Is strategic restructuring of debt the answer for banks?

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To reduce the stress on banks due to non-performing assets (NPAs), troubled accounts and burgeoning restructurings, the Reserve Bank of India (RBI) has introduced measures over the past 18 months. These include the framework for early detection of potentially stressed accounts before these turn into NPAs, the guidelines on constituting the joint lenders forum (JLF) and the mechanism for putting in place a "corrective action plan" (CAP) for stressed borrowers, and amendments to the guidelines on wilful defaulters.

The JLF-CAP framework encourages lenders to: (a) explore a transfer of equity from promoters to lenders to compensate lenders for their "sacrifice" (i.e. haircut); (b) ensure that promoters infuse more equity into the borrower; and (c) see that the promoters' shareholding is transferred to a security trustee or an escrow agent until the borrower is "turned around".

As a follow-up to the JLF-CAP framework, the RBI has now introduced the strategic debt restructuring scheme, with the overarching objective of implementing a change of ownership (of borrowers). It appears that the RBI has launched this scheme with the view that many borrowers cannot be "turned around" because of "operational/managerial inefficiencies despite substantial sacrifices made by the lending banks".

The framework prescribes that any restructuring package must specify timelines within which "viability milestones" are to be achieved by the stressed borrower, failing which the JLF should initiate "suitable measures" for recovery. To provide lenders with "enhanced capability" to initiate change of ownership for borrowers that fail to achieve such milestones, the scheme mandates the JLF to include provisions in the agreement with the borrower for conversion of the restructured debt into equity, and also requires the JLF to obtain all appropriate authorizations for such conversion upfront at the time of restructuring.

The scheme further prescribes that the conversion must result in the JLF lenders holding at least 51% of the shareholding of the stressed borrower, subject to the limit prescribed under section 19(2) of the Banking Regulation Act, 1949. The conversion must take place within 30 days of the review being conducted by the JLF where the above non-compliance of the borrower is noted.

With respect to the conversion price, the scheme prescribes that the conversion ratio must not exceed the borrower's market value (if it is listed) or break-up value (if it is unlisted). The scheme also prescribes a mechanism for determining these values.

Despite the scheme's detailed prescriptions, the decision to convert the restructured debt into equity is left to the JLF, on the basis of its assessment of the borrower's compliance with the restructuring terms and the borrower's achieving (or ability to achieve) the specified milestones. The decision to convert into equity must be supported by 60% of the JLF lenders as well as the JLF lenders that hold 75% of the restructured debt.

Under amendments notified this May, the conversion of restructured debt into equity (where the borrower is a listed company) has been exempted from the requirements of the Securities and Exchange Board of India's capital issuance regulations and takeover regulations.

In addition to enabling banks to acquire control of the borrower to implement a change in its ownership, the scheme also prescribes that the conversion of the restructured debt into equity will not be treated as a restructured account for the purposes of provisioning and asset classification. Further, on divestment of shareholding to a new promoter, the classification of the borrower will be changed to "standard" asset. This could indirectly (and unintentionally) encourage lax standards in credit appraisal by banks and client due diligence. Notably, by prescribing that the new promoter cannot be related to the previous promoters, the scheme seems to have reduced the possibility of collusion with existing promoters where shares of a restructured borrower are sold by its JLF lenders.

It is remarkable to see the RBI prescribe such a detailed set of instructions to banks on the conversion of restructured debt into equity. The introduction of this scheme appears to convey the RBI's increasing frustration with the persistent state of NPAs of the Indian banking system, and particularly those of public sector banks. The RBI's concern also appears to be motivated by the hypothesis that restructuring of stressed borrowers merely postpones their inevitable conversion into NPAs.

However, the conversion of debt into equity by itself is not a panacea for the Indian banking system because banks lack the expertise to operate a stressed borrower. Further, finding a "new promoter" to take over a stressed borrower is not easy and depends on factors such as the borrower's viability, its sector, the state of the economy, etc. The scheme's objectives are laudable and whether it can pass its litmus test is something that must be evaluated in the near term on the basis of the restructurings currently being implemented under the JLF-CAP framework.

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