Insolvency and Bankruptcy Hotline

July 11, 2017

STRESSED ASSETS: REGULATORS INITIATE TOUGH MEASURES

- RBI intervenes to direct immediate resolution of 12 NPAs.
- Significantly tougher provisioning norms for banks expected.
- SEBI rolls out exemptions from Takeover Code to facilitate transfer of distressed assets under the IBC.

BACKGROUND

- The volume of stressed assets in the banking system in India has been at an all-time high. India ranks at 130 out of 190 countries in the "*Doing Business*" rankings of 2017 which are prepared by the World Bank. Much of this has been due to the inefficient mechanism of resolving insolvency in India. The Government has been keen to implement measures to tackle these inefficiencies and streamline the processes surrounding insolvency resolution.
- Last year, the Government notified The Insolvency and Bankruptcy Code, 2016 ("**IBC**") which consolidated all insolvency laws in India into one comprehensive code for both corporate and individual debtors. Suitable amendments and repeals were made to existing legislations, most notably subsuming the winding up proceedings of the Companies Act, in order to streamline and consolidate the existing framework around insolvency and bankruptcy. The IBC provides for 180 days (plus a possible 90 day extension) for completion of resolution proceedings. If the resolution proceedings fail or are not completed within the stipulated timeline, then the debtor goes through liquidation proceedings.
- Despite such measures for facilitating insolvency and bankruptcy, banks were using their discretion to refer only those accounts for resolution proceedings which they deemed fit. This was because there is nothing in the IBC to ensure that applications are made to it by the banks or other creditors in the first. It was in this context that The Banking Regulation (Amendment) Ordinance, 2017 was promulgated by the President of India ("**Ordinance**"). The Ordinance amended the Banking Regulation Act, 1949 and gave extensive powers to Reserve Bank of India ("**RBI**") to issue directions to banks for resolution of stressed assets *(we have analysed the ordinance in our hotline earlier[1])*. The current intervention by RBI comes in the wake of the Ordinance and the background mentioned above.

MEASURES TAKEN

- The RBI via press release dated June 13, 2017 has stated that it has identified 12 accounts which are to be referred for Insolvency Resolution Proceedings ("**IRP**") under the IBC. These accounts total approximately 25% of the total gross non-performing assets (**"NPAs**") in the banking system but were not referred for IRP by the banks under the IBC.
- The RBI has further directed all the banks to refer the accounts with fund and non-fund based outstanding amount greater than INR 5000 crore, with 60% or more classified as NPA as of March 31, 2016 for IRP under the IBC. As regards the other NPA, which do not qualify under the above criteria, the RBI has recommended that banks should finalise a resolution plan within six months. If such resolution plan is not viable or not agreed upon within six months then banks will be required to file for insolvency proceedings under the IBC.
- In relation to provisioning, a report[2] of the Economic Times has stated that RBI, through an internal communication, has asked banks to provision 50% of a secured loan and 100% of an unsecured loan of a debtor once an IRP is instituted against it. Further, 100% of such loan will have to be necessarily provisioned if the IRP fails and the debtor goes into liquidation. Earlier banks were only supposed to provision 100% of the outstanding loan amount for certain types of NPAs like doubtful assets which have remained doubtful for more than three years and loss assets.[3] It seems this change would prove to be a major deterrent for the bank to refer an debtor or NPA for IRP as such an action by bank would mean that they will have to necessarily undertake higher provisioning.
- The Securities and Exchange Board of India ("**SEBI**"), in a move directed towards faster resolution of stressed assets in India, has proposed via a press release dated 21 June,2017 that acquisition of shares of a listed company which is in distress by an investor would be made exempt ("**Exemptions**") from preferential issue requirements under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR**") and from open offer obligations under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Code**"). Presently, relaxations from preferential issue requirements under ICDR and open offer obligations under the Takeover Code are only available to lenders in cases where listed companies are being restructuring through restructuring schemes provided under the guidelines of RBI like the Strategic Debt Restructuring scheme. This has led to a situation where every time the lender proposes to divest the shares of such listed company to an investor, the investor has to make a mandatory open offer which has the effect of reducing funds available for investment in the company. By way of the Exemption, SEBI wishes to attract investors for acquisition of listed companies in distress and reduce the burden of the lenders by way of facilitating their divestment from such assets. However, the Exemption will be subject to certain conditions like approval by the

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shareholders of the listed company by special resolution and lock-in of their shareholding of the investor for a minimum period of three years.

HURDLES

- An issue which has not been addressed by the recent spate of amendments and enactments is the role played by corporate debtors in delaying NPA resolution. A majority of businesses in India remain under the control of their founding promoters. A review of the 12 cases mentioned earlier that have been selected for resolution by the RBI confirms this position. In order to effectively formulate or implement a resolution plan, the creditors and the IRP would require the ongoing involvement of promoters, which makes them a key stakeholder in any NPA resolution.
- Recently, Essar Steel has filed a Writ Petition in the Gujarat High Court challenging the alleged arbitrariness of the RBI in selecting stressed accounts for initiating insolvency proceedings under the IBC. It appears from the order passed by the Court that the NCLT has been directed to adjourn the bankruptcy proceedings till the High court passes further orders on July 7, 2017. This might delay timelines and proceedings before NCLT. Other debtors may take advantage of this order and this may serve as a precedent in other unconnected cases as well.
- However, it is important to note that although an executive order / direction of RBI appears to have been challenged by Essar and not the merits of the NCLT proceedings itself, the appointment of the IRP has also been contended to be prejudicial to the interests of the Company.
- The purpose of appointing an IRP is to ensure that the assets of a Corporate Debtor are preserved for the benefit of creditors and that there is an independent single point authority which can coordinate between the creditors to formulate a resolution plan. It will be a difficult to enforce the IBC if the functioning of an IRP is interfered with by Courts. Maybe, aggressive litigation by creditors and dilatory tactics by debtors are counterproductive and both, would need to be discouraged.

ANALYSIS

- The IBC has been hailed as a game-changing legislation by industry experts, as before IBC, there was no single law which was binding on all creditors (operational and financial). There were a lot of laws and routes which could be taken by creditors to recover money from debtors. However, none of the mechanisms in place were efficacious enough to be able to salvage a respectable amount of the stressed asset, i.e. on average, only 20% of the value was recovered from NPAs in India.
- Also, none of the laws in place for insolvency and bankruptcy provided for a time bound or consolidated solution for all the parties concerned. For example, the process of winding up under the now abrogated Companies Act, 1956 used to take around 10 years. Further, to make matters worse, the management of corporate debtors was not vested with the creditors once the insolvency process was initiated.
- This move by the RBI along with the Ordinance and the SEBI Amendment shows the seriousness of the Government towards the ease of doing business in India narrative and building confidence amongst investors in India. In fact, these recent steps are not isolated steps taken by the Government towards this end, similar initiatives can also be seen in other changes brought about by the Government:
- The Financial Resolution and Deposit Insurance Bill, 2016 has been tabled in Parliament. It deals with resolution of financial service providers recognising the systemically important role they play in the economy. It provides for a corporation to be set up which will periodically review performance of financial service providers and provide resolution of such financial service providers if needed within 2 years. If such resolution fails, then it provides for liquidation of such financial service provider.
- By way of a recent amendment in Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI**"), the Government has made Non-Banking Financial Companies and holders of listed debt securities as eligible lenders for the purposes of SARFAESI which means that they can now attach and auction property of a debtor in default without a court order.
- The Ordinance has clearly given RBI more teeth to ensure compliance with the various guidelines aimed at revitalising the stressed assets in the economy. By way of identification of these 12 bank accounts, it has sent out a stern warning to the banks that if they don't act well within time then RBI will take matters in its own hands.
- While the Government is busy doling out such regulatory changes, it will be interesting to see if the National Company Law Tribunal will be able to ensure appropriate level of cooperation in resolving these high risk accounts within the strict timelines as provided under the IBC.

CONCLUSION

These changes signify a metamorphosis in the debt recovery mechanism in India. In fact, the first ever resolution plan under the IBC has been approved by the committee of creditors for Hyderabad based company 'Synergies Dooray Automotive Limited' in only about 5 months and will be submitted to the NCLT shortly. This shows that the resistance put up by debtors against the completion of insolvency proceedings in effectively being handled by mechanisms in force under IBC. The ability to recover debt in a timely manner will not only revitalise the debt market but will also have a positive cyclical impact on equity inflows. Investors should be excited more than ever before to invest in India knowing that their money is safe.

– Vinay Shukla, Arjun Gupta & Ruchir Sinha
You can direct your queries or comments to the authors

[1] *See* https://nishithdesai.com/SectionCategory/33/Insolvency-and-Bankruptcy-Hotline/12/31/InsolvencyandBankruptcyHotline/5017/2.html

[2] *See* http://economictimes.indiatimes.com/industry/banking/finance/rbis-new-diktat-could-see-banks-face-rs-50000-crore-blow/articleshow/59315250.cms

[3] *See https://rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9009*

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