S4A can curb fresh NPA slippages, but has limited applicability

It will help weak borrowers with revivable business models: CRISIL

The Reserve Bank of India's Scheme for Sustainable Structuring of Stressed Assets (S4A) is yet another tool provided to banks to tackle the growing challenge of stressed assets emanating from loans given to large corporates turning bad. This is an improvisation over the two other tools announced by the regulator in the past 18 months to address asset quality challenges at banks: structuring of project loans under the 5:25 scheme, and strategic debt restructuring (SDR) and could help banks limit fresh slippages to non-performing assets (NPAs) from large corporate exposures.

CRISIL estimates weak assets[1] in the Indian banking system will touch a high of ~Rs 8 lakh crore by end of the current fiscal.

S4A envisages the determination of a sustainable debt level for stressed borrowers, and bifurcation of outstanding debt into sustainable debt and equity/quasi-equity instruments, which are expected to provide upside to lenders when the borrower turns around. It will cover projects that have started commercial operations and have outstanding loan of over Rs 500 crore. It enhances the integrity and transparency of the resolution process through the appointment of an external agency for technical evaluation and also oversight of an independent committee comprising experts.

The 5:25 and SDR schemes have had their challenges which has limited their application across a larger set of stressed assets. The key challenge with 5:25 is that banks which structured loans under the scheme by stretching repayment periods had to mandatorily protect the net present value (NPV) of the loans refinanced. And under the SDR scheme, banks had to take majority stake (51%) in the stressed company along with management control and also find a new buyer within a short span of 18 months from the reference date, failing which the asset is classified as a non-performing one.

The S4A scheme partially addresses the challenges of both the 5:25 scheme and SDR. The relief provided by S4A is on the following lines:

- Unlike in 5:25, where banks could not take a haircut after structuring, S4A permits banks to do so by converting the unviable portion of debt to equity.
- Unlike in SDR, after conversion to equity, banks do not have a find a new buyer in any defined period of time. This provides a longer timeframe for turnaround and provides the bank an opportunity to benefit from an increase in equity valuation.

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[1] *Weak assets is CRISIL's measure for assessing banks' asset quality. Weak assets = Gross NPAs + 40% of outstanding restructured standard advances +75% of investments in security receipts (from NPAs sold to asset reconstruction companies) + 15% of loans structured under 5:25 (flexible structuring of long-term project loan)*

- S4A incentivises existing promoters to opt for this scheme as they can continue to hold majority stake. Further, banks have the option of holding optionally convertible debentures instead of equity, which might be more preferred.

However, the S4A scheme cannot be applied to all cases of stressed exposure. The limitations of the scheme are as follows:

- It can be applied to only operational projects and not to projects under construction.
- It does not allow for any rescheduling of original tenure of repayment or repricing of debt.
- Sustainable debt under the scheme -- which needs to be at least 50% of total debt -- is derived based only on the ability of current cash flows to cover debt repayment. It cannot factor in incremental cash flows that could accrue as the external environment improves. Given the significantly low level of current cash flows of most highly leveraged companies in the vulnerable sectors such as infrastructure and iron & steel, the number of stressed corporate loan accounts which could benefit from this scheme could be very low.

Yet, despite the limitations, if implemented successfully, the S4A scheme can strengthen the ability of lenders to deal with stressed assets, which have potential to be revived by providing an avenue for reworking the financial structure of entities facing genuine difficulties. This provides a lifeline to stressed corporates, while for banks it would curb additions to NPAs in the near-term.

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