The RBI issues a scheme for Sustainable Structuring of Stressed Assets

23 June 2016

First Notes on

- Financial reporting
- Corporate law updates
- **Regulatory and other information**
- Disclosures

Sector

- All
- **Banking and insurance**
- Information, communication, entertainment
- Consumer and industrial markets
- Infrastructure and government

Relevant to

- **All**
- Audit committee
- CFO
- Others

Transition

- **Immediately**
- Within the next 3 months
- Post 3 months but within 6 months
- Post 6 months

The Reserve Bank of India (RBI), through its notification, DBR.No.BP.BC.103/21.04.132 /2015-16 dated 13 June 2016, has issued guidelines for a scheme for Sustainable Structuring of Stressed Assets (the scheme) to facilitate the resolution of large borrower accounts that are facing severe financial difficulties.

The scheme is an optional framework for the resolution of large stressed accounts in addition to the Strategic Debt Restructuring (SDR) mechanism that was previously introduced by the RBI. It was issued in order to facilitate the deep financial restructuring necessary for a sustained revival of large projects, even without a change in promoters as was envisaged under the SDR mechanism.

This issue of First Notes aims to provide overview of the scheme.

Overview of the scheme

The scheme is applicable for debt relating to projects that have commenced commercial operations and where the aggregate exposure of all institutional lenders exceeds INR500 crore (inclusive of all facilities extended). In addition, the debt should be deemed sustainable by the Joint Lenders Forum (JLF) or consortium of lenders, based on an independent Techno-Economic Viability (TEV) assessment conducted by an independent, credible professional agency. The level of sustainable debt so determined should not be less than 50 per cent of current funded liabilities.

Determining sustainable debt

Sustainable debt (referred to as Part A) is determined as the level of debt (Including new funding that may be required within the next six months) that can be serviced (including interest and principal) over the respective residual maturities of existing debt, from all sources, based on the cash flows available from current as well as immediately prospective level of operations. This requires consideration of free cash flows (i.e. cash flow from operations less committed capital expenditure) available for servicing debt as per the latest audited/reviewed financial statements.

The difference between the aggregate current outstanding debt from all sources and Part A is referred to as Part B.

Resolution plan

The resolution plan under this scheme should be agreed upon by a minimum of 75 per cent of lenders by value and 50 per cent by number. It is required to have the following features:

- No fresh moratorium should be granted on interest or principal repayments for servicing Part A of the debt. Further, there should be no extension of the repayment schedule or reduction in the interest rate for Part A. This part of the loan shall also continue to have at least the same amount of security cover as was available prior to this resolution.

- Part B of the existing debt shall be converted into either equity or redeemable cumulative optionally convertible preference shares (Part B instruments). Where the resolution plan does not involve a change in promoter, lenders may also convert a portion of Part B into optionally convertible debentures. The terms for exercise of any conversion options are to be clearly defined. Further, appropriate covenants may be included to cover the use of cash flows beyond projected levels towards servicing of these quasi-equity instruments.
- As part of the resolution plan, the current promoter may continue to hold enough shares to exercise control over the borrowing entity. Alternatively, the current promoter may be replaced with a new promoters either under the SDR mechanism or based on the Prudential Norms on Change in Ownership of Borrowing Entities (outside SDR scheme). The lenders may also acquire a majority shareholding through conversion of debt into equity and either permit the current management to continue or effect a change in management to another agency/professionals.
- Where the resolution plan does not involve a change in promoter/management, the existing promoters shall dilute their shareholdings at least in the same proportion as that of Part B to the total existing debt, either by conversion of debt into equity or sale of their equity to lenders. The promoters should also provide a personal guarantee to the JLF/consortium for the Part A amount.

An Overseeing Committee constituted by the Indian Banks' Association (IBA) will act as an advisory body to review the resolution plan for reasonableness and compliance with the RBI guidelines.

Valuation of Part B instruments

The fair value for Part B instruments issued under this scheme should be determined as follows:

- Equity shares issued to banks should be marked to markets at least on a weekly basis (preferably daily basis). Unlisted equity shares or shares for which current quotes are not available should be valued at the lower of the following:
  - Break-up value (as per the company's latest audited balance sheet), or
  - Value based on the Discounted Cash Flow (DCF) method where the discount factor is the actual interest rate charged to the borrower plus 3 per cent, subject to a floor of 14 per cent. For this valuation, only cash flows occurring within 85 per cent of the useful economic life of the project shall be considered.
- Redeemable cumulative optionally convertible preference shares/optionally convertible debentures should be valued on a DCF basis with a discount rate that includes a minimum mark-up of 1.5 per cent over the weighted average actual interest rate charged to the borrower. If preference dividends are in arrears, the value determined on the DCF basis should be further discounted by at least 15 per cent if arrears are for one year, with an increment of 10 per cent in the discounting factor for each additional year of arrears.

Asset classification and provisioning requirements

In cases where there has been a change in promoter, the asset classification and provisioning requirements will be as applicable under the SDR mechanism or 'Outside SDR Scheme' if the change in ownership has been effected in this manner.

For restructurings where there has been no change in promoter, the requirements are as follows:

- A 'standstill' in asset classification of 90 days from the date on which lenders decide to resolve the account (reference date) under this scheme.
- Accounts classified as 'standard' on the reference date, shall remain so classified subject to up front provisions being made by lenders for the higher of 40 per cent of the Part B amount or 20 per cent of the aggregate outstanding debt. This will include provisions already held against this outstanding amount.
- For accounts classified as a Non-Performing Asset (NPA), the entire outstanding debt shall continue to be classified and provided for as an NPA as per applicable norms.
- Part A and B may be upgraded to a standard category after one year of satisfactory performance of Part A loans. However, Part B instruments will continue to be marked to market as per the guidelines for this scheme.
- Any additional provisioning requirement arising from the difference between the book value of Part B instruments and their fair value as per this scheme shall be made uniformly over four quarters commencing with the quarter in which the resolution plan is implemented.
- Any excess provisions held by banks can be reversed only after one year from the date of implementation of this resolution plan.
- Unamortised provisions (where provisions are made over more than one quarter) at the close of a financial year should be debited to 'other reserves'. This amount is to be reversed in the respective quarters of the subsequent financial year when the provisions are recognised in the statement of profit and loss.

Our comments

This scheme is an additional mechanism initiated by RBI to address unsustainable debt levels and enable restructuring of such stressed assets by lenders even without a change in ownership/promoter as envisaged under the SDR mechanism.

While the scheme provides some relief, this is limited due to the minimum provision requirements mandated under the scheme for 'standard' loans. The relief from immediate provisioning is only to the extent of additional provisions arising from the difference between the book value and fair value of Part B instruments.

Impact on transition to Ind AS

Banks and Non-Banking Financial Companies (NBFCs) are required to implement Indian Accounting Standards (Ind AS) from accounting periods commencing on or after 1 April 2018. On transition to Ind AS, the accounting treatment for Part B instruments as well as the provisioning requirements for the outstanding loans will be based on the requirements of the relevant Ind AS.

While banks may still be required to mark-to-market their holdings of Part B instruments (equity or optionally convertible preference shares/debentures), the fair value will be determined in accordance with Ind AS. This may be different to the valuation method described in the scheme guidelines. In addition, the recognition of additional provision over four quarters as permitted under the scheme would not be permitted under Ind AS. The lending banks would be required to recognise the entire difference between the book value of Part B debt and the fair value of Part B instruments issued by the borrower in the statement of profit and loss on restructuring.

Some borrower companies may be required to comply with Ind AS for accounting periods commencing on or after 1 April 2016 or 1 April 2017 based on the road map issued by the Ministry of Corporate Affairs (MCA). Such companies will be required to classify and measure Part B instruments issued by them, to replace the outstanding Part B debt, under Ind AS. As a result some quasi-equity instruments may continue to be classified in part as debt instruments in their audited financial statements. This can have an impact on the company's financial ratios going forward. These Ind AS implications may be relevant when defining new covenants to cover use of cash flows to service the outstanding debt in the future.

Therefore, banks should carefully evaluate the Ind AS implications that may arise from debt restructuring when initiating a resolution plan under this scheme.

The bottom line

Given the significance of the impact for the companies as well as banks at the time of transitioning to Ind AS, banks should carefully evaluate the Ind AS implications that may arise from debt restructuring when initiating a resolution plan under this scheme.

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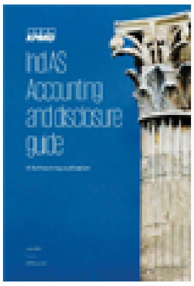
KPMG in India's IFRS institute

Visit KPMG in India's IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

New launch - The Ind AS Accounting and disclosure guide



6 June 2016

Ind AS comprises 40 accounting standards that provide extensive guidance and entail a significant change in the financial reporting framework used by Indian companies to report their financial results. Their adoption requires a detailed level of analysis for which companies may need to invest substantial amounts of time to ensure compliance.

Our publication 'Ind AS – Accounting and disclosure guide (the guide)' is an extensive tool designed to assist companies in preparing financial statements in accordance with Ind AS by identifying the potential accounting considerations and disclosure requirements that are applicable to them. It covers key recognition, measurement and disclosure requirements for each standard along with some additional considerations.

The guide is available for download from our website click here.

Missed an issue of Accounting and Auditing Update or First Notes

Issue no. 9/2016 – Transport, Logistics and Leisure

This month the Accounting and Auditing Update focusses on the transport, logistics and leisure sector and highlights key matters relating to accounting, financial reporting and regulatory areas relevant to this sector. This sector encompasses various sub-sectors. In this edition, we cast our lens on six sub-sectors: maritime, logistics, ports, rail, aviation and leisure. For the sub-sectors discussed in this publication, the Ind AS guidance relevant to revenue recognition and property, plant and equipment is likely to throw up potential challenges following the adoption of Ind AS and our articles elaborate those implementation challenges. The publication carries the results of a survey that we ran with a number of leading transport and logistics companies on the key regulatory changes that they face. These include Ind AS, the Companies Act, 2013, Income Computation and Disclosure Standards (ICDS) and proposed Goods and Services Tax (GST).

This publication also highlights direct and indirect tax issues, such as the treatment of service tax collected as part of gross income, ports facing ambiguity on claiming tax holiday and certain withholding tax issues, etc. Additionally, the article on GST highlights its expected impact on the supply chain, shipping, and logistics sub-sectors.

Finally, our publication carries a regular synopsis of regulatory updates including the guidance note on CARO 2016 issued by the Institute of Chartered Accountants of India and a summary of the clarifications given by the Ind AS Transition Facilitation Group in its second bulletin.

The central government constitutes NCLT and NCLAT and notifies the related sections of the Companies Act, 2013

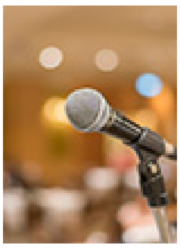
22 June 2016

On 1 June 2016, the Ministry of Corporate Affairs (MCA) notified the following:

- The constitution of the NCLT and NCLAT to exercise and discharge the powers and functions as conferred on it under the 2013 Act. For this purpose, the central government constituted 11 Benches of the NCLT consisting of a principal bench at New Delhi and one each at 10 different locations including New Delhi.
- Certain sections of the 2013 Act enabling the exercise of power by the NCLT and NCLAT have also been notified.
- With the constitution of the NCLT, the CLB constituted under the 1956 Act stands dissolved and all matters or proceedings pending before the CLB should be transferred to NCLT, which shall dispose such matters or proceedings in accordance with the provisions of the 2013 Act or 1956 Act.

These notifications are effective from 1 June 2016 (being the date they are published in the official gazette).

This First Notes provides an overview of the MCA notifications.



KPMG in India is pleased to present Voices on Reporting – a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

In our recent call, on 22 June 2016, we covered key financial reporting and regulatory matters that are expected to be relevant for stakeholders as they approach the quarter ending 30 June 2016.

Our call included updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Institute of Chartered Accountants of India (ICAI), etc.

Feedback/queries can be sent to aaupdate@kpmg.com

Previous editions are available to download from: www.kpmg.com/in