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Indian Banking Sector

Scheme for Sustainable Structuring of Stressed Assets likely to be positive for banks

.

Financial Sector Ratings

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Scheme for Sustainable Structuring of Stressed Assets likely to be positive for banks

The Reserve Bank of India (RBI), on June 13, 2016, issued guidelines on a "Scheme for Sustainable Structuring of Stressed Assets" (S4A). The scheme allows banks to bifurcate **the debt of stressed borrowers into sustainable and unsustainable portion. Under the norms, banks are required to maintain a minimum of 20% provision on the total loan outstanding or 40% of the unsustainable portion of the debt at the time of S4A. Further, banks have to provide 100% of the expected losses on unsustainable portion (in excess of the minimum requirements prescribed i.e. 20% of total or 40% of unsustainable) over the period of four quarters. Implementation of the guidelines would help to bridge the gap between the actual expected losses and provisioning cover, therefore it would be a credit positive.** These may also help the reducing the reported Gross NPA% by 30-100 bps (from current level of 7.7% as on March 2016) after a lag of one year (following satisfactory performance of sustainable debt portion), in ICRA's estimate.

As for provisioning requirement, while there will be no immediate relief to banks, the norms are likely to reduce incremental provisioning requirement[1] substantially over next 1-5 years (as *chart 2* brings out) provided sustainable portion of debt is serviced satisfactorily and there is no further decline in fair value of non-sustainable portion.

Banks with higher provision cover on stressed accounts (stressed borrower specific provisioning) are likely to benefit more.

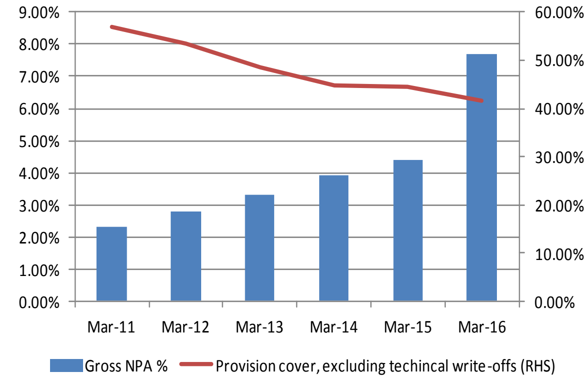
The norms could also ease funding availability to these stressed borrowers and consequently enhancing their ability to recover when stress in underlying sectors reduce. Borrowers in power and steel sectors could be main beneficiaries of the scheme.

The norm prescribes sustainability of debt to be concluded through independent techno economic viability (TEV). However, in past, accounts which were refinanced / restructured after TEV studies, have not shown satisfactory performance. Independence and competence of TEV partners and effective monitoring by Overseeing Committee (OC) would be critical to ensure reduction in Gross NPAs and provisioning in line with the actual vulnerabilities.

However, the norms could cause some moral hazard issues as banks start taking large haircuts (through conversion of debt into equity) on some large stressed borrowers.

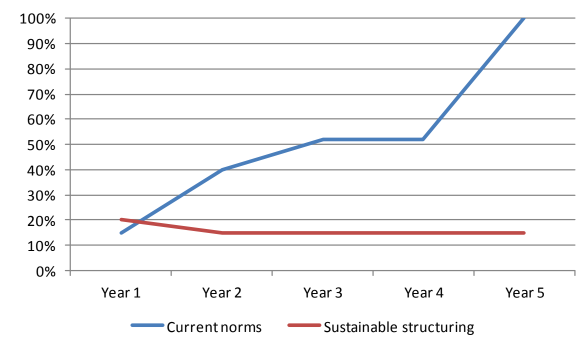
[1] For stressed borrowers classified as NPAs

Chart 1: Trend in Banks' Gross NPA % and Provision Cover



Source: RBI, ICRA research

Chart 2: Estimated Provisioning Cover on Stressed Exposure under Sustainable Structuring vs. Current Norms



Note: Assuming 70% of debt is sustainable and 30% unsustainable, 50% haircut on unsustainable portion; assuming 80% of exposure is secured and balance 20% unsecured
Source: ICRA research

The key contours of the scheme are as follows:

- Operational projects with aggregate exposure (including accrued interest) of all institutional lenders of more than Rs 5 billion will be eligible accounts. The exposure must also meet sustainability test i.e. at least 50% of current funded liabilities can be serviced from future cash flows (even if cash flows remain at their current level) over the same tenor as that of the existing facilities.

- Borrowings will be bifurcated into Part A (Sustainable Debt) and Part B.

- There shall be no fresh moratorium granted on interest or principal repayment, no extension of repayment schedule or reduction in interest rate for servicing of Part A.

- Part B shall be converted into equity / redeemable cumulative optionally convertible preference shares / optionally convertible debentures.

- Asset classification and provisioning: standstill clause for a period of 90 days from the date of lenders' decision to resolve the account under these guidelines. Provisioning thereafter will be as follows:
  In case account is standard (including standard restructured) as on reference date banks will need to create upfront provision of 20% of total outstanding (Part A and Part B)
  In case account is classified as NPA it shall continue to be classified as NPA and current provisioning norms apply however lenders can upgraded (both Part A and Part B) to standard category after one year of satisfactory performance of Part A loans
  Part B will be valued as per RBI norms; any shortfall between the fair value and book value of Part B instruments (in excess of minimum requirements prescribed i.e. 20% of total or 40% of unsustainable) to be provided over a period of four quarters.
  If the provisions held by the bank in respect of an account prior to this resolution are more than the cumulative provisioning requirement prescribed as per the scheme, the excess can be reversed only after one year from the date of implementation of resolution plan, subject to satisfactory performance during this period.

- Banks should also get promoters' personal guarantee in all such cases, for at least the amount of Part A.

- The norm prescribes sustainability of debt to be concluded through independent techno economic viability (TEV) however the performance of restructured cases (which were also assessed by techno economic viability) has not been satisfactory.

- An Overseeing Committee (OC) comprising of eminent persons will be constituted by IBA in consultation with RBI, to review the processes involved in preparation of resolution plan etc for reasonableness and adherence to the provisions of these guidelines, and opine on it.

Likely implications of the scheme:

- No immediate relief however reported Gross NPA % could come down after a period of 1 year as satisfactory performance of sustainable debt portion is established. In ICRA's estimate banks Gross NPA % could come down by 30-100 bps from the current level of 7.7% as on March 2016.

- As for provisioning requirement, while there would be no immediate relief to banks, the norms are likely to reduce incremental provisioning requirement[2] over next 1-5 years substantially (as chart 2 brings out) provided sustainable portion of debt is serviced satisfactorily and there is no further decline in fair value of non-sustainable portion.

- Provisioning requirement gets more aligned with losses expected on stressed accounts rather than extent of overdues / nature of advances (secured / unsecured), a move towards expected credit loss framework (Ind AS 109). This could augur well for transparency. As for provisioning requirement, banks are likely to benefit when scheme is implemented in existing NPA accounts and likely to create higher provisioning (in near term) when scheme is implemented on standard (including standard restructured accounts).

- Banks with higher provision cover on stressed accounts (stressed borrower specific provisioning) are likely to benefit more.

- This could also ease funding availability to these borrowers and consequently enhancing their ability to recover when stress in underlying sectors reduces.

In case of standard account (including standard restructured)	**In case of existing NPA accounts**
Banks will need to maintain minimum provision of 20% as against their current likely provision of 5% in case of restructured accounts; even if account slips to sub-standard category provisioning requirement is 15%. Hence when applied on a standard account provisioning requirement is likely to go up in near term however could save provisioning over medium-long term.	There could be reduction in provisioning requirement depending on haircut required for unsustainable portion. As the prospects of timely repayments on sustainable portion are high, lesser number of accounts will slip to harder buckets (doubtful 1, 2, 3) and hence provisioning requirement will not increase.

[2] For stressed borrowers classified as NPAs

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