CORPORATE DEBT RESTRUCTURING : MECHANISM NEEDS A RELOOK

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4. LawZ Monthly Magazine, August 2008 edition.

In this era of globalisation and competition, Indian industry is striving to survive and prosper. Growth trends in industrial sector reveal that the share of manufacturing in GDP has gone up only marginally, from 13.8 per cent in 1970-71 to around 15 per cent in 2000-01. The share of services sector, on the other hand, has risen from 32.2 per cent to 46.8 per cent during the period.

There are, therefore, inherent problems in the manufacturing sector, such as, declining competitiveness, rigid and rising costs of inputs and so on, which have affected corporate profitability. Further, the bulk of portfolio investment currently is in the information technology and other knowledge-based industries. As for banks and financial institutions, they are encumbered with non-performing assets (NPAs) arising out of corporate accounts. In this context, corporate debt restructuring (CDR) mechanism assumes greater significance.

CDR is a non-statutory voluntary mechanism applicable only to standard and sub-standard assets of banks and financial institutions with high priority given to potentially viable cases. Thus, the main concern of CDR is revival of units with potential. Investments earmarked for CDR have been estimated at around 60 per cent of the total industrial investments. With huge investment and manpower involvement, it is essential to look into the eligibility criterion for inclusion in the CDR system.

As in the UK, Korea and Thailand, India, too, has developed a CDR mechanism, which ensures timely and transparent restructuring of corporate debts of viable entities affected by internal and external factors. This restructuring mechanism applies only to multiple banking accounts/syndicates/consortium accounts with outstanding exposure of Rs 10 crores and above, with banks and financial institutions. Initially, CDR did not encompass cases pending with Board for Industrial Financial and Reconstruction (BIFR), Debt Recovery Tribunal (DRT) and other legal redressal forums. Recently, however, BIFR cases with minimum cut-off limit of Rs 25 crores of aggregate outstanding exposures have been considered for CDR.

Proposals under CDR entail mainly the following:

- Extending repayment period of loans;
- Converting un-serviced portion of interest into term loans; and
- Reducing rate of interest on outstanding advances.

The CDR system has a three-tier structure: i) the CDR standing forum and its core group; ii) the CDR empowered group; and iii) the CDR cell. The CDR standing forum lays down policies and guidelines and monitors the restructuring. The empowered group decides the acceptable viability benchmark levels, and the CDR cell assists in all the functions. 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.

There are two categories of debt restructuring under the CDR system. Accounts, which are classified as `standard' and `substandard' in the books of the lenders, restructured under the first category (Category 1). If the account has been classified as standard/substandard in the books of at least 90 per cent of the lenders (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 per cent of the lenders[1]. Accounts which are classified as `doubtful' in the books of the lenders would be restructured under the second category (Category 2). In this category, if a minimum of 75 per cent (by value) of lenders satisfy themselves of the viability of the account and consent to such restructuring.

Pros

The primary advantages of debt restructuring involve matters of control and overall creditworthiness.

- **Allows a business to gain control of its finances.** With business debt restructuring, debts carrying a high interest rate can be transferred to another lender with a lower rate and potentially a prolonged payment term so that the monthly obligation is reduced.
- **Improves credit score.** Businesses have credit scores too. If restructuring is performed properly, it can actually improve those scores after a period of time. Restructuring your existing debt ensures easier debt payments. When debts are paid regularly and on time, good credit scores result.
- **Engages the help of third party.** With intervention of third party financial institutions, thereby processing large enterprise or small business debt restructuring, everything flows more smoothly and the business owner is relieved of much of the stress of debt management.

Cons

The primary drawbacks to debt restructuring involve the availability of new lines of credit and overall business image.

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[1] Corporate Debt Restructuring Master Circular dated June 28, 2006 alongwith revised guidelines on Corporate Debt Restructuring Mechanism issued by Reserve Bank of India on November 10, 2005.

- **Places a hold on new credit applications.** While business debt restructuring is underway, the first reaction of the creditors is to hold all applications for new credit to ensure that the borrower pays the existing obligations regularly after the whole restructuring process is enforced.
- **It won't look good to the public.** If the corporate house chooses to restructure its debts and the information leaks out to customers, they may assume that the corporate houses are having problems with their finances or that they are close to bankruptcy. The customers could start looking for a more stable company to deal with.

Some aspects pertaining to Assignment of Debt

Assignment of debt means transfer of debt at option of individual lenders. A lender may transfer or assign, a part or the whole of its outstanding Financial Assistance. However, if any reference is made or any Restructuring Scheme is under preparation and / or implementation, such transfer or assignment shall be subject to the following: The Lender (Transferor) giving a prior notice to the CDR Cell of the proposed transfer.

(a) The Transferor informing the intended transferee in writing of the current status of the Restructuring Scheme including any previously decided issues not subject to renegotiation. Transfer should take place before reference /admission of the case in CDR or only after four months from the date of issuance of Letter of Agreement by CDR Cell, that is, after implementation of the package.

(b) On assignment, the transferee needs to give an undertaking to abide by the package. The transferee would get the same security / rights under the package as were available to the transferor / assignor.

Plugging the loopholes

- The CDR system provides for an exit route so long as other institutional participants are prepared to buy out these loans. Once the CDR package is finalised, loan takeouts would also follow. However, banks/financial institutions would suffer some losses, as the discounting for such takeout is likely to be high, especially as the assets are actually non-performing.

- The current system provides a preventive measure to curb NPA creation in financial institutions (FIs). But the same should be a productive one leading to increased production capacities.

- The system gives more thrust to funds flow than cash flow, which depends on the market, economy and policies, and is essential for revival of an industry.

- The longer settlement period of CDR or delayed payments affects the profitability of bank/FIs. The period of settlement should be equal to the period of the measure/relief, if any, announced by the Government.

- At times, short-term funds are diverted for long-term uses and this reduces the drawing power of the company.

As such, the CDR mechanism has not proved to be that effective in redressing loan delinquency by big borrowers; it has, in fact, enhanced the losses. It is essential to review the system to make it more effective to resolve the problems.