Resolution of Stressed Assets: Towards the Endgame

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1. Honourable Finance Minister, Shri Arun Jaitley; Chairman SEBI, Shri Ajay Tyagi; Chairman IBBI, Dr. Sahoo; Managing Trustee, National Foundation for Corporate Governance, Shri Chandrajit Banerjee; ladies & gentlemen. At the outset, I would like to compliment the organisers, Ministry of Corporate Affairs, the Insolvency & Bankruptcy Board of India (IBBI) and the National Foundation for Corporate Governance, for arranging a conference on such a critical national issue. The gross NPA (GNPA) ratio of the banking system at 9.6 per cent and the stressed advances ratio at 12 per cent as of March 31, 2017, on the back of persistently high ratios in the past few years is, indeed, a matter of concern. 86.5 percent of the GNPAs are accounted for by large borrowers, i.e., borrowers with aggregate exposure of ₹ 5 crores and above. The challenge in dealing with the issue gets accentuated when observed against the capital position of some of the banks, particularly public sector ones.

2. Swift, time-bound resolution or liquidation of stressed assets will be critical for de-clogging bank balance sheets and for efficient reallocation of capital. The Government, IBBI and the Reserve Bank have been working together to comprehensively address the challenge through a multi-pronged approach. In brief remarks today, I intend to highlight the key dimensions of this convergent approach and share the underlying thinking.

3. The specific measures taken over the last few months, both by the Government and the Reserve Bank, to strengthen the legal, regulatory, supervisory and institutional framework are aimed at the ultimate objective of

facilitating quick resolution of stressed assets in a time-bound manner. The sense of urgency imbued in these measures is reflective of the intent not to allow things to drag any further. The recent measures address, *inter alia*, two key lacunae in the earlier framework: one, the absence of a hard-coded, time-bound period for resolution; and two, the agency and coordination failures at banks and Joint Lenders Forums (JLF) in pushing through viable restructuring plans.

I. Strengthening the Legal Framework

<u>The Insolvency and Bankruptcy Code, 2016</u>

4. The enactment of the Insolvency and Bankruptcy Code, 2016 (IBC) is a watershed towards improving the credit culture in our country. Prior to the IBC, India had multiple laws that governed various facets of a corporate rescue and/or insolvency process, without having a comprehensive legal framework that envisages a holistic process applicable to troubled or defaulting companies. The IBC provides for a single window, time-bound process for resolution of an asset with an explicit emphasis on promotion of entrepreneurship, maximisation of value of assets, and balancing the interests of all stakeholders.

5. For a creditor, an asset, in most cases, is more valuable when it is a going concern and generates adequate cash flow, as compared to an asset under liquidation. IBC puts a time limit of 180 days (extendable by a further 90 days) within which creditors have to agree to a resolution plan, failing which the adjudicating authority under the law will pass a liquidation order on the insolvent company. So the threat of liquidation, which could potentially result in larger losses for the creditors as a whole, should be sufficient incentive for them to ensure efficient coordination during the insolvency resolution period so as to quickly arrive at a decision.

6. For the promoter, the biggest cost of being pushed under IBC may be the possibility of losing the firm to potential bidders. This should incentivise the

firms to avoid defaults and not over-borrow in the first place. This would improve *ex-ante* the credit culture in the country.

Turning to the Banking Regulation (Amendment) Ordinance: this has since been passed by both Houses of Parliament, under the expert stewardship of the Finance Minister.

7. The size and nature of the NPA problem necessitated concomitant measures to signal intent and commitment of the Government and the Reserve Bank to meet the challenge squarely. The IBC was in place but the required action in respect of the large stressed accounts was not forthcoming on the part of banks and JLFs. Part of the inertia may have to do with the initial days of the IBC; but part of it was also the typical (and severe) agency and moral hazard problems of not resolving NPAs when the banking sector is majorly government-owned.

8. It was to address this market failure that the need for statutory backing to the Reserve Bank to direct reference of cases under IBC was considered necessary. The Banking Regulation (Amendment) Ordinance, 2017 empowers the RBI to issue directions to banking companies to initiate an insolvency resolution process in respect of a default, under the provisions of the IBC. It also enables the Reserve Bank to issue directions with respect to stressed assets and specify one or more authorities or committees with such members as the Bank may appoint or approve for appointment to advise banking companies on resolution of stressed assets.

Follow-up action by the Reserve Bank

9. Pursuant to the promulgation of the Ordinance, the Reserve Bank identified a set of accounts to be referred for resolution under IBC, based on the recommendations of an Internal Advisory Committee (IAC). The process adopted for identifying the entities was consistent with the object of making quickest recovery of economic value. The classification criteria recommended by the IAC was based on an intelligible differentia (quantum, materiality, as

well as age as of the NPA) and had close nexus with the underlying object of the IBC and the Ordinance.

10. It must be emphasised, however, that being referred for insolvency process under IBC does not necessarily mean that the company is being liquidated. It simply puts a timeline within which the various stakeholders have to come up with a feasible resolution plan, to be approved by at least 75 per cent of the Committee of Creditors; only if this effort fails would the company end up in liquidation.

II. Evolving Regulatory Framework

11. The continuing endeavour of the Reserve Bank has been to strengthen the supervisory and regulatory framework to ensure timely recognition and disclosure of incipient stress and to facilitate effective and meaningful resolution.

12. In particular, the decision to do away with the regulatory forbearance regarding asset classification on restructuring of loans and advances effective April, 2015, was a significant step from the perspective of aligning the regulatory norms with international best practices.

13. The Asset Quality Review (AQR) exercise undertaken in 2015-16 was a critical step in recognising the aggregate stock of non-performing assets across the banking system – it was a form of “catch-up”. In tandem, a series of measures were put in place to provide a mechanism for coordinated resolution of stressed assets. Further, additional tools to deal with problem assets were also introduced, in the absence of an effective resolution framework. These tools primarily facilitate optimal structuring of credit facilities, ability to change ownership/management, and help restructuring of stressed assets. A framework was put in place for greater transparency in sale of stressed assets by banks with a view to ensuring the sale is at market determined prices.

14. The system of ‘Prompt Corrective Action’ (PCA) under which specific regulatory actions are taken by RBI if banks breach certain trigger points has recently been revised. This ensures timely supervisory action in case of problem banks following a rule based approach. The PCA’s objective and design is to strengthen a bank’s fundamentals and imbue confidence.

15. Weak credit discipline in banks, right from the appraisal to sanction stage, is one of the main bank specific factors in the build-up of stressed assets. The risk based supervisory process of the Reserve Bank keeps flagging some of these risks which are taken up with the institutions concerned for remedy. However, in order to ensure an effective enforcement action on the specific violations/breaches, a separate Enforcement Department has been established. The mandate of the Department is to develop a rule based, consistent framework to deal with breaches of law, rules and directions. Effective deterrence enforced through such actions is expected to contribute to strengthening the credit culture overall.

16. During the Annual Financial Inspections (AFIs) of the banks, it is usually observed that there is a divergence between the NPAs and provisions declared by the banks and those assessed during the AFI process. This has adverse implications on timely recognition of actual risk, trustworthiness and transparency of books of accounts, management effectiveness, etc. Accordingly, in order to address this asymmetry, disclosure requirements have been put in place – banks have to disclose in their annual accounts the details of such divergences where these exceed specified thresholds.

17. The recent decision by SEBI that requires listed entities to disclose defaults on, *inter alia*, bank loans within one working day can make a huge difference in the credit culture. If my understanding is correct: effectively, a one-day default by bank debtors will result in all bank loans to the debtor entity being generally classified as ‘default’ by the rating agencies, with attendant

implications for risk weights on such exposures and capital requirements by the banking system.

III. Institutional Measures

Central Repository of Information on Large Credits (CRILC)

18. Setting up of CRILC by the Reserve Bank in 2014 filled a critical gap in addressing the information asymmetry regarding NPAs at the system level by facilitating collection of data on all borrowers' credit exposures across the banking system. Having the aggregate view of borrower-wise and bank-wise exposures provided the requisite tool for supervisors as well as lenders to track the incipient stress in a particular account in a timely manner. In fact, without CRILC the AQR would not have been possible.

Joint Lenders Forum (JLF) Mechanism

19. The Framework for Revitalising Distressed Assets in the Economy in January 2014, with the objective of addressing coordination problems in large, consortium accounts, envisaged constitution of the JLF. Specifically, one of the key problems with the framework was the dissenting creditor exception that held up the restructuring process in many cases. In other words, what economists call the inherent agency and incentive failures due to pivotal voting constrained the JLFs from achieving the very objective they were envisioned for.

20. Some of the above issues were addressed in May 2017, immediately after the promulgation of the Ordinance. The norms for consent required for approval of a proposal was changed to 60 percent by value instead of 75 percent earlier. Banks who were in the minority on the proposal approved by the JLF were required to either exit by complying with the substitution rules within the stipulated time or adhere to the decision of the JLF; “cram downs” are now feasible. The participating banks were mandated to implement the decision of the JLF without any additional conditionality. Also, the Boards of

banks were advised to empower their executives to implement JLF decisions without further reference to them. These instructions, aimed at reducing the coordination problems among lenders while trying to resolve stressed assets outside the purview of the IBC, will hopefully result in speedier decisions amongst the lenders.

Overseeing Committee

21. In order to strengthen the role of the Overseeing Committee (OC), the Reserve Bank, in exercise of powers vested under Section 35 AB of the Ordinance, brought the OC under its aegis with an expanded membership to review the process followed by banks for restructuring outside the IBC. This was necessary to reinforce the statute-backed authority of the OC to review the processes and provide requisite comfort to the lenders, particularly public sector banks, to agree to a market-determined haircut as part of restructuring.

IV. The Fiscal Dimension

22. The success and credibility of all the resolution efforts detailed above would be critically contingent on the strength of the public sector balance sheets to absorb the costs. It is clear that PSBs will need to take haircuts on current exposures under any resolution plan agreed within or outside the IBC. Higher provisioning requirements, on this count as well as other factors, will affect the capital position of several banks. This would necessitate a higher recapitalisation of the public sector banks. The Government and the Reserve Bank are in dialogue to prepare a package of measures to enable PSBs to shore up requisite capital in a time-bound manner. The measures could include a combination of capital raising from the market; dilution of government holdings; additional capital infusion by the Government; mergers based on strategic fit; sale of non-core assets etc.

V. Conclusion and Way Forward

23. The multi-pronged approach outlined above is an on-going process. The early signs are encouraging. However, we all must realise that it will be a long haul before the intended objectives are fully achieved. There could be initial glitches and unanswered questions but these will get resolved as the process advances. The IBC process itself will evolve as case history of various NCLT/NCLAT judgements build up.

24. The contours of the approach to be adopted for other non-performing accounts are being worked through. We must, however, stress that the exercise of powers by the RBI vested in Sections 35 AA and 35 AB cannot be a regular, steady state approach. The lenders have been adequately empowered under the IBC to take necessary action upon default. It is now incumbent upon all lenders to effectively leverage these powers through proactive, timely references under IBC on their own.

25. Even under IBC, huge responsibility is cast upon the Committee of Creditors to agree to a viable restructuring plan in each admitted case within the prescribed timelines. The creditors, in particular banks, will need to devote adequate resources and strengthen internal processes to focus on these cases as the number is only going to go up.

26. In conclusion, I must reiterate the intent and resolve on the part of the Government and the regulators to collectively address the problem of stressed assets in the system. There are pains and costs to be borne, but as long as the end-game is a desirable goal, these should be worth it for placing the private economy structurally on a path of sustained growth.