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The Phenomenon of
Corporate Debt Restructuring
in India: How Far Can It Go
To Prevent Insolvency?

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THE PHENOMENON OF CORPORATE DEBT RESTRUCTURING IN INDIA: HOW FAR CAN IT GO TO PREVENT INSOLVENCY?

Introduction

The International Monetary Fund recently observed that Indian corporate entities are among the highest leveraged in the Asia Pacific region. Recent Reserve Bank of India (RBI) data shows that non-performing loans (NPLs) have almost doubled from 2.2% in March 2009 to 4.5% in March 2014 of the total loan portfolio of the Indian lenders. The rising incidence of NPLs has been continuously on the rise due to the economic slowdown post the global meltdown in 2008. Although India outperformed expectations riding through the global economic slowdown relatively unaffected, it's exposure to the crisis was unavoidable. Ultimately, with economic growth slowing down, delay in implementation of projects and rate of interest going up sharply, corporates have been under tremendous financial stress and have been finding it difficult to repay loans.

This paints a grim situation where the corporates are facing tough times and may even face liquidation. In order to avoid liquidation of the company, which has far-reaching adverse impacts both financially and socially, the borrowers seek to renegotiate with their lenders regarding modification of the terms of their loans. In fact, the lenders too might seek a reschedulement to minimise the losses and reduce non-performing loans. This action of the corporate leads to what is popularly called 'debt recast' or 'corporate debt restructuring'. To prevent bankruptcies, in 2001, the RBI came up with Corporate Debt Restructuring (CDR), a mechanism that companies unable to pay off debts can use to stay solvent, restructure and finally revive.

Indian Banks sought to restructure over \$40 billion of corporate loans in the two fiscal years from April 2012 to March 2014 through the CDR forum. This debt was greater than the cumulative amount of debt restructured under the forum since its inception in 2001.

Restructuring & Insolvency regime in India

When corporates in India are confronted with financial distress, they have to consider a number of options to achieve restructuring or liquidity. There is no single comprehensive and integrated policy on corporate insolvency and restructuring in India comparable with Chapter 11 or Chapter 7 of the US bankruptcy code. There are five broad ways for them to attempt to achieve the desired results. These include winding up under Companies Act 2013 (which recently replaced Companies Act 1956), arrangements or compromises under the Companies Act 2013, restructuring under the Sick Industrial Companies Act (SICA) and Reconstruction of assets under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act. Lastly, debt restructuring as per the RBI guidelines on CDR provides an important procedure to address these concerns.

The objective of the CDR framework is to ensure a timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of SICA and Companies Act and other legal proceedings, for the benefit of all

concerned. In particular, the framework aims at preserving economically viable corporates that are affected by certain adverse internal or external factors and minimize the losses to the creditors and other stakeholders through a coordinated restructuring programme.

Why Debt Restructuring?

In the Indian corporate world, CDR has been grabbing constant media-attention in the past 2-3 years. With a formalized CDR system and an increasing number of corporates taking refuge under its provisions, CDR has established a strong foothold in the fields of banking and finance. The total amount of cumulative debt that has been referred to the CDR cell alone amount to about \$80 bn and this does not include the bilateral debt restructuring with banks which is also happening at a very fast pace. As per a recent media report, it is estimated that debt restructured under CDR amounts to just 30% of the total debt restructured in India in FY 2014. Let's try to see why Indian corporates are leaning so much towards debt restructuring?

An Example: How Debt Restructuring Scores Over Other Remedies

Assume that there is a Company which has an outstanding debt with lenders –A ,B & C, which it cannot service.

From Company's point of view

The company can pursue a few courses of action in such a situation. It can consider the following options:

- ✓ *Option 1* - Re-financing, i.e. replace high cost debt with low cost debt in the hope of turning profitable and to pay off its original debts. However, if the Company is already in stress, it may not be in a position to sustain such levels of debt even at marginally lower interest rates. Further, the interest rates in India are already at a high level and the real returns from the asset in distress might not be sufficient to cover even the interest burden at lower rates.
- ✓ *Option 2* – The Company can go for restructuring under the Companies Act 2013. But this is long and time consuming exercise where it is difficult to bring all the creditors on the same boat. Moreover, the process requires Court approval, and any complications may result in court cases being dragged on for years.
- ✓ *Option 3* – The Company may take refuge of SICA. However, it can do so, only when as per the law's definition, the company is "sick" i.e., the Company's losses exceed its networth. This stage is too late and it practically makes any meaningful restructuring or reconstruction impossible.
- ✓ *Option 4* - Another way out could be for the Company to cease its operations and to undergo winding up or go for distress sale. This has the obvious defect of causing a premature death of the company's existence. Moreover, the value that may be realized by winding up is usually quite low and unable to cover the amount which the company owes.

At this point, the Company can consider a structured plan to re-negotiate the terms of its current debt with the lenders. This will give a breathing space to the Company provided the lenders form a significant portion of the creditors. Further, CDR is also a pro-borrower process in comparison to the existing laws in India which tend to be pro-creditors.

From Lenders A,B,& C's point of view

Under CDR framework, incentives are given in the form of regulatory forbearances to give the lenders a unique opportunity to avoid excess loss provisioning in their books against non-performing loans (NPLs) arising out of corporate accounts. Further, the lenders are more in favour of recovering the principle amount lent to the company along with returns on that investment.

Lenders or other creditors have an option to force the company to go for liquidation. However, liquidation proceedings usually yield low values and hence low recovery for creditors. Therefore, CDR becomes an instrument for the lenders, to aid the transformation of otherwise bad loans into possible productive assets.

However, does this justify the need to support their restructuring? The answer is an emphatic affirmative with a caveat – the decision should be based on a thorough examination on a case to case basis. Only if the need for restructuring is legitimate, and there is a good reason to believe that the corporation may be revived and suitably backed by a viability study, a loan must be taken up for restructuring. This is a must for the safety of the money which has been lent by the investors, i.e. the financial institutions, along with the interests of those directly associated with the working of the company.

Genesis of CDR mechanism in India: From corporate restructuring in United Kingdom, Thailand & Korea

The RBI guidelines which govern the CDR system in India are based on the experiences in the corporate restructuring programs in countries such as the UK, Thailand, Malaysia and South Korea. The corporate restructuring practices in the above mentioned countries date back to the time of their respective economic crisis viz., England in early 1990's, Thailand, Malaysia and South Korea around 1997-1998 (Asian Crisis).

In 2001, the CDR mechanism was set up by the RBI as a voluntary mechanism in order to facilitate restructuring debts of viable corporate entities, independent of the multitude of insolvency procedures available in India. The Indian CDR mechanism is largely based on the London Approach, a mechanism formulated in the early nineties wherein out-of-court agreements and settlements were encouraged to be opted by the creditors for maximising the value of the corporates as a going concern. The approach grew from the recognition that in a multi-creditor restructuring, the lenders would achieve better returns through collective and coordinated efforts to rescue a firm in distress, rather than force it into formal insolvency. In 2008, comprehensive guidelines for both institutional (CDR) as well as non-institutional restructuring (non-CDR) were issued followed by significant improvements and modifications in the ensuing years based on the practical issues experienced during the implementation of the guidelines.

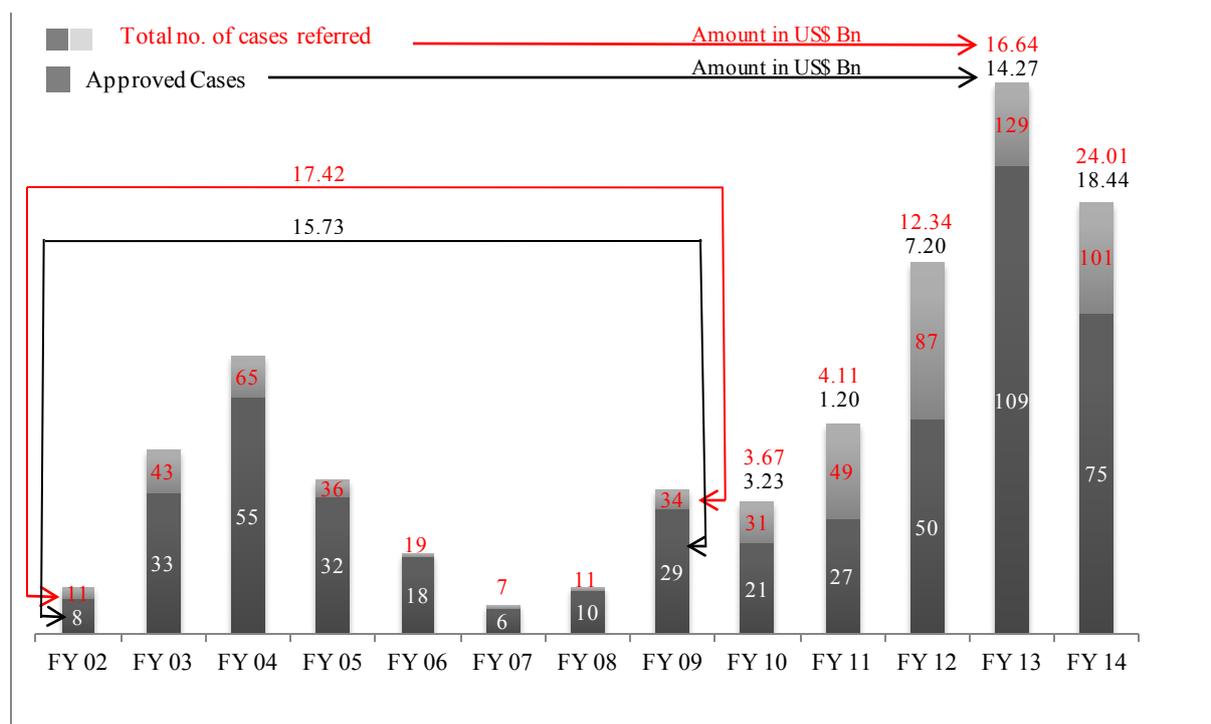
The CDR system in India is based on the principle of approvals by a super-majority of 75% of participating creditors (by value) which makes it binding on the remaining 25% to fall in line with the majority decision. The CDR Mechanism covers only multiple banking accounts and syndication/consortium accounts, where the banks and institutions together have an outstanding aggregate exposure of \$2 mn and above. It covers all categories of assets in the books of member-creditors classified in terms of RBI's prudential asset classification standards. Even cases filed in Debt Recovery Tribunals/Bureau of Industrial and Financial Reconstruction/and other suit-filed cases are eligible for restructuring under CDR.

How far it can go to prevent insolvency?

As per market estimates, about 70-80% of the loan restructuring cases referred to the CDR cells are able to meet their obligations and, almost 40% of these cases are successfully revived. However, recent failures of CDR packages in last two quarters amounting to over \$2.5 bn and the subsequent sale to the asset reconstruction companies for ultimate liquidation has put a big question mark on the ability of debt restructuring in saving the companies. Nevertheless, statistics are an indication that provides enough hope of a possible turnaround from insolvency for the companies under the process of implementation of debt restructuring packages. However, experts warn that not all debtors can be turned around.

➤ Success & Failure of the CDR mechanism

Debt Restructuring has come become the buzzword recently in Corporate India because of the significant increase in the number and volume of advances being restructured by the banks under the CDR mechanism in the recent years as presented in the diagram below:



Source: CDR Cell & Outlook India

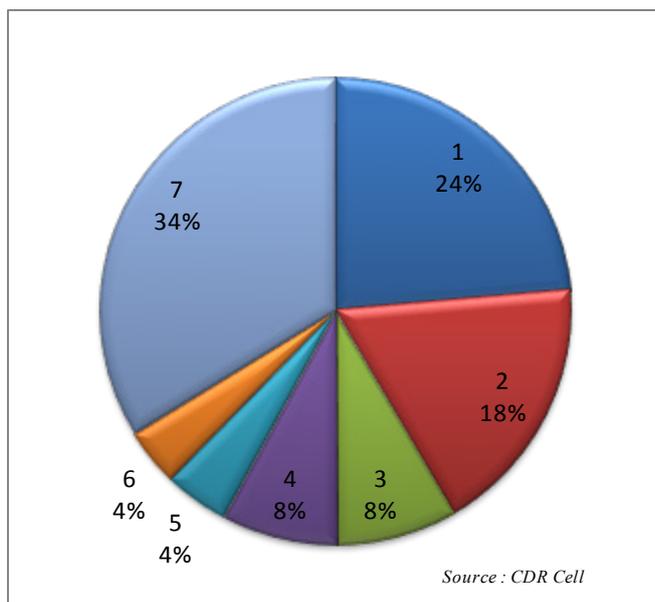
The above table shows that the number of cases referred and approved for debt restructuring via the CDR mechanism has been continuously on the rise post the 2008 global crisis. The total number of 622 cases been referred to CDR cells from its inception until March 2014 with total debts of over \$ 75bn of which the debts referred in just the last 3 financial years amount to \$53 bn. Clearly, this presents a serious cause of concern. More number of cases being referred means widespread corporate distress and sends warning signs to both the financial sector and the economy as a whole.

Further, out of the total referrals received, 476 cases with debts amounting to \$ 60bn have been approved till date. But approval of the case under CDR is no guarantee of survival. Of the total approved cases, more than 120 cases with debts amounting to over \$ 5bn to have been withdrawn on account of package failure. However, this does not take away the success of the CDR mechanism in which the successful cases till date outnumber the failures by double as given below:

(Amount in \$ bn)

Total Approved Cases		Cases withdrawn on account of package failure		Cases exited successfully		Live cases in CDR	
No. of Cases	Aggregate Debt	No. of Cases	Aggregate Debt	No. of Cases	Aggregate Debt	No. of Cases	Aggregate Debt
476	60.08	121	5.43	75	10.58	280	44.05

Source : CDR Cell



On an industry-wise analysis of the CDR cases, it may be seen that across all the years, a few sectors such as infrastructure, iron & steel, textile, power and telecom all of which are heavily leveraged and capital intensive, accounted for more than 60% of all the cases referred to CDR cell.

Banks have reported that 10-15% of the restructured loans turn bad which is an increase from corresponding figures about 2-3 years back. Bankers have also increasingly voiced concern that borrowers have been misusing the facility and

passing on their burden to the lenders. The rising number of loan recasts across the sector has resulted in a spike in NPLs in the banking sector. Out of total banking credit outstanding as on 30th September 2013, of \$1060 bn, non-performing and restructured loans amounted to almost 10% i.e. \$100 bn.

The main reason for this surge can be epithetical to the mounting debt of the corporates along with a drop in the returns which has resulted in several of the famous and listed corporate houses of the country facing challenges in servicing debt. The Indian economy, which was growing at the pace of 9% p.a. just about 2 years ago, has decreased by more than half now. So, every investment that was geared at a 9%

rate is now geared for 4.5 % rate. Further, high interest rates, slowed economy and project delays have also dented the ability of Indian companies to repay their loans and this has led to the unprecedented rise in the restructuring cases.

However, with the Indian economy on the path to recovery, a slew of reform measures by the RBI under a new Governor and simultaneous revival of the equity markets, there has been a drop in the debt restructuring by more than half in the first quarter of the current fiscal year vis-a-vis the same period a year ago.

➤ *Window of Opportunity*

Over the past one and a half decades, debt restructuring in India has seen its fair share of success and failures. While the successful turnarounds of pharma-giant Wockhardt and oil & gas major Essar Oil have been feathers in the cap of the CDR mechanism, the recent failures of shipbuilder Bharti Shipyard and hotelier Leela Ventures have cast a dark shadow on its success story.

Whether the process of debt restructuring can save a company from being insolvent can be examined by understanding the inherent weakness and drawbacks of the process and the best possible ways to tide over the said drawbacks. The failure of these cases being restructured has been due to various reasons.

Despite the existence of inter-creditor agreements (ICA) between various lenders, restructuring remains legally unenforceable as the CDR mechanism is non-statutory in nature. Even when the requisite majority of creditors have agreed to implement a scheme, dissenting creditors sometimes have commenced legal proceedings against borrowers despite this being against the spirit of ICA.

Despite the time limits being prescribed in the CDR mechanism, delays by banks in getting approvals from their respective boards and reluctance by the private sector and foreign banks to join the mechanism derails the restructuring package. Further, as uncertainty and delays in approval of CDR proposals lead to deterioration in the asset classification, some lenders may consider bowing out of the CDR process and proceed with recovery leading to liquidation of the Company.

Once a borrower is under stress, there is a perception that the CDR process is easily accessible. This is because there have been instances wherein the debt relief package has been approved without properly establishing the viability of the borrower. Any plan proposed by promoters in CDR without validation by techno-commercial industry experts is more than likely to fail, resulting in the borrowers' inability to meet their restructured obligations to banks. Hence, a thorough assessment of the viability study by accredited industry experts should be relied upon for validation.

Moreover, recent hikes in loss provisioning requirements from 2.75% to 5% for restructured loans and which will increase to 15% from April 2015 onwards have drawn criticism from some banks, which say that restructured loans have almost been brought on a par with bad loans. These policies could discourage lenders from resorting to restructuring at all. So, if the lenders are unwilling to restructure and the loan turns into an NPL, the RBI guidelines forbid the banks giving any additional monetary support to the borrower. Further, under the distress situation, finding an

alternate source of funding is a big challenge in Indian markets presently which are, at present, devoid of major stressed-asset funds.

The current CDR guidelines require equity infusions and guarantees from the promoter, but often the same are not backed by adequate net worth of the promoters. Moreover, the mechanism does not have any legal enforceability to press the promoters to bring in their commitments or take legal action, in case of failure. The recent failure of the debt restructuring package of a major shipbuilder in the country was due to the non-infusion of funds by the promoter. Thus, the debt restructuring mechanism should be granted a proper legal status so that it becomes binding in nature.

The CDR process should include milestones designed to test the success of the restructuring. Some basic parameters and recovery milestones should be laid down (e.g., regularity in debt servicing, cash flow targets to be imposed, sale of noncore assets, etc.) as part of the CDR package. If the milestones are not met, it should lead to accelerated provisioning requirements for banks. Further severe financial sanctions should be placed on the borrower in case it is unable to meet the milestones (other than for reasons beyond its control). Testing of such milestones could be outsourced to a panel of approved independent agencies.

Conclusion

The recent failures of debt restructuring in certain cases does not mean the mechanism has lost its purpose. Debt restructuring over the years has played a significant role for both the borrowers and the lenders in times of financial crisis and economic downturn. What is required is a revamp of the debt restructuring mechanism in light of present macro and micro conditions and the lessons learned over past so many years. To conclude, one can safely state that financials market worldwide will definitely be prone to business cycles as well as sudden economic aberrations and it is next to impossible to come up with a policy which can predict ways of preventing the unpredictable. In those circumstances, mechanisms like CDR could become a saviour for both the investors and the entrepreneurs. Even though laced with a few short-comings, the CDR mechanism in India can go a long way in restoring the creditors' as well as the investors' faith in the market, even in the times of economic gloom. If implemented in true spirits, it gives the entity facing financial pressure a chance of recovery and the ability to get back in the business, besides bring it back from becoming insolvent.

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