

India needs a realistic debt restructuring framework

Coordination failures could undermine the central bank's Strategic Debt Restructuring scheme



Photo: Reuters

The Reserve Bank of India (RBI) recently announced the Strategic Debt Restructuring (SDR) scheme in furtherance to the framework for revitalizing distressed assets in the economy that was notified in February this year.

The SDR scheme empowers a group of lenders (called the joint lenders' forum) to convert their loans into equity (and thereby assume control) in the event a borrower who is in restructuring fails to meet the deadlines prescribed for meeting certain viability milestones. The idea driving this reform appears to be that of deterring errant promoters and increasing the powers of resolution given to lenders, with a view to lowering the percentage of non-performing assets (NPAs) in the banking system. The SDR scheme may, however, not be as effective as it otherwise could be owing to certain features RBI has prescribed.

Lenders may choose to use their powers of conversion subject to the approval of 75% of lenders in value and 60% in number. This

appears to be a difficult threshold to meet in a distressed debt situation with multiple lenders. Imagine a scenario where the largest lender holds 50% of the borrower's debt and the balance is held across four other lenders (say, 12.5%, 15%, 10%, and 12.5%). In the light of the threshold prescribed by RBI, the conversion will require the approval of three lenders. Suppose the largest lender is well-motivated to convert the debt into equity (and then exit through a sale to a third party) but the other lenders are unsure of conversion. This can happen, for example, due to information asymmetry concerning the extent of liabilities and claims on the borrower's balance sheet and uncertainty surrounding finding a buyer for the purchased equity. Accordingly, they will withhold their approval and the senior-in-value lender cannot execute the conversion, even when that might have been valuable.

Media reports suggest that such differences between small and large lenders already exist given the reluctance of small lenders to convert their debt. It is early days but one cannot rule out coordination failure that will blunt the SDR scheme.

One solution to mitigate the risk of such coordination failure is to permit the largest lender in value to buy out the smaller lenders at a mutually determined price (and then convert the aggregate debt into equity). Enabling a secondary market in distressed debt will also mitigate the risk for the third-party purchaser when the lender(s) sells the equity. This is because the prospective purchaser will have to deal with fewer sellers than otherwise to purchase a strategic stake.

However, the SDR scheme as it exists at the moment lacks provisions that will enable the large lender to consolidate the debt in the manner discussed. RBI should suitably change the scheme to catalyse limited secondary trade in distressed debt that will mitigate the risk of coordination failure among lenders. Borrowing an idea from the US bankruptcy code, another solution could be to amend the SDR scheme to allow a "cramdown" on the dissenting lenders through a court-directed process.

The other inhibiting feature of the SDR scheme appears to be a bar on the promoter group to be the third-party buyer when the lender(s) exit. While on bare reading, the bar appears reasonable (as the promoters' "failure" to meet the viability milestones brought about the conversion in the first place); it appears that the promoter group may be useful in the sale process in some ways:

1) Finding a third-party purchaser to own and manage the distressed borrower company is likely to be difficult given the information asymmetry concerning true value of its equity. The promoter group is more likely to know the value better than the third parties. Furthermore, the promoter group also brings to the table specific human capital; the potential third-party purchasers lack that.

2) Lastly, but perhaps more pertinently, the bar on the promoter group to become a prospective purchaser appears to reflect a bias and cultural stigma against bona fide business failure. It may be noted that the cases under the SDR scheme are not those of "wilful defaulters" where the promoters have siphoned off funds or otherwise committed fraud; the failure to meet viability milestone guidelines could be a

genuine business failure and should not per se bar the promoters from bidding for purchasing equity from the lenders.

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