Committee Report on Resolution of Stressed Assets

PROJECT सशक्त (SASHAKT)

PROJECT SASHAKT

Date: 2nd July, 2018

Shri Piyush Goyal
Hon Finance Minister
Government of India
North Block
New Delhi

Dear Sir,

Sub: Recommendations of the committee on stressed assets resolution

At the outset, we thank you for the opportunity to present our report on stressed assets resolution, a subject which is of national importance. It has been our privilege to be associated with this exercise.

The starting point of our exercise has been to dimension the size of the stressed assets and the additional capital and funding requirements arising for the implementation of the recommendations. As per our assessment, the additional capital and liquidity requirements can be comfortably supported by our financial markets and hence these recommendations are realistic from the standpoint of implementation.

Second, giving regard to the individual size and diverse nature of the stressed assets, we have provided alternative approaches and thereby provide flexibility in resolution of this problem.

Common to all the resolution approaches are a few guiding principles.

- A transparent market based process that encourages participation by a large number of credible market players and thereby provide the best possible price for the stressed assets

- Ensuring a process which does not require any government intervention, and is professionally managed with strong and independent governance structure

- Ensuring speedy implementation by ensuring that the solutions provided fit into the existing regulations and is also aligned to the Indian Bankruptcy Code (IBC) process

- Emphasis on operational turnaround / rehabilitation of assets, so that employment is preserved, there is improved economic activity and the resulting value build up accrues to domestic institutions and global long-term investors

- Leverage the best in class skills from the market to ensure operational turnaround in a time bound manner

- Bring in external capital to limit the burden and risks on the domestic banking sector

- Ensure a robust governance and credit architecture is put in place to prevent similar build-up of non-performing loans in the future

The Committee recommends a five-pronged approach for resolution of stressed assets of PSBs which stood at INR 10.6 lakh crore as on 31st March 2018.

1. Our first approach is SME Resolution Approach (SRA) which applies to small sized assets with individual exposure less than 50 crores and will address approximately INR 2.1 lakh crore of stressed assets. The SME sector is a key engine for economic growth and job creation in the country. Hence resolving stressed assets in this sector in a time bound manner is critical for the overall economic activity and unleashing the entrepreneurial energy in the economy. SME loans are usually a single bank asset and hence all resolution actions are within the control of a single bank.

   In the SRA approach we recommend that each bank creates a dedicated vertical that focuses exclusively on resolution of stressed assets of SMEs. Banks should devise templated resolution approaches for different type of assets based on simple metrics. Banks should set-up empowered internal SME steering committee(s) for formulating/ validating these schemes including provision of additional funds, if required. The resolution under this approach would be non-discretionary, non-discriminatory and executed in a time-bound manner within 90 days. Additionally, banks should put in place a robust monitoring process that will ensure implementation of resolution in a time bound manner.

2. Our second approach is a Bank Led Resolution Approach (BLRA) which applies to midsized assets and will address approximately INR 3.1 lakh crore of stressed assets. The size of individual assets is usually between INR 50 crore to INR 500 crore. In order to ensure speedy resolution, we propose a solution by which the lead bank is provided with the full responsibility and authority in resolving the stressed asset and thereby provide the required speed for resolution. Under this approach, an independent screening committee of eminent personalities appointed by the IBA will be formed to validate the due process within maximum 30 days. The lead bank, will as appropriate engage industry expert to support operational turnaround of asset. In the event the lead bank is unable to implement a resolution plan in 180 days, then the assets will move to the NCLT Process.

3. Our third approach is AMC/AIF led resolution approach that would apply to large accounts with exposure spread across multiple banks and with a potential for turnaround and impact about INR 3.1 lakh crore of stressed assets. The approach is to set up an Asset Management Company (AMC) which in partnership with an ARC takes overstressed assets from banks. The AMC then conducts operational turnaround of the asset creating value for the overall system. The AMC/AIF would be the market maker and thereby ensure healthy competition, fair price and cash recovery. Given that the governance of the AMC and its independence is central to the success, we have made suggestions to ensure the same, including keeping majority ownership in the private sector, putting together a strong and independent board, hiring a professional team from the market and linking AMC compensation to returns delivered to investors. Resolution in certain stressed assets, as for example Power and Road, changes in Government policies are required and these can be most effectively achieved by having a single window for both discussions with the Government and communication of the decision by the Government.

4. The assets which are not resolved via approach 2 and 3 would be processed through our fourth approach i.e. the existing IBC/ NCLT process.

5. In addition, as the fifth approach we suggest creation of an Asset Trading Platform (ATP) for sale and purchase of loans, both performing as well as non-performing. Such a platform would provide ongoing liquidity for banks and make it simpler for shifting of credit risk and thereby enable banks and other lenders to manage their liquidity and capital on an ongoing basis. Specific recommendations have been provided for the development of a robust loan trading platform.

More importantly, the Committee has also provided detailed recommendations to support the paradigm shift in governance, risk and credit processes for PSBs that will prevent buildup of stressed assets in future. These include specific steps in strengthening of governance, organisation structure, policies, processes, technology, credit capabilities and strong risk culture which also enables creation of fresh credit capacity.

We had the opportunity to consult with a wide spectrum of people across regulators, investors, ARCs, bank officials, industry experts and international recovery and resolution professionals. We are excited and encouraged to report that almost everyone we spoke with supported the solutions outlined. We also received a number of suggestions and feedback from these discussions which have helped improve the approaches outlined here significantly.

We hereby submit the committee's report on **Resolution of Stressed Assets– Project सशक्त (SASHAKT)**. We hope you find this useful and look forward to hearing your feedback and support to take forward these recommendations for immediate implementation.

Yours sincerely,

Sunil Mehta
Committee Chairman
&
Chairman,
Punjab National Bank

Rajnish Kumar
Committee Member
&
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1. Acknowledgements

The committee has interacted and benefited from perspectives shared by experts in multiple domains.

The committee expresses its gratitude to the Honourable Finance Minister Shri Piyush Goyal for providing the opportunity to work on a topic of critical national importance. The committee would also like to thank Mr. N.S.Vishwanathan, Deputy Governor, RBI for his guidance and inputs.

The committee received responses in form of suggestions, recommendations and thoughts from multiple sources. It was overwhelmed to witness a broad-based participation towards resolution of this major challenge facing the country. The committee thanks all those who have contributed to the thought process in arriving at the final recommendations.

The committee met with Mr. Uday Kotak – Vice Chairman & MD, Kotak Mahindra Bank, Mrs. Arundhati Bhattacharya – Former Chairman, SBI, Mr. B. Sriram –MD & CEO, IDBI Bank, Mr. Sunil Srivastava – Former Deputy Managing Director, SBI, Mr. Saurabh Agarwal – Executive Director and Group CFO, Tata Sons and Mr. Rakesh Sharma – MD & CEO, Canara Bank and is thankful for their inputs on the resolution approaches.

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The committee also met a number of potential investors, Mr. V. K. Sharma – Chairman, LIC, Mr. Bryan Chew – Vice President and Mr. Anuj Ranjan – Senior Managing Partner, Brookfield, Mr. BV Krishnan - CEO, KKR India Financial Services and Mr. Neeraj Seth – MD, Blackrock and would like to thank them for providing investor perspectives.

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Turnaround Services and Mr. Anish Thacker – Partner, Mr. Ajay Rawal – Partner (UK), E&Y provided support from structuring, taxation and accounting perspective. The support provided by these professionals was exemplary and timely and the committee is thankful for the same.

The committee also reached out to a number of international experts for providing perspectives on resolution approaches followed globally. These include Mr. Alejandro Beltran – Senior Partner and Mr. Juan Antonio Bahillo – Partner, Mr. Renny Thomas – Senior Partner, Mr. Sandeep Sabharwal – Client Director, McKinsey & Co; Mr. Stephen Lerner – Partner and Mr. James Barresi – Partner, Squire Patton Boggs (LLP), US; Mr. Harish Kumar - MD, Mr. Tom McAleese - MD, Mr. Nikhil Shah – MD, Alvarez and Marsal. The committee thanks them for their valuable inputs, which were helpful in shaping the solution.

The team from SBI comprising Mr. G Ravindranath– CGM Global Markets and Mr. Sridhar Kolli – GM, Global Markets supported the effort. They contributed to identifying and fleshing out ideas, managing the data collection process and conducting a number of discussions with experts. The committee is thankful for their valuable support.

Finally, we would like to express our gratitude and thanks to the McKinsey team led by Mr. Akash Lal – Senior Partner, Mr. Sameer Shetty – Partner and Mr. Prasad Lad– Partner. They were ably supported in this effort by their team comprising Ms. Charu Singhal, Mr. Sanchit Suneja, Mr. Rohit Murmuria–all consultants with the financial services practice. Their contribution in shaping the overall solution and preparing this report has been invaluable.

2. Executive summary

The Indian banking sector, in particular PSBs, have been at the forefront of driving the economic growth of the country. In the last several years, however, the sector has been plagued by growing stressed assets on account of various issues. To ensure continued growth of the economy, it is imperative that a holistic solution is found to address the stressed assets situation. At the same time, it is necessary to ensure that a robust governance and credit architecture is established so that similar bad loans situations do not arise in the future. This note outlines the committee's recommendations on both these topics.

Context

Based on data obtained from Public sector banks, the total stressed assets pool in the country is about INR 10.6 lakh crore for PSBs and ~INR 12-13 lakh crore for the overall banking system. Many initiatives have been adopted in the last few years to resolve this pool of assets. Among others these include, the introduction of the Indian Bankruptcy Code (IBC), various restructuring schemes introduced by the RBI and numerous efforts by banks and ARCs in their individual capacity. These actions have resulted in good progress on the stressed assets front. However, given the scale of the problem and the speed of the resolution observed, multiple approaches need to work simultaneously for a quicker resolution.

Objectives

The committee has outlined following objectives for the resolution process:

- Ensure operational turnaround to retain value of assets created for national benefit
- Prevent job losses from foreclosures and create additional jobs by reviving businesses
- Ensure a large part of upside value is captured by domestic institutions
- Bring in credible long term external capital to limit the burden on the domestic banking sector
- Ensure a robust governance and credit architecture is put in place to prevent similar build-up of non-performing loans in the future
- Recommendations to be in compliance with extant regulations

In order to resolve the pool of non-performing assets (NPAs), the committee recommends a five-pronged approach:

- **SME resolution approach (SRA):** This approach will be applicable to assets which are less than INR 50 crore in value and contribute ~INR 2.1 lakh crore to the PSB stressed assets pool. These are predominantly sole banking assets and do not need co-ordination between multiple banks to resolve. These companies are SMEs where the job creation potential is the largest and the ability of the companies to survive difficult times is the least. Since resolution of these assets is completely under a single bank's control, the resolution approached should be aligned to the individual bank, albeit under a broader framework which is outlined here in. There should be customised resolution approaches for different types of assets and a well-defined time bound process to resolve them. To this end it is proposed, banks should put in place a focused vertical within the organisation with clear targets and staff this vertical appropriately. Banks should devise templated resolution approaches for different types of stressed assets based on simple metrics and define SOP for resolution. Banks should set-up empowered internal SME steering committee(s) for formulating/ validating these schemes including provision of additional funds, if required. The resolution under this approach would be non-discretionary, non-discriminatory and executed in a time-bound manner. Additionally, banks should put in place a robust monitoring process that will ensure implementation of resolution in a time bound manner within 90 days.

- **Bank-led resolution approach (BLRA)**: This approach will be applicable to mid-sized assets (less than INR 500 crore but greater than INR 50 crore). These are a larger number of assets (1,000+) and involve multiple banks. The value of stressed assets expected to be resolved under this approach from the PSB pool is ~INR 3.1 lakh crore. Under this approach, a time-bound pre-IBC process will be established to resolve bad assets within 180 days. The BLRA will be similar to the IBC process. Financial institutions will enter into a definitive inter-creditor agreement as part of which the lead banker will be provided the authority to run the resolution process. Large banks will help smaller lead banks run the process if required. An independent screening committee of eminent personalities appointed by the IBA will be formed to validate the due process within a maximum of 30 days. The lead bank may bring in operational turnaround experts to manage and run the asset or in some other cases, organise a bidding process to sell the asset. The resolution plan will be approved by lenders holding at least 66% debt. There will be monthly reviews of progress made to ensure discipline of the resolution process. In case the lead bank is unable to implement the resolution plan within 180 days, the asset will move to the NCLT.

- **AMC/AIF approach**: This approach will be applicable to large assets (banking system exposure of INR 500 crore and above), with a potential to turnaround. These are a small number (about ~200) but account for a large share of non-NCLT stressed assets in terms of value. The value of stressed assets expected to be resolved under this approach from the PSB pool is ~INR 3.1 lakh crore. Under this approach, an independent AMC will be set up. This AMC will be professionally managed and will attract institutional funding in stressed assets through AIFs. Banks also have an option to invest in the AIFs if they want to participate in the upside. Participating banks and Indian institutional investors will hold a majority of the units in the AIF. The AMC/AIF would be the market maker and thereby ensure healthy competition, fair price and cash recovery.

Financial institutions will enter into a definitive inter-creditor agreement as part of which the lead banker will be provided the authority to run the resolution process. The Lead bank would launch an open auction to invite bids for sale of the stressed asset. The AMC/AIF will partner with an ARC and jointly bid for the asset. Should the ARC win the auction, it will pay the banks in cash within 60 days. The ARC will conduct financial restructuring of the asset and then transfer the asset (both debt and equity) to the AIF. Post restructuring, the promoter would hold no more that 24% equity in the asset and AMC/ AIF (post-transfer) would become the majority holder. At this point, all the banks and the ARC would have no exposure to the asset, which will reside completely with the AMC. The AMC/AIF will conduct operational turnaround of the asset by itself or by engaging with an external party. This approach allows for consolidation of debt and bringing in specialist skills for turnaround. At the same time, this approach allows for a large part of the upside value generated from turnaround to remain with the domestic investors. This AMC/AIF can also bid for assets in the NCLT and thus play a broader role in resolutions. The net effect of this approach would be to build an open architecture and a vibrant market for stressed assets.

Though the above approaches have been drawn based on the size of exposure, depending on the complexity of individual asset, lenders will have flexibility to adopt the approach that fits best.

- **NCLT/ IBC approach:** Assets which have limited potential for turnaround or cannot be resolved within timeline stipulated by the RBI under the above approaches will be resolved through this approach. ~INR 2.3 lakh crore of stressed assets from the PSB pool is already with the NCLT for resolution.
- **Asset trading platform (ATP):** In addition to the approaches outlined above, an Asset Trading Platform should be created in the country. Such a platform will allow banks to trade loans among themselves and with select non-banking participants. This platform will be extended to both performing and non-performing loans, and thus will create a market for loans. Such a platform can help banks better manage their balance sheets and capital as well. There exists an opportunity for nodal institutions to provide credit enhancement, market making and warehousing for assets on the trading platform

The success of these recommendations will depend on a few critical factors:

- AMC/AIF: Independence of the AMC in terms of decision making and an arms-length relationship with the banks is central to the success of this solution. Towards this the committee recommends creating the following five-part governance approach

– **Ownership:** The AMC should be a private-sector entity with a maximum of 49% participation from PSUs. The predominant ownership will come from the private sector

– **Compensation:** In line with market practice, the compensation to the AMC will be in the form of an acceptable management fee and a carry which will be linked to returns generated for investors. This structure will ensure alignment of interests

– **Board:** The AMC board composition will reflect the ownership pattern, i.e., majority non-Government/PSB). In addition, the board will comprise eminent personalities as strong independent directors with diverse skill sets

– **Management team:** The management team of the AMC/AIF will comprise professionals recruited from the market. The senior team will have significant and relevant experience, e.g., managing funds, operational turnaround. Further, a significant component of the team's remuneration will be linked to returns generated for limited partners thus aligning management interests with investors

– **Investment committee:** This will comprise members from the senior management team of AMC/AIF and professionals, thus providing it complete independence. In particular, banks will play no role on the investment committee

- **Capital:** Public Sector Banks will require additional capital to drive the resolution through the five approaches described above. The overall capital requirement for resolution is expected to be about INR. 1.1 - 1.3 lakh crore. This capital will be required over a period of two fiscal years (FY 19 and FY 20). PSBs should be able to build some capital buffer through operating profits and sale of non-core assets, which should help reduce the capital requirement in FY 20. In addition to the capital above, some PSBs are already under-capitalised and require capital infusion to continue operations. Further, growth capital will also be required. These requirements are additional and not included in the calculations above.

- **Regulatory support:** All the approaches outlined above are mostly in line with current regulations. One regulatory dispensation is required from SEBI – currently AIFs are not allowed to own more than 51% in listed securities. A special dispensation is required to allow such AIFs to hold more than 51% as the NCDs issued by the asset will be listed and in many cases, the equity may be listed as well. Additionally, one more regulatory support for the AMC/AIF structure will significantly aid banks. Investments by banks in category II AIFs attract 150% risk weightage for first three years and 250% post three years. The investments of the AIF under discussion are predominantly of a debt nature as AIF would subscribe to the bonds issued by borrower company. Hence, a dispensation may be sought from RBI to allow Capital required by banks to hold AIF units to be as per rating of the bonds issued by a credit rating agency vs 150% risk weight for 3 years and 250% thereafter.

The committee also recommends a holistic approach to build a robust governance and credit architecture in order to ensure a similar build-up of stressed assets does not occur in the future. These include:

- Governance: PSBs have significant scope for enhancing governance through induction of professionals with strong banking, legal, technology and industry experience. This is the most critical step towards enhancing credit architecture for these banks. Appropriate recommendations made by committees including PJ Nayak Committee should be revisited and implemented
- Organisation structure: PSBs should review their organisation structure and ensure development of an independent, well-staffed and skilled risk function. Further, banks need to strengthen all three lines of defence. Finally, banks should build specialisation along industry verticals in their credit departments
- Policies: The committee recommends a number of product and policy changes. The objective of these is to learn from the current situation and ensure that banks have full visibility and control over promoter finances and cash flows, stop diversion of funds and control overleveraging
- Processes: A four-pronged approach to transforming credit processes is proposed—changing end-to-end credit process; moving to cash flow-based funding; adopting a risk-adjusted return on capital approach and continuous monitoring via Portfolio Quality Index (PQI)
- Technology: PSBs can adopt best-in-class technology and analytics practices to enhance credit risk management
- Credit capacity and capability: A significant area for improvement for PSBs is in credit capability. Across banks, the number and skills of people in the credit area are lacking. Lack of appropriate training and frequent transfers adds to the challenge. Finally, with the fear of investigation, the best people in the bank not preferring to join credit roles. Banks must internally review in-house talent pool in credit and risk function. If need be, banks should hire/ induct quality talent from market to supplement in house resources.
- Culture: PSBs should work towards enhancing the overall credit culture and create ownership for credit risk at every level of the organisation

3. Introduction

CONTEXT

The Indian banking system is in the middle of a major stressed assets cycle, resolving which is the top priority for the sector. The total outstanding loans under stress in Indian PSBs stood at ~INR 10.6 Lakh crore as on 31stMarch, 2018.

Resolving the stressed assets situation in the country requires significant and concerted efforts. Many steps have been taken over last few years by the government, the regulator and individual banks to enable resolution.

- RBI has issued multiple schemes and frameworks for revitalising distressed assets such as the corporate debt restructuring scheme, flexible structuring of existing long-term projects, strategic debt restructuring (SDR), change in ownership outside SDR, scheme for sustainable structuring of stressed assets (S4A) and joint lenders' forum (JLF)
- Government has passed the Insolvency and Bankruptcy Code (IBC) and prescribed the resolution process under the NCLT. A significant headway has been made towards stressed assets resolution with the introduction of the IBC. The IBC provides a time-bound process and regulatory dispensations for resolution of stressed assets. The NCLT/ IBC method is currently in the process of resolving 30-35 larger accounts with total outstanding loan amount of INR~2.3 lakh crore
- In addition, there are 24 ARCs operating in the country, which are active in buying out loans and resolving them. These ARCs have an AUM of INR 80,000-90,000 crore.
- Finally, banks continue to take steps on their own towards resolving stress in their books.

CHALLENGES

Since the magnitude of the stressed assets situation is quite big, creating the right value for the ecosystem would require a multipronged approach. Multiple issues exist within the current system for any resolution—NCLT/ IBC method, existing ARCs and bank-led resolution.

NCLT/ IBC method

The IBC provides an excellent legal framework for resolution. However, the NCLT process is constrained by the capacity of tribunals, which is adversely impacting their ability to resolve stressed assets in a time-bound manner as envisaged in the code.

Further, banks have little ability to participate in any upside that may be created from turnarounds delivered post the NCLT process.

Existing ARCs

The existing ARCs have limited role in resolving the stressed assets situation due to the following factors:

- **Limited availability of capital:** The total capital base of 24 ARCs is ~INR 4,000-6,000 crore. With the requirement to maintain a capital adequacy ratio of 15% of their risk weighted assets, the value of assets that the existing ARCs can acquire is limited
- **Lack of alignment on price discovery**: Banks and ARCs have faced challenges in aligning prices, and as a result price discovery has been difficult
- **Limited funding options**: Standalone ARCs have limited options of raising funds. With change in regulations around true sale criteria, upfront cash requirement for ARCs has increased further, limiting the number of deals and the deal size
- **Lack of a clear time-bound process for acquisition of asset by ARC:** Complexity of dealing with multiple banks for aggregation of debt results in significant delay in the acquisition

Bank-led resolution

- **Fragmentation of borrowings:** Most corporates with stressed loans have a large number of banks in the consortium—hence getting consensus among the wide spectrum of lenders has been a challenge
- **Lack of true price discovery:** From the banks' perspective, arriving at a common definition of sustainable debt is difficult as this would require upfront haircuts
- **Lack of a time-bound process:** Lack of a clear time-bound process for assets not being managed through the NCLT/ IBC method results in delayed resolution and destroys value of the underlying asset.

For any solution to be effective, it is critical to resolve these issues.

This note aims to outline a **multi-pronged approach** for effective resolution of stressed assets in India. The **objectives of the suggested approach** are:

- Ensure operational turnaround to retain value of assets created for national benefit
- Prevent job losses from foreclosures and create additional jobs by reviving businesses

- Ensure a large part of upside value is captured by domestic institutions
- Bring in credible long term external capital to limit the burden on the domestic banking sector
- Ensure a robust governance and credit architecture is put in place to prevent similar build-up of non-performing loans in the future
- Recommendations to be in compliance with extant regulations

4. Five-pronged approach towards stressed asset resolution

As part of the exercise, data on stressed assets was collected from all public-sector banks and analysed for different sectors and exposure segments. As per the analysis, the total stressed assets pool with PSBs stood at ~INR 10.6 lakh crore as on 31stMarch 2018.

Of the total pool, assets worth INR 2.3 Lakh crore are already with NCLT. Of the remaining pool of INR 8.3 Lakh crore, assets worth INR 2.1 Lakh crore have individual exposures of<INR 50 crore.

Based on the analysis, the approach for the various categories of assets is:

- **Approach 1—SME resolution approach (SRA):** Assets with the total banking exposure <INR 50 crore—setting up of a focussed stressed SME assets vertical in banks.
- **Approach 2—Bank-led resolution approach (BLRA):** Mid-sized assets (total banking exposure between INR 50 crore to INR 500 crore) and with potential for turnaround. These accounts would be resolved through a time bound process led by banks.
- **Approach 3—AMC/AIF-led resolution: –**For **large assets** (total banking exposure >INR 500 crores) and with potential for turnaround– These would be limited set of ~130-150 large accounts for PSBs where the focus would be operational turnaround by professionals.

Though the above approaches have been drawn based on the size of exposure, depending on the complexity of individual asset, lenders will have flexibility to adopt the approach that fits best.

- **Approach 4—NCLT/IBC for Assets with limited potential for turnaround:** Assets which have limited potential for turnaround or cannot be resolved within timeline stipulated by the RBI under the above approaches will be resolved through this approach.
- **Approach 5—Asset trading platform (ATP)** – The committee recommends creation of an asset trading platform that may allow trading of loans among banks and non-banking financial institutions. This platform would enable trading of both performing and non-performing loans, creating liquidity for banks

Details of the approaches are as under:

APPROACH 1: SME RESOLUTION APPROACH (SRA)

This approach will be applicable to assets which are less than INR 50 crore in value and contribute ~INR 2.1 lakh crore to the PSB stressed assets pool. These are predominantly sole banking assets and do not need co-ordination between multiple banks to resolve. These companies are SMEs where the job creation potential is the largest and the ability of the companies to survive difficult times is the least. Since resolution of these assets is completely under a single bank's control, the resolution approached should be aligned to the individual bank, albeit under a broader framework which is outlined here in. There should be customised resolution approaches for different types of assets and a well-defined time bound process to resolve them. To this end it is proposed that banks should put in place a focused vertical within the organisation with clear targets and staff this vertical appropriately. Banks should devise templated resolution approaches for different types of stressed assets based on simple metrics and also define SOP for resolution. Banks should set-up empowered internal SME steering committee(s) for formulating/ validating these schemes including provision of additional funds, if required. The resolution under this approach would be non-discretionary, non-discriminatory and executed in a time-bound manner. Additionally, banks should put in place a robust monitoring process that will ensure implementation of resolution in a time bound manner within 90 days.

APPROACH 2: BANK-LED RESOLUTION APPROACH

This approach will be applicable to mid-sized assets (less than INR 500 crore but greater than INR 50 crore). These are a larger number of assets (1,000+) and involve multiple banks. The value of stressed assets expected to be resolved under this approach from the PSB pool is ~INR 3.1 lakh crore. Under this approach, a time-bound pre-IBC process will be established to resolve bad assets within 180 days. The BLRA will be similar to the IBC process. Financial institutions will enter into a definitive inter-creditor agreement as part of which the lead banker will be provided the authority to run the resolution process. Large banks will help smaller lead banks run the process if required. An independent screening committee of eminent personalities appointed by the IBA will be formed to validate the due process within a maximum of 30 days. The lead bank may bring in operational turnaround experts to manage and run the asset or in some other cases, organise a bidding process to sell the asset. The resolution plan will be approved by lenders holding at least 66% debt. There will be monthly reviews of progress made to ensure discipline of the resolution process. In case the lead bank is unable to implement the resolution plan within 180 days, the asset will move to the NCLT.

APPROACH 3: AMC/AIF-LED RESOLUTION APPROACH

This approach will be applicable to large assets (banking system exposure of INR 500 crore and above), with a potential to turnaround. These are a small number (about ~200) but account for a large share of non-NCLT stressed assets in terms of value. The value of stressed assets expected to be resolved under this approach from the PSB pool is ~INR 3.1 lakh crore. Under this approach, an independent AMC will be set up. This AMC will be professionally managed and will attract institutional funding in stressed assets through AIFs. Banks also have an option to invest if they want to participate in the upside. Participating banks and Indian institutional investors will hold a majority of the units in the AIF.The AMC/AIF would be the market maker and thereby ensure healthy competition, fair price and cash recovery.

Financial institutions will enter into a definitive inter-creditor agreement as part of which the lead banker will be provided the authority to run the resolution process. The Lead bank would launch an open auction to invite bids for sale of the stressed asset. The AMC/AIF will partner with an ARC and jointly bid for the asset. Should the ARC win the auction, it will pay the banks in cash within 60 days. The ARC will conduct financial restructuring of the asset and then transfer the asset (both debt and equity) to the AIF. Post restructuring, the promoter would hold no more that 24% equity in the asset and AMC/ AIF (post-transfer) would become the majority holder. At this point, all the banks and the ARC would have no exposure to the asset, which will reside completely with the AMC. The AMC/AIF will conduct operational turnaround of the asset by itself or by engaging with an external party. This approach allows for consolidation of debt and bringing in specialist skills for turnaround. At the same time, this approach allows for a large part of the upside value generated from turnaround to remain with the domestic investors. This AMC/AIF can also bid for assets in the NCLT and thus play a broader role in resolutions. The net effect of this approach would be to build an open architecture and a vibrant market for stressed assets.

The AMC/AIF-led approach helps in resolving multiple issues currently hindering the resolution of assets:

- Enables true price discovery by establishing a market mechanism
- Consolidates debt into one single entity, thereby ensuring faster decision making
- Takes the loan out of the banks' balance sheets and frees up the blocked capital/funds.
- Provides banks an opportunity to participate in the upside by investing in the units of AIF
- Lastly, it helps operational turnaround of assets through specialists and industry experts and consequently improve the equity valuation which would benefit the investors of AIF

Though the above approaches have been drawn based on the size of exposure, depending on the complexity of individual asset, lenders will have flexibility to adopt the approach that fits best.

APPROACH 4—NCLT/IBC FOR ASSETS WITH LIMITED POTENTIAL FOR TURNAROUND

Assets which have limited potential for turnaround or cannot be resolved within timeline stipulated by the RBI under the above approaches will be resolved through this approach.

APPROACH 5: ASSETS TRADING PLATFORM (ATP)

In addition to the approaches outlined above, an Asset Trading Platform should be created in the country. Such a platform will allow banks to trade loans among themselves and with select non-banking participants. This platform will be extended to both performing and non-performing loans, and thus will create a market for loans. Such a platform can help banks better manage their balance sheets and capital as well. There exists an opportunity for nodal institutions to provide credit enhancement, market making and warehousing for assets on the trading platform.

4A. SME assets resolution approach (SRA)

Stressed assets with total banking exposure <INR 50 crore would mostly constitute SME accounts. These assets constitute a significant proportion of stressed assets. Given that the SME sector is a critical engine of economic and jobs growth in the country, resolving these assets in a time bound manner is critical. These assets will mostly comprise sole banking relationship with the banks and hence need to be resolved by individual banks based on their internally defined policies and procedures. The committee has outlined the SME asset resolution approach for these assets.

Under this approach, banks should set up an effective internal system or strengthen their existing system for resolving stressed assets across five key elements—organisation structure, process flows, decision-making tools, capabilities, and performance management:

1. **Organisation structure:** Key choice on organisation structure for the banks is whether to have a separate vertical for management of stressed assets in SME segment. Given the importance of this segment in the overall economy, it is recommended that banks setup a separate vertical for stressed SME accounts above an exposure cut-off of INR 5 crore depending on NPA rates in their individual portfolios. This vertical would help in focused resolution and recovery of assets through specialists. In addition, banks should create empowered internal SME steering committee(s) for formulating/ validating the resolution schemes for different types of SME assets.
2. **Decision making tools:** Standardised and templated decision-making schemes are necessary for triaging assets into various types. In order to simplify the process, the tools should be simple and metricised. The treatment for assets should be non-discretionary and non-discriminatory.
3. **Process flows:** Banks should have a clearly defined process (SOP) to be followed by relationship managers/recovery professionals. The SOP should define clear approaches for rehabilitation or liquidation depending on the type of asset. It should contain a time bound resolution plan with clearly defined day-wise interventions to be made by the relationship managers/ recovery professionals. Finally, it should also layout various external vendors that need to be engaged (e.g., lawyers), their pay-out structures and measurement and monitoring metrics for appropriate actions. These processes should be non-discretionary. Banks should set up empowered internal SME steering committee(s) for formulating/ validating the resolution schemes. The resolution schemes devised under this approach would have a resolution horizon of up to 90 days.
4. **Capabilities:** Effective resolution of stressed assets would require building up specialist skills in PSBs. These skills would include recovery specialists for

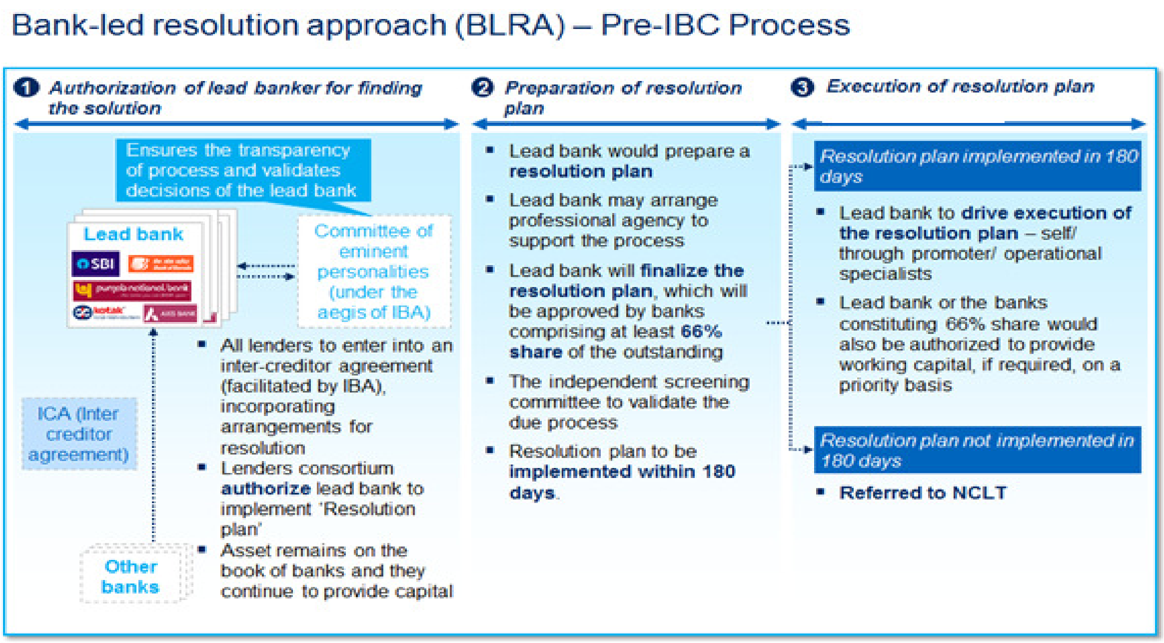
collections of dues, restructuring experts, legal experts for initiating required court proceedings for takeover and liquidation of collateral. Banks may tie-up with specialist firms to get access to these capabilities, if skills are deficient internally.

5. **Performance management:** Clearly defined KPIs at each level are critical for alignment of interest. There must be appropriate dis-incentivisation for asset transfer between SME Vertical and Stressed SME Vertical. The dis-incentive can be derived based on LGD at the time of transfer. This would promote appropriate behavior in SME lending and prevent dumping of assets in the Stressed SME vertical.

4B. Bank-led resolution approach (BLRA)

FRAMEWORK

EXHIBIT 1



1. Authorisation to lead banker for developing a resolution plan:
    a. Financial institutions enter into a definitive inter-creditor agreement whereby decisions taken by the largest participating banks (with at least 66% share of outstanding) would be binding on all the lenders and no lender would separately file case for liquidation with NCLT
    b. The lenders consortium would then authorise/appoint a lead bank to implement a resolution plan within a period of 180 days. In this process, the asset remains in the books of respective banks which would continue to provide provisions as per the prescribed norms
    c. An independent screening committee of eminent personalities (comprising finance professionals, judiciary and vigilance experts) would be set up by the IBA to validate the due process within a maximum of 30 days.

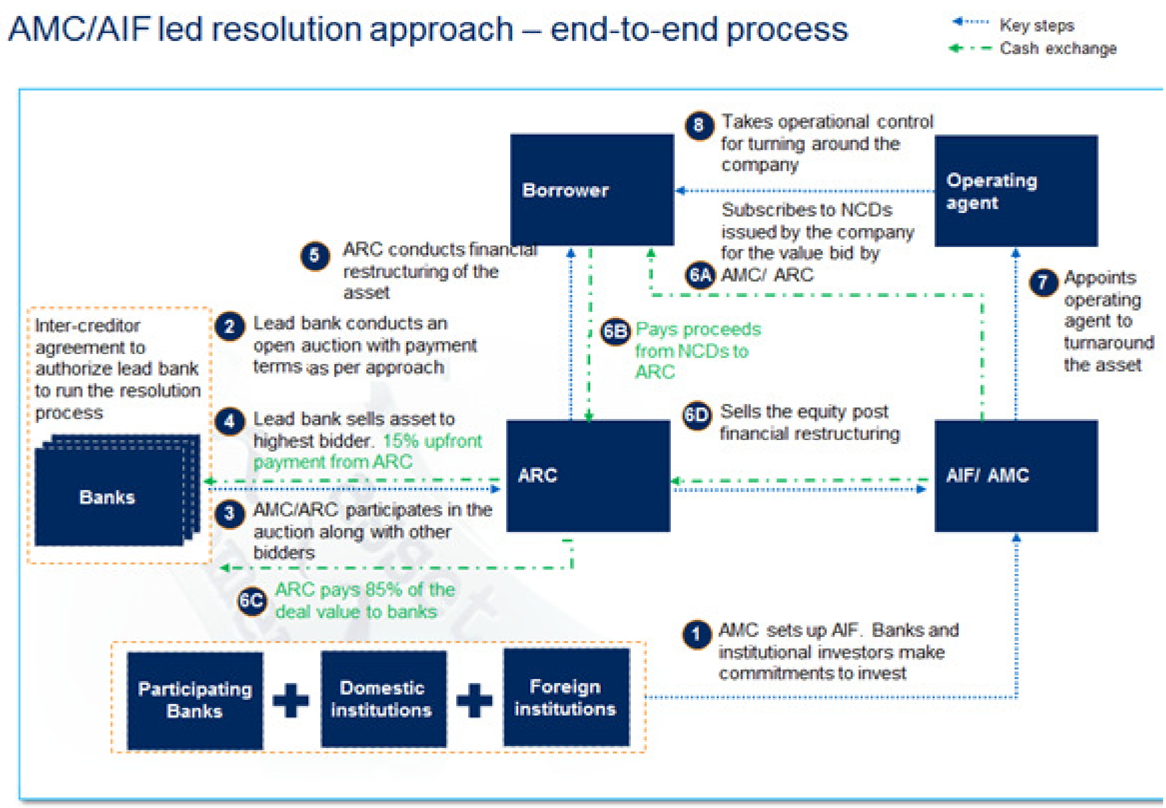
2. Preparation and implementation of resolution plan by the lead bank:
    a. Lead bank could appoint a professional agency (akin to a resolution professional in IBC process) to run the resolution process and recommend a resolution plan to the lead bank
    b. The lead bank would present the recommendation and finalise the resolution plan basis approval from lenders holding at least 66% debt
    c. If the lead bank fails to implement the resolution plan within 180 days, the asset would move to the NCLT process on the 181st day
    d. A credit rating agency will also undertake Independent Credit Evaluation (ICE) on debt wherever applicable as per extant guidelines
3. Execution of resolution plan by the lead bank:
    a. In case the resolution plan is implemented within 180 days, the lead bank would be responsible for executing the resolution plan
    b. It may execute the resolution plan on its own or with the help of promoter or may bring in some operational specialists to turnaround the asset

A monthly review of progress will be shared by the lead bank with all participating bankers to ensure discipline of the resolution process.

4C. AMC/AIF-led resolution approach

OVERALL FRAMEWORK

EXHIBIT 2



1. An independent and professionally managed AMC (Asset Management Company) would be set up under this process. The AMC will set up AIFs and solicit commitments from banks, as well as domestic and international investors
2. Financial institutions to enter into an inter-creditor agreement authorising the lead bank to run the resolution process. The lead bank would launch an open auction to invite bids for the sale of the stressed asset from the interested ARCs/ AMCs/ other investors. Bids will be invited on a 100% cash basis or 15% cash, and 85% SRs redeemable within 60 days.
3. The AMC will partner with an ARC and conduct an independent due diligence on the asset for estimating the value of sustainable debt and participates in the open auction along with ARCs and other investors.

4. The loans will be sold to the highest bidder as per the process laid down by RBI and the highest bidder would make payment as per the auction terms as indicated in point 2 above.

   In case the highest bid is from the ARC/ AMC created under this approach, the ARC would pay 15% upfront to lenders in cash, and for the remaining amount issue SRs redeemable within 60 days.

5. The ARC would aggregate the total debt and undertake financial restructuring of the asset. ARC will acquire management control of the entity. ARC will restructure the asset by converting unsustainable debt into equity. ARC may consider potential restructuring options like issuance of long term zero coupon bonds for providing upside to banks at a future date subject to a successful operational turnaround of the asset. Under financial restructuring, the borrower will issue equity such that promoter equity drops to at most 24% and ARC becomes the majority equity holder in the asset.

6. The ARC will transfer ownership and complete operating control of borrower company to the AIF, for which the following transactions will take place:

   a. The borrower company will issue NCDs equivalent to the bid amount of ARC, which will be subscribed to by the AIF

   b. The borrower will repay debt to the ARC using the proceeds received from issue of NCDs

   c. The ARC will in turn use the proceeds to redeem the SRs held by banks.

   d. The ARC will transfer equity component of the asset to the AIF at a value as per the extant regulations

   At this point, the entire exposure of the ARC (across debt and equity) will have been transferred to the AIF

7. Once the asset is transferred to the AIF, the AMC/AIF would take over the asset and work to turnaround the asset—AMC/AIF may do this either in conjunction or without the existing owner/management teams. It may also appoint an operating agent for leading the turnaround

8. Should the turnaround process succeed, it will deliver returns to the unit holders of the AIF. The unit holders of AIF—banks, domestic and international institutional investors—will receive the returns both from the NCDs and the equity upside as and when the same materialises.

FOUR FACTORS OF SUCCESS

- **Governance structure for AMC/AIF:** Ensuring that the AMC has the governance structure to act independently is critical for success of the entire process. Towards this, the committee recommends a number of initiatives in Annexure 8.1. Key highlights from these are:

- A large component of the compensation structure of the AMC and that of its senior management should be linked to returns generated for investors
- The AMC should have least 51% ownership by private institutions with no investor holding more than 10% equity to ensure independent governance of the AMC free from government intervention
- The AMC should have board representation in line with its ownership. Additionally, the AMC should appoint eminent personalities from financial services and relevant sectors as Independent directors
- The senior management team of the AMC should be market recruited professionals with prior experience in fund management and operational turnaround
- The AIF would have an independent Investment Committee (IC) comprising senior management team of the AMC/AIF and professionals. PSBs participating as LPs would not have any representation on the IC. This will ensure the IC decisions are made in transparent and independent manner.

■ **Price discovery at sale:** True price discovery at the time of sale is critical and needs to be market determined. This would be enabled by:

- The open auction process adopted by the lead bank
- Creation of a market mechanism whereby AMC/ AIF along with other ARCs and strategic investors can bid for the asset. Hence, enabling true price discovery at the time of sale.
- Only cash bids (or SRs redeemable within 60 days) would be stipulated to ensure comparison of bids submitted

■ **Key capabilities of AMC/AIF**: To effectively carry out a set of key tasks, the AMC/AIF would require the capabilities to:

- Raise and manage funds: Raise funds from banks, domestic institutions and foreign investors. This would require on-boarding professional managers/ partners with prior experience with reputed AMCs
- Make investment decisions: Set in place an institutional process for identifying and valuing deals, including conducting diligences, working with partners (lawyers, accountants) to structure and close deals
- Manage investments: Manage assets brought on board. This would require the AMC to have in house talent or partnerships with agencies which can provide these services
- Risk management: Expertise in managing various types of risks

■ **Operational turnaround of the asset:** This would be critical to ensure returns to the investors and success of the overall program, and would require:

- AMC to employ professionals with relevant turnaround and industry experience, or establish partnerships with professional firms/ turnaround agents/ strategic players to bring those capabilities
- Compensation of AMC/AIF to be linked to the operational turnaround of the asset and returns delivered to the investors. Proposed compensation structure for the AMC/AIF is an annual management fees plus carry above a pre-defined return threshold

To summarise, key features of the AMC/AIF approach are as under:

- AMC/ AIF approach augments **asset resolution capability** by establishing a professionally managed AMC supported by attracting **institutional funding** in stressed assets through AIFs
- This approach drives **consolidation** of stressed assets under AMC for better and faster decision making. This frees up management bandwidth of banks enabling **focus on credit growth** and consequent enhancement in **valuations.** The suggested structure is by and large capital neutral.
- Since SRs will be redeemed in 60 days it will provide liquidity and growth capital to banks
- The AMC/AIF would be the market maker and thereby ensure healthy competition, fair price and cash recovery
- Transfer of assets from banks to AMC/AIF would be based on **market price** and not book value
- This approach provides opportunity for banks to participate in the upside by investing in the AIF
- The net effect of this approach would be to build an open architecture and a vibrant market for stressed assets.

For detailed process and proposed structure, please refer to Appendix 8.1

4E. Asset trading platform

In addition to creating solutions for resolution of stressed assets, the committee recommends that a market oriented loan trading platform be created. Such a platform would allow trading of both performing and non-performing loans and will form the basis for banks to buy or sell such loans between themselves and also with select other market participants. This section outlines a high-level perspective on such a system. Developing such a system requires a detailed effort to flesh out all the details and a subsequent committee may be formed to outline this.

DEBT TRADING: GLOBAL EXPERIENCE

In many global markets such as the US, Hong Kong, loan trading is an established market practice. In this case, banks instead of keeping the loans on their books, trade them like stocks and bonds. Institutional investors are attracted to certain advantages that loans possess over bonds—they are senior secured debt obligations with floating rates of return.

Different loan trading associations like Loan Syndications & Trading Association (LSTA), Loan Market Association (LMA), and Asia Pacific Loan Market Association (APLMA) have developed standard documentation for both primary and secondary markets and promote standard trading, settlement and valuation procedures. They act as the liaison between loan market players and regulators.

The standard documentation helps both buyers and sellers in pricing the loans and the market makers to transparently provide two-way quotes to potential buyers. Some negotiation could still be involved based on the specifics of each case, but these are usually kept to a minimum. The LSTA publishes separate sets of documents and related settlement protocols to facilitate each of par and distressed trading.

Buyers are given two key categories of protection when utilising the LSTA's distressed trading documents:

- Additional representations and warranties
- The ability to track prior payments and distributions

Debt trading: Suggested approach for India

An online trading platform for loans should be set up. The platform can also be used to sell loans for risk transfer, both performing and non-performing.

The proposed online platform can be used not just for regular sales of loans through the request for quote (RFQ) mechanism for example, but can also be used to have live auctions for distressed loans. The live auction mechanism would also be suitable for the Indian public sector banks as otherwise they may be reluctant to sell any loan for a haircut due to risk of charges of impropriety. A live and transparent bidding auction mitigates the risk of potential impropriety.

Like in the syndicated loan market of the US, banks could also have the originate to distribute model, with other banks, and other asset managers can be the eventual investors.

Additionally, ATP offers an opportunity to the nodal institutions to provide credit enhancement, market making and warehousing for assets on trading platform.

Benefits of this process:

1. The potential improved liquidity as well as the lower turnaround times possible through such a platform, can help banks get better valuations for their stressed accounts. In many cases valuation of the underlying asset suffers due to delay in resolution process
2. A secondary loan trading market will help banks sell off the loans from their books, in a way somewhat similar to securitisation, but in a less cumbersome manner. This will improve availability of funds with banks, and can eventually lower borrowing costs for companies as well. In addition, the secondary loan market will provide a possible measure of recovery at the level of stress as well, indicated by the loan sale value. Eventually this could also help and aid the development of a Credit Default Swap (CDS) market in India.
3. Another benefit that such a platform can have is the potential savings in legal fees. Globally, legal and admin fees are the first to be paid in case of liquidation. A lengthy legal process for resolution or liquidation can add significant legal and admin costs, which are eventually borne by the creditors. In a live bidding platform, these costs can also be significantly minimised
4. Under the current ARC mechanism, differences over valuation often lead to cancellation of the sale of bad loans. As mentioned earlier, the live bidding auction mechanism on the online platform can reduce chances of such cancellations, even though sellers would still be allowed to keep a minimum threshold valuation they are willing to accept in such an auction. This mechanism can also be used by banks to sell the security receipts (SRs) issued to them by ARCs to third parties and recover value in advance, thereby freeing up additional funds for lending. Banks currently hold around INR 90,000 crore worth of SRs in their investment books. SEBI has recently approved norms for listing of security receipts issued by ARCs.

Establishing a well performing loan trading platform will require setting up a few enabling elements. Some of these are outlined are:

- Standard documentation: As in the case of LSTA, the Indian equivalent can also come up with standard documentation for secondary trades. Similarly, additional documentation requirements for distressed loans can be defined and set up.

Standardisation of documentation will help significantly in improving the turnaround time in any loan sale, and will eventually help improve liquidity in the secondary market.

- Facility agents/trustee: Trading of loans will require a facility agent entity and Trustees to be created to act as a trust to hold and manage collateral as well as to ensure documentation processes are fully compliant. Such an agency can also manage loans on an ongoing basis and ensure financial covenants are met.
- Recovery ratings: Rating agencies can help develop the distressed loan market by not just downgrading the loan facility rating, but also possibly providing both the probability of default as well as potential recovery, possibly through a simplified recovery rating specifying a scale of potential recovery ratio.

5. Capital requirement for PSBs under the proposed approach

Total capital required by PSBs for resolution of stressed assets across all the approaches is expected to be **INR 1.1-1.3lakh crore**, spread over a period of two fiscal years (FY 19 and FY 20). As the resolution process will be done in a phase-wise manner, PSBs should be able to build some capital buffer through operating profits and sale of non-core assets. This could bring down the requirement for additional capital.

Type of asset	Resolution mechanism	Outstanding loan amount (PSBS)	Capital required (PSBS)
Assets with exposure of INR <50 crore	SME asset resolution approach	~INR 2.1 lakh crore	INR 23,000-28,000 crore
Assets with exposure between INR 50-500 crore and assets >INR500 crore but with limited turnaround potential	Bank led resolution approach (BLRA) /NCLT process	~INR 3.1 Lakh crore	INR 37,000-42,000 crore
Assets with exposure >INR 500 crore with potential for turnaround	AMC/AIF-led resolution approach	~INR 3.1 lakh crore	INR 37,000-42,000 crore
Assets already with NCLT (List 1 and List 2)	NCLT process	~INR 2.3 lakh crore	INR 10,000-15,000 Crore

COMPUTATION OF CAPITAL REQUIRED UNDER AMC/ AIF APPROACH

At an exposure cut off of>INR 500 crore, stressed assets with total outstanding loan of INR ~3.6 lakh crore (in which PSBs would have ~INR 3.1 lakh crore exposure) are expected to be processed under AMC/AIF approach. The capital would be required for the following:

- Capital for upfront haircut required on sale of assets: PSBs may be required to take a haircut at the time of sale of assets to the ARC to compensate for any difference between provisions already made and sale value. We expect this haircut to be in the range of INR 40,000-45,000 crore
- Capital for investment in units of AIF: The total funding required in the AIF is expected to be INR 1.1-1.3 lakh crore. Banks will contribute 50-60% of funds—PSBs (30%) and Private sector (20-30%), domestic institutions would provide ~20-30% and foreign investors would provide ~20-30%. For this investment in AIF, PSBs would be required to maintain a capital adequacy ratio 10%. Investments in AIF carry a risk weight of 150% for first three years where they will be classified under HTM category and 250% post three years where they will be classified under AFS category. Assuming PSBs would hold 30% of units issued by AIF, capital required would be INR 4,000-5,000 crore
- Capital freed from sale of assets: Through this process, the banks would also free up capital blocked against these stressed assets. We expect the capital released to be about INR 6,000-7,000 crore

Hence, the total capital required by PSBs would be about INR 37,000-42,000 crore for this approach.

Additionally, capital will be required in the ARC. It is expected that the ARC would have assets worth ~9,000-11,000 crore at any point in time. The ARC would hence require capital of ~ INR 2,000-3,000 crore.

6. Key asks from regulatory and government bodies

Ask from	Key asks
Government	■ **A single window is required for resolution** of policy issues in specific sectors (especially for sectors like power, road, telecom) ■ Suitable stamp duty and registration fees exemption to be sought from central and state governments for all transactions under the proposed approached ■ Government to provide capital funding as required by banks in a phased manner to provide for the upfront haircut and growth capital over a period of 2 years
RBI	■ Investments by banks in category II AIFs attract 150% risk weightage for first three years where they are classified under HTM category and 250% post three years where they are classified under AFS category – A special dispensation should be sought for providing risk weightage based on credit rating of bonds held by AIF issued by a credit rating agency
SEBI	■ As per SEBI guidelines, Category II AIF should primarily invest in unlisted securities, i.e. investment in unlisted securities should be more than investment in listed securities. A special exemption should be sought to allow AIF to hold more than 51% in listed securities as the NCDs issued will be listed and for many entities the equity may be listed as well ■ As per regulations, AIF will be entitled to avail the exemption from making an open offer under the Takeover Code provided such an acquisition meets certain specified conditions including conditions on pricing, valuation, lock-in etc. – SEBI extend a clear exemption to the AIF not subject to any conditions

7. Robust credit process for future

The first part of this report focused on finding a resolution for the existing stressed assets situation in the country. In the second part, our focus is on building a robust system to prevent a massive build-up of bad assets in the future. A holistic approach—which includes governance, organisation structure, policies, processes, technology, credit capacity, capabilities and culture—will be required to achieve this objective. This section outlines the committee's views on key areas.

While devising a plan for the future, it is important to understand the factors that led to the current credit situation:

- Overall economic slowdown
- Delays in statutory and other approvals for projects under implementation
- Aggressive lending practices during upturn as evidenced from high corporate leverage
- Laxity in credit risk appraisal, loan monitoring in banks
- Lack of appraising skills for projects that need specialised skills
- Wilful default and loan frauds

The committee looked at seven areas to identify potential action plans for PSBs from a credit perspective. These are governance, organisation structure, policies, processes, technology, credit capacity and capability and culture.

GOVERNANCE

Governance, perhaps, is the most important element in ensuring a robust credit performance. A strong and independent board, comprising individuals with deep experience in credit is critical. Further, it is important that key board positions remain stable over time to be able to understand the bank's credit philosophy and build experience. PSBs have the potential to further strengthen their governance structures. Appropriate recommendations made by committees including PJ Nayak Committee should be revisited and implemented. The committee would like to highlight a few specific ones:

- Boards need to be empowered in line with SEBI's LODR guidelines
- Board agenda needs to be focused on the most important strategic issues facing the bank as against a large number of operational issues
- The NRC should be empowered to recruit board members to complement existing skills with specialist ones, e.g., credit, digital, legal, banking, etc.
- An appraisal system needs to be introduced including peer reviews to assess the effectiveness and contributions of individual board members

ORGANISATION STRUCTURE

It is critical to have clear organisation structures along with defined segregation of the three lines of defence and the ability to create specialisation. Most PSBs have the potential to significantly strengthen their risk management departments in terms of responsibilities. Further, there is a need to clearly identify the three lines of defence and embed these in performance dialogues and KPIs. There is also scope for specialisation, e.g., large banks could have specialist teams in their corporate banking business managing specific industries. The same can be extended to risk teams as well.

POLICIES

There is potential to strengthen a large number of policy elements based on the learnings from the current cycle. The lack of well-defined and strict policies in certain areas has resulted in banks being unable to have full visibility and control over the borrowers' finances, overleveraging, inability to monitor end-use of money and, in some cases, borrowers being able to divert funds. Key policy changes required include:

- Project finance/large corporate finance should be mandatory under consortium arrangement
- Overleveraged capital structure should not be permitted; banks should have full visibility over promoter's equity
- IDC should be funded by promoter/sponsors
- Unrelated diversification by promoter should be dealt with seriously in line with loan covenants
- Validate and verify all approvals and financial projections
- Related parties should not be appointed as EPC contractors

PROCESSES

Putting in place a robust credit process is crucial to managing the bad assets situation. Towards, this there is potential in PSBs to strengthen the same across four areas:

The proposed credit process is based on four key elements:

- Lending best practices across the credit lifecycle—from pre-sanction to monitoring to resolution (if required)
- Covenants
- Cashflow-based funding
- Risk and return practices (metrics and portfolio optimisation)

Lending best practices across the credit lifecycle

The credit lifecycle is a four-stage process starting with pre-sanction diligence followed by the sanction process and post sanction monitoring. The process may involve an exit/resolution in case the asset turns bad. Best practices include:

1. **Pre-sanction:** Conduct robust diligence of the promoter and have an in-depth knowledge of the business model
2. **Sanction:**
    a. Ensure pricing is commensurate to the risk undertaken by the banks
    b. Follow Common Loan Document with Standard Covenants for consortiums and MBAs
    c. Ensure that all banks honour their commitments
3. **Post-sanction monitoring:**
    a. Ensure periodic exchange of information among the lenders
    b. Ensure joint inspection
    c. Convene consortium meetings regularly
    d. Ensure that borrowers have cash management facility with one of the banks within the consortium. The MIS should be shared between banks
    e. Audit stocks and receivables at a regular interval
    f. Conduct Bank Guarantee audit in the account with high NFB limits
4. **Stressed assets identification:**
    a. Scan existing portfolio and identify weaker accounts for remedial measures
    b. Identify the accounts for exit and set exit targets
    c. Ensure timely follow-ups and recovery, as it leads to better recovery prospects

Covenants

1. Ensure that all lenders have a uniform approach to covenants
2. Conduct periodical testing of covenants to find out compliance of the stipulations and resultant action

Cash flow-based funding

1. Establish/validate the turnover using customers' bank statements with a focus on real cash flows (this requires analysis of transactions with lending bank as well as other banks)

2. Leverage advanced analytics to identify non-credit transactions that do not reflect the "true" turnover
3. Validate key ratios based on industry standards to derive P&L and working capital
4. Automate cash flow assessment model through deployment of specialised analytical tools.
5. Link bank statement analysis to Derived financials (balance sheet and P&L).
6. Analyse the credit flow to establish real turnover of the company
7. Use actual utilisation of credit limit in the last 12 months (for revolving credit facilities like Cash Credit), or average outstanding of the last 12 months (for term loans) for accurate calculation of interest expense.

A four-step approach can be used to move from stated cash flows to “real” cash flows:

1. Substantiate financial statements with cash flow streams from other undeclared sources
2. Create rules to distinguish business from personal transactions in Bank statements
3. Set criteria to establish regular transactions from one-offs in case of sales receipts
4. Define guidelines on percentage of cash-only business based on nature of business, size and area of operation

Risk and return practices (metrics and portfolio optimisation)

Banks should adopt the following metrics for comparing profitability across different businesses with varying levels of risk and capital requirement, and for mapping overall portfolio health. Monitoring based on these metrics will help the banks take interventions at the right time and increase risk vs return (move towards ideal portfolio).

1. **Risk Adjusted Return on Capital (RAROC):** This is a risk adjusted performance measuring tool that presents risk-oriented view for the revenues in terms of risks taken to generate those revenues. This presents a uniform measure of performance to compare profitability across different businesses with different levels of risk and capital requirements. The computation is:

EXHIBIT 1

$$\text{RAROC} = \frac{\text{Risk Adjusted Return}}{\text{Economic Capital}}$$

$$\text{RAROC} = \frac{[\overbrace{\text{Revenue}}^{\text{Interest + Non Interest Income}} - \text{Expenses} - \overbrace{\text{Expected Losses}}^{\text{PDxLGDxEAD}}\,]}{\underbrace{\text{Economic Capital}}_{\text{CR + MR + OR}}} \times (1\text{-Tax Rate})$$

Note:

PD: Probability of default

LGD: Loss given default

EAD: Exposure at default

CR: Credit risk

MR: Market risk

OR: Operational risk

Economic capital (EC) is the amount of risk capital that a bank estimates to remain solvent at a given confidence level and time horizon. Economic capital for a business unit will be determined based on different risk factors (CR, MR, OR).

2. **Portfolio Quality Index (PQI):** PQI analysis helps in moving towards the ideal portfolio in terms of risk and return. It represents the weighted average rating of the portfolio at a point in time. The lower the PQI, better the portfolio quality
   a. Internal rating-wise fund-based/non-fund based outstanding of the portfolio at each month/quarter/year-end.
   b. Outstanding in the risk rating grades, e.g., CR 1 to CR 8 (bank's internal ratings) can be assigned weights as under:

EXHIBIT 2

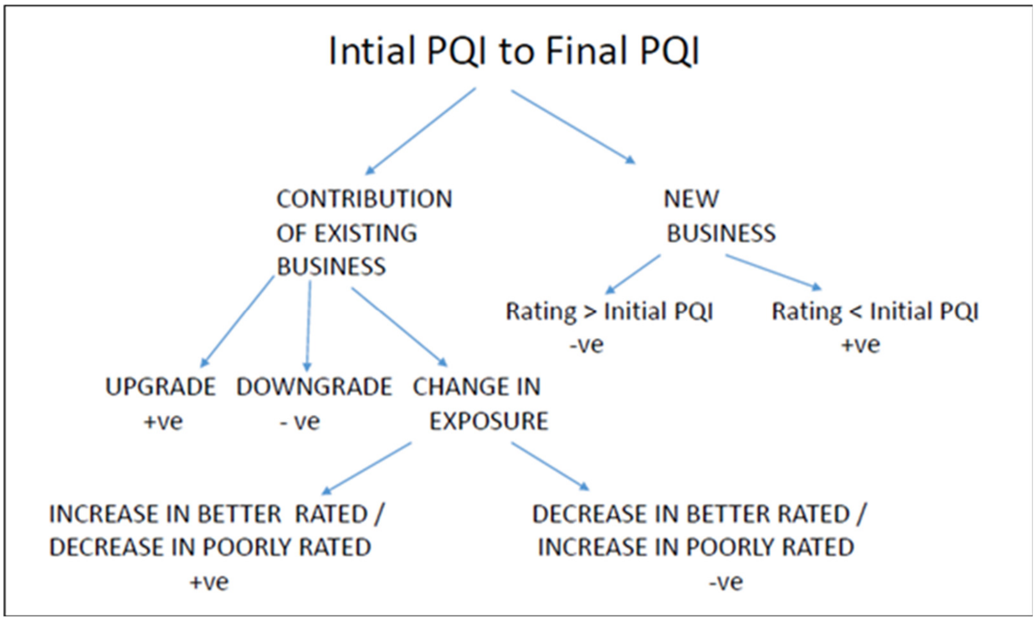
CR1 - 1, CR2 - 2,......CR8(NPA) - 8,

$$\text{PQI} = \frac{\Sigma X_i Y_i}{\Sigma Y_i}$$

X_i = rating weight

Y_i = Outstandings in the rating

EXHIBIT 3



MEASURES TO OPTIMISE RISK VS RETURN (IDEAL PORTFOLIO)

Option A	Option B	Option C
Exit of units with low RAROC and worst PQI.	Review of pricing/concessions	Both (Option A + Option B)

- Concessions in pricing and fee-based income may be linked to internal and external ratings. No concessions may be allowed for the units rated worse than certain hurdle ratings.
- Higher cash margin in respect of non-fund based facilities may be stipulated with a view to neutralise negative impact of high PD in case of low rated units.

TECHNOLOGY

There is significant potential for PSBs to enhance their adoption of technology and analytics in the credit process.

CREDIT CAPACITY AND CAPABILITY

A significant area for improvement for PSBs is in credit capacity. Across banks, the number and skills of people in the credit area are lacking. Frequent transfers, lack of appropriate training adds to the challenge. The fear of investigation has also resulted in the best people in the bank preferring to avoid credit roles. Banks must internally review in-house talent pool in credit and risk function. If need be, banks should hire/ induct quality talent from market to supplement in-house resources.

CULTURE

Finally, there is potential to improve the credit culture in PSBs. The approach followed so far requires people to focus more on compliance with processes and paperwork as against forming a point of view on credit worthiness of the borrower. PSBs need to build a culture that creates ownership for credit risk at every level of the organisation.

8. Appendix

8.1 AMC/AIF-LED RESOLUTION APPROACH (DEEP DIVE)

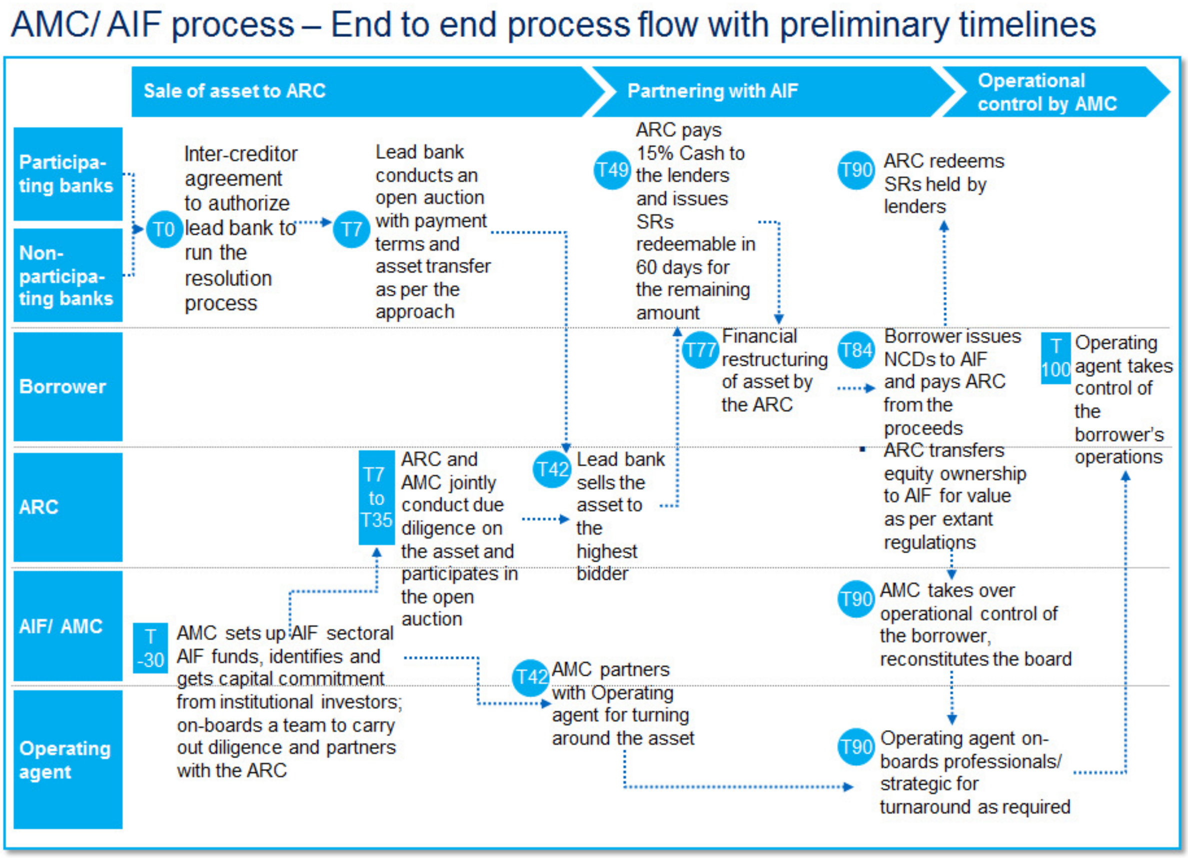
8.1.1 Key stakeholders in the framework

Lending banks	All lenders who have granted credit facilities to the borrower
Participating banks	Banks which will provide capital as LPs in AIF. These will include large public and private sector banks
Other Limited partners in AIF	Other investors in the AIF, such as domestic institutional investors, foreign investors, etc.
Borrower	An Indian entity that has defaulted on its debt to the lending banks and for which this framework will be implemented
ARC	An asset reconstruction company registered with RBI responsible for financial restructuring of the asset
AIF	An alternative investment fund registered with SEBI for investment in stressed assets.
AMC	An independent Asset management company set up under this approach. AMC would conduct independent due diligence of the asset, set up and raise funds for the AIF, bid for the asset with partner ARC, and turnaround the asset once passed to the AMC/ AIF. It would be operated by professionals with experience in Fund management and operational turnaround.
Turnaround agent	Specialist firm appointed by AMC to drive operational turnaround of the borrower under consideration.

8.1.2 How will the resolution work: End-to-end process flow

The resolution will involve a series of 10 steps involving different stakeholders as mentioned in Section 8.1.1.

EXHIBIT 4



The detailed steps are:

- **Step1—AMC sets up AIF and gets capital commitment from participating banks and investors**: An independent AMC would be setup under this approach. This AMC will be professionally managed and will attract institutional funding in stressed assets through AIFs. Banks also have an option to invest if they want to participate in the upside. Participating banks and Indian institutional investors will hold a majority of the units in the AIF. In addition, the AMC would hire senior leadership team for AIF, which must include qualified professionals with experience in deal making and turnaround.
- **Step-2—Agreement between the AMC/ AIF and ARC:** The AMC/AIF will enter into an agreement with a partner ARC detailing out construct of the roles and responsibilities of each stakeholder, compensation structure for ARC for facilitating the transaction with the banks (diligence, bidding process, upfront cash mobilisation, etc.), financial restructuring.

3. **Step-3—Open auction by Lead bank:** Banks/Financial institutions to enter into an inter-creditor agreement authorising the lead bank to run the resolution process. The lead bank would launch an open auction to invite bids for the sale of the stressed asset from the interested ARCs/ AMCs/ other investors. Bids will be invited on a 100% cash basis or 15% cash, and 85% SRs redeemable within 60 days.

- **Step 4—Independent due diligence of the asset by AMC/ AIF:** The AMC/ AIF will carry out an independent due diligence of asset under consideration to establish fair value of sustainable portion of the debt. Post diligence the IC of the AIF will approve the investment and intimate the bid to the partner ARC.
- **Step5—Submission of bid by ARC:** Based on the assessment by AMC/ AIF, ARC will participate in the open auction along with other ARCs/ AMCs/ other investors.
- **Step6—Sale of the asset by the banks to the ARC submitting highest bid as per applicable norms:**
  - In this step, the entire outstanding debt will be sold to the highest bidder as per the process laid down by RBI and the highest bidder would make payment as per the auction terms. In case the highest bid is from the ARC/ AMC created under this approach, the ARC would pay 15% upfront to lenders in cash, and for the remaining amount issue SRs redeemable within 60 days.
- **Step-7—Financial restructuring by the ARC:**
  - ARC will acquire management control of the entity. ARC will restructure the asset by converting unsustainable debt into equity. ARC may consider potential restructuring options like issuance of long term zero coupon bonds for providing upside to banks at a future date subject to a successful operational turnaround of the asset. Under financial restructuring, the borrower will issue equity such that promoter equity drops to at most 24% and ARC becomes the majority equity holder in the asset.
- **Step8—Transactions involving AMC/AIF:**
  - AIF would make a capital call on LPs and raise funds by issuing units. The borrower will issue NCDs to AIF and in turn pay ARC from the proceeds of NCD received from the AIF.
  - ARC would use these proceeds to redeem the SRs issued to banks/lenders. At this point, the lenders would be paid in full for the value.
  - ARC would also transfer its entire equity ownership in the borrower company to AIF for a value as per the extant regulations
  - At the end of this step, the entire debt and equity (to the extent held by ARC) would be transferred to the AIF
- **Step9—AMC/AIF takes over the management control of the company and proceeds with operational turnaround:**
  - As the majority equity owner of the asset, the AMC/ AIF will have the mandate for operational turnaround of the stressed asset. AMC/AIF may do this either in conjunction or without the existing owner/management teams. It may also appoint an operating agent for leading the turnaround. The AMC will have full rights to change the management team of the asset, identify and execute an

operational restructuring plan, change incentives of employees of the asset, define strategic plans, change operational processes, marketing plan, etc.

– In addition, the AMC /AIF will have flexibility to access tools such as sale of certain assets, bringing in new investors/operating agents, M&A, financial restructuring etc. These initiatives will be subject to approval by AIF's investment committee.

■ **Step10—AMC to take investment in the asset to a successful exit:** The AMC would also be responsible for identifying avenues to exit from the asset post the turnaround. Should the turnaround process succeed, it will deliver returns to the unit holders of the AIF. The unit holders of AIF—banks, domestic and international institutional investors—will receive the returns both from the NCDs and the equity upside as and when the same materialises.

8.1.3 Proposed structure of the ARC

Of the 24 ARCs in present in India today, there is potential to leverage the two public-sector ones, ARCIL and ISRAC, under the proposed AMC/AIF approach. The ARC would be responsible for placing bid for the stressed asset based on the independent diligence done by the AMC/ AIF. Post-acquisition, it would be responsible for financial restructuring and transfer equity holding of the borrower held by it to the AIF.

ARC would be compensated for the actual operating expenses and a reasonable return on capital deployed via fees.

8.1.4 Proposed structure of the AMC

Overview: The committee evaluated multiple options for the AMC. These included domestic fund managers, international fund managers, existing PSU Bank subsidiary platforms and also setting up a new AMC. The committee evaluated choices considering the following critical success factors:

■ Independent agency operating at arm's-length from the government and banks to be able to create interest among investors

■ Operated by professionals with experience in fund management and operational turnaround

■ Have full operational independence in line with private sector organisations, to be able to be agile and take the best actions for value creation for the shareholders

■ Be able to conduct diligence and turnaround large volumes given the stressed assets situation

■ Bid competitively for assets, create a competitive environment for assets

In lieu of these, the committee believes setting up a new AMC (a private sector entity with maximum 49% PSUs' ownership); an Indian institution at scale with capabilities in this area is a preferred option.

Capabilities required for the AMC to ensure the program's success:

- **Fund raising and management:** Professional managers or partners with prior experience and work experience with reputed AMCs/AIFs
- **Investment decisioning :** Institutional process for identifying and valuing deals, including conducting diligences, working with partners (e.g., lawyers, accountants) to structure and close deals
- **Operational turnaround:** Key functionaries with experience in running assets or established partnerships with professional firms for the same, ability to create operating platforms with reputable firms in the specific sectors
- **Risk management:** Expertise in managing risks (e.g., financial, environment sustainability)
- **Provide exit for the investments:** Provide sale of assets in a defined time frame to provide equity upside to the AIF investors

8.1.5 Governance structure for AMC

The AMC will be an independent agency operating at arm's-length from the government and will be operated by internationally recognised professionals with experience in fund management and operational turnaround. The committee recommends the below initiatives to ensure independence of the AMC:

Building blocks	Governance structure	Guiding principles
Ownership	■ GPs for AMCs will include recognised, pre-eminent fund management companies, PSUs and investors with a proven track record ■ Ownership of Participating PSUs will be limited to 49% ■ No investor to hold more than 10% equity in AMC	■ Professionally managed GPs and the upper cap on investments including 49% for PSUs by different stakeholders will ensure that the there is no influence in decision making and valuation & investment decisions are independent.
Board	■ AMC would be a Board managed entity	■ Bring years of functional and sectoral experience together to asses and guide the

Building blocks	Governance structure	Guiding principles
	■ Like ownership, board would also be majority private ■ In addition, there will be eminent personalities from financial services and other relevant sectors as independent directors	team on overall direction and strategy of the turnaround
Management team (CEO and senior team members).	■ AMC to hire preeminent professionals with relevant experience as fund managers and senior investment team.	■ This will ensure that AMC/AIF is run professionally
LPs	■ LPs will be a mix of domestic, institutional, foreign investors and participating banks. ■ LPs' will be vetted by the AMC	■ Mix of LPs will ensure majority of the returns are realised by domestic investors, while also bringing in non-banking capital to resolve the situation
ICs	■ IC comprising professional managers and senior management functionaries of AMC/ AIF. ■ Participating banks will not have any representation in the IC	

8.1.6 Potential options for turnaround

- Turnaround professional employed by AMC/AIF:
  - AMC may employ special turnaround professionals, who would work with the management of the borrower company to define the turnaround plan
  - They would be involved for entire term of the investment and compensated adequately, e.g., former CEO/senior managers of sectoral specific companies, operating team structure with AMC, etc.

- Operating agents: Operating agents would be specialised third-party turnaround entities with deep knowledge in the sector, e.g., consulting firms with deep sectoral understanding, eminent firms in sectors
- Strategic players: Strategic players would take over key management functions of the asset and lead turnaround. They can also participate as O&M partners or as JV partners with equity interest.

8.2 LEARNINGS FROM GLOBAL EXPERIENCE

There are several international precedents where banks regulators have designed various types of interventions for resolution of stressed assets. Subsequent points discuss some case studies across various frameworks.

8.2.1 Bank-led turnaround approach

Post the European crisis, the Spanish economy ended up with a large number of viable but overleveraged companies. In these companies, banks became defector equity holders. The resolution process involved a high cost for creditors since the process took a long time and resulted in a deterioration of asset values. Liquidation or sale of stressed assets to investors were plausible options, however neither would help preserve value of creditors. For example, it was estimated that taking no action would reduce value to creditors to 20% of debt, while sale to an opportunistic fund would reduce it to 30%, while a bank led restructuring approach would take the performing credit to 50% of initial value, 10% in terms of equity/hybrid value and in addition provide a potential upside on 20% of the initial value via equity upside. To resolve this situation, an initiative called Phoenix was launched in Spain.

Phoenix aimed to facilitate corporate restructurings with clear benefits for all stakeholders. Phoenix involved 6 banks who disaggregated their debt into sustainable and unsustainable debt. The unsustainable part was converted into equity. The sustainable part was held on bank’s balance sheet. The framework provides for the sustainable debt to be pooled into an SPV as well, however at this point, banks have decided to hold the debt on their balance sheets. Post this; Phoenix involved setting up an AMC (Phoenix Recovery Management SL). The banks entered a management contract with Phoenix AMC which was provided a management mandate to run the stressed assets and turn them around. A Monitoring committee was set up including 1 person from each bank which oversaw the AMCs performance and also took significant decisions such as sale of assets, investments etc

Phoenix has seen good early success. The first three cases with Phoenix have seen significantly higher value created as compared with the next best alternative. The current value of debt is estimated to be between 52% and 95% of initial gross debt for these companies, this is a 138%-156% higher value compared with the next best alternative (i.e. liquidation or sale to another fund). In addition, all three assets are now performing and have consequently resulted in continued jobs at these companies.

8.2.2 Large-scale liquidation and capital infusion approach

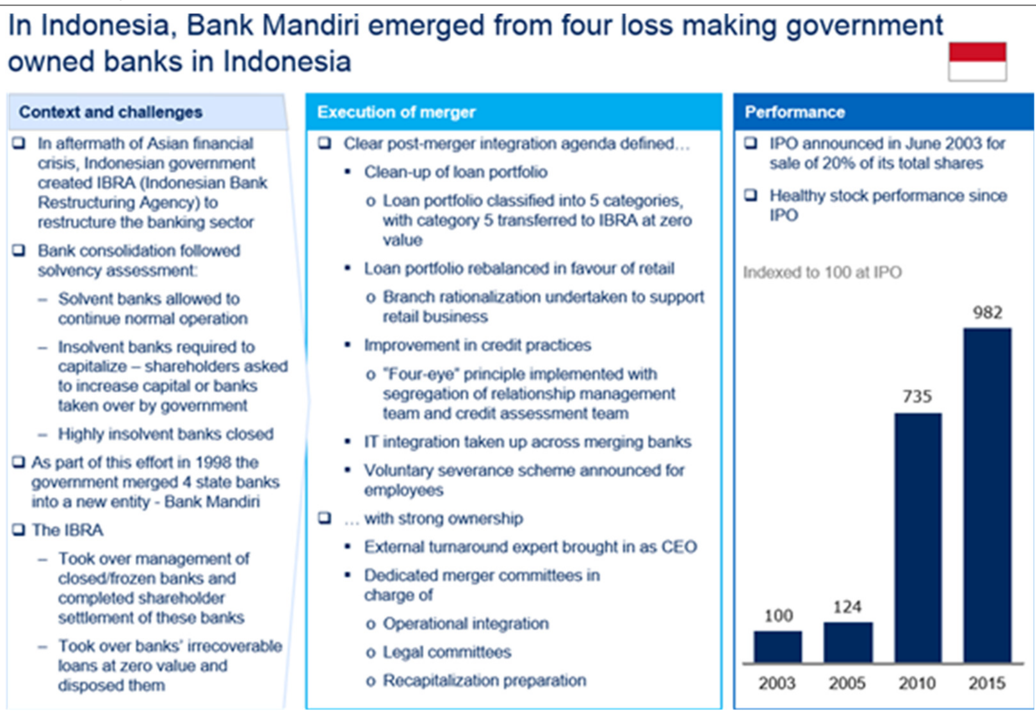
This encompasses large-scale liquidation and capital infusion approach. Countries usually adopt this approach when much of the asset value is lost and the chances of turnaround are low. The assets are aggregated into a central utility and systematically liquidated using available legal recourse. Typically, the government provides most of the recapitalisation. Certain categories of funds (such as vulture funds) may step in if they spot bargain values given the liquidity situation in these crises.

This approach was deployed by the Indonesian government in 1998 in the aftermath of the Asian banking crisis through the Indonesia Bank Restructuring Agency (IBRA) when NPAs in the banking sector rose by 5x.

The IBRA was created under the jurisdiction of the Ministry of Finance to restore the banking sector's financial health. All irrecoverable loans across banks (mostly corporate sector that were severely distressed/insolvent) were transferred to the IBRA at zero value for disposal. Non- performing loans amounting to IDR 236 trillion (equivalent to 49% of outstanding loans) were transferred to the IBRA. Subsequent recovery on these assets was around 28%.

An outcome of this exercise was consolidation in the banking industry which followed from a solvency assessment. Solvent banks were allowed to continue normal operation, insolvent banks were required to capitalise – shareholders were asked to increase capital or banks got taken over by government and highly insolvent banks were closed. This effort led to the government merging 4 state banks into a new entity called Bank Mandiri (Exhibit 7).

EXHIBIT 7



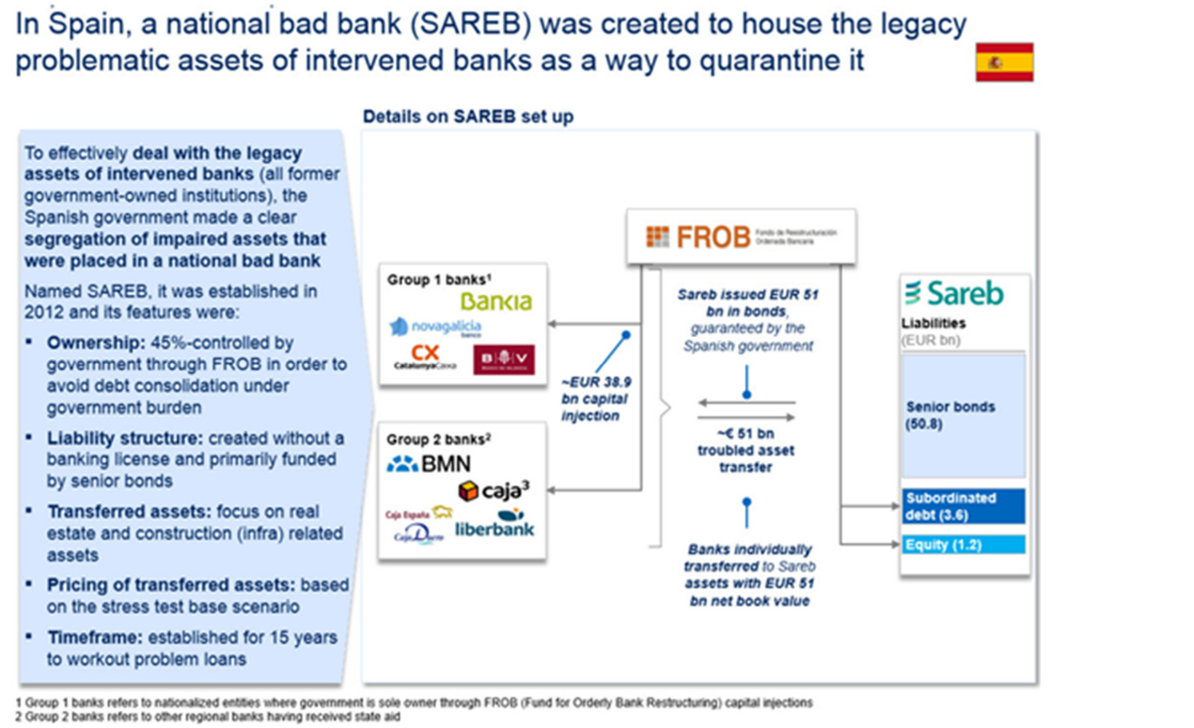
8.2.3 Long-term quarantine approach

This approach is possible in some instances where the stressed assets could potentially recover value over time and the nature of the assets is such that limited operational interventions are required, e.g., for real estate and infra related assets. In such cases, the assets are aggregated in a central utility and quarantined for a period till they recover value. Such aggregation reduces uncertainty over the portfolio quality and viability of individual banks.

This approach has been deployed in several international markets, e.g., SAREB in Spain, the Troubled Asset Relief Program (TARP) in the USA and the establishment of Asset Management Companies (AMCs) in China.

SAREB was a government sponsored national asset reconstruction company (ARC) in Spain, created to absorb and eventually resell soured property assets. It was established in 2012 with a 15-year tenure to sell off assets. Assets worth EUR 51 billion in net book value were transferred by banks to SAREB. Pricing of transferred assets was based on the base scenario outcome of stress testing (Exhibit 8).

EXHIBIT 8



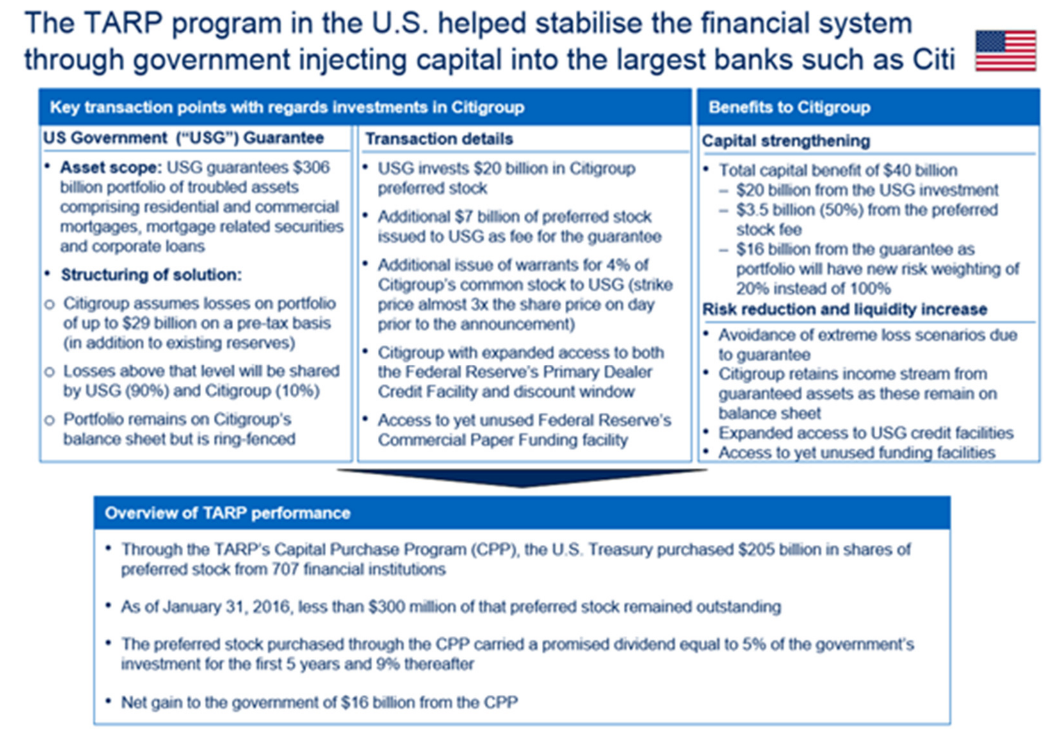
TARP was created during the financial crisis of 2008 to stabilise the financial system. Under the TARP's Capital Purchase Program (CPP), the US government purchased preferred stock in over 707 financial institutions including Citi for USD 205 billion. TARP recovery stands at 108% as of 2016.

Under the CPP, the US government guaranteed 90% of losses above the USD 29 billion in losses Citi assumed on its portfolio of over USD 300 billion comprising residential and commercial mortgages, mortgage related securities and corporate loans. This helped in strengthening the capital of Citi as well as improve its liquidity. Given the

U.S. government guarantee, the risk weighting of Citi's portfolio came down from 100% to 20% thereby saving capital.

Improvement in liquidity came from Citi being able to retain the income stream from the guaranteed assets since they remained on its balance sheet (Exhibit 9).

EXHIBIT 9



In China, four state-owned AMCs were setup in 1999 (i.e., Huarong, Cinda, Great Wall and Orient) to address the "stock" NPA problem and restore bank balance sheets. They were to buy bad debts of the four state-owned commercial banks (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China) and dispose them off over 10 years. Each of the four AMCs paired up with one of these big four banks in China. The Ministry of Finance (MoF) in the Chinese government provided each AMC with an initial equity capital injection of RMB 10 billion (USD 1.2 billion) to take over on average 20% of the bank loans outstanding and these bad loans amounted to RMB 1.4 trillion (USD 168 billion).

Thereby the equity injection by the Chinese government was limited to under 3% of the assets transferred while the rest was financed with debt. The Chinese central bank (People's Bank of China—PBoC) offered special loans to the AMCs that amounted to more than 10 times its own capital base.

In the portfolio of assets transferred, real estate, which tends to be more collectable, accounted for only 7% of NPA carve-outs while manufacturing, which is typically more difficult to recover, represented 46% of the NPAs transferred. With low coverage of collateral and given that most of these NPAs had been confirmed as problem loans for greater than 4 years, the recovery rates of NPAs was just over 20%. China's recovery rate was among the best at a little over 30% (in a seven-year timeframe) as its NPA portfolio had a higher real estate share and was closely tied to large-scale infrastructure projects.

Based on the fact that the easier-to-collect loans had been first disposed of by the AMCs, China's banking officials decided to revisit the organisation and operation of the AMCs and in 2006 decided to allow them to engage in a broader range of asset management activities, including purchasing share in other companies, as a means of providing them with more revenue. Each of the four-major state-owned commercial banks were then asked to take over a little under 50% share in the AMCs they were paired with.

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