**RBI REVISES FRAMEWORK FOR RESOLUTION OF STRESSED ASSETS**

On April 2, 2019, India's Supreme Court (the "**SC**") quashed the Reserve Bank of India's (the "**RBI**") consolidated framework for resolution of stressed assets (the "**2018 Framework**") as being *ultra vires* the RBI's powers under the Banking Regulation Act, 1949 (the "**Act**"). Consequently, on June 7, 2019, the RBI revised the 2018 Framework and released the RBI (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 (the "**Revised Framework**"). This update analyzes the potential impact of the Revised Framework on the lending market.

***Background***

In recent years, Indian banks have become increasingly burdened with bad debts as they have been unable to recover their dues from borrowers in an efficient and time-bound manner. Prior to the 2018 Framework, the RBI had attempted to solve this problem by introducing a slew of schemes which were aimed at expediting resolution of stressed assets including, *inter alia*, the Corporate Debt Restructuring Scheme, **Framework for Revitalising Distressed Assets** and the Strategic Debt Restructuring Scheme. However, none of these schemes proved to be very effective mainly because insolvency and debt recovery were governed by overlapping statutes having conflicting objectives.

Given that the Indian legal framework for insolvency resolution, debt recovery and restructuring of stressed assets was ineffective, in 2016, India enacted a harmonized **Insolvency and Bankruptcy Code** (the "**Code**"). Following this, on February 12, 2018, the RBI released the 2018 Framework to simplify the process of resolution of stressed assets, and substitute its multiple schemes and instructions.

***Key aspects of the 2018 Framework***

To ensure that the resolution of stressed assets is achieved in a time-bound manner, the 2018 Framework prescribed, *inter alia*, the following key guidelines:

- It applied to all scheduled commercial banks (except regional rural banks) ("**SCBs**") and All India Financial Institutions ("**AIFIs**").

- It prescribed a mechanism for early identification and reporting of stressed assets by mandatorily requiring SCBs and AIFIs to classify loan accounts as special mention accounts ("SMA") as soon as a default was committed. The lenders were required to classify the accounts as SMA-0, SMA-1 and SMA-2 on the basis of whether payment was due for a period of one (1) to thirty (30) days, thirty-one (31) to sixty (60) days and sixty-one (61) to ninety (90) days, respectively. Further, the 2018 Framework also mandatorily required lenders to report the credit information of the borrower entities having an aggregate exposure of over INR50 million to the Central Repository of Information on Large Credits ("CRILC") on a monthly basis, and information regarding all such entities in default to the CRILC on a weekly basis.

- It required all SCBs and AIFIs to adopt policies for resolution of stressed assets, as approved by their respective boards of directors, and in accordance with the 2018 Framework. Importantly, it required lenders to initiate steps to cure the default as soon as a default was committed by unanimously implementing a resolution plan ("RP"), which would provide for, inter alia, actions for regularizing the account, sale of exposure to other entities, change in ownership of the debtor or restructuring of the loan account.

- It provided that for accounts having aggregate exposure of more than INR20 billion (the "Large Accounts"), the RP, whether formulated under the 2018 Framework or under any of the pre-existing schemes, would be implemented within one hundred and eighty (180) days from March 1, 2018 (in cases where the borrower was in default as on March 1, 2018) or within one hundred and eighty days (180) days from the date of the default (in all other cases).

- It mandatorily required lenders to initiate insolvency proceedings under the Code if the RP was not implemented for a Large Account within fifteen (15) days from the expiry of the foregoing timelines.

- If the RP was successfully implemented for a Large Account and a default was committed within the Specified Period, it required lenders to initiate insolvency proceedings within fifteen (15) days from the date of such default. For this purpose, the "Specified Period" was defined as the period from the date of implementation of the RP until the date on which at least 20% of the outstanding principal debt as per the RP, and interest capitalization sanctioned as part of the restructuring, was repaid.

- It prescribed that an RP would be deemed to have been implemented only if:

  - the borrower entity was no longer in default with any of the lenders; or

  - if the resolution involved restructuring, (i) all related documents, including documents for creating/perfecting securities, were completed by all lenders; and (ii) the new capital structure and/or changes in the terms of the loan were duly reflected in the books of all lenders.

- It required lenders to engage credit rating agencies, specifically authorized by the RBI, to conduct an independent credit evaluation ("ICE") of RPs involving restructuring/change of ownership in respect of accounts having an aggregate exposure of more than INR1 billion while it mandated two (2) such ICEs in respect of all accounts having an aggregate exposure of more than INR5 billion.

- It also prescribed certain prudential norms applicable to the restructuring including, inter alia, norms in respect of asset classification, conditions for upgrade of classification, provisioning and income recognition.

***Challenge to the 2018 Framework before the SC***

Despite the fact that the 2018 Framework was well-intentioned, it was challenged by several debtors (collectively, the "**Petitioners**") before various high courts across India, as being *ultra vires* the RBI's powers under the Act. In appeal, the SC clubbed the challenges into a single proceeding, and the Petitioners raised the following grounds:

- Section 35AA of the Act, under which the 2018 Framework was released, permits the RBI to direct banking companies to initiate insolvency proceedings only in specific instances of default and does not empower the RBI to issue general directions to banking companies to mandatorily initiate insolvency proceedings;

- The cause underlying the default is often attributable to government delay, especially in the power sector. Therefore, in directing banking companies to mandatorily initiate insolvency proceedings for Large Accounts, the RBI did not consider the sector-specific circumstances of the debtors. In addition, the Petitioners also questioned the validity of the classification of Large Accounts;

- Given the sector-specific circumstances and the large value of debts, it was unreasonable to direct banking companies to initiate insolvency proceedings if a default was committed during the Specified Period, which would be deemed to continue for an unreasonably long period of time by virtue of its expansive definition; and

- As the 2018 Framework required all lenders to unanimously agree upon the RP, it implied that any lender could block the implementation of the RP, regardless of whether such lender had a significant stake in the loan account.

Additionally, the Petitioners challenged the constitutionality of Section 35AA of the Act itself on the grounds that the delegation of power to the RBI under the foregoing section was extremely broad, arbitrary and unfettered. While the SC rejected this last argument of the Petitioners on the ground that sufficient directions were given to the RBI in the preamble and other sections of the Act, it quashed the 2018 Framework as being *ultra vires* the powers of RBI under Section 35AA of the Act.

***Key aspects of the Revised Framework***

While the SC's quashing of the 2018 Framework provided much needed relief to debtors, lenders were left with no mechanism to recover their dues in a time-bound manner except by initiating insolvency proceedings under the Code. However, recognizing the need for an effective mechanism for resolution of stressed assets *de hors* the Code, the RBI retained the core framework and introduced the Revised Framework with, *inter alia*, the following key changes:

- The Revised Framework is applicable to a much larger number of lenders as it applies to small finance banks, Systemically Important Non-Deposit taking Non-Banking Financial Companies ("**NBFCs**") and Deposit-taking NBFCs, in addition to SCBs and AIFIs. <u>In our view, given the liquidity crisis plaguing NBFCs in India, the application of the Revised Framework to NBFCs is likely to aid NBFCs in recovering their dues in a time-bound manner</u>.

- The Revised Framework prescribes an independent timeline for classification of SMAs in respect of revolving credit facilities. Such accounts are required to be classified as SMA-1 if the balance remains continuously in excess of the sanctioned limit for a period of thirty-one (31) to sixty (60) days and as SMA-2 if it remains in excess for a period of sixty-one (61) to ninety (90) days. <u>As such loan accounts can at times remain in excess of the sanctioned limit on account of working capital requirements, which in our view, will provide much needed relief to debtors</u>.

- If a default is reported by an SCB, AIFI or a small finance bank, the Revised Framework prescribes an additional period of thirty (30) days, calculated from the reference date (as prescribed in the Revised Framework) (the "**Review Period**"), during which lenders are required to undertake a *prima facie* review of the loan account and determine the appropriate resolution strategy. Further, lenders are also required to implement the RP within one hundred and eighty (180) days from the end of the Review Period. <u>In our view, the additional Review Period will allay the fears of debtors who had raised concerns about being mandatorily pushed into a RP as soon as a default was committed</u>.

- Lenders are now also required to enter into an inter-creditor agreement ("**ICA**") during the Review Period which shall list out the ground rules for finalization and implementation of the RP. Additionally, the ICA is also required to provide that any decision agreed by lenders representing 75% of the total outstanding dues and 60% of the lenders by number shall be binding upon all lenders. <u>In our view, this mandatory voting threshold will ensure that a single lender is not able to block the implementation of the RP</u>.

- Lastly, rather than mandatorily requiring lenders to initiate insolvency proceedings if a RP is not implemented within the prescribed period, the Revised Framework imposes additional provisioning requirements upon the lenders. Consequently, if the RP is not implemented within one hundred and eighty (180) days from the end of the Review Period, the lenders are required to make an additional provisioning of 20% of the outstanding amount and make a further provisioning of 15% of the outstanding amount (i.e., total 35%) if the RP is not implemented within three hundred and sixty-five (365) days.

***Our Comments***

By focusing on a balanced resolution framework, the RBI has remained committed towards taking all necessary steps for the expeditious and effective resolution of stressed assets in India.

Further, the RBI has also recognized the dangers of the requirement that the RP must get the blessings of all the lenders. At the same, however, the Revised Framework does not prevent lenders from initiating insolvency proceedings while the RP is being implemented.

Lastly, the effect of imposing the additional provisioning requirements on the lenders has been diluted because the Revised Framework allows lenders to reverse 50% of the additional provisioning made on the date of filing an insolvency application. Further, lenders are also empowered to reverse the rest of the provisioned amount on the date the application is admitted by the National Company Law Tribunal ("**NCLT**"). Therefore, while the RBI has withdrawn the requirement for mandatorily initiating insolvency proceedings by imposing penal provisioning requirements, it has essentially incentivized lenders to initiate insolvency proceedings if the RP is not implemented within one hundred and eighty (180) days. <u>Given the foregoing, the RBI has effectively dealt with the spirit of the SC decision, but the end result may just be that a number of lenders will approach the NCLT despite the Revised Framework</u>.