RBI announces prudential framework for resolution of stressed assets

June 10, 2019

In brief

The Reserve Bank of India (RBI) recently released a prudential framework[1] for the resolution of stressed assets by banks. The fundamental principles of the framework are listed below –

i. Early recognition and reporting of default of large borrowers by banks, Financial Institutions (FIs) and Non-Banking Finance Companies (NBFCs);

ii. Complete discretion to lenders with regard to the design and implementation of resolution plans, in supersession of earlier resolution schemes (S4A, SDR, 5/ 25, etc.), subject to the specified timeline and independent credit evaluation;

iii. A system of disincentives in the form of additional provisioning for delay in implementation of resolution plan or initiation of insolvency proceedings;

iv. Withdrawal of asset classification dispensations on restructuring. Future upgrades to be contingent on a meaningful demonstration of satisfactory performance for a reasonable period;

v. For the purpose of restructuring, the definition of “financial difficulty” to be aligned with the guidelines issued by the Basel Committee on Banking Supervision; and,

vi. Signing of inter-creditor agreement (ICA) by all lenders to be mandatory, which will provide for a majority decision making criteria.

In detail

Prudential framework

Applicability

This framework would apply to the following lenders –

1. Scheduled commercial banks;
2. All India term FIs;
3. Small finance banks; and
4. NBFC-ND-SI and NBFC-D.

Special mentioned accounts categorisation

Lenders are required to classify the accounts immediately on default of principal of interest wholly or partly overdue or in case of revolving credit facilities, the outstanding balance remains in excess of sanctioned amounts. The accounts can be classified as special mention accounts (SMA)-0, SMA-1 and SMA-2.

Reporting

Lenders are required to report the credit information/ classification as SMA to the Central Repository of Information on Large Credits (CRILC) for borrowers having aggregate exposure of INR 50 million and above on a weekly and monthly basis.

[1] Press Release 2018-2019/2886 dated 7 June 2019

Resolution plan

a) The lenders must put in place a board approved resolution policy for resolution of stressed assets.

Once the borrower is in default of any scheduled commercial bank, all India term FIs or small finance banks, the lenders shall undertake a *prima facie* review of the borrower within 30 days of the default and may decide on resolution strategy, approach, etc. *With the introduction of the concept of review period, the lenders get an additional period of 30 days over and above the timeline as mentioned in the framework.*

b) In case lenders decide to implement the resolution plan, they will enter into an ICA during the review period, which would provide that the decision agreed upon by the following shall be binding on all lenders:

i. Lenders representing 75% of the value of total outstanding credit facilities; <u>*and*</u>

ii. 60% of lenders in number.

This is a new requirement where the decision-making is not only linked to the quantum of loan held by lenders but also the number of lenders.

c) The resolution plan should provide that dissenting lenders will not get less than the liquidation value due to them.

d) The framework also states that the ICA may provide for duties of lenders and protect the rights of dissenting lenders and treatment of lenders with priority in cash flows/ differential security interest.

Timeline

- The resolution plan should be implemented within 180 days from the end of the review period:
  - <u>INR 20 billion or more</u>: In case of accounts with exposure to scheduled commercial banks, all India term FIs or small finance banks with more than INR 20 billion, the review period shall commence from –
    - 7 June 2019 in case the account is already under default; or
    - Date of default after 7 June 2019.
  - <u>INR 15 billion and above but less than INR 20 billion:</u> In case of accounts with exposure more than INR 15 billion but less than INR 20 billion, the reference period to calculate the review period is 1 January 2020. Thus, the review shall commence from:
    - 1 January 2020 – in case the account is in default on that date; or
    - Date of default after 1 January 2020.

    This means that accounts between INR 15 to 20 billion, which are already in default have already been given an extended period from 7 June 2019 until 31 December 2019 to get their default rectified. If default still stands on 1 January 2020 the period of 30 + 180 days shall commence.
  - <u>Less than INR 15 billion</u>: The RBI has not yet announced the reference date for such accounts <u>and</u> thus in case of defaults in such accounts, they can continue to rectify the same until the date a reference date is announced for them.
- The resolution plan may involve any action, plan, reorganisation including, but not limited to, regularisation of the account by payment of all over dues by the borrower entity, sale of exposures to other entities, investors, change in ownership and restructuring.
- Resolution plans (RP) involving restructuring change in ownership shall require independent credit evaluation by credit rating agencies appointed by the lenders. Only such plans that receive a credit opinion of RP4 or better for the residual debt, shall be considered for implementation. *This would be relevant for PE/ strategic players who are trying to acquire companies in the pre-IBC mechanism and acquire ownership of the company. Their resolution plans need to obtain a credit opinion of RP4 for the residual debt. The change in ownership will also be deemed to be implemented when all documentation is completed, new capital structure is reflected in the books and no default subsists with any lenders.*
- Resolution plan that involves lenders exiting the exposure by assigning them to third party or a RP involving recovery action shall be deemed to be implemented only if the exposure to the borrower is fully extinguished. *This would be relevant for varied structures being adopted through asset reconstruction companies etc. The plan would be implemented only if*

the exposure to the borrower is fully extinguished.

Additional provisioning

- In case the implementation of resolution is delayed beyond 180 days, lenders must undertake an additional provisioning of 20% of total outstanding. If implementation is delayed beyond 365 days from the end of the review period, an additional provision of 15% is to be made of the total outstanding (i.e. total additional provisioning of 35%).
- These additional provisions can be reversed if:
    - The resolution plan involves payment of overdue by the borrower. Then only if there is no additional default for a period of six months from the date of clearing of overdue.
    - If the plan involves restructuring change in ownership outside IBC then upon its implementation.
    - If plan is pursued under IBC, then 50% when the application is filed under IBC and the balance when the application is admitted.

The lenders would have stringent criteria to evaluate and approve plans outside the IBC. In case the lenders believe that there is no viable plan being offered, they may be inclined to push the company into IBC to avoid additional provisioning norms. This effectively takes this framework back to similar lines as promulgated earlier in the 12 February 2018 circular[2] that unless a viable resolution plan is offered to lenders under the pre-IBC regime, then the companies would have to be pushed into IBC. The only difference is that under the 12 February 2018 circular[2] the lenders were statutorily required to pursue IBC at the end of the 180 day period. However, in this case, it is left to the commercial and economic judgment of the lenders. Lenders must undertake a balancing act between their commercial judgment of waiting beyond 180 day period versus additional provisioning requirements and supervisory review by the RBI.

Insolvency proceedings

Notwithstanding anything contained in this framework, wherever necessary, the RBI will issue directions to banks for initiation of insolvency proceedings against borrowers for specific defaults. This framework shall not be available for borrower entities for which specific instructions have already been issued or are issued by the RBI to the banks for initiation of insolvency proceedings under IBC. "Lenders shall pursue" such cases as per the specific instructions issued to them. With this, the RBI may continue to refer specific cases like 'top 12 cases' to IBC from time-to-time.

MSMEs

The above-mentioned provisions, except the SMA classifications and reporting requirements, shall not apply to MSMEs and they shall continue to be governed by the **Framework for Revival and Rehabilitation of Micro, Small and Medium Enterprises (MSMEs)** prescribed by the RBI *vide* RBI/ 2015-16/338 dated 17 March 2016.

Withdrawal of existing resolution structures

The extant instructions on resolution of stressed assets such as:

- Framework for Revitalising Distressed Assets;
- Corporate Debt Restructuring Scheme;
- Flexible Structuring of Existing Long-Term Project Loans;
- Strategic Debt Restructuring Scheme (SDR);
- Change in Ownership outside SDR; and
- Scheme for Sustainable Structuring of Stressed Assets (S4A)

stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum, as mandatory institutional mechanism for resolution of stressed accounts also stands discontinued. *This brings utmost clarity to lenders and companies that, no other traditional framework can be pursued by lenders in dealing with stressed assets except this framework.*

Prudential norms applicable to resolution plans

The key norms are as follows –

1. Asset classification: In case of restructuring, the accounts classified as "standard" shall be immediately downgraded as non-performing assets (NPAs), i.e., "sub-standard" to begin with.
2. Additional finance: Any additional finance approved under the resolution plan (including plan approved under IBC) may be treated as "standard asset" during the monitoring period under the approved plan, provided the account demonstrates

[2] RBI Circular no. DBR.No.BP.BC.101/21.04.048/2017 -18 dated 12 February 2018

satisfactory performance during the monitoring period. If the restructured asset fails to perform satisfactorily during the monitoring period or does not qualify for upgradation at the end of the monitoring period, the additional finance shall be placed in the same asset classification category as the restructured debt. *This is a critical factor for banks that are providing additional funding under the resolution plan proposed in IBC.*

3. Interim finance: Similarly, any interim finance extended by the lenders to companies undergoing IBC may be treated as “standard asset” during the CIRP. Subsequently, upon approval of the RP the treatment of such interim finance shall be as per the norms applicable to additional finance, provided above. *This clause may hamper situations where resolution professionals are trying to raise interim finance. The lenders would now weigh the possibility of failure of CIRP and consequent classification of interim finance provided by them.*

4. Conversion of principal into debt equity: Asset classification, provisioning and valuation norms would also apply to converted debt/ debentures/ bonds/ ZCBs/ LCBs issued as part of restructuring/ resolution plan. The framework also provides valuation norms for equity/ preference shares issued consequent to the resolution plan.

5. Change in ownership: In case of change in ownership of the borrower entity, the credit facilities of the concerned borrowing entities may be continued/ upgraded as “standard” after the change in ownership is implemented, either under the IBC or under this framework. If the change in ownership is implemented under this framework, then the classification as ‘standard’ shall be subject to the following conditions:

   a. Acquirer shouldn’t be disqualified under section 29A of IBC.

   b. ‘New promoter’ should not be a person/ entity/ subsidiary/ associate etc. (domestic as well as overseas), from the existing promoter/ promoter group (as defined in SEBI ICDR).

   c. The new promoter shall have acquired at least 26% of paid up equity capital as well as voting rights of the borrower entity and shall be the single largest shareholder of the borrower entity.

   d. The new promoter shall be in “control” of the borrower entity (‘control’ as defined in Companies Act and SEBI).

   e. The conditions for implementation of RP as provided in this framework are complied with.

6. Sale and leaseback transactions: A sale and leaseback transaction of the assets of a borrower or other transactions of similar nature will be treated as an event of restructuring for the purpose of asset classification and provisioning in the books of lenders with regard to the residual debt of the seller as well as the debt of the buyer, if the seller is in financial difficulty and more than 50% of the revenues of the buyer from the specific asset are dependent upon the cash flows from the seller and 25% or more of the loans availed by the buyer for the purchase of the specific asset are funded by the lenders who already have a credit exposure to the seller.

7. Refinancing of exposure to borrowers: If borrowings/ export advances for the purpose of repayment/ refinancing of loans denominated in same/ another currency are obtained from lenders who are part of the Indian banking system or with the support from the Indian banking system in the form of Guarantees/ SBLC / Letters of Comfort, etc., such events shall be treated as “restructuring” if the borrower concerned is under financial difficulty.

8. Regulatory exemptions: RBI Acquisition of non-SLR securities by conversion of debt is exempted from the restrictions and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI.

9. Acquisition of shares due to conversion of debt to equity during a restructuring process will be exempted from regulatory ceilings/ restrictions on capital market exposures, investment in para-banking activities and intra-group exposure. However, these will require reporting to the RBI and disclosure by banks in Annual Financial Statements and it will be subject to compliance with the provisions of section 19(2) of the Banking Regulation Act, 1949.

10. Regulatory exemptions – SEBI:

    a. Exemptions available under SEBI ICDR for restructuring as per regulations issued by the

RBI shall continue to apply.

b. A new pricing methodology is prescribed in the framework which shall apply with respect to sub-regulation 158(6)(a) of the SEBI ICDR. The reference date in such cases shall be the date on which the bank approves the restructuring scheme. In the case of conversion of convertible securities into equity, the "reference date" shall be the date on which the bank approves the conversion of the convertible securities into equities.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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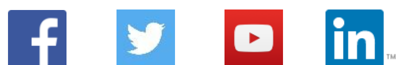

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