

Management & Resolution of Stressed Assets

WIRC ICAI

Knowledge series on Banking Pension & Insurance

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Existing environment

Stress in the banking sector continues as gross non performing advances (GNPA) continue to rise

GNPA for scheduled commercial banks may rise from 11.6% in March 2018 to 12.2% in March 2019

Eleven PSBs are under prompt corrective action

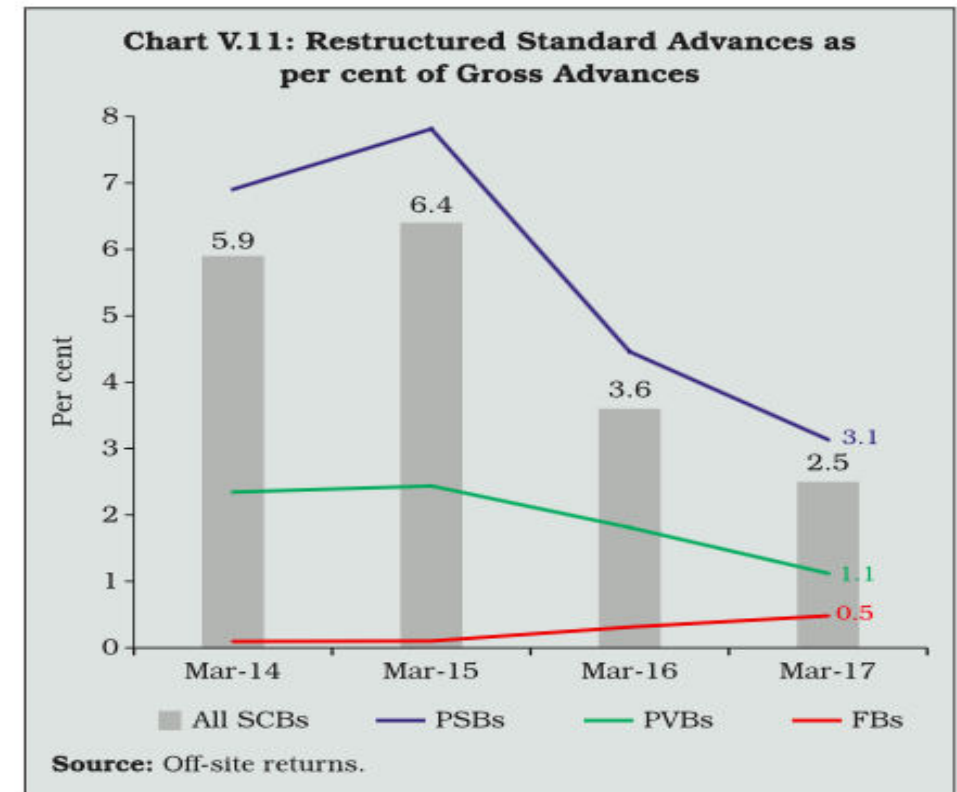
PSBs may see their GNPA worsen from 21% in March 2018 to 22.3% in March 2019, with 6 PSBs likely to fall below the 9% capital adequacy for risk weighted assets

Existing environment

Table V.14: Trends in Non-performing Assets – Bank Group-wise

(Amount in ₹ billion)

Item	PSBs*	PVBs	FBs	All SCBs#
Gross NPAs				
Closing Balance for 2015-16	5,400	562	158	6,119
Opening Balance for 2016-17	5,400	562	158	6,120 [^]
Addition during the year 2016-17	3,275	814	66	4,157
Recovered during the year 2016-17	1,000	237	36	1,274
Written-off during the year 2016-17	827	207	51	1,085
Closing Balance for 2016-17	6,847	932	136	7,918
Gross NPAs as per cent of Gross Advances**				
2015-16	9.3	2.8	4.2	7.5
2016-17	11.7	4.1	4.0	9.3
Net NPAs				
Closing Balance for 2015-16	3,204	267	28	3,498
Closing Balance for 2016-17	3,831	478	21	4,331
Net NPAs as per cent of Net Advances				
2015-16	5.7	1.4	0.8	4.4
2016-17	6.9	2.2	0.6	5.3



Source: RBI report

Large borrowers with exposure more than INR 50m accounted for than 86% of all NPAs while they constituted 56% of total advances

Existing environment

Table V.15: Classification of Loan Assets – Bank Group-wise
(As at end-March)

(Amount in ₹ billion)

Bank Group	Year	Standard Assets		Sub-Standard Assets		Doubtful Assets		Loss Assets	
		Amount	Per cent*	Amount	Per cent*	Amount	Per cent*	Amount	Per cent*
PSBs#	2016	52,875	90.7	2,005	3.4	3,232	5.5	163	0.3
	2017	51,816	88.3	1,731	3.0	4,904	8.4	213	0.4
PVBs	2016	19,184	97.2	186	0.9	311	1.6	62	0.3
	2017	21,748	95.9	310	1.4	519	2.3	90	0.4
FBs	2016	3,606	95.8	62	1.6	60	1.6	36	0.9
	2017	3,304	96.0	40	1.2	83	2.4	14	0.4
All SCBs	2016	75,666	92.5	2,252	2.8	3,603	4.4	260	0.3
	2017	76,868	90.7	2,081	2.5	5,505	6.5	316	0.4

Notes: 1. Constituent items may not add up to the total due to rounding-off.
2. *: As per cent to gross advances.
3. #: Includes IDBI Bank Ltd. and Bharatiya Mahila Bank.

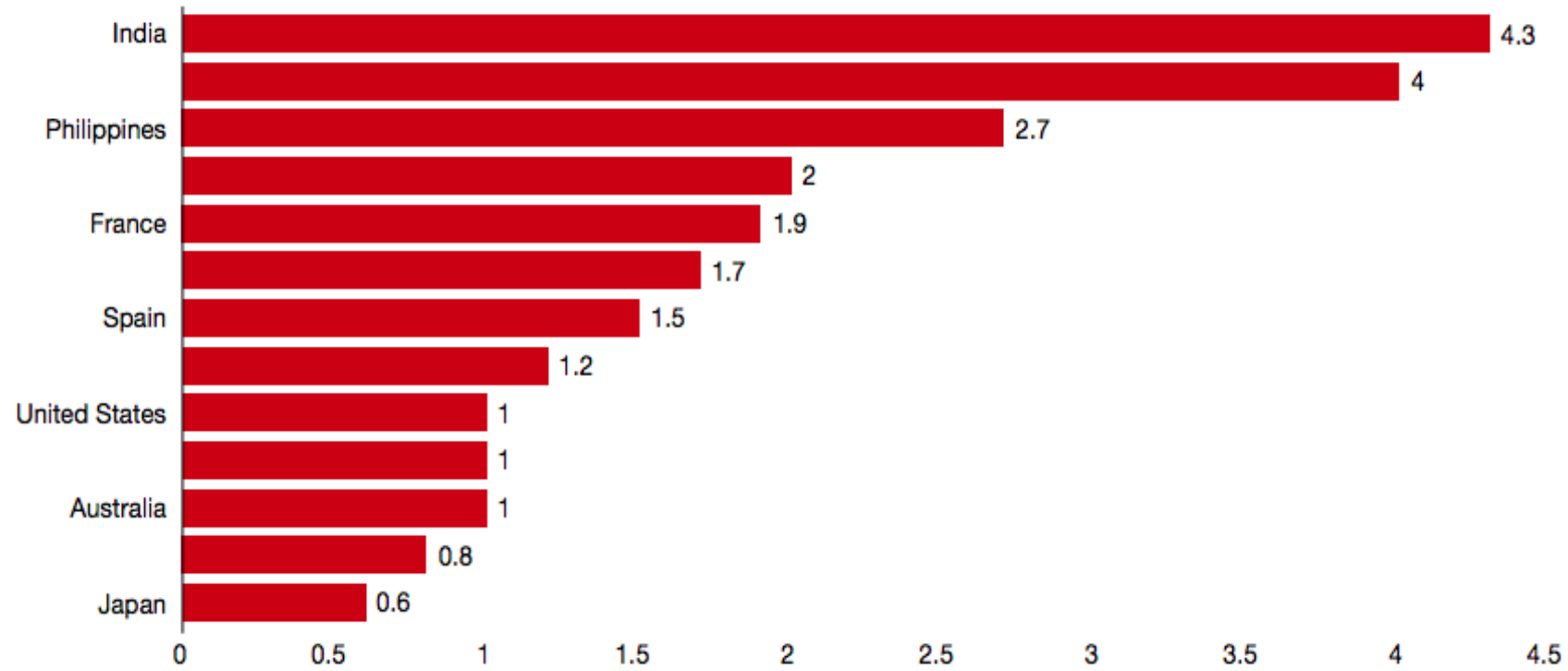
Source: Off-site returns.

Source: RBI report

As of March 2017, for all SCBs, total stressed accounts is approx INR 800,000 cr

Existing environment

No immediate resolution for insolvency



Source: World Bank's Doing Business 2018 report

Time taken in years to resolve insolvency -->

NPA resolution in India is tedious, complex and time consuming

Early Signs - Early warning signals (EWS)

EWS need to be identified and dealt with at the right time. A robust EWS monitoring system can reduce future slippages

Some of EWS are:

- SMA1, SMA2 reporting (reporting on a monthly basis except cases of INR 50m and above where reporting should be on a weekly basis)
- longer debtor/inventory days,
- leverage ratios,
- fall in margins,
- debtors due for more than 180 days*,
- devolved LC/BGs

***In one of S4A cases, debtors due for > 2-3 years, the oversight committee (OC) refused to consider them as eligible source of repayment for non sustainable portion**

It is at this stage that a forensic audit should be done to identify leakages, diversions

Management & Resolution of Stressed assets

There are 5 broad ways to deal with stressed assets:

1. Restructuring
2. One Time Settlement
3. Enforcement of Security
4. Litigation (including IBC)
5. Sale to ARC

Restructuring

This involves an act by the lender, for economic or legal reasons, to offer concessions to the borrower

This involves:

- re-evaluating cashflows to assess repayment ability, extending tenor, moratorium
- increasing / decreasing the coupon (interest rates), one time fee
- taking additional security
- taking promoter / corporate guarantees, where possible
- Regulatory approvals, where applicable (ECBs)
- revised documentation

To qualify for upgrade to standard, apart from satisfactory performance, for accounts more than 100cr, satisfactory investment grade rating by CRA (accounts more than 500cr, two ratings by CRAs)

Failed restructuring - promoter brought in the desired funds (about INR 500cr) but banks failed to release their share of additional financing..who is to blame?

Restructuring..continued

Multiple rollovers not allowed for fixed tenor loans, ever-greening not allowed

Extension of loans/facilities if the borrower is being reported as SMA2 being questioned

Under the Feb 2018 circular, sale & lease back transaction of an asset qualifies as restructuring if:

- seller of assets in financial difficulty
- 25% or more of the loan availed by the buyer is funded by lenders who have also lent to seller
- > 50% of the revenue of the buyer(lessor) for that asset is dependent on the seller (lessee)

Borrowers who have committed fraud/wilful default will be ineligible for restructuring

Case study: In 2007, there was an expectation that the company would default on its FCCBs, hence they were trading at a 60% discount. Under a successful restructuring, the company borrowed debt to the extent of the 40% market price and extinguished 100% of the FCCBs

One Time Settlement (OTS)

The OTS is a popular and useful tool used by bankers to arrive at a settlement with the defaulting borrower/promoter

- Typically, after weeks (or months of negotiation), an amount is agreed with the promoter
- The bank would normally agree on an upfront amount in lieu of a steep haircut (normally $\geq 50\%$)
- Such settlements normally agreed when future recovery options look bleak, no further costs/resources to be allocated

The amount is expected to be paid between 3-6 months, failing which the bank reserves the right to revert to the original repayment obligations, adjusted for payments already made

One has to justify that the NPV of the OTS is more than the NPV of future cashflows or NPV from security realizations

OTS can vary from upfront cash to payment over 24 months with clawback options

Enforcement of security

Most of the lending is generally secured by current assets or fixed assets (*in today's IBC scenario, unsecured creditors get almost nothing*)

In terms of security enforcement, timing is very important - anything more than 6-12 months (other than real estate) leads to value destruction

In stress, current assets evaporate quicker than fixed assets (debtors fail to pay/ inventory is scrap)

Fixed assets generally have a value, but the right buyer is required

The most effective tool available to banks is SARFAESI (Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act)

SARFAESI...continued

Under SARFAESI, banks can take over asset securities of defaulting borrowers, third parties

General steps involved:

- Notice to Borrower/Owner
- Obtain latest valuation
- Fix Reserve Price
- Newspaper advert
- Auction process

In SARFAESI of commercial property, supreme court stay as tenant claimed rights. Matter delayed for more than 2 years

SARFAESI of brands such Kingfisher Airlines, Nakshatra diamonds have not yielded any results

Enforcement of security..some examples

Exclusive term lender with fixed assets including land and building, security cover of more than 4x, no buyers

About 80 properties of 5 group companies cross collateralised between 8 banks, very difficult to enforce

Security of ships, 2.5x cover at the time of default. Since no action taken by the bank or the promoter, vessels have been lying unmanned for the last 3 years - zero recovery

Litigation

The not so preferred but widely used method is to initiate litigation against defaulting 'obligors'

Litigation could be

- Recovery suit in Debt Recovery Tribunal (DRT)
- Winding up petition in High Court
- Summary Suit in relevant court (enforce cross border judgements)
- Insolvency & Bankruptcy Code 2016
- Sec 138 cases for cheque bounce

Litigation needs to be initiated before expiry of limitation (3 years)

Litigation...DRT

This involves filing an application before the tribunal with necessary supporting, documentation etc

Application involves history of when the loan was disbursed, how the facility was enhanced and current status of default

Application generally makes the borrower, corporate and personal guarantors as defendants

Prayers to the tribunal include (apart from request for payment)

- Promoters submit a net worth statement, restraining orders on disposing of security
- Generally individual banks file and the matter is jointly heard

Litigation...Winding up petition in High Court

This involves filing an application before the High Court with necessary supporting, documentation etc

Application involves history of when the loan was disbursed, how the facility was enhanced and current status of default

Application against the borrower or a corporate guarantor

Prayers to the include:

default has occurred, borrower/guarantor unable to pay, risk of assets being alienated, hence company to be liquidated

This serves as a effective tool to bring the promoter to the discussion table. However, process is long and takes 2-3 years for matters to come up for hearing

Litigation...Summary Suits

This involves filing an application before the Court to enforce a judgment by an international bench

Sometimes, documents are under English Law and enforceable under the Courts of England, Singapore etc

An example when a suit was filed in Singapore and a judgement obtained against the promoter

Background checks indicated that promoter does not have assets in Singapore, so the decision was to enforce the judgment in India

Filed summary suit in India

However, the judgement needs to be from Judge/Court and not from a lower level practitioner/secretary.

Although the International judgement recorded that the defendants lawyers had no instructions to oppose, the matter could not be pursued in India

Economic Offenses Wing (EOW) / Inspecting Officers

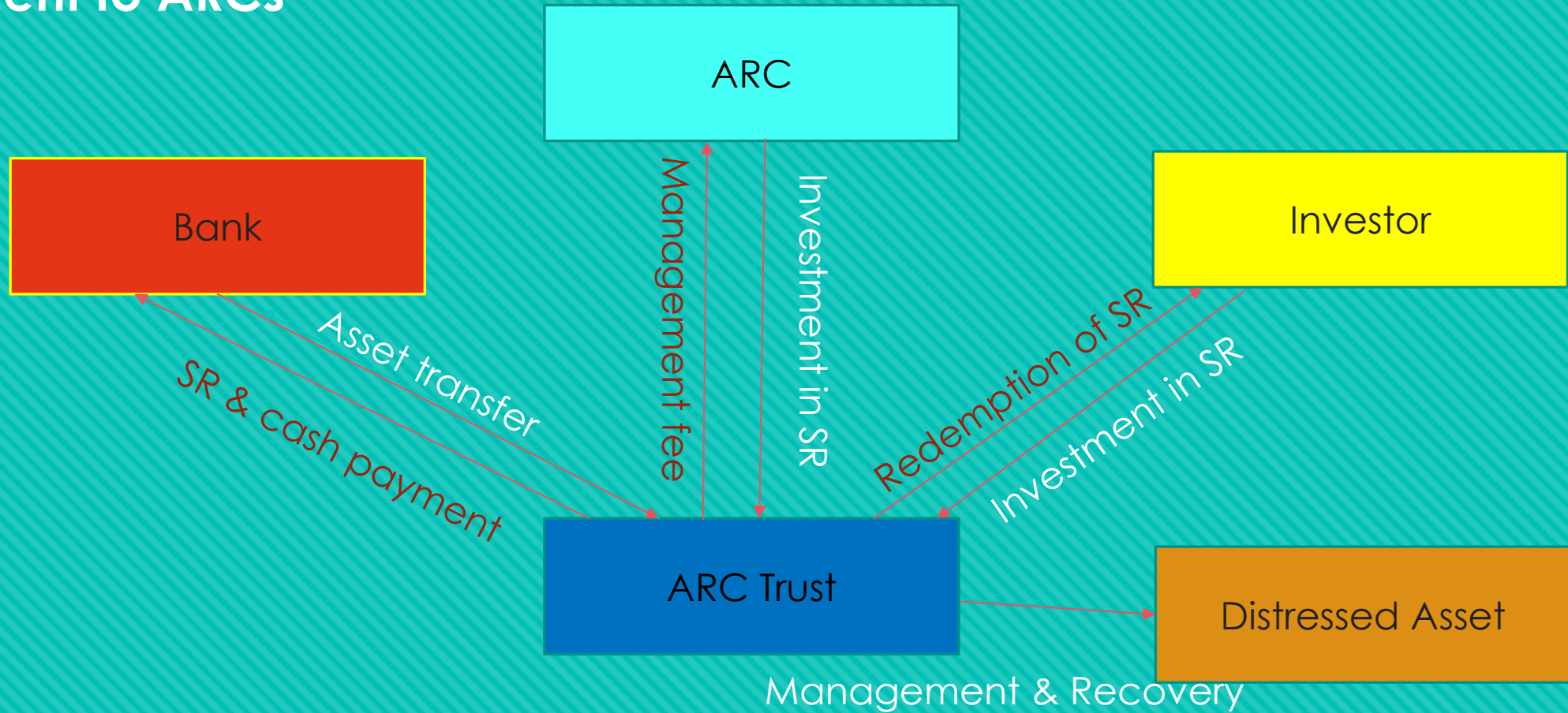
This is used when there are/suspected frauds, diversion of funds, absconding promoters

Application is made to EOW to investigate the matter with detailed supportings, documentation etc

Other supporting include

- Last 5 year bank statements
- Last 5 years financial statements, indicating dividend etc paid to group companies when bank debt was kept in default
- Personal statements from account manager handling the account, Credit approver, approval process of the banks including approval/lending policy and credit analysis at the time of loan sanctioning

Assignment to ARCs

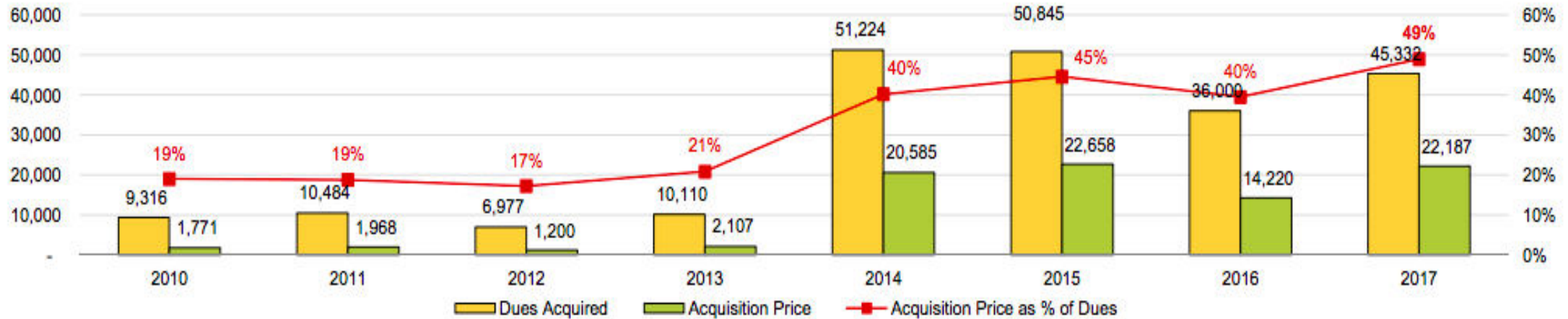


ARCs are effective entities involved in the aggregation and resolution of stressed assets (currently 24 ARCs registered with RBI)

Assignment to ARCs

Sale of Assets to ARCs

Rs Crore



NPA sale to ARCs to increase as Banks attempt to clean books faster aided by Regulatory push

Source: JM Financial

A win-win for Banks and ARCs

Acquisition price includes Cash & SRs. Currently, ARCs have to invest 90% cash upfront, else the selling bank does not get the benefit of the asset transfer

Assignment to ARCs

RBI has a specific processes to be followed for this sale:

Steps involved:

Identification of potential sale accounts and maintaining an 'Available for Sale' list to be maintained

Two external valuations for exposures more than INR 50 cr (costs to be borne by the bank)

If offer received from ARC for more than 30% of outstanding in cash, then follow Swiss Challenge method, which involved giving preference to an ARC who has already aggregated more than 25% of debt

Wilful defaulter

This is another effective tool used to deal with shady promoters. A mere notice threatening to consider the promoter/guarantors as willful defaulters brings them forward for discussion

Considerations for willful default include:

- default in payments even when it has the capacity (ability but not willingness to repay)
- diversion of funds
- not used borrowed funds for stated purpose
- diluted security which is secured to the Bank

Specific RBI guidelines on how to declare willful defaulter. This includes evaluation by a review committee, give the promoter a chance to be heard and present his case, final decision by the approval committee

Under IBC, willful defaulters are in-eligible to submit resolution plans

Wilful defaulter..how do you evaluate for diversion/fraud?

Borrower was a supplier to top car manufacturers like Maruti Suzuki, Tata Motors, Eicher etc

Banks granted a bill discounting facility to the borrower, granting upfront cash against payments to be received from Maruti, Eicher etc

Banks to be notified if there was a dispute

On due date, money received from Maruti to be paid to the Banks

On investigation, the consortium had reason to believe that the funds were received but not used to repay the banks

Practical aspects of the IBC

Pioneering space for viable businesses - Unlike SARFAESI, IBC provides for distinction between bankruptcy and insolvency, providing a time bound chance for companies to turn around

Shift control to creditors - IBC is at par with Insolvency laws in UK, Canada and Australia in terms of shift of control to creditors post default, unlike US, where control continues to be with debtor

Can be initiated on payment default - does away with redundant BIFR laws such more than 50% net worth eroded for reference to BIFR. In mature markets, you can initiate insolvency on covenant defaults

The code brings Indian and foreign creditors at par, unlike any existing recovery laws

Practical aspects of the IBC

Priority Funding / Interim Finance

The Resolution Professional (RP) can seek interim finance to keep the company operational. Banks have been hesitant to give additional finance to NPA accounts. Normally, additional finance to NPA accounts qualifies as NPA from day 1...what under IBC?

In terms of priority in liquidation, this finance ranks senior to all other debt, including secured bank debt and statutory dues...this is the first of its kind in India in terms of waterfall.

For non operational companies, the RP is finding it difficult to raise such financing

Its a one way street - once the application is admitted by NCLT, it cannot be withdrawn - recent changes include that if 90% of creditors agree, the matter can be withdrawn, only before EOIs have been sought

Practical aspects of the IBC

For the first time, we are seeing resolution of big accounts. However, operational creditors have threatened to stop supplying materials for a company which has been resolved. How successful can we expect the resolution to be?

It has a domino effect on the business, once the advert is published that the company is under IBC, creditor automatically stop giving further credit.

As an unsecured creditor, very limited chance that you will recover anything. The funding market for unsecured loans / bonds will practically vanish

Promoters fear that they will lose control of the company, hence coming forward for settlements and clearing old dues. The Sec 29A eligibility test is an effective tool to prevent defaulting promoters to bid for companies. Should you be eligible on ICD, resolution submission date?

Practical aspects of the IBC

As a minority secured creditor, very limited chance to swing things your way. Once 75 (66%) of the financial creditors by value decide on a resolution plan, then you have to accept it or walk away with liquidation value. If companies have been non operational for 2-3 years, value of assets is only paper value

For EPC companies, no major assets, hence liquidation value is almost negligible

For Shipping companies, liquidation value evaluated on the Insolvency Commencement Date (ICD), however, once company is under IBC, the ships get arrested and remain idle for 270 days. Hence liquidation value is much lower

Tax liability on loan waivers - Waivers & concessions granted by lenders could result in MAT (c. 18.5%) for the Corporate Debtor

RBI intervention - Feb 2018 circular

All schemes such as S4A, SDR, 5/25, JLF, CAP abolished

Borrowers with exposures more than INR 2000 crores to implement a resolution (approved by all banks) within 180 days of March 1, 2018 failing which the account to be compulsory referred to IBC)*

Emphasised on early identification - SMA0, SMA1, SMA2 (EWS)

As soon as there is a default, all lenders to initiate steps to cure the default

Accounts more than 100Cr, Independent Credit Evaluation (ICE) by credit rating agency (CRA).
Accounts more than 500cr, ICE by 2 CRAs with sustainable debt rating

RBI directs banks to refer the dirty dozen to IBC –Cases such as Bhushan Steel, Bhushan Power, Essar Steel, ABG Shipyard, Amtek Auto, Monnet Ispat, Lanco etc

Under IBC, Secured Exposure - 50% provision and unsecured exposure - 100% provision

*for less than 2000cr, timelines for resolution will be announced by RBI over a 2 year period

Government intervention – Project Shashakt - July 2018

For loans above INR 500Cr

- An AMC would be set up by state run banks to focus on resolution & recovery
- Multi sector specific AIFs would be set up which would raise funds from domestic and international investors and invest in the stressed assets bought by existing ARCAs
- The ARCAs will use these fund to redeem SRs issued to banks against bank loans
- The Government will not interfere in the Resolution Process
- The ARCAs after buying the asset will transfer ownership to the AIF
- AMC – AIF will hold upto 76%, Promoters will be allowed to retain 24% in such companies

For loans between INR 50-500cr

- a Bank Led Resolution Approach (BLRA) has been recommended, wherein financial institutions will enter into inter-creditor agreements to authorise the lead bank to implement a resolution within 180 days
- Incase no resolution within 180 days, then refer to IBC

For loans upto INR 50cr

- Banks to create a focussed vertical for management of stressed assets for priority resolution of SMEs, with a deadline of 90 days

Importance of relationship with the promoter

This is one of the most important aspects, often underestimated

You have to decide how thick skinned is the promoter, what is the tone of engagement

Live examples of promoters having gone out of their way to settle, after 2 years of chasing.

Litigation without relationship will not yield the most optimum result

Case Study

A auto manufacturer (cars / scooters) is in default with banks for about INR 200cr. Bank A share is 25%.

Since last 2 years, no principal and interest servicing. Current EBITDA is about INR20cr pa – just enough to service interest

Long term prospects of the industry are favourable...borrower profile expected to improve

2 banks have agreed on an OTS for c. 30% of their dues. Will you accept an OTS for a similar 30% repayable over 24 months. If not OTS, the option is to continue and hope that he will repay you

No major assets, so no scope of recovering from SARFAESI etc

Decision to be made: Accept OTS, restructure and/or initiate litigation?

There is a risk that the 4th bank may take the borrower to IBC, payments to Bank A may get reversed as preferential transactions under IBC

What if borrower is also a wilful defaulter...will you trust him and accept the OTS?

Thank You

Note: The presentation is for discussion purpose only and should not be construed as advice

Views expressed are entirely personal

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