3 Clarifications on the Resolution Framework for COVID-19 related stressed assets

This article aims to:

– Summarise the clarifications provided by RBI regarding the Resolution Framework.

Background

To help preserve the soundness of the Indian banking sector and mitigate risks to financial stability, on 6 August 2020, the Reserve Bank of India (RBI) had notified the Resolution Framework for COVID-19 related stress (Resolution Framework). The Resolution Framework is a special window under the RBI (Prudential Framework for Resolution of Stressed Assets) Directions, 2019, issued in June 2019 (Prudential Framework), which enables resolution of accounts under stress on account of COVID-19, without adversely affecting the asset classification of these accounts.

The Resolution Framework has guidance on following two sections:

Resolution of stress in personal loans

Resolution of stress in 'Other Exposures'

On 14 October 2020, RBI issued 17 Frequently Asked Questions (FAQs) which provide clarification on various aspects of the Resolution Framework.

This article provides a summary of the clarifications provided by RBI.

Summary of the clarifications

The FAQs issued by RBI provide clarification on the following aspects of the Resolution Framework:

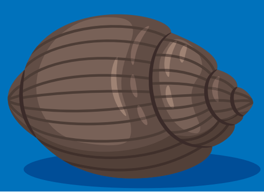
I. Eligible borrowers and eligibility criteria for the Resolution Framework

The Resolution Framework is applicable to personal loans and other exposures which have stress on account of COVID-19. Eligibility criteria for these loans/credit facilities to apply Resolution Framework has been specified in the framework. Exposures which do not fulfil the required eligibility conditions, would continue to be resolved under the Prudential Framework, or the relevant instructions applicable to specific category of lending institutions.

Clarifications

Following are the clarifications relating to eligibility of loans and their classification as personal loans/ other exposures:

- The Resolution Framework may be invoked for resolution of all exposures of lending institutions to eligible borrowers including investment exposures (such as corporate bonds, commercial papers, etc.). However, the Resolution Framework is without prejudice to all applicable guidelines issued by the relevant financial sector regulators and other Departments of the RBI in respect of any particular exposure. *(Clarification no. 7).*
- For entities/exposures (including investment exposures) that are undergoing COVID-19 related stress and meet the eligibility criteria prescribed in the Resolution Framework, only the Resolution Framework can be used for resolving that stress. For all other borrowers, the RBI's extant instructions[1] as otherwise applicable would be applicable. *(Clarification no. 4).*
- Personal loans are defined (in RBI circular DBR. No.BP.BC.99/08.13.100/2017-18) as loans given to individuals, which consist of consumer credit, education loan, loans given for creation/ enhancement of immovable assets and loans given for investment in financial assets. Accordingly, loans against property, which are used for business purposes or loans to individuals, where non-individuals have been considered as co-borrowers would not qualify as personal loans. In such cases, the resolution of eligible borrowers may be undertaken under the Resolution Framework for 'Other Exposures'. *(Clarification no. 17)*



1. Paragraph 2(1)(zc)(ii) of the Master Circular – The Housing Finance companies (NHB) Directions, 2010 for housing finance companies, and Paragraph 2.2.7.21 of the Master Circular- Income Recognition, Asset Classification, Provisioning and Other Related Matters – UCBs dated 1 July 2015 for Urban Co-operative Banks.

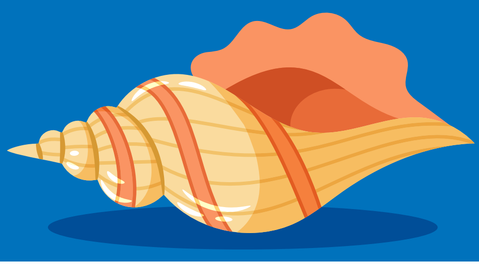
The circular specifies six categories of borrowers/ credit facilities which would not be eligible for resolution under the Resolution framework. These include:

- MSME borrowers whose aggregate exposure to lending institutions is INR25 crore or less as on 1 March 2020
- Farm credit (as defined in master directions issued by RBI on priority sector lending)[2]
- Loans to specific organisations, which would be on-lending for agricultural purposes
- Financial service providers
- Government bodies
- Exposures of Housing Finance Companies (HFCs) which have been rescheduled under the Master Circular - The Housing Finance Companies (NHB) Directions, 2010 after 1 March 2020.

Clarifications

Clarifications that delineate the applicability of the Resolution Framework are as follows:

- Effective 1 July 2020, the definition of MSME has been revised. For the purpose of assessing eligibility under the Resolution Framework, the definition of MSME that existed as on 1 March 2020 (i.e. the old definition) would apply. *(Clarificaition no. 14)*
- All farm credit exposures (as defined in the master circular on priority sector lending) of all lending institutions, except for loans to allied activities are excluded from the scope of the Resolution Framework. However, loans given to farmer households would be eligible for resolution under this Resolution Framework, provided they do not meet any other conditions for exclusions specified in the Resolution Framework. *(Clarificaiton no. 2)*
- All loans that meet the eligibility criteria, unless specifically excluded from the Resoultion Framework, would fall within the purview of the Resolution Framework. Loans that fall within the definition of 'personal loans' would be resolved as per criteria laid down in the Resolution Framework, even if they are not explicitly classified as such in any regulatory/supervisory reporting. In other cases, they would be resolved as per the criteria of 'other exposures' in the Resolution Framework. *(Clarification no. 5)*



The Resolution Framework sets out 1 March 2020 as the reference date for the purpose of assessing whether loans meet the eligibility conditions prescribed thereunder. Additionally, for the loans to be eligible under this framework, they should be classified as a standard asset as on the reference date, and they should not be in default for more than 30 days. However, it is not clear if 1 March 2020 would be considered as the reference date for the outstanding amount of debt too.

Clarifications

The clause mentioning the reference date of 1 March 2020 in the Resolution Framework is a general clause regarding the date on which the eligibility criteria for resolution under the Resolution Framework may be assessed. Therefore, the actual debt that would be considered for resolution would be the outstanding amount as on the date of invocation. *(Clarification no. 1)*

In certain cases, exposures that did not meet the eligibility criteria as on 1 March 2020 (e.g. a loan account was more than 30 DPD on 1 March 2020), and subsequently met the eligibility criteria (i.e. post the reference date). In such cases, those exposures cannot be resolved under the Resolution Framework but may be resolved under the Prudential Framework or other extant guidelines. *(Clarification no. 16)*

2. Para 6.1 of the Master Directions on priority sector lending (Master Direction FIDD.CO.Plan.1/04.09.01/2016-17 dated July 7, 2016 (as updated)) defines farm credit as:
   A. Loans to individual farmers (including Self Help Groups (SHGs) or Joint Liability Groups (JLG)) and proprietorship of farmers, directly engaged in agriculture and allied activities
   B. Loans to corporate farmers, farmers' producer organisations/ companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in agriculture and allied activities (allied activities would be upto a specified limit).

   Allied activities include dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture.

II. Invocation and Implementation of the resolution plan

The circular requires all resolution plans under the Resolution Framework to be invoked by 31 December 2020. Further, it provides 90 days for implementation of the plan for personal loans, and 180 days for implementation of plans for other exposures.

Clarifications

Following are the clarifications:

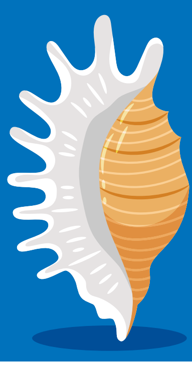
- Date of invocation has been defined in the circular as the date when both the borrower and the lender (requisite lenders in case of multiple lenders) have agreed to proceed with a resolution plan under the Resolution Framework.
- For personal loans, the resolution plan would be deemed to have been implemented when the documentation is in place, changes in terms and conditions of the loans is reflected in the lenders' books, and the borrower is not in default with the lending institution as per the revised terms.
- A resolution plan for other exposures would have a similar meaning as prescribed in the Prudential Framework. Accordingly, resolution plans for other exposures would be deemed to have been implemented when:
  - *Resolution plans involving restructuring/ change in ownership:* When documentation is in place, changes in terms of conditions of the loans is reflected in the lenders' books, and the borrower is not in default with the lending institution
  - *Resolution plans not involving restructuring/ change in ownership:* When the borrower is not in default with any of the lenders as on the 180[th] day from end of review period
  - *Resolution plan where lenders exit the exposure by assignment/recovery:* When exposure to the borrower is fully extinguished. *(Clarification no. 6)*

III. Features of the resolution plan

The circular prescribes some of the features of the resolution plan which may include restructuring (excluding compromise settlements), change in ownership, extension of the loan, provision of a moratorium of a maximum of two years, etc. However, the circular is silent on whether resolution plans involving deferment of Date of Commencement of Commercial Operations (DCCO) in respect of projects under implementation can be implemented under the Resolution Framework.

Clarification

The restructuring in respect of projects under implementation involving deferment of DCCO are excluded from the scope of the Resolution Framework. The extant regulations contained in Paragraph 4.2.15 of DBR.No.BP.BC.2/21.04.048/2015-16 dated 1 July 2015, DOR.No.BP.BC.33/21.04.048/2019-20 dated 7 February 2020 and the other relevant instructions as applicable to specific category of lending institutions, already permit revisions of the DCCO and consequential shift in repayment schedule without being treated as restructuring subject to a maximum of four years in the case of infrastructure projects and a maximum of two years in the case of non-infrastructure projects (including commercial real estate exposures). In addition to the above, DCCO of projects may be extended by a further two years in case of change in ownership subject to the conditions specified in the above instructions. *(Clarification no. 11)*



IV. Specific aspects relating to resolution of other exposures

The Resolution Framework prescribes various requirements while invoking and implementing a resolution plan for 'Other Exposures'. Some of these requirements include:

- **Lenders to sign an inter-Creditor Agreement (ICA):** In all cases involving multiple lending institutions, once the resolution process has been invoked, ICA should be signed by all lenders (and at least the requisite number of lending institutions[3]) within 30 days from the date of invocation. Failure in doing so would result in the invocation being lapsed, and a resolution process cannot be invoked again for that facility, under Resolution framework.
- **Key ratios:** RBI constituted an Expert Committee which has recommended a list of financial parameters (key ratios) with sector specific ranges for such parameters[4]. These parameters need to be factored into the assumptions that go in **each resolution plan[5]** pertaining to 'other exposures'.
- **Escrow account:** In accounts involving multiple banking arrangements, post implementation of the resolution plan, all receipts and repayments by the borrower, and additional disbursements by lenders as part of the resolution plan, would be routed through an escrow account maintained by one of the lending institutions.

In its circular dated 7 September 2020, RBI stated that the applicability of ICA and maintenance of escrow account would be at a borrower level.

Clarifications

Following are the clarifications:

- The circular does not provide for any minimum cut off with respect to aggregate outstanding exposure with banking system for mandatorily signing ICA. Accordingly, if there are multiple lending institutions with exposure to a borrower falling in the category of 'Other Exposures' of the Resolution Framework, then all lending institutions having exposure to such borrower are required to enter into ICA. *(Clarification no 12)*
- The list of financial parameters prescribed by the Expert Committee are applicable to all resolution plans to be undertaken in terms of Resolution Framework. The Resolution Framework is applicable to all borrowers in respect of 'Other Exposures'. *(Clarification no. 9)*
- For sectors, where the sector-specific thresholds (financial parameters) have not been specified in the list issued by the Expert Committee, the lenders are required to make their own internal assessment for specific ratios[6]. *(Clarification no. 15)*
- In the case of real estate sector, and other sectors, a company typically has multiple projects which are financed through multiple instruments. Therefore,
  - There is a sufficient flexibility to the lending institutions to formulate the ICAs in order to address specific requirements of each borrower, including designing different resolution approaches for different projects within an ICA
  - While an escrow account is required to be set up at a legal entity level, there is no prohibition in setting up additional separate escrow accounts at each project level, if the lenders desire
  - Only in respect of borrowers belonging to real estate sector, which have both residential and commercial real estate business, the prescribed thresholds for the financial parameters may be applied at the project level. *(Clarification no. 3)*

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3. Requisite number of lending institutions include:
   - At least 75 per cent by value of total outstanding credit facilities, and
   - At least 60 per cent by number of total lending institutions
4. In its circular dated 7 September 2020, the Expert Committee has prescribed the key ratios to be considered while evaluating resolution plans, and has specified 26 sectors with sector specific ranges for the key ratios.
5. Irrespective of the exposure.
6. 6 Lenders are required to make internal assessment of the following ratios- Total Outstanding Liabilities/Adjusted Tangible Net Worth (TOL/ATNW) and Total debt/EBITDA. However, the current ratio and Debt Service Coverage Ratio (DSCR) would be 1.0 and above in all cases, and Average DSCR (ADSCR) would be 1.2 and above in all cases.

As per the circular, resolution plans for accounts where the aggregate exposure of the lending institutions at the time of invocation of the resolution process is INR100 crore and above, are required to obtain an Independent Credit Evaluation (ICE) by any one Credit Rating Agency (CRA) authorised by RBI under the Prudential Framework. However, the circular does not specify the minimum desirable ICE symbol for the plan to be considered for implementation.

Clarification

The RBI clarified that resolution plans which receive a credit opinion of RP4 or better for the residual debt from one/multiple CRAs, would be considered for implementation under the Resolution Framework. In case credit opinion is obtained from more than one CRA, all such credit opinions must be RP4 or better. *(Clarification no. 13)*

V. Additional loan loss provisions to be maintained under the framework

Once the resolution plan has been implemented under the framework, the lending institutions are required to maintain loan loss provisions (termed as additional provisions) which would be higher of the provisions held as per the extant Prudential Norms on Income Recognition, Asset Classification and Provisioning (IRAC norms) or a prescribed percentage of the existing debt. However, it was not clear whether these provisions would be treated as specific provisions or as general provisions that would partly qualify to be included as Tier 2 capital.

Clarification

The additional provisions would be treated as specific provisions which would be maintained in respect of each exposure under consideration. *(Clarification no. 10)*

VI. Accounting implications of the Resolution Framework

The Resolution Framework prescribes the additional provisions that are required to be maintained on exposures for which a resolution plan has been implemented. However, it is silent on the accounting treatment for these provisions for financial institutions that have adopted the Indian Accounting Standards (Ind AS). Under Ind AS, entities are required to follow the principles enunciated in Ind AS 109, *Financial Instruments* for creating a provision for impairment on financial assets. However, it was not clear on whether they would be required to follow the principles of Ind AS or the provisions of the circular while accounting for the additional provisions.

Clarification

NBFCs which are required to comply with Ind AS would continue to be guided by the guidelines duly approved by their Boards and as per advisories issued by the Institute of Chartered Accountants of India (ICAI) for recognition of significant increase in credit risk and computation of Expected Credit Losses (ECL).

The additional provisions prescribed in the circular would constitute prudential floors[7]. *(Clarification no. 8)*

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7. As per RBI circular dated 13 March 2020 (which provides additional guidance to NBFCs and Asset Reconstruction Companies on Ind AS implementation), NBFCs are required to maintain provisions in the financial statements as per Ind AS. They are also required to compute the provision as per IRAC norms which would be treated as prudential floors. These entities would then disclose a comparison between prudential floors and Ind AS in the notes to financial statements.