Business Standard

Saving banks' distressed assets

RBI's move to empower banks to take charge of companies that default on loans could run into legal hurdles

Abhineet Kumar June 14, 2015 Last Updated at 21:35 IST

Reserve Bank of India (RBI) empowering banks to convert their debt exposure to defaulting companies into equity has been welcomed for its intent, but its implementation has raised doubts.

State Bank of India's (SBI) Chairman Arundhati Bhattacharya urged the government to expedite the creation of a commercial court system with the expertise to handle defaulters. "It's definitely welcome," Bhattacharya said reacting to the RBI's strategic debt restructuring (SDR) move at an international forum. "What's required is to enable the banks to work through the legal processes very quickly."

She has reason to be worried about the legal processes.

In October 2011, the Bombay High Court, in the case filed against Wockhardt by the holders of its foreign currency convertible bonds, ordered the drug maker to repay the unsecured lenders before the secured ones.

The judgment was passed after staying a winding up petition admitted by a lower court on behalf of bond holders.

This was unprecedented, as SBI, along with other banks, argued. Since most assets of Wockhardt were charged to them, bondholders who had unsecured exposure to the company had no right over the money deposited by Wockhardt.

"Giving right to unsecured lenders before secured ones set a wrong precedence," said Siby Antony, managing director and chief executive officer, Edelweiss Asset Reconstruction Company.

There are several examples of such legal tussles in Indian courts.

Last year, Edelweiss ARC bought 60 per cent of the Rs 5,800 crore exposure to troubled Bharti Shipyard from a consortium of lenders led by SBI. The corporate debt restructuring for the ship builder had failed and banks were making their last attempt to recover money. But now, other lenders such as Life Insurance Corporation of India, Shipping Corporation of India and IDBI Capital Market, have filed winding-up petitions against Bharti Shipyard in Bombay High Court.

While Antony is looking for a legal "work around", banks from the consortium are worried that they would not be able to redeem the security receipts they have received from the ARC. This may eventually lead to banks writing off the asset from their books. Security receipts become void if a company is wound up as ARCs are not able to recover on behalf of the banks.

"Even under the CDR and framework for revitalising of distressed assets, banks had the option of converting their loans into equity and also as an enforcement procedure under SARFESI," said Dina Wadia, a partner at corporate law firm J Sagar Associates.

SARFESI is the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Currently, under the restructuring process, if a borrower company defaults after the restructuring, then the banks have the right to enforce their security and sell the assets and shares to recover their dues. More recently, banks have been selling loans to ARCs and taking the loans off their books. Sometimes, the lenders could take some portion in security receipts issued by the ARCs.

"However, operationally, banks faced issues in relation to compliance with preferential allotment rules, valuation and applicable pricing in case of listed companies, holding of shares, provisioning, etc," she said.

Gross non-performing assets of Indian commercial banks have risen a 26 per cent to Rs 3.02 lakh crore at the end of March from Rs 2.4 lakh crore a year ago as banks are struggling to get their dues. So it is understandable when the RBI's move for SDR allows banks to continue with existing asset classification for 18 months and when the stake is divested to a new promoter the asset classification is upgraded to standard. But banks worries are genuine.

"Often debtors abuse the process of law by filing frivolous applications before the competent courts and tribunals drawing banks into unwarranted litigation when any recovery actions are initiated against them," said Neerav Merchant, partner, at law firm Majmudar & Partners.

Debtors usually manage to seek an interim stay, either on grounds of convenience or in the interest of justice. Once an interim stay is obtained, the debtors do their best to protract the proceedings by seeking adjournments without plausible cause. "These adjournments are granted by the courts and tribunals solely because of the backlog of pending matters," Merchant added.

The debtors are aware that by the time an order would eventually be passed against them or when their application would be dismissed, considerable time (of at least 18 to 24 months) would have been lapsed and there would not be any punitive implications.

Frustrated with a legal system that can take years to process debt recoveries, banks are awaiting a bankruptcy law from the government that will lay out a system to deal with insolvencies and help lenders tackle the highest level of soured credit in 13 years.

Bankers are awaiting a national code that will incorporate laws for resolving bankruptcies, including recovering debts from companies that go bust. The finance ministry set up a panel in August, 2014, to study the legal framework and to submit a report to the government. Developing such a code will require more time because of the web of laws and adjudicatory forums governing insolvencies in India, the panel said in an interim report in February.

In the meantime, creditors rely on the nation's debts recovery tribunals that were created under a 1993 law to help financial institutions reclaim loans. The tribunals have been swamped with so many cases that it may take at least another four years to clear them, RBI governor Raghuram Rajan estimated in November.

Meantime Rajan is seeking new ways to clean up lenders' balance sheets as bad loans threaten to derail an economic recovery. Under the SDR, lenders are required to incorporate clauses relating to conversion of debt into equity in the restructuring agreements. "This would mitigate risks of such clauses being challenged by the borrowers at the time of enforcement," says Devidas Banerji, partner, Khaitan & Co.

In addition, the guidelines set out by the Reserve Bank of India on Joint Lenders' Forum (JLF) stipulate that a borrower and the lenders which are a part of the JLF may enter into a Debtor Creditor Agreement which usually includes a 'stand still' clause under which the debtor and creditor(s) agree to a legally binding commitment to not take recourse to any other legal action during such 'stand-still' period. Such measures are expected to further shield lenders from onerous litigations initiated by debtors. But this does not stop an unsecured lender to move a court with a winding up petition.

"These developments would not completely shield banks from prolonged litigations but definitely provide for a new avenue of recourse that would be available to banks while dealing with restructured loans that have subsequently gone bad," said Karan Kalra, co-head, banking and finance practice at Nishith Desai Assoiciates.

Nikhil Shah, the managing director of Alvarez & Marsal in India who specialises in turning around distressed companies, echoes the lenders concern, "It is definitely a positive step, but cannot replace the need for a comprehensive bankruptcy code with an empowered, competent authority to drive the process."