S4A - a new way for banks to tackle debt

S4A, the new debt recovery scheme the Reserve Bank of India has recently announced could well become a panacea for banks struggling with the ever increasing NPAs:

The Reserve Bank of India has introduced a new restructuring tool - 'Scheme for Sustainable Structuring of Stressed Assets', or S4A, as it is called. This is an alternative restructuring methodology for banks struggling with delinquencies in large accounts.

Says Prem Rajani, managing partner, Rajani Associates, an firm of advocates and solicitors that specializes in issues relating to banking and financial services: "S4A actually looks at deep restructuring of large accounts to revive projects that are viable. The scheme allows banks to determine and segregate the debt into 'sustainable debt' (consisting of loans, which are capable of being serviced by the current cash flows of the company and representing not less than 50% of the current funded liabilities) and restructure the balance amounts into equity or quasi-equity instruments. This will be advantageous to banks, in case of recovery."

He explains that to be eligible under S4A, banks are required to ensure that the account belongs to a project that has commenced commercial operations, aggregate exposure (including accrued interest) of all institutional lenders in the account exceeds ₹500 crore and the debt meets the test of sustainability. The banks would need to appoint an independent agency to conduct a techno-economic viability survey and determine the amount of sustainable debt. After determining the sustainable debt, the banks are required to formulate a plan, which needs to be approved by a minimum of 75% of banks by value and 50% of banks by number in the consortium.

Prem Rajani feels that it is in the interest of all that efforts are made to ensure that an enterprise is not allowed to fail

DUAL OBJECTIVE

"I am of the view that S4A aims to achieve a dual objective - help banks deal better with stressed assets and help debt-laden companies get their projects back on track. However, there are concerns over the banks' risk because the high debt of these over-leveraged companies means their market capitalization does not match the haircuts banks are likely to take," says Rajani.

Nevertheless, if implemented successfully, he says, S4A can strengthen the ability of banks to deal with stressed assets, provide an avenue for reworking the financial structure of entities facing genuine difficulties, serve as way to relieve stressed corporates. Banks can cut down on additions to NPAs.

DEFAULT/DEFRAUD

Rajani elaborates further: "How do banks get to accumulate stressed assets? It can either be on account of default by the borrowers or these borrowers resorting to defrauding the banks. Many see a major difference in these two acts of commission, but I would like to believe the events that lead to a customer resorting to either default or defraud appear to be almost the same - extraneous situations like the meltdown, extreme market conditions, sudden changes in government policies, et al. If the banks, spurred by the regulator and the government to some extent, try to understand the psyche of the minds of the defaulter or the person resorting to frauds, and provide somewhat easier methods to resolve the issues, we may not see the stressed assets remaining at the current level. S4A is a move in this direction. Remember bad loans of the 40 listed banks in India touched Rs5.8 trillion end March 2016 and this is most likely to rise substantially in 2017."

Holistically speaking, it is in the banks' interest, in the country's interest and in the interests of the stakeholders that a company should not be allowed to fail. The banks will lose their money, the country's economy as a whole will be impacted and the number of jobless will go up. "I will cite a classic example - the failure and resurrection of Satyam Computer Services. It was fraud nevertheless perpetrated by the promoters, but the government intervened and ensured that it did not close down. It helped the banks to recover their money, it helped the employees to retain their jobs. If banks in the current situation allow an enterprise to fail, see the impact it would have caused. At the same time, real perpetrators of the fraud were punished under law", he adds.

Rajani also says he firmly believes in government in genuine instances initiating loan waivers for the corporate sector like such waivers for the agricultural sector.

PREVENTIVE MEASURES

He avers that NPAs are actually created because our system does not invoke preventive action in the correct sense. "It's like police action against helmetless driving. See Mumbai where helmetless driving is common. However, in the neighboring Pune, you rarely see helmetless riders. This is because the police there is very strict about punishing the violators of the law instantaneously."

Going into the merits of S4A, Rajani outlines that it allows banks to convert up to half the loans held by corporate borrowers into equity or equity-like securities and they will be allowed to rework stressed loans under the oversight of an external agency, thereby ensuring transparency while also protecting bankers from undue scrutiny by investigative agencies. "The scheme allows a bank to determine the amount of debt that it thinks a firm can service with its current cash flows. This proportion of debt must not be less than half the loans or funded liabilities of the company. Once the sustainable level of debt has been determined, banks can convert the rest of the debt into equity or quasi-equity instruments. However, banks are not allowed to offer any moratorium on repayment on the sustainable part of the debt. They are also not allowed to extend the repayment schedule or reduce the interest rate on the debt. Banks will also need to set aside higher provisions if they choose to follow this route. They will have to make provisions to the extent of 20% of the total outstanding amount or 40% of the amount of debt that is seen as unsustainable," says Rajani.

SDR

"You will ask me whether the earlier SDR, or strategic debt restructuring, scheme announced by the regulator has failed. I would not say yes. Because the aim of SDR was different. Under it, a consortium of banks could convert part of their loan exposure in a stressed company into equity and own at least 51% of it. The banks were given a window of 18 months to bring the books of the stressed company in order. However, this time period was rather short," says Rajani.

He emphasizes that S4A is different from SDR in that under S4A, the banks are being allowed to convert up to half the loans of corporates into equity or equity-like securities. It does not allow the banks to offer any moratorium on debt repayment. They are also not allowed to extend the repayment schedule or reduce the interest rate. The conversion of part of debt into equity or quasi-equity instruments will be governed by valuation norms, prescribed by the regulator. Banks will also have to earmark funds for 20% of the total outstanding debt or 40% of the debt that is seen as unsustainable. This is more than what banks typically need to provide for bad loans - 15% in the first year.

"I am of the opinion that S4A is an effective tool that can help banks handle bad loans, but they need not be very optimistic mainly because only those projects that have started commercial production can take advantage of this scheme and while working on the revival package, the banks need to use the current cash flows of the concerned projects to determine the quantum of sustainable debt. The scheme does not offer any comfort on account of unsecured creditors because they can always approach a court and get a stay," says Rajani.

DRT PROCEDURES

Another benefit that will flow from S4A, according to him, is the fact that banks, at least in certain cases, will not be tied down by the long-winding and laborious proceedings at the debt recovery tribunals. Once a case goes to the DRT, recovery of dues from sale of assets - especially assets like aircraft - in a meaningless process, says he.

"Finally, with all its limitations, S4A is a scheme that will help banks to handle stressed assets, especially those that have potential for revival and control NPAs. It provides a way out for financial restructuring of such companies that face genuine difficulties. Besides, it is clearly an escape route for companies that are in distress for they can at least turn around those projects that are viable and sustainable and try to get out of the debt trap in the long run." he concludes..

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Exceptions

Rating agency Crisil has said the S4A scheme cannot be applied to all cases of stressed exposure. The main limitation of the scheme, according to the agency is that given the significantly low level of current cash flows of most highly leveraged companies in the vulnerable sectors, the number of stressed corporate loan accounts which could benefit from this scheme could be very low.