Corporate Debt Restructuring Mechanism: The Need to Balance Between Carrot and Stick

Abstract

The first part of this paper focuses attention primarily on the concept – what it is, how it has evolved and functioning now, its macro-economic importance. The paper then critically evaluates the mechanism drawing from the experience of the authors and the literature available in the web. We have included the role of bankers in identifying, implementing and monitoring the CDR cases. As statistics and discussions papers indicate, much needs to be done on the CDR front in developing countries particularly in India in order that all stakeholders derive benefit. The paper also discusses a small case study for the benefit of the readers

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PART - I

1.0 Introduction

Credit Risk is said to be as old as the mountains; bankers and financial institutions know it well. Money lent needs to be recovered and lenders follow a number of measures for recovery. These have been now fairly structured and IT-enabled. One of them is to go for a one-time settlement of debt with some acceptable sacrifices. The other one involving sacrifices is rehabilitation: to have a re-look at the delinquency dispassionately and decide to nurse the unit. The clique one can be described as 'throwing the baby with the bathwater'. Both the government and RBI have taken noteworthy steps for rehabilitation of sick units prompting thereby a rapid growth of institutions, legislations and different forums for attending to the needs of good but defaulting/sick borrowers.

1.1 Corporate Debt Restructuring - defined

Corporate debt restructuring, basically a development in the new millennium in India, is akin to an extent to the older concept of rehabilitation. But it differs philosophically. CDR is a globally accepted

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activity in which the fiscal vertical, the finance ministry or government as well as the monetary vertical, the central bank of the country are involved. It pertains to the health of big corporates. CDR takes into consideration 'standard' and 'substandard' assets in addition to the sick industrial concerns. But it is for basically big ticket players. The shape of the economy to a large extent depends on the shape of these big corporates. Apart from the impact on growth, there are other dimensions like employment, social security, investors' morale, which a regulating agency can ill afford to ignore. Given below is the summary of RBI circulars on the subject:

1.2 Genesis of CDR Mechanism In India

There are occasions when corporates find themselves in financial difficulties because of factors beyond their control and also due to certain internal reasons. For the revival of such corporates as well as for the safety of the money lent by the banks and financial institutions, timely support through restructuring of genuine cases is called for.

However, delay in agreement amongst different lending institutions often comes in the way of such endeavors. Based on the experience in countries like the UK, Thailand, Korea, Malaysia, etc. of putting in place an institutional mechanism for restructuring of corporate debt and need for a similar mechanism in India, a Corporate Debt Restructuring System was evolved and detailed guidelines were issued by Reserve bank of India on August 23, 2001 for implementation by financial institutions and banks.

The Corporate Debt Restructuring (CDR) Mechanism is a voluntary non-statutory system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA) and the principle of approvals by super-majority of 75% creditors (by value) which makes it binding on the remaining 25% to fall in line with the majority decision. The CDR Mechanism covers only multiple banking accounts, syndication/consortium accounts, where all banks and institutions together have an outstanding aggregate exposure of Rs.200 million and above. It covers all categories of assets in the books of member-creditors classified in terms of RBI's prudential asset classification standards. Even cases filed in Debt Recovery Tribunals/Bureau of Industrial and Financial Reconstruction/ and other suit-filed cases are eligible for restructuring under CDR. The cases of restructuring of standard and sub-standard class of assets are covered in Category-I, while cases of doubtful assets are covered under Category-II.

Reference to CDR Mechanism may be triggered by:

- Any or more of the creditors having minimum 20% share in either working capital or term finance, or
- By the concerned corporate, if supported by a bank/FI having minimum 20% share as above.

It may be emphasized here that, in no case, the requests of any corporate indulging in fraud or misfeasance, even in a single bank, can be considered for restructuring under CDR System. However, Core Group, after reviewing the reasons for classification of the borrower as wilful defaulter, may consider admission of exceptional cases for restructuring after satisfying itself that the borrower would be in a position to rectify the wilful default provided he is granted an opportunity under CDR mechanism.

1.2.1 Structure of CDR System

The edifice of the CDR Mechanism in India stands on the strength of a three-tier structure:

- CDR Standing Forum
- CDR Empowered Group
- CDR Cell

1.2.2 Legal Basis of CDR

The legal basis to the CDR System is provided by the Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA). All banks /financial institutions in the CDR System are required to enter into the legally binding ICA with necessary enforcement and penal provisions. The most important part of the CDR Mechanism which is the critical element of ICA is the provision that if 75% of creditors (by value) agree to a debt restructuring package, the same would be binding on the remaining creditors.

Similarly, debtors are required to execute the DCA, either at the time of reference to CDR Cell or at the time of original loan documentation (for future cases). The DCA has a legally binding 'stand still' agreement binding for 90/180 days whereby both the debtor and creditor(s) agree to 'stand still' and commit themselves not to take recourse to any legal action during the period. 'Stand Still' is necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the 'stand still' is applicable only to any civil action, either by the borrower or any lender against the other party, and does not cover any criminal action.

Besides, the borrower needs to undertake that during the 'stand still' period the documents will stand extended for the purpose of limitation and that he would not approach any other authority for any relief and the directors of the company will not resign from the Board of Directors during the 'stand still' period."

1.3 Financial Restructuring: The Basics

We, as students of management, are aware of organizational interventions. There can be a change in the organizational structure and/or design. We are also aware of strategic interventions like Business process re-engineering. Financial restructuring can be an essential part of that holistic effort. It can also be an independent strategic move by the CFO. Financial restructuring, as the term indicates, is a deliberate act of restating the financial position of a company as reflected by its balance-sheet on a given day. Mr. Pratap Subramanyam ('Investment Banking: an Odyssey in High Finance', TMH, p-698) calls it an 'art'.

Financial restructuring is a complex process because it involves not only legal dimensions but it also concerns several conflicting interests. It can be undertaken either on the asset side or the liability side or even both depending on the circumstances and the imperatives that trigger it. Revaluation of assets for example is restructuring on the asset side. Once the asset side is restated, obviously the liability side will have to be restated. It also encompasses restructuring of the debt capital (outside liabilities) as well as equity capital. **Equity restructuring** is the process of alteration of the structure of shareholders' funds. It may be necessitated by an over-sized equity base which leads to modest earnings per share. Tamilnadu Newsprint Ltd (TNPL) undertook successful equity restructuring in 1995. It turned around.

However, in several cases in India, financial restructuring primarily involves debt restructuring. Debt restructuring can take place in three broad scenarios:

Category I: A healthy company substituting its high-cost debt with low-cost debts through ECB (external commercial borrowings) or other processes – called 'swapping' in financial engineering parlance.

Category II: A company laden with poor debt servicing abilities and liquidity crunch may restructure its debt portfolio to augment its working capital funds and reduce cost of debt capital.

Category III: An insolvent company may need a total restructuring of its debt portfolio with a view to rehabilitating itself.

Let it be repeated, we are talking about large corporates here. The RBI guidelines as stated above also say that corporates with total exposure of not less than rupees 10 crores are only eligible. That obviously brings the Banks and FIs into the frame because they are the creditors. If a big asset does not perform well, the bottomlines dwindle given the extant prudential norms. (Refer RBI circular for prudential norms).

Resuming with the categories of debt restructuring, it is the second category that is commonly seen in India.

1.4 How Does a Company Fall into the Debt Trap ?

There could be several reasons. And not in the least is the inefficient monitoring effort of the bank. We shall deal with it in part – II of this paper. A few others are as under:

- Wrong assessment of working capital needs
- Lack of working capital funds or bad treasury management being treated as a temporary liquidity problem
- This results in bank allowing temporary facilities increasing the debt which continue to be served partially and often not on due dates resulting in increased financial stress for both the company and the lender

- Systemic risks like recession or sudden change of policy etc.
- Improper analysis of strategy gaps (Refer C.K. Prahalad)

The key point to be noted here is that the long-term debts are serviced by funds from operations. So competent working capital management is the key. That predominantly includes inventory management and cash management.

The crucial paradigm for CDR is the potential of the company to overcome the rough weather given a fresh and structured dose of finance within a certain time bucket. This is like a fresh credit appraisal for a banker. The company brings interest free loans or subordinated debts, bank allows moratorium on interest and sanctions fresh loans to augment working capital and the company turns around. The EBIT improves as predicted. That in short is the working cycle of debt restructuring.

Section 391 of Company's Act in India allows restructuring through the intervention of court. There can be also out-of-court debt restructuring. In either case the process will be the same as described above.

1.5 A Few Cases of Debt Restructuring

As per news reports (Economic Times, 17.03.2011) Air India has accepted a CDR package prepared by SBI Caps and vetted by Deloitte, the global consultancy firm. Haldia Petrochemical Ltd and Wockhardt are a few other examples. Cases referred to the corporate debt restructuring cell increased to 34 at the end of March 2009, as against 10 at the end of 2007-08 (Business Standards, April, 23). The detailed position as on 31st December, 2010 as published by RBI is given below:

Progress Report

(As on December 31, 2010)

(i) <u>Overall Status</u>

(Rs. crore)

Total References Received		**Cases Rejected/Closed**		**Cases under finalization of Restructuring packages**		**Total Cases Approved (including cases withdrawn/ Exited**	
No. of cases	Aggregate Debt	No. of cases	Aggregate Debt	No. of cases	Aggregat e Debt	No. of cases	Aggregate Debt
285	125908	36	8730	19	9831	230	107347

(ii) Industry-wise Classification of Approved Cases

Sr. No.	Industry	No.	Aggregate Debt (Rs. crore)	% of share
1	Iron & Steel	25	36673	34.16
2	Fertilizers	8	8454	7.88
3	Textiles	50	9192	8.56
4	Petrochemicals	3	5493	5.12
5	Refineries	1	4874	4.54
5	Cements	6	4663	4.34
6	Telecom	8	5427	5.06
7	Sugar	22	5533	5.15
8	Power	7	3836	3.57
9	Chemicals	13	2717	2.53
11	Metals (Non-ferrous Metals)	5	2171	2.02
12	Electronics	2	2132	1.99
13	Infrastructure	9	5166	4.81
14	Pharmaceuticals	6	2130	1.98
15	Paper/Packaging	12	1680	1.57
16	Cables	8	1201	1.12
17	Automobiles	2	551	0.51
18	Auto Components	7	563	0.52
19	Wood Products	1	463	0.43
20	Engineering	8	758	0.71
21	Ceramic Tiles	6	374	0.35
22	Ship-Breaking/Ship Building	2	869	0.81
23	Rubber	3	167	0.16
24	Hotels	2	147	0.14
25	Forgings	1	112	0.10
26	Glass	2	82	0.08
27	Plastic	3	399	0.37
28	Retail	1	470	0.44
29	Battery	1	35	0.03
30	NBFC	1	115	0.11
31	Other (Dairy, Jewellery)	5	900	0.84
	TOTAL	**230**	**107347**	100.00

Arvind Mills Ltd – a case study (source: Arvind's Near Death experience—Business World, 13th May 2002)

Name: M/s Arvind Mills Ltd.

Based at: Ahmedabad

Product: Denim Manufacturer

Other details: Capacity at 110 million meters per annum was the third largest at the world. This was built during 1987-97.

Problem: Problem started in 1997. By this time the company had leveraged its balance-sheet heavily with a mix of domestic loans and ECBs, which included a $125 million FRN issue. Theirs was a global commodity and so when the prices started declining in 1998-99, the company had no control on it. Arvind Mills had their own captive power plant. Its feedstock was naphtha. The prices of naphtha doubled during that period – another development over which the company had no control. The total number of domestic and international lenders was a staggering 85 with cumulative exposure of rupees 2700 crores. The problem of making 85 lenders to agree to a common plan seemed to defy solution.

Eventually, two entities came forward: KSA Tecnopack and Jardine Fleming Singapore Securities. The latter in fact was one of the lenders. While the former prepared the restructuring plan titled 'Market Study and Due Diligence of Business Plan of Arvind'. Jardine Securities headed the steering committee of the lenders. The committee represented 60% of Arvind's total borrowings. The committee accepted the business plan prepared by KSA Tecnopack and the related future cash flow and decided to write off 40% of the total debt commitments of Arvind.

Three banks were not happy with the decision and approached Gujarat High Court petitioning for foreclosure. But the honourable High Court dismissed the petition and directed the three dissenting bankers to fall in line.

Arvind survived and prospered. For the first quarter of FY 2002-03, it made a profit of rupees 10 crores, for the first time in three years. The staggered debts were also cleared.

It may be pertinent to mention here that the lenders enjoy what is known as the right to recompense. The CDR cell in India in its recent circular has very clearly categorised those rights. Once the company recovers and starts earning profit, it will compensate the loss of interest and a few other losses as agreed to over a period of time

PART - II

1.6 Indian Banks and CDR

The role of Banks can be hardly exaggerated in making CDR mechanism a success. One finds, while going through the reports of Harvard Asia Business Conference, that in developing countries more than 50% of debts are in need of restructuring. Banks in India are par excellence short-term lenders. They lend for working capital needs and have over the years developed total expertise. Their asset-liability positions do not encourage long-term loans. So in effect commercial banks prefer joining a consortium of FIs as small lenders with paripassu charges on assets. But at the time of reconstruction/rehabilitation, the commercial banks provide working capital help – the additional dose, that is. The commercial banks provide working capital assistance even otherwise without joining the project financing or term-lending syndication. Thus the attitude of the bankers towards the restructuring exercise is as crucial as their expertise on financial re-engineering. The Arvind case clearly shows Banks' first choice was 'sticks'. The other lenders, 60% of them were prepared to forgo 40% of their dues to revive the unit.

Legal action is the action of least resistance. It is a safe decision to ward off accountability. The other issues like the potential of the unit to revive, the social security and rehabilitation of the workers, fate of the investors etc. do not really matter once the die is cast for legal action. On the other hand the prudential norms make it imperative to get the restructuring done and improve the asset quality in order that your bottomlines are not hit.

Apart from the attitudinal aspects, there are a few other issues which need to be discussed here. Bulk of what is being written here is based on the discussions at the Harvard Asia Business Conference and the paper presented at World Bank Conference, New Jersey, by Michael Pomerleano on April 7, 2000 titled 'Emerging Market Economies Recover, But Debt Restructuring Problems Linger On'. It is worthwhile to mention here that in the Asian crisis of 1990s, the value of Thai Currency (Baht) lost more than 80% of its value at the beginning of the crisis. 45% of total lending amounting to US$ 65 billions became non-performing loans.

1.7 Issues to be Resolved by Banks in India

- Most of the PSBs in India do not have **a separate HRD or Credit vertical**. The cultural preference has been for a manager who has worked in all regions and all departments to eventually become a GM. An officer works in treasury department for 2/3 years on an average before he is taken out and put into operations. Same is the status in large borrower cell. Given the complexity of business environment now, it may be prudent to allow a few chosen officers to develop expertise in a particular industry like Iron and Steel, Pharmaceuticals, Cement etc. Without an insight into the 'real' market, a credit officer armed only with knowledge of balance-sheet and credit rating cannot appreciate the philosophy of CDR as perceived by RBI from a macro economic angle.

- **Credit counseling** is an urgent need. The experience of the World Bank as recorded suggests that Courts in South East Asia are culturally soft towards the owners in bankruptcy/liquidation petitions. The owners themselves also do not welcome any change in status within the company although the restructuring exercise may warrant it. Bankruptcy laws in UK for instance allow one last chance to the subject company for improvement. This gives an opportunity to the creditors to come together and think laterally to save the company provided there is indeed a potential. If after a due diligence study of viability, it is seen that revival chances are poor or even when chances are bright, they are highly sensitive to minor changes in market or sale prices, then a decision could be taken for legal action or OTS.

- The same exactitude will be of help while **identifying willful default**. RBI, particularly for SME category of borrowers has made the policy very transparent. The borrower must be given an adequate opportunity to defend. Once the default is malafide or willful, then 'sticks' come into play. But then that has to be studied dispassionately. The decision has to be carefully balanced between carrot and stick. As most bankers know and as the sub-prime crisis has also grimly reminded, ill-liquid securities like land and buildings hardly substitute a good cash flow. Even where the financing is with recourse, cash flow may be the prime criterion of appraisal. That backed with careful monitoring – eternal vigilance is the price of liberty—not only does wonders for the health of the asset, it also brings the creditor closer to the lender.

1.8 Conclusions

We would prefer to conclude with what the second annual conference on emerging market finance organized by The World Bank, International Monetary Fund and Brookings, held at Florham Park, New Jersey, March 30-31, 2000. "Going forward, a major challenge for all countries—especially the developing countries – is to insulate themselves against the likelihood and severity of future financial crises. As outlined in the paper by Ashoky Moody of the World Bank and Ken Kletzer of the University of California at Santa Cruz, countries can take at least three 'self-help' measures: building up foreign exchange reserves, arranging contingent credit lines (with private lenders and/or the IMF) and penalizing short-term foreign currency borrowings (as Chile did during most of the 1990s)." These were the conclusions reached in the wake of the Asian crisis of the 1990s. Their relevance is not lost even after a decade. With forex reserves increasing satisfactorily, RBI seems to have taken the first step of 'self-help'. But a lot remains to be done particularly by the creditors: their expertise in financial re-engineering, their familiarity with mark-to-market accounting and the attitudinal balance between carrot and sticks.

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