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RBI ISSUES FINANCIAL PARAMETERS FOR RESOLUTION PLAN UNDER 6 AUGUST CIRCULAR

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In our previous post (Previous Post), we analysed the Reserve Bank of India's (RBI) circular on Resolution Framework for Covid-19 Related Stress dated 6 August 2020 (August 6 Circular) that provided for a limited time window for resolution of stress of certain categories of borrowers affected by the Covid-19 pandemic (Pandemic) while permitting the eligible borrower accounts to retain their status as 'standard'. The August 6 Circular proposed constitution of an expert committee headed by Shri K. V. Kamath (Expert Committee) to make recommendations to the RBI on the required financial parameters, along with the sector-specific benchmark ranges for such parameters, to be factored into the resolution plans prepared for eligible corporates, under the August 6 Circular.

Pursuant to the recommendations submitted by the Expert Committee on 4 September 2020 (Expert Committee Recommendations), the RBI has issued a circular on Resolution Framework for COVID-19-related Stress – Financial Parameters dated 7 September 2020 (Circular) setting out key sector specific financial parameters for 26 (twenty six) sectors (Identified Sectors) to be mandatorily considered by lending institutions while finalising the resolution plans under the August 6 Circular (Key Ratios).

The key provisions of the Circular are set out below:

Key Ratios:

The Circular sets out a list of financial parameters required to be considered by lending institutions while finalising a resolution plan for the Identified Sectors. The Key Ratios identified in the Circular and their definitions are set out hereinbelow:

Key Ratio	Definition
Total Outside Liabilities / Adjusted Tangible Net Worth (TOL/ATNW)	Addition of long-term debt, short term debt, current liabilities and provisions along with deferred tax liability divided by tangible net worth net of the investments and loans in the group and outside entities

Total Debt/EBITDA	Addition of short term and long-term debt divided by addition of profit before tax, interest and finance charges along with depreciation and amortisation.
Current Ratio	Current assets divided by current liabilities
Debt Service Coverage Ratio (DSCR)	For the relevant year addition of net cash accruals along with interest and finance charges divided by addition of current portion of long term debt with interest and finance charges.
Average Debt Service Coverage Ratio (ADSCR)	Over the period of the loan addition of net cash accruals along with interest and finance charges divided by addition of current portion of long term debt with interest and finance charges.

Consideration of Key Ratios in the Assumptions:

The Circular sets out thresholds (floor or ceiling, as the case may be) for each of the Key Ratios that are required to be considered by the lending institutions into the assumptions that go into each resolution plan (Assumptions) with respect to an eligible borrower. Further, the lending institutions are permitted to factor in other financial parameters as well while finalizing the Assumptions in addition to the Key Ratios. The Circular clarifies that requirements to factor in Key Ratios are applicable even in cases when there is only one lending institution with exposure to an eligible borrower. The Circular in accordance with the Expert Committee Recommendations has also clarified that certain Key Ratios are inapplicable for certain Identified Sectors. Examples of inapplicability of Key Ratios includes (i) TOL/ATNW, Total Debt/EBITDA and Current Ratio being inapplicable in the roads sector considering that in the roads sector, the financing is cash flow based and at special purpose vehicle level where the level of debt is decided at the time of initial project appraisal and the working capital cycle is also negative; (ii) DSCR and ADSCR being inapplicable in aviation and wholesale trading since most of the airline companies work on refinancing of debt as a financing strategy and in wholesale trading, companies rarely use long term debt for funding their operations and are usually unlisted; and (iii) Current Ratio being inapplicable in automobile manufacturing considering the "*just in time inventory*" business model for raw materials and parts, and finished goods inventory is funded by channel financing available from dealers.

Furthermore, the Circular stipulates that while the Key Ratios are intended as floors or ceilings, as the case may be, the resolution plans are required to take into account the pre-Pandemic operating and financial performance of the borrower and impact of the Pandemic on its operating and financial performance at the time of finalising the resolution plan, to assess the cashflows in subsequent years, while stipulating appropriate ratios in each case. Further, the Expert Committee Recommendations provide that in respect of those sectors where the threshold parameters have not been specified by the Expert Committee, lending institutions can make their own internal assessments for the solvency ratios i.e. TOL/ATNW and Total Debt/EBIDTA, however, the current ratio and DSCR shall be 1.0 and above, and ADSCR shall be 1.2 and above.

Adoption of a Graded Approach:

The Circular acknowledges that the Pandemic has had differential impact on various sectors/entities. Accordingly, it allows the lending institutions to, at their discretion, adopt a graded approach depending on the severity of the impact on the borrowers, while preparing or implementing the resolution plan. Such graded approach may also entail classification of the impact on the borrowers into mild, moderate and severe, as recommended by the Expert Committee. The Circular is silent on the consequences of such graded approach and whether the lending institutions can relax the Key Ratios for the accounts classified as severe.

Maintenance of Key Ratios:

The Circular stipulates that lending institutions are expected to ensure compliance to the TOL/ATNW agreed as per the resolution plan at the time of implementation itself. Additionally, in all cases, this ratio is required to be maintained as per the resolution plan by 31 March 2022 and on an ongoing basis thereafter. However, wherever the resolution plan envisages equity infusion, the same may be suitably phased-in over this period. All other Key Ratios are required to be maintained as per the resolution plan by 31 March 2022 and on an ongoing basis thereafter. Interestingly, the Expert Committee Recommendations had suggested in its report that as far as financial projections are concerned, the threshold TOL/ATNW and Total Debt/ EBIDTA ratios should be met by 31 March 2023 while the other three Key Ratios should be met for each year of the projections starting from Financial Year 2022. The Circular further lays down that the compliance in regard to meeting the agreed ratios must be monitored as financial covenants on an ongoing basis and during subsequent credit reviews. Any such breach not rectified within a reasonable period, in terms of the loan contract, will be considered as financial difficulty.

Applicability of mandatory provisions of August 6 Circular:

The Circular clarifies that the requirements of the August 6 Circular, such as mandatory requirement for lending institutions to execute an inter-creditor agreement (ICA) wherever applicable, maintenance of an escrow account after implementation of a resolution plan etc. shall be applicable at the borrower-account level, i.e., at the level of legal entities in which the lending institutions have exposure to. The Circular further clarifies that such legal entity could also include a special purpose vehicle having a legal-entity status, set up for a project. Further, the Circular clarifies that signing of the ICA is a mandatory requirement for all lending institutions in all cases involving multiple lending institutions, where the resolution process is invoked. The requirement of additional provisions if the ICA is not signed within 30 (thirty) days of invocation does not substitute for the mandatory nature of the ICA. Compliance with this regulatory requirement shall be assessed for all lending institutions as part of the supervisory review.

Comments

As set out in the Pervious Post, the limited period window for resolution of stress under the August 6 Circular while retaining the asset as "standard" means that the stakeholders would now need to speed up the process of agreeing on the inter-creditor mechanism and work out a resolution plan within the timelines prescribed. In light of this, the recommendations of the Expert Committee were critical to determine the scope and extent of the financial parameters to be applied with respect to eligible borrowers in dealing with requests for resolution under the August 6 Circular.

In light of the Circular, the provisions of the August 6 Circular now provide a clear way forward for dealing with distress of eligible borrowers caused as a direct consequence of the Pandemic, especially for borrowers in the Identified Sectors. The Key Ratios laid down by the Circular would help the lending institutions to finalise resolution plans expeditiously, laying out clear parameters of financial performance that would be required to be achieved by eligible borrowers seeking resolution/restructuring under the August 6 Circular.

Having said that, the success of the one-time restructuring regime introduced by RBI also depends on the co-operation of the institutional/ foreign creditors/ investors who are not covered by the August 6 Circular and are currently in a stand-still mode on account of suspension of Sections 7, 9 and 10 of the Insolvency and Bankruptcy Code (IBC).

In that sense, the success of resolution plans going through a voluntary compromise process under the August 6 Circular read together with the Circular would also remain intrinsically linked to the continued suspension of the IBC beyond 6 (six) months for this new regime to be effectively used by lenders to support businesses in distress.

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