OUTLOOK FOR STRESSED ASSETS MARKET IN INDIA

2014

ALVAREZ & MARSAL

CONTENT

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This report is an outcome of extensive primary and secondary research carried out on the Indian stressed asset market. During the course of this study we have interacted with all 14 ARCs, more than 10 banks (mix of public, private and foreign banks), several special situation investors, CDR cell attendees and a few industry experts. We conducted more than 30 interviews. As part of the study, a survey was also conducted to gauge the market trends and preferences of the players. We have not independently verified the available information contained herein. Alvarez & Marsal Holdings, LLC and its subsidiaries & affiliates (Alvarez & Marsal) and their respective shareholders, partners and employees make no representation or warranty, express or implied as to the accuracy, reasonableness or completeness of the information contained in the report. The goal of the research was to provide an overview of the current landscape of the stressed asset sector in India and establish key trends and recommendations for the industry. Sources and references have been provided in the appendix. The exchange rate used for USD 1 is INR 63.

FOREWORD

News reports in recent months have highlighted the rapid growth in non-performing assets and restructured loans in the Indian banking system. The Reserve Bank of India has underlined the rising incidence of stressed assets as a serious issue and has taken policy measures to address it.

This renewed focus can be seen as an opportunity to revisit the fundamentals of the system, and to usher in new ideas that would strengthen the foundation of India's financial systems and the economy as a whole.

As a global thought leader in the turnaround and restructuring of stressed assets, Alvarez & Marsal has always been at the forefront in assisting stressed borrowers, creditors and policy makers. We felt the need for a comprehensive study, which would address the entire ecosystem of stressed assets, including lenders, investors, promoters and industry professionals. It was with this intent that the current study has been undertaken. This report aims to outline the current status of the stressed asset market in India and present our outlook for the near future. It also brings to the forefront, the perspectives of different stakeholders operating in this field and identifies key challenges faced by them.

This report also puts forth a few strong suggestions and recommendations that address three key areas. First, the views outlined in this report could serve as a basis for setting policies and regulations at a macro level. Second, it could aid banks to successfully restructure non-performing assets (NPAs) through early identification of stress and to create structures that improve the likelihood of recovery. Finally, our recommendations could help develop meaningful exit options for lenders and improve liquidity in the market for stressed assets.

We hope this report will be of value to anyone with an interest in the stressed assets market and also to the decision makers who can genuinely influence a reversal in recent trends. As a firm, Alvarez & Marsal remains committed to further developing the knowledge in this field through its wide experience in revitalizing stressed assets.

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EXECUTIVE SUMMARY

Stressed assets in the Indian banking system have increased to an all-time high during the last few years. During the six months ended September 30, 2013, gross non-performing assets (GNPA) and restructured advances increased from 9.1% to 10.2% of total advances, adding up to over INR 6.3 trillion (USD 100 billion). Reviewing the trend of growth in the number of stressed advances, it can be seen that private and foreign banks have fared better than public sector banks in terms of credit evaluation and stressed asset management. Growth of non-performing assets (NPA) in the non-priority sector has outstripped that in the priority sectors, with the industrial sector showing the highest incidence of stress. Within the industrial sector, borrowers in infrastructure (especially power), iron & steel and textile industries have been most affected as a result of stalled projects, delayed policy decisions, economic slowdown, several macro factors related to supply and demand and mismanagement.

NPAs affect profitability of banks in two ways – first, due to loss of income and, second, due to provisioning for the loss of value of these assets. Data over the last eight quarters for the representative set of public and private banks indicates that the impact on the profitability of public banks has been more severe as compared to that of private banks. The Government of India regularly infuses capital, through equity purchases, into public sector banks to shore up depleted reserves. This lowers the ability of banks to lend to borrowers that genuinely require capital to expand their businesses, which would create economic activity and jobs. In addition, this may translate into a higher burden for taxpayers in the broader economy. Further, the systemic risk of a contagion due to large scale defaults would be disastrous for the economy.

Restructuring via the Corporate Debt Restructuring (CDR) cell and bilateral restructuring are the most favored alternatives to address stressed assets among the banks. Under the CDR cell, standard assets are restructured more often than NPAs. CDR has guidelines and is generally a time-bound process and preferred in the case of a consortium of lenders as it allows lenders to extend the maturity of loans without making provision. Borrowers prefer this route as well, as there is no impairment to the promoters' equity and the additional time affords an opportunity to grow into the capital structure. One-time settlements have been a route less travelled due to the immediate write-off that needs to be undertaken for the difference between the amount recovered and the total obligation. Between 2002 and 2005, sale to Asset Reconstruction Companies (ARCs) was a popular route among banks to address NPAs, but the poor returns from realization-linked Security Receipts (SRs) has dis-incentivized banks to use this route. Efforts taken by banks to reduce the stressed assets have not yielded the expected results due to several challenges plaguing the industry. Indicators such as slippage, which is higher for public banks than that for private and foreign banks, point to the issue of delayed recognition of stress. Easy accessibility to CDR has encouraged deferral of core issues by extending repayment schedules, while conducting fewer checks at the beginning and during the restructuring process. There is a urgent need for early recognition and management of stressed assets, robust credit appraisal, post disbursement monitoring and sound evaluation of restructuring cases. Apart from internal issues, creditors find their hands tied when enforcing changes in management at various stages. According to our survey of leading banks, bankers identified dealing with promoters as the biggest challenge in restructuring NPAs. The issue is further compounded by the lack of clear guidelines to aid a swift and successful restructuring. The other significant challenge is faced by special situation and stressed asset funds in acquiring NPAs. Dry powder of USD 3 to 5 billion is available with special situation funds for stressed asset space in India, but so far their involvement has been limited due to promoters' lack of credibility, financial irregularities, and difficulties and delays in dealing with lenders. Exit through sale of distressed assets to ARCs is also underutilized, primarily due to the large valuation expectation gap between the buyers and sellers. Current guidelines on the valuation of NPAs conducted by banks need to be improved to offer a fair valuation. Creditors also find it difficult to enforce the SARFAESI Act as a result of the legal loopholes and inordinate delays in the process.

The stressed asset situation has been under the lens of the Reserve Bank of India (RBI), the Ministry of Finance and the media over the last year. Legislative efforts in the Companies Act 2013 have been aimed at legal reforms through a National Company Law Tribunal and detailed guidelines for fast-track rehabilitation of sick companies. On 30th January 2014, RBI released a regulatory framework for early recognition and revitalization of distressed assets, which details steps for early recognition and quick action upon the first signs of stress in any account. The framework also proposes a structure to incentivize banks for faster action by way of restructuring or sale of assets. We believe that the guidelines will aid in arresting the deterioration of economic value; increase deal flow to ARCs, special situation funds and stressed asset investors. In addition, the guidelines ease the process for lenders to change the management and rehabilitate stressed borrowers, which in turn will allow these companies to survive and preserve jobs.

During FY 2014-15, proactive recognition of stressed assets through incentives and penalties, tightening of the CDR process and facilitation of change in management will help banks to address the rising number of stressed assets. Our survey suggests that special situation funds are optimistic about deploying capital in this asset class. Both banks and special situation funds foresee the need for professional support in areas such as working capital management and financial and operational restructuring. Banks expect restructuring and sale of assets to ARCs (on a cash basis) to be the preferred routes to address NPAs. Improving banks' recoveries by sale to ARCs, promoting distressed debt special purpose vehicles (SPVs), expediting legal process and tax incentives are the other steps that will aid other stakeholders in the stressed assets market in India. We have outlined our views and suggestions in detail in the later sections of this report. We believe that our recommendations would aid policy and decision makers, at a micro and macro level in dealing with stressed assets in a timely and efficient manner.

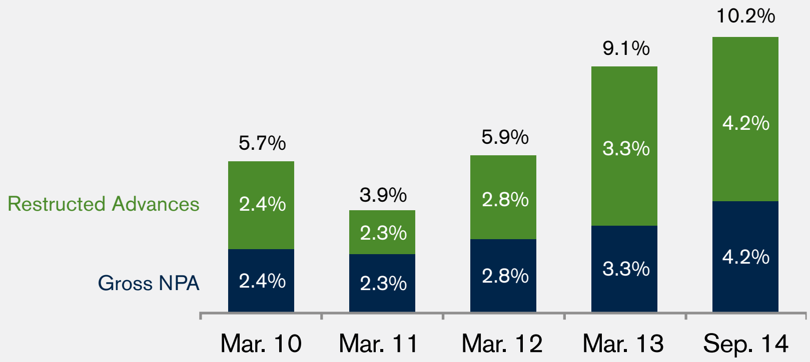
OVERVIEW OF STRESSED ASSETS MARKET IN INDIA

STRESSED ASSETS AS PROPORTION OF TOTAL ADVANCES IS AT AN ALARMING LEVEL IN THE INDIAN BANKING SYSTEM

At nearly INR 2.3 trillion (USD 36.8 billion) as of September 2013, Gross Non-Performing Assets (GNPA) in the Indian banking sector are at the highest level in recent years (refer to Figure 1). Since March 2013, this number has increased over 25%. However, the gross NPA level alone does not present a complete picture. With restructured advances adding up to nearly 6% of total advances (around INR 4 trillion or USD 64 billion), total stressed assets account for over 10% of all advances as of September 2013.

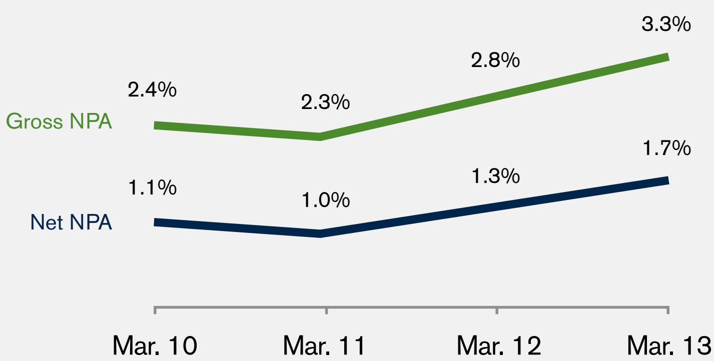
While the RBI has mandated prudential norms on provisioning of stressed assets, the actual provisioning by banks falls well short of the true quality of the assets (refer to Figure 2). Rising trend in Gross NPA and Net NPA highlights the need for revisiting the provisioning norms and methodologies.

Figure 1 - Stressed Assets as % of Total Advances



Source: RBI Database of Indian Economy, December 2013

Figure 2 - Gross NPA vs. Net NPA as % of Total Advances

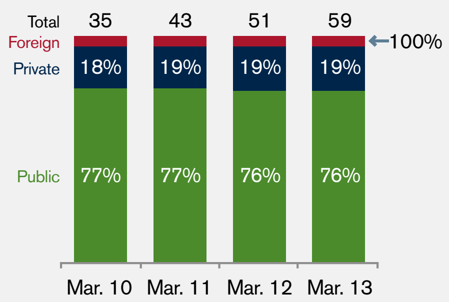


Source: RBI Database of Indian Economy, December 2013

STRESSED ASSET SITUATION IS MORE PRONOUNCED IN PUBLIC SECTOR BANKS

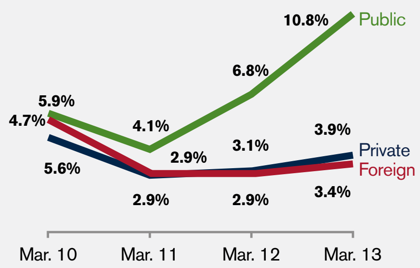
The dominance of the public sector banks in the system is evident since these banks consistently constitute over 75% of the total advances made (refer to Figure 3). However, the contribution of the public banks to the total stressed advances in the system is disproportionately high and has been on the rise during the last four years (refer to Figure 4). Factors such as slow policy descision-making, tight liquidity and a sluggish economy have contributed to this disparate performance. However, fundamentally, private sector banks and foreign banks fare much better in terms of credit evaluation and management.

Figure 3 - Bank Sector Contribution to Total Advances
INR Trillion, Percent



Source: RBI Database of Indian Economy, December 2013

Figure 4 - Stressed Assets to Total Advances for Banking Sector
Percent



Source: RBI Database of Indian Economy, December 2013

The movement in the asset quality indicators for public, private and foreign banks (refer to Figure 4) points to the importance of effective credit evaluation and policies. While PSU banks have shown a steady decline in the asset quality, private and foreign banks have managed their stressed asset portfolios better; however, the overall proportion of NPAs has been rising steadily over the last two years. Lesser number of restructured advances in private and foreign banks is an indication of concerted efforts to reduce stressed assets, rather than delaying by restructuring of unviable accounts. Regulatory measures are also effective in incentivizing active credit management as evident with foreign banks. Foreign banks are more conservative about restructuring advances when the bank's parent country has more stringent provisioning requirements (typically mark-to-market).

PRIORITY SECTOR LENDING IS NOT THE MAJOR REASON FOR HIGHER NPAs

As mandated by the RBI, banks need to meet predefined targets for lending to priority sectors such as agriculture, micro and small enterprises, education and housing, among others. As of March 2013, domestic banks were falling short of the priority sector lending target of 40% of adjusted net bank credit (refer to Figure 5 and Figure 6). Data compiled by RBI shows that for public banks, the share of priority sector in total advances is 36%, but its contribution in total GNPA is higher at 43%. However, in FY12-13, the GNPAs in non-priority sectors grew at much faster rate of 58% compared with that in priority sectors at 19%. If this trend continues, the non-priority sector GNPA can become a bigger cause of concern for public banks.

For private banks, priority sectors are a lesser cause of concern as its contribution to GNPA at 26% is lower.

INFRASTRUCTURE, IRON & STEEL AND TEXTILE SECTORS HAVE HIGH NPAs

An analysis of NPAs by sector of credit deployment reveals that at nearly 16% of advances, stressed assets are highest in the industrial sector (refer to Figure 7). Stressed asset ratios for services and agriculture are lower at around 7.8% and 6.5%, respectively. The retail loans (i.e., non-institutional) segment exhibits the best asset quality with a stressed asset ratio of around 2.5%. Interestingly, public sector banks have a relatively low share (around 16%) of their loan portfolio deployed in the retail segment as compared to private banks (~28%).

Infrastructure, iron & steel, and textiles, are the top three industries in terms of contribution to stressed assets (refer to Figure 8 and Figure 9).

Figure 5 - Priority Sector Lending at Public Banks
Percent, March 2013

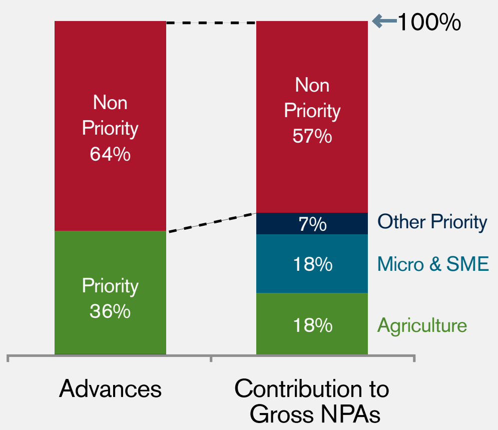
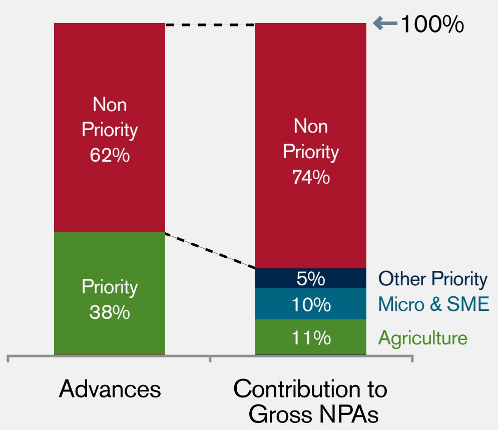


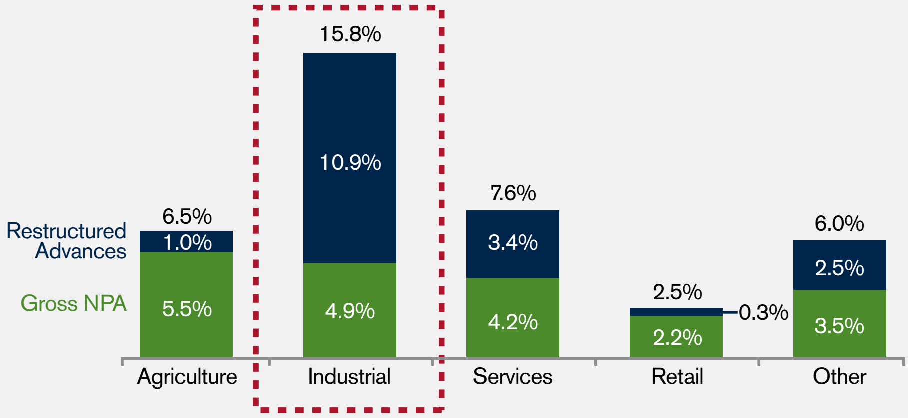
Figure 6 - Priority Sector Lending at Private Banks
Percent, March 2013



Source: RBI Trends & Progress in Banking in India, March 2013; Annual report of RBI, March 2013

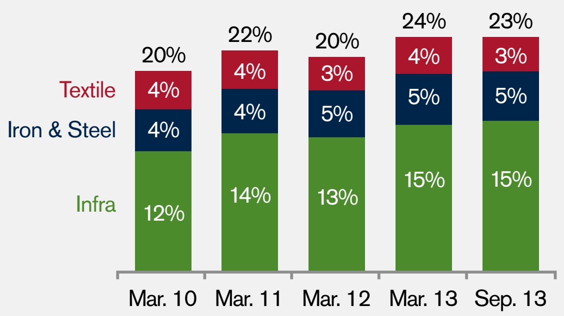
Note: Priority sector lending targets are tracked as a percentage of Adjusted Net Bank Credit, while NPAs are tracked as a percentage of advances. Although the two may not be strictly comparable, the comparison gives a fair idea of the relative asset quality of the priority and non-priority sectors within the loan portfolios.

Figure 7 - Stressed Assets as % of Total Advances by Sector
Percent, September 2013



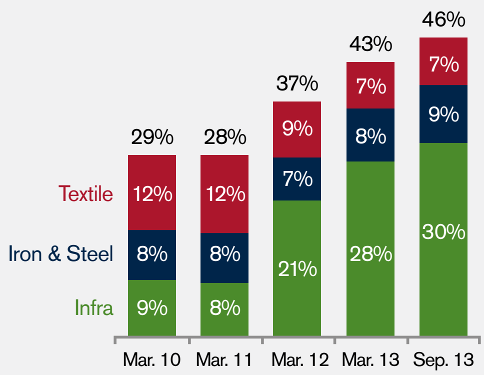
Source: RBI Financial Stability Report, December 2013

Figure 8 - Share of Top 3 Industries in Total Advances
Percent



Source: RBI Financial Stability Report, December 2013

Figure 9 - Share of Top 3 Industries in Stressed Assets
Percent



Source: RBI Financial Stability Report, December 2013

Within infrastructure, power sector forms a large segment for most of the public banks where the exposure is mainly to state-run power companies and state distribution companies. State distribution companies suffer losses across the distribution system for both technical and commercial reasons. According to a report, losses in developed countries are below 15%, whereas in India's state utilities, losses have been as high as 30%, between 2008 and 2013. About one-third of this loss is technical, but rest is given away in subsidies or on account of pilferage. Regular fuel supply is another key reason. Coal in India did not meet its production target, resulting in reliance on imports, which challenges the existing structure of power purchase agreements and tariffs designed around cheaper domestic supply.

The iron & steel sector has suffered due to supply and demand factors. The ban on mining of iron ore in key states has constrained supply and has forced steelmakers to buy iron ore at higher prices abroad. Suspension of environmental clearances and delays in granting clearances to iron ore mines has further limited supply. The industry has been plagued by factors such as power shortage, rising freight costs, ban on export of iron ore and acute slowdown in demand from the construction and infrastructure sectors.

Export demand is sluggish in textiles on the back of persistent economic slowdown in key export destinations of U.S. and Europe and continuous detoriation in India's competiveness compared to Asian geographies, such as China, Vietnam and Bangladesh. Input costs are volatile and timing / efficiency of raw material buying, receivables and inventory mangement are key liquidity determinants. The textile debt recast plan, approved by the RBI in 2012, failed as most of the textile companies have been restructured during the 2008-09 slowdown. A second restructuring would render them as NPA, depriving them of benefits under the Technology Upgradation Fund Scheme (TUFS) and increasing their borrowing costs. Hence, the scheme remained largely unutilized and textile companies opted for higher interest rate loans to stay afloat.

IMPACT OF NPAs ON BANKS' PROFITABILITY

NPAs affect profitability of banks on two fronts – first, due to loss of income in the form of interest and, second, due to provisioning of assets. The effect can clearly be seen when we analyze a sample of public and private sector banks over the last nine quarters. Looking at trends in gross NPAs (refer to Figure 10), we can see that private sector banks have maintained their GNPA at a fairly steady level with consistency in provisioning. Whereas, public sector banks have witnessed a steady rise in NPA ratios. Looking at the profitability across this sample (refer to Figure 11), the impact during this period is telling.

In Oct 2013, the government announced an infusion of INR 140 billion [USD 2.37 billion] through the preferential share allotment route to meet the credit requirement of productive sectors in the economy and to maintain the core capital in public sector banks above 8%. The government infused about INR 201 billion [USD 4.41 billion] in public sector banks in FY2010-11 and INR 120 billion [USD 2.5 billion] in FY2011-12.

Figure 10 - Gross NPA for Representative Banks
Percent

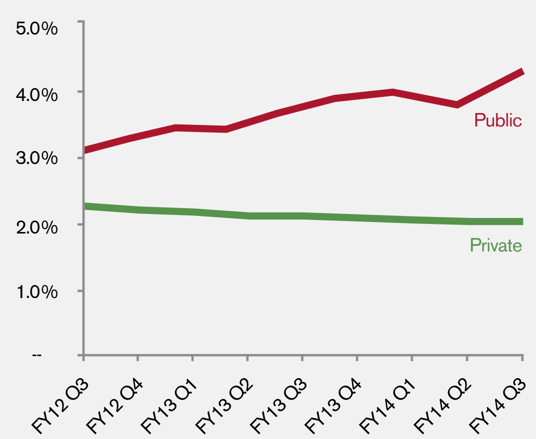
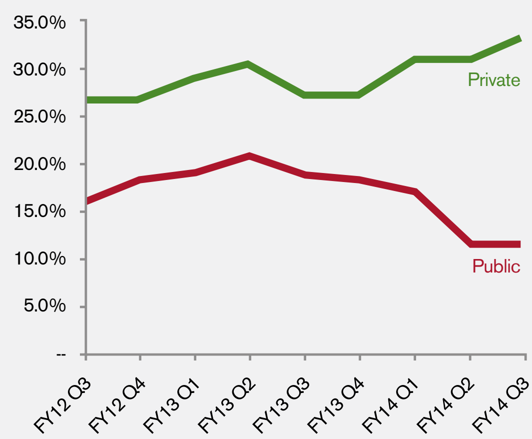


Figure 11 - Profit Before Tax for Representative Banks
Percent

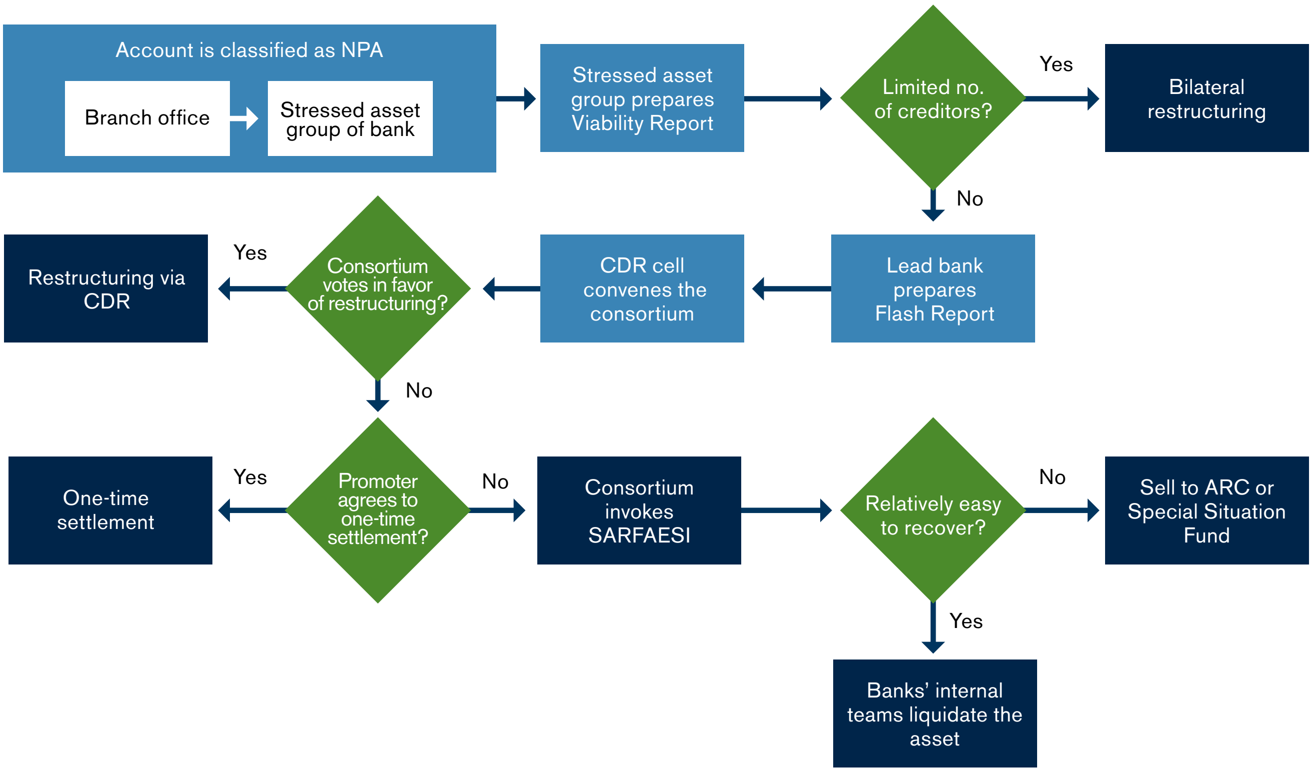


Source: Quarterly company reports

Note: PBT margins expressed as a % of total interest income; sample of banks constitute three large public and private banks in terms of advances made as of March 2013.

RESTRUCTURING ALTERNATIVES AVAILABLE TO BANKS

DECISION-MAKING PROCESS FOR BANKS



BILATERAL RESTRUCTURING AND RESTRUCTURING VIA CDR CELL ARE THE MOST FAVORED OPTION

Banks can undertake a loan restructuring for a NPA, as well as a standard asset. In line with international banking practices, RBI tightened norms for bank loan restructuring and increased the provision on new restructured standard loans to 5% with effect from June 1, 2013, as against the existing 2.75%. The RBI has also mandated that the standard loan accounts cannot retain their standard status after restructuring effective from April 1, 2015.

Typical restructuring mechanisms undertaken by banks are:

- Ballooning (reducing payouts in near term and subsequently increasing at a later stage)
- Providing moratorium on principal and interest payments
- Extending repayment schedule
- Reducing interest rate

Most banks prefer the bilateral restructuring route in case of a single or limited number of lenders, where consensus can be reached quickly as individual banks can have different restructuring plans under this mechanism.

The Corporate Debt Restructuring cell was formed to facilitate restructuring in multiple lending scenarios. Most of the public and private banks are signatories to the CDR cell. Even creditors that are not part of CDR system can join by signing on a transaction basis. As on December, 2013, 443 cases worth INR 2,893 billion [USD 49.4 billion] have been restructured under CDR cell, out of which 69 cases worth INR 526 billion [USD 9.0 billion] have been exited successfully.

Table 1 - Top Five Sectors Restructured Under CDR, December 2013

Industry	Number Of Accounts	Aggregate Debt (INR Billion)	Debt in %
Infrastructure	22	408	19.6%
Iron & Steel	45	372	17.9%
Power	15	263	12.7%
Textiles	44	196	9.5%
Telecom	5	108	5.2%

Source: CDR cell

Under the CDR cell, standard assets are restructured more often than NPAs. CDR is preferable in cases in which there is consortium of lenders, as there are well defined RBI guidelines and it is a time bound process (90 to 120 days). All creditors have to follow the same plan which is agreed by consensus (75% by value and 60% by number).

Restructuring via the CDR cell has been a popular mechanism for banks, but it has several issues. The mechanism is very procedural and in some cases certain banks in the consortium can holdout the decision-making process, which can lead to significant delays. In many cases, the CDR platform is being misused to protect the company without making any efforts to revive payments. In these cases, a restructured capital structure is not supported by cash flows and, hence, cannot lead to an effective restructuring.

ONE-TIME SETTLEMENT WITH BORROWER

When restructuring is unviable based on cash flow projections of the business, banks prefer entering into one-time settlement with promoters. Asset reconstruction companies (ARC), non-banking financial companies (NBFC) or special situation funds can also intervene at this stage and provide funds to promoters for settlement with the banks.

ENFORCEMENT OF SARFAESI

This is the final method of recovering the loan for the banks. A majority of banks issue a notice under the SARFAESI Act as soon as the loan becomes a NPA and take symbolic possession by posting a notice on the land / building as negotiating leverage with promoters. Subsequently, banks start negotiations with promoters and any one of the above routes is followed, if viable, and an agreement can be reached. However, if restructuring and one-time settlement are unviable, recovery by sale is followed, wherein the bank can either sell the asset through its internal recovery department or to an Asset Reconstruction Company.

SALE TO ARC AND SPECIAL SITUATION FUNDS

Asset Reconstruction Companies (ARCs) were formed after the enactment of the SARFAESI Act in December 2002. Currently there are 14 ARCs in India that have formed the ARC Association of India.

In 2003, selling loans to ARCs in return for Security Receipts (SR) became popular with banks. Certain banks offloaded a big chunk of NPAs from their books via this route. However, in the past few years, this option has not been exercised by the banks often due to the expectation gap in the realization of Security Receipts. Poor performance of Security Receipts has affected the industry in two ways – first, the overall deals between ARCs and banks have reduced considerably; second, more banks prefer cash sale to SRs.

Few funds are focused on the stressed asset market and the total funds available in India are estimated to be between USD 3 billion to USD 5 billion. These include global funds such as Apollo, KKR and TPG, and regional and local funds, Clearwater Capital and AION Capital.

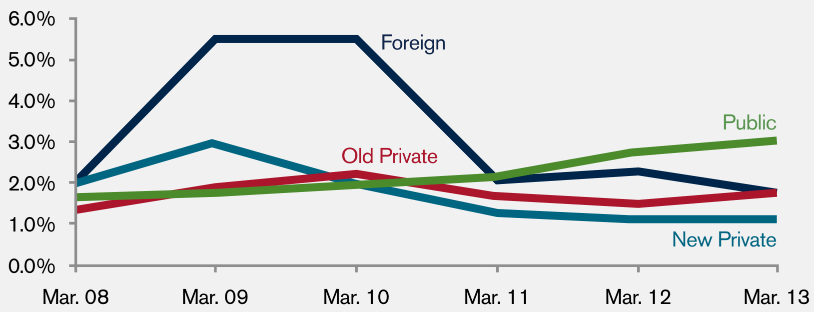
CURRENT CHALLENGES IN THE STRESSED ASSETS MARKET IN INDIA

DELAYED RECOGNITION OF STRESSED ASSET AT BANKS

The slippage ratio, fresh accretion of NPAs during the year as percentage of total standard assets at the beginning of the year, is a good metric to assess credit management. In the aftermath of the global economic crisis in FY09-10, all bank groups had similar slippage ratio, but in subsequent years, the ratio has considerably deteriorated for public sector banks considerably (refer to Figure 12). Evidently, there is not enough diligence at the time of disbursement of loans and monitoring of health of the borrower during the term of the loan.

The ability of public sector banks to manage the quality of their asset portfolio has remained weak on several accounts – a) poor credit appraisal prior to sanctioning, b) ignorance of early indicators of deterioration in asset quality, c) lack of granular data on slippages, d) absence of detailed evaluation of restructuring. There has been significant increase in indebtedness of large business groups and also credit growth has remained concentrated in segments with higher level of stressed assets (refer to Table 3).

Figure 12 - Percentage of Slippage in Bank Sector



Source: RBI presentation at BANCON 2013

Table 3 - Sectors with High Stressed Asset Ratio Percent, March 2013

Sectors	CAGR Of Credit 2009-2012	Impaired Assets Ratio (March 2013)
Iron & Steel	25%	17%
Infrastructure	33%	18%
Power	41%	18%
Telecom	28%	16%
Aggregate Banking Sector	**19%**	**11%**

Source: RBI presentation at BANCON 2013

Table 4 - Advance Related Frauds (more than INR 10 million) by Bank Group
Percent, Number

Bank Group	FY10-11	FY11-12	FY12-13	Till Date
Public	83%	84%	89%	65%
Private	15%	9%	10%	18%
Foreign	1%	7%	1%	17%
Total	**242**	**273**	**348**	**2,760**

Source: RBI presentation at BANCON 2013

Once a loan is impaired, there is a perception that the CDR process is easily accessible. It encourages postponement of the problem by allowing further time for repayment without degrading the asset rating and nominal provisioning of 2.75%. In line with the international banking process, the RBI has increased the provision on new restructured loans to 5% with effect from June 1, 2013. For the existing restructured standard assets as on March 31, 2013, the provisioning will be increased in a phased manner by March 31, 2016. Also, standard loan accounts cannot retain their standard status post restructuring from April 1, 2015. These steps taken by the RBI are in line with international banking practices; however, they will take few years to take effect.

LIMITED ENFORCEABILITY OF PROMOTER DISCIPLINE

Incidence of frauds, especially large value frauds have increased considerably in recent years (refer to Table 4). Poor appraisal systems in public sector banks and absence of equity has led to a large number of advance related frauds mainly through diversion of funds.

Through our survey, lack of credibility of promoters and disagreement on terms with promoters emerged as the top issue that banks are facing in restructuring / recovery of NPAs. Promoter discipline will not improve if CDR is too “convenient” to access or if NBFCs do not have adequate enforcement and recovery mechanisms. Also, banks need to make concerted efforts to detect financial irregularities, as they do not have the capability internally. Even after restructuring, there are limited steps that banks can take to ensure commitment by promoters to revive the company.

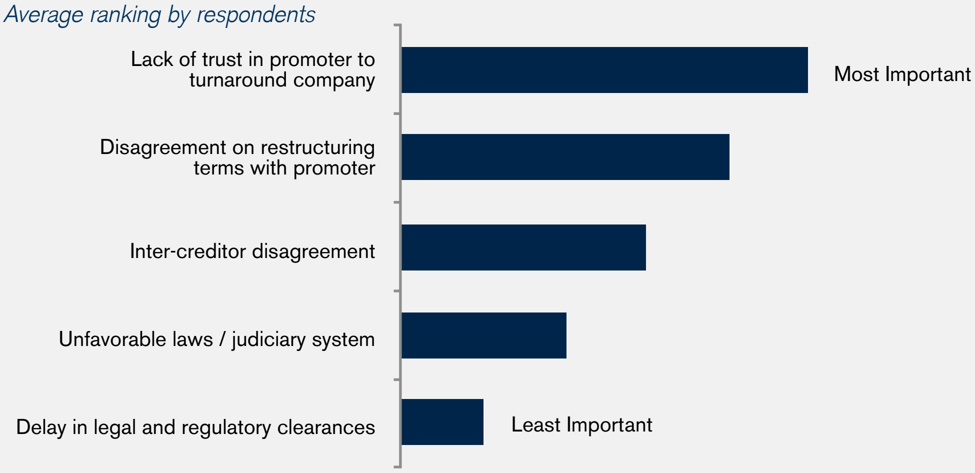
LACK OF GUIDELINES TO SUPPORT ‘SUCCESSFUL’ RESTRUCTURING

The plan proposed by promoters in CDR without validation by techno-commercial industry experts is more than likely to fail, resulting in the borrowers’ inability to meet their restructured obligations to banks. Further, most banks use the “one-size-fits-all” approach for restructuring under CDR cell without addressing the specific situation faced by the borrower. Therefore, the restructured capital structure may not be appropriate for the borrower and may lead to subsequent defaults.

TIME-CONSUMING RESTRUCTURING GUIDELINES

Inter-creditor disagreement was ranked the third most important issue, which hamper banks in the process of recovery. The CDR process can take a long time to implement, since usually no strong decision making / leadership role is possible. Since the CDR process requires the consensus of 75% of the creditors by value and 60% of the creditors

Figure 13 - Top Issues Faced by Banks in Restructuring
Average ranking by respondents



Source: A&M Stressed Asset Market Survey

by number, it has been difficult in many cases for banks to meet the requisite thresholds to approve the CDR package. Banks with smaller exposures are less incentivized to participate. Special situation funds interviewed during the course of the study pointed out that inter creditor negotiations is the biggest impediment for entry into this segment.

The CDR process does not effectively use independent experts to determine the techno-commercial viability of the companies in CDR. Financial projections provided by the management of the company and their advisors are prepared with the objective of restructuring plan being acceptable to creditors rather than being based on conservative and objective assumptions that are certain of being achieved.

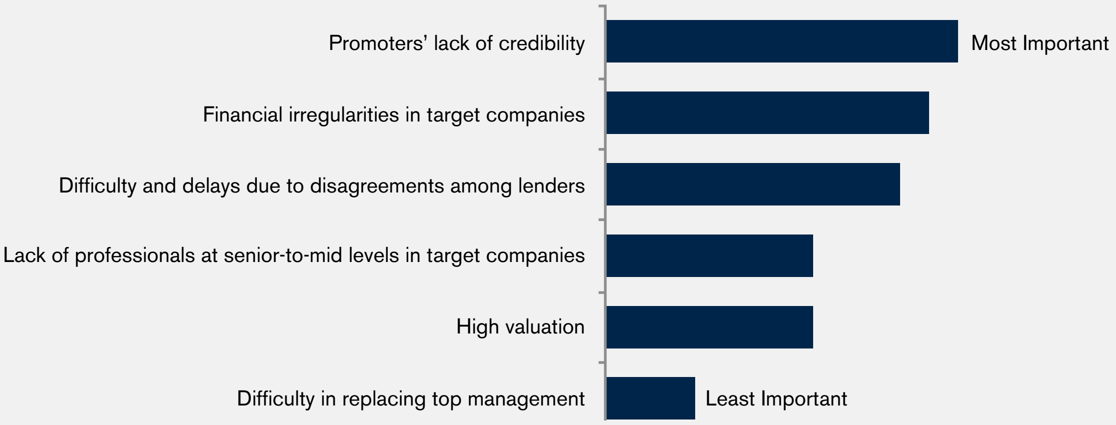
VERY LIMITED INTEREST FROM SPECIAL SITUATION AND STRESSED ASSET FUNDS

Funds consider the promoters lack of credibility, financial irregularities and alignment of multiple banks during negotiations as the biggest challenge in deal sourcing. As NBFCs are not covered under SARFAESI, enforcement is difficult; the slow legal process is another significant challenge. Funds are also averse to investing in security receipts due to poor past performance and the lack of a secondary market for these receipts.

VALUATION MISMATCH WITH ASSET RECONSTRUCTION FIRMS

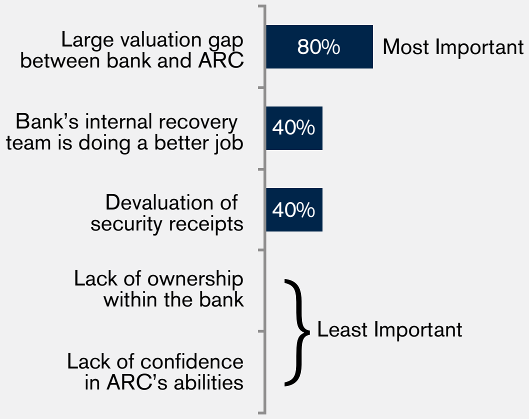
Large gap in valuation expectations was cited as the most significant hindrance by banks, as well as ARCs for lower sales to ARCs (refer to Figure 15 and Figure 16). This is mainly on two counts – quality of independent experts used by banks and vastly different discounting rate used by banks and ARCs. While banks use discount rates in the range of 10% to 15% given their access to cheap capital in the form of public deposits, ARCs use much higher discount rates of 20% to 25%, as their cost of funds is relatively higher than that of banks. Without realistic valuation guidelines, there is no incentive for private investors to participate in auctions as the reserve price tends to be high given the low discount rate used by banks vis-à-vis ARCs and private investors. As a result, banks are forced to continue holding these positions until most of their value has deteriorated, resulting in larger losses.

Figure 14 - Issues Faced by Special Situation and Stressed Asset Funds in Investing in India
Average ranking by respondents



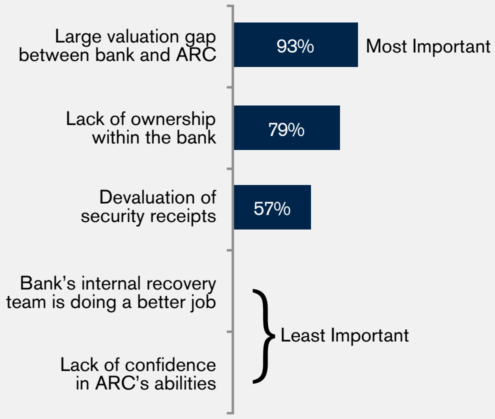
Source: A&M Stressed Asset Market Survey

Figure 15 - Reasons for Lower Sales to ARC
Percentage of respondents (Bank)



Source: A&M Stressed Asset Market Survey

Figure 16 - Reasons for Lower Sales to ARC
Percentage of respondents (ARCs)



Source: A&M Stressed Asset Market Survey

LEGAL ISSUES IN ENFORCING SARFAESI

As per Section 34 of the SARFAESI Act, civil courts are discouraged from interfering in matters related to the Act. However, the jurisdiction of civil courts is not completely overruled in view of the 'Mardia Chemicals case.' Civil courts can intervene in case of fraud or if a remedy before the DRT is not available under Section 17. The borrower has a right to challenge the sale proceedings. In case the borrower succeeds, the DRT can pass orders to cancel the auction sale proceedings, in which case, a fresh date is fixed. Promoters are increasingly relying on this route to delay the process.

RECENT DEVELOPMENTS AND 12-MONTH OUTLOOK

RECENT DEVELOPMENTS

- **Regulatory focus:** The RBI is concerned about the increase in non-performing loans at banks as slower economic growth and high interest rates make it tough for borrowers to repay debts, and stalled project approvals crimp corporate cash flows. Recently, the central bank had restrained a Kolkata-based bank from advancing loans of more than INR 100 million to any single borrower and barred it from restructuring stressed loans amid increasing concerns over the pile-up of bad loans. The RBI has initiated a special audit of another Kolkata-based lender, to assess the potential non-performing assets and 'special mention accounts' as part of its efforts to ensure that the lenders upgrade their Early Warning Systems so that timely action can be taken before more accounts slip into the NPA category.

  On January 30, 2014, RBI released a framework outlining a corrective action plan that will offer incentives for early recognition of stressed assets by banks, timely revamp of accounts considered to be unviable and prompt steps for recovery or sale of assets in the case of loans at the risk of turning bad. The RBI also proposes to permit leveraged buyouts and outlines steps to enable better functioning of ARCs. Early in February 2014, RBI also allowed banks to utilize up to 33 per cent of countercyclical provisioning buffers / floating provisions held by them as of March 31, 2013, for making specific provisions for non-performing assets. This is the first time that the RBI is allowing banks to utilize these contingency provisions that were created in 2010.

  We believe that the guidelines will lead to early recognition of stressed assets and facilitate active steps by banks, instead of the current reactionary response. Changes in the CDR process will aid speedy restructuring under specific timelines, leading to lesser degradation of the economic value of assets. The proposed changes will offer a much required breather to other stakeholders by helping increase the deal flow to ARCs, special situation funds and stressed asset investors. Most importantly, the new framework will take the Indian banking industry to the next level by easing the process of change in management by lenders to rehabilitate stressed companies, which in turn could potentially help save innumerable jobs.

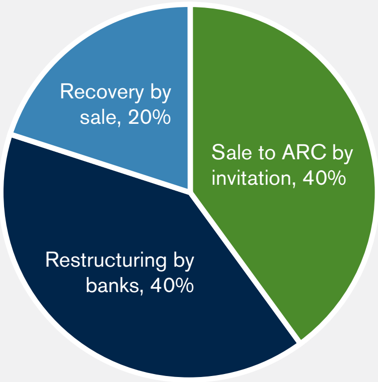
- **Companies Bill, 2013:** Under the Companies Act, 2013, the National Company Law Tribunal (NCLT) is being set up to bring all lawsuits pertaining to companies under a single body. The NCLT will have 12-to-13 benches in different parts of the country and will have a judicial and technical team. High court judge for a period of five years will be eligible to be the president of the NCLT. The addition of technical and experienced judicial teams will lead to better interpretation and application of laws.

- **Banks are more receptive:** Recently, a few banks have been advocating for changes in management at companies that are NPAs or are under corporate debt restructuring packages. Banks are also open to engaging turnaround and restructuring firms.

A&M SURVEY FINDINGS – 12-MONTH OUTLOOK

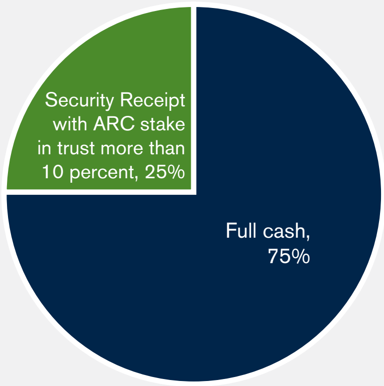
Banks opted for Restructuring and Sale to ARC by invitation to be the most preferred route to address NPAs. Banks are also expected to sell NPAs to ARCs primarily via cash deals.

Figure 17 - What Will be the Most Preferred Route for Banks to Address NPA?
Percentage of respondents



Source: A&M Stressed Asset Market Survey

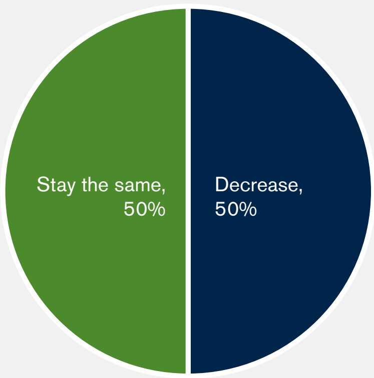
Figure 18 - What Will be the Most Likely Mode of Sale of Assets to ARC?
Percentage of respondents



Source: A&M Stressed Asset Market Survey

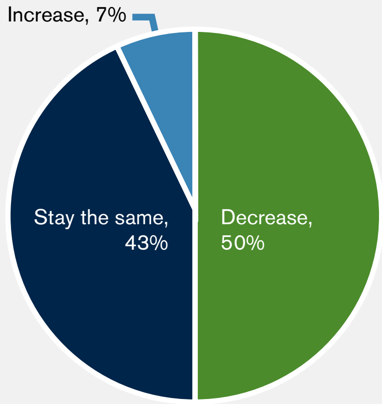
There is no clear consensus between banks and ARCs on valuation gap between both the parties.

Figure 19 - What is Your Bank's 12-month Outlook on Valuation Gap with ARC?
Percentage of respondents



Source: A&M Stressed Asset Market Survey

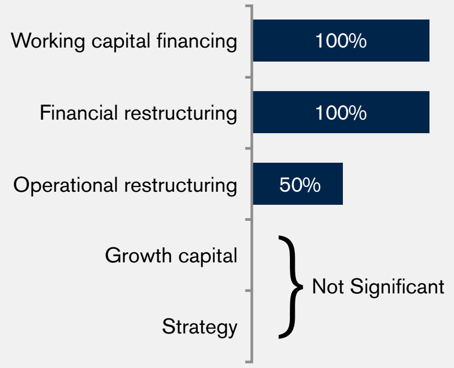
Figure 20 - What is Your ARC's 12-month Outlook on Valuation Gap with Bank?
Percentage of respondents



Source: A&M Stressed Asset Market Survey

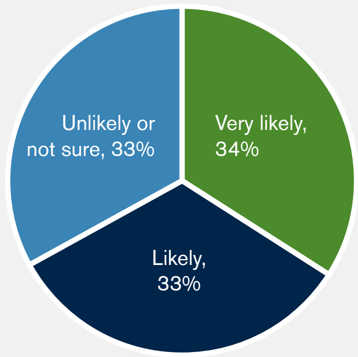
Special situation and stressed asset investors are positive about investment in this space. Financial restructuring, working capital financing and operational restructuring are the top three areas which investors expect will require support.

Figure 21 - Expected Areas of Support Required by Special Situation and Stressed Asset Investor
Percentage of respondents



Source: A&M Stressed Asset Market Survey

Figure 22 - Likelihood of Engaging Professional Restructuring Firms
Percentage of respondents



Source: A&M Stressed Asset Market Survey

SUGGESTIONS AND RECOMMENDATIONS

PROACTIVE RECOGNITION OF NPAS – INCENTIVES AND PENALTIES

There is a strong need for the banking system to recognize signs of non-performance early and to take prompt steps towards restructuring and recovery of stressed assets. 50% of the banks that participated in the survey estimated the average holding period for NPA to be over four years; another 25% pegged it between 2-to-4 years.

The RBI's recent "Framework for Revitalizing Distressed Assets in the Economy" (Framework) proposes a few important changes – including formation of lender's committee with timelines to agree to a plan for resolution, incentives for lenders to agree collectively and quickly to a plan and a penalty in the form of accelerated provisioning in case an agreement cannot be reached, among other measures. The following additions will further aid the process of timely recognition and effective resolution.

- Time required for rectification should be prescribed so that in case the option is not viable, the lenders committee can timely explore other options (i.e., restructuring / recovery) to avoid accelerated provisioning.

- To ensure that the lenders committee reaches early consensus, the Joint Lenders Forum (JLF) decision threshold should be revised to 60% in terms of value and 51% in terms of numbers (as against the Framework's 75% by value and 60% by number). Further, if any lender does not cooperate or participate in the meetings, the said lender should not count in the consensus estimation, and should attract a negative supervisory view. This would reduce the problem of banks 'holding out' and speed up the process.

- Greater incentives, such as tax breaks, should be provided to borrowers / promoters that initiate rectification under the Special Mention Account (SMA) classification, as defined by the RBI, at the first signs of incipient stress.

- Imposition of higher degree of penalties for borrowers / promoters that do not cooperate with lenders. The Framework proposes higher interest costs for subsequent borrowing, but this should include measures that will drive borrowers / promoters to cooperate with lenders such as (i) declaration as a willful defaulter (which will shut borrowers / promoters out of the capital markets), (ii) transfer of promoter shares to an escrow account until a turnaround takes place (which will enable a change of management) and (iii) loss of the ability for borrowers / promoters in default to file civil suits (which only serve to delay recovery efforts by lenders).

TIGHTENING THE CDR PROCESS

- **Tightening the Terms of Restructuring:** The terms of restructuring should be shortened. The period prescribed under the CDR Guidelines and the CDR Master Circular is currently 10 years (for non-infrastructure loans) / 15 years (for infrastructure loans) – this should be changed to 3 or 5 (for non-infrastructure loans) / 5 or 7 years (for infrastructure loans).

- **Better Evaluation of Restructuring Viability:** Techno-Economic Viability (TEV) reports by accredited industry experts (not only finance and accounting professionals) should be relied upon for validation. The restructuring plan itself must be based on the borrowers' projected feasible cash flow, taking into account industry fundamentals, risks and an objective assessment of the borrowers' ability to meet obligations. Rather than adopting a standard approach to restructuring, the revised capital structure should be customized to suit the borrower's specific situation and address the real threats to successful resolution.

- **Decision-making Process to be Made Easier:** The banks with higher exposures should be given more power to drive the decision-making in the CDR process for all matters other than the requirement to make further disbursements. There should be a defined time frame within which proposals are required to be cleared by participating banks (say 45 days), failing which the package would be deemed approved (except for any obligation to make further disbursements).

- **Monitoring / Approval of Independent Valuers:** Currently, the CDR Guidelines require that the CDR can only be undertaken if the viability parameters are met. The RBI discussion paper proposes that for an aggregate exposure of INR 5,000 million and above restructuring package should be subject to evaluation of an Independent Evaluation Committee (IEC) of experts. This is an important recommendation and should be accepted at the outset.

- **Milestones to be Prescribed and Met:** The CDR process should include milestones designed to test the success of the restructuring. Some basic parameters and recovery milestones should be laid down (e.g., regularity in debt servicing, cash flow targets to be imposed, sale of non-core assets, etc.) as part of the CDR package. If the milestones are not met, it would lead to accelerated provisioning requirements for banks. Testing of such milestones can be outsourced to a panel of approved independent agencies.

- **Eligibility to be Tightened:** Borrowers should not be permitted to undergo CDR more than once. Further, CDR restructuring should be permitted only if banks obtain (i) 100% pledge of promoter's and promoter group's shareholding in the borrower, or (ii) 51% of the total shareholding of the borrower, whichever is lower. Banks would, therefore, have the unfettered ability to change ownership and management, if CDR restructuring fails and this would incentivize the promoter to ensure that the CDR package is complied with. For new loan sanctions, banks should be encouraged to act as a consortium and act collectively, particularly with respect to obtaining a pledge of promoter's shareholding as security.

- **Promoter Support to be Strengthened:** The current CDR Guidelines require guarantees from the promoter, but often the guarantees are not backed by adequate net worth of the promoters. The provisions in relation to the promoter's support should be strengthened. One option is for the banks to require additional security / non-disposal of undertakings, in relation to personal property, to ensure that the personal guarantees of promoters remain valuable.

INCENTIVES / DISINCENTIVES TO ALIGN BANKS FOR QUICK RESOLUTION TO PRESERVE VALUE

- **Ensuring Adequate Provisioning:** The RBI can incentivize banks to undertake additional / accelerated provisioning, for example, by allowing banks to amortize the provisioning over a period of time, so that the banks eventually have adequate provisioning for distressed assets. If the banks are required to undertake higher provisioning, it will compel them to explore options such as the sale of NPAs, since continuing to hold such stressed assets will be less attractive.

- **Incentives by Way of Relaxation in Provisioning Norms:** Banks should be allowed the benefit of less stringent provisioning, if they take effective steps towards resolving the NPA and rehabilitating the company by implementing a change in management (as set out below).

ENABLING / FACILITATING CHANGE OF MANAGEMENT

- **Ability to Enforce and Change Management:** Banks should have the unfettered ability to change ownership and management if CDR restructuring fails. This would also operate as an incentive to the promoter to ensure that the CDR package is complied with. Banks should be encouraged to act as a consortium and act collectively, particularly with respect to obtaining a pledge of promoter's shareholding as security, and facilitating change in the company.

- **Enforcement / Exemption of Pledges:** Banks should be allowed to enforce pledges of a borrower's capital when the account is an NPA, by way of a sale of the pledged shares to third parties (so that banks do not become owners of such shares and are not required to show such investments in shares on their own balance sheet). It could be provided that such sale should usually be undertaken through an auction process. The new investor who purchases the shares and takes over control of the borrower would have to then comply with the requirements under the CDR regulations (for instance, in relation to promoter personal guarantees) and to ensure that the borrower complies with the milestones in the CDR package. The pledge can be exempted from the ambit of capital market exposure limits when the pledge of promoter shareholding is obtained either through the CDR process or at the time of new sanction.

- **Acquisition Financing to be Permitted in Some Cases:** Banks should be permitted to provide acquisition financing in the limited context of permitting financing, when banks have decided to implement change in management through the CDR process. The new investor who purchases the shares and takes over control of the borrower would have to then comply with the requirements under the CDR regulations (for instance, in relation to promoter personal guarantees) and to ensure that the borrower complies with the milestones in the CDR package.

IMPROVING THE RECOVERY BY SALE TO ARC

- **Streamlining the Auction Process:** Many ARCs were concerned that banks are using the auction process as a price discovery mechanism and not for actually selling assets, which is also evident from the low success rate of auctions. The RBI Framework mandates banks to disclose a reserve price and mandatory sell account if the bid received is more than the reserve price. This will help in more deals through auctions and will also generate interest from secondary investors like distress asset funds which can participate via ARCs.

- **Defining the Valuation Guidelines:** To reduce large gaps in the valuation expectations of bank and ARCs, the RBI or Indian Banks' Association and ARC Association should define valuation guidelines. At present, the guidelines for each bank are different and may not take into account all the factors. Specific guidelines should be provided to banks for determining their reserve price for the sale of NPAs. These could include a trailing 12-month EBITDA multiple, using an appropriate discount rate given the borrowers distressed situation (and TEV projections based on accredited industry experts), using accredited third-party valuation firms for asset (current and fixed) sales taking into account the time required to monetize these assets.

- **Developing a Secondary Market for Security Receipts:** Establishment of a secondary market for security receipts will improve liquidity and attract special situations funds and qualified institutional investors towards this market.

- **Incentivizing Early Sale of NPAs:** The RBI has allowed banks to spread any shortfall due to the sale of an NPA, to be spread over two years. Increasing this window to three years will allow more banks, especially smaller ones, to treat this as a favorable alternative to transferring these assets to ARCs and other funds.

DISTRESSED DEBT SPVS / STRUCTURES

- **Relaxation in Accounting Norms:** The RBI should consider providing differential treatment in accounting norms for certain investments, such as notes / securities issued in relation to NPAs, by investors who have purchased such NPAs. The accounting treatment for such investments should be the same as the accounting treatment for loans.

- **SARFAESI Rights for Distressed Debt SPVs:** Further, such companies / vehicles that purchase distressed debt and manage and rehabilitate the borrower should be extended statutory recovery and enforcement rights (SARFAESI) over the security in relation to such borrower.

- **Free Flow of Capital for Distressed Debt SPVs:** The RBI should consider allowing free flow of foreign capital into such companies / vehicles, solely for the purpose of rehabilitation of distressed debt. This would enable better funding and allow banks more options to offload NPAs, while continuing to have the benefit of some upside.

OTHER IMPORTANT REQUIREMENTS

- **Tax Incentives:** Favorable tax treatment for purchase and sale of distressed debt should be introduced to incentivize revitalization of capital.

- **Expediting Legal Process:** The Company Act of 2013, provides for the constitution of the National Company Law tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT). NCLT is expected to be operational by April 2014, and is expected to ease the legal process if it is adequately manned by qualified judges and operates in a tight time-bound manner, given the serious economic deterioration due to delays in stressed situations.

APPENDIX

OVERVIEW OF ASSET RECONSTRUCTION COMPANIES (ARC)

ARCs were formed after the enactment of the SARFAESI Act in December 2002. Before this act came into existence, lenders could enforce their security interests only through courts, which was a time consuming process. After the establishment of the Act many Asset Reconstruction Companies (ARCs) were formed, ARCIL being the first of them. Currently, there are 14 active ARCs which have formed the ARC Association of India.

STRUCTURE OF ARC

The SARFAESI Act allows banks to transfer NPAs to ARCs, which can take measures for recovery. It also allowed ARCs to issue Security Receipts linked to the recovery from the underlying assets.

ARCs can form trusts that acquire NPAs from banks and financial institutions. The maximum life of these trusts can be five years, which is extendable up to eight years, with the board's approval. ARCs, seller banks and any other qualified institutional buyers can invest in these trusts and are issued security receipts (SRs) for their investment. When trusts acquire an NPA, it becomes the legal owner of the asset and security receipt holders become its beneficiary. As per the regulations, an ARC has to make a minimum of 5% investment in the trust. The trust redeems money to the investors as per the recovery from underlying assets and the SRs are rated by external agencies and quarterly NAVs are published.

ARCs can also take an asset-specific approach, especially in the case of large assets. The trust scheme allows them to make a portfolio of assets and aggregate debt and assets from different banks.

SOURCES OF REVENUE FOR AN ARC

Income: Surplus generated from recovery, over the acquisition cost of

- Management incentive: Typically, ARCs keep 20% as management incentive and the rest is distributed to holders of security receipts.
- Investment in Security Receipts: An ARC has to hold minimum of 5% in the trusts; hence proportionate income is generated from recovery.
- Management Fee: Fee for managing the trust, generally varies from 0.5% to 2% of assets under management (AUM).
- Advisory Fee / Commission: ARC advice companies on restructuring and banks on recovery; commissions from bank can also be linked to the actual realization.

DEAL TYPES AND PREFERENCES

ARCs can either participate in a bank auction or acquire assets through bilateral discussion with banks. Preferences for acquisition mode and asset types vary across ARCs.

Preferred Acquisition Mode	Number Of ARCs
Bilateral Discussions	8
Both Bilateral and Auction	3
Auction (primarily cash)	2
Auction (primarily security receipts)	1

Preferred Deal Type	Number Of ARCs
Corporate	12
Retail	2

EXIT STRATEGY OF ARCS

Exit options for ARCs can be placed in two broad categories:

Sale of assets

- Sale of assets by invoking SARFAESI (hostile)
- Sale of assets with the promoter's support
- Delayed sale after giving the promoter time for turnaround

Recovery through restructuring

- Long-term restructuring, recovery by cash flows
- Long-term restructuring, recovery by one-time settlement

Preferred Exit Route	Number Of ARCs	Estimated Time Taken
Restructuring Preferred (for >50% accounts)	3	2-6 years
Sale of Asset Preferred (for >50% accounts)	6	1-4 years
Indifferent (equal number of accounts)	2	–
Not Known	3	–

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