

# Highlights and Rationale of the Recommendations of the Working Group To Review the Existing Prudential Guidelines on Restructuring

B. Mahapatra  
Reserve Bank of India

# Structure

- Approach of the working group
- Important recommendations and rationale
- Conclusion

# Approach

- **Recognition of restructuring** as
  - A legitimate banking practice
  - Societal point of view – protect the productive assets
- **Align** with international best practices
- Align with international accounting standards

- **Extraordinary rise in restructured standard assets** in recent years since March 2010

- (Rs. in lakh crore)

<u>Item</u>	<u>March09</u>	<u>March10</u>	<u>March11</u>	<u>March12</u>
• GA	27.94	32.72	40.12	46.55
• Std.	27.2	31.90	39.18	45.29
• RS	0.60	0.98	1.07	2.18
• GN%	2.44	2.50	2.35	2.94
• RS%	2.16	2.99	2.66	4.68
• Analysts add the last two ratios to analyse stressed assets				

- A rating agency says **by March 2013 restructured standard assets may touch Rs. 3.25 lakh crore**
- The Economist, August 18-24, 2012 – India's public sector **banks are sitting on something unpleasant (restructured standard loans)**
- The Economic Times of September 9, 2012 – **Completely defeating restructuring**
- The **credibility of Indian banking system** at stake

# Recommendations

# Regulatory forbearance

- Regulatory forbearance on asset classification – since 1999/2001 and enhanced in 2008 during the global financial crisis
- **International accounting standard** – IAS 39 and FAS 15 and 114 – restructuring as impaired
- **Basel II IRB** approach treats it as an event of default
- **Capital market and rating agencies** also treat as default

- Many other regulators like Australia, USA, France, etc. treat restructuring as impaired till sufficient evidence of good repayment behaviour
- **Therefore the working group recommended to align our prudential norms with international best practices and accounting standards by recognising restructured assets as impaired or withdrawing regulatory forbearance**

- Working group was sensitive to current domestic and global macroeconomic situation
- **Therefore, recommended to implement this recommendation after two years**
- The other options was to create a new asset class with higher provisioning or transitioning to the new asset class over two years with higher provisioning requirement in stages during the transition

# Provisioning buffer

- **Latent weakness** in restructured standard accounts
- FSR June 2012 – **15% may turn NPA**
- Restructurings have been done recently with long moratorium and repayment holidays – repayment behaviour not known
- The working group assumed a conservative and **stressful scenario** that **25-30% may turn NPA**

- Secured sub-standard asset provision is 15%
- **Working group therefore recommended 5% (4.5%) (i.e., 15% of 30%) as general provision for restructured standard assets as a buffer**
- The working group was sensitive to the immediate impact on banks' P & L account and **therefore calibrated it in phases – 3.5% in first year and 5% in second year for stock and 5% for flow from current 2%**
- To coincide with withdrawal of regulatory forbearance after two years

# Infrastructure loan restructuring

- Working group was sensitive to the need for infrastructure for country's development and lack of certainties in getting clearances by such entities
- Therefore, **recommended to continue with regulatory forbearance only on account of change in DCCO for some more time but with higher provisioning of 5%**

# Up-gradation in multiple facilities

- Extant instruction is one year from the date when first payment of interest or principal
- Some banks were up-grading one year after a small portion of FITL interest falls due, whereas the major portion of loan is under moratorium
- Australia – six months or 3 repayment cycles
- France – reclassified into a separate sub-category of performing asset till fully paid

- Working group had two options:
  - (1) One year from the first repayment of interest or principal, whichever is later, on the credit facility with longest moratorium, or
  - (2) Objective criteria of repayment, say 10% of the debt
- Working group thought the first option more prudent and recommended, provided the other facilities are also performing satisfactorily

# Distribution of losses

- Promoters' sacrifice
  - Observed to be not sufficient or commensurate with lenders' sacrifice
  - **Therefore 15% of lenders' sacrifice should be the bare minimum and banks may prescribe higher**
  - **Should be linked to quantum of loan – therefore 15% of lenders' sacrifice or 2% of restructured debt, whichever is higher recommended**

- **Personal guarantee of the promoter**
  - Exiting instruction – mandatory
  - However, in case of “external factors pertaining to the economy and industry” it was waived
  - Subjected to subjective interpretation
  - Working group thought that promoters should have **“skin in the game”** or commitment to the restructuring proposal and its viability. Therefore made it mandatory
  - Corporate guarantee is not a substitute for promoter’s personal guarantee

- Lenders' sacrifice - provision for diminution in fair value of restructured advances
  - Ambiguity observed
  - Illustrative examples to be given
  - For rural/small branches for loans up to Rs. 1 crore, 5% of restructured exposure to continue on a long term basis

- Conversion of debt into shares/preference shares
  - Banks were adversely affected in many cases
  - Akin to writing off the debt as preference shares carried zero or low coupon and no market value, no voting rights
  - Conversion into equity shares with high premium
  - **Working group recommended that there should be a ceiling / cap on such conversion, say 10% of restructured debt**

# Exit option

- Legal system has improved with DRT and SARFAESI
- “Carrot and stick” policy – if borrowers do not perform as per restructuring plan, banks should evaluate the exit option seriously

# Right of recompense

- Mandatory for CDR cases
- Compounded and 100% payable
- Exit from CDR not happening
- Working group recommended whether it can be made flexible – 75% recompense could lead to exit but 100% if loans given below Base Rate
- Made it mandatory for non-CDR cases also

# Assessing viability

- Viability is prime requirement for restructuring
- RBI had given **broad parameters** like ROCE, DSCR, IRR-COF, etc. But no benchmarks prescribed. CDR Cell has some benchmarks but in case of solo restructuring, banks decide on **benchmarks**
- Lack of skill at branches and controlling offices

- Time span given for restructuring too long – 10 / 15 years
- Working group recommended RBI to prescribe broad benchmarks and banks to adopt suitably for specific sectors.
- Time span for viability be reduced to 5 / 8 years

# Disclosure

- Presently banks are disclosing on a cumulative basis, even if the account has come out of restructuring
- Rationalised to drop from disclosure once account is no more subject to higher provisioning or risk weight, if applicable

# Roll-over of short term loan

- Roll-over of short term loans if assessed properly, and no concessions granted due to financial weakness of the borrower, need not be considered as restructuring, but such roll-over is restricted to 2 to 3 times

# Incentive for quick implementation

- CDR and non-CDR time period rationalised

# Repeated restructuring with negative NPV

- Repeated restructuring with negative NPV was considered not as an event of restructuring for CDR
- Facility withdrawn due to financial engineering adopted

# Conclusion

- Balance
  - international best practices and societal needs
  - Distribution of losses between lender and promoter
- Gradual and calibrated
- Rationalisation of CDR and non-CDR restructuring