Banks Can Play The Biggest Role In Resolving NPAs

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With the tightening of norms by RBI in recognition of and provisioning for Non Performing Assets (NPAs), banks' NPAs have attracted a lot of attention in recent years. The reasons for so many loans becoming NPAs could be many - bad regulatory environment, inadequate management rigour, outright poor management, diversion of funds to other projects or at times simple fraud and wrong practices by promoters.

However, it is clear that in a majority of cases of NPAs, the reason is the borrower not being able to service debt due to over leverage vis-à-vis EBITDA earned by it. As mentioned earlier, the reasons for such over leverage could be many, including diversion of funds and outright frauds. It is equally clear unfortunately that a major reason for NPAs also has been either a complete non-existence of monitoring or grossly inadequate monitoring on part of lenders.

It is also well known that attempts to park debts with ARCs (Asset Reconstruction Companies) have not resulted in significant resolution of NPAs. The reason for this is that this step does not address the fundamental issue on hand i.e. inadequate EBITDAs to service the debt.

It was also expected that introduction of IBC (Insolvency and Bankruptcy Code) in 2016 would address this major issue. It is common knowledge, however, that due to various reasons – both procedural as well as structural/ legal, not much headway has been possible even under IBC. I feel that the main reasons for non-addressal of NPAs by way of IBC are as under :

(a) Due to poor balance sheets and track record, such companies have not been able to attract much private equity interest, since most P/Es like to look for 'healthy companies' with 'good managements' and do not have the mindset to invest in stressed assets.

(b) The lenders (mainly banks) are inherently reluctant to upset the apple cart by either taking control from promoters by conversion of debt into equity under RBI guidelines dated 7/6/2019 due to constraints on ability and resources to manage such companies, or taking these to IBC for fear of such companies not continuing as going concerns and yielding low values on liquidation. Unfortunately, the practical difficulties in resolving the NPA issues keep pushing the concerned NPA company invariably into a deeper hole due to lack of clarity, continuing uncertainty about being a going concern, unavailability of much needed working capital (since lenders try to squeeze out whatever cash they can lay their hands on) and no long term interest of the promoter knowing that in most cases they cannot have enough resources to retire debt.

Under the circumstances, I feel that the lending banks themselves will have to play a significant role in resolving these NPAs. My suggestions are as under :

(i) The lenders must convert the entire or at least significant majority of debt outstanding (leaving only what could be considered as a sustainable debt vis-à-vis the EBITDA of the company) into equity as per guidelines of RBI which permit the conversion of NPAs into equity at lower of book value and FMV (subject to a minimum of PAR value as required under the Companies Act). It is absolute necessary for such distressed companies to have some breathing space by not having to bother about day-to-day funds for survival.

(ii) As the conversions would, in virtually all cases, result in the lenders collectively owning majority (super majority in most cases), the lenders must totally reconstitute the Board by removing the erstwhile promoters from the Board (and management) and appoint either its own nominees or Independent Directors of repute (preferably with majority of Independent Directors) on the Board. The new Board must immediately review the management and replace particular officials, if any, who it considers undesirable and suspect.

(iii) Such conversion can become the basis of a 'pre-pack' with creditors if the lenders feel that there is a need for protection under IBC from past unadmitted liabilities or criminal actions/ investigations. This would be recommended as such protection would be necessary for smooth functioning of the company in future as also for attracting investor interest. With this proposal of conversion to equity being a legally binding proposal, the company be taken to IBC, with this proposal becoming the 'base bid' or 'the stalking horse' for mandated auction under a 'Swiss challenge' whereby the lenders will proceed to convert if bids are lower than the amount of equity value converted and debt retained. In case of the other bids being higher, the lenders will have a Right of First Refusal (ROFR). As a part of its offer, the lenders can also specify the reduction in operating creditors' dues that it would expect, if any.

The critical element for the above to succeed is for appointment of Specialized Management Services Company (MSC) by the lenders who shall act as the 'Corporate Office' for the concerned company and be responsible for continuous governance and review of the management and performance of the company on one hand and provide strategic guidance and function-wise assistance to the Board and Management going forward on the other. This way, while the company will retain its full management structure, the MSC as an arm of the Board will allow the Board to have deep governance over the company policies and reporting and will be able to review the operational and financial performance at all times.

The biggest advantage of such an approach would be that since there would be a proper auction, the process would not get entangled in legal challenges. In addition, right at the time of admission under NCLT, irrespective of suitable bids being received, the resolution will be guaranteed due to the available legally binding bid as a fallback. This would not only save valuable time but would provide absolute certainty for the company remaining a going concern – whether under the ownership of the lenders or the new bidders. It would also invariably enable the lending bank consortium to extend "priority lending", if required for urgently needed working capital of the company with a clear condition that the funds post conclusion of the final bid (including from free cash flows of the company) will be paid to settle such priority lending before any other payments.

I believe that once the company is repaired with its Balance Sheet cleaned of past legacies, a professional management sans the promoters being in place, comfortable working capital position and sustainable leverage, its operational performance can be quickly turned around and brought back to earlier levels when it was healthy. Once that is achieved, the lenders will find many avenues to monetize their equity holding. These could be by way of strategic sale, sale to PE investors, listing in IPO and QIP sales in case of listed entities. SEBI has already exempted need for public offering in case of conversion to equity by lenders. Am sure that it would also be pleased not to recognize lender group as 'Promoters' and thus relieve them of attached obligations and restrictions. It is mostly likely that they will end up realizing best value for their investment through this route.

I have no doubt that following the approach suggested above would enable a very large number of NPA companies from closing down and remaining going concerns. This would result in saving vital jobs and precious capital and enable resurrection of such companies who could have good potential going forward.

However, it is my belief that in doing so, the banks as lenders would have to change the mindset and instead of remaining mute spectators from the sidelines will have to step into the centre stage by being ready to take control of the company and ousting the current promoters to give the company a chance of revival. Unfortunately, I feel that in the absence of such an approach, many companies that can be saved and sustained will end up being liquidated and vanishing forever.