Note

RBI's report on restructured loans shirks the issues

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Note

While most of the recommendations of the Mahapatra Group fail to address the seriousness of the issue, the RBI may accept the recommendations and banks may happily use restructuring to keep their NPA levels cosmetically low.

The report of a Reserve Bank of India (RBI) working group to review the existing prudential guidelines on restructuring of advances by banks/financial institutions, under the chairmanship of B Mahapatra (Mahapatra Group) submitted its report on the 18th July[1]. The report shirks the problem of bludgeoning NPAs (non-performing assets) in the banking system piling up as restructured loans and suggests solutions which are short term in nature for a problem that is long term—quite like an ostrich burying its head to avoid a danger.

What are restructured loans?

Restructuring of loans happens when large corporate borrowers are unable to pay their loans on time, and they seek the loan to be restructured. Restructuring would mostly involve rescheduling of the loan payments, granting more time to the borrower. This is usually done by making a case that the loan is inherently sound, but that the cash-flows of the borrower cannot meet the current schedule of payments.

Where the company in question is a large borrower and has borrowed from various banks under multiple or consortium lending arrangements, the restructuring proposal has to be forced on all such banks, and hence it goes to a common body of banks called the CDR (corporate debt restructuring) Cell. If the loan is from a single bank, the bank may obviously enter into a mutual arrangement with the borrower to restructure the loan. Prima facie, restructuring is done in response to the weakness of the loans—therefore it is quite obvious that a restructured loan is not a healthy loan. However, RBI norms provide that if banks restructure a loan before it becomes an NPA, it is still treated as standard, meaning it does not have to be treated as a non-performing loan. The only consequence is that there is a higher provisioning requirement of 2% in case of restructured loans. This compares with a minimum 10% provisioning required in case of NPAs.

[1] (http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/WRPN180712FL.pdf)

The tsunami of restructured loans:

At the present moment, there is a deluge of restructuring proposals piling up with banks. Many large corporates in core sectors such as steel, infrastructure, tourism, etc are queuing up before the CDR Cell. The reasons are quite obvious—cash-flows out of core sector projects are stuck, and in any case, lots of entities had over-leveraged themselves.

The RBI's Financial Stability Report of June 2012 was at least candid to admit the bludgeoning position of restructured loans. It showed that the growth rate in restructured advances is nearly three times the growth rate in corporate advances. While banks in India have happily been reporting a reduction in NPA levels, the Financial Stability Report shows that even if 15% of the restructured loans ultimately slip into an NPA category, the NPA levels will be higher than what they were before the global crisis of 2007.

In fact, the situation may be worse than what is shown in the RBI report. First, because it assumes a slippage rate of 15%, whereas, in reality, the rate of fall from restructured to NPA category may be much higher. In fact, the Mahapatra Group itself has said that in stress scenarios, the slippage may be 30%-40%. Second, because the figure of restructured loans taken by the RBI Report is as of 31st March 2011, after which there is substantial surge in the number. In fact, even if one picks up the number on 31st March 2012, the number available on the CDR cell website (which, euphemistically, is called CDR Progress Report) is 292 cases involving Rs1,50,515 crore of debt (http://www.cdrindia.org/statistical.htm). Let us not forget that this number is not all—there are loads of loans that are restructured without coming to the CDR Cell, and lots of SME loans that also go for restructuring.

The working group proposals:

Sure enough, a bank cannot prevent a loan from getting into problems. Quite often, this happens due to what is called a "systemic crisis"—that is, macroeconomic factors cause a wide-spread downturn. For example, the Eurozone crisis is a systemic crisis. India has not had any such crisis over the last few decades—therefore, whatever loans have gone bad have gone because of bad lending decisions. Borrowers tend to over-leverage, or banks fix repayment terms that are unrealistic.

When loans become weak, banks may have to restructure the loan to realign the loan terms to the cash-flows of the borrower. When a loan is restructured, the loan is said to have become 'impaired'—that is, its value is adversely affected. The lender is required, as per mandatory accounting standards, to write off an impairment loss when an asset becomes impaired. In case of loans, the impairment loss is the present value of the loan before restructuring, and the present value after restructuring.

One of the key issues before the Mahapatra Group was provisioning requirement. While it does recognise that the best practice, as internationally followed, is to create an impairment provision, "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". This is like saying that to incentivise banks to continue to restructure loans, we must continue to keep a cover on the provisions—almost like a doctor should not prescribe a bitter pill as that does not taste good and would disincentivise the patient.

The Mahapatra Group recommends the rate of provisioning be increased 2% to 5%. In fact, this is a straight-jacket provision and does not take into consideration the real depletion in the fair value of the loan due to restructuring. The sacrifice involved in the restructuring might be more than 5%, or may be less than 5%. A straight 5% provision disregards the impact of restructuring.

Most of the other recommendations also fail to address the seriousness of the issue at stake. For example, the Mahapatra Group makes recommendations about conversion of debt into preference or equity shares, cautioning that banks should only exceptionally convert their debt into preference shares. Preference shares are a non-voting as well as subordinated instrument. Conversion into, as an option, needs to take a futuristic look at the turnaround of the entity, and may be an excellent kicker. However, these are strategies which need to be exercised with great degree of caution. Making any list of rules for the action on the part of banks is like missing the intricacy of the point altogether.

In short, it may be likely that the RBI may accept the recommendations of the

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Mahapatra Group and banks may happily use restructuring as the device to keep their NPA levels cosmetically low.