Working Group on Restructuring of Advances

September 2012

1 ASSET CLASSIFICATION AND PROVISIONING

1.1 Recommendations

- Forbearance regarding asset classification, provisioning & capital adequacy - RBI may do away with forbearance regarding asset classification, provisioning and capital adequacy on restructuring of loans and advances after two years (considering the current domestic macroeconomic situation) in line with the international prudential measures. [Recommendation 1]
- Provision Requirement - RBI may increase provision requirement on assets classified as standard on restructuring from 2% to 5% with immediate effect in cases of new restructuring but in a phased manner during two years (3.5% in first year and 5% in second year) for existing standard restructured accounts. [Recommendation 2]

1.2 Arguments in Favour

- Considering success rate of restructured account to be in the region of 70%-80% and high LGD of 50%, the recommendations were considered reasonable
- The withdrawal of regulatory forbearance was supported by various people like representative of funds, CA firms, ARCs and a few banks who emphasised that restructuring should be strictly need based and should not have any incentive. They felt that this will stop mis-utilisation of regulatory provision for managing the IRAC status of the accounts.

1.3 Arguments Against

- The process of restructuring has enabled at least 80 per cent of cases to be salvaged. Banks were willing to do so because of continuing regulatory classification which also enabled fresh liquidity/funding for borrowers. Withdrawal of regulatory forbearance on asset classification may lead to difficulties for the borrowers to arrange for any additional need based financing

including for working capital purposes. This could lead to destruction of economic value of assets.

- The recovery climate has not improved yet - recovery of debt through legal action such as DRT / SARFAESI action, change of management is (i) time consuming and (ii) fraught with legal challenges which make recovery action ineffective, implying relatively high LGD compared to international standards.
- At present in order to maintain the status of the account, lenders have to file flash report with CDR EG before the account becomes 90 days past due. Thus, an expeditious action is taken to restructure the account. If the regulatory forbearance is withdrawn, the banks will not have an incentive for expeditious finalisation of the package. In such situations, the lenders will not have any time pressure to refer the case for restructuring and can wait for up to one year (till the account remains sub-standard). This may result in delay in worsening the situation and increasing eventual losses.
- Currently, provisions are made for diminution in value as also for FITL (which is shown as provision in banks books) in addition to 2 per cent. Hence, there should be no further provisioning.
- Since the current formula actually makes banks undertake fair valuing for restructured accounts the additional requirement of prescriptive provisioning of 2% to 5% is not justified.
- In case of withdrawal of regulatory forbearance, an additional provision of at least 15% will be required which together with provision on account of diminution in fair value and FITL will add up to close to 30%. This seems an unduly high level of provisioning.

1.4 Suggestions

- The regulatory concessions need to be withdrawn so that the incentives to restructure and remain in that category are no longer there.
- Allow the asset classification as per existing norms but increase the provisioning on restructured accounts to the level suggested
- Alternatively, the asset may be classified as sub-standard asset but the provisioning requirement may be restricted to the higher of the provisioning requirement of the sub- standard asset or as a blanket requirement for restructured standard asset including the diminution in fair value and FITL provisions
- To ensure that there is no laxity in finalisation of restructuring package by the lenders, a stipulation may be made that further regulatory forbearance as regards continued status of the account as sub-standard will be available only if the account is restructured within 6

months of it being classified as sub-standard or else provisioning for further down gradation to D1, D2 etc. will be applicable

- RBI could consider having an across the board provisioning of 10 per cent based on the expected 20 per cent slippage and 50 per cent LGD without getting into DFV calculation which in many cases is arbitrary. This could be modified as fresh evidence of slippage and LGD is available.

2 INFRASTRUCTURE LOANS

2.1 Recommendations

- The extant benefits in cases of change of date of commencement of commercial operations (DCCO) may be allowed to continue. [Recommendation 3]
- However, additional stringent conditions may be added to prevent misuse of the clause. A higher provisioning of 5% as against current requirement of 2% on such loans is suggested. [Recommendation 3]
- Only Indian banks (not overseas) may be allowed to avail the certain extant asset classification relaxations even when there is delay in date of commencement of commercial operation (DCCO) in respect of repayment period of restructured advances and regarding tangible security in cases of bank financing to infrastructure. [Recommendation 15]

2.2 Suggestions

- It was also felt that manufacturing projects which are also dependent on infrastructure availability may also be allowed to enjoy the extant asset classification benefits on account of delay in DCCO
- To continue with regulatory forbearance if there is shift in Commercial Operations Date (COD) without any change in repayment programme

3 RESTRUCTURING DURING CRISIS

3.1 Recommendations

- RBI should design a framework which will precisely and objectively define a severe crisis (requiring both government and regulatory intervention) and broadly indicate the fiscal and regulatory measures to be taken under such conditions in phase of (i) crisis containment (ii) debt restructuring [Recommendation 5]

3.2 Arguments Against

- There should be a differentiation between overall macro-economic crisis and specific industry wise crisis. Examples of current difficulties in textiles and steel industry were cited and contrasted with overall crisis in 2008. Approaches should differ in both cases and this differentiation needs to be recognised.

3.3 Suggestions

- It was felt that there may be a need for such forbearance to be combined with fiscal package in the event of specific sectors / industries being affected due to reasons beyond their control for example regulatory forbearance for repeated restructurings in FY2009

4 REPEATED RESTRUCTURING

4.1 Recommendations

- The working group recommended withdrawal of special dispensation which allowed any second time restructuring under CDR restructuring to be not considered repeated restructuring if it does not lead to negative NPV. [Recommendation 14]

4.2 Suggestions

- It was felt that there may be a need for repeated restructurings in certain industries. In such situations, there may be a need for regulatory dispensation

5 DISTRIBUTION OF LOSSES – PROMOTERS' CONTRIBUTION

5.1 Recommendations

- RBI can consider a higher amount of promoters' sacrifice in cases of restructuring of large exposures under CDR mechanism. [Recommendation 16]
- The promoters' contribution should be prescribed at a minimum of 15% of the diminution in fair value or 2% of the restructured debt, whichever is higher. [Recommendation 16]
- The working group recommended that 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. [Recommendation 22]
- RBI should prescribe that corporate guarantee cannot be a substitute for the promoters' personal guarantee. [Recommendation 23]

5.2 Arguments in Favour

- In general, recommendations about promoters sacrifice and personal guarantee were welcomed.
- However, it was felt that the current as well as the recommended norms for promoter's contribution were inadequate and did not factor in the cost to lenders on account of liquidity support / income sacrifice.

5.3 Arguments Against

- One of the speakers (a borrower) opposed the recommendation which disallowed equating corporate guarantee with personal guarantee. He requested that banks should differentiate between borrowers who have brought in their entire wealth to salvage the company operations and others. Promoters who are seen as cooperative and honest should not be required to give personal guarantees

5.4 Suggestions

- Particularly in the restructuring cases involving long period, provision may be made for bringing additional contribution by the promoters in subsequent years in a phased manner to meet the increased requirement of the business

- Since other equity holders also need to contribute, it was felt that other than promoters', a write down of equity for all class of shareholders would be more appropriate means to seek sacrifice from shareholders, which may be treated separately from promoter's contribution.
- Any fresh infusion of funds by promoters or through fresh investment should be seen only as new contribution and not as sacrifice

6 CONVERSION OF DEBT TO SHARES/PREFERENCE SHARE

6.1 Recommendations

- The conversion of debt into preference shares should be done only as a last resort and should be restricted to a cap (say 10% of the restructured debt). [Recommendation 17]
- Any conversion of debt into equity should be done only in the case of listed companies. [Recommendation 18]

6.2 Arguments Against

- If post restructuring, promoters' ownership/control remains unchanged, the entire cost is borne by the banks.

6.3 Suggestions

- There is a need for a clause similar to "Damocles sword" wherein in the event of certain defaults – the promoter would face the risk of losing control over the company by virtue of lenders having right to convert their overdue interest into equity at 90% of the book value or market value whichever is lower to create dis-incentives for borrowers to seek restructuring.
- The conversion into equity should be allowed without any cap as it would allow lender's a share of upside in the event of better performance of the company post restructuring.
- The conversion into equity in listed company's shares should be such that the lender's don't suffer from mark to market losses immediately upon restructuring, hence conversion at say 10% below prevailing market price may be considered and in the event of unlisted company's it should be at lower of book value or par value.

7 EXIT OPTION

7.1 Recommendations

- The working group observed that there were which were found to be viable before restructuring but the assumptions leading to viability did not materialise in due course of time or 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 came in observation. The working group 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. [Recommendation 19]
- Also, the terms and conditions of restructuring should clearly state an incentive for viable accounts and disincentives for non-adherence to the terms of restructuring and under-performance. [Recommendation 19]

7.2 Arguments Against

- While entry for restructuring easy, there are various barriers to exit- DRTs ready to give stay, SARFEASI neglected many times, SICA taken advantage of leading to problems of exit for banks.

7.3 Suggestions

- The lenders are generally reluctant to give additional funding to restructured accounts. The existing provisions do not permit ARCs to extend funding to them from the trust funds, which is their main source of funds. ARCs may be permitted by RBI to use trust funds for this purpose.
- To encourage sale to ARCs, it was suggested that banks may be given a share in case of an upside. Sale compensation may be given by ARCs to banks in two parts i.e., in form of cash payment and security receipt with the provision that in case of higher realisations beyond the defined limits set therein, the amount will be shared with the lenders selling the assets.
- It was recommended that there may be a case to stipulate strict guidelines for assignment of debt to ARC's such as in the event of failure of restructuring and non-recovery within a period of 3 years after account becomes NPA

- A dedicated fund may be set up for extending additional financial assistance to the restructured units. Lenders may be allowed appropriate regulatory and fiscal concessions for contributing to such fund.
- The failure to achieve envisaged performance and/or non-compliance of key/critical terms and conditions of the approved restructuring package should be treated as an Event of Default (EOD) and consequences should follow when such EODs is/are breached. For example, if within two years after moratorium period, the projected cash accruals are not achieved, the project should be sent out of the CDR mechanism as a failure instead of waiting for the full period. Similarly, if the unit is able to achieve actual cash accruals to support payment of commercial rates of interest and repayments of principal, the unit again should be sent out of the CDR mechanism. In such an event, commercial terms should become applicable in place of the concessional terms and exit from the CDR should be encouraged.
- The other additional measures such as pressure points were also suggested so that the units

  will not opt to remain in the CDR. Any freeze or reduction in the pay and emoluments of the promoters, non-payment of any commission during the package implementation period, non-payment of dividend during the package implementation period and recompense amount could be made directly proportional to the length of the package implementation period. As an incentive for earlier and easy exit, recompense should increase proportionately as the length of the package implementation increases. Also, the recompense amount should be disclosed by the borrower as contingent liability in their balance sheet.

8 RIGHT TO RECOMPENSE

8.1 Recommendations

- CDR cases - Clause on 'recompense' may be made flexible to facilitate the exit of the borrowers from CDR Cell. However, 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 . [Recommendation 20]

- Non CDR cases - The present recommendatory nature of 'recompense' clause should be made mandatory. [Recommendation 21]

8.2 Suggestions

- The recompense amount should be frozen upfront at the time of finalisation of the package
- A common approach needs to be evolved in arriving at both, diminution in value and right of recompense between loans and investments both of which are "exposures" as far as the bank is concerned. In view of the fact that credit spreads and term spreads could be quite discretionary, it would be useful to use the difference between either FIMMDA rate and the package rate can be used as a measure to arrive at the NPV of the diminution in value.
- It was further argued by some that recompense should include (a) cost of liquidity support through the package (b) loss of earnings and (c) loss of opportunity yield though (c) was somewhat subjective in quantification.

9 ASSESSING VIABILITY

9.1 Recommendations

- RBI may prescribe the broad benchmarks for the viability parameters based on those used by CDR Cell and banks may suitably adopt them with appropriate adjustments, if any, for specific sectors. [Recommendation 7]
- The viability time span in absence of general downturn of the economy should not be more than five years in non-infrastructure cases and not more than eight years in infrastructure cases. [Recommendation 8]

9.2 Suggestions

- The overall view was that the existing time frame prescribed for establishing viability of five years for non-infra cases and eight years for infra cases was necessary and any reduction of same would not be appropriate
- There was also general consensus that the viability studies for restructuring should be undertaken by bank and not borrowers for the studies to be more authentic.

- Further there were suggestions that business restructuring be considered first before financial restructuring. Business restructuring to include change of product mix, change in management and processes.

10 DISCLOSURE

10.1 Recommendations

- Disclosure in notes on accounts - The WG recommended that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either *abinitio* or on up gradation 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. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions. [Recommendation 9]
- The WG also recommended that banks may be required to disclose details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable), provisions made on restructured accounts under various categories as also details of movement of restructured accounts. [Recommendation 9]

10.2 Suggestions

- Suggestions were made that the NPV of diminution in value be arrived at upfront at the time of evolution of package. Corporate should be required to disclose the amount as a contingent liability. Also, the MDNA section of the Annual Report of the corporate must comment on current status of being in line or not being in line with the assumptions in the restructured package.

11 PROVISION FOR DIMINUTION IN THE FAIR VALUE

11.1 Recommendations

- Restructured advances - There is a need for clarity on calculation on erosion in the fair value as there have been instances of different interpretations of the formula (BPLR/Base Rate plus credit risk premium and term premium) by banks, RBI may illustrate the NPV calculations by way of a few examples .[Recommendation 10]
- Small restructured accounts –the amount of diminution in the fair value of small accounts can be computed at 5% of the total exposure at small/rural branches in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore. This provision may be continued on a long term basis. [Recommendation 11]

11.2 Suggestions

- For calculating diminution in value, instead of using the base rate plus term premium plus risk premium, it may be better to use document rate now that interest rates have been adjusted to the more recent trends unlike the period where document rates were very high.
- In order that there is a more realistic calculation of diminution of fair value, banks can uniformly adopt the FIMMDA rates for a credit grade equal to the default category.

12 RECOMMENDATIONS FOR CDR MECHANISM

12.1 Suggestions

- Eligibility for reference to CDR mechanism - Currently at Rs. 10 crore minimum exposure and at least two banks. The general consensus supported by the CDR cell was that the current threshold for entry to the CDR mechanism should be raised. The exposure needs to be sufficiently large (suggestions ranged from Rs. 100-500 crore) and there should be minimum of 4-6 banks.

13 OTHERS

13.1 Recommendations

- For non-CDR restructuring, RBI may adopt International Federation of Insolvency Practitioners (INSOL)'s principle on 'priority to repayment of additional finance' in order to provide incentive for any additional financing provided by an existing or new lender. [Recommendation 4]
- The WG recommended that '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. Further, the WG also recommended that the accounts classified as NPA on restructuring by the bank should be upgraded only when all the outstanding loans/facilities in the account perform satisfactorily during this specified period, i.e. principal and interest on all facilities in the account are serviced as per terms of payment. [Recommendation 6]
- As the CDR cases involve multiple banks, the required implementation period of restructuring packages under CDR cases should be of 120 days from the *date of approval* of the restructuring package by the CDR mechanism. This recommendation will lose its relevance after full implementation of the withdrawal of regulatory forbearance. [Recommendation 12]
- The WG recommended that RBI may clarify that the cases of roll-over of short term loans, where proper pre-sanction assessment has been made, such roll-over is allowed depending upon the actual requirement of the borrower and no concession has been provided due to weakness of the borrower, then these might not be considered as restructured accounts. Further, a cap may be placed on the number of times that a short term loan can be rolled over say, not more than 2 or 3 times. [Recommendation 13]

13.2 Suggestions

- The extant IRAC norms are based on debt service default process. By the time this stage comes, the unit has already gone through stress for 1-2 years. Therefore, these norms needs to be modified to classify on the basis of stress signals to enable early detection of problems.

An intermediate category may be introduced in the IRAC norms which recognise this class of assets. This will result in early detection of problem and remedy.

- Prudential provisions and write offs should receive same tax treatment as actual write offs.
- There is a need to delink provisions and revival.
- Information frequency by CIBIL to be made monthly instead of quarterly as at present; RBI MIS requirement from banks to be correspondingly changed
- Fiscal concessions may be given for funds which invest for revival of assets with banks
- Emphasis should be laid on cash flows for revival packages
- Restructuring packages should be need based so they do not lead to competitive restructuring from other sectoral participants
- At times the lenders call for quotations for certain assets from ARCs. However, thereafter decide not to sell the asset. This information is used by them for price discovery for further negotiations with the borrower for one tie settlement etc. In such cases, the lenders should be required to make full provision in accordance with the price discovered.