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New calls for bankruptcy laws

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INDIA RESTRUCTURING Pressure intensifies for India to adopt international standard

Pressure is mounting for India to adopt internationally accepted bankruptcy laws in the face of a growing number of bad debts.

The Reserve Bank of India on July 20 tabled tough recommendations for the classification of non-performing loans in a bid to increase the visibility of restructured assets on banks' balance sheets.

Such measures, however, conflict with the traditional approach to restructurings in India, where the concept of bankruptcy is seen as abhorrent.

It reflects the reluctance of India's many family-owned businesses to declare insolvency. It also points to an endemic resistance among lenders to declare their debts as non-performing assets.

"Debt restructuring is viewed very differently in India," said Karan Kalra of Nishith Desai, a Mumbai-headquartered law firm.

"Here, bankruptcy and restructuring laws are more in the line of useful social tools to protect productive assets, while in many western countries restructuring is looked at as an event of impairment and the legal framework centres around curing the impairment. For India to embrace a proper bankruptcy law, this mindset towards restructurings should totally change."

Slower economic growth and declining asset quality, however, are making that model unsustainable. Ratings firm Fitch last Wednesday warned that restructurings in 2012 and 2013 were running at the highest pace in a decade, while Crisil warned that banks would need to restructure nearly Rs2trn (US$36bn) of loans over the two fiscal years.

The RBI has recommended increased loan-loss provisions and, ultimately, an end to forbearance on asset classification. Instead, the central bank will recognise non-performing assets in line with global standards.

Forcing lenders to classify assets under restructuring as non-performing will lead to the Indian banking industry becoming more transparent, a change RBI has said may well take place in as little as two years.

Measures and means

That recommendation alone signals a change in mindset, but the RBI did not stop there. It also recommended a phasing in over the next two year enhanced provisioning to 5% from 2% on restructured loans. At the same time, it is asking for a higher 15% sacrifice from promoters.

Furthermore, it is asking promoters to provide guarantees to ensure they have stakes in the loans they sell.

At present, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act allows lenders recover their bad debts. However, for issuers, the Corporate Debt Restructuring Cell, an RBI creation that initially examines restructuring plans, provides the best alternative.

Even though CDR Cell does not provide protection to issuers from third parties, its restructurings have, so far, stood the test of the time.

Since 2002, when CDR Cell was set up, 67 deals have been restructured and around 26 cases are in the process of completion, according to an official. The exits constitute 43% of the total cases under the CDR Cell, but, in terms of value, they comprise 85%.

"The CDR Cell is like an intensive-care unit, where only the first and second stages of companies are admitted. The advanced-stage borrowers are rejected tight away," said the CDR Cell official.

RBI also noted that only viable entities should be restructured to minimise losses. B Mahapatra, RBI executive director and head of the working group behind the review, has also recommended the use of a "carrot and stick" policy.

Restructuring should be an incentive for the right cases and a disincentive for those that do not adhere to the terms and conditions

of agreements. RBI has invited comments on these recommendations on or before August 21.

RBI's recommendations come amid a growing consensus among lenders in favour of stronger action. For instance, at a special meeting of CDR members on May 21 this year, banks asked for change in management if the performance was not satisfactory, even 18 months after a reorganisation.

Towards global standard

"Resolution of stressed assets under the CDR package is largely from the point of view of lenders. There is a need to look at comprehensive rules that can better address the concerns of the companies," said Siddharth Shah of Nishith Desai.

Some key differences in the global bankruptcy law and its closest comparable in India – the CDR scheme – highlight the need for change.

The CDR scheme is a mere contractual obligation and does not offer any protection against third parties. However, once a company is declared bankrupt under Chapter 11 in the US, it gets total immunity.

Also, the CDR scheme does not allow the insolvent company to void any transactions. Chapter 11 allows the court to cancel any deals if it helps a company get back on its feet.

Critics, however, disagree that a Chapter 11-like law is the answer to the woes of Indian corporations.

"Chapter XI bankruptcy reorganisation, results in all liabilities of the company/promoters effectively being extinguished, while the company goes in for new loans and has the option of renegotiating old contracts," ." said Amit Shah, director, Avista Advisory Group.

Shah see this as flawed because it, first, encourages wiping out the debt and, then, recreating the same when the company comes back from the reorganisation.

"Typically, it also results in the current owners loosing all stakes in the company. As such, it is not always the best option for a restructuring or revival of a company – from the lenders and promoters point of view. This option suits companies that are not promoter driven." Shah said.

He points out that restructurings, under the aegis of CDR Cell in India, work well where both lenders and the promoters are committed to the process and promoters get a chance to continue holding their stake (although mortgaged) in the business, motivating them to fulfil outstanding liabilities.

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