Ratings

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'S4A' — an improvised financial engineering tool to abate NPAs albeit with formidable challenges

What is S4A?

The Reserve Bank of India (RBI), in order to improve asset quality of the bank's which are stuck in the quagmire of high NPAs, has been issuing various guidelines/norms/schemes, with S4A as one of the latest ones, which was released in June 2016. S4A stands for 'Scheme for Sustainable Structuring of Stressed Assets'. The main aim of S4A guidelines is to strengthen the lender's ability to deal with stressed assets and to put viable assets back on track for entities facing genuine difficulties by providing an avenue for reworking financial structure.

What are the eligibility criteria?

The scheme is applicable to the projects which have

1. Commenced their commercial operations,
2. Aggregate exposure (including accrued interest) of all institutional lenders should be more than Rs.500 crore (including Rupee Term Loan, Foreign Currency Loans, External Commercial Borrowings),
3. Debt (including accrued interest) which meets sustainability test needs to be at least 50% of the total debt.

**Sustainability test is described in Page 2 under heading "Determination of sustainable debt under S4A"*

How S4A will tackle challenges of 5:25 and Strategic Debt Restructuring (SDR)?

RBI, in order to address the large borrowal accounts which are facing severe financial difficulties and in-turn require deep financial restructuring, had earlier issued schemes such as 5:25 and SDR. The challenge of 5:25, for banks that structured loans by stretching repayment periods, had to mandatorily protect the net present value (NPV) of loans refinanced; and under the SDR, banks had to take majority stake (at least 51%) in the stressed company along with the management control and find a new buyer within 18 months from the reference date, failing which the asset is classified as a non-performing asset.

The S4A scheme partially addresses the challenges of both schemes.

- Under 5:25, banks cannot take haircut after restructuring, however, under S4A, banks can take haircut by converting unviable portion of debt into equity or redeemable cumulative optionally convertible preference shares/optionally convertible debentures.
- Under SDR, banks need to find a new buyer after conversion of equity into debt within short period of about 18 months, but S4A provides banks sufficient gestation period to find new buyer if required, adequate time for the company to turnaround which addressing various issues faced by it.

Determination of sustainable debt under S4A

Sustainable debt is the level of debt (including new funding required to be sanctioned within next six months and non-funded credit facilities crystallizing within next six months) that can be serviced (both interest and principal) within the respective residual maturities of existing debt based on cash flows available from the current as well as immediately prospective (not more than six months) level of operations. The aforesaid portion of sustainable debt is categorized as Part A and the remaining portion as Part B.

For this purpose, free cash flows (cash flow from operations minus committed capital expenditure) available for servicing debt as per latest audited/reviewed financial statement will be considered. Furthermore, the maturity of various debt facilities remains unchanged and the maturity of each facility shall be that which exists on the date of finalizing resolution plan. For the purpose of determining the level of debt that can be serviced, the assessed free cash flow shall be allocated to servicing each existing debt facility in the order in which its servicing falls due.

Resolution Plan

The joint lender forum (JLF)/ consortium/ banks shall engage in the services of credible professional agencies to conduct the Techno Economic Viability (TEV) study and preparation of resolution plan. Furthermore, from a risk management perspective, lenders should not assign above work to one professional agency to avoid concentration of such assignments.

The resolution plan should be agreed by minimum of 75% of the lenders by value and 50% of the lenders by number in JLF/consortium/banks. At individual bank level, the bifurcation into Part A and Part B shall be in the proportion of Part A and Part B at the aggregate level.

The Resolution Plan shall have the following features:

a) There should not be any fresh moratorium granted on interest or principal repayment for servicing of Part A. There should not be any extension of the repayment schedule or reduction in the interest rate for servicing of Part A, as compared with repayment schedule and interest rate prior to this resolution.

b) Part B of existing debt shall be converted into either equity or redeemable cumulative optionally convertible preference shares (Part B instruments). However, in cases where the resolution plan does not involve change in promoter, banks/lenders may, at their discretion, convert a portion of Part B into optionally convertible debentures.

An Overseeing Committee (OC) constituted by the Indian Banks Association (IBA) in consultation with RBI will act as an advisory body to review the processes involved in preparation of resolution plan to ensure reasonableness and compliance with the RBI guidelines.

Valuation of Part B instruments under S4A

The fair value for Part B instruments, ie, Equity or Redeemable cumulative optionally convertible preference shares/optionally convertible debentures issued under this scheme should be determined as follows:

- Equity shares issued to the banks should be marked to market at least on a weekly basis (preferably daily basis). The equity shares, for which current quotes are not available on the stock exchanges, should be valued at the lower of the followings methodologies:
  - Break-up value (without considering revaluation reserve) has to be ascertained from the company's latest audited balance sheet (Should not be more than one year old prior to date of valuation). If latest audited balance sheet is not available, the shares will be valued at Rs.1 per company. Furthermore, assistance can be taken from independent TEV to arrive at Breakup value.
  - Discounted cash flow (DCF) method where discount factor would be interest rate charged to the borrower plus 3% (subject to a floor of 14%). For this valuation, only cash flows which are occurring within 85% of the useful economic life of the project shall be considered.
- Redeemable cumulative optionally convertible preference shares/optionally convertible debentures should be valued on a DCF basis with a discount rate that includes a minimum mark-up of 1.5% over the weighted average actual interest rate charged to the borrower. If preference dividends are in arrears, the value determined on the DCF basis should be further discounted by at least 15% if arrears are for one year, with an increment of 10% in the discounting factor for each additional year of arrears (ie, 25% for two years).

Asset classification and provisioning

1. In cases where there is change of promoter, the asset classification and provisioning requirements will be as applicable under the 'SDR mechanism' or 'Outside SDR Scheme'.
2. In cases where there is no change in promoter, the requirements are as follows:
   I. The asset classification would remain unchanged for 90 days from the date of lenders decision to resolve the account. This period is meant for JLF/consortium/bank to formulate resolution plan and implement the same. Furthermore, if the resolution plan is not implemented within this period then the asset classification will be as per the extant asset classification norms.
   II. Accounts classified as 'standard' on the reference date (the date of lenders decision to resolve the account under S4A guidelines), will remain 'standard' subject to up front provisions being made by lenders for higher of 40% of the Part B amount or 20% of the aggregate outstanding debt. This will include provisions already held against this outstanding amount.

III. For accounts classified as a Non-Performing Asset (NPA), the entire outstanding debt (Part A and Part B) shall continue to be classified and provided for as a NPA as per Income Recognition, Asset Classification (IRAC) norms.

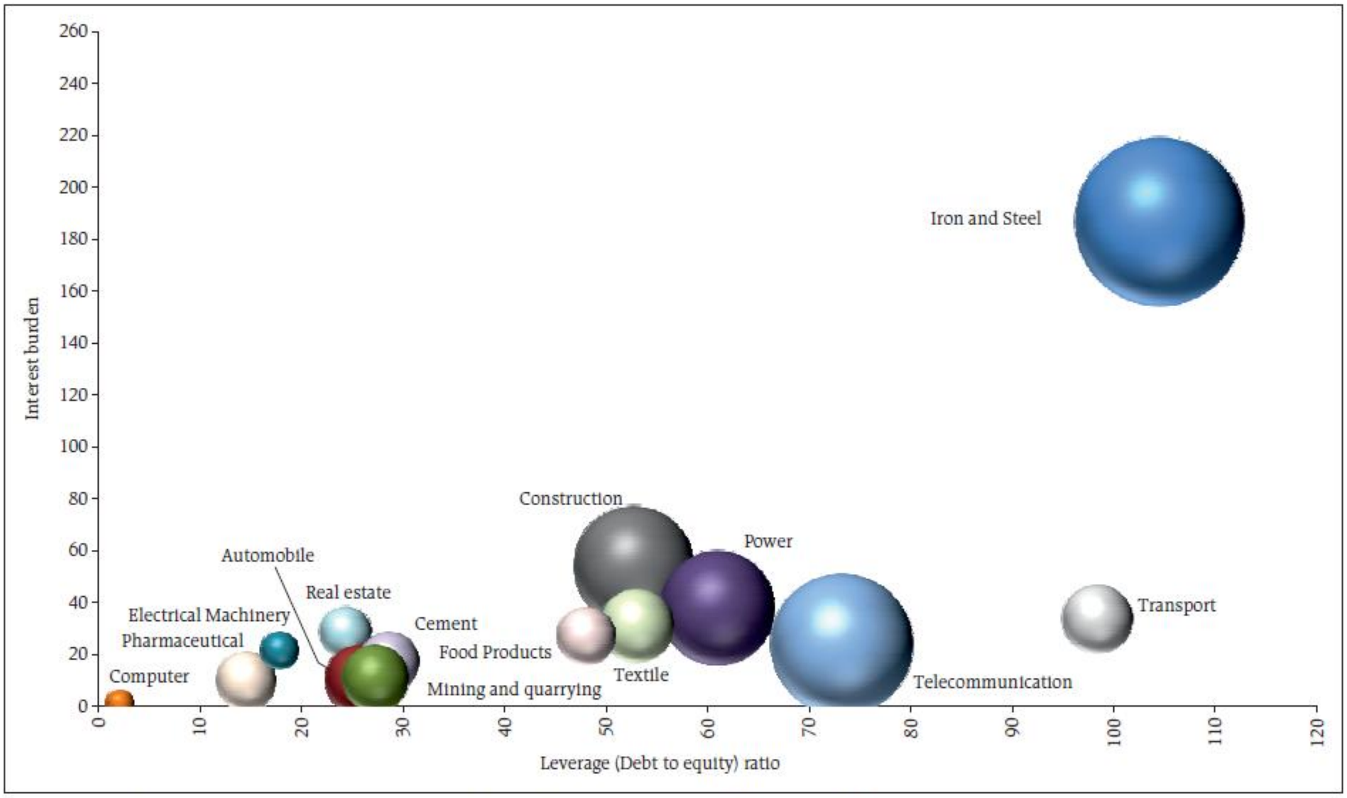
IV. Part A and B may be upgraded to a standard category after one year of satisfactory performance of Part A loans. However, Part B instruments will continue to be marked to market as per the guidelines for this scheme. In case of any pre-existing moratorium in the account, the upgrade will be permitted one year after completion of the longest moratorium, subject to satisfactory performance of Part A debt during moratorium.

V. Any provisioning requirement arising from the difference between the book value of Part B instruments and their fair value as per this scheme in excess of minimum requirements shall be made uniformly over four quarters commencing with the quarter in which the resolution plan is implemented, so that Mark to Market (MTM) provision held is not less than 25% of the required provision in the first quarter, not less than 50% in the second quarter and so on. For this purpose, the provision already held in the account can be considered.

Formidable challenges of S4A

- The S4A, although, setoffs the weaknesses embedded in 5:25 and SDRs schemes, but the eligibility criterion (mentioned in Page 1) filters out many companies especially the project stage ones thus leaving very few companies to be qualified.
- S4A does not allow rescheduling of original tenure of repayment or restructuring of the debt with better interest rates considering the projected improvement in liquidity post to implementation of the scheme.
- In order to determine Part A debt, the S4A scheme does not factor incremental cash flows which the company may be deriving through improvement in industry environment in which it is operating.
- As per the Financial Stability Report published by RBI in June 2016, a macro stress test of sectoral credit risk revealed that in a severe stress scenario, among the select seven sectors (such as iron & steel, infrastructure, cement, agriculture, construction, engineering and automobiles), iron and steel industry (which had the highest GNPA ratio at 30.4% as of March 2016) could see its GNPA ratio moving up to 33.6% by March 2017. Since February 2016, the Iron and Steel sector has seen some respite on account of introduction of Minimum Import Price (MIP) which is expected to be lifted during October 2016. Though there is severe pressure to extend the same but the recurrence of the boon to the sector remains bleak on account of possibility of violation of WTO agreement terms. The aforementioned situation of the sector chips of ~30% of GNPA from qualifying for this scheme.

Risk profiles of select industries (March 2016)



Note: Size of the bubble is based on relative share of debt of the industry in total debt of all industries derived from sample companies.
Source: RBI (Half-yearly statements of select NGNF listed companies).

- From the perspective of banks, they would be required to set large amount of provision (ie, higher of 40% of the Part B amount or 20% of the aggregate outstanding debt) as part of this scheme, which would deeply affect not only the value of the loan but also the profitability of the banks. Furthermore, the ability of lending of the banks may by trimmed due to higher provisioning and blockage of the advances in the form of equity/quasi equity in the subjected company for this scheme.

Conclusion:

The aim of S4A guidelines though is to strengthen the lender's ability to deal with stressed assets, the eligibility criterion filters out many companies to be unqualified. Right from the point of identification of the asset subjected to this scheme till the point of implementation is an arduous process and being untested lacks hardnosed trail. The scheme goes by the thumb rule of certain parameters applicable to across all the sectors, however in real terms every sector has its own nuance of black spots inhibiting their growth, thus the current scheme does not addresses such issues but is primarily an another formulae driven financial engineering tool. With all the aforesaid factors, the actual implementation of the S4A tool and fructification of the expected results are yet to be seen.

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