Debt Restructuring Schemes: Temporary relief or permanent solution to rising NPA's?

The writing was on the wall; it's just that no one wanted to acknowledge it. The bad loan crisis that has gripped India's banking sector did not happen overnight. The rise in stressed assets is indeed a reason for concern as it suggests higher probability of credit default that ultimately impacts the profitability and liquidity of banks. Globally, over the last two decades, the banking regulators have passed major reforms to reduce NPA's and India is no exception. It is therefore imperative to understand the effectiveness of these mechanisms, in achieving bank stability. This article is an attempt to understand debt restructuring reforms introduced in India and its effectiveness as it also opens up potential acquisition opportunities for corporates. Read on to know more…

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BACKGROUND

Last year when the RBI adopted the "zero tolerance approach" and asked banks to clean up their book by March 2016 by classifying visibly stressed assets as bad loans, Gross Non-Performing Assets (GNPAs) witnessed a substantial jump of ₹200,000 crore in just one quarter (Q4'16). *Refer Figure 1.*

BANKS WITH MOST BAD LOANS (BEFORE AND AFTER ASSET QUALITY REVIEW)

	Mar 2016	Sept 2015	NPAs as % of advances*
State Bank of India	98,172	56,834	6.50
Punjab National Bank	55,581	24,945	12.90
Bank of India	49,879	29,894	13.07
Bank of Baroda	40,521	23,710	9.99
Canara Bank	31,638	14,021	9.40
Indian Overseas Bank	30,049	19,424	17.40
ICICI Bank	26,221	15,858	5.82
IDBI Bank	24,875	14,758	10.98
Central Bank of India	22,721	13,358	11.95
Uco Bank	20,908	12,227	15.43
TOTAL (38 banks)	5,90,772	3,49,659	

*As of March 2016 (Figures in ₹ crore)

Figure 1: NPAs before and after RBI asset quality review

GNPAs has grown at a CAGR of 35%; from ₹53,917 crore in September 2008 (before the global financial crisis), to ₹5,90,772[1] crore in March 2016. During this period, GNPA as a percentage of the total loans has grown from 2.11% to 7.7%[2] (Refer Figure 2), the highest level in 12 years. Currently, public-sector banks account for over 90%[1] of GNPAs. RBI's projections show that the gross NPA of Indian banking sector could go up to 8.5% in March 2017.

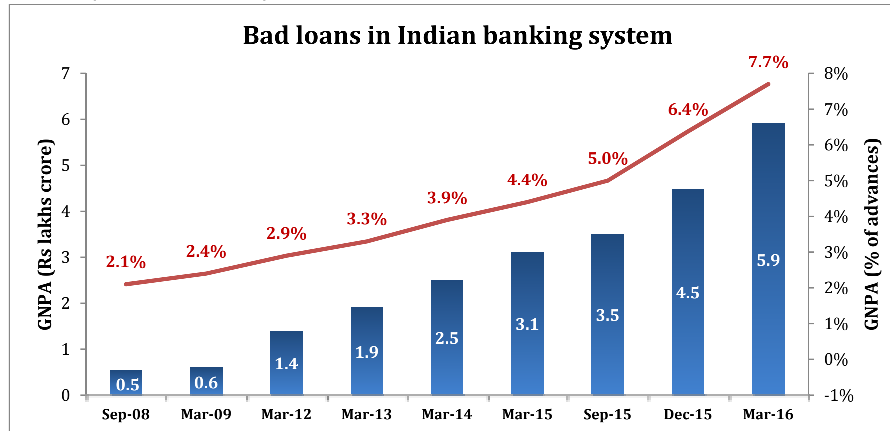

Figure 2: NPA's in 39 listed banks of India

BANKING REFORMS – JOURNEY SO FAR...

Corporate Debt Restructuring Scheme ("CDR")

In the beginning of 2000's, when corporates were facing challenges in debt servicing, the RBI introduced CDR scheme on 23rd August 2001. The idea was to provide speedy, cost effective and market friendly reform to assist in reviving viable corporates and take the credit market out of downward spiral. Over the past 15 years, CDR in India has seen its fair share of success and failures. While the successful turn around of companies like Wockhardt Pharmaceuticals are shining examples of CDR, the failures of Bharti Shipyard and Leela Ventures showed a dark shadow on its success story.

As on 30th June 2016, 208 cases were under CDR amounting to ₹2,36,868 crore[3] (22% in steel industry). Since its inception, 94 cases (₹68,894 crore) have successfully exited CDR scheme by fulfilling package conditions, while 228 cases (₹97,242 crore) have withdrawn from CDR citing package failure.

5:25 Scheme

In 2014, the RBI admitted that there was a mismatch between cashflow from infrastructure projects having long gestation period and its ability to service debts in initial years *vis-a-vis* lending terms of banks (front end loaded) with tenure of 10-12 years. To overcome the asset-liability mismatch, RBI in December 2014, allowed banks to extend the maturity of infrastructure loans (more than ₹500 crore) for up to 25 years in a manner that the portion of the principal which remains unpaid at the end of 5 years can be

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[1] CARE ratings
[2] CRISIL research
[3] CDR performance report issued by CDR cell

refinanced. This is popularly known as the "5:25 scheme". Initially, it was introduced for new projects but has been now extended to existing projects. The key challenge for the banks shall be to protect the NPV of the loans being refinanced and hence, the cost is likely to balloon up towards the end. Till 31st March 2016, ₹1.25 lakh crore loans are refinanced under 5:25 scheme. The "moment of truth" will however come when these loans will be due for first refinancing, i.e. after 5 years.

STRATEGIC DEBT RESTRUCTURING SCHEME

In an attempt to strengthen the lenders' ability to deal with stressed assets, the RBI in June 2015 introduced the SDR scheme which empowers the banks to convert loans (including unpaid interest) into 51% equity stake followed by selling at least 26% stake[4] to a new promoter with a 'Right of First Refusal' to new promoters for remaining stake. Banks were allowed to reduce the rate of interest and provide additional finance based on the credit rating of the new promoter. This scheme is subsequent to any other restructuring exercise undertaken by the company in past. It is envisaged as a way to deal with errant promoters and give banks an option to change the management for business turnaround.

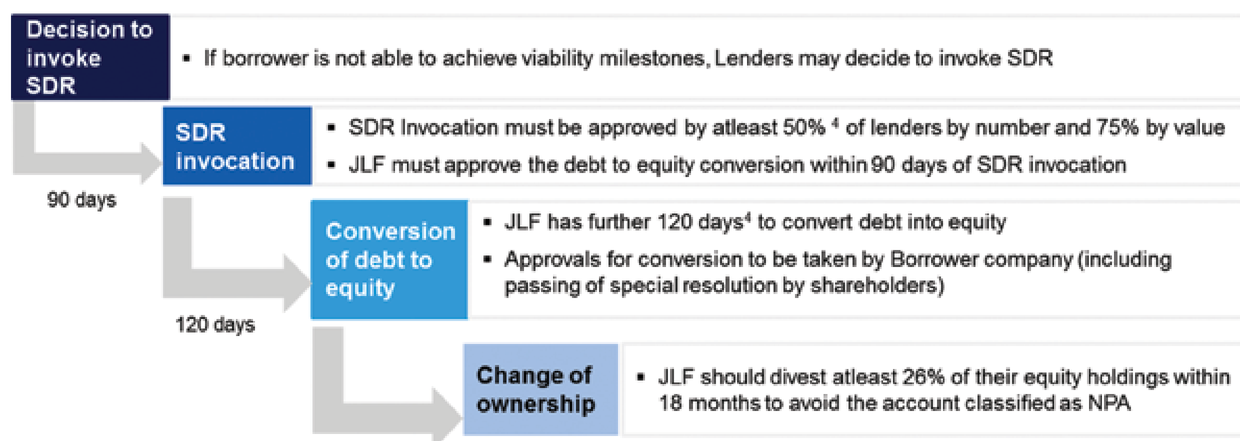
- **Standstill clause**
  Asset classification as on the date of SDR invocation shall continue for 18 months. The RBI mandated atleast 15% provisioning[4] to all SDR cases. To avoid the cliff effect of resultant provisioning, the RBI allowed provision to be made in equal instalments over four quarters from SDR reference date.
- **Open offer exemption**
  Banks are exempted from the mandatory open offer under the SEBI Takeover code on conversion of loan to equity.
- **Refinancing without treating Restructuring**
  SDR empowers Banks to refinance the existing debt without treating it as separate loan restructuring and adhering to necessary provisioning thereon.

SDR CASES TO DATE

Company	Debt (₹ crore)
Adhunik Power	3,120
AMW Motors	1,430
Ankit Metal and Power	1,280
Coastal Projects	5,810
Electrosteel Steels	10,990
Gammon India	14,810
GOL Offshore Ltd	2000
IVRCL	10,340
Jyoti Structures	2,640
Lanco Teesta	2,400
Monnet Ispat	12,500
Rohit Ferro-Tech	2,630
Shiv-Vani Oil & Gas	4,010
Transstroy	4,300
Visa Steel	3,090
Alok Industries	15,350
Tilaknagar Ind	800
Total	97,480
Total expected cases(30-40) Mar 2017	1,50,000
As a per cent of system credit	2.2

Source: Religare

SDR Process overview



PROS of SDR

- **Upgradation in asset classification**
  Banks can upgrade an asset to "standard asset" if they divest at least 26%[4] stake to the new promoter within 18 months (applicable only if new promoter does not belong to existing promoter/promoter group).
- **Associate Accounting exemption**
  Banks acquiring more than 20% under SDR is not treated as investment in associate. Hence, banks are exempt from recognising its share of profit/loss of the subject entity in its books.

[4] *Revised SDR guidelines issued by RBI on 25th February'16*

With schemes like CDR, SDR and change of management outside SDR not yielding desired results, RBI on 13th June 2016 unveiled another scheme called Scheme for Sustainable Structuring of Stressed Assets ("S4A") for reworking the financial structure of corporate entities facing genuine difficulties.

CONS of SDR – Practical aspects

- **No open offer exemption for the buyers**
  While banks are exempted from mandatory open offer requirement, there is no such exemption for the new promoter. Hence, the cost of equity for acquirer to buy additional stake in open offer gets linked to the market price which may not justify the overall enterprise valuation of the company computed by the buyer.
- **Conversion of debt to equity**
  Conversion to equity happens at market value (for listed companies) of average of 10 days closing price proceeding JLF's decision to undertake SDR or book value as per latest audited accounts whichever is lower. Since the Companies Act, 2013 does not allow issue of shares at discount to face value; banks incur huge mark-to-market losses during conversion where the market price is lower than face value which is most likely the case for companies under stress.
- **Strict timelines to divest equity stake**
  Amidst overall slowdown in the economy and crash in commodity prices, banks are facing challenges in selling their stake within 18 months as it includes identifying a new promoter, due diligence, value negotiation, shareholder approvals *etc.*
- **Revocation of Standstill benefit**
  If banks are unable to sell at least 26%[4] equity stake to a new promoter within 18 months, then the standstill benefit will be revoked and lenders have to treat these assets as NPAs and make requisite provisioning.
- **Periodic valuation of equity shares**
  Equity shares acquired under SDR will have to be periodically valued and depreciation (if any) in value of these shares is to be provided. Banks have the option of distributing this depreciation over four quarters. This is a revision from SDR guidelines issued in June 2015 wherein shares were exempt from the requirement of periodic mark-to-market for the 18-months period.
- **Not a solution to structural problems**
  Many accounts run into problems not because of inefficient management but due to structural problems like weak demand, cheap imports, overcapacity *etc.* In such cases, effecting a management change may not substantially improve the company's performance.
- **Difficulty in managing day-to-day operations**
  In the absence of any interest from external agencies to run day to day operations of the company, banks are left with no other choice but to existing managements to run the company post acquisition of majority stake under SDR.

CHANGE OF MANAGEMENT OUTSIDE SDR

The biggest drawback of SDR was the need for banks to acquire shares of defaulting companies and then selling it to an interested buyer. To address this issue, RBI issued guidelines for change of management outside SDR in September 2015, wherein banks can effect change of management by using rights to banks usually conferred under the loan agreements like pledge invocation, conversion of defaulted debt into equity *etc.* Under this scheme also, the account can be upgraded from non-performing to standard on change of management and refinancing of existing debt is possible considering the risk profile of the new promoter.

Sustainable Structuring of Stressed Assets

With schemes like CDR, SDR and change of management outside SDR not yielding desired results, RBI on 13th June 2016 unveiled another scheme called Scheme for Sustainable Structuring of Stressed Assets ("S4A") for reworking the financial structure of corporate entities facing genuine difficulties.

Scheme Framework

Under the S4A scheme, outstanding debt will be divided into two parts. Part A will be sustainable debt which the free cash flow is capable to service. No reduction in interest rate, fresh moratorium on interest/principal repayment, extension of the repayment schedule is allowed for servicing Part A debt. The Balance debt ("Part B") will be converted into equity/redeemable convertible preference shares. Equity shares will need to be marked to market on weekly basis, while preference shares/ debentures would be valued on discounted cash flow basis (discounted at 1.5% higher than lending

rates). If there is no change in promoter, banks may also convert Part B into optionally convertible debentures.

S4A is applicable for projects that have started commercial operations and have outstanding loan above ₹500 crore. To ensure transparency, an Overseeing Committee, is being set up by Indian Banks Association in consultation with RBI to review the process involved in preparation of resolution plan.

Asset Classification and Provisioning

Banks are required to make provisions of 20% of the total outstanding or 40% of Part B (unsustainable debt) whichever is higher. These provisions are higher than 15% that banks make for NPA accounts in the first year. The asset classification requirements are:

- If change of promoter- As per the SDR scheme
- If no change of promoters- Asset classification as on reference date (lenders' decision to resolve account under S4A) will continue for 90 days to enable lenders formulate the resolution plan and implement it. If not implemented, then the asset classification will be as per the extant provisioning norms, assuming there was no 'stand-still'.

Accounts already under NPA category on reference date, will continue to be NPA and can be upgraded to standard after one year of satisfactory performance of Part A debt.

Challenges in S4A

- **Limited scope**
  S4A is allowed only for projects where commercial operations have commenced.
- **Sustainable debt really sustainable?**
  It is feared that not many companies will be able to service even the sustainable debt.
- **No change in financing terms**
  S4A scheme does not allow banks to change the terms of loan. Hence, no support in the form of moratorium on interest/principal repayment to sustainable debt portion can be extended.
- **Slow process**
  The Overseeing Committee might slow the overall process but it is a necessary evil, as it takes away the fear of investigation among banks.
- **Huge dilution for equity shareholders**
  High level of equity dilution resulting from the scheme could be negative for shareholders and may reduce the incentive for promoters to actually turn around the company.
- **Provisioning requirement**
  In the last two quarters of 2016 (H2 2016), Banks have already provided 15% in potential NPA cases where stress had been identified under the RBI's asset quality review. Any further provisioning will directly hurt the profitability of the banks.

Therefore, while implementation of restructuring scheme can be a temporary support to companies in stress, but the ability of the management to operationally turnaround the company will be the real solution to the bad loan issue in the banking industry.

What is different under S4A?

Unlike the earlier restructuring norms, under S4A the existing promoters are allowed to have management control. Hence, this is positive for promoters of stressed companies wherein they are given an opportunity to revive the company however, at the cost of their stake getting diluted.

CONCLUSION

It is hard to say whether debt restructuring schemes were a response to the growing NPA's or the NPA growth itself was the outcome of failed re-structuring. When RBI came out with the norms for SDR, it seemed that banks would benefit significantly from the scheme. But as the details of companies entering SDR emerged, it became clear that banks might have to undergo a makeover even if they find suitable buyers for their stakes in these companies. While the S4A scheme still remain to be tested, the path will not be easy, as there are numerous bottlenecks that lenders may face to successfully implement it.

Many believe that the debt restructuring schemes are a mechanism to defer the recognition of stressed loans as NPA's without solving the core bad asset problem. Undoubtedly, the need of the hour is to operationally turnaround the stressed businesses with competent managerial competencies. After all, in the long run, operational cash flows must service the financing requirements of a business. Therefore, while implementation of restructuring scheme can be a temporary support to companies in stress, but the ability of the management to operationally turnaround the company will be the real solution to the bad loan issue in the banking industry. ■

We don't see things as they are, we see them as we are. - Anais Nin