# The phenomenon of corporate debt restructuring in India: How far can it go to prevent insolvency?

The winner of the Richard Turton Award 2014, Anant Khandelwal, writes on the current trends in the insolvency landscape in India

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*We are delighted to announce that the winner of the Richard Turton award for 2014 is Anant Khandelwal from India.*

*Anant works for SBI Capital Markets Limited and is part of the debt restructuring and advisory team in the investment bank. He has been involved in some of the country's largest and landmark debt restructuring deals.*

*Anant was invited to the Annual Congress in Istanbul to receive his award.*

*A summary of his paper is presented here. The full version complete with all references can be found on line: at www.insol-europe.org/featured-articles/richard-turton-award-2014/*

## 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) figures show that non-performing loans (NPLs) of the total loan portfolio of the Indian lenders have almost doubled from 2.2% in March 2009 to 4.5% in March 2014. The rising incidence of NPLs has been continuously on the rise due to the economic slowdown after the global meltdown in 2008. Although India outperformed expectations riding through the global economic slowdown relatively unaffected, its exposure to the crisis was unavoidable. Ultimately, with economic growth slowing down, delay in implementation of projects and rate of interest going up sharply, corporations have been under tremendous financial stress and have been finding it difficult to repay loans.

This paints a grim situation where the corporations are facing tough times and may even face liquidation. In order to pre-empt the liquidation of the company, which has a far reaching adverse impact both financially and socially, the borrowers seek to renegotiate the terms of the loan with their lenders. In fact, the lenders too might seek a reschedulement in order to minimise the losses and reduce non-performing loans. This action 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 in corporate loans in the last two fiscal years from April 2012 to March 2014. This debt, restructured through the CDR forum, was greater than the cumulative amount of debt restructured under the forum since its inception in 2001.

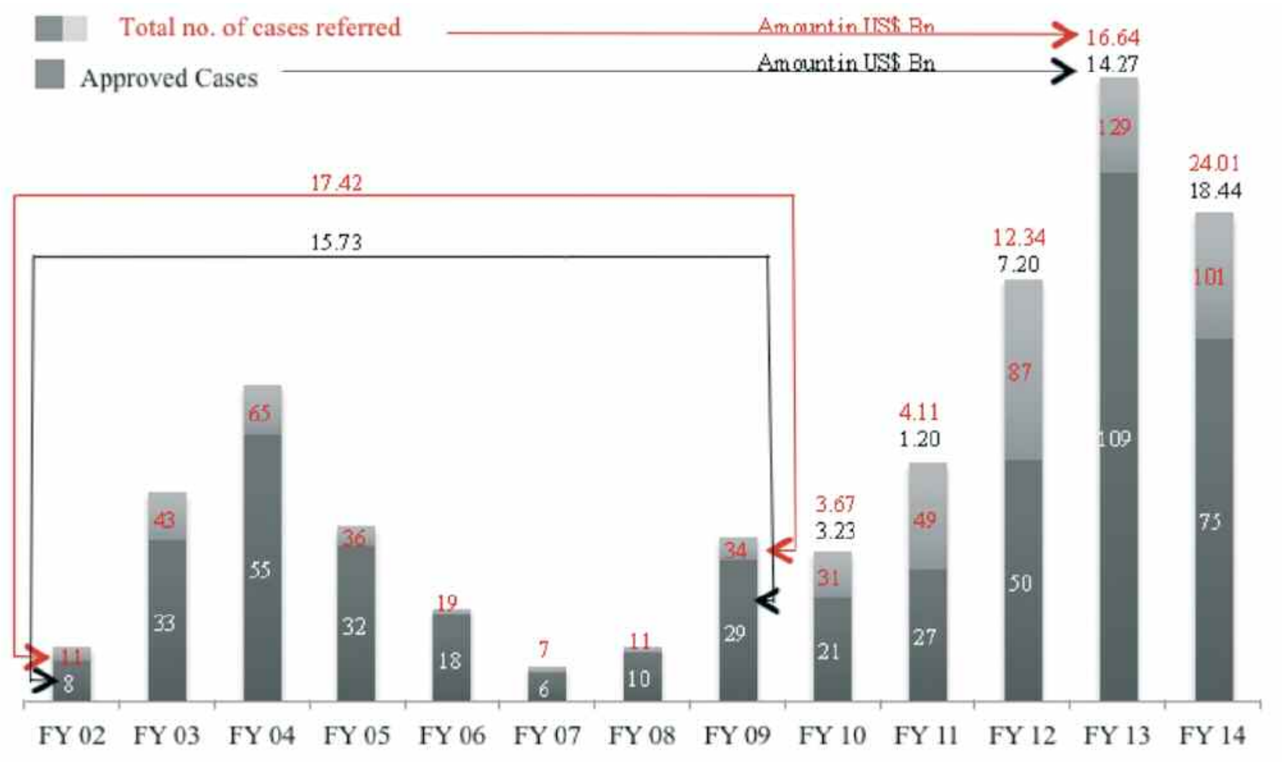
## Restructuring & insolvency regime in India

When corporations in India are confronted with financial distress they have to consider a number of options in order to achieve restructuring or liquidity. There is no single comprehensive and integrated policy on corporate insolvency and restructuring in India comparable to the Chapter 11 or Chapter 7 bankruptcy code in the US. There are **five** broad ways for them to attempt to achieve the desired results. These include (1) winding up under the 2013 Company Act (which recently replaced the 1956 Company Act), (2) arrangements or compromises under the Companies Act 2013, (3) restructuring under the Sick Industrial Company Act (SICA) and (4) Reconstruction of assets under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act. Lastly, (5) debt restructuring as per the RBI guidelines on CDR provides an important forum to address these concerns.

The objective of the framework known as CDR is to ensure a timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of SICA and other Company Acts and other legal proceedings, for the benefit of all concerned. In particular, the framework aims at preserving economically viable corporations that are affected by certain internal and external factors and minimise the losses to the creditors and other stakeholders through a coordinated restructuring programme.

## 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




*Source: CDR Cell & Outlook India*

are successfully revived. However, recent failures of CDR packages in the 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 just debt restructuring in saving the companies. Nevertheless, statistics are just 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 can be turned around.

### *Success & failure of the CDR mechanism*

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

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

Banks have reported that 10-15% of the restructured loans turn bad, which is an increase from corresponding figures about two to three years back. Bankers have also increasingly voiced 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 the 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.

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

### *A window of opportunity*

Over the past one and a half decade debt restructuring in India has seen its fair share of success and failures. While the successful turnaround 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.

One can decide whether the process of debt restructuring can save a company from being insolvent by looking into the

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*Anant receiving his award from INSOL Europe Honorary Chairman Marc Udink at the Annual Congress in Istanbul*

inherent weaknesses and drawbacks of the process and the best possible ways to tide over the said drawbacks.

The failure of cases being restructured has been due to various reasons.

Despite the existence of inter-creditor agreement (ICA) between various lenders, restructuring remains 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 the fact that they are against the spirit of ICA.

Once a borrower is under stress, there is a perception that the CDR process is easily accessible. This is because there have been instances when the debt relief package has been approved without properly establishing the viability of the borrower. Hence, a thorough assessment of the viability study by accredited industry experts should be a must 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 par with bad loans. These policies could discourage lenders from turning 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 to give 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 which are, at present, devoid of major stressed asset funds.

The current CDR guidelines require equity infusions and guarantees from the promoter, but often they are not backed by their adequate net worth. 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. Thus, the debt restructuring mechanism should be granted a proper legal statute so that it becomes binding in nature.

## Conclusion

The recent failures of debt restructuring in certain cases does not mean the mechanism has lost its purpose. What is required is a revamp of the debt restructuring mechanism in light of present macro and micro conditions and the lessons learned over the past years.

To conclude, one can safely state that financial markets 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.

The mechanisms like CDR could appear as a saviour for both the investors and the entrepreneurs. Even though laced with few short comings, the CDR mechanism in India can go a long way in instilling both the creditors and the investors with faith in the market even in the times of economic gloom. If implemented in its true spirit, it gives the entity facing financial pressure a chance to recover and get back in the business besides bringing it back to life from insolvency. ■

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