# Report of the Working Group to

# Review the existing prudential guidelines on restructuring of advances by banks/financial institutions

**Reserve Bank of India**

**July 2012**

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
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कार्यपालक निदेशक
Executive Director

**Letter of Transmittal**

Shri Anand Sinha
Deputy Governor
Reserve Bank of India
Mumbai

July 18, 2012

**Working Group to review the existing prudential guidelines on restructuring of advances by banks/financial institutions**

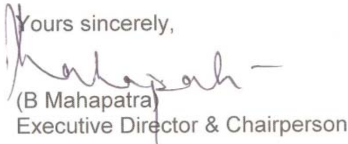
Dear Sir,

We have great pleasure in submitting the Report of the Working Group appointed vide Memorandum dated January 31, 2012 to review the existing prudential guidelines on restructuring of advances by banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards. The report has reviewed the existing prudential guidelines on restructuring of advances by banks and financial institutions and recommended revisions to the existing guidelines taking into account the international best practices and accounting standards. We hope the report will be useful to the Reserve Bank in enhancing the prudential guidelines on restructuring of advances.

We sincerely thank you for entrusting this responsibility to us.

With kind regards,

Yours sincerely,



(B Mahapatra)
Executive Director & Chairperson

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हिंदी आसान है, इसका प्रयोग बढ़ाइए

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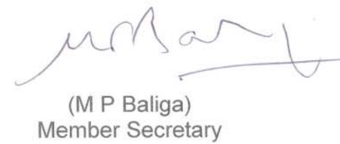

(M P Baliga)
Member Secretary

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## Approach and recommendations

0.1 Restructuring of loans and advances is accepted across most jurisdictions as a legitimate mechanism through which banks try to support the viable accounts to preserve the economic value of their loans. Restructuring of loans and advances is a part of financial restructuring and is different from a business restructuring, which may involve changes in the business strategy/ mergers/acquisitions/diversification/consolidation, etc. A financial restructuring involves changes in the debt and/or equity structure of an entity. A paper on financial restructuring by the World Bank has mentioned[i], "The main aims of financial restructuring are separating and treating appropriately viable and nonviable firms and creating the right incentives for operational restructuring. Operational restructuring, an on-going process, includes improvements in efficiency and management, reductions in staff and wages, sales of assets (for example, reduction in subsidiaries), enhanced marketing efforts, and so on, with the expectation of higher profitability and cash flow".

0.2 Restructuring of loans and advances is not a new phenomenon in India and terms such as rescheduling/renegotiation/rehabilitation/restructuring have been used interchangeably by the Reserve Bank of India (RBI) and the banks for many years. RBI's prudential guidelines on restructuring of advances have evolved over a period of time from simple instructions to reschedule the loans of people affected by natural calamities in the late 1970s to comprehensive guidelines on restructuring of loans to large corporates under consortium/multiple banking. The guidelines gradually evolved with the dynamics of the financial and real markets by taking into account the international best practices, recommendations of various committees and feedback from the stakeholders.

0.3 The extant guidelines of RBI on the subject are comprehensive and cover all borrowal accounts under three broad categories, viz., (i) Restructuring for large corporate advances with multiple/consortium banking under the Corporate Debt Restructuring (CDR) Scheme (ii) Restructuring of Small and Medium Enterprises

under SME Debt Restructuring Mechanism and (iii) Restructuring of all other advances. These guidelines also extend special asset classification benefit to accounts on restructuring, except in the cases of Commercial Real Estate (CRE) Exposures, Capital Market Exposures (CME) and Consumer and Personal Loans, subject to adherence to certain conditions. Besides these, there are separate guidelines for restructuring of accounts affected by natural calamities.

0.4 The above guidelines have been useful to both the borrowers and the banks in situations of economic downturns and temporary cash flow problems. In the year 2008, when following the collapse of Lehman Brothers, the borrowers faced genuine difficulties in repaying their debt, the RBI had allowed certain special concessions and asset classification benefits as a special measure with the objective of enabling the borrowers to tide over their genuine difficulties in a time of widespread economic and financial stress and help banks retain the quality of viable assets. The exceptional/special regulatory treatment allowed the asset classification benefit even in the case of CRE Exposures and for repeatedly restructured accounts (other than CRE, CME and personal/consumer loans) restructured up to June 30, 2009.

0.5 The special regulatory treatment allowed in the case of standard accounts helped the borrowers as well as the banks to address challenges faced during the global crisis situation. However, this led to a spurt in the level of restructured standard assets on account of the one-time measures allowed up to June 30, 2009. The total cumulative position of restructured standard advances increased from Rs.60,379 crore as at the end of March 2009 to Rs.1,06,859 crore as at the end of March 2011.

0.6 The restructured standard assets at Rs.97,834 crore in March 2010 and Rs.1,06,859 crore in March 2011 were higher than the gross NPAs of the banking system at Rs.81,816 crore and Rs.94,088 crore respectively during the respective period. Although, the above figures were cumulative and do not reflect the accounts which have come out of distress and have become normal,

there was a concern that some of these restructured standard accounts could fall back into the NPA category over a period of time if these borrowers facing temporary cash flow problems in the wake of the global financial turmoil, did not recover within a reasonable time and attain viability.

0.7 The above concerns have also been flagged by RBI's 'Financial Stability Report (FSR) June 2012' which has calculated an 'NPA ratio with 15% of restructured standard advances added back' for the period 2009 – 2012 in its empirical analysis of the asset quality of banks' advances portfolio. The FSR has indicated that this ratio has exhibited an increasing trend.

0.8 The RBI's Annual Financial Inspections (AFIs) of banks also observed lack of clarity of instructions on the part of banks while undertaking restructuring of advances. Some concerns were also expressed whether in the event of these restructured advances actually turning into NPAs, banks would have sufficient provision to meet the shock.

0.9. In the background of the above developments, RBI, in its Second Quarter Review of Monetary Policy 2011-12 on October 25, 2011, proposed to constitute a Working Group (WG) to review the existing prudential guidelines on restructuring of advances by banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards. Accordingly, a WG was constituted under the Chairmanship of Shri B. Mahapatra, Executive Director, RBI. Constitution of the WG and its terms of reference are detailed in Chapter 1 of this report, titled 'Introduction'.

**The Approach**

0.10 The WG approached the whole issue from the perspective that restructuring of advances serves a useful social purpose as it protects the productive assets of the economy. It helps viable borrowers to recover from temporary problems and provides incentives to banks to nurture such accounts without making much sacrifice. Another important perspective was that the RBI's

current guidelines have generally evolved along with the international best practices and they were to be reviewed in the same light with their relevance in the Indian context. It also approached the issue from the perspective that restructuring of an account is an event of impairment irrespective of whether an account's asset classification is downgraded or not.

0.11 The WG reviewed the international accounting standards on restructuring of troubled debts and the prudential regulatory practices of seven jurisdictions viz. Australia, France, Hong Kong, Singapore, Thailand, the United Kingdom and the United States of America, with respect to the treatment of restructured accounts. The common element observed was that restructured accounts are classified as impaired if the restructuring (i) is on account of financial stress of the borrower or due to delays/non-payment as per contractual terms by the borrower and (ii) the modification of terms is non-commercial, i.e. disadvantageous to the lenders.

0.12 Further, all jurisdictions require a reasonable period of satisfactory performance as per the new terms before the account could be upgraded. Differences amongst jurisdictions are more on account of granular aspects of the definition and treatment. For instance, to upgrade a restructured account in Australia, a satisfactory performance is to be observed for six months or three repayment cycles, whichever is longer, whereas in Thailand, satisfactory performance over three consecutive months/ three instalments is required. France, while allowing restructured accounts to be upgraded on account of satisfactory performance, requires that these accounts be reclassified into a specific sub-category of performing accounts until they are paid in full.

0.13 The WG also observed that restructuring of standard advances without recognising the impairment could lead to issues regarding asset quality. In view of this, the WG felt the need to adopt international prudential norms on restructuring which included recognition of impairment. Nevertheless, the WG was sensitive to the current economic situation and adopted a gradual and

calibrated approach to recognition of impairment and strengthening of provisioning.

0.14 Although there were several estimates of slippages of standard restructured accounts to the NPA category, the WG adopted a conservative approach and assumed that in the most pessimistic and stressful scenario, such slippages to be around 25% to 30%. This assumption is based on past experience of repayment behaviour of borrowers as per the restructured terms and conditions and takes into consideration that many borrowers have been granted repayment holidays/moratorium and many have restructured only in recent past. The actual behaviour/performance of such accounts will be known only over time and the WG has made a conservative assumption regarding these loans. However, in the meantime it needs to be ensured that sufficient provision is made by the banks to absorb the expected losses on account of restructured standard accounts turning into NPAs.

0.15 The WG also took note of the importance of infrastructure in the country's development and observed that in view of the delays/uncertainties associated in obtaining clearances for infrastructure projects, the extant asset classification benefit allowed to such projects on change in date of commencement of commercial operation (DCCO) need to be continued for some more time.

**The Recommendations**

0.16 Recommendations of the WG can be broadly viewed as forward-looking as well as contemporary to the current issues. The forward-looking recommendations are aimed at bringing the RBI's present prudential guidelines on restructuring of advances in line with the international prudential norms in a time-bound manner; and gradually develop the restructuring guidelines to the needs of a globalised economy. In the meanwhile, the contemporary recommendations address the moral hazard issues arising from extant guidelines, which might have hitherto dissuaded the lenders from proper due-diligence and viability assessment on one hand and encouraged the borrowers

in excessive risk taking or adopting lax business practices on the other hand, by tightening certain prudential norms. The contemporary recommendations are also aimed at rationalising certain extant norms.

0.17 The recommendations of the WG preceded by briefs on the relevant issues are given below. Details of the discussions in the various meetings of the WG, suggestions and clarifications made, as also the consensus arrived by the WG are given in the last Chapter, titled 'Summary of proceedings'.

**Asset classification and provisioning norms in respect of restructured accounts**

0.18 The WG examined the practices adopted internationally for asset classification of the restructured accounts. The WG observed that internationally accounts are generally treated as impaired/downgraded on restructuring. The WG examined the consequences of aligning our restructuring guidelines with this best practice but felt that doing so immediately might act as a disincentive to banks to restructure viable accounts. *(Chapter 3, 4 & 6)*

**Recommendation 1**

0.19 The WG therefore recommended that the RBI may do away with the regulatory forbearance regarding asset classification, provisioning and capital adequacy on restructuring of loan and advances in line with the international prudential measures. However, in view of the current domestic macroeconomic situation as also global situation, this measure could be considered say, after a period of two years.

**Recommendation 2**

0.20 However, the WG also recommended that in the interregnum, in order to prudently recognise the inherent risks in assets classified as standard on restructuring, the provision requirement on such accounts should be increased from the present 2% to 5%. This may be made applicable with immediate effect

in cases of new restructurings (flow) but in a phased manner during the two year period for the existing standard restructured accounts (stock), i.e., *abinitio* a provision of 3.5% in the first year of adoption of the recommendation which should be subsequently raised to 5% in the second year of adoption of the recommendation, when the asset classification benefit ceases.

**Recommendation 3**

0.21 Notwithstanding the Recommendation 1 for progressively doing away with the asset classification benefit on restructuring, the WG felt that extant asset classification benefits in cases of change of date of commencement of commercial operation (DCCO) of infrastructure project loans may be allowed to continue for some more time in view of the uncertainties involved in obtaining clearances from various authorities and importance of the sector in national growth and development. However, the WG also recommended that additional stringent conditions may also be added in this regard in order to prevent the misuse of this clause. A higher provision of 5% as against current requirement of 2% on such loans is suggested in this regard.

**INSOL principles**

0.22 The WG examined the International Federation of Insolvency Practitioners (INSOL)'s 'Statement of Principles for a Global Approach to Multi-Creditor Workouts' and observed that while INSOL Principles regarding 'standstill clause' and 'priority in repayment of additional finance' were suitably adopted in the RBI's guidelines on CDR mechanism, adoption of INSOL Principles, especially, the principle regarding 'priority in repayment of fresh facilities in restructuring' may be examined even in cases of non-CDR restructuring. *(Chapter 4)*

**Recommendation 4**

0.23 In this regard, the WG recommended that the RBI may consider adopting INSOL Principle on 'priority to repayment of additional finance' even in cases of

non-CDR restructuring in order to provide incentive for any additional financing provided by an existing or a new lender.

**Restructuring during crisis**

0.24 It was observed that restructuring mechanism, with regulatory forbearance and government intervention, evolved in other countries as a response to some crisis. It was also observed that the international practices on restructuring have two distinct, though overlapping, phases, viz. (i) crisis containment and (ii) debt restructuring phase. Such a phase was clearly seen in India during the 2008 financial crisis, when government and RBI both intervened in the real and financial markets with incentives and regulatory forbearance. The WG felt that the concept of regulatory forbearance combined with fiscal incentives and government intervention in the times of *crises* may be examined in future, provided the triggers for the crises are objectively and precisely defined. This becomes important in view of the increasing integration of Indian economy with the global economy. *(Chapter 4)*

**Recommendation 5**

0.25 Therefore, the WG recommended that the RBI and the government should come out with a framework which will precisely and objectively define a severe crisis (like the 2008 financial crisis) requiring both the government and regulatory intervention. Such a framework should also broadly indicate the fiscal and regulatory measures to be taken under such conditions in the phases of (i) crisis containment and (ii) debt restructuring.

**Criteria for upgradation of accounts classified as NPA on restructuring**

0.26 The WG observed that the extant RBI guidelines prescribed that all restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for upgradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. Further, specified period is defined as a period of one year from the date when

the first payment of interest or instalment of principal falls due under the terms of restructuring package.

0.27 In some cases of restructuring with moratorium on payment of principal as well as major portion of interest, the accounts were upgraded on the basis of payment of interest on only a small portion of the debt, say FITL, for the specified period. As such the account may still have its inherent credit weakness as payment of a small portion of interest does not show the 'satisfactory performance'. Therefore, the specified period should be redefined by taking into consideration this aspect. *(Chapter 3 & 6)*

**Recommendation 6**

0.28 The WG recommended that 'specified period' should be redefined in cases of restructuring with multiple credit facilities as 'one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium. Further, the WG also recommended that the accounts classified as NPA on restructuring by the bank should be upgraded only when all the outstanding loans/facilities in the account perform satisfactorily during this specified period, i.e. principal and interest on all facilities in the account are serviced as per terms of payment.

**Assessing the viability for restructuring of accounts**

0.29 In terms of the present guidelines, the RBI has prescribed only the broad parameters of viability, whereas the benchmarks are determined by the banks themselves. The WG observed that while restructuring of advances on solo basis, banks, particularly at branch or controlling office level where sufficient skill is not available, generally do not establish the viability of the account as rigorously as being done while restructuring under CDR. The WG discussed the need for prescribing certain objective criteria and indicative benchmarks by RBI for restructuring of accounts by banks so as to ensure that accounts, where the viability is in doubt, do not get restructured. Therefore, the WG felt that there

was a need to follow appropriate viability parameters by the banks. It was also felt that the present time span allowed for an account becoming viable was too long and it may be rationalised. *(Chapter 6)*

**Recommendation 7**

0.30 The WG recommended that RBI may prescribe the broad benchmarks for the viability parameters based on those used by CDR Cell; and banks may suitably adopt them with appropriate adjustments, if any, for specific sectors.

**Recommendation 8**

0.31 The WG also felt that the prescribed time span of seven years for non-infrastructure borrowal accounts and ten years for infrastructure accounts for becoming viable on restructuring was too long and banks should take it as an outer limit. The WG, therefore, recommended that, in times when there is no general downturn in the economy, the viability time span should not be more than five years in non-infrastructure cases and not more than eight years in infrastructure cases.

**Disclosures in notes on accounts**

0.32 Banks are required to disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances. In terms of present guidelines, banks are required to disclose annually all accounts restructured in their books on a cumulative basis even though many of them would have subsequently shown satisfactory performance over a sufficiently long period. As such the present position of disclosures are quite stringent and do not take into account the fact that in many of these accounts the inherent weaknesses in the accounts have disappeared and the accounts are in fact standard in all respects, but continue to be disclosed as restructured advances. The WG examined this aspect in the light of the RBI’s circular dated May 18, 2011 which has prescribed a higher provision of

2% for accounts classified as standard on restructuring as also for restructured accounts classified as NPA but upgraded to standard category, for certain time periods. *(Chapter 6)*

**Recommendation 9**

0.33 The WG recommended that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either *abinitio* or on upgradation from NPA category) revert back to the normal level on account of satisfactory performance during the prescribed period, such advances should no longer be required to be disclosed by banks as restructured accounts in the "Notes on Accounts" in their Annual Balance Sheets. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions. The WG also recommended that banks may be required to disclose details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable), provisions made on restructured accounts under various categories as also details of movement of restructured accounts.

**Provision for diminution in the fair value of restructured advances**

0.34 Reduction in the rate of interest and/or reschedulement of the repayment of principal amount, as part of the restructuring, results in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and has an impact on the bank's market value of equity. Banks are, therefore, required to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. The WG discussed the methodology of calculation of fair value by arriving at the NPV of the cash flows and the discount rate used. The WG however felt that there is a need for clarity on the issue. *(Chapter 6)*

**Recommendation 10**

0.35 The WG is of the view that the current instructions relating to calculation of diminution of fair value of accounts by discounting both pre restructured and post restructured cash flows at BPLR/Base Rate plus credit risk premium and term premium applicable to the borrower risk category as on the date of restructuring is appropriate and correctly captures the erosion in the fair value. So, the same may be continued for computing the diminution both in the cases of restructuring done under the CDR mechanism and other restructuring. However, since there have been instances of different interpretations of the formula by banks, RBI may illustrate the NPV calculations by way of a few examples including where there is no change in the repayment period and where there is a change in the repayment period on restructuring.

**Provision for diminution in fair value of small restructured accounts**

0.36 In terms of existing instructions, if due to lack of expertise/appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small/rural branches, as an alternative to the methodology prescribed for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor, at 5% of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore till the financial year ending March 2013. The position would be reviewed thereafter. The WG felt that this provision should be continued on a long term basis. *(Chapter 6)*

**Recommendation 11**

0.37 The WG recommended that the option of notionally computing the amount of diminution in the fair value of small accounts at 5% of the total exposure at small/rural branches in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore, may be provided on a long term basis.

**Incentive for quick implementation of restructuring package**

0.38 As regards CDR restructuring, the RBI guidelines permit asset classification benefit for quick implementation if restructuring package is implemented within 120 days from the *date of approval* by the CDR Mechanism; whereas under non-CDR restructuring, asset classification benefit is allowed if the restructuring package is implemented within 90 days from the *date of receipt of application*. The WG felt that the present prescription does not provide sufficient time for viability study for restructuring of advances under non-CDR mechanism. *(Chapter 6)*

**Recommendation 12**

0.39 In case of non-CDR restructurings, asset classification benefit is available in case the restructuring package gets implemented within 90 days from the *date of receipt of application*. As 90 days period after receipt of application is considered insufficient for properly ascertaining the viability of the account, the period for quick implementation under non-CDR mechanism including SME Debt Restructuring mechanism should be increased to 120 days from the *date of application*. As the CDR cases involve more than one bank, the required implementation period of restructuring packages under CDR cases should logically be more than that for non-CDR cases and may be continued to be at the present requirement of 120 days from the *date of approval* of the restructuring package by the CDR mechanism. The WG, however, took note of the fact that in line with Recommendation 1, this recommendation will lose its relevance after the interregnum period when the regulatory forbearance on asset classification will no longer be available.

**Roll-over of short term loans**

0.40 The WG discussed the prevalent practice of banks granting short term corporate loans to borrowers which are then rolled over in many cases. The WG was of the view that such roll-overs should not be treated as restructuring if the same is done on the strength of the borrower's balance sheet, i.e. if the loans

are not rolled over due to the weakness in the balance sheet. However, if the roll-over is done due to inability of the borrower to repay the outstanding loan, it should be treated as restructuring. *(Chapter 6)*

**Recommendation 13**

0.41 The WG recommended that RBI may clarify that the cases of roll-over of short term loans, where proper pre-sanction assessment has been made, such roll-over is allowed depending upon the actual requirement of the borrower and no concession has been provided due to weakness of the borrower, then these might not be considered as restructured accounts. Further, a cap may be placed on the number of times that a short term loan can be rolled over say, not more than 2 or 3 times.

**Repeated restructuring**

0.42 The existing instructions of RBI provide asset classification benefit in the case of first time restructured accounts subject to compliance with certain regulatory stipulations; such asset classification benefit is not available to repeatedly restructured accounts. However, it is understood that RBI has advised CDR Cell that a second time restructuring done by them would not be considered as repeated restructuring if there is no negative NPV on discounting of cash flows. It was felt that this has led to restructuring of some unviable borrowal accounts under the CDR mechanism. *(Chapter 6)*

**Recommendation 14**

0.43 The WG recommended that the special dispensation provided to CDR Cell that any second time restructuring under CDR restructuring need not be considered as repeated restructuring if it does not lead to negative NPV, be withdrawn. The WG is of the view that such special dispensation could result in repeated restructuring due to the dilution in the norms for CDR cases without attracting stricter asset classification and provisioning norms. Hence, the same may be dispensed with. Simultaneously, the WG took note of the fact that in line

with Recommendation 1, this recommendation will lose its relevance after the interregnum period when the regulatory forbearance on asset quality will no longer be available.

**Relaxations in asset classification status for restructured infrastructure accounts**

0.44 Certain relaxations as far as conditions regarding asset classification even when there is delay in date of commencement of commercial operation (DCCO), in respect of repayment period of restructured advances and regarding tangible security have been extended to bank financing to infrastructure sector. The WG is of the view that these relaxations need to be limited to infrastructure financing done within India, considering the importance of the sector for the economic development of the country. *(Chapter 6)*

**Recommendation 15**

0.45 The WG is of the view that the above relaxations in restructuring guidelines be permitted for infrastructure projects in view of the importance of infrastructure development in our country. The WG, therefore, recommended that the RBI may clarify that the above relaxations are only applicable in the case of infrastructure financing undertaken by banks in India and not overseas.

**Promoters' sacrifice**

0.46 One of the conditions for eligibility for regulatory asset classification benefit on restructuring is that promoters' sacrifice and additional funds brought by them should be a minimum of 15% of banks' sacrifice. The term 'bank's sacrifice' means the amount of "erosion in the fair value of the advance". The WG felt that there is a need for ensuring the promoters in fact sacrifice a minimum amount as prescribed and there is a need for clarifying as to how this could be ensured. It was also felt that stipulating promoter's sacrifice at 15% of the bank's sacrifice was not sufficient. *(Chapter 6)*

**Recommendation 16**

0.47 The WG recommended that RBI may consider a higher amount of promoters' sacrifice in cases of restructuring of large exposures under CDR mechanism. Further, the WG recommended that the promoters' contribution should be prescribed at a minimum of 15% of the diminution in fair value or 2% of the restructured debt, whichever is higher.

**Conversion of debt into preference/equity shares**

0.48 The WG observed that banks were adversely affected in cases of conversion of a large portion of debt into preference shares. Such conversions are akin to writing off the debt as in many cases these preference shares carried zero or low coupon, added with the fact that they had no market value and they did not carry voting rights like equity shares. *(Chapter 6)*

**Recommendation 17**

0.49 The WG recommended that conversion of debt into preference shares should be done only as a last resort. It also recommended that conversion of debt into equity/preference shares should, in any case, be restricted to a cap (say 10% of the restructured debt).

**Recommendation 18**

0.50 The WG recommended that any conversion of debt into equity should be done only in the case of listed companies.

**Exit option**

0.51 The WG observed that viability should be the prime criteria for restructuring of advances and there should be exit options for the banks in cases of non-viable accounts. The WG analysed the international best practices in this regard as also the extant RBI guidelines which state that though flexibility is available whereby the creditors could either consider restructuring outside the purview of

the CDR system or even initiate legal proceedings where warranted, banks/FIs should review all eligible cases where the exposure of the financial system is more than Rs.100 crore and decide about referring the case to CDR system or to proceed under the new Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002 or to file a suit in DRT, etc. *(Chapter 6)*

**Recommendation 19**

0.52 The WG observed that there were cases which were found to be viable before restructuring but the assumptions leading to viability did not materialise in due course of time. There were also cases where the approved restructuring package could not be implemented satisfactorily due to external reasons or due to promoters' non-adherence to the terms and conditions. The WG recommended that in such cases, banks should be advised to assess the situation early and use the exit options with a view to minimise the losses. The WG also recommended that the terms and conditions of restructuring should inherently contain the principle of 'carrot and stick', i.e. while restructuring being an incentive for viable accounts, it should also have disincentives for non-adherence to the terms of restructuring and under-performance.

**Right of recompense**

0.53 The WG discussed that it was important to clearly define the right of recompense. It was observed that banks generally waived the benefits accruing to them from right of recompense at a later stage. The WG also discussed the CDR instructions in this regard in the light of the fact that the RBI guidelines make the 'right of recompense' clause mandatory in cases of CDR restructuring. The WG took note of the fact that due to the current guidelines issued by CDR Cell that recompense be calculated on compounding basis and that 100% of recompense so calculated is payable, exit of companies from CDR system was not happening. As on date, there were several companies where right of

recompense has already been triggered but there were disputes regarding recompense amount / calculation thereof. *(Chapter 6)*

**Recommendation 20**

0.54 The WG recommended that CDR Standing Forum/Core Group may take a view as to whether their clause on 'recompense' may be made somewhat flexible in order to facilitate the exit of the borrowers from CDR Cell. However, it also recommended that in any case 75% of the amount of recompense calculated should be recovered from the borrowers and in cases of restructuring where a facility has been granted below base rate, 100% of the recompense amount should be recovered.

**Recommendation 21**

0.55 The WG also recommended that the present recommendatory nature of 'recompense' clause should be made mandatory even in cases of non-CDR restructurings.

**Personal guarantee of promoters**

0.56 The WG observed that as per the extant restructuring guidelines personal guarantee by the promoter was one of the conditions for the asset classification benefit except when the unit is affected by external factors pertaining to the economy and industry. However, the WG observed that some promoters do not agree to extend personal guarantee under any circumstances. It was also observed that the criteria, 'external factors pertaining to the economy and industry' was subjective and difficult to implement. Considering that the restructuring of debt by lenders benefits the promoters and also leads to sacrifice by lenders, it was important to ensure promoters' "skin in the game" or commitment by stipulating personal guarantee. *(Chapter 6)*

**Recommendation 22**

0.57 As stipulating personal guarantee will ensure promoters' "skin in the game" or commitment to the restructuring package, the WG recommended that obtaining the personal guarantee of promoters be made a mandatory requirement in all cases of restructuring, i.e. even if the restructuring is necessitated on account of external factors pertaining to the economy and industry.

**Recommendation 23**

0.58 The WG also recommended that the RBI should prescribe that corporate guarantee cannot be a substitute for the promoters' personal guarantee.

## Chapter 1

## Introduction

1.1 Restructuring of loans and advances is a procedure to modify the terms and conditions of an existing loan in order to alleviate the difficulties in repayment by the borrower due to temporary cash flow problems or general economic downturn. Internationally, the practice of loan restructuring under a modern banking system could be traced back to as far back as during the Great Depression under the name of 'loan modification'. During the Great Depression, in the United States a number of mortgage modification programs were enacted by the States to limit foreclosure sales and subsequent homelessness and its economic impact. Because of the shrinkage of the economy, many borrowers lost their jobs and income and were unable to maintain their mortgage payments.

1.2 In 1933, the Minnesota Mortgage Moratorium Act was challenged by a bank which argued before the United States Supreme Court that it was a violation of the contract clause of the Constitution. In *Home Building & Loan Association v. Blaisdell*, the court upheld the law imposing a mandatory mortgage modification[ii]. During this period, loan modification became a matter of national policy, with various actions taken to alter mortgage loan terms to prevent further economic destabilization.

1.3 Internationally, loan restructuring approaches may be placed in the continuum between an excessive debtor-oriented approach and an excessively creditor-oriented approach. An excessively debtor-oriented approach has the aspects of *moral hazard* as it may encourage the debtor to take excessive risks in the knowledge that the burden of any losses will fall disproportionally on creditors. Nevertheless, it is a prominent Central Banking tool during the times of economic crisis. During the recent financial crisis, in a Testimony[iii] before the Committee on Financial Services, US House of Representatives, Washington DC, on 6 December 2007, Mr Randall S Kroszner, Member of the Board of

Governors of the US Federal Reserve System, cited Loan Modifications as one of the responses of the Federal Reserve System to problems in the sub-prime market.

He stated "*prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower, but there may be instances when such arrangements are not prudent or appropriate. In trying to help homeowners, we must also be careful to recognize the existing legal rights of investors, avoid actions that may have the unintended consequence of disrupting the orderly functioning of the market, or unnecessarily reducing future access to credit. Provisions intended to immunize servicers from liability should be crafted to avoid creating moral hazard of parties disregarding their contractual obligations, which would ultimately have negative impacts for markets and consumers. Sustainable solutions, and not those that simply hide for the short term real repayment challenges, should be our goal".*

1.4 There are several but similar definitions of 'Loan Restructuring'. RBI's prudential guidelines on restructuring define a restructured account as one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/repayable amount/the amount of instalments/rate of interest (due to reasons other than competitive reasons).

1.5 In a Bank for International Settlements (BIS) paper "Non-performing Loans and the Real Economy – Japan's Experience", a restructured loan has been defined as "Loans for which the bank has provided more favourable terms and conditions to the borrower than those in the original agreement, with the aim of providing restructuring support. These include reducing interest rates,

rescheduling interest and principal payments, or waiving claims on the borrower."

1.6 RBI had issued guidelines to banks in 1992 and 1999 regarding asset classification for the assets where the terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled. These guidelines were reviewed in the light of international best practices and the Basel Committee on Banking Supervision (BCBS) guidelines issued in the matter and revised guidelines were issued by RBI in March 2001 relating to restructuring/rescheduling/renegotiation of terms of the standard and sub-standard loan assets.

1.7 The above guidelines were further reviewed in August 2001 and juxtaposed to the restructuring needs of large corporate exposures from multiple banks under consortium or multiple banking arrangements. The present prudential guidelines on restructuring of advances by banks is an evolution of these guidelines from 1992 through 2008 under the recommendations of various high power committees and Working Groups as also a result of the changing dynamics of Indian banking and real sector and their increased integration with the global macroeconomic developments. A detailed description of this evolution is given in the next Chapter titled 'Evolution of prudential guidelines on restructuring in India'.

1.8 The guidelines on restructuring of advances by banks issued in August 2008 allowed banks to restructure accounts of viable entities classified as standard, sub-standard and doubtful. It was prescribed in the August 2008 guidelines that accounts of borrowers engaged in important business activities and classified as standard assets may retain their standard asset classification on restructuring subject to certain conditions. In the aftermath of the global financial turmoil in 2007, RBI had proactively taken many steps to arrest the downward spiral in the economy and the banking sector. An account of these steps is given in Box 1 in Chapter 2 of this report.

1.9 The special regulatory treatment allowed at that time limited the growth of gross nonperforming advances in the banking system. At the system level, the restructured standard advances as a percentage of gross advances increased from 2.16% as at end-March 2009 to 2.66% as at end-March 2011. Restructured standard advances of banks have been showing a rising trend and such advances have exceeded the gross NPAs since March 2010, details of which are furnished in the table below. The complete audited figures for March 2012 are not available till the preparation of this report.

(Rs. in crore)

| Item | March 2009 | March 2010 | March 2011 |
|---|---|---|---|
| Gross advances | 27,93,572 | 32,71,896 | 40,12,079 |
| Standard advances<br>- of which restructured | 27,25,350<br>60,379 | 31,90,080<br>97,834 | 39,17,991<br>1,06,859 |
| Gross NPAs | 68,222 | 81,816 | 94,088 |
| Gross NPAs as a % of gross advances | 2.44 | 2.50 | 2.35 |
| Restructured standard advances as % of gross advances | 2.16 | 2.99 | 2.66 |

1.10 Further, data shows that the number of cases referred to CDR Cell has also increased from 225 cases as on March 2009 to 392 cases as on March 31, 2012. The amount of debt referred to CDR Cell has also increased from Rs. 95,815 crore as on March 31, 2009 to Rs.2,06,493 crore as on March 31, 2012.

1.11 The restructuring guidelines have generally helped both the lenders and borrowers, especially during economic downturns. However, due to lack of clarity in the guidelines/concerns of certain provisions, RBI has been receiving requests from stakeholders to review the restructuring guidelines in the light of experience gained. Accordingly, in the Second Quarter Review of Monetary Policy 2011-12 announced on October 25, 2011, it was proposed to constitute a

WG to review the existing prudential guidelines on restructuring of advances by banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards.

1.12 Accordingly, a WG to review the existing prudential guidelines on restructuring of advances by banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards was constituted on January 31, 2012 under the Chairmanship of Shri B. Mahapatra, Executive Director, RBI. The WG comprises of members from various departments of RBI (DBOD, DBS and RPCD), Government of India, select commercial banks, Indian Banks' Association, CDR Cell and a rating agency. The composition of this WG is as follows:

| Sr. No. | Members | |
|---|---|---|
| 1. | Shri B. Mahapatra<br>Executive Director, RBI | Chairperson |
| 2. | Shri Tarsem Chand<br>Director, DFS, MoF, GoI | Member |
| 3. | Shri A. Madasamy<br>Chief General Manager, DBS, RBI | Member |
| 4. | Shri C. D. Srinivasan<br>Chief General Manager, RPCD, RBI | Member |
| 5. | Shri N. Seshadri<br>Executive Director, Bank of India | Member |
| 6. | Shri B. V. Chaubal*<br>Chief General Manager, State Bank of India | Member |
| 7. | Ms. Malini Bansal<br>Chief General Manager, CDR Cell | Member |
| 8. | Shri Rakesh Jha<br>Deputy Chief Financial Officer, ICICI Bank | Member |
| 9. | Shri Sunil Prabhu<br>Regional Head, Standard Chartered Bank | Member |

| | | |
|---|---|---|
| 10. | Shri Manish Kumar<br>Chief Risk Officer, Citi Commercial Bank | Member |
| 11. | Shri Ananda Bhoumik<br>Senior Director, Fitch Ratings India | Member |
| 12. | Shri K. Unnikrishnan<br>Deputy Chief Executive, IBA | Member |
| 13. | Shri M. P. Baliga<br>General Manager, DBOD, RBI | Member Secretary |

* Promoted as Deputy Managing Director with effect from April 30, 2012.

1.13. The broad terms of reference of the WG are as under:

(i) To review the existing prudential guidelines on restructuring vis-a-vis international best practices/ experiences and accounting standards;

(ii) To review the implementation of restructuring guidelines by banks/financial institutions;

(iii) To study the need for bringing in more clarity to the existing restructuring guidelines, if considered necessary;

(iv) To review the current disclosure requirements;

(v) Suggestions for revision to the existing guidelines taking into account the international best practices and accounting standards; and

(vi) Any other matter germane to the issue.

1.14 The WG held seven meetings on February 21, March 13 & 28, April 30, June 11, July 2 & 18, 2012 and prepared this report after studying the best international practices and accounting standards and taking into account the views of stakeholders. Shri Tarsem Chand, though nominated a member of the WG, could not attend any of the meetings.

1.15 The WG conveys its deep sense of gratitude to Shri S.K. Agrawal, Vice President, ICAI who attended meetings as a special invitee and Shri Deepak Singhal, Chief General Manager-in-Charge, DBOD, RBI who was a permanent invitee to the meetings of the WG. The WG immensely benefited from their experience and expertise. The WG would also like to express its appreciation of

the excellent inputs and support provided by Ms. Anupam Sonal, General Manager, Shri Manoj Poddar, Assistant General Manager, Shri Amarvir Saran Das, Assistant General Manager and Shri Tushar Bhattacharya, Assistant General Manager of RBI.

1.16 The report is organised in 6 chapters. Chapter 2 elaborates how the prudential guidelines on restructuring evolved over a period of time in India. Chapter 3 highlights the accounting standards for restructuring of advances. Chapter 4 indicates the international practices relating to restructuring of advances. Chapter 5 elaborates the existing framework for restructuring of advances in India. Chapter 6 summarises the discussions and deliberations which took place in the meetings of the WG.

## Chapter 2

### Evolution of prudential guidelines on restructuring in India

2.1 Restructuring of loans and advances is not a new phenomenon and terms such as rescheduling/renegotiation/rehabilitation/restructuring have been used interchangeably by RBI and the banks for a long period of time. Guidelines on restructuring evolved not only with the changing economic, social and technological environments but also sometimes with the political environment.

2.2 The earliest directives on restructuring of non-industrial accounts can be seen in late 1970s when Government of India (GoI) and RBI had advised the banks to extend relief to the people affected by floods and other natural calamities by rescheduling of loans in 1978[iv]. Banks were also advised in 1978[v] to adopt a package of measures to restore the health of the enterprises of the MISA/DISIR (Acts imposed during the Emergency) detenus which included provision of fresh credit, rescheduling of loans, non-imposition of penal interest, grant of moratorium, etc. Before this, RBI and GoI had issued directives in 1976[vi] to the banks and Financial Institutions (FIs) to identify and draw up plans for rehabilitation of sick units. Detailed guidelines with parameters on viability of sick units were issued in 1985[vii].

2.3 The earliest prudential measure taken by RBI regarding asset classification of loans and advances was introduction of 'Health Code System' for borrowal accounts in November 1985[viii]. However, asset classification of restructured accounts was explicitly prescribed for the first time in April 1992[ix] with the introduction of asset classification norms defined on objective criteria of past due and record of recovery. These definitions were on the basis of the recommendations of 'The Committee on Financial System' under the Chairmanship of Shri M. Narasimham. It was stated that an asset, where the terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production, should be

classified as sub-standard and should remain in that category for at least two years of satisfactory performance under the renegotiated or rescheduled terms.

2.4 Separate guidelines on Income Recognition, Asset Classification (IRAC) and Provisioning Norms for FIs were issued in March 1994[x]. These guidelines for FIs were comparatively lenient compared to those for the banks as they allowed a time over-run of 50% of the contracted time for completion of projects before downgrading the asset.

2.5 On representations from the banks, the above-mentioned requirement of keeping a restructured account in sub-standard category for a period of two years was reduced to one year or four quarters in May 1999[xi]. During the same year[xii], special asset classification benefits on restructuring were provided to project loans. Board of Directors of the banks were given freedom to decide whether there is a need for restructuring of the loan of a unit which has started commercial production but the cash flows were not adequate to service the loans. In such cases, banks were allowed to reschedule the project loans and treat them as standard if in their opinion the bottleneck in achieving regular commercial production was of temporary nature not indicative of any long-term impairment of the unit's economic viability and if the unit was likely to achieve cash break-even if some time was allowed. This prescribed lead time was 'not exceeding one year' from the date of commencement of commercial production as indicated in the terms of sanction.

2.6 The above guidelines were reviewed in the light of the international best practices and the BIS guidelines in the matter, and revised guidelines relating to restructuring/rescheduling/renegotiation of terms of the standard and sub-standard loan assets were issued by RBI in March 2001[xiii]. Restructured standard accounts were allowed to retain their asset classification, (i) when instalments of principal were rescheduled provided the loan was fully secured and (ii) when interest element was restructured provided the sacrifice in terms of present value was either written off or provided for.

2.7 Restructured sub-standard accounts were also allowed to be continued in the sub-standard category for the specified period subject to adherence to the conditions stipulated in case of restructured standard accounts. These guidelines also specified that all standard and sub-standard restructured accounts would continue to be eligible for fresh financing. Disclosure requirements for restructured accounts were also stipulated for the first time.

2.8 The above guidelines prescribed three stages of restructuring in terms of commencement of commercial production. Further, it was mentioned in the 2004 Master Circular on IRAC Norms that only manufacturing accounts and not the trading accounts will qualify for the asset classification benefits. This gave an impression that restructuring was permitted only in cases of manufacturing and trading accounts. Therefore, it was clarified[xiv] that restructuring was permitted also with regard to units which are neither manufacturing nor trading, however, these units will not be accorded the special asset classification benefit.

2.9 The guidelines on restructuring by banks were initially focused on restructuring of an individual bank's exposure, including those towards corporate borrowers. Banks found it difficult to smoothly design and implement restructuring in cases of exposures with multiple lenders. Therefore, a need was felt to devise a system where restructuring needs of large corporate exposures from multiple banks under consortium / multiple banking arrangements could be carried out. This need was in view of the fact that such a restructuring package requires taking into account different levels of exposures, securities, terms and conditions of different banks as also the need of a centralised monitoring of implementation of the package.

2.10 In view of the difficulties faced by the banks in restructuring of large advances of corporates under multiple/consortium banking, RBI put in place a scheme of Corporate Debt Restructuring (CDR) in August 2001[xv] based on the mechanism prevalent in countries like the U.K., Thailand, Korea, Malaysia, etc. These guidelines were finalised after extensive discussion between GoI, RBI,

banks and FIs. The objective of the CDR framework was to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework aimed at preserving viable corporates with multiple banking accounts/syndicates/consortium accounts that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

2.11 Subsequently, as proposed in the Union Budget 2002-03, RBI constituted a High Level Group under the Chairmanship of Shri Vepa Kamesam, the then Deputy Governor to review the CDR mechanism and to suggest measures to make the scheme even more effective. During the initial period, RBI retained the authority to approve CDR proposals on the specific recommendations of CDR Core Group, if a minimum 75% (by value) of lenders, constituting banks and FIs, consented for CDR, irrespective of differences in asset classification status in banks/FIs.

2.12 Based on the recommendations of the High Level Group under Shri Vepa Kamesam, a revised scheme of CDR mechanism was issued in February 2003. A major change in 2003 review was that even the doubtful accounts were allowed to be restructured for the first time subject to their viability under category 2 CDR System. These guidelines were further reviewed by a Special Group under the Chairmanship of Smt. S. Gopinath, the then Deputy Governor and revised Guidelines on CDR mechanism were issued in November 2005. These revised guidelines lowered the eligibility ceiling of accounts for CDR in terms of exposure to Rs.10 crore from the then existing limit of Rs.20 crore. RBI also completely delegated the authority of approving CDR packages to CDR Empowered Group (EG) and retained the authority to issue only the broad guidelines.

2.13 As part of an announcement made by the Hon'ble Finance Minister for improving flow of credit to small and medium enterprises, RBI issued guidelines

for restructuring of debt of all eligible Small and Medium Enterprises (SME) in September 2005[xvi]. These guidelines were applicable to (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 which are viable or potentially viable.

2.14 As there was also a need for banks to restructure credit facilities pertaining to borrowers who were not covered by any of the above guidelines, it was proposed in the Annual Policy Statement for the year 2006-07 to constitute a WG 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. Based on the recommendations of the WG and the public comments received on the draft prudential guidelines, the principles governing restructuring of different types of advances were aligned and fresh guidelines on the subject superseding all the guidelines on the subject were issued in August 2008.

2.15 The guidelines on restructuring of advances by banks issued in August 2008 allowed banks to restructure accounts of viable entities classified as standard, sub-standard and doubtful. These guidelines also prescribed that accounts of borrowers engaged in important business activities and classified as standard assets may retain their standard asset classification on restructuring subject to certain conditions. Only exceptions to these benefits were CRE, CME and personal/consumer loans. Nevertheless, housing and education loans were also brought in the ambit of asset classification benefit.

2.16 It was only coincidental that issue of ‘Prudential Guidelines on Restructuring of Advances’ in August 2008 was followed by collapse of the Lehman Brothers which also was a watershed event culminating the sub-prime crisis into the full-fledged Global Financial Crisis. This required a proactive

regulatory approach and RBI took a number of steps to assuage the unprecedented hardship faced by the borrowers, especially the large projects.

***Box 1: Regulatory Response to the Crisis***

In the year 2008, when following the collapse of Lehman Brothers, the borrowers faced genuine difficulties in repaying their debt, RBI had allowed certain special concessions and asset classification benefits as a special measure with the objective of enabling the borrowers to tide over their genuine difficulties in a time of widespread economic and financial stress and help banks retain the quality of viable assets. At that time the banks had become excessively risk-averse, especially towards the SMEs. In view of this, RBI instructed the banks in October 2008 to restructure the accounts of SMEs wherever warranted and on the basis of merit as also disburse the sanctioned limits on commercial judgment.

The restructuring guidelines were relaxed as one-time measure in December 2008. In view of the extraordinary stress faced by Commercial Real Estate (CRE) Sector, the exceptional/special regulatory treatment allowed the asset classification benefit to that sector for accounts restructured upto June 30, 2009. Further, repeatedly restructured accounts (other than CRE, CME and personal/consumer loans) restructured upto June 30, 2009 were also allowed special asset classification benefit.

On further representation from the banks that they were facing operational difficulties in availing the relaxations provided in December 2008, RBI provided further one-time measure in January 2009 as below:

- All eligible accounts which were standard accounts on September 1, 2008 were allowed to be treated as standard accounts on restructuring provided the restructuring was taken up on or before January 31, 2009 (extended up to March 31, 2009 in February 2009) and the restructuring package was put in place within a period of 120 days from the date of taking up the restructuring package.
- The period for implementing the restructuring package was extended

from 90 days to 120 days.

- Condition of being 'fully secured' was relaxed for WCTL portion in view of sharp decline in inventory values.

Recently, RBI extended one time measure of relaxing the condition of being fully secured in cases of Micro Finance Institutions (MFIs) when they faced unprecedented problem in recovery and liquidity due to environmental factors.

2.17 RBI also issued instructions on restructuring of derivative contracts in October 2008[xvii] and banks were advised that in cases where a derivative contract is restructured, the mark-to-market value of the contract on the date of restructuring should be cash settled. It was also stated that for this purpose, any change in any of the parameters of the original contract would be treated as a restructuring. Further, these instructions were also made applicable to the foreign branches of Indian banks.

## Chapter 3

## Restructuring of advances and accounting standards

### Introduction

3.1 There are two major international sets of Generally Accepted Accounting Principles (GAAPs) – standards issued by the International Accounting Standards Board (IASB), followed in the European Union, Canada, Australia, South Korea and several other jurisdictions and standards issued by the Financial Accounting Standards Board (FASB), which are primarily followed in the USA. Many national accounting standards boards base their standards on either of the two international GAAPs. After the global financial crisis, there have been efforts under the auspices of the G20 to harmonise these two sets of accounting standards to converge to a single set of global high quality accounting standards.

### Accounting for Impairment under International Financial Reporting Standards (IFRS)

3.2 Accounting Standards issued by IASB are christened International Financial Reporting Standards (IFRS). IFRS also include International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC), the predecessor of the IASB. *IAS 39: Financial Instruments Recognition and Measurement* deals with impairment of financial assets.

3.3 The standard deals with impairment through a two-step process. Firstly, the entity is required to carry out an impairment review of its financial assets at every balance sheet date to determine if there is any objective evidence of impairment. Examples of objective evidence include significant financial difficulty of the issuer or obligor, high probability that borrower will enter bankruptcy or other financial reorganisation, breach of contract such as default or delinquency in interest or principal payments, ***lender granting concessions to the borrower for economic/ legal reasons that it would not otherwise consider***,

etc. Secondly, if there is objective evidence of impairment, the entity should measure and record the impairment loss in the reporting period.

3.4 Impairment only affects financial assets carried at amortised cost/cost or through assets carried under the available for sale (AFS) category whose fair value changes are recognised in other comprehensive income (OCI). A financial asset that is carried at fair value through profit and loss account does not give rise to any impairment issues since diminution in value due to impairment is already reflected in the fair value.

3.5 In the case of impairment of assets carried at amortised cost /cost, the amount of loss is measured as the difference between the assets carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. In the case of impairment of assets carried under AFS, the entire cumulative loss that has been recognised in OCI has to be reclassified from equity and recognised in profit or loss account.

The IAS 39 is under revision and will be replaced by *IFRS 9: Financial Instruments*.

3.6 Thus, it may be seen from the above that ***lender granting concessions to the borrower for economic/ legal reasons that it would not otherwise consider,*** is a ground for considering an asset as impaired. However, it may be noted that under IFRS an account need not be classified as impaired on restructuring if there is no negative impact on the present value of cash flows on account of restructuring.

**Accounting for Impairment under Generally Accepted Accounting Principles in the United States (US GAAP)**

3.7 Prior to the Accounting Standards Codification which came into effect for interim and annual financial reporting periods commencing after September 15,

2009, US GAAP requirements relating to impairment were mainly covered under Statement of Financial Accounting Standard (FAS) 114: *Accounting by Creditors for Impairment of Loans,* FAS 5*: Accounting for Contingencies* and FAS 15: *Accounting by Debtors and Creditors for troubled debt restructuring.*

3.8 As per FAS 114, a loan is considered to be impaired when based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. In case a loan has been restructured in a troubled debt restructuring, the contractual terms of the loan agreement refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. FAS 15 specifies that a creditor in a troubled debt restructuring involving a modification of terms should account for the restructured loan in accordance with FAS 114.

3.9 In respect of measurement, FAS 114 provides that creditors should have latitude to develop measurement methods that are practical in their circumstances. The various methods specified in the standard are summarised below:

i) Present value: When a loan is recognised as impaired the impairment is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate.

ii) Observable market price or Fair Value of Collateral: As a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of the collateral if the loan is collateral dependent[1], instead of measuring the present value as indicated above. Regardless of the measurement method, a creditor is required to measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable.

[1] A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

3.10 Subsequent to initial measurement if there is significant change in the amount or timing of expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor is required to recalculate the impairment.

3.11 It is seen from the above that even in the US GAAP, restructured troubled debt is considered as impaired.

**Indian position**

3.12 The Institute of Chartered Accountants of India (ICAI), the accounting standard setting body in India has issued *AS 30 - Financial Instruments: Recognition and Measurement,* which is very similar to IAS 39. However, AS 30 has not been notified under Companies Act, 1956. In February 2011, ICAI clarified the status of applicability of AS 30 wherein it *inter-alia* provided that:

> (i) To the extent of accounting treatments covered by any of the existing notified accounting standards (for example, AS 11, AS 13, etc.,) the existing accounting standards would continue to prevail over AS 30.
>
> (ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g. loan impairment, investment classification or accounting for securitizations by RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30.
>
> (iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

3.13 It may be seen from the above that as a general principle, the Indian accounting standards follow the IAS and the applicable accounting standard for restructured debt is AS 30, which is similar to IAS 39. However, the Indian accounting standard (AS 30) gives precedence to the regulatory requirements of relevant regulators like RBI. Therefore, the accounting treatment accorded by RBI for restructured advances will apply in India.

3.14 India envisages converging to IFRS. In February 2011, the Ministry of Corporate Affairs (MCA) published 35 IFRS converged Indian Accounting Standards (Ind AS) stating that their implementation date would be notified later, after all issues including those relating to taxation are resolved.

3.15 The WG has, therefore, observed that as per international accounting standards, accounts are generally treated as impaired on restructuring and recommended that similar practice should be followed in India. It was also noted that 'Definition of Default' under the Internal Ratings Based (IRB) approach of Basel II for computation of capital requirement for credit risk, identified restructuring as an event of default irrespective of the asset classification as it states that restructured assets classified as standard assets will be treated as defaulted for the limited purpose of computation of capital under IRB. Therefore, the WG opined that for consistency, restructuring should be treated as default (sub-standard).

3.16 Further, the WG also took note of the fact that the capital market and the rating agencies viewed any restructuring of an account as an event of impairment even if the regulators allowed the accounts to retain the 'standard' asset classification on restructuring.

3.17 The WG was conscious of the consequences of aligning restructuring guidelines with this best practice but felt that doing so immediately at this juncture when the impact of global financial crisis is still substantial and a new crisis in the form of European sovereign debt crisis is unfolding, might act as a disincentive to banks to restructure viable accounts which could lead to substantial distress to the borrowers and increase in the non-performing assets and provision requirements for the banks. The WG has, therefore, recommended a gradual approach towards classifying a restructured account as impaired. *[Recommendation 1]*

**Prudential regulatory treatment of restructured facilities i.e. classification of restructured loan accounts in other jurisdictions**

3.18 Notwithstanding the generally accepted accounting principles under IAS/IFRS or FAS, prudential regulatory treatment of restructured loan accounts varies from country to country. Unlike in capital market, where Re.1 default is treated as a default, the loan market is more flexible because of customer relationship. Recognizing this, banks and their regulators allow a more balanced prudential asset classification for restructured loans. Some of the cross country practices observed by the WG are described below:

***Australia***

3.19 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 ADI (Authorised Deposit-taking Institution). Provisioning, including prescribed provisioning, does not apply to formally restructured facilities.

3.20 Provided an appropriate adjustment has been made to the value of a facility, a restructured facility need not be treated as impaired when all of the following requirements are satisfied: a) an ADI 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 ADI 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.

3.21 Where a restructured facility does not satisfy all of the above requirements, it must continue to be treated as impaired and make provisions as per the prescribed guidelines.

3.22 A single facility cannot be split into impaired and non-impaired parts in the absence of a formal restructuring agreement. In these circumstances, if a facility cannot support all cash flows, the whole facility must continue to be regarded as impaired.

3.23 Cases, where sufficient evidence exists to demonstrate relative improvement in the condition and debt service capacity of an entity, apart from performance, 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 ADI may return the facility to non-impaired status for the purpose of reporting to Australian Prudential Regulatory Authority (APRA) provided the other requirements specified above in this regard are satisfied.

***Singapore***

3.24 All restructured loans should be placed under specific grade under classified loans (i.e. impaired loans). A bank shall place a restructured credit facility in the appropriate classified grade depending on its assessment of the financial condition of the borrower and the ability of the borrower to repay based on the restructured terms.

3.25 Restructured loan can only be upgraded after the obligor has fulfilled its revised loan obligation for a reasonable period of time or 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.

3.26 A restructured credit facility shall, at the minimum, remain classified as impaired 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.

3.27 A restructured credit facility in respect of which a debt moratorium is given shall remain classified as impaired 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.

***The USA***

3.28 All loans whose terms have been modified in a troubled debt restructuring must be evaluated for impairment using the present value of future cash flows and discounted at the effective interest rate of the original loan (that is before or after restructuring).

3.29 A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained on non-accrual status. A restructured non-accrual loan can be immediately restored to accrual status if the lender is reasonably assured of repayment and performance according to the modified terms. In certain circumstances, other information, such as the borrower having obtained sustained and reliable sales, lease or rental contracts which affect the borrower's ability to repay e.g., if important developments are expected to significantly increase borrower's cash flow and debt service capacity and strength, then the borrowers commitment to pay must be sufficient. A preponderance of such evidence may be treated as sufficient to

warrant returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment. While restructured debt that qualifies for accrual status must be disclosed as troubled debt in the year of restructuring, it need not be disclosed in subsequent years.

***Hong Kong***

3.30 A rescheduled loan will normally require an adverse classification as impaired loan under the loan classification system i.e. as substandard or doubtful. Rescheduled advances which have been overdue for more than three months under the revised repayment terms are also treated as overdue advances.

***Thailand***

3.31 The write-off and provision requirements for restructured accounts are as follows:

(a) In cases where concession is made to the debtors by reducing the principal or interest accrued prior to debt restructuring, or repayment has been accepted by the transfer of assets, financial instruments, or equity of such debtor from securitization (the conversion of the debt into equity), a commercial bank can write-off the debtor account(s), recognize the incurred loss and reverse the entry for the portion that exceeds the provision reserved for such a debtor for the whole amount.

(b) In cases where a commercial bank has made a concession to a debtor by relieving the conditions on debt repayment without reducing the principal or interest accrued prior to the debt restructuring, which causes the expected recoverable amount of restructured debt calculated according to the regulation on debt restructuring of financial institutions prescribed by the Bank of Thailand to be lower than the sum of the original book value of the loan and accrued interest recorded in the account prior to the debt restructuring, such commercial bank shall recognize the provision for the entire amount of incurred loss. A commercial bank can reverse the entry for the provision set before debt

restructuring of such a debtor only for the portion that exceeds the incurred loss. However, in case where the provision set before the debt restructuring of such a debtor is lower than the incurred loss, a commercial bank shall set aside additional provision to cover such loss.

(c) In cases where a commercial bank has granted the debtor a reduction in the principal or interest accrued prior to the debt restructuring, or has accepted the partial repayment by the transfer of assets, financial instruments, or securitization and has made a concession by relieving the conditions on the remaining debt repayment to a debtor, such a commercial bank shall comply with (a) for the case of concession by reducing of the principal or interest or receiving of the debt repayment, and comply with (b) for the case of concession by relieving the conditions on debt repayment.

3.32 During the monitoring of debtor's compliance with the debt restructuring conditions where a debtor is required to make the debt repayment according to the new terms of the debt restructuring agreement for at least a period of 3 consecutive months or 3 instalments, whichever is longer, a commercial bank shall comply with the following:

- A debtor originally classified as Doubtful or Doubtful shall be reclassified as Substandard.
- A debtor originally classified as Substandard or Special Mention (or Requiring Special Caution) shall be retained in the same class.

3.33 A commercial bank shall set provision based on the debtor status after the debt restructuring for the case where the provision set according to (b) is greater than the provision for incurred loss from the debt restructuring under (a) (b) and (c).

3.34 A debtor who has successfully complied with the new terms of the debt restructuring agreement and where the debt repayment has been made for at least a period of 3 consecutive months or 3 instalments, shall be reclassified such as Pass.

### *France*

3.35 Loans restructured because of the debtors' financial situation, may be reclassified as performing loans, but in a specific sub-category until they have been repaid in full.

### *The UK*

3.36 The Financial Services Authority (FSA) has broadly laid down good and bad practices in accordance with the provisions of IAS 39 for recognition, monitoring, provisioning and accounting for impaired and forbearance accounts. The lending firms are free to formulate their own internal policies in these matters subject to these broad guidelines of FSA.

### Conclusion

3.37 The common element observed was that restructured accounts are classified as impaired if the restructuring (i) is on account of financial stress of the borrower or due to delays/ non-payment as per contractual terms by the borrower and (ii) the modification of terms is non-commercial, i.e. disadvantageous to the lenders. Further, all jurisdictions require a reasonable period of satisfactory performance as per the new terms before the account could be upgraded. Differences amongst jurisdictions are more on account of granular aspects of the definition and treatment. For instance to upgrade a restructured account in Australia, a satisfactory performance is to be observed for six months or three repayment cycles, whichever is longer whereas in Thailand satisfactory performance over three consecutive months/ three instalments is required. France, while allowing restructured accounts to be upgraded on account of satisfactory performance, requires that these accounts be reclassified into a specific sub-category of performing accounts until they are paid in full. A detailed comparison of treatments across the jurisdictions is given in Appendix I.

3.38 The WG analysed the above requirements vis-à-vis the current RBI guidelines, which require satisfactory performance of one year from the date when the first payment of interest or instalment of principal falls due under the terms of restructuring package, and observed that RBI guidelines were more stringent as regards upgradation of accounts classified as impaired on restructuring. However, the WG also noted that in some cases of restructuring involving multiple credit facilities and moratorium on most of the facilities, this provision was factored in for upgradation of restructured account after satisfactory performance on a facility (such as interest payment on FITL) while majority of facilities were still under moratorium. In view of this observation, the WG recommended that this loophole be plugged by suitable regulatory prescription. *[Recommendation 6]*

## Chapter 4

## International practices relating to restructuring of advances[2]

### Introduction

4.1 RBI's prudential guidelines have evolved over a period of time taking into account the international best practices. As regards restructuring of advances, RBI's guidelines have taken into account the international best practices regarding asset classification on restructuring, out of court restructuring of corporate debts, etc. In this Chapter, an overview of the international best practices regarding restructuring of corporate as well as household debt is given. A snapshot of restructuring practices around the world is given in Appendix II.

4.2 The global economy has been beset with unprecedented economic volatility in the past few decades, starting with the oil shock in the early 1970s and the resulting recession in the developed world, Latin American debt crisis in the 1980s, Japanese deflation starting 1991, recession in the UK and USA in the 1990s, the East Asian crisis in 1998, the dot-com bubble burst in 2001, and the financial sector crisis of 2008. The economic uncertainty continues to play out presently with the current European sovereign debt crisis.

### Approaches to Corporate Debt Restructuring

4.3 Internationally, the reasons for development of Corporate Debt Restructuring can be summarised as given below, in the backdrop of the various crises engulfing the regional and world economies:

- Debt deleveraging on a global scale forcing financial institutions, corporates and households to reduce their debt burdens.

[2] This Chapter is based on two IMF Staff Position Notes (i) Principles of Household Debt Restructuring – June 26, 2009 authored by Luc Laevan and Thomas Laryea, and (ii) Approaches to Corporate Debt Restructuring in the wake of Financial Crisis – January 26, 2010 authored by Thomas Laryea.

- The write down of assets and concerns of counterparty driving liquidity pressures on banks and other financial institutions.
- Financial distress in the banking sector constraining credit to corporates and households.
- Economic downturn resulting in reduced corporate revenues and household incomes.
- Reversals in capital flows further constraining liquidity and exacerbating exchange rate pressures.
- Exchange rate depreciation in some countries with high incidence of FX denominated debt accelerating defaults in the corporate and household sectors. Conversely, the effects of contractionary policies, motivated by the objective of maintaining the nominal exchange rate in some countries, reduce debt servicing capacity.

4.4 Apart from the above, corporate debt restructuring can be an important component of economic adjustment programs supported by supranationals such as International Monetary Fund (IMF): current examples include the debt restructuring programs in Iceland and Latvia. Features of 'Out of Court' corporate restructuring processes in some countries are given in Appendix III.

4.5 Starting with the early 1970s, creditor institutions together with the government and regulators have been working on developing an orderly construct for corporate debt restructuring. The critical goals of a corporate debt restructuring regime focus on enabling timely restructure of viable firms and facilitating the exit of weak and structurally insolvent businesses.

4.6 Accordingly, three broad approaches can be identified based mainly on the degree of government and regulatory intervention:

- Case by Case Market Based Approach
- Across the Board Government Intervention
- Intermediate Approach

## A. Case by case market based approach

4.7 This approach is characterised by minimum government intervention and is used in cases where private sector debtors and creditors are generally left free to determine the nature, scope and terms of the burden sharing on a case by case basis and principally relying on market solutions (e.g., Hungary and Poland in the 1990s, Korea, Malaysia, and Thailand in the late 1990s). While this approach is essentially market-oriented, the government would still have an important role through implementing legal reforms to encourage timely market-driven restructuring.

4.8 Furthermore, fiscal support (if any) in this approach would be on an indirect basis through support of the financial sector (e.g., use of public funds to recapitalize domestic banks that meet certain soundness requirements, and thereby strengthen the capacity of those banks to absorb losses within debt restructuring). The common characteristics of the aforementioned country cases were: (i) virtually all corporate and household debt was held by domestic banks and most, if not virtually, all the corporate debt was in domestic currency; (ii) legal reforms focused on improving insolvency procedures and removing impediments to corporate debt restructuring, such as strengthening collective rights of majority creditors; and (iii) the immediate fiscal costs ranged from 6% of GDP (Poland) to 20% (Korea) and 44% (Thailand) financed mainly by the issuance of government bonds.

***Box 2: London Approach***

London Approach is a classic model of case by case market based approach. During the 1970s, following the sharp spike in oil prices and the ensuing slowdown, the United Kingdom faced a period of industrial recession and high inflation. There was an increase in bad loans for commercial banks, which had little previous experience in restructuring and workouts. Insolvency legislation was outdated and an established institutional framework for debt restructuring did not exist. In the classic London Approach, the Bank of England played a

critical role in encouraging and overseeing participation by bank creditors.

The London Approach has influenced the evolution of government sponsored guidelines for multicreditor out-of-court debt restructurings. Under the leadership of the Bank of England, UK banks developed the London Approach as a set of informal guidelines on a collective process for voluntary workouts to restructure debts of corporates in distress, while maximizing their value as going concerns. The initiative grew from the recognition that creditors would likely achieve better returns through collective efforts to support an orderly rescue of a firm in distress, instead of forcing it into a formal insolvency.

Subsequently, countries facing wide scale corporate debt distress in the late 1990's turned to the London Approach as a basis to develop their own guidelines to encourage out-of-court corporate debt workouts. For instance, in Indonesia, Korea, Malaysia, and Thailand, the London Approach was modified through enhancing the centralized role of government agencies to provide incentives for restructurings. Furthermore, in these country cases, government enhancements were added to establish a more structured framework to support restructurings, including (i) regulatory suasion to require all banks to sign on to the workout principles (for example, as a quid pro quo to government recapitalization); (ii) agreements to arbitrate disputes, thus avoiding unpredictable or protracted formal judicial processes; and (iii) imposition of penalties for failure to meet deadlines under the workout principles.

However, where creditors are large in number, diversified beyond banks and include both domestic and international interests, coordination problems become more difficult to manage within a London Approach model: specifically, unanimous agreement among creditors and voluntary adherence to standstills can prove a major impediment to operation of out-of-court restructuring principles. Conversely, where there are only one or two creditors for each corporate debtor, some of the formalities of a London Approach model, such as the establishment of creditor committees, can be unduly cumbersome.

Furthermore, the application of the underlying London Approach model has

been mixed in circumstances where the legal and institutional framework is less developed. In the context of systemic crises where the number of cases warranting debt restructuring are large relative to institutional capacity or where the alternative of the formal judicial process is unreliable, enhancements of workout principles through a more structured framework—as illustrated in the Indonesia, Korea, Malaysia, and Thailand experiences—have been necessary.

4.9 The case by case market based approach has certain subtle differences across geographies. In the United States, the Chapter 11 process takes place under judicial oversight, though the role of the courts in many cases is primarily to administer a "pre-packaged" bankruptcy which has been voluntarily agreed between the creditors and the debtors. Similarly, there is Voluntary Administration insolvency regime in Australia and the Civil Rehabilitation Law in Japan. The Indian BIFR process also has active court oversight.

4.10 In Indonesia, the Jakarta Initiative Task Force (JITF) was established as a state agency to facilitate out-of-court corporate debt workouts supported by a framework of regulatory "carrots" (such as tax relief and regulatory forbearance) and "sticks" (such as potential de-listing or license revocation). On balance, the JITF framework was relatively successful. In the absence of a credible legal and judicial system and within a difficult legal environment, it provided a reasonably predictable forum for restructuring. In addition, the Indonesian Bank Restructuring Agency (IBRA) was established to restructure and recapitalize banks, maximize recoveries from taken-over assets, and support corporate debt restructuring.

4.11 While IBRA worked well in stabilizing the banking system, it performed less well in maximizing asset recoveries, and its role in supporting corporate restructuring was decidedly mixed. Inadequacy of political support was a key factor compromising IBRA's performance.

4.12 Following lessons from the Asian crisis, the international federation of insolvency practitioners (INSOL International) published in 2000 the **'Statement of Principles for a Global Approach to Multi-Creditor Workouts'**. These principles build on the London Approach (but without addressing some of the government enhancements that may be needed in crisis contexts):

- **First principle:** Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to cooperate with each other to give sufficient (though limited) time (a "standstill period") to the debtor for information about the debtor to be obtained and evaluated, and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.
- **Second principle:** During the standstill period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor, but are entitled to expect that during the standstill period their position relative to other creditors will not be prejudiced.
- **Third principle:** During the standstill period, the debtor should not take any action that might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the standstill commencement date.
- **Fourth principle:** The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty. Such coordination will be facilitated by the selection of one or more representative coordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.
- **Fifth principle:** During the standstill period, the debtor should provide, and allow relevant creditors and/or their professional advisors reasonable and timely access to all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to

be made of its financial position and any proposals to be made to relevant creditors.

- **Sixth principle:** Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill, should reflect applicable law and the relative positions of relevant creditors at the standstill commencement date.
- **Seventh principle:** Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.
- **Eighth principle:** If additional funding is provided during the standstill period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

4.13 The INSOL Principles remain a useful starting point in the design of out of court debt restructuring guidelines. RBI's extant guidelines on CDR mechanism are based on these principles and the principles regarding 'standstill period' and 'priority in repayment of additional funding' have been duly incorporated in the guidelines on CDR mechanism.

**B. Across the board approach**

4.14 This approach is generally used in the wake of a systemic economic crisis which affects a significant number of entities and resolution is beyond a market based solution. Here, the government determines the method and distribution of the burden, and a common solution is applied to all economic agents in a pre-specified category irrespective of individual situations. The government can either provide direct fiscal support to corporates or mandate certain loss absorption by creditors.

4.15 Fiscal support through government guarantees, refinancing support and interest rate subsidies have met with some success in Chile and Mexico in the 1980s. The common characteristics of the Chile (1982) and Mexico (1983) cases were: (i) corporate debt was mainly held by foreign creditors and/or denominated in U.S. dollars; (ii) no major legal or regulatory reform was undertaken; and (iii) no use of market-based restructurings by recapitalized banks or a government asset management company.

4.16 There are two alternative characteristic features of this approach. The first is direct fiscal support to corporates, which could range from a predetermined amount of support for specified purposes (e.g., to protect against foreign exchange rate risk), to tax and other fiscal-related incentives for firms that engage in restructuring. The second is a legislatively mandated absorption of losses by creditors; such a strategy should be avoided given the risks of legal challenge and undermining the credit culture of a country.

4.17 The approach adopted by the Argentine government during the 2002 debt crisis is analogous to the second approach. The government introduced an asymmetric pesification of bank balance sheets, which required dollar-denominated assets to be converted into pesos at par, while dollar-denominated liabilities were converted at an exchange rate of US$1 = Arg$1.4. In addition, the government introduced an asymmetric indexation of assets and liabilities, under which deposits were indexed to the CPI, while certain loans were indexed to wage inflation.

4.18 Although the government compensated domestic banks for direct losses arising from the asymmetric pesification and indexation (totalling around Arg$56 billion), substantial indirect loses were suffered by the banks due to the loss of depositor and borrower confidence and the collapse in financial intermediation. Also, legal challenges by depositors followed, with some successful in obtaining court orders releasing deposits at market exchange rates. The substantial litigation risks and damage to Argentina’s financial system and perceptions of

credit worthiness underscores the aversion to countries adopting such forced restructuring techniques even in the most extreme cases of financial crisis.

4.19 In the Indian context, across the board approach can be juxtaposed to Agricultural Debt Waiver and Debt Relief Scheme (ADWDRS), 2008, whereby 'eligible amount' of debt of small and marginal farmers was waived by the Government and in case of other farmers, 25% of the 'eligible amount' of the debt was waived subject to the farmers agreeing to pay the remaining 75% of the 'eligible amount'. In both the cases, accounts were allowed to be classified as 'standard'.

**C. Intermediate approach**

4.20 The intermediate approach relies on case by case negotiations supplemented by government financial incentives and legal and regulatory reforms. This method has been used in countries characterised by high domestic and foreign debt, complex balance sheets and the need for legal reforms for credit enforcement.

4.21 The approach was used in Mexico in 1995 and Indonesia in 1998, but entailed sizeable fiscal costs though had reasonable success. The common characteristics of these cases were: (i) the corporate sector carried high levels of both domestic and foreign currency debt, with government involvement aimed mainly at the foreign debt; (ii) the complexities of the balance sheets led to the creation of several government led mediation entities, as well as schemes for direct corporate debt relief; (iii) legal reforms to bolster the credit enforcement institutions and culture were pursued, but with mixed results; and (iv) there were nonetheless sizeable fiscal costs (20% for Mexico and 55% for Indonesia), financed by government bonds.

## D. Comparison of the three approaches

4.22 Overall, the choice, design and implementation of a restructuring strategy is dependent on specific country situations. In the absence of a widespread crisis, the market based approach has usually been the most effective. While any approach needs to be tailored to the circumstances of a country—including macroeconomic conditions, composition of debt and legal/institutional framework—the experience with corporate debt restructurings in the aftermath of systemic crises indicates that a properly designed intermediate strategy would generally be expected to make the best use of limited fiscal resources and avoid shifting the burden of restructuring unsustainably to creditors.

4.23 The intermediate approach would tend to be more effective than the case by case approach in optimizing debt restructuring where the scale of the debt distress is beyond the capacity of the court system and the market place to resolve in a timely manner. The advantage of the intermediate approach over across-the board solutions is that it seeks to leverage private resources (such as they exist) and to contain dead weight losses implied by full across the board interventions. Notably, the substantial reliance on across the board measures in the Chile and Mexico strategies proved costly to public debt sustainability and contributed to the need for sovereign debt restructurings to restore the public sector balance sheets.

4.24 Furthermore, across the board measures, without distinction based on firm viability, would disadvantage more efficient firms and dampen procompetitive forces in the economy. However, in determining whether an intermediate approach is preferable in any given strategy, the dead weight losses of full across the board interventions need to be weighed against the inefficiencies from the potential grid-lock faced where the number of debt default cases is substantially higher than the institutional capacity can handle.

4.25 Countries could also adopt more than one approach in parallel, for example, an across the board approach for categories of SMEs (due to the

number and small size of claims) and an intermediate approach for larger corporates. In Indonesia, an across-the-board approach was implemented for the restructuring of SME debt held by Indonesian Bank Restructuring Agency (IBRA), whereas the approach for larger corporates was intermediate.

**Household debt restructuring – the international experience**

4.26 Internationally, governments and regulators have actively intervened during the time of crisis to restructure the debt of households because of macroeconomic and social reasons. Household debt overhang and debt servicing problems feed into different but connected downward spirals. First, they weaken bank balance sheets through an increase in nonperforming loans. This in turn may lead to a reduction in credit availability which puts further pressure on house prices and prices of other asset classes. The resulting decrease in wealth and collateral value further worsen the household debt problem. Second, household debt problems can negatively impact consumption. This may turn into lower growth and higher unemployment, compressing household income and further feeding into both downward spirals.

4.27 Household debt restructuring can also be warranted on account of addressing externalities that arise when massive loan defaults by households result in unnecessary and costly liquidations, including foreclosures on real estate. Such problems are particularly severe when homeowners possess negative equity in their homes. In addition, foreclosures can have a negative effect on neighbourhood values. Essentially, this can be seen as a multiple equilibria situation: in one equilibrium, debt overhang is resolved more rapidly, leading to a stabilization of house prices and resumption of growth; in the other, debt overhang lingers, resulting in further declines in house prices and contributing to a worsening of the recession.

## Summaries of previous episodes of household debt restructuring

### United States (1933)

4.28 In 1933, at the onset of the U.S. Great Depression, the Home Owners Loan Corporation (HOLC) was established to prevent mortgage foreclosures. HOLC bought distressed mortgages from banks in exchange for bonds with federal guarantees on interest and principal. It then restructured these mortgages to make them more affordable to borrowers and developed methods of working with borrowers who became delinquent or unemployed, including job searches.

4.29 Eligible mortgages included mortgages with an appraised value of $20,000 or less ($321,791 in 2008 dollars). Approximately 40% of those eligible for the program applied and half of these applications were rejected or withdrawn. Of the one million loans HOLC issued, it acquired 200,000 homes from borrowers who were unable to pay their mortgages. HOLC ended up making a relatively small profit when it was liquidated in 1951, in part because declining interest rates and the government guarantee allowed it to borrow inexpensively.

### Mexico (1998)

4.30 Following the unsuccessful “Fondo Bancario de Protección al Ahorro or "Banking Fund for the Protection of Savings" (FOBAPROA) bank restructuring program initiated in 1995, the government of Mexico initiated in December 1998 the Punto Final program, which was a government-led debt relief program targeted at mortgage holders, agribusiness, and small and medium-sized enterprises. The program offered large subsidies (up to 60% of the book value of the loan) to bank debtors to pay back their loans. The discounts depended on the sector, the amount of the loan, and on whether the bank restarted lending to the sector.

4.31 For every three pesos of new loans extended by the bank, the government would assume an additional one peso of discount. The program thus combined loss sharing between the government and the banks with an incentive to restart

lending. The program was successful in terms of rapid debt relief but at very large cost to the taxpayer.

**Uruguay (2000)**

4.32 In Uruguay, a debt restructuring scheme approved in June 2000 offered a framework for the systemic and compulsory restructuring of small loans (up to US$50,000), by extending loan maturities and introducing gradually increasing payment schedules, and a largely voluntary scheme for large borrower workouts, with strong incentives for both banks and borrowers to reach restructuring agreements. Incentives to encourage creditor participation included (i) flexible classification system for restructured loans to encourage banks to recognize implicit losses; and (ii) a reclassification as a loss with a 100% provisioning requirement of the failure to restructure a nonperforming loan within the timeframe provided by the scheme.

**Korea (2002)**

4.33 A rapid expansion of the credit card market in Korea, encouraged by lax lending standards and other factors, resulted in a distressed credit card market with rising delinquencies in 2002. Credit card debt as percentage of GDP reached 15% in 2002. The credit card crisis spilled over to commercial banks, as commercial banks were heavily exposed to troubled credit card issuers through credit lines. Korean commercial banks' lending to one single large troubled credit card issuer stood at 38% of creditor banks' combined equity. Nevertheless, Korea's commercial banks were generally able to absorb the losses for their credit card units without broader repercussions, as affected credit card units were generally merged into the respective parent banks.

4.34 The stand-alone credit card companies were generally more severely impacted by the credit card crisis. The principal ways of dealing with the bad credit card debt were loan write-offs. Other resolution methods employed include sales to third parties and debt-to-equity conversions of credit card

issuers' debt. In addition, Korean authorities allowed credit card issuers to roll over delinquent credit card loans, a practice known as "re-ageing." This form of regulatory forbearance eased the burden of provisions and charge-offs of these loans for issuers.

**Argentina (2002)**

4.35 The 2002 Argentine asymmetric pesification is an example of what not to do. Argentina introduced a heterodox economic program in response to the crisis in January 2002 that included an external debt moratorium, an end to Convertibility, and introduction of a dual exchange regime. In February, the exchange regime was unified, the maturities of time deposits extended (the "corralón"), and bank balance sheets dedollarized at asymmetric rates—Arg$1 per dollar on the asset side, and Arg$1.4 per dollar on the liability side. The assets and liabilities of the banks were also subjected to asymmetric indexation: deposits were indexed to the rate of consumer price inflation while certain loans were indexed to wage inflation.

4.36 This policy framework imposed significant losses on banks and depositors. The fiscal cost amounted to about 15% of GDP, largely due to fiscal outlays accruing to the banks, the losses suffered by banks far exceeded the entire net worth of the banking system. The deposit freeze and conversion resulted in a loss of depositor confidence and the collapse in financial intermediation. The conversion of deposits meant a dollar value erosion of 40%. Banks also lost because many of the creditworthy borrowers worrying about a further change in government's decision opted to pay off their loans. This left the banks with a smaller and a lower quality loan book. Most banks reported significant reductions in both staff and in branches and remained cautious in expanding credit. The conversion led to a severe undercapitalization of the banking system.

4.37 Moreover, depositors took advantage of exceptions and loopholes in the system, using judicial rulings to release frozen deposits at market exchange rate. In this environment, a large number of banks were weakened and became

dependent on the central bank liquidity window, accounting for 13% of total assets in 2003. The crisis had profound effects on the portfolio of the banking system. Private sector credit fell sharply, reflecting the collapse in credit demand and the repayments by existing borrowers. By 2003, the loans to the private sector declined to 15% of total assets (US$8.4 billion) while exposure to the public sector increased to 50% of total assets.

**Taiwan (2005)**

4.38 Rapid expansion of credit card debt resulted in a distressed credit card market, although credit card losses mostly affected small and specialized institutions. The ratio of non performing loans (NPL) to total loans for cash cards peaked at about 8% in 2006 (up from about 2% a year earlier), and for credit cards at about 3.5% (up from about 3% a year earlier). The system-wide NPL ratio was not visibly affected and continued its downward trend that began when Taiwan POC's financial sector reform program began in 2000.

4.39 Whilst the system wide NPL ratio was not that much affected by the nonperforming card loans, there was a negative impact on the profitability of domestic banks. Average return on equity of domestic banks dropped to –0.41% at end-2006 (from 4.58% at end-2005) and average return on assets dropped to –0.03% at end-2006 (from 0.31% at end-2005). To facilitate renegotiation of debt between credit card issuers and debtors, the authorities initiated a personal debt restructuring program offering better repayment terms, covering 30% of outstanding credit card balances. Restructured loans were largely reclassified as performing, effectively granting issuers regulatory forbearance.

**United States (2008)**

4.40 A prolonged credit boom, supported by low interest rates and lax underwriting standards, and the expectation of rising house prices, came to a halt in 2007. The burst of the U.S. housing bubble led to rising foreclosures, which further depressed house prices. Foreclosures were on the rise because of

household debt overhang, coordination failures in arranging pre-foreclosure workouts, and legal impediments to loan workouts. The U.S. federal government introduced or sponsored a number of homeowner “rescue” programs, starting with the FHA Secure program announced in August 2007, and later on the Hope for Homeowners (H4H) program, which was activated on October 1, 2008. These efforts met with only very limited success in stemming foreclosures.

4.41 In addition, the Federal Deposit Insurance Corporation (FDIC) introduced a streamlined modification program for the mortgage loans it picked up from failed mortgage lender/servicer IndyMac. A similar program for Fannie Mae and Freddie Mac guaranteed mortgages was also introduced by the Federal Housing Finance Agency (FHFA).

4.42 Several large U.S. banks also designed voluntary workouts of distressed mortgages. For example, CitiGroup announced early in November 2008 that it would modify terms on mortgages with debt-to-income ratios in excess of 40%. Modifications would include a lowering of the interest rate, extension of the terms of the loans, and as a last resort a reduction in principal. Also, some states imposed foreclosure moratoriums, typically of three-to six months long.

**Hungary (2008)**

4.43 In November 2008, Hungarian commercial banks—faced with increased credit risk of their loan portfolios denominated in foreign currency due to a sharp depreciation of the local currency — signed a gentleman’s agreement with the ministry of finance on a foreign-currency loan workout program.

4.44 The workout provided the borrowers with the following options: (a) apply to have their foreign currency loans converted to forint-denominated loans. If they do so before the end of the year, they will not be charged additional fees; (b) ask for an extension of the loan duration free of charge if there is a significant rise in their monthly repayments; and (c) ask for a temporary easing of repayment obligations, especially for borrowers who become unemployed. The key

elements of the restructuring (i.e. the rate of loan conversion into the local currency and interest rates charged on restructured loans) were left to be determined by the parties involved.

**United Kingdom (2008)**

4.45 Early December 2008, the U.K. Treasury announced the Homeowners Support Mortgage Scheme to reduce the number of home foreclosures. Under the scheme, U.K. homeowners struggling to make mortgage payments can defer a portion of their payments by up to 2 years. Borrowers with mortgages up to £400,000 and with savings lower than £16,000 were eligible to roll up mortgage payments into the principal, and pay off the principal when conditions improve.

4.46 The U.K. Treasury will guarantee the deferred interest payments for those banks participating in the scheme. Most of the country's largest lenders agreed to participate in the program.

**Cross border insolvency**

4.47 Insolvency proceedings of enterprises with assets and liabilities in different countries present potential conflicts among jurisdictions, resulting in inefficient delays. These problems can be mitigated through the insolvency law incorporating generally accepted principles for coordination of courts and insolvency administrators among countries, in line with the United Nations Commission on International Trade Laws (UNCITRAL) Model Law on Cross-Border Insolvency.

4.48 Expectations of the operation of an insolvency law, however well designed, need to be qualified in the context of a financial crisis. The insolvency law would be a limited tool in the crisis containment phase. In the debt restructuring phase, the effectiveness of an insolvency law may remain compromised due to continuing market inefficiencies arising from the crisis. Furthermore, given that

implementation of the insolvency law depends on the institutional framework, including judges and insolvency administrators and practitioners, the formal legal process and institutions can hardly (if ever) be expected to address the total volume of debt default cases that can arise after a crisis.

4.49 Accordingly, all reliance cannot be placed on the formal insolvency system. Rather, a more measured objective is to establish incentives through the law that would catalyse out-of-court restructurings, to the extent possible. Especially important would be a provision enabling a court in an expedited manner to make a restructuring agreement that is accepted by a qualified majority of creditors binding on dissenting creditors. With the increase in the number and diversity of investors holding corporate debt, the ability to reliably bind-in holdout creditors has become even more critical to the success of restructuring efforts.

4.50 Revision of other laws may need to be considered to support out of court debt restructuring in the aftermath of a crisis. These include corporate governance rules on the responsibilities of managers of a firm and the rights and liabilities of shareholders.

4.51 The UNCITRAL Model Law on Cross-Border Insolvency does not entail a substantive unification of insolvency laws, but rather sets out procedural rules to be adopted on cross-border insolvencies. The Model Law focuses on (i) access to courts by foreign country insolvency administrators; (ii) determining when legal effect would be given to a foreign insolvency proceeding; (iii) clarifying procedures for cooperation among insolvency proceedings and administrators; (iv) specifying rules for coordination between concurrent insolvency proceedings; and (v) establishing rules for coordination of relief granted in different insolvency proceedings. The Model Law has been essentially adopted in eighteen countries.

**Conclusion**

4.52 International practices on restructuring as seen in the above paragraphs can be placed in the continuum of degree of government intervention and are essentially seen in the context of some financial / economic crisis, whereas, the Indian restructuring guidelines evolved over a period of time in the backdrop of natural calamities and industrial sickness, when India was largely a closed economy. Further, RBI's guidelines on restructuring are in the nature of standing instructions and they are applicable in all times, crisis or no crisis. Regulatory forbearance regarding provisioning, asset classification and capital adequacy is crisis specific in the international scenario, whereas, they have become a permanent feature in the Indian context.

4.53 The WG reflected on these features and has also made appropriate recommendation that regulatory forbearance regarding asset classification, provisioning and capital adequacy should be done away with as a permanent feature in a gradual manner. *[Recommendation 1]*

4.54 Further, the WG reflected that while INSOL Principles regarding 'standstill clause' and 'priority in repayment of additional funding' have been suitably adopted in the RBI's guidelines on CDR mechanism, INSOL Principle on the priority in repayment of fresh facilities in restructuring may be extended to non-CDR cases also. It was observed that, under extant RBI guidelines, any fresh facility allowed to a borrower under restructuring package was treated as 'standard' irrespective of the asset classification of the existing restructured facilities. This was basically an incentive to the banks for extending fresh credit facilities to a distressed borrower, wherever warranted. As banks do not maintain any additional provision on such fresh facilities, these should get preference in repayment over other facilities.

4.55 In this regard, the WG recommended that RBI may consider adopting INSOL Principle even in cases of non-CDR restructuring in order to provide incentive for any fresh facility by an existing or a new lender and prescribe that

repayment of any additional financing extended to a borrower under restructuring should be accorded priority status. *[Recommendation 4]*

4.56 In the light of UNCITRAL Model Law on Cross-Border Insolvency, the WG felt that there was a need for a proper legislation on cross-border resolution as India was increasingly integrating with the world economy both in the real and financial sector. In absence of such a legislation, restructuring of accounts of borrowers with assets in multiple countries as also in cases of consortium arrangement having offshore lender(s) may face difficulties. It was observed that eighteen countries (most of them being developed) have adopted the UNCITRAL Model Law for this purpose.

4.57 As India is emerging as a major force in the international arena and world economy, the WG felt that suitable steps should be taken in this regard. The WG also examined the World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, which were developed, inter-alia, on INSOL and UNCITRAL principles. Although, not in the terms of reference of the WG, it was felt that the issues should be taken at appropriate forum.

***Box 3: World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems***

Legal Framework for corporate insolvency – key objectives and policies

Though country approaches vary, effective insolvency systems should aim to (a) integrate with a country's broader legal and commercial systems, (b) maximize the value of a firm's assets by providing an option to reorganize, (c) strike a careful balance between liquidation and reorganization, (d) provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors, (e) provide for timely, efficient, and impartial resolution of insolvencies, (f) prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments, (g) provide a transparent procedure that contains incentives for gathering and dispensing information, (h) recognize existing creditor rights and respect the priority of claims with a

predictable and established process, and (i) establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

4.58 It was also observed that the above International practices have two distinct, though overlapping, phases, viz. (i) crisis containment and (ii) debt restructuring phase. Such a phase was clearly seen during the 2008 financial crisis, when government and RBI both intervened in the real and financial markets with incentives and regulatory forbearance. Government intervention can also be seen in the Indian context in ADWDRS 2008 and rehabilitation of sick micro and small enterprises (MSEs), which is a standing scheme.

***Box 4: World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems***

**Principle 26. Informal workout procedures** A country's financial sector (possibly with the informal endorsement and assistance of the central bank or finance ministry) should promote the development of a code of conduct on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure, especially in markets where enterprise insolvency has reached systemic levels. An informal process is far more likely to be sustained where there are adequate creditor remedy and insolvency laws. The informal process may produce a formal rescue, which should be able to quickly process a packaged plan produced by the informal process. The formal process may work better if it enables creditors and debtors to use informal techniques.

4.59 The WG also observed that the requests for special dispensations and one-time measures are frequently made to RBI for restructuring of a particular sector of economy or industry on the basis that such sectors were facing extraordinary stress or unprecedented adverse conditions. In view of such frequent requests, the one-time measures lose their meaning and these also have adverse impact on the regulatory safeguards of the banking system. In view of this the WG felt that the requests for such regulatory forbearance should not be made a regular

feature and any such forbearance should be accompanied with fiscal incentives to ensure the viability of the sector after restructuring.

4.60 However, the concept of regulatory forbearance combined with fiscal incentives and government intervention in the time of *crises* may be examined in future provided the triggers for the crises are objectively and precisely defined. This becomes important in view of the increasing integration of Indian economy with the Global Economy. Therefore, the WG recommended that RBI and the government should come out with a framework which will precisely and objectively define a severe crisis (like the 2008 financial crisis) requiring both the government and regulatory intervention. Such a framework should also broadly indicate the fiscal and regulatory measures to be taken under such conditions in the phases of (i) crisis containment and (ii) debt restructuring.

*[Recommendation 5]*

# Chapter 5

## Existing framework for restructuring of advances in India

5.1 In order to align the principles governing restructuring of different types of advances, “Prudential guidelines on restructuring of advances by banks” were issued on August 27, 2008. These guidelines harmonised the prudential norms across all categories of debt restructuring mechanisms, other than those restructured on account of natural calamities. These prudential norms are applicable to all restructurings including those under CDR Mechanism. Some of the important features of the existing framework for restructuring of advances are as under:

### Prudential guidelines on restructuring of advances by banks

### 5.2 General Principles and Prudential Norms for Restructured Advances

(i) A restructured account is defined as an account where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/repayable amount/the amount of instalments/rate of interest (due to reasons other than competitive reasons).

(ii) Banks are allowed to restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories. Banks are not allowed to reschedule/restructure/renegotiate borrowal accounts with retrospective effect. Also, borrowers indulging in frauds and malfeasance and BIFR cases without their express approval are not eligible for restructuring.

**(iii)** No account should be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable

viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include the Return on Capital Employed, Debt Service Coverage Ratio, Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance. The accounts not considered viable should not be restructured and banks should accelerate the recovery measures in respect of such accounts. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects/activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / **action.**

### 5.3 Asset Classification Norms

(i) The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring. The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule.

(ii) All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for upgradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. Any 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 pre-restructuring facilities were 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. 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 substandard.

### 5.4 Income Recognition Norms

Interest income in respect of restructured accounts classified as 'standard assets' will be recognized on accrual basis and that in respect of the accounts classified as 'non-performing assets' will be recognized on cash basis.

### 5.5 Provisioning Norms

(i) Banks will hold provision against the restructured advances as per the existing provisioning norms. Reduction in the rate of interest and /or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in fair value is an economic loss for the bank and will have impact on the bank’s market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions required as per existing provisioning norms.

(ii) For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR/Base Rate as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR/Base Rate as on the date of restructuring plus the appropriate term

premium and credit risk premium for the borrower category on the date of restructuring.

(iii) The diminution in the fair value 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/Base Rate, 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.

(iv) If due to lack of expertise/ appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small/rural branches, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor**,** at 5% of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore.

**5.6 Prudential Norms for Conversion of Principal into Debt / Equity**

(i) A part of the outstanding principal amount can be converted into debt or equity instruments, as part of restructuring. The debt/equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance. These instruments should be held under AFS and valued as per usual valuation norms.

(ii) In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis. In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

### 5.7 Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments

The FITL/debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of FITL/ debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance. The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

### 5.8 Special Regulatory Treatment for Asset Classification

(i) Special regulatory treatment for asset classification will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions. Such treatment is not extended to Consumer and personal advances, advances classified as Capital market exposures and advances classified as commercial real estate exposures.

(ii) As an incentive for quick implementation of the package, if the approved package is implemented by the bank as per the following time schedule, the asset classification status may be restored to the position which existed when the reference was made to the CDR Cell in respect of cases covered under the CDR Mechanism or when the restructuring application was received by the bank in non-CDR cases:

a. Within 120 days from the date of approval under the CDR Mechanism.

b. Within 90 days from the date of receipt of application by the bank in cases other than those restructured under the CDR Mechanism.

(iii) Subject to compliance with the following conditions an existing 'standard asset' will not be downgraded to the sub-standard category upon restructuring and during the specified period and the asset classification of the sub- standard/doubtful accounts will not deteriorate upon restructuring, if satisfactory performance is demonstrated during the specified period**:**

- The dues to the bank are ‘fully secured’. The condition of being fully secured by tangible security will not be applicable in the following cases:
- SSI borrowers, where the outstanding is up to Rs.25 lakh.
- Infrastructure projects, provided the cash flows generated from these projects are adequate for repayment of the advance, the financing bank(s) have in place an appropriate mechanism to escrow the cash flows, and also have a clear and legal first claim on these cash flows.
- The unit becomes viable in 10 years, if it is engaged in infrastructure activities, and in 7 years in the case of other units.
- The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances, other than housing loans.
- Promoters' sacrifice and additional funds brought by them should be a minimum of 15% of banks' sacrifice.
- If the promoter is facing genuine difficulties in bringing the funds, the contribution may be brought in 2 instalments, 50% upfront at the time of restructuring and the remaining 50% within 1 year of the restructuring.
- Personal guarantee is offered by the promoter except when the unit is affected by external factors pertaining to the economy and industry.
- The restructuring under consideration is not a 'repeated restructuring'.

### 5.9 Disclosures

Banks are required to disclose in their published annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances.

**5.10** The detailed guidelines are furnished in Appendix IV.

## Chapter 6

## Summary of proceedings

6.1 The WG deliberated on issues such as the need for appropriate asset classification and provisioning to capture the risk inherent in restructured accounts in line with international best practices, ensuring a proper viability exercise being carried out by banks before restructuring any account, appropriate disclosure requirements, etc. The need for RBI to clarify certain issues like the rate of discounting, relaxations relating to restructuring extended to infrastructure sector, etc. were also discussed. The issues discussed and the recommendations of the WG are as under:

### Asset classification and provisioning norms in respect of restructured accounts

6.2 The WG has examined the practices adopted internationally for asset classification of the restructured accounts. The WG has observed that internationally accounts are generally treated as impaired/downgraded on restructuring. The WG examined the consequences of aligning our restructuring guidelines with this best practice but felt that doing so immediately might act as a disincentive to banks to restructure viable accounts which would severely impact the viable accounts facing temporary challenge and may result in higher provisioning requirement for banks on account of increase in the non-performing assets.

6.3 As regards restructured accounts classified as standard advances, in view of the inherent credit weakness in such accounts, banks are required to make higher general provision of 2% for the first two years from the date of restructuring. In case of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2% for the period covering moratorium and two years thereafter.

6.4 Further, restructured standard unrated corporate exposures and housing loans are also subjected to an additional risk weight of 25 percentage points in terms of paragraph 5.8.3 of circular DBOD.No.BP.BC.90/20.06.001/2006-07 dated April 27, 2007 on 'Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of the New Capital Adequacy Framework' and paragraph 4 of circular DBOD.No.BP.BC.76/21.04.0132/2008-09 dated November 3, 2008 on 'Prudential Guidelines on Restructuring of Advances by Banks', respectively.

6.5 This is with a view to reflect the higher element of inherent risk which may be latent in entities whose obligations have been subjected to restructuring. Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2% in the first year from the date of upgradation (paragraph 3 of circular DBOD.No.BP.BC. 94 /21.04.048/2011-12 dated May 18, 2011 on 'Enhancement of Rates of Provisioning for Non-Performing Assets and Restructured Advances').

6.6 The WG also observed that under the Internal Ratings Based (IRB) approach for calculation of capital charge for credit risk, restructured assets classified as standard assets are treated as defaulted for the limited purpose of computation of capital under IRB. Further, restructured assets are given risk weights as applicable to defaulted asset barring the cases where 'hardship' clauses might have been extended to the borrowers.

6.7 However, it was also noted that such restructured accounts are eligible for upgradation to the standard category after observation of 'satisfactory performance' during the period of one year from the date when the first payment of interest or instalment of principal falls due under the terms of restructuring package. It is also mentioned in RBI's circular on IRB that this treatment of restructured assets classified as standard assets is from the perspective of capital adequacy and should not be seen as a contradiction of asset classification norms which have implications for provisioning.

6.8 The WG deliberated on the issue in great detail and decided that at present it may not be prudent to completely align the asset classification on restructuring with international practices and may be aligned in gradual steps. The WG discussed the following three step approach:

> i. Continue for the time being with the present system of retaining the asset classification but enhance the provisioning requirement for the restructured accounts which are retained in the standard category. In the most pessimistic and stressful scenario, the WG assumed the slippage from standard restructured accounts to NPAs to be around 25% to 30%. Members broadly indicated that the provisioning requirement may be raised to around 4% or 5%, based on an estimate that around 25% to 30% restructured standard assets slipped to sub-standard category for which the provision is 15%.
>
> ii. Create a new asset classification category between standard and sub-standard category. For this category the provisioning requirement may be slightly higher than for the standard category but slightly lower than that for the sub-standard category.
>
> iii. Tighten asset classification norms whereby, in all cases on restructuring an account may be downgraded one notch from its existing classification (prior to restructuring), other than accounts classified under doubtful for more than 3 years category.

6.9 While one view was that creating a new asset class could create a negative perception in the market about a bank's asset quality, another view was to introduce a new asset class category but after giving some transition time i.e. say a timeline of one year each for migration from standard to the new asset class (e.g. restructured standard) and from the new asset class category to the sub-standard category. The WG, however, felt that in line with international prudential measures the asset classification benefit available on restructuring of advances be done away with. But in view of the current domestic

macroeconomic situation as also global situation, this should be done, say, after a period of two years. *[Recommendation 1]*

6.10 In the interregnum, the WG recommended that the provisioning requirements for restructured standard accounts may be increased from present 2% to 5%. The WG also decided that the recommendation in this regard should reflect its applicability in stock and flow concepts. The increased provision may be made applicable immediately for the new restructurings (flow) and in a phased manner during the two year period for the existing standard restructured accounts (stock), i.e., a provision of 3.5% in the first year of adoption of the recommendation which should be subsequently raised to 5% in the second year of adoption of the recommendation, when the asset classification benefit ceases. *[Recommendation 2]*

6.11 While the WG recommended doing away with the asset classification benefit on restructuring in a phased manner, it was sensitive to the current economic situations and took note of importance of the infrastructure sector in the country's development and observed that withdrawal of extant asset classification benefit to infrastructure project loans on change of DCCO may hamper the growth of economy. Therefore, the WG felt that extant asset classification benefits to infrastructure project loans due to change in DCCO may be allowed to continue for some more time in view of the delays/uncertainties associated in obtaining clearances for such projects. However, the WG also recommended that additional stringent conditions may also be added in this regard in order to ensure prudential application of these norms by banks. In this regard, it suggested a higher provision of 5% in line with Recommendation 2. *[Recommendation 3]*

**Exclusion of non-project loans from asset classification benefit on restructuring –**

6.12 The WG discussed about excluding non-project loans from special asset classification benefit on restructuring during the interregnum period i.e. before

complete withdrawal of asset classification benefit on restructuring. It was noted that the August 2008 guidelines extended the asset classification benefits available to borrowers engaged in industrial activities (under CDR Mechanism, SME Debt Restructuring Mechanism and outside these mechanisms) to the accounts of borrowers engaged in non-industrial activities too. August 2008 guidelines also extended the CDR Mechanism to borrowers engaged in non-industrial activities.

6.13 It was also pointed out that during the economic downturn not only the industries but also the households, especially, the home loan borrowers face problems and in absence of any special asset classification benefit, banks may not be willing to reschedule the loans of mortgage borrowers. Further, it was pointed out that during the sub-prime crisis, the US Federal Reserve devised schemes to modify the mortgage loans in order to arrest a large number of foreclosures and houselessness. It was also mentioned that at present special asset classification benefits are not available to CRE and CME in view of their speculative/sensitive nature and also to personal/consumption loans in view of their non-productive nature.

6.14 Therefore, the WG decided that the asset classification benefit should be continued to be made available to non-project loans (excluding CRE, CME and personal/consumption loans) as per the extant guidelines during the interregnum period before withdrawal of asset classification benefit on restructuring as per Recommendation 1.

**Criteria for upgradation of accounts classified as NPA on restructuring**

6.15 The WG observed that the extant RBI guidelines prescribed that all restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for upgradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. Further, ’specified period’ is defined as a period of one year from the date when

the first payment of interest or instalment of principal falls due under the terms of restructuring package.

6.16 In view of the above definition, it was pointed out by the WG that in some cases of restructuring with moratorium on payment of principal as well as major portion of interest, accounts were upgraded on the basis of payment of interest on a small portion of the debt, say FITL, for the specified period. The WG further pointed out that the account may still have its inherent credit weakness as payment of a small portion of interest does not show the 'satisfactory performance'. Therefore, it was felt that the specified period should be redefined by taking into consideration this aspect.

6.17 The WG recommended that RBI may revisit the definition of 'specified period' in the light of the above definition in cases of restructuring with moratorium. One view was that it may be redefined in cases of multiple credit facilities on restructuring as 'one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium'. Another view was that an objective criterion of repayment should be used for deciding the satisfactory performance. For this purpose, it was suggested that a minimum of 10% of debt repayment should be made mandatory for upgradation of an account classified as NPA to standard category.

6.18 The WG examined the above two views and concluded that the first view was more prudent as it will ensure that all facilities of a restructured loan performed satisfactorily before upgrading a restructured account to standard category.

6.19 Therefore, the WG recommended that 'specified period' should be redefined in cases of multiple credit facilities on restructuring for NPA cases as 'one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium

provided other outstanding loans/facilities in the account also perform satisfactorily. *[Recommendation 6]*

**Assessing the viability for restructuring of accounts**

6.20 The WG discussed the need for prescribing certain objective criteria and indicative benchmarks by RBI, for restructuring of accounts by banks, so as to ensure that accounts where the viability is in doubt do not get restructured. In terms of the present guidelines of RBI, no account should be taken up for restructuring by the banks unless the financial viability is established and there is reasonable certainty of repayment from the borrower, as per the terms of restructuring package**.** The viability should be determined by the banks, based on the acceptable viability benchmarks determined by them, which may be applied on a case-to-case basis, depending on merits of each case. Illustratively, the parameters may include the Return on Capital Employed, Debt Service Coverage Ratio, Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance.

6.21 The accounts not considered viable should not be restructured and banks should accelerate the recovery measures in respect of such accounts. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects/activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action.

***Box 5: Viability***

Viability of an account is the most important and foremost condition put forward by RBI for taking up an account for restructuring irrespective of the asset classification benefit. Viability was first defined, in RBI's November 1985 guidelines on rehabilitation of Sick Units, as:

“A unit may be regarded as viable if it would be in a position, after implementing a relief package spread over a period not exceeding seven years from the commencement of the package, from banks, financial institutions, Government (Central/State), Government agencies, shareholders, labour, suppliers of goods and services and other creditors, as may be necessary, to continue to service its repayment obligations as agreed upon including those forming part of the package, without the help of the concessions after the aforesaid period. The repayment period for restructured debts should not exceed ten years from the date of commencement of the package.”

It was further mentioned in the circular ibid “*As may be seen from the definition of viability given earlier, the period of rehabilitation packages should have an outer limit of seven years. If, within the frame-work of the parameters for concessions & reliefs as indicated above, a unit cannot be expected to regain health within seven years, then it should not be regarded as commercially viable. Where a unit is considered viable and a rehabilitation package has been drawn up, the period of repayment of restructured debts may, however, extend up to a maximum period of ten years. The rehabilitation packages should invariably provide for the right of annual review of the reliefs & concessions extended.”*

RBI’s current requirement of an account becoming viable in seven years (ten years in cases of infrastructure account) is based on the above definition. Further, Return on Capital Employed (ROCE), Debt Service Coverage Ratio (DSCR), Gap between the Internal Rate of Return (IRR) and the Cost of Fund (CoF), and Extent of Sacrifice were prescribed as the broad parameters for determining viability in February 2003 circular on restructuring. However, the authority to decide the acceptable benchmarks of these parameters was delegated to CDR Empowered Group (EG). These parameters are still applicable.

Recently economists have been paying more attention to another phenomenon associated with NPLs, namely “forbearance lending” (or what Peek and Rosengren (2003) term “ever-greening policy” and Caballero et al (2003) term

"zombie lending"). Under such conditions, banks are said to have been reluctant to write off NPLs and to have rolled over their lending, even in cases where there was little prospect of the borrower firm being able to repay the loans extended.

6.22 However, the WG has observed that while restructuring of advances on solo basis, banks, particularly at branch or controlling office level where sufficient skill is not available, generally do not establish the viability of the account as rigorously as being done under CDR. Also, a few members observed that in case of solo restructuring, while proper and intensive viability study might be done for medium and large accounts, for small accounts viability study is generally very limited.

6.23 As the present guidelines of RBI only indicate the broad parameters that need to be considered while undertaking the viability study but do not indicate any benchmark for the parameters, the WG recommended prescription of suitable benchmarks for the restructuring carried out by individual banks. In this connection, the WG indicated the following benchmarks, based on the benchmarks adopted by CDR Cell, as a reference point for establishing financial viability of the restructured advances:

- Return on capital employed should be at least equivalent to 5 year Government security yield plus 2%.
- The debt service coverage ratio should be greater than 1.25 within the 7 years period in which the unit should become viable and on year to year basis the ratio should be above 1. The normal debt service coverage ratio for 10 years repayment period should be around 1.33.
- The benchmark gap between internal rate of return and cost of capital should be at least 1%.
- Operating and cash break even points should be worked out and they should be comparable with the industry norms.

- Trends of the company based on historical data and future projections should be comparable with the industry. Thus behaviour of past and future EBIDTA should be studied and compared with industry average.

6.24 Besides, the above financial parameters, banks should have their own internal policies and guidelines regarding validation of the financial projections by way of a Techno Economic viability study to be carried out for larger exposures. In view of the foregoing discussion, the WG recommended that RBI may prescribe the broad benchmarks for the viability parameters based on those used by CDR Cell and banks may suitably adopt them with appropriate adjustments, if any, for specific sectors. *[Recommendation 7]*

6.25 The WG also felt that the prescribed time span of seven years for non-infrastructure accounts and ten years for infrastructure accounts becoming viable on restructuring was too long and banks should take it as an outer limit. It was felt that in times when there is no general downturn in the economy, the viability time span should not be more than five years in non-infrastructure cases and not more than eight years in infrastructure cases. *[Recommendation 8]*

**Disclosures in notes on accounts**

6.26 Banks are required to disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances under the following categories:

(i) Standard Advances Restructured,

(ii) Sub-Standard Advances Restructured, and

(iii) Doubtful Advances Restructured.

Under each of the category above, advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories are required to be shown separately.

6.27 The disclosures made by the banks in their balance sheets as regards restructured accounts are used by market players and analysts for assessing the financial condition of the banks. In terms of present guidelines banks are required to disclose annually all accounts restructured in their books on a cumulative basis even though many of them would have subsequently shown satisfactory performance over a sufficiently long period. As such the present position of disclosures are quite stringent and do not take into account the fact that in many of these accounts the inherent weaknesses in the accounts have disappeared and the accounts are in fact standard in all respects.

***Box 6: Disclosure Requirements***

The first instructions on 'Disclosure' requirements of restructured accounts were issued in March 2001 circular on 'Treatment of Restructured Accounts'. Banks were advised to disclose in their published Annual Accounts, under the Notes on Accounts, the following in respect of restructuring undertaken during the year:

- Total amount of assets subject to restructuring, etc:
- The amount of standard assets subjected to restructuring, etc.; and
- The amount of sub-standard assets subjected to restructuring, etc.

With the issue of first guidelines on CDR in August 2001, the above disclosure requirements were also made applicable in respect of CDR undertaken during the year. With introduction of Category 2 CDR System in February 2003, the amount of doubtful assets subjected to CDR was also included in the above disclosure requirements.

Further, banks were advised to disclose standard, sub-standard and doubtful assets of SME accounts restructured during the year with issue of 'Debt Restructuring Mechanism for SMEs' in September 2005.

The disclosure requirements regarding CDR were made more granular by including number and sacrifice with the amount of assets restructured in November 2005.

All the above disclosure requirements were clubbed together in a tabular form in August 2008 circular and at present banks are required to disclose information

relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances with respect to CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately.

6.28 RBI has prescribed higher provisioning and risk weights for restructured accounts in view of the inherent credit weakness in these accounts. However, once the higher provisioning and additional risk weights cease to be applicable for these accounts they may be treated on par with normal standard accounts. Therefore, the WG recommended that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either *abinitio* or on upgradation from NPA category) revert back to the normal level on account of satisfactory performance during the prescribed period, such advances should no longer be required to be disclosed by banks as restructured accounts in the "Notes on Accounts" in their Annual Balance Sheets. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions. The WG also recommended that banks may be required to disclose details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable), provisions made on restructured accounts under various categories as also details of movement of restructured accounts. On the basis of its recommendations, the WG also suggested a format for the disclosures of restructured accounts as given in Appendix V. *[Recommendation 9]*

**Provision for diminution in the fair value of restructured advances**

6.29 Reduction in the rate of interest and/or reschedulement of the repayment of principal amount, as part of the restructuring, results in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. Banks are, therefore, required to measure such diminution in the fair value of the advance and make

provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms for advances.

6.30 For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR/Base Rate as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR/Base Rate as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

***Box 7: Provisioning and Risk Weights***

RBI's continuous reviews of the prudential guidelines and any relaxation thereto have been complemented with higher provisioning as also additional risk weightage in some cases. The ceiling of 10 years on repayment period of non-infrastructure loans (for qualifying for asset classification benefit) was relaxed for housing loans in November 2008, in view of the nature of such loans, simultaneously an additional risk weight of 25 percentage points was prescribed for restructured housing loans in order to trade off the risk arising from a longer repayment period. It may be mentioned here that such additional risk weight was already in force for restructured standard accounts of unrated corporate exposures since April 2007.

Making provision for or writing off the sacrifice in restructuring was a condition for asset classification benefit since 2001. August 2008 guidelines made it mandatory for banks to provide for diminution in fair value of advances on

restructuring across the board and irrespective of the asset classification benefit. However, these guidelines also simplified the calculation process for diminution in fair value in cases of small ticket loans in rural and small branches at 5% of the total exposure. In May 2011, a higher provisioning of 2% was prescribed for restructured accounts classified as Standard, either *abinitio* or on upgradation from NPA category after satisfactory performance, for certain periods in view of inherent credit weakness in such accounts.

Prior to revision of the guidelines on restructuring of advances under CDR Mechanism in November 2005, the methodologies prescribed by RBI for the computation of sacrifice by the banks and FIs differed. Banks discounted the future interest due as per the original loan agreement to the present value at a rate appropriate to the risk category of the borrower (i.e. current PLR plus 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. FIs, however, reckoned the future interest due, based on the PLR or its equivalent (rate charged to a AAA rated borrower immediately preceding the date of restructuring, if such rate was different from the announced PLR) as on the date of restructuring plus the original risk factor (risk factor applicable to the borrower at the time of initial sanction of the loan).

On representations from the banks, it was decided in April 2009 to modify the formula for computing diminution in the fair value of restructured loan, in respect of all accounts which were restructured in terms of Circular dated August 27, 2008 and the subsequent circulars issued on the subject. Accordingly, "The erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's 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." Fair value of the loan after restructuring will be computed as the present value of cash flows

representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's 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 ".

6.31 The WG was of the view that there is a need to clarify as to whether banks could use Base Rate in place of BPLR since banks' lending is now linked to Base Rate. It was indicated that RBI has already clarified that either Base Rate or BPLR (whichever is applicable to the borrower) could be used for computing the discount rate for calculating diminution in fair value on restructuring. A few members also felt that there is a need for RBI to clarify whether the discount rate to be used for calculating the diminution in the fair value of restructured advances for pre and post restructuring cash flows is the same.

6.32 The WG discussed the issue and concluded that in terms of existing instructions the pre and post restructuring discount rates as far as they relate to the BPLR (or Base Rate) and the credit risk premium should be the same as the date of restructuring is same, however, the term premium would be different if there is any change in the repayment period like elongation of repayment period on restructuring. The WG, however, felt that there is a need for clarity on the issue.

6.33 The WG was of the view that the current instructions relating to calculation of diminution in fair value of accounts by discounting both pre restructured and post restructured cash flows at BPLR/Base Rate plus credit risk premium and term premium applicable to the borrower risk category as on the date of restructuring is appropriate and correctly captures the erosion in the fair value. So, the same may be continued for computing the diminution both in the case of sole restructuring and restructuring done under the CDR mechanism. However, since it is learnt that the formula has been interpreted differently by banks, RBI may illustrate the NPV calculations by way of a few examples including

instances where there is no change in the repayment period and where there is a change in the repayment period on restructuring. *[Recommendation 10]*

6.34 The WG debated as to whether there should be a minimum provision for diminution in fair value of account on restructuring in view of the observation that at times the diminution in fair value of accounts was being structured in such a way as to be marginal in some cases in order to avoid making the provision. The WG felt that in view of the fact that promoter(s)' sacrifice was linked to the diminution in fair value of the account, this issue could be addressed while looking at the issue of promoters' sacrifice.

**Provision for diminution in fair value of small restructured accounts**

6.35 In terms of existing instructions, if due to lack of expertise/appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small/rural branches, as an alternative to the methodology prescribed for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor, at 5% of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore till the financial year ending March 2013. The position would be reviewed thereafter. The WG viewed this dispensation as a useful one as it simplifies the calculation of diminution in fair value in respect of small restructured accounts and concurred that it should be continued on a long term basis.

6.36 The WG recommended that the option of notionally computing the amount of diminution in the fair value of small accounts at 5% of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore at small/rural branches has been found to be useful, therefore, this dispensation may be provided on a long term basis. *[Recommendation 11]*

**Incentive for quick implementation of restructuring package**

6.37 As regards CDR restructuring, RBI guidelines provide incentive of asset classification benefit for quick implementation if restructuring package is implemented within 120 days from the date of approval by the CDR Mechanism; whereas under non-CDR restructuring incentive under quick implementation of the restructuring package is allowed if the restructuring package is implemented within 90 days from the date of receipt of application. The WG felt that the present prescription does not provide sufficient time for viability study for restructuring of advances under non-CDR mechanism.

6.38 In case of non-CDR cases, incentive for quick implementation is available in case the restructuring package gets implemented within 90 days from the date of receipt of application. As 90 days period after receipt of application is considered insufficient for properly ascertaining the viability of the account, the period for quick implementation under non-CDR mechanism should be increased to 120 days from the date of application. As the CDR cases involve more than one bank, the required implementation period of restructuring packages under CDR cases should logically be more than that for non-CDR cases and may be continued to be at the present requirement of 120 days from the date of approval of the restructuring package by the CDR mechanism. The WG, however, took note of the fact that in line of Recommendation 1, this recommendation will lose its relevance after the interregnum period when the regulatory forbearance on asset quality will no longer be available.

*[Recommendation 12]*

**Roll-over of short term loans**

6.39 The WG discussed the prevalent practice of banks granting short term corporate loans to borrowers which are then rolled over in many cases. A view was expressed that such roll-over of short term loans might be construed as restructuring. In terms of RBI definition, a restructured account is one where the bank, for economic or legal reasons relating to the borrower's financial difficulty,

grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/repayable amount/the amount of instalments/rate of interest (due to reasons other than competitive reasons).

6.40 The WG was of the view that such roll-overs should not be treated as restructuring if the same is done on the strength of the borrower’s balance sheet, i.e., if the loans are not rolled over due to the weakness in the balance sheet. However, if the roll-over is done due to inability of the borrower to repay the outstanding loan, it should be treated as restructuring.

6.41 The WG recommended that RBI may clarify that the cases of roll-over of short term loans, where proper pre-sanction assessment has been done and no concession has been provided due to weakness of the borrower, should not be considered as restructured accounts. However, the WG also expressed its apprehension that such a facility might not be used for the intended aim in future, especially, when the WG was making recommendation to do away with the asset classification benefit on restructuring. Therefore, it was added that such roll-overs should only be need based and there should be a cap, say two or three times, on such roll-overs. *[Recommendation 13]*

**Repeated restructuring**

6.42 When a bank restructures an account for a second (or more) time(s), the account will be considered as a 'repeatedly restructured account'. However, if the second restructuring takes place after the period up to which the concessions were extended under the terms of the first restructuring, that account shall not be reckoned as a 'repeatedly restructured account'. While the existing instructions of RBI provide asset classification benefit in the case of first time restructured accounts subject to compliance with certain regulatory stipulations, such asset classification benefit is not available to repeatedly restructured accounts. The WG mentioned that RBI has advised CDR Cell that a

second time restructuring done by them would not be considered as repeated restructuring if there is no negative NPV on discounting of cash flows.

6.43 The WG recommended that the special dispensation provided to CDR Cell, that any second time restructuring under CDR restructuring need not be considered as repeated restructuring if it does not lead to negative NPV, be withdrawn. The WG was of the view that such special dispensation could result in repeated restructuring due to the dilution in the norm for CDR cases without attracting stricter asset classification and provisioning norms. Hence, the same may be dispensed with. *[Recommendation 14]*

**Relaxations in asset classification status for restructured infrastructure accounts**

6.44 Infrastructure project accounts of banks are classified as sub-standard if the date of commencement of commercial production is extended beyond a period of two years after the date of completion of the project, as originally envisaged. With effect from March 31, 2010 (Circular DBOD.No.BP.BC. 85/21.04.048/2009-10 dated March 31, 2010), if an infrastructure project loan classified as 'standard asset' is restructured any time during the above period of two years, it can be retained as a standard asset if the fresh date of commencement of operations is fixed within the following limits, and further provided the account continues to be serviced as per the restructured terms.

- Up to another 2 years (beyond the existing extended period of 2 years i.e. total extension of 4 years), in case the reason for extension of date of commencement of production is arbitration proceedings or a court case.

- Up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years), in other than court cases.

6.45 Further, certain relaxations as far as conditions specified for deriving asset classification benefits under our restructuring guidelines are made in respect infrastructure exposure of banks i.e. in respect of repayment period of restructured advances and regarding tangible security (Paragraph 6.2.2 of circular DBOD No. BP.BC.37/21.04.132/2008-09 dated August 27, 2008). It was discussed as to whether the relaxations should be valid even if infrastructure financing takes place for overseas projects.

6.46 The WG was of the view that the above relaxations in our restructuring guidelines are allowed for infrastructure projects in view of the importance of infrastructure development in our country and as such are designed to encourage flow of credit to this sector within the country. The WG, therefore, recommended that RBI may clarify that the above relaxations are only applicable in the case of infrastructure financing undertaken by banks in India and not overseas. *[Recommendation 15]*

**Promoters' sacrifice**

6.47 One of the conditions for eligibility for regulatory asset classification benefit on restructuring is that promoters' sacrifice and additional funds brought by them should be a minimum of 15% of banks' sacrifice. The term 'bank's sacrifice' means the amount of "erosion in the fair value of the advance". The promoter's sacrifice and additional funds required to be brought in by the promoters should generally be brought in upfront. However, if banks are convinced that the promoters face genuine difficulty in bringing their share of the sacrifice immediately and need some extension of time to fulfil their commitments, the promoters could be allowed to bring in 50% of their sacrifice, i.e. 50% of 15%, upfront and the balance within a period of one year.

6.48 Further, promoter's contribution need not necessarily be brought in cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest free loans. The WG felt

that there is a need for ensuring the promoter in fact brings the minimum amount of sacrifice as prescribed.

***Box 8:* Promoters' Contribution**

Instructions regarding promoters' contribution were first issued in November 1985 guidelines on rehabilitation of sick industrial units. It is reproduced below:

*Promoters' contribution should comprise fresh injection of funds as distinct from internal generation and proceeds from sale of assets already charged. Proceeds from sale of assets not charged, may be taken into account as promoters' contribution. In the cases involving change of management and professional management, the promoters should be required to bring in 15% of the additional long term requirements envisaged under the package. In other cases, the promoters' contribution shall be 20%. Of the above, at least 10% should be brought in immediately and the balance of 10% or 5%, as the case may be, within six months. Such funds will be on non-interest bearing basis. If there is indication that there has been siphoning off of funds from the unit by the promoters/management, the package should stipulate that these funds should be brought back within a specified time limit. If this is not complied with, the further implementation of the package should be reviewed by the banks and term lending institutions.*

November 2005 circular on CDR prescribed that promoters' sacrifice and additional funds brought by them should be minimum 15% of the lenders' sacrifice. August 2008 circular made this provision applicable to all accounts as one of the conditions for special asset classification benefit. Promoters' contribution was to be brought upfront and not in phases. On a review, this provision was relaxed in October 2010 and it was decided that if banks are convinced that the promoters face genuine difficulty in bringing their share of the sacrifice immediately and need some extension of time to fulfil their commitments, the promoters could be allowed to bring in 50% of their sacrifice, i.e. 50% of 15%, upfront and the balance within a period of one year. It was also clarified that contribution by the promoter need not necessarily be brought in

cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest free loans.

6.49 The WG recognised the fact that an equitable and just allocation of losses as a result of restructuring among the creditors and debtors should be a fundamental premise for any restructuring of loan, more so in the cases of large corporate borrowers. It also observed that while the lenders were required to make provision for diminution in fair value upfront, the borrowers made their contribution at only 15% of the banks' sacrifice and that too in a phased manner. The WG observed that such a norm created opportunities for the borrowers to ask banks to make a 'sacrifice'.

6.50 The WG also observed that in cases of restructuring of large corporate exposures, especially, under CDR mechanism, promoters' contribution at 15% of bank's sacrifice was not sufficient in view of very large sacrifices made by the lenders. The members concurred that RBI may consider prescribing a higher amount of promoters' sacrifice in cases of restructuring of large exposures under CDR mechanism. Further, the WG recommended that the promoters' contribution should be calculated at a minimum of 15% of the diminution in fair value or 2% of the restructured debt, whichever is higher. *[Recommendation 16]*

**Conversion of debt into shares/preference shares**

6.51 The WG observed that banks were adversely affected in cases of conversion of a large portion of debt into equity instruments, especially preference shares. The members noted that the trend of such conversion has increased recently, especially in cases of large exposures restructured under CDR mechanism. They observed that such conversions were akin to writing off the debt as in many cases these preference shares carried zero or low coupon, added with the fact that they had no market value as also they did not carry voting rights as the equity shares.

6.52 In view of the above, the WG felt that there should be a ceiling/restriction on conversion of debt into zero / very low interest preference shares. Another view was that RBI should prescribe a minimum coupon (say yield on 364 days TBs) on such preference shares. The WG concurred and recommended that the conversion of debt into preference shares should be done only as a last resort. The WG also recommended that conversion of debt into equity/preference shares should, in any case, be restricted to a cap (say 10% of the restructured debt). *[Recommendation 17]*

6.53 The WG also observed that in some cases of restructuring, unreasonable losses were allocated to the lenders as a result of conversion of debt into equity shares at a very high premium (say 100%) over the current market price. It was also observed that the lenders suffered heavy losses due to further decline in the market prices of such shares. In view of this, the WG felt that RBI may prescribe that conversion of debt into equity shares on restructuring cannot take place at off market rates, i.e. at a price which is higher than the latest available market price. However, it noted that conversion price of debt into equity was under the regulatory domain of SEBI and RBI may consider taking up the issue with SEBI separately. The WG felt that the conversion into unlisted shares should be restricted due to the limited exit options available to banks for unlisted shares. The WG recommended that any conversion of debt into equity should be done only in the case of listed companies. *[Recommendations 18]*

**Non-Infrastructure project loans**

6.54 The WG discussed that the extant prudential norms on restructuring in cases of non-infra project loans allowed a total extension of 12 months of the DCCO from the original DCCO for retaining the 'standard' asset classification provided that the restructuring application is received before the expiry of six months from the original DCCO, when the account is still 'standard' as per the record of recovery. The WG observed that infrastructure projects were allowed a total extension of four years from the original DCCO in cases of arbitration or

court related matters or a total extension of three years from the original DCCO in cases of reasons of other than court related matters.

6.55 The WG observed that, as such, non-infrastructure projects were highly disadvantaged vis-à-vis infrastructure projects; therefore, another extension of six months should be allowed when the delay in such cases is due to arbitration proceedings or court case. The WG also felt the need to define DCCO due to the lack of clarity on this issue, in some cases even a symbolic commencement of operations was treated as DCCO.

6.56 However, the WG noted that a recommendation to extend the change in DCCO for asset classification benefit will be against the spirit of the Recommendation 1 which suggests disallowing any asset classification benefit on restructuring and therefore, it refrained from making any recommendation in this regard. The WG also noted that it may not be possible to arrive at a single definition of DCCO in view of the wide variability in the nature of different projects.

**Exit options**

6.57 The WG observed that the extant guidelines on restructuring provided the banks freedom to decide, especially, in cases of CDR accounts, to either proceed legally under SARFAESI or DRT or take up the account for restructuring, if found viable. The WG discussed the need for faster exit options in light of the international resolution mechanism and recommended that exit options to banks in cases of non-viable accounts should be made more comprehensive and in cases of all accounts.

6.58 It was also observed that the nonperforming loans affect banks' ability to extend other loans because bad debt negatively weighs on the balance sheet and hurts their ability to raise new capital. As time passes, the market value of a pledged collateral asset that backs the loan continues to deteriorate. As noted[xviii] by President Yang of China's Huarong Asset Management Company,

*“Nonperforming loans are like an ice cream cone. If you don’t get rid of them, they melt all over your hands and you don’t have anything left to sell.”*

6.59 The WG further observed that there were cases which were found to be viable before restructuring but the assumptions leading to viability did not materialise in due course of time. There were also cases where the approved restructuring package could not be implemented satisfactorily due to environmental reasons or due to promoters’ non-adherence to the terms and conditions. The WG observed that in such cases, banks should be advised to assess the situation early and use the exit option with a view to minimise the losses. The WG also agreed that the terms and conditions of restructuring should inherently contain the principle of ‘carrot and stick’, i.e. it should also have disincentives for non-adherence to the terms of restructuring and under-performance. *[Recommendation 19]*

**Right of recompense**

6.60 The WG discussed that it was important to clearly define the right of recompense. It was observed that banks generally waived the benefits accruing to them from right of recompense at a later stage. The WG also discussed the CDR instructions in this regard in the light of the fact that RBI guidelines make the ‘right of recompense’ clause mandatory in cases of CDR restructuring. Detailed guidelines on Recompense Policy were first enunciated in the CDR Cell’s Master Circular dated June 28, 2006 stating that the upper limit of recompense should be limited to waivers (excluding interest and liquidated damages) plus present value of future economic loss on account of reduction in interest rate. It was further stipulated that at least 25% of the upper limit of recompense amount should be recovered. No lender was allowed to fix recompense amount individually.

6.61 Thereafter, certain modifications were made in October 2006 viz. the amount of recompense to be finalized at the CDR EG level but the lenders may individually decide regarding actual recompense amount to be recovered from

the company subject to minimum of 25%. The other change made was in the rate to be used for calculation of NPV viz. BPLR plus term premium and credit risk premium or document rate whichever is lower.

6.62 In July 2007, trigger events for payment of recompense were stipulated. Recompense would be triggered mandatorily at the exit of borrower from CDR mechanism either voluntarily or at the end of the restructuring period. Other trigger events were if the performance of the borrower exceeded projected EBIDTA by 25% or the company declared dividend in excess of 10% or if the borrower desired to incur any capital expenditure other than modernization/expansion necessary for sustained viability of the unit out of borrowed funds not envisaged in the **CDR package.**

***Box 9: Right of Recompense***

Instructions regarding right of recompense can be first observed in November 1985 guidelines on rehabilitation of sick industrial units. It is reproduced below:

"*In regard to concessions and reliefs made available to sick units, a clause could be added whereby, when the units turn the corner and the rehabilitation is successfully completed, the sacrifices undertaken by the institutions and banks should be recouped from the companies out of their future profits/cash accruals. Alternatively, there may be provision for equity participation to the extent of the sacrifices made*".

Revised Guidelines on CDR Mechanism issued in November 2005 also introduced a paragraph on Creditors' Rights as given below:

*"All CDR approved packages must incorporate creditors' right to accelerate repayment and borrowers' right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum."*

Comprehensive guidelines issued in August 2008 continued the mandatory inclusion of 'right of recompense' in cases of CDR

*All CDR approved packages must incorporate creditors' right to accelerate*

*repayment and borrowers' right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum.*

As regards non-CDR cases, it recommended that *banks may consider incorporating in the approved restructuring packages creditor's rights to accelerate repayment and the borrower's right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the banks*.

Master Circular on Interest rates on advances in July 2010 also stated that *In case of restructured loans if some of the WCTL, FITL, etc. need to be granted below the Base Rate for the purposes of viability and there are recompense etc. clauses, such lending will not be construed to be violative of the Base Rate guidelines.*

*The WG also deliberated on the definition of 'Recompense'. It was felt that the diminution in fair value of the accounts on restructuring is the actual sacrifice made by the banks, and as such, this should be the quantum of recompense at the time of restructuring. It also noted that to take into account the time value of money, such recompense should be suitably compounded. The WG felt that the rate of compounding may be the average of base rates during the concession period.*

*It also felt that the exit of borrower from restructuring should be linked with the payment of recompense clause.*

6.63 The WG took note of the fact that due to the current guidelines issued by the CDR Cell that recompense be calculated on compounding basis and that 100% of recompense so calculated is payable, exit of companies from CDR system is not happening. As on date there were several companies where right of recompense have already been triggered but there were disputes regarding recompense amount/calculation thereof. In view of this, the WG felt that CDR Standing Forum/Core Group may take a view as to whether this clause may be made somewhat flexible in order to facilitate the exit of the borrowers from CDR Cell. However, it also felt that in any case 75% of the amount so calculated should be recovered from the borrowers and in cases of restructuring where a

facility has been granted below base rate, 100% of the recompense amount should be recovered. *[Recommendation 20]*

6.64 The WG also recommended that the present recommendatory nature of 'recompense' clause should be made mandatory even in cases of non-CDR cases. *[Recommendation 21]*

**Personal guarantee of promoters**

6.65 The WG observed that as per the extant restructuring guidelines personal guarantee by the promoter was one of the conditions for the asset classification benefit except when the unit is affected by external factors pertaining to the economy and industry. However, the members observed that some promoters do not agree to extend personal guarantee under any circumstances. It was also observed that the criteria, 'external factors pertaining to the economy and industry' was subjective and it made it difficult for the banks to press for promoters' personal guarantee. Considering that the restructuring of debt by lenders benefit promoters and also leads to sacrifice by lenders, it was important to ensure promoters' "skin in the game" or commitment by stipulating personal guarantee.

6.66 The WG discussed that in case personal guarantee is made mandatory, promoters will be ensuring only viable package is submitted for restructuring. Further, personal guarantee of promoters will ensure promoters' "skin in the game" or commitment to the restructuring package. In view of the foregoing, the WG recommended that RBI may prescribe the promoters' personal guarantee as a mandatory requirement for all cases of restructuring, i.e. even if the restructuring is necessitated on account of external factors pertaining to economy and industry. *[Recommendation 22]*

6.67 The WG also recommended that RBI may prescribe that corporate guarantee cannot be a substitute for the promoters' personal guarantee.

***[Recommendation 23]***

**Appendix I**

**Cross-country definitions, asset classification and provisioning of restructured accounts**

| Definition | Asset Classification | Provisioning |
|---|---|---|
| **Australia** | | |
| A facility in which the original contractual terms have been modified by way of an formal agreement between the authorised deposit-taking institution (ADI) bank and borrower 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. | A restructured facility can be treated as non-impaired provided that the following conditions are satisfied.<br>a) The value of the facility has been adjusted to reflect the fair value<br>b) An ADI expects the entity will perform on the restructured terms<br>c) 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;<br>d) Any other restructured terms are considered by the ADI as similar to those applicable to new facilities | The value of a restructured facility must be reduced to fully reflect 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 ADI. |

| Definition | Asset Classification | Provisioning |
|---|---|---|
| | with similar risk;<br>e) 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<br>f) No provisions remain assessed against the restructured facility on an individual basis | |
| **Singapore** | | |
| A credit facility is restructured when a bank grants concessions to a borrower because of deterioration in the financial position of the borrower or the inability of the borrower to meet the original repayment schedule. | A bank shall place a restructured credit facility on the appropriate classified grade *(i.e., NPA)* depending on its' assessment of the financial condition of the borrower and the ability of the borrower to repay based on the restructured terms.<br>A restructured facility can be upgraded if there are reasonable grounds for the bank to conclude that the borrower will be able to service all future principal and | Adequate provisions to be made to reflect the loss of value of the loans. |

| Definition | Asset Classification | Provisioning |
|---|---|---|
| | interest payments on the credit facility in accordance with the restructured terms in addition to that the borrower has complied with all restructured terms and serviced the principal and interest for 6 months (in case of monthly repayment), one year (in case repayment is quarterly or semi-annually) or at the end of one repayment period (if the repayment is annual or longer). | |
| **United States of America** | | |
| In a troubled debt restructuring, a bank grants a borrower concessions for economic or legal reasons related to a borrower's financial difficulties that it would not otherwise consider. However, a loan extended or renewed at a stated rate equal to current interest rate for new debt with similar risk is not considered | A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in non-accrual status. In deciding whether to return an asset to accruing status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. | All loans whose terms have been modified in a troubled debt restructuring must be evaluated for impairment by discounting the present value of future cash flows at the |

| Definition | Asset Classification | Provisioning |
|---|---|---|
| as renegotiated debt. | | effective interest rate of the original loan (that is, before the restructuring) and necessary adjustments have to be made. |
| | **Hong Kong** | |
| "Rescheduled loans" refer to loans: i) that have been restructured and re-negotiated between authorized institutions (AIs) and borrowers because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and ii) for which the revised repayment terms, either of interest or the repayment period, are non-commercial | A rescheduled loan will normally require an adverse classification as impaired loan under the loan classification system i.e., as substandard or doubtful. Rescheduled advances which have been overdue for more than three months under the revised repayment terms are also treated as overdue advances. | |

| Definition | Asset Classification | Provisioning |
|---|---|---|
| to the AI.<br><br>Under normal circumstances, a loan is to be treated as being rescheduled on non-commercial terms if one of the following conditions exists: a) a reduction in the principal amount of the loan; b) a reduction of accrued interest; c) a reduction of interest rate to a level that is lower than the current market rate for a new loan with a similar risk; d) modification of terms that are not normally offered to customers, e) deterioration in a borrower's financial position to the extent that the AI will not provide any new credit in accordance with its lending policies | | |

| Definition | Asset Classification | Provisioning |
|---|---|---|
| **Thailand** | | |
| Debt restructuring is a form of remedy against general debts and troubled debts, to maximize the financial institution's opportunity of getting repayment and to maximize the mutual benefits of both the financial institution and the debtor. In particular, debt restructuring should be carried out to help debtor who has difficulties in loan repayment problem as a result of the economic crisis but having the prospect of continuing its business.<br><br>General Debt Restructuring refers to debt restructuring whereby the financial institution has incurred no loss and Troubled Debt Restructuring refers to | A debtor who has successfully complied with the new terms of the debt restructuring agreement and where the debt repayment has been made for at least a period of 3 consecutive months or 3 instalments, shall be reclassified such as Pass.<br><br>During the monitoring of debtor's compliance with the debt restructuring conditions where a debtor is required to make the debt repayment according to the new terms of the debt restructuring agreement for at least a period of 3 consecutive months or 3 instalments, whichever is longer, a commercial bank shall comply with the following:<br><br>• A debtor originally classified as Doubtful of Loss or Doubtful shall be reclassified as Substandard.<br><br>• A debtor originally classified as Substandard or | The bank has to provide fully for diminution in the value of the loan apart from writing off income already recognised. |

| Definition | Asset Classification | Provisioning |
|---|---|---|
| debt restructuring where the financial institution incurs loss. | Special Mention (or Requiring Special Caution) shall be retained in the same class.<br><br>However, subject to certain conditions a restructured account can be directly classified as Pass. | |
| **France** | | |
| Restructuring implemented because of financial difficulties being experienced by the borrower concern doubtful loans and result in a forgiveness of debt and/or the rescheduling of the principal or interest and/or the modification of the contractual rate charged to the borrower. | Loans restructured because of the debtors' financial situation may be reclassified as performing loans, but in a specific sub-category until they have been repaid in full. | Whenever principal or interest, due or accrued, is forgiven, the loss is recognised. In addition, provision has to be made for diminution in net present value and impairment loss. |
| **United Kingdom** | | |
| The guidelines issued by FSA for mortgages, allow for forbearance | FSA has broadly laid down good and bad practices in accordance with the provisions of IAS 39 for | |

| Definition | Asset Classification | Provisioning |
| --- | --- | --- |
| facilities (similar to restructuring) by firms (banks) in cases where financial assets are either impaired or where the customers experience a period of financial stress. Primary facilities in this context include supporting a period of financial stress through a) temporary reduction in monthly repayment amount b) Capitalisation including Standard capitalisation; and Repayment capitalisation c) Temporary or permanent transfer of all or part of mortgage on to 'Interest Only', terms, d) Extension of the mortgage term, e) Use of flexible facilities or other equity withdrawal such as payment holidays; drawdown against previous overpayments or perceived | recognition, monitoring, provisioning and accounting for impaired and forbearance accounts. The lending firms are free to formulate their own internal policies in these matters subject to these broad guidelines of FSA. | |

| Definition | Asset Classification | Provisioning |
| --- | --- | --- |
| overpayments; use of linked pre-approved reserve/credit/overdraft limits on mortgage or a linked account; and further advance or second loan.<br><br>**Source: Forbearance and Impairment Provisions – Mortgages, FSA, October 2011** | | |

## Appendix II

## Restructuring practices around the world: Snapshot

| Country | Features |
|---|---|
| United States | • Restructuring under the judicial "Chapter 11" process<br>• Voluntary petition can be filed by the debtor or creditor<br>• 180 days to obtain acceptance<br>• US trustee (Justice Department) monitors process<br>• Trend towards pre-packaged bankruptcies (creditors and shareholders vote beforehand)<br>• Re-organisation facilitated by syndications and clarity on seniority of claims |
| Australia | • Legislated by the Corporations Act<br>• Voluntary Administration Regime<br>• Deed of Company Arrangement signed (contract between company and its creditors)<br>• Receivership as last resort |
| Japan | • Civil Rehabilitation Law<br>• Heavily influenced by Chapter 11<br>• Also uses Corporate Reorganisation Law – court appointed administrator, management loses control |
| China | • Enterprise Bankruptcy Law<br>• Stringent sanctions against directors<br>• Banks tend to pursue legal processes rather than restructure |
| UK | • Voluntary approach ("London Rules")<br>• Due diligence, Standstill by creditors<br>• Creditor's committee.<br>• New money, generally gets preference in repayment |

| | |
|---|---|
| | • Seniority of Claims & sharing of losses.<br>• Financial & Operational restructuring. |
| Korea | • Corporate Restructuring Co-ordination Committee (CRCC)<br>• Management targets by borrower for Operational improvements & debt reduction.<br>• Agree to equity write-downs. |
| Malaysia | • Corporate Debt Restructuring Committee (CDRC)<br>• Require shareholders to take bigger haircuts than creditors.<br>• Designates use of funds; include financial covenants in agreements. |

## Appendix III

### Features of out-of-court corporate restructuring processes

| *Feature* | *Indonesia* | *Korea,* | *Rep. of Malaysia* | *Thailand* | *Czech Republic* | *Turkey* | *Mexico* | *Brazil* |
|---|---|---|---|---|---|---|---|---|
| **Initiative or coordinating body** | Jakarta Initiative Task Force (JITF) | Corporate Restructuring Coordination Committee (CRCC) | Corporate Debt Restructuring Committee (CDRC) | Corporate Debt Restructuring Advisory Committee (CDRAC) | None | Istanbul approach | Unidad Coordinadora del Acuerdo Bancario Empresarial (UCABE) | None |
| **Basic approach** | Forum for negotiations, followed by adoption of time-bound mediation procedures | Forum for negotiations | Forum for negotiations | Forum for facilitation, superseded by contractual approach (debtorcreditor agreements) | None | Forum for negotiations, superseded in the fall of 2001 by a legal approach (Law on | Promotion of a voluntary debt workout program for the largest 40 corporations (only about 10% | None |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Corporate Debt Restructuring) | of all bank lending) | |
| **Onset of the crisis** | Late 1997 | Late 1997 | Late 1997 | Late 1997 | 1997 | February 2001 | Late 1994 | January 1999 |
| **Resolution of inter-creditor disputes** | No special procedure | Possibility to have loan of opposing creditor purchased; also arbitration committee consisting of private experts | Nothing special, apart from persuasion by central bank | Three-person panel to attribute differences, but any concerned creditor can opt out | No established framework for creditor coordination; efforts to reach settlements frequently undermined by minority and dissenting creditors | None | Possibility to form a *convention*; all creditors are treated equally and decisions bind all creditors | No possibility of consensual resolution among parties or establishment of creditor committees |

| **Default structure for failure to reach agreement** | JTIF may refer uncooperative debtor to government for possible bankruptcy petition | Foreclosure, liquidation through court receivership | Foreclosure, liquidation or referral to asset management company with superadministrative powers | If less than 50% support the proposed workout, debtor-credit agreement obliges creditors to petition court for collection of debts | Regular bankruptcy | Regular bankruptcy | Criminal bankruptcy procedures or "suspension of payments" to banks permitted by courts | Financial institutions not allowed to invoke insolvency relief pledge for secured debt; unsecured debt can be deferred or reduced (*concordat*) |
|---|---|---|---|---|---|---|---|---|

Source: Stijn Claessens, 2005, "Policy Approaches to Corporate Restructuring around the World: What Worked, What Failed?" in *Corporate Restructuring: Lessons From Experience* (Washington: World Bank), p. 16.

## Appendix IV

### Current guidelines on restructuring of advances by banks

### 1. **Background**

1.1 The guidelines issued by the Reserve Bank of India on restructuring of advances (other than those restructured under a separate set of guidelines issued by the Rural Planning and Credit Department (RPCD) of the RBI on restructuring of advances on account of natural calamities) are divided into the following four categories :

i. Guidelines on restructuring of advances extended to industrial units.
ii. Guidelines on restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism
iii. Guidelines on restructuring of advances extended to Small and Medium Enterprises (SME)
iv. Guidelines on restructuring of all other advances.

In these four sets of guidelines on restructuring of advances, the differentiation has been broadly made based on whether a borrower is engaged in an industrial activity or a non-industrial activity. In addition an elaborate institutional mechanism has been laid down for accounts restructured under CDR Mechanism. The major difference in the prudential regulations lies in the stipulation that subject to certain conditions, the accounts of borrowers engaged in industrial activities (under CDR Mechanism, SME Debt Restructuring Mechanism and outside these mechanisms) continue to be classified in the existing asset classification category upon restructuring. This benefit of retention of asset classification on restructuring is not available to the accounts of borrowers engaged in non-industrial activities except to SME borrowers. Another difference is that the prudential regulations covering the CDR Mechanism and restructuring of advances extended to SMEs are more detailed and comprehensive than that covering the restructuring of the rest of the advances including the advances extended to the industrial units, outside CDR Mechanism. Further, the CDR Mechanism is available only to the borrowers engaged in industrial activities.

1.2 Since the principles underlying the restructuring of all advances were identical, the prudential regulations needed to be aligned in all cases. Accordingly, the prudential norms across all categories of debt restructuring mechanisms, other than those restructured on account of natural calamities which will continue to be covered by the extant guidelines issued by the RPCD were harmonised in August 2008. These prudential norms applicable to all restructurings including those under CDR Mechanism are laid down in para 3. The details of the institutional / organizational framework for CDR Mechanism and SME Debt Restructuring Mechanism are given in Annex - 1.

It may be noted that while the general principles laid down in para 3 inter-alia stipulate that 'standard' advances should be re-classified as 'sub-standard' immediately on restructuring, all borrowers, with the exception of the borrowal categories specified in para 6.1 below ( i.e. consumer and personal advances, advances classified as capital market and real estate exposures), will be entitled to retain the asset classification upon restructuring, subject to the conditions enumerated in para 6.2.

1.3 The CDR Mechanism (Annex - 1) will also be available to the corporates engaged in non-industrial activities, if they are otherwise eligible for restructuring as per the criteria laid down for this purpose. Further, banks are also encouraged to strengthen the co-ordination among themselves in the matter of restructuring of consortium / multiple banking accounts, which are not covered under the CDR Mechanism.

## 2. Key Concepts

Key concepts used in these guidelines are defined in Annex - 2.

## 3. General Principles and Prudential Norms for Restructured Advances

The principles and prudential norms laid down in this paragraph are applicable to all advances including the borrowers, who are eligible for special regulatory treatment for asset classification as specified in para 6. In these cases, the provisions of paras 3.1.2, 3.2.1 and 3.2.2 would stand modified by the provisions in para 6.

3.1 Eligibility criteria for restructuring of advances

3.1.1 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories.

3.1.2 Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re-classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

3.1.3 Normally, restructuring cannot take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

3.1.4 No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include the Return on Capital Employed, Debt Service Coverage Ratio, Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance. The accounts not considered viable should not be restructured and banks should accelerate the recovery measures in respect of such accounts. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action.

3.1.5 While the borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring, banks may review the reasons for classification of the borrowers as wilful defaulters specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default. The restructuring of such cases may be done with Board's approval, while for such accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group only.

3.1.6 BIFR cases are not eligible for restructuring without their express approval. CDR Core Group in the case of advances restructured under CDR Mechanism / the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

3.2 **Asset classification norms**

Restructuring of advances could take place in the following stages:

a. before commencement of commercial production / operation;
b. after commencement of commercial production / operation but before the asset has been classified as 'sub-standard';
c. after commencement of commercial production / operation and the asset has been classified as 'sub-standard' or 'doubtful'.

3.2.1 The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring.

3.2.2 The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower

asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule.

3.2.3 All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for upgradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period' (Annex -2).

3.2.4 In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

3.2.5 Any 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 prerestructuring facilities were 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.

3.2.6 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 substandard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion. However, such advances restructured on second or more occasion 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.

3.3 **Income recognition norms**

Subject to provisions of paragraphs 3.2.5, 4.2 and 5.2, interest income in respect of restructured accounts classified as 'standard assets' will be recognized on accrual basis and that in respect of the accounts classified as 'non-performing assets' will be recognized on cash basis.

3.4 **Provisioning norms**

3.4.1 **Normal provisions**

Banks will hold provision against the restructured advances as per the existing provisioning norms.

3.4.2 **Provision for diminution in the fair value of restructured advances**

(i) Reduction in the rate of interest and / or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms as indicated in para 3.4.1 above, and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR/Base Rate (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR/Base Rate (whichever is applicable to the borrower) 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 above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to follow consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

(ii) In the case of working capital facilities, the diminution in the fair value of the cash credit / overdraft component may be computed as indicated in para (i) above, reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

(iii) In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will

ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

(iv) The diminution in the fair value 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 or Base Rate (whichever is applicable to the borrower), 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.

(v) If due to lack of expertise / appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small / rural branches, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore till the financial year ending March 2013. The position would be reviewed thereafter.

3.4.3 The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

**4. Prudential Norms for Conversion of Principal into Debt / Equity**

4.1 **Asset classification norms**

A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. The debt / equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

12.2 **Income recognition norms**

4.2.1 **Standard Accounts**

In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis.

4.2.2 **Non- Performing Accounts**

In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

4.3 **Valuation and provisioning norms**

These instruments should be held under AFS and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any,)which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available the shares are to be valued at Rs 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted,it should be valued at Rs. 1. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

**5. Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments**

5.1 **Asset classification norms**

The FITL / debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of FITL / debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

5.2 **Income recognition norms**

5.2.1 The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

5.2.2 The unrealised income represented by FITL / Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)".

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

5.2.4 Only on repayment in case of FITL or sale / redemption proceeds of the debt / equity instruments, the amount received will be recognized in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

5.3 **Valuation & Provisioning norms**

Valuation and provisioning norms would be as per para 4.3 above. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

6. Special Regulatory Treatment for Asset Classification

6.1 The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated in para 3, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 6.2 below. Such treatment is not extended to the following categories of advances:

i. Consumer and personal advances;

ii. Advances classified as Capital market exposures;

iii. Advances classified as commercial real estate exposures

The asset classification of these three categories accounts as well as that of other accounts which do not comply with the conditions enumerated in para 6.2, will be governed by the prudential norms in this regard described in para 3 above.

6.2 **Elements of special regulatory framework**

The special regulatory treatment has the following two components :

(i) Incentive for quick implementation of the restructuring package.

(ii) Retention of the asset classification of the restructured account in the pre-restructuring asset classification category

6.2.1 **Incentive for quick implementation of the restructuring package**

As stated in para 3.1.2, during the pendency of the application for restructuring of the advance with the bank, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the application is under consideration. However, as an incentive for quick implementation of the package, if the approved package is implemented by the bank as per the following time schedule, the asset classification status may be restored to the position which existed when the reference was made to the CDR Cell in respect of cases covered under the CDR Mechanism or when the restructuring application was received by the bank in non-CDR cases:

(i) Within 120 days from the date of approval under the CDR Mechanism.

(ii) Within 90 days from the date of receipt of application by the bank in cases other than those restructured under the CDR Mechanism.

6.2.2 **Asset classification benefits**

Subject to the compliance with the undernoted conditions in addition to the adherence to the prudential framework laid down in para 3:

(i) In modification to para 3.2.1, an existing 'standard asset' will not be downgraded to the sub-standard category upon restructuring.

(ii) In modification to para 3.2.2, during the specified period, the asset classification of the sub-standard / doubtful accounts will not deteriorate upon restructuring, if satisfactory performance is demonstrated during the specified period.

However, these benefits will be available subject to compliance with the following conditions:

i) The dues to the bank are 'fully secured' as defined in Annex -2. The condition of being fully secured by tangible security will not be applicable in the following cases:

(a) SSI borrowers, where the outstanding is up to Rs.25 lakh.

(b) Infrastructure projects, provided the cash flows generated from these projects are adequate for repayment of the advance, the financing bank(s) have in place an appropriate mechanism to escrow the cash flows, and also have a clear and legal first claim on these cash flows.

(c) Dues of Micro Finance Institutions (MFIs) restructured up to March 31, 2011

ii) The unit becomes viable in 10 years, if it is engaged in infrastructure activities, and in 7 years in the case of other units.

iii) The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances. The aforesaid ceiling of 10 years would not be applicable for restructured home loans; in these cases the Board of Director of the banks should prescribe the maximum period for restructured advance keeping in view the safety and soundness of the advances. Lending to individuals meant for acquiring residential property which are fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented are risk weighted as under the new capital adequacy framework, provided the LTV is not more than 75% , based on board approved valuation policy. However, the restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points to the risk weight prescribed already.

iv) Promoters' sacrifice and additional funds brought by them should be a minimum of 15% of banks' sacrifice. The term 'bank's sacrifice' means the amount of "erosion in the fair value of the advance", to be computed as per the methodology enumerated in para 3.4.2 (i) above.

v) However, based on the representations received from Banks and Indian Banks' Association that corporate under stress find it difficult to bring in the promoters share of sacrifice and additional funds upfront on some occasions, it was decided that:

a) The promoter's sacrifice and additional funds required to be brought in by the promoters should generally be brought in upfront. However, if banks are convinced that the promoters face genuine difficulty in bringing their share of the sacrifice immediately and need some extension of time to fulfil their commitments, the promoters could be allowed to bring in 50% of their sacrifice, i.e. 50% of 15%, upfront and the balance within a period of one year.

b) However, in case the promoters fail to bring in their balance share of sacrifice within the extended time limit of one year, the asset classification benefits derived by banks will cease to accrue and the banks will have to revert to classifying such accounts as per the asset classification norms specified under para 3.2 of this circular.

c) Promoter's contribution need not necessarily be brought in cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest free loans.

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

vii) The restructuring under consideration is not a 'repeated restructuring' as defined in para (v) of Annex -2.

**7. Miscellaneous**

7.1 The banks 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.

7.2 Acquisition of equity shares / convertible bonds / convertible debentures in companies by way of conversion of debt / overdue interest can be done without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached. However, this will be subject to reporting of such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. Nonetheless, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.

7.3 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 the RBI in the aforesaid DSB return.

7.4 Banks may consider incorporating in the approved restructuring packages creditor's rights to accelerate repayment and the borrower's right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the banks.

7.5 Since the spillover effects of the global downturn had also started affecting the Indian economy particularly from September 2008 onwards creating stress for the otherwise viable units / activities, certain modifications were made in the guidelines on restructuring as a onetime measure and for a limited period of time i.e. up to June 30, 2009. These relaxations have ceased to operate from July 1, 2009; however the same have been consolidated in Annex - 8.

## 8. Disclosures

Banks should also disclose in their published annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances in Annex -3. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately. Banks must disclose the total amount outstanding in all the accounts / facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means even if only one of the facilities / accounts of a borrower has been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities / accounts of that particular borrower.

## 9. Illustrations

A few illustrations on the asset classification of restructured accounts are given in Annex -7.

**10.** It has been re-iterated that the basic objective of restructuring is to preserve economic value of units, not evergreening of problem accounts. This can be achieved by banks and the borrowers only by careful assessment of the viability, quick detection of weaknesses in accounts and a time-bound implementation of restructuring packages.

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**Organisational Framework for Restructuring of Advances under Consortium / Multiple Banking / Syndication Arrangements**

## A. Corporate Debt Restructuring (CDR) Mechanism

### 1.1 **Objective**

The **objective** of the Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporates that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

### 1.2 **Scope**

The CDR Mechanism has been designed to facilitate restructuring of advances of borrowers enjoying credit facilities from more than one bank / Financial Institution (FI) in a coordinated manner. The CDR Mechanism is an organizational framework institutionalized for speedy disposal of restructuring proposals of large borrowers availing finance from more than one banks / FIs. This mechanism will be available to all borrowers engaged in any type of activity subject to the following conditions:

a) The borrowers enjoy credit facilities from more than one bank / FI under multiple banking / syndication / consortium system of lending.

b) The total outstanding (fund-based and non-fund based) exposure is Rs.10 crore or above.

CDR system in the country will have a three tier structure :

- CDR Standing Forum and its Core Group
- CDR Empowered Group
- CDR Cell

### 2. **CDR Standing Forum**

2.1 The CDR Standing Forum would be the representative general body of all financial institutions and banks participating in CDR system. All financial institutions and banks should participate in the system in their own interest. CDR Standing Forum will be a self empowered body, which will lay down policies and guidelines, and monitor the progress of corporate debt restructuring.

2.2 The Forum will also provide an official platform for both the creditors and borrowers (by consultation) to amicably and collectively evolve policies and guidelines for working out debt restructuring plans in the interests of all concerned.

2.3 The CDR Standing Forum shall comprise of Chairman & Managing Director, Industrial Development Bank of India Ltd; Chairman, State Bank of India; Managing Director & CEO, ICICI Bank Limited; Chairman, Indian Banks' Association as well as Chairmen and Managing Directors of all banks and financial institutions participating as permanent members in the system. Since institutions like Unit Trust of India, General Insurance Corporation, Life Insurance Corporation may have assumed exposures on certain borrowers, these institutions may participate in the CDR system. The Forum will elect its Chairman for a period of one year and the principle of rotation will be followed in the subsequent years. However, the Forum may decide to have a Working Chairman as a whole-time officer to guide and carry out the decisions of the CDR Standing Forum. The RBI would not be a member of the CDR Standing Forum and Core Group. Its role will be confined to providing broad guidelines.

2.4 The CDR Standing Forum shall meet at least once every six months and would review and monitor the progress of corporate debt restructuring system. The Forum would also lay down the policies and guidelines including those relating to the critical parameters for restructuring (for example, maximum period for a unit to become viable under a restructuring package, minimum level of promoters' sacrifice etc.) to be followed by the CDR Empowered Group and CDR Cell for debt restructuring and would ensure their smooth functioning and adherence to the prescribed time schedules for debt restructuring. It can also review any individual decisions of the CDR Empowered GROUP and CDR Cell. The CDR Standing Forum may also formulate guidelines for dispensing special treatment to those cases, which are complicated and are likely to be delayed beyond the time frame prescribed for processing.

2.5 A CDR Core GROUP will be carved out of the CDR Standing Forum to assist the Standing Forum in convening the meetings and taking decisions relating to policy, on behalf of the Standing Forum. The Core GROUP will consist of Chief Executives of Industrial Development Bank of India Ltd., State Bank of India, ICICI Bank Ltd, Bank of Baroda, Bank of India, Punjab National Bank, Indian Banks' Association and Deputy Chairman of Indian Banks' Association representing foreign banks in India.

2.6 The CDR Core GROUP would lay down the policies and guidelines to be followed by the CDR Empowered GROUP and CDR Cell for debt restructuring. These guidelines shall also suitably address the operational difficulties experienced in the functioning of the CDR Empowered GROUP. The CDR Core GROUP shall also prescribe the PERT chart for processing of cases referred to the CDR system and decide on the modalities for enforcement of the time frame. The CDR Core GROUP shall also lay down guidelines to ensure that over-optimistic projections are not assumed while preparing / approving restructuring

proposals especially with regard to capacity utilization, price of products, profit margin, demand, availability of raw materials, input-output ratio and likely impact of imports / international cost competitiveness.

3. **CDR Empowered Group**

3.1 The individual cases of corporate debt restructuring shall be decided by the CDR Empowered Group, consisting of ED level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd. and State Bank of India as standing members, in addition to ED level representatives of financial institutions and banks who have an exposure to the concerned company. While the standing members will facilitate the conduct of the GROUP's meetings, voting will be in proportion to the exposure of the creditors only. In order to make the CDR Empowered Group effective and broad based and operate efficiently and smoothly, it would have to be ensured that participating institutions / banks approve a panel of senior officers to represent them in the CDR Empowered Group and ensure that they depute officials only from among the panel to attend the meetings of CDR Empowered Group. Further, nominees who attend the meeting pertaining to one account should invariably attend all the meetings pertaining to that account instead of deputing their representatives.

3.2 The level of representation of banks / financial institutions on the CDR Empowered Group should be at a sufficiently senior level to ensure that concerned bank / FI abides by the necessary commitments including sacrifices, made towards debt restructuring. There should be a general authorisation by the respective Boards of the participating institutions / banks in favour of their representatives on the CDR Empowered Group, authorising them to take decisions on behalf of their organization, regarding restructuring of debts of individual corporates.

3.3 The CDR Empowered Group will consider the preliminary report of all cases of requests of restructuring, submitted to it by the CDR Cell. After the Empowered Group decides that restructuring of the company is prima-facie feasible and the enterprise is potentially viable in terms of the policies and guidelines evolved by Standing Forum, the detailed restructuring package will be worked out by the CDR Cell in conjunction with the Lead Institution. However, if the lead institution faces difficulties in working out the detailed restructuring package, the participating banks / financial institutions should decide upon the alternate institution / bank which would work out the detailed restructuring package at the first meeting of the Empowered Group when the preliminary report of the CDR Cell comes up for consideration.

3.4 The CDR Empowered Group would be mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified time frame of 90 days, or at best within 180 days of reference to the Empowered Group. The CDR Empowered Group shall decide on the acceptable viability benchmark

levels on the following illustrative parameters, which may be applied on a case-by-case basis, based on the merits of each case :

* Return on Capital Employed (ROCE),

* Debt Service Coverage Ratio (DSCR),

* Gap between the Internal Rate of Return (IRR) and the Cost of Fund (CoF),

* Extent of sacrifice.

3.5 The Board of each bank / FI should authorise its Chief Executive Officer (CEO) and / or Executive Director (ED) to decide on the restructuring package in respect of cases referred to the CDR system, with the requisite requirements to meet the control needs. CDR Empowered Group will meet on two or three occasions in respect of each borrowal account. This will provide an opportunity to the participating members to seek proper authorisations from their CEO / ED, in case of need, in respect of those cases where the critical parameters of restructuring are beyond the authority delegated to him / her.

3.6 The decisions of the CDR Empowered Group shall be final. If restructuring of debt is found to be viable and feasible and approved by the Empowered Group, the company would be put on the restructuring mode. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and / or liquidation or winding up of the company, collectively or individually.

4 **CDR Cell**

4.1 The CDR Standing Forum and the CDR Empowered Group will be assisted by a CDR Cell in all their functions. The CDR Cell will make the initial scrutiny of the proposals received from borrowers / creditors, by calling for proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group, within one month to decide whether rehabilitation is prima facie feasible. If found feasible, the CDR Cell will proceed to prepare detailed Rehabilitation Plan with the help of creditors and, if necessary, experts to be engaged from outside. If not found prima facie feasible, the creditors may start action for recovery of their dues.

4.2 All references for corporate debt restructuring by creditors or borrowers will be made to the CDR Cell. It shall be the responsibility of the lead institution / major stakeholder to the corporate, to work out a preliminary restructuring plan in consultation with other stakeholders and submit to the CDR Cell within one month. The CDR Cell will prepare the restructuring plan in terms of the general policies and guidelines approved by the CDR Standing Forum and place for consideration of the Empowered Group within 30 days for decision. The Empowered Group can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days. However, for sufficient reasons

the period can be extended up to a maximum of 180 days from the date of reference to the CDR Cell.

4.3 The CDR Standing Forum, the CDR Empowered Group and CDR Cell is at present housed in Industrial Development Bank of India Ltd. However, it may be shifted to another place if considered necessary, as may be decided by the Standing Forum. The administrative and other costs shall be shared by all financial institutions and banks. The sharing pattern shall be as determined by the Standing Forum.

4.4 CDR Cell will have adequate members of staff deputed from banks and financial institutions. The CDR Cell may also take outside professional help. The cost in operating the CDR mechanism including CDR Cell will be met from contribution of the financial institutions and banks in the Core Group at the rate of Rs.50 lakh each and contribution from other institutions and banks at the rate of Rs.5 lakh each.

5. **Other features**

5.1 **Eligibility criteria**

5.1.1 The scheme will not apply to accounts involving only one financial institution or one bank. The CDR mechanism will cover only multiple banking accounts / syndication / consortium accounts of corporate borrowers engaged in any type of activity with outstanding fund-based and non-fund based exposure of Rs.10 crore and above by banks and institutions.

5.1.2 The Category 1 CDR system will be applicable only to accounts classified as 'standard' and 'sub-standard'. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as 'standard'/ 'substandard' in the books of at least 90% of creditors (by value), the same would be treated as standard / substandard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10% of creditors. There would be no requirement of the account / company being sick, NPA or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs will get priority. This approach would provide the necessary flexibility and facilitate timely intervention for debt restructuring. Prescribing any milestone(s) may not be necessary, since the debt restructuring exercise is being triggered by banks and financial institutions or with their consent.

5.1.3 While corporates indulging in frauds and malfeasance even in a single bank will continue to remain ineligible for restructuring under CDR mechanism as hitherto, the Core Group may review the reasons for classification of the borrower as wilful defaulter specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default provided he is granted an opportunity under the CDR mechanism. Such exceptional cases may

be admitted for restructuring with the approval of the Core Group only. The Core Group may ensure that cases involving frauds or diversion of funds with malafide intent are not covered.

5.1.4 The accounts where recovery suits have been filed by the creditors against the company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under the CDR system is taken by at least 75% of the creditors (by value) and 60% of creditors (by number).

5.1.5 BIFR cases are not eligible for restructuring under the CDR system. However, large value BIFR cases may be eligible for restructuring under the CDR system if specifically recommended by the CDR Core Group. The Core Group shall recommend exceptional BIFR cases on a case-to-case basis for consideration under the CDR system. It should be ensured that the lending institutions complete all the formalities in seeking the approval from BIFR before implementing the package.

5.2 **Reference to CDR system**

5.2.1 Reference to Corporate Debt Restructuring System could be triggered by (i) any or more of the creditor who have minimum 20% share in either working capital or term finance, or (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) above.

5.2.2 Though flexibility is available whereby the creditors could either consider restructuring outside the purview of the CDR system or even initiate legal proceedings where warranted, banks / FIs should review all eligible cases where the exposure of the financial system is more than Rs.100 crore and decide about referring the case to CDR system or to proceed under the new Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 or to file a suit in DRT etc.

5.3 **Legal Basis**

5.3.1 CDR is a non-statutory mechanism which is a voluntary system based on Debtor- Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA) shall provide the legal basis to the CDR mechanism. The debtors shall have to accede to the DCA, either at the time of original loan documentation (for future cases) or at the time of reference to Corporate Debt Restructuring Cell. Similarly, all participants in the CDR mechanism through their membership of the Standing Forum shall have to enter into a legally binding agreement, with necessary enforcement and penal clauses, to operate the System through laid-down policies and guidelines. The ICA signed by the creditors will be initially valid for a period of 3 years and subject to renewal for further periods of 3 years thereafter. The lenders in foreign currency outside the country are not a part of CDR system. Such creditors and also creditors like GIC, LIC, UTI, etc., who have not joined the CDR system, could join CDR mechanism of a particular

corporate by signing transaction to transaction ICA, wherever they have exposure to such corporate.

5.3.2 The Inter-Creditor Agreement would be a legally binding agreement amongst the creditors, with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by the various elements of CDR system. Further, the creditors shall agree that if 75 per cent of creditors by value and 60 per cent of the creditors by number, agree to a restructuring package of an existing debt (i.e., debt outstanding), the same would be binding on the remaining creditors. Since Category 1 CDR Scheme covers only standard and sub-standard accounts, which in the opinion of 75 per cent of the creditors by value and 60 per cent of creditors by number, are likely to become performing after introduction of the CDR package, it is expected that all other creditors (i.e., those outside the minimum 75 per cent by value and 60 per cent by number) would be willing to participate in the entire CDR package, including the agreed additional financing.

5.3.3 In order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium / syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.

5.3.4 One of the most important elements of Debtor-Creditor Agreement would be 'stand still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) shall agree to a legally binding 'stand-still' whereby both the parties commit themselves not to take recourse to any other legal action during the 'stand-still' period, this would be necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the stand-still clause will be applicable only to any civil action either by the borrower or any lender against the other party and will not cover any criminal action. Further, during the stand-still period, outstanding foreign exchange forward contracts, derivative products, etc., can be crystallised, provided the borrower is agreeable to such crystallisation. The borrower will additionally undertake that during the stand-still period the documents will stand extended for the purpose of limitation and also that he will not approach any other authority for any relief and the directors of the borrowing company will not resign from the Board of Directors during the stand-still period.

5.4 **Sharing of Additional finance**

5.4.1 Additional finance, if any, is to be provided by all creditors of a 'standard' or 'substandard account' irrespective of whether they are working capital or term creditors, on a pro-rata basis. In case for any internal reason, any creditor (outside the minimum 75 per cent and 60 per cent) does not wish to commit

additional financing, that creditor will have an option in accordance with the provisions of para 5.5.

5.4.2 The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure

5.5 **Exit Option**

5.5.1 As stated in para 5.4.1 a creditor (outside the minimum 75 per cent and 60 per cent) who for any internal reason does not wish to commit additional finance will have an option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditors can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last instalment of the principal due to the creditor.

5.5.2 In addition, the exit option will also be available to all lenders within the minimum 75 percent and 60 percent provided the purchaser agrees to abide by restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance.

5.5.3 The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.

5.5.4 In order to bring more flexibility in the exit option, One Time Settlement can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

5.6 **Category 2 CDR System**

5.6.1 There have been instances where the projects have been found to be viable by the creditors but the accounts could not be taken up for restructuring under the CDR system as they fell under 'doubtful' category. Hence, a second

category of CDR is introduced for cases where the accounts have been classified as 'doubtful' in the books of creditors, and if a minimum of 75% of creditors (by value) and 60% creditors (by number) satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions :

(i) It will not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend will depend on each creditor bank / FI separately. In other words, under the proposed second category of the CDR mechanism, the existing loans will only be restructured and it would be up to the promoter to firm up additional financing arrangement with new or existing creditors individually.

(ii) All other norms under the CDR mechanism such as the standstill clause, asset classification status during the pendency of restructuring under CDR, etc., will continue to be applicable to this category also.

5.6.2 No individual case should be referred to RBI. CDR Core Group may take a final decision whether a particular case falls under the CDR guidelines or it does not.

5.6.3 All the other features of the CDR system as applicable to the First Category will also be applicable to cases restructured under the Second Category.

5.7 **Incorporation of 'right to recompense' clause**

All CDR approved packages must incorporate creditors' right to accelerate repayment and borrowers' right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum.

**B SME Debt Restructuring Mechanism**

Apart from CDR Mechanism, there exists a much simpler mechanism for restructuring of loans availed by Small and Medium Enterprises (SMEs). Unlike in the case of CDR Mechanism, the operational rules of the mechanism have been left to be formulated by the banks concerned. This mechanism will be applicable to all the borrowers which have funded and non-funded outstanding up to Rs.10 crore under multiple /consortium banking arrangement. Major elements of this arrangements are as under :

(i) Under this mechanism, banks may formulate, with the approval of their Board of Directors, a debt restructuring scheme for SMEs within the prudential norms laid down by RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.

(ii) While framing the scheme, banks may ensure that the scheme is simple to comprehend and will, at the minimum, include parameters indicated in these guidelines.

(iii) The main plank of the scheme is that the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.

(iv) Banks should work out the restructuring package and implement the same within a maximum period of 90 days from date of receipt of requests.

(v) The SME Debt Restructuring Mechanism will be available to all borrowers engaged in any type of activity.

(vi) Banks may review the progress in rehabilitation and restructuring of SMEs accounts on a quarterly basis and keep the Board informed.

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**Annex – 2 to Appendix IV**

## Key Concepts

### (i) Advances

The term 'Advances' will mean all kinds of credit facilities including cash credit, overdrafts, term loans, bills discounted / purchased, factored receivables, etc. and investments other than that in the nature of equity.

### (ii) Agricultural Activities

As defined in RPCD circular RPCD.No.Plan.BC.84/04.09.01/2006-07 dated April 30, 2007 as modified from time to time.

### (iii) Fully Secured

When the amounts due to a bank (present value of principal and interest receivable as per restructured loan terms) are fully covered by the value of security, duly charged in its favour in respect of those dues, the bank's dues are considered to be fully secured. While assessing the realisable value of security, primary as well as collateral securities would be reckoned, provided such securities are tangible securities and are not in intangible form like guarantee etc., of the promoter / others. However, for this purpose the bank guarantees, State Government Guarantees and Central Government Guarantees will be treated on par with tangible security.

### (iv) Restructured Accounts

A restructured account is one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances / securities, which would generally include, among others, alteration of repayment period / repayable amount/ the amount of instalments / rate of interest (due to reasons other than competitive reasons). However, extension in repayment tenor of a floating rate loan on reset of interest rate, so as to keep the EMI unchanged provided it is applied to a class of accounts uniformly will not render the account to be classified as ‘Restructured account’. In other words, extension or deferment of EMIs to individual borrowers as against to an entire class, would render the accounts to be classified as 'restructured accounts.

### (v) Repeatedly Restructured Accounts

When a bank restructures an account a second (or more) time(s), the account will be considered as a 'repeatedly restructured account'. However, if the second

restructuring takes place after the period upto which the concessions were extended under the terms of the first restructuring, that account shall not be reckoned as a 'repeatedly restructured account'.

**(vi) SMEs**

Small and Medium Enterprise (SME) is an undertaking defined in RPCD circulars RPCD.PLNFS.BC.No.63.06.02/2006-07 dated April 4, 2007 amended from time to time.

**(vii) Specified Period**

Specified Period means a period of one year from the date when the first payment of interest or installment of principal falls due under the terms of restructuring package.

**(viii) Satisfactory Performance**

Satisfactory performance during the specified period means adherence to the following conditions during that period.

**Non-Agricultural Cash Credit Accounts**

In the case of non-agricultural cash credit accounts, the account should not be out of order any time during the specified period, for a duration of more than 90 days. In addition, there should not be any overdues at the end of the specified period.

**Non-Agricultural Term Loan Accounts**

In the case of non-agricultural term loan accounts, no payment should remain overdue for a period of more than 90 days. In addition there should not be any overdues at the end of the specified period.

**All Agricultural Accounts**

In the case of agricultural accounts, at the end of the specified period the account should be regular.

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| Particulars of Accounts Restructured | | | | |
|---|---|---|---|---|
| Amt. (Rs. in crore) | | | | |
| | | **CDR Mechanism** | **SME Debt Restructuring** | **Others** |
| **Standard advances restructured** | **No. of Borrowers** | | | |
| | **Amount outstanding** | | | |
| | **Sacrifice (diminution in the fair value)** | | | |
| **Sub standard advances restructured** | **No. of Borrowers** | | | |
| | **Amount outstanding** | | | |
| | **Sacrifice (diminution in the fair value)** | | | |
| **Doubtful advances restructured** | **No. of Borrowers** | | | |
| | **Amount outstanding** | | | |
| | **Sacrifice (diminution in the fair value)** | | | |
| **TOTAL** | **No. of Borrowers** | | | |
| | **Amount outstanding** | | | |
| | **Sacrifice (diminution in the fair value)** | | | |

Annex – 4 to Appendix IV

## Asset Classification of Restructured Accounts under the Guidelines

| | Particulars | Case 1 | Case 2 | Case 3 | Case 4 |
|---|---|---|---|---|---|
| **Asset Classification of Restructured Accounts under the Guidelines** | | | | | |
| I | Assumed due date of payment | 31.01.2007 | 31.01.2007 | | |
| | Assumed date of restructuring | 31.03.2007 | 31.03.2007 | 31.03.2007 | 31.03.2007 |
| | Period of delinquency as on the date of restructuring | 2 months | 2 months | 18 months | 18 months |
| | Asset Classification (AC) before restructuring | 'Standard' | 'Standard' | 'Doubtful - less than one year' | 'Doubtful - less than one year' |
| | Date of NPA | NA | NA | 31.12.05 (Assumed) | 31.12.05 (Assumed) |
| II | **Asset classification (AC) on restructuring** | | | | |
| | Assumed status of the borrower | Eligible for special regulatory treatment | Not eligible for special regulatory treatment | Eligible for special regulatory treatment | Not eligible for special regulatory treatment |
| | AC after restructuring | 'Standard' | Downgraded to 'Substandard' w.e.f 31.03.07 (i.e., on the date of restructuring) | 'Doubtful - less than one year' | 'Doubtful - less than one year' |
| | Assumed first payment due under the revised terms | 31.12.07 | 31.12.07 | 31.12.07 | 31.12.07 |
| III | **Asset classification after restructuring** | | | | |
| A | The account **performs satisfactorily** as per restructured terms | | | | |
| (a) | AC during the specified one year period (i.e., from 31.12.07 to 31.12.08) | No change (i.e., remains 'Standard') | 'Doubtful - less than one year' w.e.f. 31.03.08 (i.e. one year after classification as | No change (i.e., remains 'Doubtful - less than one year') | 'Doubtful - one to three years' w.e.f. 31.12.07 (i.e., one year after classification |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | 'Substandard') | | as 'Doubtful less than one year') |
| | (b) | AC after the specified one year period | Continues in 'Standard' category | Upgraded to 'Standard' category | Upgraded to 'Standard' category | Upgraded to 'Standard' category |
| B | If **performance not satisfactory** vis-à-vis restructured terms | | | | | |
| | (a) | AC during the specified one year period (in case the unsatisfactory performance is established before completion of one year period) | Treated as substandard w.e.f 30.4.2007 and downgraded to 'Doubtful less than one year' with effect from 30.04.08. | 'Doubtful - less than one year' w.e.f. 31.03.08 (i.e. one year after classification | 'Doubtful one to three years' w.e.f. 31.12.07 | 'Doubtful - one to three years' w.e.f. 31.12.07 (i.e., one year after classification as 'Doubtful less than one year' (on 31.12.06) |
| | (b) | AC after the specified one year period, if the unsatisfactory performance continues | Will migrate to 'Doubtful - one to three years' w.e.f. 30.04.09 and 'Doubtful more than three years' w.e.f. 30.04.2011. | Will migrate to 'Doubtful - one to three years' w.e.f. 31.03.09 and 'Doubtful more than three years' w.e.f. 31.03.2011. | Will migrate to 'Doubtful - more than three years' w.e.f. 31.12.09 | Will migrate further to 'Doubtful more than three years' w.e.f. 31.12.09 |

# Appendix V

## Format for disclosure of restructured accounts

(Rs. In Crore)

| Sl No | Type of Restructuring → | | Under CDR Mechanism | | | | | Under SME Debt Restructuring Mechanism | | | | | Others | | | | | Total | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Asset Classification → | | Standard | Sub-Standard | Doubtful | Loss | Total | Standard | Sub-Standard | Doubtful | Loss | Total | Standard | Sub-Standard | Doubtful | Loss | Total | Standard | Sub-Standard | Doubtful | Loss | Total |
| | Details ↓ | | (a) | (b) | (c) | (d) | (e) | (f) | (g) | (h) | (i) | (j) | (k) | (l) | (m) | (n) | (o) | (p) | (q) | (r) | (s) | (t) |
| 1 | Restructured Accounts as on April 1 of the FY (opening figures*) | No. of borrowers | | | | | | | | | | | | | | | | | | | | |
| | | Amount outstanding | | | | | | | | | | | | | | | | | | | | |
| | | Provision thereon | | | | | | | | | | | | | | | | | | | | |
| 2 | Fresh restructuring during the year | No. of borrowers | | | | | | | | | | | | | | | | | | | | |
| | | Amount outstanding | | | | | | | | | | | | | | | | | | | | |
| | | Provision thereon | | | | | | | | | | | | | | | | | | | | |

| 3 | Upgradations to restructured standard category during the FY | No. of borrowers | | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Amount outstanding | | | | | | | | | | | | | | | | | | | | |
| | | Provision thereon | | | | | | | | | | | | | | | | | | | | |
| 4 | Restructured standard advances at the beginning of the current FY, which cease attract higher provisioning and / or additional risk weight at the end of the current FY and hence need not be shown as restructured standard advances | No. of borrowers | | NA | NA | N<br>A | | | NA | NA | N<br>A | | | NA | NA | N<br>A | | | NA | NA | N<br>A | |
| | | Amount outstanding | | NA | NA | N<br>A | | | NA | NA | N<br>A | | | NA | NA | N<br>A | | | NA | NA | N<br>A | |
| | | Provision thereon | | NA | NA | N<br>A | | | NA | NA | N<br>A | | | NA | NA | N<br>A | | | NA | NA | N<br>A | |

| | at the beginning of the next FY | | | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5 | Downgradations of restructured accounts during the FY | No. of borrowers | | | | | | | | | | | | | | | | | | | | |
| | | Amount outstanding | | | | | | | | | | | | | | | | | | | | |
| | | Provision thereon | | | | | | | | | | | | | | | | | | | | |
| 6 | Write-offs of restructured accounts during the FY | No. of borrowers | | | | | | | | | | | | | | | | | | | | |
| | | Amount outstanding | | | | | | | | | | | | | | | | | | | | |
| | | Provision thereon | | | | | | | | | | | | | | | | | | | | |
| 7 | Restructured Accounts as on March 31 of the FY (closing figures*) | No. of borrowers | | | | | | | | | | | | | | | | | | | | |
| | | Amount outstanding | | | | | | | | | | | | | | | | | | | | |
| | | Provision thereon | | | | | | | | | | | | | | | | | | | | |

N.B. – For the purpose of disclosure in the above Format:

(i) Upgradation during the year (Sl No. 3 in the Format) means:

‘Restructured NPA’ accounts - movement to ‘standard asset classification from substandard or doubtful category’ as the case may be in terms of para 3.2.3 of the circular DBOD.BP.BC.No.37/21.04.132/2008-09 dated August 27, 2008 on ‘Prudential Guidelines on Restructuring of Advances’ dated August 27, 2008. These will attract higher provisioning and / or risk weight’ during the ‘prescribed period’ as indicated in paragraph 4 above. Movement from one category into another will be indicated by a (-) and a (+) sign respectively in the relevant category.

(ii) Movement of Restructured standard advances (Sr. No. 4 in the Appendix) out of the category into normal standard advances will be indicated by a (-) sign in the column for standard.

(iii) Downgradation from one category to another would be indicated by (-) ve and (+) ve sign in the relevant categories.

(iv) Upgradation, Downgradation and write-offs are from their existing asset classifications.

(v) All disclosures are on the basis of current asset classification and not ‘pre-restructuring’ asset classification.

*excluding the figures of restructured standard advances which do not attract higher provision and risk weight (if applicable).

## References


[i] Policy Approaches to Corporate Restructuring around the World: What Worked, What Failed? – Stijn Claessens - World Bank Publication – "Corporate Restructuring – Lessons from Experience"

[ii] Wikipedia

[iii] BIS Review 146/2007

[iv] Circular DBOD.No.BP.BC.104/C.453(G)-78 dated August 9, 1978 titled 'Assistance to People Affected by Floods and Other Natural Calamities'

[v] Circular DBOD.No.BP.1164/C.469(W)-78 dated November 16, 1978 titled 'Bank Finance to Victims of Emergency'

[vi] Circular DBOD.No.CAS.133/C.446(SIU)-76 dated November 26, 1976.

[vii] Circular IECD.No.IRD.BC.132/SIU-A-85 dated November 5, 1985 titled 'Parameters for Provision of Reliefs / Concessions by Banks under Rehabilitation Packages evolved for Sick Units considered as Potentially Viable'

[viii] Circular DBOD.No.FoI.BC.136/C.249-85 dated November 7, 1985 titled 'Credit Monitoring System – Introduction of Health Code for Borrowal Accounts in Banks'.

[ix] Circular DBOD.No.BC.129/21.04.043/92 dated April 27, 1992 titled 'Income Recognition, Asset Classification, Provisioning and Other Related Matters

[x] Circular FIC.No.841/01.02.00/93-94 dated March 28, 1994 titled 'Income Recognition, Asset Classification, Provisioning and other related Matters.

[xi] Circular DBOD.No.BP.BC.35/21.01.002/99 dated April 24, 1999 titled 'Monetary and Credit Policy Measures'.

[xii] Circular DBOD.No.BP.BC.45/21.04.048/99 dated May 10, 1999 titled 'Income Recognition, Asset Classification and Provisioning – Concept of Commencement of Commercial Production'.

[xiii] Circular DBOD.No.BP.BC.98/21.048/2000-01 dated March 30, 2001 titled 'Treatment of Restructured Accounts'

[xiv] Mail Box Clarification dated December 7, 2005 titled 'Prudential Norms – Restructuring / Rescheduling of Loans'

[xv] Circular DBOD.No.BP.BC.15/21.04.114/2000-01 dated August 23, 2001 titled 'Corporate Debt Restructuring'

[xvi] Circular DBOD.No.BP.BC.No.34/21.04.132/2005-06 dated September 8, 2005 titled 'Debt Restructuring Mechanism for Small and Medium Enterprises (SMEs) – Announcement made by the Union Finance Minister'

[xvii] Circular DBOD.No.BP.BC.57/21.04.157/2008-09dated October 13, 2008 titled "Prudential Norms for Off-balance Sheet Exposures of Banks"

[xviii] World Bank Publication – "Corporate Restructuring – Lessons from Experience"

Wikipedia

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