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Role of Asset Reconstruction Companies (ARCs) in Handling Non-Performing Assets (NPA) in Banking

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ABSTRACT

Asset reconstruction companies (ARCs) is a type of finance company in India. They were formed as part of steps taken by the Government to clean up the balance sheets of banks and financial institutions and help revive the credit and investment cycle in India. The ARC industry was born out of the Recapitalization and Financial Services Industry Development Act 2002. The Act gave an opportunity to banks, insurance companies, and financial institutions that have been in losses for some time, or are facing temporary capital problems.

Keywords: *Asset, Banks, Asset Reconstruction Companies (ARCs), Credit, Investment, Non-Performing Assets (NPAs), and Recapitalization.*

I. INTRODUCTION

A sound banking system is an essential requirement for maintaining financial stability in any country. One of the parameters of soundness is the level of non-performing assets (NPAs) in the banking system. In this context, it is common knowledge that the Indian banking system has often been saddled with high levels of NPAs which has been affecting the profitability and eventually the capital position of banks, especially the public sector banks (PSBs). This has been one of the factors which have led to some level of risk aversion among the banks and thereby deceleration of credit growth in the country in recent years. The level of gross NPAs (GNPAs) of scheduled commercial banks (SCBs) stood at 7.5% at the end of March 2021. The Financial Stability Report of July 2021 published by the Reserve Bank of India (RBI) indicates that the GNPA ratio of SCBs may transition to 9.80% in the baseline scenario by March 2022 and may increase to 10.36% and 11.22% under the other stress scenarios. Such a high level of NPAs in the economy can further decelerate the growth of credit in the economy and can potentially undermine the stability of the financial system.

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II. EVOLUTION OF IMPORTANT LEGAL AND REGULATORY FRAMEWORKS FOR HANDLING OF STRESSED ASSETS

In view of its importance for the health of the banking system, management of NPAs has been attracting attention from the RBI and the Government for quite some time now. A chronological evolution of important legal and regulatory frameworks for handling of stressed assets is given in the Figure A1 below. The first such significant legal framework to manage the stress in the banking system was the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). It was enacted for timely detection of sickness in industrial units and to undertake speedy action to resolve the insolvency of sick units through a Board of experts, namely the Board for Industrial and Financial Reconstruction (BIFR). SICA failed to meet its objective due to delays caused by legal suits and lack of timely decisions by the stakeholders and, therefore, was finally repealed in the year 2003. Related provisions of this Act were added in the Companies Act, 2013 and the National Company Law Tribunal (NCLT) took over the functions of BIFR. Insolvency resolution frameworks as a tool for handling stressed assets culminated into the Insolvency and Bankruptcy Code, 2016 (IBC). IBC was enacted as a single code to consolidate the existing frameworks for insolvency and bankruptcy and has emerged as a significant tool for recovery.

Other noteworthy legislations which aimed to facilitate recovery of debt for banks and Financial Institutions include the Recovery of Debt due to Banks and Financial Institutions Act, 1993 (RDDBFI Act) and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. The former Act attempts to provide speedy recovery through tribunals, namely, Debt Recovery Tribunals (DRTs) whereas the latter allows secured creditors to enforce their security interest without the intervention of the courts. The Act also led to creation of asset reconstruction companies (ARCs) as a permanent institutional arrangement to handle the stressed financial assets of banks and other financial institutions.

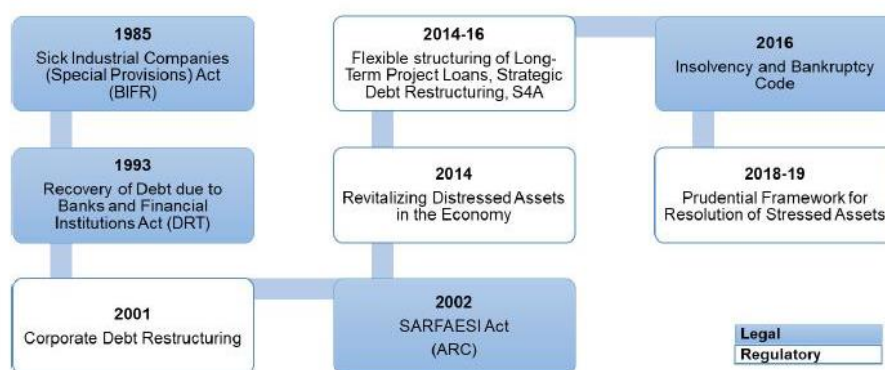
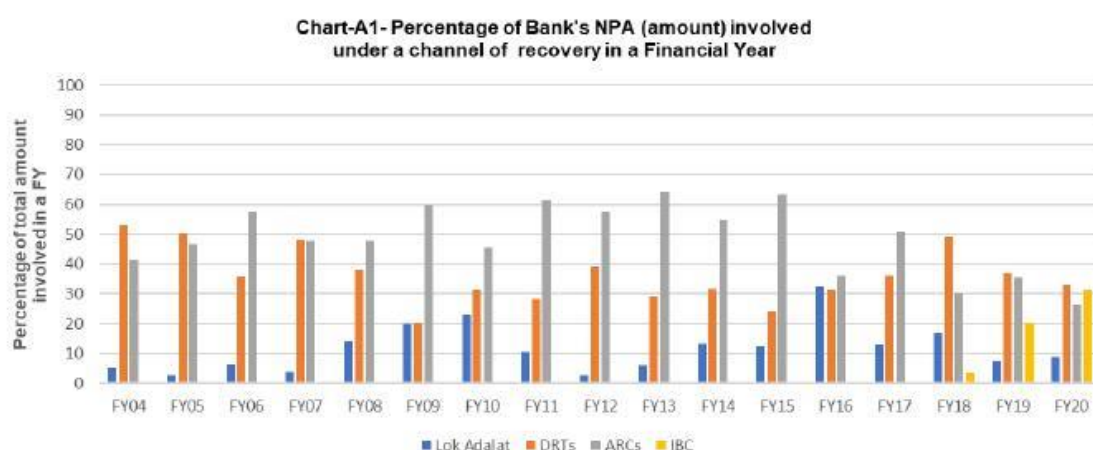
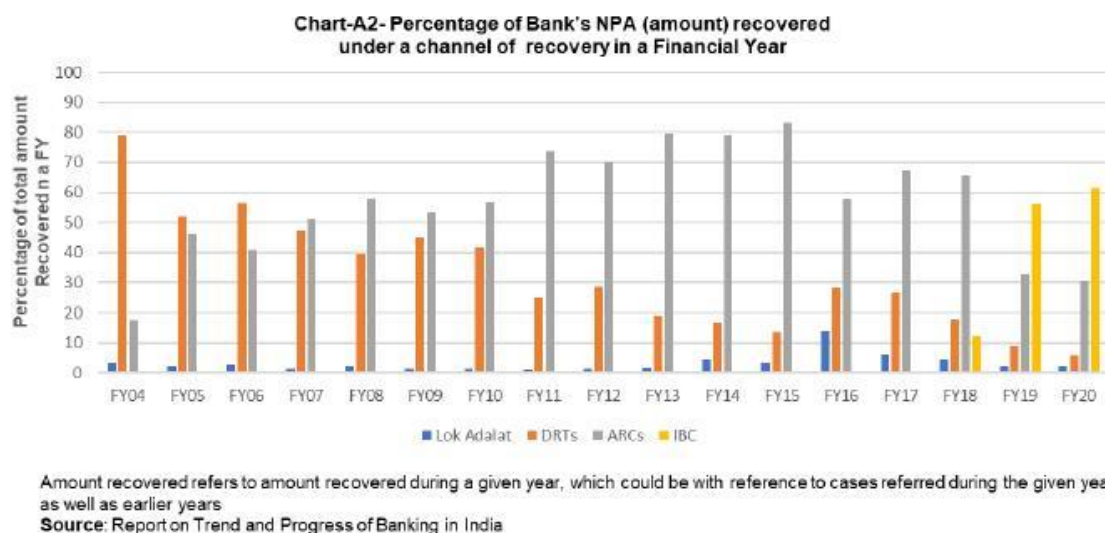


Figure 1 Evolution of important legal and regulatory frameworks for handling of stressed assets

RBI has been providing regulatory frameworks to banks for efficient handling of stressed assets in their books. The Corporate Debt Restructuring framework envisaged and provided a mechanism for timely and transparent restructuring of debt of viable entities, outside the purview of BIFR, DRT and other legal proceedings. This framework aimed at preserving viable corporates and minimizing losses to the creditors through an orderly and coordinated restructuring programme. Another major regulatory intervention was the “Framework for Revitalising Distressed Assets in the Economy” dated January 30, 2014. This framework attempted to centralise reporting and dissemination of information on large credit, incentivise lenders to agree collectively and quickly to a restructuring plan, provide improvements in restructuring process, etc. This was followed by various schemes of restructuring prescribed by RBI, namely, Flexible Structuring of Long-Term Project Loans, Strategic Debt Restructuring Scheme, Scheme for Sustainable Structuring of Stressed Assets (S4A), etc. Owing to the mixed success of these schemes, RBI issued a new set of guidelines vide the “Prudential Framework for Resolution of Stressed Assets” dated June 7, 2019. The new guidelines provide a framework for early recognition, reporting and time bound resolution of stressed assets and withdraw the aforementioned frameworks and schemes.

Charts A1 and A2 below depict the use of various channels by banks for recovery of their NPAs. Data indicates that after their introduction in 2003, ARCs have been a major channel of recovery for banks until FY19. In FY20, however, banks took more NPAs for resolution through IBC compared to the ARC channel. Data also suggests that from FY19 onwards, recovery through IBC has been greater than the recovery through ARCs (Chart A2).





Preference given to ARCs by banks is largely on account of three fundamental needs that ARCs are able to fulfil. First, ARCs allow banks/ FIs to focus on their core function of lending by removing the sticky stressed assets from their books and thereby freeing up their capital and management for productive use. Second, where lenders invest in security receipts (SRs), ARCs make recovery for lenders by acting as the manager of the stressed assets. Third, ARCs can help the borrowers in reviving their businesses. Revival of businesses is a significant need both for protecting the viable and productive assets of the economy and for ensuring better return to lenders from their stressed assets.

The recent trend of shift towards IBC is primarily driven by two factors. First, IBC promises both time-bound and optimal recovery for creditors as well as insolvency resolution of the borrowers in an intertwined manner. The other factor for this shift may be the lacklustre performance of the ARC sector, both in terms of ensuring recovery and reviving businesses.

As on date, there are 28 ARCs in operation. The AUM of the top five ARCs (as on March 31, 2021) constitute 70% of total AUM of all the ARCs in terms of book value acquired. Further, only three ARCs have net owned fund (NOF) above Rs.1500 crore. Furthermore, in terms of the capital base of the sector, over 54% is held by the top three ARCs; the corresponding share is 62% for the top five ARCs. While ARCs have been in operation since 2003, their performance in management of stressed assets of banks/ FIs is still uneven on several parameters.

Overall recovery made by the ARC sector during the period FY04 to FY13³ was 68.6% when measured in terms of redemption of SRs as a percentage of total SRs issued. However, the same comes down to 14.29% when the redemption is measured in terms of the book value of the

³ ARCs are required to resolve the assets within 8 years of acquisition. Therefore, period beyond FY13 may have SRs for which resolution would still be underway. For prudential purposes it is assumed that for the period FY04-FY13 resolution has been concluded.

assets acquired. Similarly, ARCs' performance in ensuring revival of businesses has also been poor. The data indicates that approximately 80% of the recovery for the sector, so far, has come through deployment of methods of reconstruction that do not necessarily lead to revival of business. ARCs have rarely used methods such as change in or takeover of the management of the business of the borrower or conversion of debt into equity in a borrower's company. Rescheduling of payment of debts was also involved only in 19.9% of the recovery made by ARCs.

The overall performance of ARC Sector has left much to be desired. However, it would be incorrect to assume that the problems of ARC sector are entirely of its own making. In fact, the ageing of NPAs before their sale may be contributing to poor recovery. This gets further aggravated by lack of debt aggregation. Revival of stressed business typically requires additional funding which is difficult to come by for old NPAs. Inadequate capital at ARC level and the regulatory prescription limiting the extent of funds that could be raised, from external investors through securitization, seems to have made ARCs' attempt at revival of businesses even more difficult. ARCs' lack of skill sets in turning around borrowers cannot be ignored.

Despite the reshaping of the ecosystem available for lenders for handling of stressed assets and the ARC sector's sub-optimal performance and its challenges, the ARC model remains relevant as a private sector led permanent institutional framework for out-of-court resolution of stressed assets of the financial sector. Also, the ARC model, uniquely, allows investors to hold on to the upside of stressed assets in uncertain times through issuance of security receipts. However, for the model to remain sustainable, ARCs need to focus on turning around borrowers and not merely making recoveries. ARCs also need to acquire differentiated skill sets, and resources vis-à-vis the selling lenders in resolving stressed assets. Such empowered ARCs would better serve the needs of the financial sector and economy in general.

III. GENESIS OF ARCS IN INDIA AND INTERNATIONAL EXPERIENCE

The genesis of ARCs in India

The Committee on Banking Sector Reforms of 1991 (Narasimham Committee I) had envisaged an asset management company (AMC) like structure, namely an Asset Reconstruction Fund (ARF) to address the NPA crisis of that time. The ARF was to take over bad and doubtful assets off the balance sheets of banks and FIs and allow lenders to recycle their funds and direct the same into generating new productive assets. The ARF was to be provided with broader powers for recovery and was proposed to be funded by Government of India, RBI, PSBs and financial institutions. However, the recommendation was not implemented.

The current form of the ARC Model finds its root in one of the recommendations of the Committee on Banking Sector Reforms of 1998 (Narasimham Committee II). The Committee, while expecting that a combination of policy and institutional development would lower the level of new NPAs, emphasized the need for addressing the problem of the huge backlog of NPAs. The Committee held that financial restructuring in the form of hiving off the NPA portfolio from the books of the banks would play a major role in strengthening of the banks.

The Committee therefore suggested that all loan assets in the doubtful and loss categories could be transferred to an ARC which would issue to the banks 'NPA Swap Bonds' representing the realizable value of the assets transferred. The Committee recommended that an ARC could be set up by one bank or a set of banks or even in the private sector. Funding of such an ARC could be facilitated by treating it on par with venture capital for the purpose of tax incentives. The Committee also recognized that some banks may be willing to fund such assets, in effect, by securitising them. It also recommended that to enable the ARC to effect recoveries, it may be allowed access to DRTs. The committee noted that these approaches should be backed by changes in the legal system as well.

Another important committee involved in shaping the current form of the ARC model was the Expert Committee for Recommending Changes in the Legal Framework concerning Banking System (Andhyarujina Committee) (1999-2000) which, inter alia, had recommended a legal framework for securitisation. The Committee recognised that securitisation as a product provides many benefits to the originator, the investor and the financial system in general. The Committee had examined each stage of securitisation, viz., the transfer or assignment or vesting or transmission of financial assets, the form and the nature of special purpose vehicles, the issue of transferable receipts, and enunciated the legal initiatives required. The current framework of securitisation under the SARFAESI Act is based on the Committee's draft Securitisation Bill.

The Government of India enacted the SARFAESI Act in 2002 and paved the way for setting up ARCs in India. The Act envisaged that ARCs would be registered and regulated by RBI. Accordingly, initial guidelines were issued by RBI in April 2003. The first ARC, namely, Asset Reconstruction Company (India) Limited, was also registered in 2003. As on date, there are 28 ARCs in operation. As on March 31, 2021, the cumulative AUM of the Sector stood at approximately Rs.5.2 lakh crore in terms of book value acquired and the cumulative capital at play, as measured in terms of NOF, of the Sector stood at approximately Rs.9.8 thousand crore.

IV. LEGAL FRAMEWORK OF ASSET RECONSTRUCTION COMPANIES (ARCS)

Asset Reconstruction Company

An asset reconstruction company is a special type of financial institution that buys the debtors of the bank at a mutually agreed value and attempts to recover the debts or associated securities by itself.

The asset reconstruction companies or ARCs are registered under the RBI and regulated under the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI Act, 2002).

ARCs are registered and regulated under the Act. They acquire financial assets from banks/ FIs either on their own books or in the books of a trust set up for the purpose of securitisation and/or reconstruction. Section 10 of the Act outlines the other permissible activities of the ARCs. Accordingly, ARCs are permitted to undertake only the business of asset reconstruction, securitisation and other fee-based business as enumerated under Section 10(1) of the Act. Any other activity can be undertaken by these entities only with the prior approval of RBI. Some of the important provisions of the Act specifically pertaining to ARCs are enumerated below:

Table 1 Important provisions of the Act specific to ARCs

Section 3	Registration of ARCs
Section 4	Cancellation of Certificate of Registration
Section 5	Acquisition of Rights or Interest in Financial Assets
Section 7	Issue of Security by Raising of Receipts or Funds by ARCs
Section 8	Exemption from Registration of Security Receipt
Section 9	Measures for Asset Reconstruction
Section 10	Other Functions of ARC
Section 12	Power of RBI to determine Policy and issue Directions
Section 12A	Power of RBI to call for Statements and Information
Section 12B	Power of RBI to carry out Audit and Inspection
Section 30A	Power of Adjudicating Authority to impose Penalty
Section 30B	Appeal against Penalties
Section 30C	Appellate Authority

Source: SARFAESI Act, 2002

The ARCs take over a portion of the debts of the bank that qualify to be recognised as Non-Performing Assets. Thus, ARCs are engaged in the business of asset reconstruction or securitisation or both.

All the rights that were held by the lender (the bank) in respect of the debt would be transferred to the ARC. The required funds to purchase such debts can be raised from Qualified Buyers.

Asset Reconstruction

It is the acquisition of any right or interest of any bank or financial institution in loans, advances granted, debentures, bonds, guarantees or any other credit facility extended by banks for the purpose of its realisation. Such loans, advances, bonds, guarantees and other credit facilities are together known by a term – ‘financial assistance’.

Securitisation

It is the acquisition of financial assets either by way of issuing security receipts to Qualified Buyers or any other means. Such security receipts would represent an undivided interest in the financial assets.

Qualified Buyers

Qualified Buyers include Financial Institutions, Insurance companies, Banks, State Financial Corporations, State Industrial Development Corporations, trustee or ARCs registered under SARFAESI and Asset Management Companies registered under SEBI that invest on behalf of mutual funds, pension funds, FIIs, etc. The Qualified Buyers (QBs) are the only persons from whom the ARC can raise funds.

Typical transactions involved in securitisation

In terms of Section 5(1) of the Act, ARCs can acquire financial assets from banks and FIs as defined under the Act. Another significance of an entity (e.g., a NBFC) being classified as FI under the Act is that it also gets enforcement powers with respect to secured financial assets under Section 13 besides the eligibility to sell financial assets to ARCs.

Section 7 of the Act empowers ARCs to issue security receipts (SRs) and only qualified buyers (QBs) are permitted to acquire such SRs. Section 2(1)(u) of the Act defines QBs to include a financial institution, insurance company, bank, state financial corporation, state industrial development corporation, ARC or any asset management company making investment on behalf of mutual fund or a SEBI registered foreign institutional investor, any category of non-institutional investors as may be specified by RBI or any other body corporate as may be

specified by SEBI.

ARCs for the purpose of securitisation create trusts which are governed by the provisions of the Indian Trust Act, 1882. Section 7(2A) of the SARFAESI Act specifies that such trusts are to be managed by ARCs, and ARCs shall hold the assets in trust for the benefit of the QBs. ARC regulations require that ARCs, as trustees, compulsorily invest and remain invested in at least 15% of the SRs of each class till the redemption of all the SRs issued by them under each scheme. ARC's skin in the game helps in aligning the interest of QBs (beneficiary) and the ARCs (trustee). Selling lenders may also acquire SRs as part of the consideration for transfer of assets to the trust. In fact, this has been the dominant practice till 2016. Typical transactions involved in securitisation done by ARCs are indicated in the Figure 2 below.

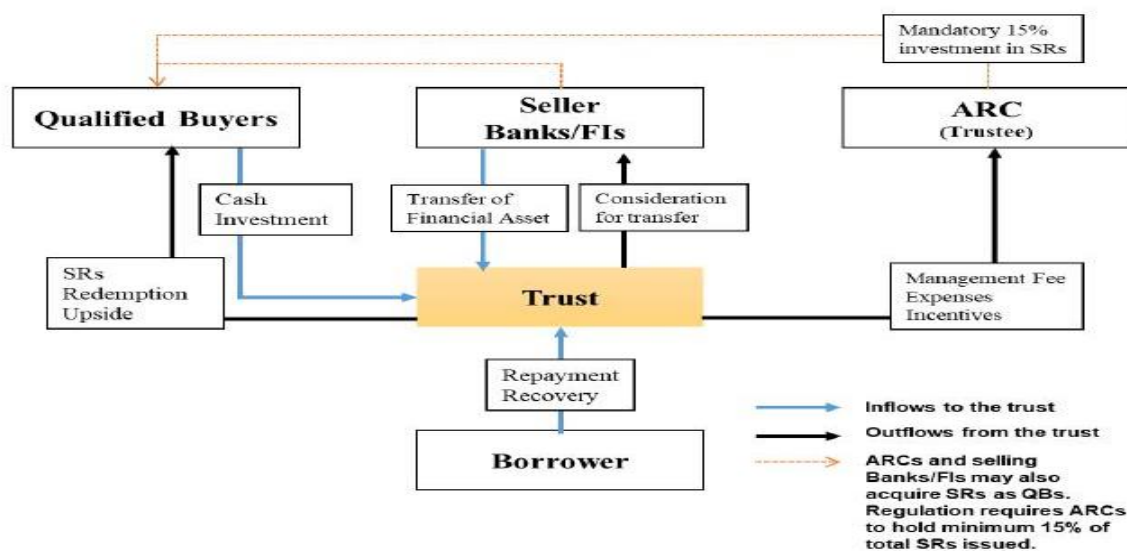


Figure 2 Transactions involved in securitisation

On acquisition of financial assets, ARCs are required to realise the financial assets within the maximum permitted period of eight years from the date of acquisition. Section 9(1) of the Act prescribes measures of asset reconstruction that can be used by ARCs. The term 'Asset Reconstruction' is defined under Section 2(1)(b) of the Act as acquisition by any ARC of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance. The Act empowers RBI under Section 9(2) to issue guidelines on the measures of asset reconstruction and Section 9(3) makes it binding on ARCs to take this measure in accordance with RBI guidelines.

Role of Asset Reconstruction Company

- Acquisition of financial assets (as defined u/s 2(L) of SRFAESI Act, 2002)
- Change or takeover of Management / Sale or Lease of Business of the Borrower

- Rescheduling of Debts
- Enforcement of Security Interest (as per section 13(4) of SARFAESI Act, 2002)
- Settlement of dues payable by the borrower

Objectives of Asset Reconstruction Company

The major objectives of formation Asset Reconstruction Company are:

- Asset management activity so as to generate cash flows for repayment of debt and interest thereon.
- Ability to bring in operational efficiency and economies of scale in the organization.
- To promote innovation in financial markets.
- To develop new instruments for risk management and credit enhancement techniques.
- Developing securitization market by promoting high-grade financial assets.
- Enhancement of project evaluation, monitoring, and implementation capabilities.
- Developing infrastructure for alternate sources of long-term finance

Schemes Offered by Asset Reconstruction Company

The schemes offered by various ARCs vary from one Asset Reconstruction Company to another Asset Reconstruction Company and normally include:

- 1) **Securitization and Reconstruction of Financial Assets (SARFAESI Act 2002 / Debts Recovery Tribunals 2000)**- Creation of securities backed by non-performing assets (NPAs).
- 2) **Capital Market Linkages**- Participating in the capital market either as a lead manager or as an investor through quasi-equity instruments such as convertible warrants, preference shares, etc.
- 3) **Treasury operations**- Maximizing return on surplus funds through investments in money markets or bank deposits.
- 4) **Loans against shares**- Loans given against pledged shares/convertible warrants/fixed deposits.
- 5) **Cash management services**- Payment collections, cash concentration, and investments in the short-term money market.
- 6) **Trade finance**- Advancing credit for business transactions to India or global clients of Indian exporters/importers.

7) **Borrower Advisory Services (BAS)**- To provide advisory on debtor profile, financial analysis of potential borrowers, restructuring of debt, etc.,

8) **Asset reconstruction/securitization funds**- Formation of funds with participation from banks, financial institutions, and other investors to acquire assets/NPAs at a discount to the bank book value thereof. These assets will then be reconstructed as per SEBI guidelines and sold either as an entire portfolio or as a single asset.

9) **Project Advisory Services (PAS)**- Advising promoters on project appraisal, structuring of equity/debt capital, and institutional development.

10) **Portfolio Management / Portfolio Advisory services**- Providing third-party asset management service to banks, financial institutions, and investors in the Indian market using their expertise either in-house or through an outside fund manager. Banks can also manage part of their restructured loan portfolio through ARC / Asset Management Companies / Trusts under RBI guidelines.

11) **Security advisory services**- Acting as a trustee for issuing debt instruments, a security consultant for corporate clients on issues like debenture trusteeship, dematerialization of securities, etc.

12) Other activities such as providing pure trade finance products e.g., export credit, import credit, finance for the turnaround of loss-making companies, etc.

Working of the ARC

The working of the ARC can be summarized by the following diagram:

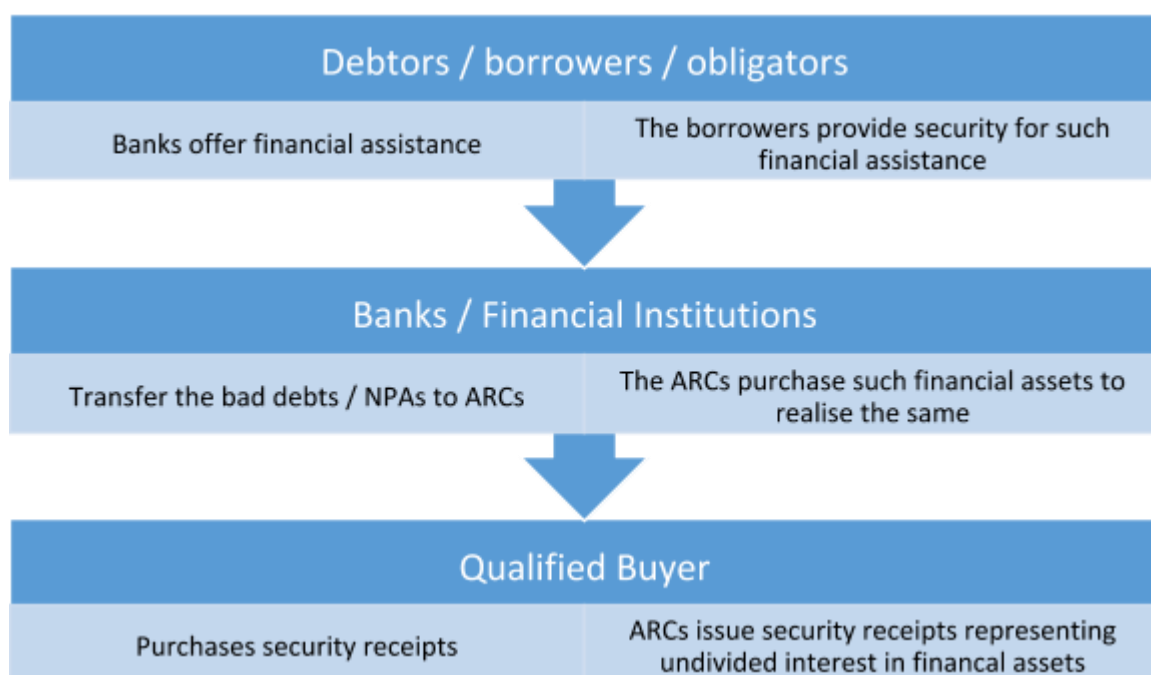


Figure 3 Working of the ARC

The business of asset reconstruction or securitisation may be commenced only after obtaining a registration certificate under Section 3 of the SARFAESI Act, 2002. The main requirement in this regard is that the 'net owned funds' as prescribed in the RBI Act should be Rs. 100 crore or more.

Process of Asset Reconstruction by ARC

The main intention of acquiring debts / NPAs is to ultimately realise the debts owed by them. However, the process is not a simple one. The ARCs have the following options in this regard:

- Change or takeover of the management of the business of the borrower.
- Sale or lease of such business.
- Rescheduling the payment of debts – offering alternative schemes, arrangements for the payment of the same.
- Enforcing the security interest offered in accordance with the law.
- Taking possession of the assets offered as security.
- Converting a portion of the debt into shares.

Type of Debts ARC can Take Over

The ARC can take over only secured debts which have been classified as a non-performing asset (NPA). In case debentures / bonds remain unpaid, the beneficiary of the securities is required to give a notice of 90 days before it qualifies to be taken over.

Non-performing Assets

Banks and other financial institutions are required to classify the debts owned by them into the following four categories:

- Standard
- Sub-standard
- Doubtful
- Loss

The criteria for the classification into such categories depend upon the type of financial institution and the regulatory authority governing such bank or financial institution. Out of the above 4 categories, a non-performing asset would be either a sub-standard, doubtful or a loss asset.

Table 2 Asset Classification

Asset Classification (Assets that are held in books of ARC)	Standard: During the planning period of 6 months otherwise if not an NPA;
	Sub-standard Asset: for a period not exceeding twelve months from the date it was classified as NPA;
	Doubtful Asset: if the asset remains a sub-standard asset for a period exceeding twelve months;
	Loss Asset: if the asset is non-performing for a period exceeding 36 months; the financial asset including SRs is not realized within the total time frame specified

Source: RBI Master Direction dated October 25, 2018.

V. BUSINESS AND FINANCIAL MODEL OF ARCS

Acquisition and Securitisation of Financial Assets

The business of ARCs involves acquisition of stressed assets from lenders and recovery using various measures of asset reconstruction. It typically also involves securitisation of acquired assets.

Acquisition of assets by ARCs, in terms of book value, grew at a CAGR of 27.2% for the period FY04 to FY21. As depicted in Chart 4 below, a considerable jump in acquisition was seen in FY14, followed by an overall upward trend over the succeeding years. Data shows that overall, 79.8% of assets flowing into the ARC sector has been from the banks. Assets acquired from PSBs alone constituted 51.6% of the total assets acquired by the ARC sector. However, FY17 onwards, ARCs have been acquiring financial assets from a diverse set of entities.

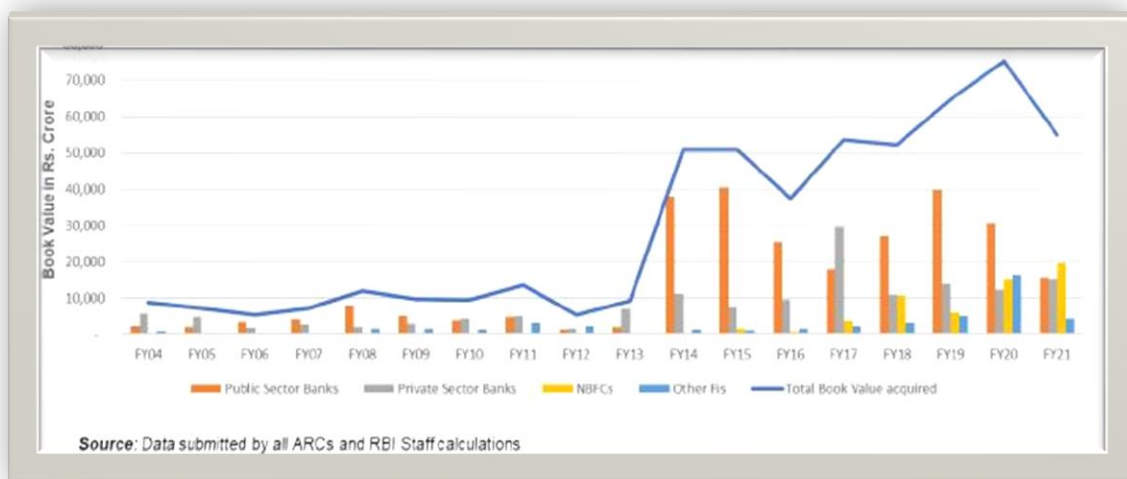


Figure 4 Acquisition of Financial Assets by ARC Sector

NBFCs have emerged as a significant class of sellers of stressed assets since the notification of select NBFCs as FIs for the purpose of Act in FY17. During the period FY17-FY21 acquisition from NBFCs grew at a CAGR of 87.9%. In fact, in FY21, NBFCs were the largest supplier of stressed assets among the eligible entities. The emergence of NBFCs as a significant class of sellers can be attributed to multiple factors. One of the factors may be that, after initial notification in FY17, Central Government has been notifying an increasing number of NBFCs as FIs. At present, all NBFCs having asset size of Rs.100 crore and above are notified as FIs. Another underlying factor may be the liquidity crunch faced by the NBFC sector around FY19 which would have pushed them to increase encashment of financial assets.

The increase in NBFCs' share in supply of financial assets can also be explained in part by the shrinking of banks' sale of financial assets to ARCs. PSBs' sales to ARCs have been declining from FY19 onwards. One of the factors behind this decline may be the introduction of progressive provisioning for banks' SR based deals which was introduced vide RBI circular dated September 1, 2016 and came into full force from FY19 onwards.

To understand the banks' use of ARCs as a mechanism for management of stressed assets, a comparison has been made between the GNPA (including assets sold to ARC)⁴ of scheduled commercial banks and ARC's acquisition of financial assets from banks for the period of FY08 to FY19 in Chart 5 below. The data indicates that post FY14 there has been a downward trend in the percentage of NPAs sold to ARCs despite the upward trend in the level of GNPA in SCBs. Apart from the progressive provisioning discussed above, the emergence of IBC as an

⁴ Gross NPA (including assets sold to ARCs): Gross NPA data of SCBs have been taken from the Handbook of Statistics on Indian Economy published by RBI. To this figure of assets sold to ARCs has been added

alternative resolution mechanism may also have contributed to this trend.

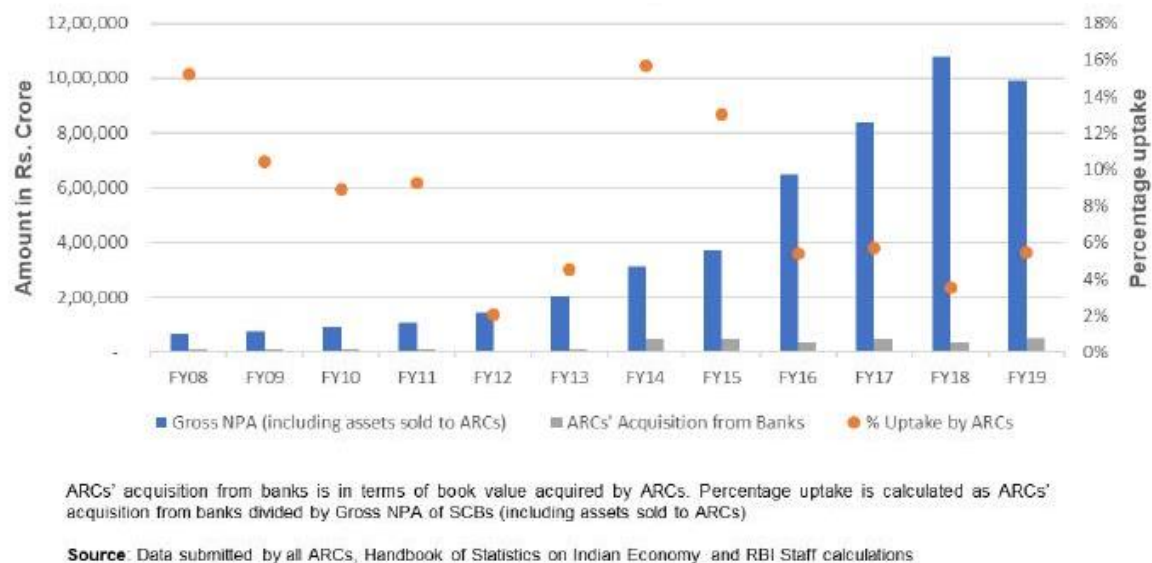


Figure 5 Banks' use of ARC as a mechanism for management of stressed assets

During the period FY04-FY21, the average discount rate at which ARCs acquired the financial assets stood at 66%. However, there has been an approximately 15 percentage point decline in the average discount rate during FY14-FY21 as compared to the period before it. Chart 6 below highlights this decline. The decline in the discount rate may reflect increased quality consciousness of ARCs, as the 'skin in the game' requirement for them (to hold in the ARC's own books a minimum percentage of the SRs issued) was increased to 15% from 5% vide circular dated August 05, 2014.

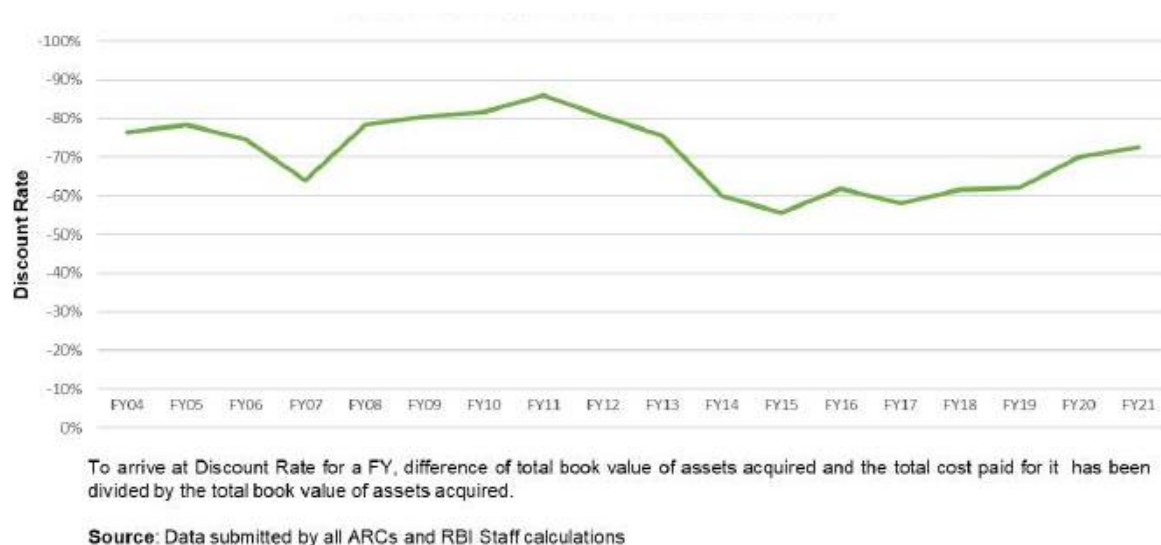


Figure 6 Year-Wise Average Discount Rate

SRs issued by ARCs as part of securitisation of assets acquired grew at a CAGR of 30% during the period FY04-FY21. A snapshot of the current status of SRs originated in a particular year

is shown in the Chart D7 below.

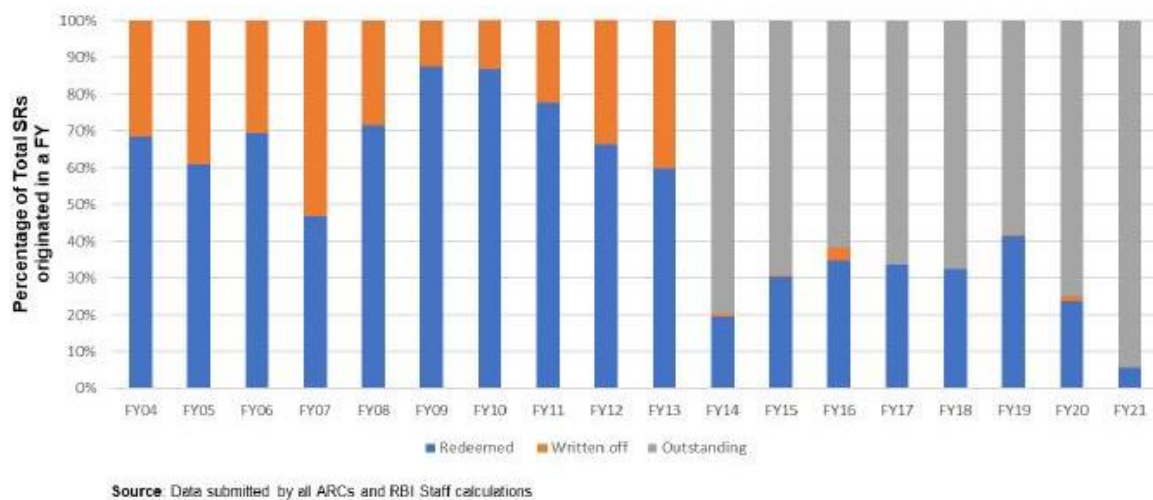


Figure 7 Status of SRs originated during FY04-13 and FY14-21

ARCs are required to resolve the assets within a maximum of 8 years of acquisition of financial assets and redeem the SRs representing the assets. Therefore, the period after FY13 has SRs for which resolution is still underway. The overall redemption of SRs issued by the ARC sector during FY04 to FY13 was 68.6% of the total value of SRs issued. The redemption of SRs issued during this period, as a percentage of the book value of stressed assets acquired, however comes down to as low as 14.29%. This implies that banks and other investors could recover only about 14% of the amount owed by their borrowers⁵ A snapshot of the status of SRs originated during FY04-13 and FY14-21 is indicated in Table 3 below.

Table 3 Status of SRs

	FY04-FY13		FY14-FY21	
	as % of Total issued	as % of Book value acquired	as % of Total SRs issued	as % of Book value acquired
Redeemed	68.6%	14.3%	28.5%	10.4%
Written off	31.4%	6.5%	0.7%	0.3%
Outstanding	0.0%	0.0%	70.8%	25.9%

⁵ Here the total SRs issued reflects the cost of acquisition for the ARCs vis-à-vis the book value of such financial assets. Redemption of SRs is a proxy for the amount recovered from these accounts.

The above data shows that the discount rate on book value has been high and a significant portion of SRs have had to be written off. This indicates two issues with the current market: (a) low rates of redemption, and (b) inflated acquisition costs. While enhancing the ability of ARCs to undertake asset reconstruction, we also recognize the importance of creating incentives to ensure that the price discovery process yields the true value of SRs. Such a process would minimize the write-off of SRs while aligning the discount (to asset book value) at which SRs are issued, to better reflect the realisable value of the assets sold.

The relevant incentives are integrally linked with the percentage of investment in SRs by non-lender entities. Low proportions of such investment by non-lender entities are likely to be associated with high deal values. On the other hand, at high proportions of such investment by non-lender entities, the buyer's bids are likely to be lower than the lender's ask prices, thereby restricting market activity. Hence an economic model was developed to examine the combinations of acquisition cost and investment by non-lender entities (conversely, holding of SRs by lenders) that would be acceptable to both lenders and ARCs, and would yield true values of SRs.

The model identifies the ranges of investment by non-lender entities that would facilitate the discovery of true value through the market mechanism. If the market operates in this range, (which is specified in paragraph D.1.7(b) below), we become confident that the market mechanism is leading to the discovery of true value. Hence, prudential norms with regard to provisioning can be relaxed. The model also indicates that the relaxation of the abovementioned norms is not merely justified on conceptual grounds, but necessary to kickstart the market.

VI. MEASURES FOR RECONSTRUCTION OF FINANCIAL ASSETS

Section 9(1) of Act prescribes the measures of asset reconstruction that ARCs can deploy under the guidelines issued by RBI. Data indicates that approximately 80% of the recovery for the sector, so far, has come through deployment of methods of reconstruction that do not necessarily lead to revival of the business. ARCs have rarely used change or takeover of the management of business of the borrowers or conversion of borrowers' debt into equity as measures for reconstruction (see Chart D8 below). Rescheduling of payment of debts was also involved in only 19.9% of the recovery made by ARCs. This trend has been consistent over the life of the sector. The only change in this trend is use of IBC as a resolution mechanism after it became available. ARCs get the power to use IBC through IBC, 2016 and not through the Act. Assets bought after FY14 are increasingly being resolved through IBC. However, use of IBC by ARCs may not be indicative of a preference for IBC since ARCs' participation in IBC may be

involuntary, with the initiative being taken by primary lenders.

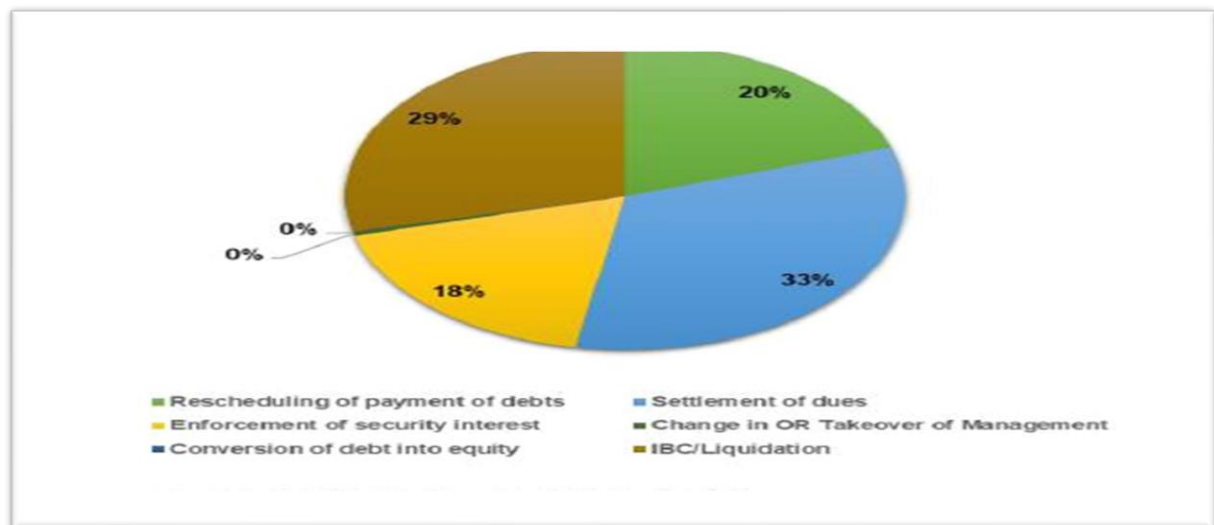


Figure 8 Methods of reconstruction deployment during FY04-FY21

Effectiveness of asset reconstruction can be measured by the extent of SRs redeemed and the upside income earned on such SRs. As discussed elsewhere, both have been low. Some of the factors that predominantly affect the effectiveness of asset reconstruction include quality of financial assets acquired, extent of debt aggregation, ARC's ability to fund the borrower, regulatory limitations and their skill sets. These also determine the methods of asset reconstruction that ARCs can gainfully deploy.

Limitations of the restructuring options usually force the ARCs either to take up the measures of recovery only or focus on such assets which do not require major resolution. In general, turnaround of stressed borrowers requires additional funding. In fact, they require different sources of funding and various debt and equity instruments, including but not limited to share capital, priority debt, mezzanine debt, senior debentures, etc. to continue to run the operations efficiently. For a stressed borrower, raising such funds becomes difficult. Almost all stressed borrowers require additional working capital facilities, which is not available from the regular banking system due to adverse asset classification of such accounts. Therefore, for turning around companies, ARCs should be able to timely and sufficiently fund them. Today, there are many limitations for ARCs for funding such requirements. They are not able to provide interim finance in insolvency resolution processes or significantly contribute to a turnaround due to their inability to provide meaningful last mile funding. For undertaking any restructuring of such debt acquired by them, ARCs also have additional restrictions, which limit the extent of restructuring support finance which they can provide. Currently, this is capped at 25% of the funds raised by them under the scheme and should be disclosed upfront in the scheme.

At present, ARCs can acquire financial assets and hold the same in a trust set up for the purpose of securitisation or hold these financial assets in their own books. The Committee feels that the role of an ARC is primarily that of an asset manager and therefore envisages that balance sheets of ARCs should remain 'asset light', i.e., ARCs should not acquire the equity/ debt of borrower in their own books. Acquisition of assets in the books of ARCs may lead to conflict of interest as ARCs may prefer to focus more on the resolution of assets held in their own books compared to the assets for which they may be acting as the manager.

Given the limitation of traditional sources of financing for ARCs. The ARCs should be allowed to sponsor an AIF. All categories of AIFs have already been specified as QBs. Allowing an ARC to sponsor and set up an AIF, duly registered with SEBI with the objective of investing in stressed assets could address the above constraints and provide an additional investor base including HNIs and improve the ability of the ARC to effectively reconstruct the debt and also turn around the borrower. This would be in the interests of the SR investors and the economy.

Further, there would be increased flexibility in restructuring options, given that investments to debt/ equity may be funded directly from the AIF. Using the AIF as a source can help ARCs in raising funds in a risk mitigated manner (in line with other AIFs) based on their performance track record and help in turning around many stuck cases.

The objective is to use the AIF as an additional vehicle to advance the purpose of the ARCs to facilitate restructuring/ recovery of the acquired debt. For revival of stressed companies, the ARCs may need flexibility to arrange the financial assistance from banks and FIs and additional capital for revival.

Accordingly, an ARC should be allowed to set up an AIF which can subscribe to SRs issued by the trust set up by the it and also invest in such companies for which debt has been acquired by the ARC for securitisation. As per Section 10(2) of Act, ARCs may undertake activities other than the permitted businesses, only with the prior approval of RBI. The Committee recommends that RBI should exercise the powers granted under Section 10(2) to allow ARCs to set up AIFs which should be registered with SEBI.

VII. CONCLUSION

The prominent problem in the country right now is the alarming volume of Non-Performing Assets within the banking system. Several attempts were made to tackle NPAs. A serious such step was the creation of dedicated institutions called Asset Reconstruction Companies or ARCs that purchase bad assets or NPAs from banks at a negotiable price and helps banks to clean up their balance sheets.

The performance of the ARCs is under evaluation in the context of the mounting NPAs. At the same time, the new Insolvency and Bankruptcy Act will give a critical role to the ARCs in settling bad assets through the insolvency process.

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