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Guidelines on sale of stressed assets by banks

Deal Advisory

In a bid to promote long-term resolutions for large amount of stressed assets in India, the Reserve Bank of India (RBI) has launched a new set of guidelines governing the sale of these assets on September 01, 2016*.

The RBI has now widened the scope for potential buyers of these assets to other banks, Non-Banking Financial Companies (NBFCs) and other Financial Institutions (FIs), apart from only Asset Reconstruction Companies (ARCs) allowed earlier. This policy does not modify the existing framework for resolution, including Corporate Debt Restructuring (CDR), 5/25 refinance for infrastructure loans, Strategic Debt Restructuring (SDR) and Scheme for Sustainable Structuring of Stressed Assets (S4A).

The salient features of the guideline are as follows:

Specific policy on identification and sale of stressed assets

- The Board of individual banks needs to formulate a clear policy and lay down guidelines for sale of NPA assets including identification of the assets to be sold, the norms and procedures for their valuation and sale, provisioning, etc.
- The process of identification of NPA assets for sale should have a top down approach, with active involvement of head office/ corporate office of banks and should take place at least once every year, preferably at the beginning of the year.
- Each bank, in line with its policy, should identify a list of stressed assets to be made available for sale during the year. At a minimum, all assets classified as 'doubtful assets' category above a pre-defined threshold should be covered.
- The identification policy defined by the bank should include a minimum sale price for the identified accounts.
- Banks to periodically review the efficacy of their policy and amend when appropriate, in line with their laid-out principles.

Potential buyers

- The sale of assets would not be restricted to Securitisation Companies (SCs) and ARCs only, and would be made available to other classes of investors having adequate capital to purchase the asset viz. other banks, NBFCs, FIs, etc.

Proposed process for sale

- Once a bid (above the minimum defined threshold) for an asset featuring on the list of assets for sale maintained by banks is received, the banks should publicly call for counter bids from other prospective buyers, on comparable terms, under the 'Swiss challenge' method as prescribed by the bank's policy.
- The banks are recommended to use e-auction/ open auction process to attract a larger set of investors as well as for better price discovery of the asset.
- Prospective buyer to be given adequate time for due diligence, with a minimum period of two weeks.
- To promote debt aggregation with a single institution, the SC/ARC having the largest share (greater than 25 to 30 per cent) in the asset to have the first right of refusal for acquiring the asset by matching the highest bid.
- For accounts with exposure greater than INR 500 million, banks have to seek two independent external valuations commissioned by the bank.
- The seller bank to define the discounting rate for valuation objectively on the basis of parameters such as cost of equity, average cost of funds or the opportunity cost etc., however, subject to a floor of the contracted interest rate and penalty.

***Note:** The guidelines can be accessed at https://rbidocs.rbi.org.in/rdocs/notification/PDFs/CIR563104EA2E56CC4305844C469BB753331C.PDF

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- In case the bank decides to not sell their asset to the highest bidder, it would need to provide for the loan, which will be the higher of the discount on the book value quoted by the highest bidder or the asset provisioning according to existing RBI norms.
- The guideline is also aimed at the 'true sale' of an asset, and restriction of the investment by banks through Security Receipts (SRs) in their own assets.
- The guidelines, provide disincentive for Banks's to own Security Receipts (SRs) where the underlying loan portfolio comprises its own NPL loans. With effect from April 01, 2017, in case the Security Receipts (SRs) held by a bank comprises more than 50 per cent of the Non-Performing assets of the same bank, will attract higher provision in accordance with existing RBI guidelines, assuming, the NPL loan was still on the books of the bank. With effect from April 01, 2018, this threshold of 50 per cent will be reduced to 10 per cent.
- Banks would need to disclose the book value of the SRs backed by NPAs and the provision held against these, according to the vintage of the SRs (Less than 5 years, 5 to 8 years, greater than 8 years) resulting in higher disclosures for Non-Performing assets.

Our point of view

We have analysed the merits and demerits of the guidelines introduced by RBI

Merits

- The guidelines help in formalising the policy for each bank on critical matters such as sale of stressed assets, valuation of stressed assets, process and methodology for sale, etc.
- Early identification of potential sale candidates and public disclosure to help in early disposal of such assets thereby minimising loss in value.
- The circular provides a robust framework to enable a vibrant secondary market for stressed asset of banks, which is the need of the hour in India; it assists in creating a market for trading of SRs and Non-performing assets
- It is expected to help in bringing down the vintage of the stressed asset during sale, and enabling faster debt aggregation.
- The policy aims at true price discovery, enabling the sale of the asset at 'fair price'.
- The guidelines can potentially lead to development of secondary market for SR given better price discovery.
- It promotes banks to engage in 'cash transactions' which can enable them to recapitalise their balance sheet.
- It gives the ARCs/ special situation fund/ turnaround funds an option to consolidate debt for better and faster resolution of the asset.

Demerits

- Mandating a Board-approved policy for each individual lender goes against the principle of the Joint Lender's framework (JLF) mechanism, laid down by the regulator earlier for resolution of stressed assets.
- The guidelines leave little discretion for banks to do private or negotiated sale of highly complex and unique assets.
- The focus of lenders may shift to buying, selling and management of these assets, rather than their core function of lending.
- For executing cash transactions as envisaged by the scheme, the ARC needs to be adequately capitalised, which is a challenge in current environment.
- ARCs are required to leverage their balance sheets by raising funds or look at alternate structures to raise funding and structure transactions.

With keen interest exhibited by large global players to invest in the stressed asset segment, it was imperative to set-up a robust framework for the identification, sale and ultimately, the revival of these assets, which the circular provides. The success or failure of the scheme would ultimately depend upon the seriousness of selling banks, extent of the appetite the market finally has in purchasing these assets and the efforts that will go into actually reviving the operations of these companies.

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