RESOLUTION OF STRESSED ASSETS

- RBI'S NEW FRAMEWORK

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Introduction

The Reserve Bank of India ("**RBI**") had issued a circular dated February 12, 2018 introducing a revised framework for resolution of stressed assets by scheduled commercial banks and all India financial institutions ("**Prior Framework**"), which was struck down by the Supreme Court of India *vide* its judgement dated April 2, 2019 in the case of *Dharani Sugars and Chemicals Limited* v. *Union of India*[1] ("**Dharani Sugars judgment**") on the ground of being *ultra vires* section 35AA of the Banking Regulation Act, 1949 ("**BR Act**"). Consequently, all actions taken under the Prior Framework, including proceedings by financial creditors[2] against debtors under section 7 of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") pursuant to the Prior Framework, became null and void.

Pursuant to the aforesaid, the RBI *vide* press release dated April 4, 2019 declared that it will take necessary steps, including issuance of a revised circular, for expeditious and effective resolution of stressed assets.

Accordingly, on June 7, 2019, the RBI introduced the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions 2019 ("**Prudential Framework**"), providing fresh directions to lenders on the resolution of stressed assets. The Prudential Framework has been brought into force with effect from June 7, 2019.

The Prudential Framework has been formulated to strengthen and improve the credit culture and to ensure promotion of a strong and resilient financial system in India. It aims to address the concerns raised by the Supreme Court of India in the Dharani Sugars judgment by, *inter alia*, prioritizing incentive structures over compulsory initiation of insolvency against large borrowers. Rather than compelling lenders to initiate insolvency proceedings within a certain timeline, the Prudential Framework instead provides a system of disincentives in the form of additional provisioning for delay in implementation of resolution plan ("**Plan**") or initiation of insolvency proceedings.

Applicability of the Prudential Framework

The Prudential Framework is applicable to the following entities:

a) Scheduled commercial banks (excluding regional rural banks);

b) All India term financial institutions (National Bank for Agriculture and Rural Development, National Housing Bank, Export-Import Bank of India and Small Industries Development Bank of India);

c) Small finance banks; and

d) Systemically important non-deposit taking non-banking financial companies (NBFC-ND-SI) and deposit taking non-banking financial companies (NBFC-D) ("**NBFCs**").

The Prudential Framework shall not be applicable in the following events:

a) where the RBI has already issued instructions to banks for initiation of insolvency proceedings against specific borrowers;

[1] *Dharani Sugars and Chemicals Limited* v. *Union of India*, Supreme Court, Transferred Case (Civil) No. 66 of 2018 in Transfer Petition (Civil) No. 1399 of 2018 (April 2, 2019).

[2] As defined under section 5(7) of the IBC.

b) restructuring of projects under implementation involving deferment of date of commencement of commercial operations; and

c) restructuring of loans in the event of a natural calamity, including asset classification and provisioning.

In addition to the above, the provisions of the Prudential Framework pertaining to the implementation of the Plan, including conditions and delayed implementation in connection therewith, shall not apply to the revival and rehabilitation of micro, small and medium enterprises, which shall continue to be governed by the Framework for Revival and Rehabilitation of Micro, Small and Medium Enterprises prescribed by the RBI *vide* its notification dated March 17, 2016.

Further, any Plan under consideration as on the date of the Prudential Framework may be pursued by lenders under the Prudential Framework subject to requirements/ conditions specified in the Prudential Framework being met.

With the introduction of the Prudential Framework, all extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR and Scheme for Sustainable Structuring of Stressed Assets (S4A) shall stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum has also been discontinued. Consequently, for the resolution of stressed assets, lenders may hereafter proceed only under the Prudential Framework.

Identification and reporting of stressed accounts

Lenders are required to classify accounts immediately upon default[3] in payment of whole or any part of the instalment, into different categories of special mention accounts ("**SMA**"). Further, lenders are required to report credit information, including classification of an account as SMA to the Central Repository of Information on Large Credits for borrowers having aggregate exposure of Rs. 50 million and above, on a periodic basis.

Resolution Plan

Implementation of Resolution Plan

All lenders are required to put in place policies approved by their board of directors for resolution of stressed assets, including the timelines for resolution.

Review period

Upon default being reported by a scheduled commercial bank, an all India term financial institution or a small finance bank, the lenders shall undertake a *prima facie* review of the borrower's account within 30 (thirty) days from such default ("**Review Period**"), during which, lenders may decide on the resolution strategy, including the nature of the Plan, the approach for implementation of the Plan, etc. The lenders may also choose to initiate legal proceedings for insolvency or recovery.

[3] Non-payment of debt (as defined under section 2(11) of the IBC) when whole or any part or instalment of the debt has become due and payable and is not paid by the debtor or the corporate debtor, as the case may be. In case of revolving facilities like cash credit, default would mean the outstanding balance remaining continuously in excess of the sanctioned limit or drawing power, whichever is lower, for more than 30 (thirty) days.

Inter-creditor agreement

In cases where the lenders decide to implement a Plan, the Prudential Framework mandates all lenders, including asset reconstruction companies, to enter into an inter-creditor agreement during the Review Period to provide for ground rules for finalisation and implementation of the Plan. The Plan must provide for payment of at least the liquidation value[4] to the dissenting lenders.

Any decision taken under the inter-creditor agreement as agreed by: (a) lenders representing 75% (seventy five percent) of the value of the total outstanding credit facilities (fund based and non-fund based), and (b) 60% (sixty percent) of lenders in number, shall be binding on all lenders. It may be noted that the inter-creditor agreement under the Project Sashakt required consent of all lenders holding at least 66% (sixty six percent) by value of the total outstanding debt.

Timeline for implementation of the Plan

In respect of accounts where aggregate exposure of any borrower to scheduled commercial banks, all India term financial institutions or small finance banks is of Rs. 20 billion and above, the Review Period shall commence no later than June 7, 2019, if the account is in default on such date.

Further, in case of accounts where the aggregate exposure is Rs. 15 billion and above, but less than Rs. 20 billion, the Review Period shall commence no later than January 1, 2020, if default has been declared in respect of the account on such date. In view of this, such accounts are already being given an extended period from June 7, 2019 till December 31, 2019 to get their default rectified. In case the default still stands on January 1, 2020, then the Review Period shall commence.

Lastly, in case of accounts with aggregate exposure of less than Rs. 15 billion, the reference date for commencement of the Review Period shall be announced by the RBI in due course.

In the event that an account falling in any of the above categories is not in default on the corresponding reference date, then for such accounts, the Review Period shall commence from the date on which the first default occurs after the corresponding reference date.

The Plan must be clearly documented by the concerned lenders and implemented within 180 (one hundred eighty) days from the end of Review Period.

Conditions for implementation of Plan

Restructuring/ change in ownership

In case of accounts where the aggregate exposure of lenders is Rs. 1 billion and above, if the Plan involves restructuring/ change in ownership it would require independent credit evaluation ("**ICE**") of the residual debt (i.e. aggregate fund based and non-fund based debt envisaged to be held by all the lenders as per the Plan) by credit rating agencies ("**CRAs**") specifically authorised by RBI for this purpose. Accounts with aggregate exposure of Rs. 5 billion and above will require 2 (two) ICEs and the other accounts will require 1 (one) ICE. Plans which receive a credit opinion of RP4[5] or better for the residual debt from the CRAs will be considered for implementation.

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[4] Liquidation value would mean the estimated realisable value of the assets of the relevant borrower, if such borrower were to be liquidated as on the date of commencement of the Review Period.

[5] Debt facilities/ instruments with this symbol are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such debt facilities/ instruments carry moderate credit risk.

Continuing credit exposure

The Plans listed below involving continuing credit exposure by the lenders shall be deemed to be implemented upon fulfilment of the corresponding conditions:

Nature of Plan	Conditions
Plans not involving restructuring/ change in ownership	- Borrower is not in default with any of the lenders as on 180th (one hundred eightieth) day from the end of the Review Period. - Any subsequent default (after the above period) shall be treated as a fresh default, resulting in a fresh review.
Plans involving restructuring/ change in ownership	- Completion of all necessary documentation, including execution of necessary agreements between the lenders and the borrower, creation and perfection of security are completed by all lenders, in line with the Plan being implemented. - New capital structure and/ or changes in the terms of conditions of the existing loans, get duly reflected in the books of all the lenders and the borrower. - Borrower is not in default with any of the lenders.
Plan involving lenders exiting the exposure by assigning the exposures to a third party	Upon extinguishment of the entire exposure to the borrower.
Plan involving recovery action	Upon extinguishment of the entire exposure to the borrower.

Additional provisioning for delay in implementation of Plan

All lenders are required to make additional provisions in the following cases:

a) if a viable Plan is not implemented within the stipulated timelines; or

b) where the lenders have initiated recovery proceedings (unless the recovery proceedings are fully completed).

In case the implementation of a Plan is delayed beyond 180 (one hundred eighty) days from the end of Review Period, then lenders are required to do an additional provisioning of 20% (twenty percent) of the total outstanding in respect of the debt and in case it is delayed beyond 365 (three hundred sixty five) days from the commencement of the Review Period, then an additional provisioning of 15% (fifteen percent) of the total outstanding in respect of the debt (i.e. in total an additional provisioning of 35% (thirty five percent)).

The additional provisions shall be made by all lenders having exposure to such borrower, over and above the higher of provisions already held or provisions required to be made as per the asset

classification status of the borrower account, subject to the total provisions held being capped at 100% (one hundred percent) of the total outstanding.

It may be noted that additional provisioning shall also be required to be made in cases where lenders have initiated recovery proceedings, but such proceedings have not been fully completed.

Reversal of the additional provisioning

The additional provisioning may be reversed in the following cases upon fulfilment of the corresponding conditions:

Nature	Conditions
Plans involving only payment of overdues by the borrower	Borrower is not in default for at least 6 (six) months from the date of clearing all overdues with all the lenders.
Plans involving restructuring/ change in ownership outside the IBC	Upon implementation of the Plan.
Where resolution is pursued under the IBC	- Half of the additional provisions may be reversed on filing of insolvency application. - Remaining half of the additional provisions may be reversed upon admission of application for commencement of the corporate insolvency resolution process under the IBC.
Where assignment of debt/ recovery proceedings is initiated	Upon completion of the assignment of debt/ recovery.

Prudential Norms

Asset classification

In the event of restructuring, accounts classified as 'standard' are required to be downgraded to 'sub-standard' assets. Non-performing assets ("**NPA**") would continue to have the same asset classification as prior to restructuring. The asset classification, in both cases, will continue to be governed by the ageing criteria as per extant asset classification norms.

Conditions for upgrade

The 'standard' assets which are classified as NPAs and NPAs which are retained in the same category on restructuring can only be upgraded when all outstanding facilities demonstrate satisfactory performance[6] during the period from the date of implementation of the Plan up to the date by which at least 10% (ten percent) of the sum of outstanding principal debt as per the Plan and interest capitalisation sanctioned as part of the restructuring, if any, is repaid ("**Monitoring Period**").

In case of accounts having aggregate exposure of Rs. 1 billion and above, the credit facilities of the borrower are additionally required to obtain investment grade rating (i.e. BBB- or better) by

[6] Satisfactory performance means that the borrower entity is not in default at any point of time during the period concerned.

CRAs. Accounts with aggregate exposure of Rs. 5 billion and above will need to obtain 2 (two) ratings and other accounts will require 1 (one) rating.

Lenders are required to make additional provisions of 15% (fifteen percent) at the end of the Review Period, for accounts wherein the borrower fails to demonstrate satisfactory performance during the Monitoring Period.

Any default by a borrower in any of the credit facilities with any of the lenders subsequent to upgrade in asset classification as above but before the end of the specified period[7], will require a fresh Plan to be implemented, along with an additional provision of 15% (fifteen percent) at the end of the Review Period.

Additional finance and interim finance

Additional finance granted to a borrower under the Plan (including any resolution plan approved under the IBC) will be treated as a 'standard' asset during the Monitoring Period under the approved Plan. However, this would be subject to the account performing satisfactorily during the Monitoring Period. If the account fails to demonstrate satisfactory performance during the Monitoring Period or does not qualify for upgradation at the end of the Monitoring Period, such additional finance granted will be placed in the asset classification category as the restructured debt.

Similarly, any interim finance[8] extended by the lenders to debtors undergoing insolvency proceedings under the IBC may be treated as a 'standard' asset during the insolvency resolution process period. During this period, asset classification and provisioning for the interim finance shall be governed by the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015, as may be amended from time to time. Subsequently, upon approval of the resolution plan by the adjudicating authority, treatment of such interim finance shall be as per the norms applicable to additional finance.

Income recognition

In respect of restructured accounts classified as 'standard' assets, the interest income can be recognised on accrual basis and in respect of restructured accounts classified as NPAs, the interest income will be recognised on cash basis. However, in case of accounts where additional finance is provided, if the pre-restructuring facilities were already classified as NPA, the interest income will be recognised only on cash basis unless the restructuring is accompanied by change of ownership.

Conversion of principal into debt/ equity and unpaid interest into FITL, debt or equity instruments

Any fresh securities issued under the Plan to the lenders, as a result of restructuring, will be held by the lenders in lieu of a portion of the pre-restructured exposure and the funded interest term loan ("**FITL**"), debt and equity instruments created by conversion of part of principal or unpaid interest are required to be placed in the same asset classification category in which the restructured advance has been classified. The manner in which such instruments acquired by the lenders under the Plan shall be valued has been provided in the Prudential Framework.

[7] "Specified period" means the period from the date of implementation of the Plan up to the date by which at least 20% (twenty percent) of the sum of outstanding principal debt as per the Plan and interest capitalisation sanctioned as part of the restructuring, if any, is repaid. For accounts restructured under the IBC, the specified period shall be deemed to commence from the date of implementation of the resolution plan as approved by the adjudicating authority.

[8] As defined under section 5(15) of the IBC.

Change in ownership

Subject to the conditions mentioned in the Prudential Framework, in case of a change in the ownership of the borrower entity, the credit facilities of the concerned borrowing entities may be continued/ upgraded as 'standard' after the change in ownership is implemented, either under the IBC or under the Prudential Framework.

Any change in ownership under the Prudential Framework will have to comply with the provisions of section 29A of the IBC. Additionally, it has also been stipulated that the new promoter should not be a person/ entity from the existing promoter group (including as defined under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018).

Further, the new promoter shall acquire at least 26% (twenty six percent) of the paid-up equity capital as well as voting rights of the borrower entity, be the single largest shareholder of the borrower entity and be in 'control'[9] of the borrower entity.

Regulatory Exemptions

The regulatory exemptions available in case of restructurings under the Prudential Framework are set out hereinbelow:

RBI

- Acquisition of non-statutory liquidity ratio securities by way of conversion of debt is exempted from the restrictions and the prudential limit on investment in unlisted non-statutory liquidity ratio securities prescribed by the RBI.

- Acquisition of shares due to conversion of debt to equity during a restructuring process will be exempted from regulatory ceilings/ restrictions on capital market exposures, investment in para-banking activities and intra-group exposure. However, these will require reporting to the RBI and disclosure by banks in its annual financial statements and it will be subject to compliance with the provisions of section 19(2) of the BR Act.

SEBI

- Exemptions have been provided by the Securities and Exchange Board of India from the requirements of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 for restructurings carried out as per regulations issued by the RBI.

- With respect to the requirements under regulation 158(6)(a) of SEBI ICDR Regulations, the issue price of the equity will be the lower of (i) or (ii) below:

  (i) the average of the weekly high and low of the volume weighted average price of the related equity shares quoted on the recognised stock exchange during the 26 (twenty six) weeks preceding the reference date or the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the 2 (two) weeks preceding the reference date, whichever is lower; and

  (ii) book value which is to be calculated (per share) from the latest audited balance sheet (without considering revaluation reserves, if any) adjusted for cash flows and financials post the earlier restructuring, if any. The balance sheet shall not be more than 18

[9] As defined under section 2(27) of the Companies Act, 2013.

(eighteen) months old. In case the audited balance sheet is not available, the total book value of the shares shall be set at Rs. 1 per company.

The reference date in such cases shall be the date on which the bank approves the restructuring scheme. In the case of conversion of convertible securities into equity, the reference date shall be the date on which the bank approves the conversion of the convertible securities into equities.

Cases of frauds/ willful defaulters

Borrowers who have committed frauds/ malfeasance/ wilful default will be ineligible for restructuring. However, in cases where the existing promoters are replaced by new promoters, and the borrower company is totally delinked from such erstwhile promoters/ management, lenders may take a view on restructuring such accounts based on their viability, without prejudice to the continuance of any criminal action against the erstwhile promoters/ management.

Concluding Remarks

The Prudential Framework provides that the provisioning maintained as on April 2, 2019 (i.e. the date of the Dharani Sugars judgment) in respect of any borrower shall not be reversed by a lender unless the reversal is a consequence of an asset classification upgrade or recovery or resolution following the instructions set out in the Prudential Framework.

The Prudential Framework also provides that the RBI may take stringent actions in case of any action by lenders is taken with an intent to conceal the actual status of accounts or evergreen the stressed accounts. In addition to a direction to banks to file insolvency application under the IBC, such action may include higher provisioning on such accounts and monetary penalties.

It may be noted that the definition of default under the Prudential Framework is the same as under the Prior Framework, but the RBI has introduced a 30 (thirty) days' review period for the lenders to decide on the resolution strategy.

Further, under the Prudential Framework, in respect of the inter-creditor arrangement, the additional condition requiring consent of 60% (sixty percent) of lenders by number seems to have been introduced to combat situations wherein a sole lender holds 75% (seventy five percent) or more of the value of total outstanding credit facilities of an account which previously did not leave any decision making powers to the minority lenders.

Unlike the Prior Framework, the Prudential Framework is also applicable to NBFCs and small finance banks. However, it may be noted that whilst the Prudential Framework is applicable to NBFCs, it appears that the Review Period will not get triggered in the event of a default in respect of NBFCs. Given that NBFCs currently are major players in the lending sector in the country, it will be interesting to see how this practically pans out and if the RBI subsequently comes up with any clarification in this regard.

Under the Prior Framework, lenders were statutorily required to pursue action under the IBC at the end of 180 (one hundred eighty) days' period. However, under the new Prudential Framework, the decision to proceed under the IBC in respect of the stressed accounts is at the discretion of the lenders of the stressed borrower.

An interesting point to note is that the Prudential Framework does not clarify the status of erstwhile schemes of the RBI for resolution of stressed assets and the rights of lenders and borrowers thereunder between April 2, 2019 (i.e. the date of the Dharani Sugars judgment) and June 7, 2019 (i.e. the date of issue of the Prudential Framework). Thus, it is unclear whether such erstwhile schemes were re-implemented for the interim period following the Dharani Sugars judgment.

The introduction of the Prudential Framework showcases the RBI's continued focus on time-bound resolution of stressed assets. However, unlike the Prior Framework, it appears that the Prudential Framework is intended to provide a fair amount of flexibility to lenders to use their commercial and economic judgment to put in place a resolution strategy.

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