Reserve Bank of India Allowing Banks To Take Over Defaulting Companies With Bad Debts

In its latest move to assist banks in recovering their advances from companies which have gone bad, Reserve Bank of India has given permission to banks to convert their loans into equity and take control of these defaulting companies. There are five challenges that need to be understood before the move yields any result:

1. Most of the companies are sick and it is not sure how the bank will be able to turnaround the companies. Ideally these companies will have to be sold / merged with companies of similar businesses to make the companies profitable.

2. Most of the promoters have already pledged as high as 90% of the stocks and borrowed against the same. The status of such lenders needs to be protected in event of takeovers. These are personal loans given to the promoters.

3. Ideally SEBI, RBI and Ministry of Corporate affairs should publish guidelines so that such takeovers are smooth and completed in fastest possible time. Courts also need to be sensitized to have quick clearance of litigations pertaining to such takeovers.

4. SEBI rules require that if there is a substantial takeover then offer should be made to other shareholders and opportunity for them to exit should be available through a buy back. This law would have to be tweaked in order that the banks which are already burdened with dead loans are not expected to give more money to other shareholders for purchase

5. Valuation of the companies for purpose of converting the loans to equity shares is another challenge. Since this is a distress sale aggressive pricing may be insisted upon. This will play havoc with the shares prices if the company is listed on the exchange.

Banks shall also consider transferring promoters' holdings to a security trustee or an escrow arrangement till turnaround of company.

If the lender agrees to this then it will permit a change in the management control. The circular from RBI further says that it has been observed that in many cases of restructuring of accounts, borrower companies are unable to come out of stress due to operational or managerial inefficiencies despite substantial sacrifices made by lending banks.

This measure is taken to provide banks with a more convenient way to recover bad debts which have been mounting over months/years.