Keeping in mind the poor condition of project debt servicing in India and to prevent misuse of the restructuring mechanism, the RBI has, via the Circular, brought about a more stringent regime for restructuring of debt

Banks tend to restructure some distressed loan accounts instead of classifying them as non-performing assets (**NPAs**) so as to avoid provisioning (i.e., setting aside a specific portion of their revenue to make up for the loss that could arise from potential default) for such loans. In the financial year 2012-13, restructuring of distressed loans was at an all-time high of 764.7 billion.

To address this, the Reserve Bank of India (**RBI**) formed a working group (**Working Group**) under Mr. B. Mahapatra, an Executive Director of the RBI, to review the existing framework for restructuring. On the basis of the recommendations given by the Working Group, the RBI issued a circular on May 30, 2013 prescribing certain changes to the then prudential guidelines on restructuring of advances by banks and financial institutions (**Circular**).

Amongst others, the Circular has increased the rate of provisioning for restructured accounts from 2.75% to 5%, and has also stipulated that restructured accounts be classified as sub-standard or as an NPA (except in certain prescribed exceptions). The Circular also casts a duty on banks to ensure that restructured accounts achieve viability within 8 years and 5 years of restructuring for infrastructure loans and non-infrastructure loans, respectively.

Classification of restructured loans

The Circular makes it mandatory for banks to classify restructured loan accounts as sub-standard accounts or NPAs from April 1, 2015. An exception to the above is loans to infrastructure and non-infrastructure projects, where the only change is the change in the date of commencement of commercial operation (**Commencement Date**) within 2 years from the original Commencement Date in case of infrastructure projects, and within 1 year from the original Commencement Date in case of non-infrastructure projects.

Further, a mere extension in the Commencement Date of commercial real estate projects will not result in their classification as sub-standard accounts or NPAs. The above exception is subject to the conditions that the revised Commencement Date falls within a period of 1 year from the original Commencement Date, and there is no change in any other terms and conditions of the loan except for changes in the repayment schedule and loan servicing requirements.

The Circular also prescribes that the extension of Commencement Date of a private public partnership (**PPP**) account due to a shift in the 'Appointed Date' (as provided in the concession agreement) will not be treated as restructuring if (a) the project is an infrastructure project under the PPP model awarded by a public authority, (b) the loan disbursement is yet to begin, (c) the revised Commencement Date is documented through a supplementary agreement between the borrower and the lender, and (d) the project viability has been reassessed and sanction from the appropriate authority has been obtained.

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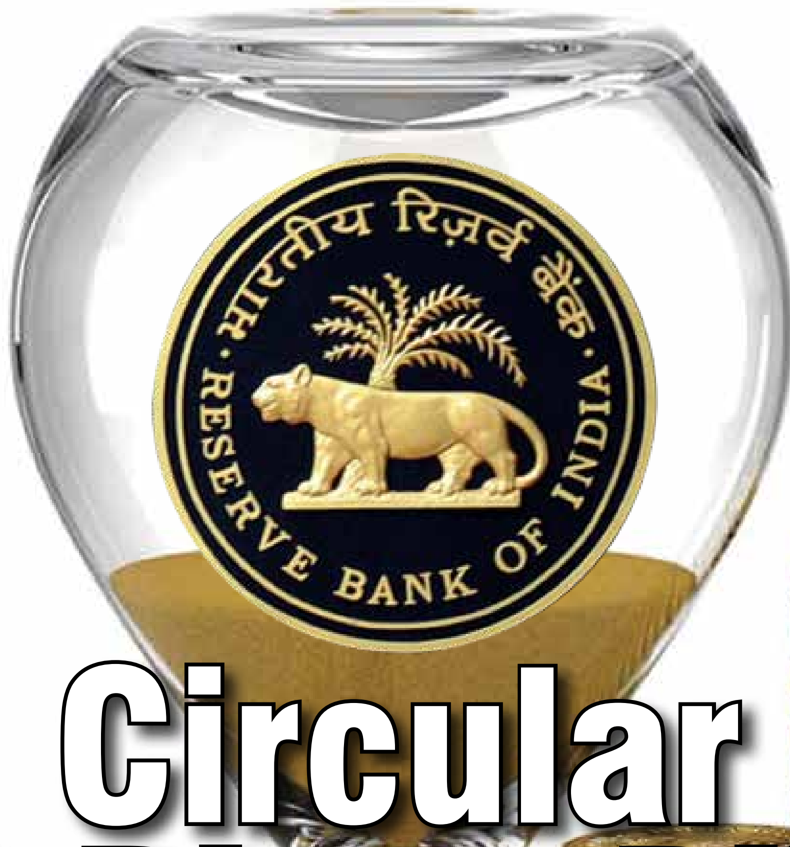

Circular A Bitter Pill

The Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances issued on July 2, 2012 (**2012 Master Circular**) had prescribed that commercial operations in respect of non-infrastructure projects were to commence within a period of 6 months from the original Commencement Date to avoid classification of such loan account as an NPA. The Circular relaxes this period to 1 year from the original Commencement Date. The Circular also permits banks to prescribe a fresh Commencement Date if there is a delay in commencement of commercial operations beyond the above stipulated period of 1 year from the original Commencement Date. However, any such fresh Commencement Date prescribed by a bank should not exceed a period of 2 years from the original Commencement Date. The above are reflected in the updated Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances issued on July 1, 2013 (**2013 Master Circular**).

The Circular requires promoters to have "skin in the game" by making it mandatory for promoters to furnish personal guarantees in respect of the restructured account

Provisioning norms increased

The Circular has increased the rate of provisioning for new restructured standard accounts from 2.75% to 5% commencing from June 1, 2013. For all restructured standard accounts as on March 31, 2013, the Circular prescribes that this increase in provisioning will be in a phased manner: to 3.50% (with effect from March 31, 2013 spread over the four quarters of 2013-14); to 4.25% (with effect from March 31, 2015 spread over the four quarters of 2014-15); and to 5% (with effect from March 31, 2016 spread over the four quarters of 2015-16).

The Circular has also advised banks to capture the diminution in fair value of restructured accounts correctly, as this would impact the provisioning required to be made by them.

Rolling over of Short-Term Loans

The Working Group had recommended that rollover of short-term loans should not be considered as restructuring if proper pre-sanction assessment had been made by the lending bank, and the rollover was done on the basis of the actual need of, and not the credit weakness of, the borrower. However, the Working Group had also recommended that in the case of an account that had been rolled over twice already, the third rollover would result in the account being classified as a restructured account.

While incorporating the above recommendations, the Circular has clarified that working capital loans like revolving cash credit or working capital demand loans would not be considered as short-term loans for the purpose of this provision of the Circular.

Cap on converting debt into equity

Prior to the Circular, except for Section 19 of the Banking Regulation Act, 1949, there was no restriction on banks converting debt into equity/ preference shares pursuant to restructuring. Pursuant to the recommendation of the Working Group, the Circular prescribes that only up to 10% of the restructured debt (subject to the abovementioned statutory ceiling) should be converted into equity/ preference shares, and that conversion of debt into preference shares should be done "only as a last resort". Additionally, conversion of debt into equity pursuant to restructuring should only be done for listed companies.

Upgradation of NPAs

The 2012 Master Circular provides for upgrading restructured accounts that have been classified as NPAs on restructuring. Such NPAs, as per the 2012 Master Circular, are eligible for upgradation to the 'standard' category on satisfactory performance during a 'specified period'.

The Circular has adopted the recommendations of the Working Group to define the specified period (in case of restructuring of

multiple facilities) as a period of 1 year commencing from the date of the first payment of interest or principal (whichever is later) on the facility with the longest moratorium period as per the terms of the restructuring package. Additionally, the Circular also prescribes that any upgradation can only occur when principal and interest payments on all outstanding facilities of the restructured account are serviced during the specified period in accordance with the terms of the restructuring. These changes have been reflected in the 2013 Master Circular.

Skin in the game

Personal Guarantees

The Circular requires promoters to have *"skin in the game"* by making it mandatory for promoters to furnish personal guarantees in respect of the restructured account. Corporate guarantees have been ruled out by the Circular, except in cases where promoters are bodies corporate rather than individuals, or where such individual promoters cannot be clearly identified.

Promoters' Contribution

While the Working Group had recommended that promoters bring in additional funds to the extent of the higher side of 15% of the diminution in fair value of the advance or 2% of the total restructured debt, the Circular has stipulated a higher percentage of 20% of the diminution in fair value of the advance or 2% of the total restructured debt (whichever is higher) as the additional funds that are to be brought in by the promoter for restructured accounts.

The above is the minimum threshold, and banks have been given the liberty to require a higher percentage depending on the risk-level associated with the project and the ability of the promoter(s) to bring in a higher amount of money. Additionally, while the Working Group had recommended that additional funds can be brought in by the promoters in two phases to provide time to the promoters to raise their part of the contribution, the Circular stipulates that such additional funds have to be brought in upfront at the time of restructuring.

Conclusion

Keeping in mind the poor condition of servicing of project debt in India and also to prevent the misuse of the restructuring mechanism, the RBI has, via the Circular, brought about a more stringent regime for restructuring of debt. Since many companies in India are promoter driven, the increase in promoters' contribution is expected to halt the current debt spree of Indian companies. The Circular is also expected to result in the breaking of the ever-expanding debt cycles that Indian companies indulge in, and more sustainable debt cycles becoming the practice rather than the recommendation.

While these norms may appear unreasonable, especially at a time when the corporate sector in India is grappling with many crises (indeed some have even complained that these norms may lead to an increase in the number of bad loans!), it must be appreciated that this has been done with the ultimate aim of strengthening the Indian banking sector.

***Disclaimer** – The views expressed in this article are the personal views of the authors and are purely informative in nature.*