Ruling out Default by Definition*

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The expected has finally occurred. Banks that were pretending for long that Kingfisher Airlines would wriggle out of its problems and take to the sky again have decided the end has come. A group among the 18-member lender's consortium led by the largest lender, public sector giant State Bank of India, have decided to recall loans of around Rs. 7,500 crore that they had advanced to Kingfisher Airlines.

Recall requires immediate repayment of the loan by the borrower. Since Kingfisher is in no position to do that, this is a declaration by the consortium that they intend to liquidate the collateral and guarantees provided by the borrower to recover as much of their loans as possible. Not much, say those in the know. Though Kingfisher had reportedly provided collateral to the tune of Rs. 6,500 crore in the form of real estate and shares and corporate and personal guarantees, it seems only a fraction of the sum involved can be garnered as compensation for the loans, even after a long drawn out legal process. Expecting that, State Bank of India claims that it has already made provisions for as much as 97 per cent of the Rs. 1,700 crore it has lent the airline. A big haircut seems inevitable.

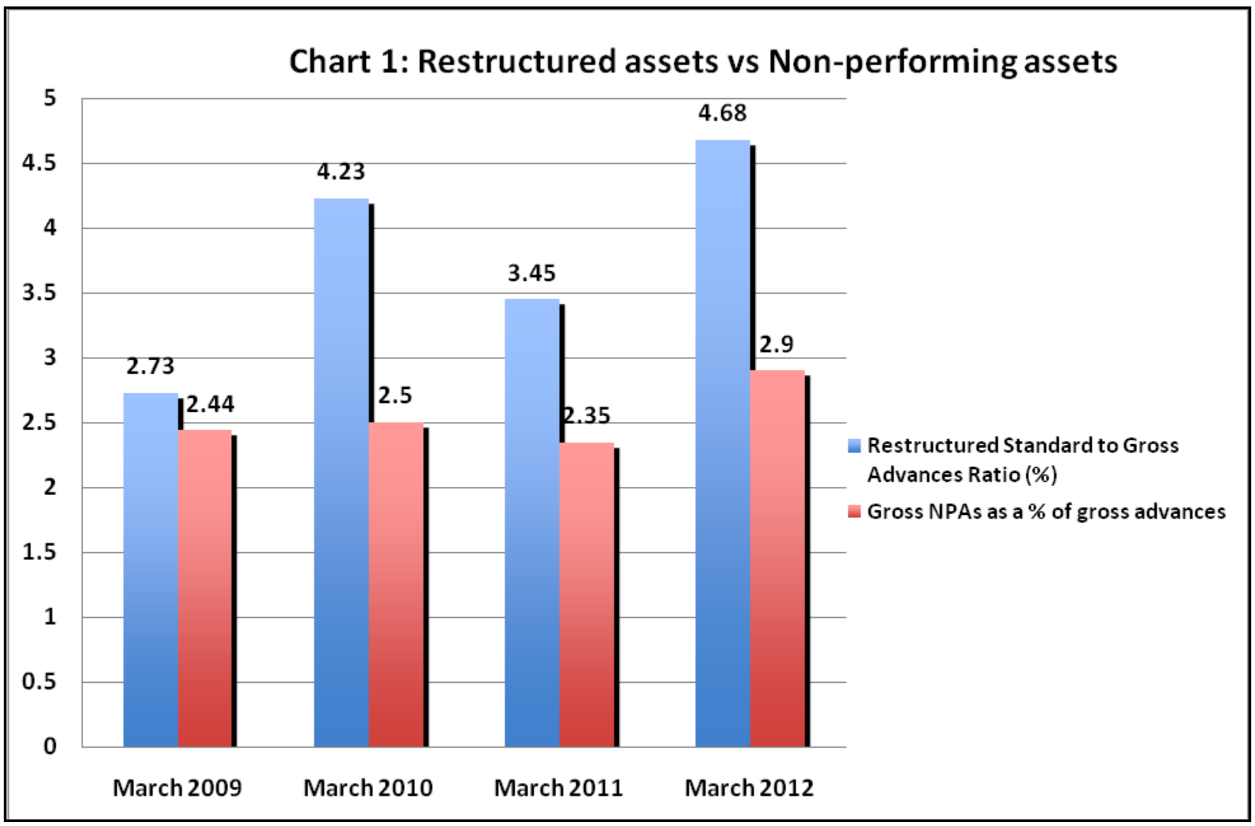
This loss comes on top of losses suffered earlier as part of a debt restructuring process that began in November 2010. At that time the banks involved had got together and under the Corporate Debt Restructuring (CDR) scheme of the RBI, restructured debt to the tune of Rs. 77 .2 billion owed by Kingfisher. An aspect of the restructuring process was the conversion in April 2011 of a significant share of the loans due into a 23 per cent equity stake in the airline, in order to reduce its interest and amortisation payment commitments. With the carrier's equity now worthless, almost all of that has been wiped out.

With hindsight it is clear that bank lending to civil aviation, where few airlines are making profits, was a mistake in the first place. If so, restructuring that debt rather than cutting losses by exiting early seems an even greater blunder, especially in the case of Kingfisher, which worsened the effects of an erroneous civil aviation policy through its own follies: bad strategy, bad acquisitions, profligacy and obvious mismanagement.

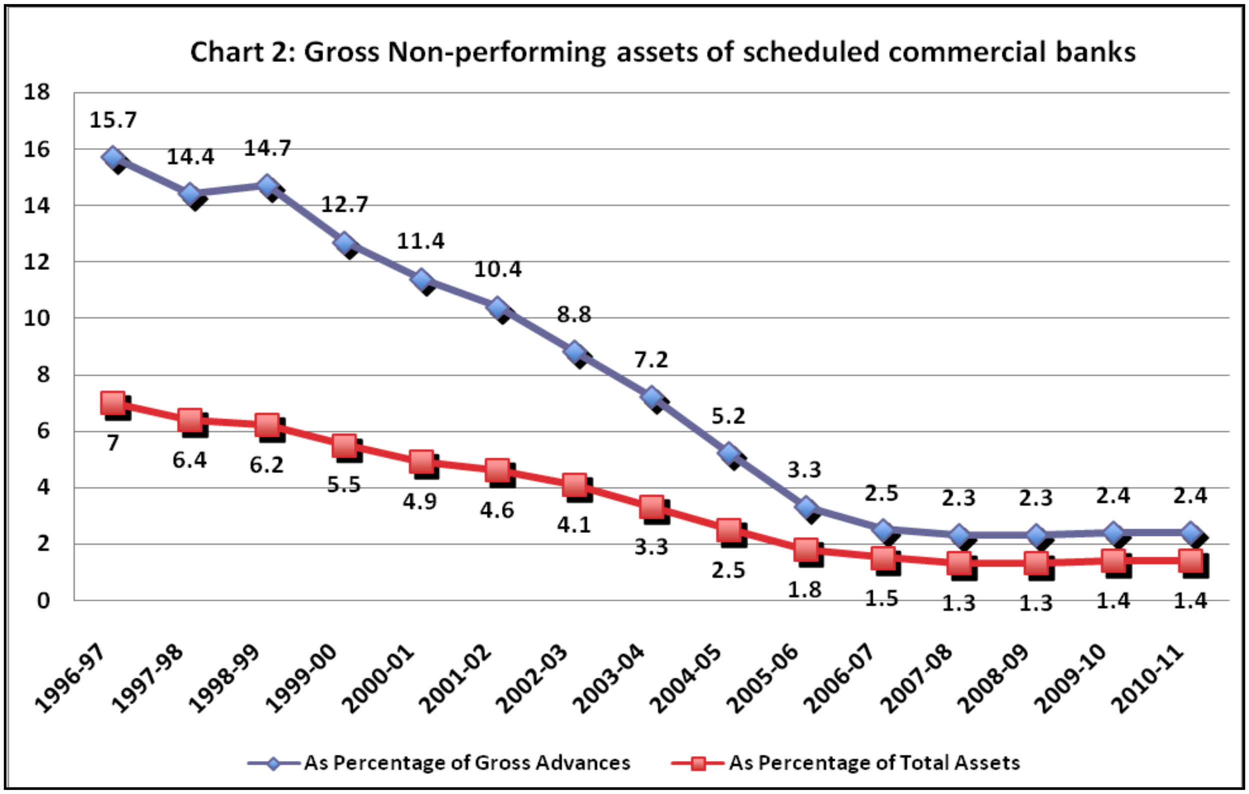
But the banks that were pressured into supporting with credit the government's policy of attracting private investors to the infrastructural sector found themselves in a mess when default was a possibility. If they withdrew, they would force default of the large volume of debt they had already provided. So they restructured debt, offered better terms, extended repayment periods, and provided more credit to keep the unit afloat. That amounted to sending good money after bad.

However, under prevailing guidelines, even though debt was being restructured, the assets could remain classified as "standard assets" and not "non-performing assets". That was attractive to the banks. In fact, restructuring of debt got a boost after these guidelines were put in place. When in the immediate aftermath of liberalisation in 1991, asset classification guidelines were issued, loans of companies that had been renegotiated and restructured after they started commercial production were to be classified as sub-standard and to remain in that category for at least two years of satisfactory performance under the renegotiated or rescheduled terms. But through a gradual process of liberalization, by 2001 it was decided that restructured accounts could retain their "standard asset" classification: (i) when installments of principal were rescheduled provided the loan was fully secured and (ii) when the interest element was restructured provided the sacrifice in terms of present value was either written off or provided for. This gave banks the freedom to restructure problem assets without having to declare them sub-standard or make the required provision.

In recent times banks seem to have exercised this privilege repeatedly, especially in the case of the bulky loans they have provided to infrastructural sectors such as power generation and distribution and telecommunications. Loans to these sectors as a share of the total advances of scheduled commercial banks to the industrial sector have risen sharply, from less than 2 per cent at the end of March 1998 to 16.4 per cent at the end of March 2004 and as much as 31.5 per cent at the end of March 2012. So have the instances where some of these companies have declared inability to meet their payments commitments and gone in for debt restructuring.



According to data from the Corporate Debt Restructuring (CDR) Cell, the number of restructuring cases approved increased from 184 (involving aggregate debt of Rs. 86,536 crore) at the end of March 2009 to 362 cases (involving debt of Rs, 2,11,978 crore) at the end of March 2012. The net result has been a sharp increase in the proportion of "restructured standard assets" in the total advances of the banking system. As Chart 1 shows that proportion has risen from 2.73 per cent at the end of March 2009 to 4.68 per cent by the end of March 2012. While this has been occurring, the government has taken pride in the fact that the non-performing assets of the commercial banking system have come down quite significantly post-reform (Chart 2), though this is because the truth has been concealed by definition.



Much of this debt is in sectors that are facing significant difficulties. Iron and Steel, Infrastructure, Construction, Power and Telecom account for 91 of the 362 restructuring cases as of March 2012, and as much as 52 per cent of the aggregate debt. That makes it likely that Kingfisher may be not the last instance of large losses. The implications for the stability of the banking system are also by no means inconsequential.

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