Report of the Working Group to review the existing guidelines on restructuring of advances and align them with the guidelines on CDR Mechanism

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Executive Summary

1. In the Annual Policy Statement for the Year 2006-07, it was proposed that a Working Group will be constituted to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR mechanism. Accordingly, in order to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR mechanism, a Working Group comprising members from commercial banks, Indian Banks' Association (IBA), Department of banking Operations and Development (DBOD) and Department of Banking Supervision (DBS) of RBI was constituted.

2. The Group studied the existing RBI guidelines on restructuring of advances under CDR Mechanism, under SME debt restructuring Mechanism, guidelines applicable to advances to other industrial borrowers not covered under CDR/SME debt restructuring mechanisms and the borrowers in the non-industrial sectors. The Group observed that there exist significant differences in the guidelines relating to restructuring of these distinctive categories. The Group identified the following issues from the existing position:

a) Whether the prudential norms and regulatory concessions prescribed under CDR Mechanism should be extended to other categories of advances also?

b) If so, what should be the framework? Whether different sets of prudential norms and concessions need to be applied to different categories of advances?

3. Based on the analysis carried out(Chapter 4), the Group arrived at mainly two broad conclusions. **First,** the regulatory framework prescribed under CDR Mechanism is very exhaustive and is conceptually sound. Therefore, it should be the basis of restructuring framework for all other advances. **Second**, while the basic prudential framework for all advances would be the same, some modifications would be required for different categories of advances. The difference could be mainly in the applicability of the prudential norms and the manner in which the diminution in the value of the loan is computed and provided for.

4. The advances extended to traders differ from the advances for production purposes in as much as the reasons for cash flow problems such as cost escalation, delay in project in implementation, change in working capital cycles, problems in procuring the raw material and retention of the market share of the product are not relevant for these advances. Similarly, the retail loans including housing loans are also different inasmuch as they do not depend upon the repayment from the productivity of the asset, which has been financed by the bank. Therefore, the terms for restructuring of the advances for traders, retail loans including housing loans should be relatively more stringent. Further, RBI need not prescribe detailed parameters for restructuring of these advances and may issue only very broad guidelines.

5. Accordingly, the Group has suggested division of all Non-CDR/Non-SME borrowers in the following categories for the purpose of restructuring frameworks:

i) Borrowers engaged in **industrial activities** and not covered under CDR/SME debt restructuring mechanisms and the borrowers in **agricultural and services sector** having **single bank** arrangements but above Rs. One crore.

ii) Borrowers engaged in **agricultural and services sector** having multiple banking/consortium/syndicate arrangements

iii) All borrowers including those in industrial sector with outstanding facilities below Rs. One crore except (iv) below.

iv) Trading Accounts/Retail loans including Housing Loans and any unsecured advances irrespective of amount.

6. The Group has suggested certain changes in the prudential norms applicable to restructured advances, in addition to those effected under CDR Mechanism. These changes, which are mostly in the nature of clarifications to the existing instructions, would need to be applied to advances restructured under CDR mechanism/SME Debt restructuring also.

7. The Group has excluded from its purview the restructuring of advances in case of natural calamities. The restructuring of advances of the borrowers who suffer from natural calamities will be done as per separate set of guidelines issued by RPCD from time to time. The Group does not propose any change in this regard.

Chapter 1

Introduction

The Reserve Bank of India (RBI) had issued guidelines in March 2001 allowing banks/financial institutions to restructure/reschedule credit facilities extended to industrial units which are fully secured by tangible assets, subject to certain conditions. In August 2001, an institutional mechanism for restructuring of corporate debt in the form of the Corporate Debt Restructuring (CDR) system was put in place. The CDR mechanism, which was reviewed twice in 2003 and 2005, covers multiple banking accounts/syndication/consortium accounts with outstanding exposure of Rs.10 crore and above by banks and institutions. Besides, in September 2005, the Reserve Bank issued guidelines for restructuring of debt of all eligible Small and Medium Enterprises (SME). These guidelines encompass (a) all non-corporate SMEs irrespective of the level of dues to banks. (b) All corporate SMEs, which are enjoying banking facilities from ***a single bank***, irrespective of the level of dues to the bank. (c) All corporate SMEs, which have funded and non-funded outstanding up to Rs.10 crore under ***multiple/ consortium banking arrangement***

1.2. The debt restructuring mechanisms indicated above cover only the accounts of borrowers engaged in industrial activities, and have rationalized the prudential norms applicable to such accounts with a view to striking a balance between the regulatory concessions extended towards restructuring of the accounts and the measures to prevent use of the restructuring mechanism as a tool for evergreening of the problem accounts. Against this backdrop, it was felt necessary to review the existing guidelines relating to accounts of non-industrial borrowers. Accordingly, in the Annual Policy Statement for the Year 2006-07, it was proposed that a Working Group will be constituted to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR mechanism.

1.3. Accordingly, in order to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR mechanism, a Working Group comprising members from commercial banks, Indian Banks' Association (IBA), Department of banking Operations and Development (DBOD) and Department of Banking Supervision (DBS) of RBI was constituted. The members are

(i) Shri Prashant Saran Chief General Manager-in-Charge Department of Banking Operations & Development Reserve Bank of India	Chairman
(ii) Shri T R Bajalia Chief General Manager Industrial Development Bank of India Ltd.	Member
(iii) Shri G Sankaranarayanan Senior Vice President Indian Banks' Association	Member
(iv) Shri Ajai Singh Deputy General Manager State Bank of India	Member
(v) Shri K Gopalakrishnan, General Manager, Department of Banking Supervision Reserve Bank of India	Member
(vi) Shri P R Ravi Mohan General Manager Department of Banking Operations & Development Reserve Bank of India	Member Secretary

Chapter 2

Extant guidelines on Corporate Debt Restructuring and Debt Restructuring Mechanism for Small and Medium Enterprises (SMEs) and other accounts

A comparison of the salient features of the various types of restructuring mechanisms is attempted in this chapter with the primary objective of identifying the gaps existing in the restructuring of accounts other than the CDR mechanism and SME accounts. This would facilitate the formulation of guidelines in tandem with the extant norms for restructuring under CDR mechanism to such accounts as per the terms of reference for the group. The comparisons have been attempted under the parameters viz., Coverage of guidelines, Additional finance, One-time settlement, Restructuring of doubtful debts & Prudential norms.

2.1. Coverage of guidelines

2.1.1 CDR Mechanism

The CDR guidelines cover accounts of all corporate borrowers having outstanding fund-based and non-fund based exposures of Rs.10 crore and above from more than one bank / FI. The prudential norms applied under CDR mechanism have been largely based on the general asset classification norms applicable to restructured accounts of borrowers engaged in manufacturing / industrial activities. As trading involves only buying and selling of commodities and the problems associated with manufacturing units such as bottlenecks in commercial production, time and cost escalation etc. are not applicable to them, these guidelines should not be applied to restructuring/ rescheduling of credit facilities extended to traders.

2.1.2. SME Debt Restructuring

These guidelines encompass (a) all non-corporate SMEs irrespective of the level of dues to banks. (b) All corporate SMEs, which are enjoying banking facilities from ***a single bank***, irrespective of the level of dues to the bank. (c) All corporate SMEs, which have funded and non-funded outstanding up to Rs.10 crore under ***multiple/ consortium banking arrangement***.

2.1.3 General Guidelines for restructuring of accounts of industrial borrowers other than those covered above

The general guidelines at present cover the accounts of the borrowers in the industrial sector who have credit facilities from a single bank and are not covered under CDR/SME debt restructuring mechanisms.

2.1.4 General Guidelines for restructuring of accounts of non-industrial borrowers other than those covered above

At present, banks have been delegated authority to formulate policies with the approval of their Board of Directors for restructuring of non-industrial accounts subject to normal prudential norms prescribed by RBI for restructured accounts.

2.2 Additional Finance

2.2.1 CDR Mechanism

The additional finance may be treated as 'standard asset', up to a period of one year after the first interest / principal payment, whichever is earlier, falls due under the approved restructuring package. However, in the case of accounts where the existing facilities are classified as 'sub-standard' and 'doubtful', interest income on the additional finance should be recognised only on cash basis. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

2.2.2 SME Debt Restructuring

Additional finance, if any, may be treated as 'standard asset' in all accounts viz; standard, sub-standard, and doubtful accounts, up to a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the approved restructuring package. If the restructured asset does not qualify for upgradation at the end of the above period, additional finance shall be placed in the same asset classification category as the restructured debt.

2.2.3 General Guidelines for restructuring of accounts of industrial borrowers other than those covered above

Any additional finance has to be classified under the same category as the original finance and the income recognition and provisioning will be done in accordance with normal IRAC norm.

2.2.4 General Guidelines for restructuring of accounts of non-industrial borrowers other than those covered above

The same as in the case of para 2.2.3 above.

2.3. One time settlement as part of restructuring package

2.3.1 CDR Mechanism

CDR mechanism allows one time settlement option as a part of the restructuring package in order to bring more flexibility in the exit option to the lenders who are no more interested in continuing their exposure in the corporate.

2.3.2 SMEs debt restructuring

One time settlement option as a part of restructuring not envisaged.

2.3.3 General Guidelines for restructuring of accounts of industrial borrowers other than those covered above

Same as para 2.3.2 above

2.3.4 General Guidelines for restructuring of accounts of non-industrial borrowers other than those covered above

No specific guidelines have been issued in this regard.

2.4. Restructuring of doubtful accounts

2.4.1 CDR Mechanism

Doubtful accounts are eligible to be restructured under CDR mechanism and are thus entitled to concession in the asset classification norms.

2.4.2 SMEs

Provision on the lines of CDR mechanism has been extended.

2.4.3 Industrial borrowers other than CDR and SMEs borrowers

Doubtful accounts are restructured as per the loan policies formulated by individual banks.

2.4.4 Non-industrial borrowers

Same as para 2.4.3 above

2.5. Prudential norms

2.5.1 Asset classification and provisioning norms

2.5.1.1 CDR mechanism

Restructuring of corporate debts under CDR system could take place in the following stages:

a. before commencement of commercial production;

b. after commencement of commercial production but before the asset has been classified as ‘sub-standard’;

c. after commencement of commercial production and the asset has been classified as ‘sub-standard’ or ‘doubtful’.

Treatment of ‘standard’ accounts restructured under CDR

A. A rescheduling of the installments of principal alone, at any of the aforesaid first two stages would not cause a standard asset to be classified in the sub-standard category and reschedulement of installments of principal at the third stage refer to above would not cause sub-standard / doubtful asset to slip further down in the asset classification categories, provided the following conditions are satisfied.

i) Advance is fully secured

ii) The restructuring conforms to the following parameters:

a) Restructuring under CDR mechanism is done for the first time,

b) The unit becomes viable in 7 years and the repayment period for the restructured debts does not exceed 10 years,

c) Promoters’ sacrifice and additional funds brought by them should be a minimum of 15% of creditors’ sacrifice, and

d) Personal guarantee is offered by the promoter except when the unit is affected by external factors pertaining to the economy and industry.

B. A rescheduling of interest element at any of the foregoing first two stages would not cause an asset to be downgraded to sub-standard category and reschedulement of interest element at the third stage refer to above would not cause sub-standard / doubtful asset to slip further down in the asset classification categories, provided the following conditions are satisfied.

i) The amount of sacrifice, if any, in the element of interest measured in present value terms is provided/ written off. For this purpose, the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring.

ii) The restructuring conforms to the following parameters:

a) Restructuring under CDR mechanism is done for the first time,

b) The unit becomes viable in 7 years and the repayment period for the restructured debts does not exceed 10 years,

c) Promoters' sacrifice and additional funds brought by them should be a minimum of 15% of creditors' sacrifice, and

d) Personal guarantee is offered by the promoter except when the unit is affected by external factors pertaining to the economy and industry.

(iii) The moratorium period for interest payments fixed under restructuring is not longer than the original moratorium.

C. A rescheduling of interest element would render a sub-standard / 'doubtful' asset eligible to be continued to be classified in sub-standard / 'doubtful' category for the specified period, i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms. The account can be upgraded after one year of satisfactory performance as indicated herein.

2.5.1.2 SMEs debt restructuring

The same in the case of para 2.5.1.1

2.5.1.3 Industrial borrowers other than CDR and SMEs borrowers

The asset classification and provisioning norms for this category of borrowers are more or less the same except for the following:

i. In these cases sacrifice in the element of interest is computed as difference between the present value of future interest income reckoned based on the **original rate of interest** and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring.

ii. The conditions enumerated at para 2.5.1.1(A)(ii) & B(ii) and (iii) are not applicable to such accounts.

2.5.1.4 Non-industrial borrowers

While banks may consider accounts other than that of industrial units also for restructuring, such accounts would have to qualify the basic test of viability before it is considered for restructuring. However, these accounts would not qualify for the special asset classification status available to restructured 'standard' and restructured 'substandard'/Doubtful accounts as indicated in paras 2.5.1.1 above. The accounts which do not qualify for restructuring/ rescheduling in terms of para 5.1.1above, will be subjected to the following prudential norms.

i) These restructured/ rescheduled accounts would continue to age and migrate to the next asset classification status in the normal course. Banks should ensure that the amount of sacrifice, if any, in the element of interest - both in term loans or working capital facilities, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. For the purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + the appropriate credit risk premium for the borrower-category) and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis.

ii) These restructured/ rescheduled accounts, whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the revised terms, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms as aforesaid, could also be reversed after the one year period.

2.5.2 Annual review of provisions

2.5.2.1. CDR Mechanism

Sacrifice may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

2.5.2.2 SMEs

Same as in the para 2.5.2.1

2.5.2.3. Industrial borrowers other than CDR and SMEs borrowers

The provisions are not required to be recalculated on annual basis.

2.5.2.4 Non-industrial borrowers

Not applicable.

2.5.3. Prudential norms on conversion of debt into equity

2.5.3.1 CDR mechanism

Where overdue interest is funded or outstanding principal and interest components are converted into equity, debentures, zero coupon bonds or other instruments and income is recognized in consequence, full provision should be made for the amount of income so recognized. Equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and / or interest should be classified in the AFS category and valued in accordance with the extant instructions on valuation of banks' investment portfolio except to the extent that (a) equity may be valued as per market value, if quoted (b) in cases where equity is not quoted, valuation may be at break-up value in respect of standard assets and in respect of sub-standard / doubtful assets, equity may be initially valued at Re1 and at break-up value after restoration / up gradation to standard category.

If the conversion of interest into equity, which is quoted, interest income can be recognized after the account is upgraded to the standard category at market value of equity, on the date of such up gradation, not exceeding the amount of interest converted into equity. If the conversion of interest is into equity, which is not quoted, interest income should not be recognized.

In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA ab-initio in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Consequently, income should be recognized on these instruments only on realization basis. The income in respect of unrealised interest which is converted into debentures or any fixed maturity instruments, would be recognized only on redemption of such instruments.

Banks may reverse the provisions made towards income recognised at the time of conversion of accrued interest into equity, bonds, debentures etc. when the instrument goes out of balance sheet on sale / realisation of value / maturity.

2.5.3.2 SMEs debt restructuring

Not envisaged for SMEs. General norms as indicated in para 2.5.3.3 below will be applicable.

2.5.3.3 Industrial borrowers other than CDR and SMEs

The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such

equity must thereafter be classified in the “available for sale” category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realisation basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognised only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

2.5.3.4 Non-industrial borrowers

No specific instructions issued by RBI.

2.5.4. Applicability of capital market exposure norms to equity created by conversion of debt.

2.5.4.1 CDR Mechanism

The CDR Empowered Group, while deciding the restructuring package, should decide on the issue regarding convertibility (into equity) option as a part of restructuring exercise whereby the banks / financial institutions shall have the right to convert a portion of the restructured amount into equity, keeping in view the statutory requirement under Section 19 of the Banking Regulation Act, 1949, (in the case of banks) and relevant SEBI regulations.

Equity acquired by way of conversion of debt / overdue interest under the CDR mechanism is allowed to be taken up without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached, subject to reporting such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. However, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act 1949

Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI, subject to periodical reporting to RBI in the aforesaid DSB return.

2.5.4.2 SMEs debt restructuring

The provisions on the lines of CDR mechanism not extended to SMEs. The general guidelines as indicated in para 2.5.4.3 below are applicable to SMEs also.

2.5.4.3 Industrial borrowers other than those covered above

The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognized in consequence, full provision should be made for the amount of income so recognized to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognized at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognized only on realization basis. The income in respect of unpaid interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

2.5.4.4 Non- industrial borrowers

No specific instructions issued by RBI.

2.5.5. Asset classification of repeatedly restructured accounts

2.5.5.1 CDR mechanism

The regulatory concession in asset classification (paragraph 2.5.1 above) would not be available if the account is restructured for the second or more times. In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion its asset classification would be reckoned from the date when it became NPA on the previous occasion. However, such assets restructured for the second or more time may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

2.5.5.2 SMEs debt restructuring

Same as above

2.5.5.3 Industrial borrowers other than CDR and SMEs

Banks are not expected to repeatedly restructure/ reschedule the amounts due to them unless there are very strong and valid reasons which warrant such repeated restructuring/rescheduling. Restructuring in all cases should be based on viability parameters. Any restructuring done without looking into cash flows of the borrower would invite supervisory concerns. It will not be appropriate to extend the special asset classification status as provided for in para 2.5.1 above to the accounts, where there are repeated restructuring/ rescheduling.

2.5.6 Linkage of regulatory concessions with the timely disposal of applications/implementation of packages

2.5.6.1 CDR Mechanism

During pendency of the case with the CDR system, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the case is referred to the CDR Cell. However, if a restructuring package under the CDR system is approved by the Empowered Group, and the approved package is implemented within 4 months from the date of approval, the asset classification status may be restored to the position which existed when the reference to the Cell was made. Consequently, any additional provisions made by banks towards deterioration in the asset classification status during the pendency of the case with the CDR system may be reversed.

If an approved package is not implemented within 4 months after the date of approval by the Empowered Group, it would indicate that the success of the package is uncertain. In that case, the asset classification status of the account should not be restored to the position as on the date of reference to the CDR Cell.

2.5.6.2 SME Debt Restructuring

Banks should work out the restructuring package and implement the same within a maximum period of 60 days from date of receipt of requests.

2.5.6.3 Industrial borrowers other than CDR and SMEs

No time limit has been prescribed.

2.5.6.4 Non-industrial borrowers

No time limit has been prescribed.

2.6. Viability benchmarks

2.6.1 CDR mechanism

CDR Standing Forum would lay down policies and guidelines including those relating to the critical parameters for restructuring(for example, maximum period for a unit to become viable under a restructured package, minimum level of promoters' sacrifice.

2.6.2 SMEs debt restructuring

Banks may decide on the acceptable viability benchmark, consistent with the unit becoming viable in 7 years and the repayment period for restructured debt not exceeding 10 years.

2.6.3 Industrial borrowers other than CDR and SMEs

Banks are free to determine the viability parameters in respect of such accounts.

2.6.4 Non-industrial borrowers

Banks are free to determine the viability parameters in respect of such accounts.

2.7. Coverage of willful defaulters

2.7.1 CDR Mechanism

The Core Group has discretion in dealing with willful defaulters in certain cases other than cases involving frauds or diversion of funds with malafide intentions.

2.7.2 SMEs debt restructuring

In the case of SMEs, the accounts of willful defaulters are not eligible for restructuring. Accounts involving willful default, fraud and malfeasance will not be eligible for restructuring under these guidelines. However banks may review the reasons for classification of the borrower as willful defaulter specially in old cases where the manner of classification of a borrower as willful defaulter was not transparent and satisfy themselves that the borrower is in a position to rectify the willful default provided he is granted an opportunity under the Debt Restructuring Mechanism for SMEs. Such exceptional cases may be admitted for restructuring with the approval of the Board of Directors of the banks only.

2.7.3 Industrial borrowers other than CDR and SMEs

There are no specific instructions from RBI on the aspect in the case of these borrowers.

2.7.4 Non-industrial borrowers

Same as para 2.7.3

2.8. Institutional arrangement for restructuring of advances

2.8.1 CDR mechanism

CDR mechanism has detailed institutional framework comprising 3 Tier structure to attend to the restructuring of cases eligible under the mechanism. In addition to this, there is a time schedule which need to be adhered while the case is being processed through various stages.

2.8.2 SMEs debt restructuring

In regard to accounts with single bank, the individual banks would deal with the restructuring in the following manner:

a) The restructuring would follow a receipt of a request to that effect from the borrowing units.

b) In case of eligible SMEs which are under consortium/multiple banking arrangements, the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.

2.8.3 Industrial borrowers other than CDR and SMEs

No specific instructions issued by RBI.

2.8.4 Non-industrial borrowers

Same as above.

2.9. Disclosures

2.9.1 CDR mechanism

Disclosure in the form prescribed by RBI are required to be made.

2.9.2 SMEs debt restructuring

Same as para 2.9.1.

2.9.3 Industrial borrowers other than CDR and SMEs

Same as para 2.9.1

2.9.4 Non-industrial borrowers

Same as para 2.9.1

Chapter 3

International practices relating to restructuring of loan accounts

International practices relating to restructuring of loan accounts particularly that regarding the prudential norms applicable to such accounts were studied. However, not much material could be collected on all the aspects of restructuring presently covered under the CDR mechanism. A brief account of practices observed in respect of a few parameters is given hereunder:

3.1 Definition of Restructured Facility

Australia

- A restructured facility is defined as a facility in which the original contractual terms have been modified to provide for concessions of interest, or principal, or other payments due, or for an extension in maturity for a non-commercial period for reasons related to the financial difficulties of an entity.

- Any of the following concessions lead to a facility being classified as restructured:

(a) a reduction in the principal amount of the facility, or the amount payable at maturity, as set down in the original loan agreement;

(b) an interest rate below the terms originally contracted;

(c) a reduction of accrued interest, including forgiveness of interest;

(d) a deferral or extension of interest or principal payments, including interest capitalisation;

(e) an extension of the maturity date or dates at a stated interest rate lower than the current market rate for new facilities with a similar risk; or

(f) an extension of the maturity date or dates materially beyond the maturities that would be offered to new facilities with similar risk.

- For a facility to be classified as restructured, the bank and the entity which is party to the facility must formally agree to the new terms. In the event that the new terms are not subject to a formal agreement, a facility must be treated as impaired. A facility which is extended or renewed on terms in line with those which would be offered at that time to new clients with similar risk profiles, and where such extension or renewal does not flow from any financial difficulties of an entity, is not considered a restructured facility .

Singapore

A credit facility is restructured when a bank grants concessions to a borrower because of a deterioration in the financial position of the borrower or the inability of the borrower to meet the original repayment schedule. The revised repayment terms relating to the interest or repayment period, are normally considered as non-commercial by a bank.

3.2 Computation of diminution in the fair value of the loan consequent upon restructuring

Australia

Where a facility has been restructured, the value of the facility for capital purposes must be reduced to fully reflect, at the date of restructuring, the effect of any reduction in cash flows previously due under contracted terms. Such change in value must be implemented by way of adjustment to the Tier 1 capital of the bank.

Thailand

(1). Where concessions have been granted to the debtor, troubled debt restructuring requires that financial institutions calculate the new net book carrying value of the restructured loan (including any overdue or accrued interest) and hence the loss from restructuring using the first applicable method ranked by preference of priority as follows:

(a). The present value of expected future cash flows according to the restructured contract using the discount rate detailed in Para (3) below;
(b). The market value of the restructured loan, if there is a market for such debts and the market price is known, for example, the auction price obtained by the Financial Sector Restructuring Authority; or
(c). The market value of the collateral (appraised following Bank of Thailand collateral valuation and appraisal regulations) under the restructured contract if the loan is collateral dependent.

If the new net book carrying value of the restructured loan as calculated using one the above methods is less than the book value of the original loan, the financial institution must recognise the amount in its profit and loss statement in that accounting period, and determine the appropriate loan loss provisions.

(2). In cases where the financial institution accepts a transfer of assets, equity instruments, debt instruments and/or the conversion of the borrower's debt into equity (debt-equity swaps) in full settlement of the debt, financial institutions must deduct the market value of the assets and equity interests transferred from the book value of the loan, and write off the difference as a loss in the profit-loss statement as soon as the transfer is made. The reserve for doubtful debt shall also be taken into consideration.

In cases where the creditor accepts a transfer of assets, equity instruments, debt instruments and/or the conversion of the borrower's debt into equity (debt-equity swaps) in partial settlement of the debt with a modification of terms for the remaining debt, financial institutions must undertake the procedure prescribed in Para (2) and account for the remainder of the debt following the regulations in Para (1).

(3). Financial institutions may use the market interest rate as the discount rate in present value cash flow calculations. Examples of market interest rates include the internal MLR, MOR, or MRR rates of the institution, or the LIBOR or SIBOR rates for foreign currency debt. Financial institutions should apply the market rate as at the date of debt restructuring appropriate to the structure of the debtor's business and as such,

institutions must set out and adhere to the policies and procedures on debt restructuring.

3.3 Classification of restructured Assets

Australia

The restructured facility is classified as impaired.

Hong Kong

Generally, rescheduled loans where concessions have been made to the customer on interest or principlal because of deterioration in the customer's financial position should be classified at least as sub-standard.

Singapore

A bank shall place a restructured credit facility on the appropriate classified grade (impaired) depending on its assessment of the financial condition of the borrower and the ability of the borrower to repay based on the restructured terms.

Thailand

After restructuring each case, financial institutions shall classify and make provisions against each debtor following the BOT Notification regarding "Worthless or irrecoverable assets and other doubtful assets which may be worthless or irrecoverable whereby the period over which provisioning may be phased-in shall not exceed the remaining period up to the maturity of the restructuring contract.

3.4. Upgradation of restructured facilities

Hongkong

The restructured loans may be upgraded to pass once they have been serviced according to the revised terms for six months in the case of monthly repayments or 12 months in the case of quarterly or six-monthly repayments.

Australia

Provided an appropriate adjustment has been made to the value of a facility, if a facility is restructured so that all of the following requirements are satisfied:

(a) a bank expects the entity will perform on the restructured terms so that it will receive in a timely manner the full amount of cash flows now contracted to be received or is otherwise well secured;

(b) the restructured facility yields an effective rate of return equal to or greater than the effective rate of return which could be earned at the date of restructuring on other new facilities of similar risk;

(c) any other restructured terms are considered by the bank as similar to those applicable to new facilities with similar risk;

(d) the restructured facility has operated in accordance with the restructured terms and conditions for a period of at least six months or three payment cycles, whichever is longer; and

(e) no provisions remain assessed against the restructured facility on an individual basis,

the facility can be returned to a non-impaired status. If a restructured facility does not satisfy all of the above requirements, it must continue to be treated as impaired.

In certain circumstances, sufficient evidence may exist to demonstrate relative improvement in the condition and debt service capacity of an entity, apart from performance to date, which would warrant return to non-impaired status prior to the six-months (or three payments cycles) threshold. This might include the signing of lease or rental contracts, or an equity injection. Where this occurs, the bank may return the facility to non-impaired status for the purpose of reporting to APRA provided the other requirements specified above are satisfied.

Singapore

A bank may restore a classified credit facility to unclassified status only when, in the case of a restructured credit facility, there are reasonable grounds for the bank to conclude that the borrower will be able to service all future principal and interest payments on the credit facility in accordance with the restructured terms.
A restructured credit facility shall, at the minimum, remain classified unless the borrower has complied fully with the restructured terms and has serviced all principal and interest payments continuously for either a period of 6 months, in the case of credit facilities with monthly repayments, or a period of 1 year, in the case of a credit facility with quarterly or semi-annual repayments. For a restructured credit facility with repayments of principal and interest on an annual or longer basis, a bank shall only upgrade that credit facility if the borrower has complied fully with the restructured terms and demonstrated the ability to repay
after the end of one repayment period. A restructured credit facility in respect of which a debt moratorium is given shall remain classified unless the same conditions required to upgrade a restructured credit facility with no debt moratorium set out in the paragraph above (save that the conditions apply only after the end of the period of the moratorium) are satisfied.

Chapter 4

Issues in designing regulatory framework for restructuring of credit facilities

It may be observed from the comparative position of the existing guidelines on restructuring of advances extended to various categories of borrowers, issued by RBI (Chapter 2) that there exist significant differences in the guidelines relating to restructuring of these distinctive categories. The following issues emerge from the existing position:

c) Whether the prudential norms and regulatory concessions prescribed under CDR Mechanism should be extended to other categories of advances also?

d) If so, what should be the framework? Whether different sets of prudential norms and concessions need to be applied for different categories of advances?

The Group's views on the above issues are indicated below:

4.1 Eligibility for regulatory concessions for various categories of advances

The regulatory concessions in the form of asset classification extended to restructured advances availed by industrial units are not available to other borrowers even though existing instructions require the banks to compute sacrifice in the element of interest and make provisions in the case pf these loan also. There is a need for rationalizing the norms for extending regulatory concessions across various categories of advances. Analysis of various aspects of restructuring of advances including prudential norms from the perspective of issues highlighted above is furnished below:

4.1.1 Additional finance

Under CDR and SME debt restructuring mechanism the additional finance is treated as 'standard asset', up to a period of one year after the first interest / principal payment, whichever is earlier, falls due under the approved restructuring package. However, in the case of CDR accounts where the existing facilities are classified as 'sub-standard' and 'doubtful', interest income on the additional finance

is recognised only on cash basis. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

The above guideline is a departure from the general prudential norm that all facilities extended to a borrower should be classified under the same category. Since, the probability of regular repayment of the additional finance would be the same as that of existing finance due to the source of repayment being the same, the norm can be termed only as a concession in the cases where the existing assets are classified as non-performing assets after restructuring. As there is no ground to deny this concession to other categories of advances, we may extend this norm to all other advances for productive purposes (i.e. advances excluding advances for trading activities, retail loans and housing loans where downgradation is being proposed).

4.1.2 One- time settlement as part of restructuring package

CDR mechanism allows one time settlement option as a part of the restructuring package in order to bring more flexibility in the exit option to the lenders who are no more interested in continuing their exposure in the corporate.

Facility of OTS as part of restructuring on the pattern of CDR mechanism should also be extended to SMEs borrower having facilities from multiple banks. The question of OTS option as part of restructuring doesn’t arise in the case of borrowers having facilities from a single bank.

4.1.3 Extension of asset classification concession to doubtful accounts of other category of advances

Doubtful accounts restructured under CDR mechanism/ SME Debt Restructuring are eligible for asset classification concession indicated in para 5.1.1 of Chapter 2. However, doubtful accounts belonging to other categories of advances are not eligible for such concessions, even though the banks are expected to make provision for any sacrifice in the element of interest.

The Group is of the view that this provision should be extended to advances to agricultural and services sector also.

4.1.4 Prudential norms

A. Asset classification and provisioning norms for restructured advances

(I) In the matter of computation of provision in lieu of sacrifice in the element of interest consequent of restructuring of advances there are two major issues as indicated below:

(i) Whether the sacrifice is to be computed with reference to the original rate of interest or the market related interest represented by the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

ii) As the guidelines do not speak about computing the sacrifice (in terms of opportunity loss incurred) made by banks by elongation of the repayment period of principal, there is an impression that the guidelines require the banks to make provision for the sacrifice in the element of interest alone and there is no focus on computing the diminution fair value of the entire loan, which is an internationally accepted practice.

Original versus market related rate of interest

Under CDR / SME debt restructuring mechanism, the sacrifice in the element of interest is computed as the difference in the present value of *notional interest income based on current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring* and *the interest income reckoned based on the rate of interest fixed under the terms of restructuring*. In other cases, it is computed as the difference in the present value of *notional interest income based on the current BPLR as per the original terms of the loan* and *the interest income reckoned based on the rate of interest fixed under the terms of restructuring*. The discount rate used in both the cases is the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The use of *BPLR + risk premium* instead of *original rate of interest* for computing the notional interest income under CDR mechanism ensures that the computation of sacrifice/ diminution in the value of loan is done with reference to the book value of the loan. The Group is, therefore, of the view that the same approach should be followed in all other cases.

Diminution in the fair value of the loan versus the sacrifice in interest element alone

Procedure followed by CDR Cell for computing sacrifice

Under CDR Mechanism, banks compute the sacrifice as a difference in the PV of the following two interest cash flow streams:

(a) "The present value of future interest income reckoned based on 'the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring' and as per **the revised repayment schedule**(the existing repayment schedule if it is not changed)

(b) The present value of the interest income reckoned based on the actual interest charged as per the restructuring package and **the revised repayment schedule** (the existing repayment schedule if it is not changed).

It may be stated that existing CDR guidelines issued by RBI are silent on the repayment period of principal to be considered for calculating the interest cash flows represented by stream (a) above. On their own, banks have been taking into account the revised repayment schedule for both the cash flow streams. **Incidentally, the procedure followed by banks under CDR Mechanism gives the amount of sacrifice which is equivalent to the diminution in the value of the entire loan with reference to its book value indicating that, knowingly or unknowingly, banks have been providing for the diminution in the value of the entire loan i.e. both interest and principal.** Though the procedure followed by the bank under CDR Mechanism is mathematically correct for working out the diminution in the fair value of the loan, it obscures the basis on which it has been arrived at. (*Please see Illustration at Annex 1).*

Guidelines for computation of sacrifice in other cases

Existing RBI instructions for computation of sacrifice in the element of interest in non-CDR cases require the banks to compute the difference between the PV of interest cash flows calculated based on original residual repayment schedule applying the original rate of interest and the new repayment schedule applying the new rate of interest. The computation of this value not only lacks any theoretical basis but it also does not serve any purpose. In some cases, where the repayment schedule for principal is elongated beyond a point, the PV of interest as per revised scheduled exceeds the PV of interest as per original schedule despite reduction in rate of interest and results in negative sacrifice in the element of interest despite reduction in rate of interest. (Please see Illustration at Annex 1).

II. Suggested framework

(Recommendation No. 5.5.1)

i) The Group is of the view that RBI instructions need to clearly state that the focus of the framework is to capture the diminution in the value of the entire loan and not just that in the element of interest. It would not create any extra provisioning requirements because, as stated above, under CDR mechanism the banks are already computing provisions equivalent to the diminution in the value of the entire loan.

ii) For arriving at the diminution in the fair value of the loan consequent upon reduction in the rate of interest, it is necessary to take into account the NPV of both interest and principal cash flows. It is a different matter that in cases where the repayment schedule is not changed, for calculating the diminution in the fair value of the loan, it is sufficient to compute the sacrifice in the element of interest cash flows alone because the PV of principal will remain the same in both the scenarios and will get cancelled out. However, in the cases where the repayment schedule is changed, the cash flows representing repayment of principal should also be taken into account for the purpose of computation of diminution in the value of the loan, because PV of the principal as per revised repayment schedule could be less than the PV of the principal cash flows as per the revised repayment schedule.

iii) Summarily, the Group suggests that, irrespective of whether the repayment schedule is changed or not, banks should work out the diminution in the value of the entire loan, and not just the sacrifice in the element of interest, as the difference in the PV of the following two cash streams:

a) The present value of future interest income based on ‘the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring’ and of the installments of principal, as per **the original (residual) repayment schedule. (**As

this cash stream is equal to the book value of the loan, no calculation are required to be made and the book value can be directly taken as the PV of cash stream (a).**)**

b) The present value of future interest income based on the actual interest charged as per the restructuring package and of the installments of principal as per **the revised repayment schedule** (**the original (residual) repayment schedule if not changed)**

For the purpose of calculation of the present value as indicated above, the discount rate used will be the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on that date.

iv) In the case of borrowers in agricultural and services sector as also in the industrial sector, with outstanding facilities below Rs. 1 crore, in order to make it easier for small branches and uncomputerised branches in the rural areas having scarcity of skilled staff to restructure the loans and hold provision for sacrifice, the current asset classification status of the account can be retained in the event of reschedulement of principal/interest or both, provided the following two conditions are complied with:

a. The advance is fully secured

b. The bank makes a provision at aggregate level equivalent to 5% of total advances restructured under this mechanism in lieu of diminution is fair value of the loan, if any, without computing it in terms of PV.

(Recommendation No. 5.1.3)

v) In the case of accounts classified as 'Doubtful', the provision in lieu of sacrifice/diminution in the fair value of the loan(but excluding any provisions in the nature of reversal of unrealized income), may be restricted to the difference between the book value of the loan and the existing provision held. In other words, the total provision need not exceed 100% of the book value of the loan.

(Recommendation No. 5.5.1 (ii))

B. Annual review of provisions

Under CDR mechanism, the sacrifice is re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

The same treatment may be extended to other advances also where provisions for sacrifice is made.

C. Prudential norms on conversion of unpaid interest into equity

(Recommendation No. 5.5.2)

i) Under CDR mechanism where overdue interest is funded or outstanding principal and interest components are converted into equity, debentures, zero coupon bonds or other instruments and income is recognized in consequence, full provision is required to be made for the amount of income so recognized.

ii) Equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and / or interest should be classified in the AFS category and valued in accordance with the extant instructions on valuation of banks' investment portfolio except to the extent that (a) equity may be valued as per market value, if quoted (b) in cases where equity is not quoted, valuation may be at break-up value in respect of standard assets and in respect of sub-standard / doubtful assets, equity may be initially valued at Re1 and at break-up value after restoration / up gradation to standard category.

iii) If the conversion of interest into equity, which is quoted, interest income can be recognized after the account is upgraded to the standard category at market value of equity, on the date of such up gradation, not exceeding the amount of interest

converted into equity. If the conversion of interest is into equity, which is not quoted, interest income should not be recognized.

iv) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA ab-initio in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Consequently, income should be recognized on these instruments only on realization basis. The income in respect of unrealised interest which is converted into debentures or any fixed maturity instruments, would be recognized only on redemption of such instruments.

v) Banks may reverse the provisions made towards income recognised at the time of conversion of accrued interest into equity, bonds, debentures etc. when the instrument goes out of balance sheet on sale / realisation of value / maturity.

It is observed that the conversion into equity takes place both in respect of interest and principal. In the case of equity created in lieu of interest, there are two ways in which the unrealized income can be provided for. One way is to treat the transaction as if the interest income was received, accounted for and the funds utilized to purchase equity. Any diminution in the value of equity subsequently can be taken care of by subjecting the equity to usual valuation as per existing norms.

Another way to treat the transaction is to treat the equity a worthless receivable and make 100% provision against it. This would in a way reverse the credit to P&L Account which was effected while creating the equity. In that case there would be no need for any valuation.

In view of the above, our instructions that the equity created in lieu of interest should be valued as per market value and at the same time the banks should hold 100% provisions against it/the income recognized would result in double provisioning for the same instrument. There cannot be two debits to P&L Account (provision and depreciation) to set off the one credit which was made to it.

Therefore, the Group is of the view that in the case of equity created by conversion of overdue interest, full provision should be held. Any diminution in the value of such equity subsequently should be adjusted against the provision held. The interest income may be finally recognized on cash sale of the instrument, equivalent to the sale proceeds. Any amount realized in excess of the original value of equity may be accounted for as profit on sale of investments.

D. Applicability of capital market exposure norms to equity created by conversion of debt/overdue interest

(Recommendation No. 5.6)

Under CDR mechanism equity acquired by way of conversion of debt / overdue interest under the CDR mechanism is allowed to be taken up without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached, subject to reporting such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. However, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act 1949. Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI, subject to periodical reporting to RBI in the aforesaid DSB return.

The above exemptions have been extended due to the fact that the equity is acquired as part of restructuring effort and the additional risks involved in breaching the regulatory ceiling for capital market exposure will be out weighed by the benefits accruing to both banks and units on account of restructuring. Therefore, this exemption should be extended to all non-CDR cases also.

E. Asset classification of repeatedly restructured accounts

(Recommendation No. 5.5.4)

Under CDR mechanism the regulatory concessions in asset classification are not available if the account is restructured for the second or more times. In case a

restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion its asset classification would be reckoned from the date when it became NPA on the previous occasion. However, such assets restructured for the second or more time may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

In this context, a clarification is needed that all cases involving reschdulement / rephasement should be treated as second restructuring, if such reschdulement/ rephasement results in reduction in the present value of the loan (principal / interest cash flows), irrespective of whether the terminal date is postponed or not. However, if the modification does not result in reduction in the present value of principal / interest cash flows, it need not be treated as a second restructuring, provided the advance continues to be fully secured.

These norms may be extended to all other accounts also as they are aimed at preventing the misuse of restructuring to defer the downgrading of accounts.

F. Timely implementation of approved restructuring package

(Recommendation No. 5.1.1.1(II) and 5.1.3 (II)

Under CDR Mechanism, if an approved package is not implemented within four months after the date of approval by the Empowered Group, it would indicate that the success of the package is uncertain. In that case, the asset classification status of the account should not be restored to the position as on the date of reference to the CDR Cell.

Similar provisions may also be extended to other categories of advances. Further, it may be clarified that if the package is not implemented within the stipulated time, the asset classification of the account on the date of actual implementation of the

package will continue. However, the account will not slip further into lower asset classification categories during the period it is under observation and will be upgraded as per usual norms.

The paragraphs G and H below are essentially reflect the clarifications which DBOD has already issued to CDR Cell. These are discussed below and can be incorporated in the instructions being proposed for other categories of advances.

G. Reduction in rate of interest consequent upon improvement in the rating of the borrower/general decline in rate of interest

(Recommendation No. 5.5.3)

G.1 Reduction in the rate of interest in the case of first restructuring

In the case of loans extended at BPLR linked rates, the benefit of decline in the general rates of interests and the improvement in the credit quality of the borrowers is passed on to the borrowers as and when the banks change BPLR and review the credit rating of the borrowers. However, in cases where the term loans have been extended at fixed rates of interest, the rates are not reset unless there is a specific provision for it. If a bank wants to reduce the rate of interest in such cases due to decline in general rate of interest or due to improvement in the credit quality of the borrower, the question arises whether it should be treated as a restructuring. It is felt that reduction in rate of interest not effected as a measure of concession to a borrower owing to its financial difficulty should not cause the credit facility to be treated as a restructured facility. However, in such cases it would be necessary to have a method of distinguishing the reduction in the rate of interest as indicated above from the one which is effected as a measure of concession.

The following method is suggested to effect such reduction in rate of interest :

(i) The notional rate for the particular borrower may be determined by adding to existing BPLR the credit risk premium and term premium applicable to the category of the borrower as on the date of reduction of the interest rate.

(ii) Any reduction in the rate of interest equal to the difference between the fixed rate of interest being charged and the rate of interest determined as indicated in

para (i) above may not be treated as a concession and therefore the account not treated as having been restructured.

G.2 Reduction in the rate of interest in the case of second restructuring

a) Where Interest rate fixed on the restructured loan is linked to BPLR:

In case of restructured accounts where interest is linked to BPLR, if the reduction in rate of interest is done only to the extent that the original difference between the spread justified by the rating and the spread actually charged is maintained, it need not be treated as second restructuring. For instance, if the rate justified by the risk rating was BPLR + 5% and the borrower was charged BPLR + 2% after first restructuring, the concession given is 3%. Now suppose the improvement in prospects of the industry to which the unit belongs or in the borrower's financial position results in better credit score for the borrower and the rating improves with the result that the risk premium justified by the rating is reduced to 4%. In that case, the bank may lower the rate to BPLR + 1%, (maintain the level of concession given) and pass on the benefit of improved rating to the borrower.

However, to qualify for above treatment, reduction in the rate should be effected through revision in rating of the borrower as suggested above, not independent of it, as this would be necessary to distinguish the reduction justified by improved rating from any arbitrary reduction in the nature of further concession.

b) Where rate of interest rate on the restructured loan is fixed

In cases where rate of interest on restructured accounts is fixed, the benefit of reduction in rate of interest without attracting provisions of second restructuring can be passed on to the borrower by notionally converting the fixed rate being charged as per first restructuring into BPLR + risk premium and applying the framework suggested above.

H. Impact of changes in non-financial terms of the loan

(Recommendation No. 5.5.5)

Any changes in the terms of restructuring which do not result in reduction in the present value of the loan (principal plus interest cash flows) or the advance being rendered partially / fully unsecured need not be treated as restructuring.

I. Computation of provision in lieu of sacrifice in element of interest in the case of FITL

(Recommendation No. 5.5.6)

I.1 FITL created as part of restructuring package

As per existing instructions, banks are required to compute provision in lieu of sacrifice in the element of interest in the case of working capital advances also. A sample study carried out by the Department to ascertain the actual practice being followed by various banks in this regard revealed that banks were computing sacrifice in the case of all the three components of a restructured working capital facility viz. Regular working capital portion, WCTL and FITL.

In this context, it is observed that as per current instructions (para 4.2.14(v) (g) (i) of Master Circular on prudential norms on advances, the treatment for provisions against FITL is the same as that in the case of equity, debentures etc. created by conversion of unpaid interest. The guidelines require that banks should reverse the interest income recognized as result of creation of FITL by way of making provision for equal amount. This provision should continue to be held even after the facilities have been upgraded. As the banks would hold full provision against the FITL, any additional provision for diminution in FITL for whatever reason including that due to reduction in rate of interest would not be required. Therefore, in the case of restructured working capital advances, banks may not compute sacrifice in the element of interest (in present value terms) in the case of FITL.

I.2. FITL created during the implementation of the project

Banks fund the interest charged to the borrowers on project loans during the implementation period, by sanctioning them FITL. The corresponding interest is taken to income; and recovered over a long period of time (as repayment of FITL) alongwith other dues. When the account turns NPA, the bank has to reverse the income and hold provisions against the FITL amount. In this context, an issue has arisen whether, in view of the fact that FITL funds a part of the project cost, it can continue to be treated as principal even after the account becomes NPA and provisions made as per usual provisioning norms. This would mean that on the account becoming an NPA, the interest income corresponding to FITL should not be reversed. Even if it is reversed, it should be allowed to be re-booked after upgradation of the account.

In this context, the Group felt that even though FITL is treated as part of the project cost, treating this as income in the case of NPA Accounts would not be prudent. The facility of booking the income on accrual basis is available only for standard accounts during a brief period of project implementation plus 6 months. However, after the account is upgraded to standard category, there is case for according it the same treatment as would have been accorded had the account continued as a standard asset. Thus, after upgradation, the banks may be allowed to reverse the outstanding provisions against the FITL.

There may be cases where the account is restructured as a standard asset and rate of interest on FITL is reduced with or without elongation in the repayment schedule. In such cases, the bank would not be holding any provisions against the FITL. Therefore, the diminution in the fair value of FITL (both principal and interest) should be computed as per usual norms and provision for diminution made. However, in cases where the account is classified as NPA after restructuring, no provision is required for any diminution in the fair value of FITL during the period when account continues to be NPA because FITL during this period is otherwise

required to be fully provided for. However, after upgradation of such accounts, the full provision will be reversed(as suggested above), and therefore, the diminution in the fair value of FITL (both principal and interest) should be computed as per usual norms and provision for diminution made.

Banks should not fund, through FITL or otherwise, the interest charged beyond the original date of completion of project, even if the borrowers capitalize the interest as per usual accounting norms applicable to them.

4.2 Framework for restructuring of advances

(Recommendation No. 5.1 and 5.2)

4.2.1 (a) The debt restructuring framework smaller borrowers could be somewhat different from the one applicable to large borrowers. The difference could be in the following dimensions of restructuring:

i) For large borrowers above Rs. 1 crore the norms as applicable to CDR mechanism can be applied without any modifications. For small borrowers, provision on aggregate basis as suggested in para 4.1.4 A. (II)(iv), may be made in lieu of the diminution in the value of the loan.

ii) The time limit for disposal of applications and implementation of packages.

(Recommendation No. 5.1.1.(II) and 5.1.3.II)

b) The accounts of the borrowers engaged in **agricultural and services sector** and having multiple banking/consortium/syndicate arrangements can be restructured under the existing CDR mechanism.

c) The Group is of the view that the advances extended to traders differ from the advances for production purposes in as much as the reasons for cash flow problems such as cost escalation, delay in project in implementation, change in working capital cycles, problems in procuring the raw material and retention of the

market share of the product are not relevant for these advances. Similarly, the retail loans including housing loans are also different inasmuch as they do not depend upon the repayment from the productivity of the asset, which has been financed by the bank. Therefore, the terms for restructuring of the advances for traders, retail loans including housing loans should be relatively more stringent. Further, RBI need not prescribe detailed parameters for restructuring of these advances and may issue only very broad guidelines.

4.2.2. Accordingly, the Group suggests division of all NON-CDR/Non-SME borrowers in the following categories for the purpose of restructuring frameworks:

iii) Borrowers engaged in **industrial activities** and not covered under CDR/SME debt restructuring mechanisms and the borrowers in **agricultural and services sector** having **single bank** arrangements but above Rs. One crore.

iv) Borrowers engaged in **agricultural and services sector** having multiple banking/consortium/syndicate arrangements

v) All borrowers including those in industrial sector with outstanding facilities below Rs. One crore except (iv) below.

vi) Trading Accounts/Retail loans including Housing Loans and any unsecured advances irrespective of amount.

4.2.3 The Group has excluded from its purview the restructuring of advances in case of natural calamities. The restructuring of advances of the borrowers who suffer from natural calamities will be done as per separate set of guidelines issued by RPCD from time to time. The Group does not propose any change in this regard.

(Recommendation No. 5.3)

4.2.4 In this Chapter, the Group has suggested certain changes in the prudential norms applicable to restructured advances, in addition to those effected under CDR Mechanism, which are mostly in the nature of clarifications. These changes would need to be applied to advances restructured under CDR mechanism/SME Debt restructuring also.

(Recommendation No. 5.5 and 5.7)

4.3 Disclosures

(Recommendation No. 5.4)

The amount of all restructured accounts including the accounts restructured by banks under their own policies should be disclosed along with the amount of provisions held thereagainst in the balance sheet.

Chapter 5

Recommendations

As discussed in Chapter 4, the regulatory framework prescribed under CDR Mechanism is very exhaustive and is conceptually sound. Therefore, it should be the basis of restructuring framework for all other advances. However, the group is of the view that the computation of diminution in the fair value of the loan should be based on both interest and principal cash flows rather than only interest cash flows. Further, while the basic prudential framework for all advances would be the same, some modifications would be required for different categories of advances. As indicated in para 4.2 of Chapter 4, the following framework is suggested for restructuring of different categories of advances:

5.1 Borrowers engaged in non-trading activities

5.1.1 Borrowers engaged in *industrial activities* and not covered under CDR/SME debt restructuring mechanisms and the borrowers in *agricultural and services sector* having *single bank* arrangements but above Rs. One crore *(Para 4.2.)*

The following norms are suggested for restructuring of accounts of such borrowers:

I. The same prudential norms as are applicable under CDR Mechanism should be followed with the modifications indicated in para 5.5. below.

II. The applications should be finally disposed of and the packages implemented within 60 days from the receipt of application by the bank.

(***para 4.1.4 & 4.2.1 (a)(ii)***)

III. The asset classification status of the account as on the date of receipt of the application may be restored if the package is implemented within 60 days from the receipt of the application.

IV. If the package is not implemented within 60 days, the asset classification of the account on the date of actual implementation of the package will continue. However, the account will not slip further into lower asset classification categories during the period it is under observation and will be upgraded as per usual norms.

(Para 4.1.4. F & 4.2.1 a. (ii)

5.1.2 Borrowers engaged in agricultural and services sector having multiple banking/consortium/syndicate arrangements ***(para 4.2.2)***

The entire CDR framework may be applied to such borrowers enjoying credit facilities above Rs. 10 crore and the SME debt restructuring scheme for all borrowers enjoying credit facilities below Rs. 10 crore.

5.1.3. All borrowers including those in industrial sector (SMEs) with outstanding facilities below Rs. One crore except those covered in para 5.2 below.

(para 4.1.4 A & 4.2.2)

I. All norms applicable to SME borrowers would be applicable, subject to following modifications:

The current asset classification status of the account can be retained in the event of re-schedulement of principal/interest or both subject to the following two conditions:

a) The advance is fully secured (except in the case of tiny industrial units having credit facilities below Rs. 5 lakh where collateral security is not taken as per RBI instructions)

b) The bank makes a provision at aggregate level equivalent to 5% of total advances restructured under this mechanism, in lieu of the diminution in the fair value of the loan, if any, without computing it in terms of PV.

(para 4.1.4.F & 4.2.1.a(i))

II. The asset classification status of the account as on the date of receipt of the application may be restored if the package is implemented within 60 days from the receipt of the application.

III. If the package is not implemented within 60 days, the asset classification of the account on the date of actual implementation of the package will continue. However, the account will not slip further into lower asset classification categories during the period it is under observation and will be upgraded as per usual norms.

(Para 4.1.4.F ¶ 4.2.1(a)(ii)

5.2 Trading Accounts/Retail loans including Housing Loans and any unsecured advances irrespective of amount

(para 4.2.1.c & 4.2.)

I. The assets to be immediately downgraded to substandard or other appropriate category of NPAs after restructuring.

II. All other prudential norms as applicable for CDR Accounts would be applicable to these accounts to the extent relevant.

III. Banks to have their own policies regarding operational matters relating to disposal of such applications

5.3 Advances affected by natural calamities (Para 4.2.3)

The Group has excluded from its purview the restructuring of advances in case of natural calamities. The restructuring of advances of the borrowers who suffer from natural calamities will be done as per separate set of guidelines issued by RPCD from time to time. The Group does not propose any change in this regard.

5.4 Disclosures ***(para 4.3)***

The amount of all restructured accounts including the accounts restructured by banks under their own policies should be disclosed along with the amount of provisions held thereagainst in the balance sheet.

5.5 Changes proposed in the prudential norms relating to restructuring of advances

(para 4.1.4 & 4.2.4)

The Group has suggested certain changes in the prudential norms applicable to restructured advances, in addition to those effected under CDR Mechanism, which are mostly in the nature of clarifications. These provisions enumerated below may also be applied to advances restructured under CDR mechanism:

5.5.1. Computation of diminution in the fair value of the loan *(para 4.1.4)*

i) Irrespective of whether the repayment schedule is changed or not, banks should work out the diminution in the value of the entire loan, and not just the sacrifice in the element of interest, as difference in the PV of the following two cash streams:

a) The present value of future interest income based on *'the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category* on the date of restructuring' and of the installments of principal, as per **the original (residual) repayment schedule. (***As this cash stream is equal to the book value of the loan, no calculation are required to be made and the book value can be directly taken as the PV of cash stream (a).***)**

b) The present value of future interest income based on *the actual interest charged as per the restructuring package* and of the installments of principal as per **the revised repayment schedule** (**the original (residual) repayment schedule if not changed)**

For the purpose of calculation of the present value as indicated above, the discount rate used will be the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on that date.

ii) In the case of accounts classified as 'Doubtful', total provisions held including the provision in lieu of sacrifice/diminution in the fair value of the loan(but excluding any provisions in the nature of reversal of unrealized income), should not exceed 100% of the book value of the loan.

5.5.2. Provisions against the equity created by conversion of unpaid interest ***(para 4.1.4 C)***

In the case of equity created by conversion of overdue interest, full provision should be held. Any diminution in the value of such equity subsequently should be adjusted against the provision held. The interest income may be finally recognized on cash sale of the instrument, equivalent to the sale proceeds. Any amount realized in excess of original rate of equity may be accounted for as profit on sale of investments.

5.5.3. Reduction in rate of interest consequent upon improvement in the rating of the borrower/ general decline in rate of interest ***(para 4.1.4.G)***

i) Reduction in the rate of interest in the case of first restructuring

In the case of loans extended at BPLR linked rates, the benefit of decline in the general rates of interests and the improvement in the credit quality of the borrowers is passed on to the borrowers as and when the banks change BPLR and review the credit rating of the borrowers. However, in cases where the term loans have been extended at fixed rates of interest, the rates are not reset unless there is a specific provision for it. If a bank wants to reduce the rate of interest in such cases due to decline in general rate of interest or due to improvement in the credit quality of the borrower, the question arises whether it should be treated as a restructuring. It is felt that reduction in rate of interest not effected as a measure of concession to a borrower owing to its financial difficulty should cause the credit facility to be treated as a restructured facility. However, in such cases it would be necessary to have a method of distinguishing the reduction in the rate of interest as indicated above from

the one which is effected as a measure of concession. The following method is suggested to effect such reduction in rate of interest :

(i) The notional rate for the particular borrower may be determined by adding to existing BPLR the credit risk premium and term premium applicable to the category of the borrower.

(ii) Any reduction in the rate of interest equal to the difference between the fixed rate of interest being charged and the rate of interest determined as indicated in para (i) above may not be treated as a concession and therefore the account not treated as having been restructured.

ii) Reduction in the rate of interest in the case of second restructuring

a) Where Interest rate fixed on the restructured loan is linked to BPLR:

In case of restructured accounts where interest is linked to BPLR, if the reduction in rate of interest is done only to the extent that the original difference between the spread justified by the rating and the spread actually charged is maintained, it need not be treated as second restructuring. For instance, if the rate justified by the risk rating was BPLR + 5% and the borrower was charged BPLR + 2% after first restructuring, the concession given is 3%. Now suppose the improvement in prospects of the industry to which the unit belongs or in the borrower's financial position results in better credit score for the borrower and the rating improves with the result that the risk premium justified by the rating is reduced to 4%. In that case, the bank may lower the rate to BPLR + 1%, (maintain the level of concession given) and pass on the benefit of improved rating to the borrower.

However, to qualify for above treatment, reduction in the rate should be effected through revision in rating of the borrower as suggested above, not independent of it, as this would be necessary to distinguish the reduction justified by improved rating from any arbitrary reduction in the nature of further concession.

b) Where rate of interest rate on the restructured loan is fixed

In cases where rate of interest on restructured accounts is fixed, the benefit of reduction in rate of interest without attracting provisions of second restructuring can be passed on to the borrower by notionally converting the fixed rate being charged as per first restructuring into BPLR + risk premium and applying the framework suggested above.

5.5.4 Asset classification of repeatedly restructured accounts*(para 4.1.4 E)*

Under CDR mechanism the regulatory concessions in asset classification are not available if the account is restructured for the second or more times. In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion its asset classification would be reckoned from the date when it became NPA on the previous occasion. However, such assets restructured for the second or more time may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance. These norms may be extended to all other accounts also as they are aimed at preventing the misuse of restructuring to defer the downgrading of accounts.

Further, all cases involving reschdulement / rephasement should be treated as second restructuring, if such reschdulement/ rephasement results in reduction in the present value of the loan (principal / interest cash flows), irrespective of whether the terminal date is postponed or not. However, if the modification does not result in reduction in the present value of principal / interest cash flows, it need not be treated as a second restructuring, provided the advance continues to be fully secured.

5.5.5 Impact of changes in non-financial terms of the loan *(para 4.1.4 H)*

Any changes in the terms of restructuring which do not result in reduction in the present value of the loan (principal plus interest cash flows) or the advance being rendered partially / fully unsecured need not be treated as restructuring.

5.5.6 Computation of provision in lieu of sacrifice in element of interest in the case of FITL

(Para 4.1.4 I)

5.5.6.1 FITL created as part of restructuring package

As per current instructions of RBI (para 4.2.14(v) (g) (i) of Master Circular on prudential norms on advances, banks should reverse the interest income recognized as result of creation of FITL by way of making provision for equal amount. This provision should continue to be held even after the facilities have been upgraded. As the banks would hold full provision against the FITL, any additional provision for diminution in FITL for whatever reason including that due to reduction in rate of interest should not be required. Therefore, in the case of restructured working capital advances, banks may not compute sacrifice in the element of interest (in present value terms) in the case of FITL.

5.5.6.2 FITL created during the implementation of the project

i) Provisions against FITL

(a) If the account is classified as NPA, after restructuring or otherwise, the entire FITL amount should be provided for as hitherto.

(b) After upgradation of the account, the provisions made against the FITL may be reversed.

ii) **Provisions against diminution in the fair value of FITL due to reduction in rate of interest**

(a) There may be cases where the account is restructured as a standard asset and rate of interest on FITL is reduced with or without elongation in the repayment schedule. In such cases, the bank would not be holding any provisions against the

FITL. Therefore, the diminution in the fair value of FITL (both principal and interest) should be computed as per usual norms and provision for diminution made.

(b) In cases where the account is classified as NPA after restructuring, no provision is required for any diminution in the fair value of FITL during the period when account continues to be NPA because FITL during this period is otherwise required to be fully provided for. However, after upgradation of such accounts, the full provision will be reversed, and therefore, the diminution in the fair value of FITL (both principal and interest) should be computed as per usual norms and provision for diminution made.

iii) Banks should not fund, through FITL or otherwise, the interest charged beyond the original date of completion of project, even if the borrowers capitalize the interest as per usual accounting norms applicable to them.

5.6 Applicability of capital market exposure norms to equity created by conversion of debt

(Para 4.1.4 D)

Under CDR mechanism equity acquired by way of conversion of debt / overdue interest under the CDR mechanism is allowed to be taken up without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached, subject to reporting such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. However, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act 1949. Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI, subject to periodical reporting to RBI in the aforesaid DSB return. The above exemption should be extended to all non-CDR cases also.

5.7 Changes in the existing SME framework

(Para 4.2.4)

The revision to CDR guidelines was effected in November 2005 after issuance of guidelines on SME Debt restructuring. Hence, some of the prudential norms applicable for CDR Mechanism have not been applied to SME debt restructuring. In order to bring about parity in the application of prudential norms, all the norms applicable to CDR Mechanism should be applied to all SME Accounts above Rs. One crore, as is being proposed in respect of all such accounts in other sectors.

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