if the MD’s assets are already encumbered, or worse, he himself faces insolvency proceedings? These questions are far from academic, however, they strike at the heart of prudent banking, especially in an era where regulatory oversight is stringent, and non-performing assets (NPAs) can sink reputations overnight.

In the evolving landscape of corporate financing, banks often encounter situations, whether substantial loans can be sanctioned solely on the basis of a personal guarantee furnished by the Managing Director or promoter of a borrowing entity, in the absence of any tangible collateral.

The issue, while seemingly straightforward, involves a careful understanding of the interplay between the Indian Contract Act, 1872, the Reserve Bank of India’s prudential norms, and the provisions of the Insolvency and Bankruptcy Code, 2016 (IBC).

At the outset, a personal guarantee is a recognized and valid form of contract under Sections 126 to 147 of the Indian Contract Act, 1872. It creates a legally enforceable obligation whereby the guarantor undertakes to discharge the liability of the principal debtor in the event of default. Therefore, in principle, there is no legal impediment to a bank extending a loan facility solely on the strength of such a guarantee.

However, the real concern lies not in the legal permissibility, but rather in the prudential soundness and enforceability of such a practice.

That, the Reserve Bank of India, through its Master Circulars and Prudential Norms (including the April 2024 guidelines on income recognition, asset classification and provisioning), unequivocally classifies such credit facilities as **“unsecured exposures.”** This classification has serious consequences for the bank. Since these loans are unsecured, the bank has to set aside more money as a safeguard, which reduces its

profits. It also affects the bank's overall financial strength and ability to meet capital requirements under Basel III norms. More importantly, unsecured exposures inherently heighten the credit risk portfolio of the bank, particularly when large sums are sanctioned without the cushion of tangible security.

The enforceability of personal guarantees in practice has also been a matter of judicial scrutiny. The Hon'ble Supreme Court of India in catena of judgements have upheld the liability of personal guarantors, thereby affirming that creditors can proceed against guarantors simultaneously with the principal borrower. However, the practical challenge arises when the guarantor's assets are either insufficient, encumbered, or subject to competing claims from multiple creditors. In such circumstances, the personal guarantee, while valid on paper, may offer little comfort in terms of actual recovery.

Further, under the IBC framework, personal guarantors are exposed to insolvency proceedings independent of the corporate debtor. While this enhances the creditor's rights in theory, it also creates procedural complexities, particularly where multiple creditors seek to enforce parallel claims against the same guarantor. The existence of prior charges, encumbrances, or attachment orders often dilutes the enforceability of the guarantee, thereby leaving the bank exposed to recovery risks.

Therefore, while a personal guarantee can legally serve as the sole basis for sanctioning a loan, the prudential wisdom of such a practice is highly questionable. Therefore, efficient banking practice demands that personal guarantees be treated as additional comfort rather than primary security. Extensive due diligence into the guarantor's net worth, an assessment of existing liabilities, and continuous monitoring of the guarantor's financial position are indispensable safeguards. Moreover, internal risk management policies must clearly delineate the circumstances under which such unsecured exposures can be sanctioned, to prevent arbitrary or excessive reliance on personal guarantees.

In conclusion, while extending unsecured credit facilities backed merely by a personal guarantee may appear commercially expedient in certain circumstances, such practices invariably expose the lending bank to heightened credit, legal, and regulatory risks. A personal guarantee, though contractually binding, does not in itself constitute a robust security interest, particularly when weighed against the uncertainties of enforcement, the possibility of competing creditor claims, and the practical challenges posed by insolvency or financial distress of the guarantor.

It is therefore imperative that banks adopt a multi-layered risk-mitigation framework when considering such facilities. By supplementing personal guarantees with corporate guarantees from solvent entities, hypothecation of assets, third-party indemnities, or pledges of financial securities, banks can significantly enhance the recoverability of their exposure. Each of these mechanisms, if properly structured, documented, and legally enforceable, provides an additional layer of protection and reduces over-reliance on an individual guarantor's fluctuating financial position.

Further, the imposition of financial covenants and periodic monitoring of the borrower's financial performance ensures ongoing oversight and early detection of stress signals, thereby equipping the bank to take timely corrective measures. Such prudential safeguards not only align with the Reserve Bank of India's regulatory expectations but also serve to strengthen the bank's credit discipline, preserve its capital adequacy under Basel III norms, and uphold stakeholder confidence in its lending practices. By adopting the safeguards discussed above, banks can protect their interests, ensure sustainable lending practices, and contribute to the stability of the wider financial system.