Corporate Debt Restructuring

Contextually thinking RBI's Review of Existing Prudential Guidelines

"...corporate sector restructuring and reform have recently been considered essential to economic recovery, the long term viability of corporations, and a lower risk of (subsequent) financial crises." — *Stijn Claessens*

Ajay Yadav

The Reserve Bank of India (RBI) on 20th July 2012 placed on its website the Report of the Working Group (WG) to review the existing prudential guidelines on restructuring of advances by banks/financial institutions and invited comments from all concerned. This story takes a look at, the gravity of the debt recast scenario in India, the recommendations of the working gorup,. But before we do that it would be worthwhile to take a look at the prevailing gravity of corporate debt restructuring scenario in the country.

THE GRAVITY OF DEBT RECAST SITUATION

As per NDTV Profit website, in the first quarter of 2012-13 Loans worth Rs. 19,000 crore were referred for corporate debt restructuring (which is 30 per cent higher than the previous quarter. The website further states that as many as 37 accounts were referred to the CDR cell during this period. And the prominent accounts among these were Visa Steel (Rs. 3,000 crore), Tayal Group (Rs. 2,811 crore) and Indu Projects (Rs. 2,800 crore) which are among the biggest loans restructured in the first quarter.

Mr. Ram Raj Pai, President CRISIL Ratings, in his article titled "Indebtedness Incorporated" published in Financial Express, while reflecting on the gravity of the debt recast situation in the country states that "The sizeable loan restructuring by banks reflects corporate India's strained credit quality. This surge has been largely caused by increased funding challenges faced by corporates, especially the large and medium-sized corporates with large debt". And on the threat to the banking system as a whole states that: "Despite the challenges posed by the quality of corporate credit, CRISIL believes there's no immediate threat to India's banking sector. The capital position of the domestic banking sector continues to be healthy. The net worth coverage of net NPAs of the overall banking sector stood at 8 times as on March 31, 2012. The average tier I capital adequacy ratio (CAR) remains healthy, at around 10%, which would enable and facilitate a smooth transition to the Basel III regime commencing from January 2013. Also, the resource profile of the domestic banking sector continues to be stable, with a high proportion of around 60% retail deposits in its total deposit base and a stable CASA base of 34% of deposits."

THE WG'S RECOMMENDATIONS

Regulatory forbearance- The RBI may do away with the regulatory forbearance i.e. regarding asset classification, provisioning and capital adequacy but in the difficult economic circumstances the same could be considered say, after a period of two years.

• **Provisioning Requirement-** be increased from the present 2% to 5% in a phased manner over a two-year period, i.e. 3.5% in the first year and 5% in the second year. However, in cases of new restructuring of standard asset (flow), provision of 5% should be made with immediate effect. In the interregnum, in order to prudently recognise the inherent risks in existing assets classified as standard on restructuring (stock), the provision requirement on such accounts should (Para 6.10)

• **Asset classification benefit to be withdrawn progressively-** Notwithstanding the recommendation for progressively doing away with the asset classification benefit on restructuring, the WG felt that extant asset classification benefits in cases of change of date of commencement of

VOICE

SALMAN KHURSHID
Minister for Law and Justice, Govt. of India

"In the context of CDR we have done better than the rest of the world. And the credit goes to our banking system which is still robust"

commercial operation (DCCO) of infrastructure project loans may be allowed to continue for some more time in view of the uncertainties involved in obtaining clearances from various authorities and importance of the sector in national growth and development.

• **Account classification, redefinition of "specified period"-** Accounts classified as NPAs upon restructuring are presently eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. The specified period has been defined as a period of one year from the date when the first payment of interest or instalment of

VOICE

ALOK DHIR
Managing Partner, Dhir & Dhir Associates

"The recommendations in the report of the RBI Working Group (WG) elude the problem and root cause of ballooning NPAs (non-performing assets) in the banking system piling up as restructured loans and suggests solutions which are short term in nature for a problem that is long term. In the recent times, the levels of impairment and restructured debt have reached alarming levels and many large Corporates in core sectors such as steel, infrastructure, telecom, discom, tourism, etc are queuing up before the CDR Cell. As such, an over-leveraged sector and not over-leveraged companies is the problem: 85% of the total NPAs of the banking sector are in real estate, infrastructure and priority sector lending. This is the root cause of the budding banking crisis.

REGULATORY FORBEARANCE:

Prima facie, restructuring is done pursuant to the weakness of the loans—therefore it is certain that a restructured loan is not a healthy loan. However, RBI norms provide that if banks restructure a loan before it becomes an NPA, it is still treated as standard, and not a NPA. While taking cognizance of the internationally accepted best practices with regards to treatment of impairment loss in case of restructured assets, the WG felt that doing so immediately might act as a disincentive to banks to restructure viable accounts and so recommended a deferral of the same for a period of two years from now. The deferment will only result in a further surge in unhealthy loans being standardised under the array of restructuring and an opportunity to the banks to face lift their financials as they will not be required to make provisions on such unhealthy loans.

PROVISIONING NORMS

The WG recommends that the rate of provisioning be increased in respect of such re-structured assets from 2% to 5% in a staggered manner over a period of two years. In fact, this blanket provision does not take into consideration the real depletion in the fair value of the loan due to restructuring. The sacrifice involved in the restructuring might be more than 5%, or may be less than 5%. The increased provisioning would be a deterrent for the lenders to restructure viable accounts.

PROMOTERS' SACRIFICE

The WG recommends that the prevailing norm of contribution by the promoter to the tune of 15% of the sacrifice on part of the lenders should be the bare minimum and the banks may prescribe a higher sacrifice by the promoters, being 15% in diminution in fair value or 2% of the restructured debt, whichever is higher. The same sounds harsh and overlooks all the funds arranged by the promoter in the past to be able to fund the losses/shortfall in the working capital requirements to keep the business up and running.

PERSONAL GUARANTEE

The WG has recommended to make it mandatory for the promoters to extend their personal guarantee in all cases of re-structuring to ensure promoters' "skin in the game". The WG observed that in case Personal Guarantee is made mandatory, the promoters will be ensuring that only viable packages are submitted. The same is against the principle of `limited liability' in case of corporate. If the present facilities are without the personal guarantee of the promoters, the same should not be insisted upon at the time of re-structuring as no fresh funding is being extended to the borrower. If the promoter is reluctant to extend his personal guarantee then the restructuring should not be denied as the same would ultimately result in the account slipping into NPA and consequently result in deterioration of productive assets of the economy.

All the above recommendations of the WG appear to be solely directed towards safeguarding the lenders' interest and at the same time giving a cosmetic lift to their Balance Sheets, without any serious thought or effort being put towards the availability of easy finance for the revival of industry which is presently reeling under serious stress of an economic downturn.

The need of the hour is to lay down improved norms and increase expertise in assessing the viability of a venture. If found viable, ease out the flow of money under strict vigil, tighter prudential norms regime to ensure effective utilization of available credit and gearing up the lenders to monitor face deterioration in asset quality."

principal falls due under the terms of restructuring package. The WG has recommended that the 'specified period' should be redefined in cases of restructuring with multiple credit facilities as 'one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium.

Restriction on Conversion of debt into preference shares- Conversion of debt into preference shares should be done

• only as a last resort, also, conversion of debt into equity/preference shares should be

• restricted to a cap (say 10% of the restructured debt). Further, conversion of debt into equity should be done

• only in the case of listed companies.

PROMOTERS TO BEAR THE BURDEN OF RISK

• **Increase Promoters' contribution in cases of restructuring of large exposures:** A higher amount of promoters' sacrifice the promoters' contribution should be prescribed at a minimum of 15% of the diminution in fair value of the restructured account or 2% of the restructured debt, whichever is higher.

• **Promoters' personal guarantee be made mandatory:** obtaining the personal guarantee of promoters be made a mandatory requirement in all cases of restructuring, i.e., even if the restructuring is necessitated on account of external factors pertaining to the economy and industry. Further, corporate guarantee should not be considered as a substitute for the promoters' personal guarantee.

VIABILITY PARAMETERS TO BE BENCHMARKED BROADLY

• RBI may adopt broad benchmarks used by CDR Cell may be prescribed for the viability parameters and banks may suitably adopt them with appropriate adjustments, if any, for specific sectors.

• Reduction of the viability time span: the WG observes that currently the prescribed time i.e. seven years for non-infrastructure borrowal accounts and ten years for infrastructure accounts for becoming viable on restructuring is too long and banks should take it as an outer limit.

• Therefore: In times when there is no general downturn in the economy, the viability time span should not be more than five years in non-infrastructure cases and not more than eight years in infrastructure cases.

RECOVERED RESTRUCTURED NOT TO BE DISCLOSED IN BANKS'-

• The WG observed that in terms of present guidelines, banks are required to disclose annually all accounts restructured in their books on a cumulative basis even though many of them would have subsequently shown satisfactory performance over a sufficiently long period. The WG has, therefore, recommended that

• once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either abinitio or on upgradation from NPA category) revert back to the normal level on account of satisfactory performance during the prescribed period,

• such advances should no longer be required to be disclosed by banks as restructured accounts in the "Notes on Accounts" in their Annual Balance Sheets. (Para 6.28)

ASSUMPTIONS LEADING TO VIABILITY ESTIMATES DID NOT MATERIALIZE-

• The WG observed that there were cases which were found to be viable before restructuring but the assumptions leading to viability did not materialise in due course of time.

• There were also cases where the approved restructuring package could not be implemented satisfactorily due to external reasons or due to promoters' non-adherence to the terms and conditions.

• The WG recommended that in such cases, banks should be advised to assess the situation early and use the exit options with a view to minimise the losses. The WG also recommended that the terms and conditions of restructuring should inherently contain the principle of 'carrot and stick', i.e. while restructuring being an incentive for viable accounts, it should also have disincentives for non-adherence to the terms of restructuring and under-performance.

VOICE

HEMINDRA HAZARI
Head of Research, Nirmal Bang Institutional Equities

The maximum NPAs are coming from the corporate sector and the SME sector which are inter-linked, which relies on both government and private sector banks for their financing requirements. It is therefore unlikely that only government banks are having a problem with corporate NPAs while private banks are reporting far lower NPAs.

RECOMMENDATIONS REGARDING RECOMPENSE CLAUSE:

• Due to the current guidelines issued by CDR Cell that recompense be calculated on compounding basis and that 100% of recompense so calculated is payable, exit of companies from CDR system was not happening. Therefore, the WG recommended that CDR Standing Forum/Core Group may take a view as to

> **Any kind of restructuring has to be accompanied by prudence on the part of the lenders and financial discipline on the part of the borrowers. Absence of these conditions results in dead weight loss to the society in general. He rued the fact that the provisions of the CDR mechanism have not been used very ethically and judiciously, giving rise to the unprecedented increase in cases under CDR.**

whether their clause on 'recompense' may be made somewhat flexible in order to facilitate the exit of the borrowers from CDR Cell.

- However, it also recommended that in any case 75% of the amount of recompense calculated should be recovered from the borrowers and in cases of restructuring where a facility has been granted below base rate, 100% of the recompense amount should be recovered.

- The WG also recommended that the present recommendatory nature of 'recompense' clause should be made mandatory even in cases of non-CDR restructurings.

THE NEED AND CONTEXT OF RECOMMENDATIONS

In his Address, Dr. K. C. Chakrabarty, Deputy Governor, RBI, at Centrum Group's conference on Corporate Debt Restructuring in Mumbai on August 11, 2012, analysed the trends in India's CDR scenario. He reasoned that any kind of restructuring has to be accompanied by prudence on the part of the lenders and financial discipline on the part of the borrowers. Absence of these conditions results in dead weight loss to the society in general. He rued the fact that the provisions of the CDR mechanism have not been used very ethically and judiciously, giving rise to the unprecedented increase in cases under CDR.

- **Regulatory discomfort:** with the manner in which the extant restructuring guidelines and the associated regulatory forbearance are being used. While clearly there is cause for concern given the pace and quantum of restructuring over the last few years, the concerns are aggravated by the fact that the restructuring is neither being permitted in a transparent and objective manner by banks nor is it being resorted to in a non-discriminatory manner.

- **Public sector banks share a disproportionate burden:** Reflecting on the burden of bad debts he stated that the trends are arguably a reflection of the fact that public sector banks have not been as judicious in the use of restructuring as a credit management tool as the private sector and foreign banks.

- **Substantial bias towards more privileged borrowers:** He maintained that the data on restructuring seems to suggest that, when it comes to restructuring, our banks have a substantial bias towards more privileged borrowers vis-à-vis small borrowers. It seems to suggest that restructuring of accounts is being resorted to avoid classification of accounts as NPA.

CONCLUSION

Though the CDR situation is dire yet with prudence on the part of the banks first in granting loans and later on in restructuring them and financial discipline on the part of the corporates may redeem the situation. All in all the recommendations seem to be in right direction and may infuse a sense of prudence and financial discipline.

ABOUT AUTHOR

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