Asset reconstruction companies in India

The story so far

Introduction

Over the last three years, Indian banks have been saddled with increasing levels of stressed assets that call to mind the 2001–03 crisis, when gross non-performing assets (NPAs) ratios crossed 10%.[1] Macroeconomic factors, combined with weak credit assessment and monitoring, are responsible for this situation, prompting the Central Bank to conduct a bank-by-bank asset quality review and unequivocally directing banks to clean up their books by March 2017.

To stem the tide of NPAs that has engulfed lenders, the regulator has taken several earnest measures. However, these are not instant or perfect solutions and have their own shortfalls, which are discussed below.

Introduced in February 2014, the **Joint Lenders' Forum (JLF)** allowed multiple lenders to devise a collective resolution mechanism. However, the lenders seldom agreed with each other and recoveries remained dismal.

The **Strategic Debt Restructuring (SDR)** Scheme of 2015 allowed banks to convert borrowers' debt into equity. However, this was dependent on promoters and finding buyers for this equity was often difficult.

The **Scheme for Sustainable Structuring of Stressed Assets (S4A)**, introduced in 2016, allowed banks to restructure large loans but with the caveat that projects should be up and running. Hence, the scheme had limited efficacy.

The **Insolvency and Bankruptcy Code (IBC)** of 2016 is the strongest measure taken yet, but due to lack of operational guidelines and a legal framework, this mechanism too has its fair share of critics.

Asset reconstruction companies (ARCs), created under the ambit of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, were aimed at bringing about a system for unlocking value from the stressed loans of banks/financial institutions (FIs). ARCs act as debt aggregators with the objective of acquiring non-performing loans from the banking system, and of managing and recovering them by putting them on the path of resolution. However, the actual journey of ARCs has deviated considerably from the envisaged path, with exit through sale of stressed loans to ARCs remaining largely subdued. This paper seeks to underline the challenges faced by ARCs and discusses the inefficacy of the ARC resolution mechanism and regulatory environment.

1. RBI. (2014). Re-emerging stress in the asset quality of Indian banks. Working paper. Retrieved from https://rbi.org.in/Scripts/PublicationsView.aspx?Id=15720 (last accessed on 29 January 2018)

Evolution of ARCs

The late 1990s and early 2000s marked the emergence of a new problem in the Indian banking industry—that of low recoveries from NPAs. In 1998, the 2nd Narasimham Committee Report highlighted that the huge backlog of NPAs was continuing to exert pressure on the banking sector and had severely impacted profitability. The report also recommended the creation of an asset recovery fund which would acquire and recover stressed assets and enable banks to focus on their core business. Pursuant to this and the enactment of the SARFAESI Act, many ARCs were formed in India, with ARCIL being the first. These ARCS were set up as private entities, mostly with the support of banks and as on November 2017, there were 24 operating ARCs. The evolution of the ARC landscape in India is summarised in the figure below.

ARC: A brief history

1987
BIRF
BIFR formed to revive sick industrial companies and wind up unviable units

1993
DRT
Debt recovery tribunals set up (RDDBFI Act)

1998
Narasimham Committee
Recommends setting up of ARCs

2002
SARFAESI ACT
Allowed banks and FIs to recover stressed assets

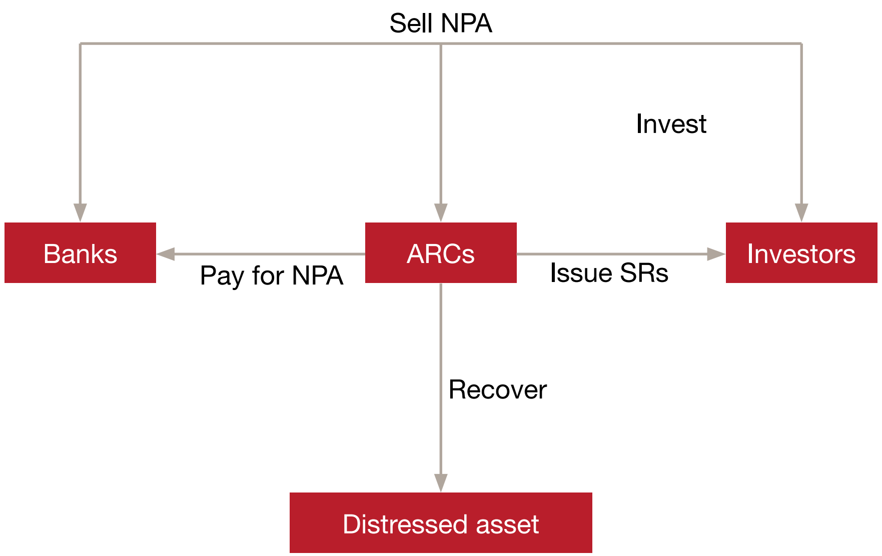
2002
ARCIL
First ARC set up by ICICI bank, State Bank of India and IDBI

2005-06
FDI allowed
Foreign investment in ARCs at 49% allowed

2007 - 2017
24 ARCs operating
Edelweiss the largest ARC operating amongst all 24

1. BIFR establishment year - 1987 (https://en.wikipedia.org/wiki/Board_for_Industrial_and_Financial_Reconstruction)
2. DRT establishment year - 1993 (https://www.drt.gov.in/)
3. Narasimhan Committee II on Banking Sector Reforms - 1998 (https://en.wikipedia.org/wiki/Narasimham_Committee_on_Banking_Sector_Reforms_(1998))
4. SARFAESI Act enactment year - 2002 (https://www.drt.gov.in/pdf/Act-s/SARFAESI%20Act.pdf)
5. ARCIL set- up year - 2002 (http://www.arcil.co.in/aboutus/about_details.php?id=62)
6. 49% FDI allowed in ARCs - 2005-06 (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=2613&Mode=0)
7. Number of ARCs in India - 24 (https://rbidocs.rbi.org.in/rdocs/content/pdfs/LSCRCRBI07092016.pdf)

To understand how ARCs have evolved, it is critical to appreciate their business model and operations. Under the SARFAESI Act, a bank puts up stressed assets for auction after applying a haircut but with a reserve price and sells them to the highest bidding ARC. ARCs acquire these assets by paying in cash or by issuing security receipts or 'hope notes' whose redemption is contingent on the recoveries made. Since security receipts (SRs) are backed by impaired assets, without predicable cash flows, they have the characteristics of both debt and equity. An ARC considers a number of different routes to maximise realisation from the assets, including liquidation/settlement/restructuring or rehabilitation and turnaround to ensure payment from the improved operating cash flows of the company. Proceeds, if any, are distributed according to the shareholding of the SRs. As an intermediary recovering dues on behalf of SR holders, ARCs charge a management fee. The distribution of recovery proceeds follows a so-called waterfall structure, with legal and resolution expenses being met first, followed by the deduction of management fees from proceeds before the balance recoveries are distributed among SR holders.



ARC evolution can be broadly divided into **four phases**,[2] beginning from 2002 until now.

Phase 1 — 2002 to 2005
- High NPA – ~6.1 %
- No investment requirement for ARCs
- ARCs just introduced – low transaction volumes in first three years

Phase 2 — 2006 to June 2013
- Low NPA – ~2.6 %
- 5% investment requirement for ARCs under each scheme
- Low ARC sales due to controlled low NPAs and bank demand for all cash deals

Phase 3 — July 2013 to Aug 2014
- High NPA – ~4.1 %
- 5% requirement for ARCs under each scheme
- Allowing SMA2 sale and conducive amortisation rule resulted in higher volumes albeit with higher pricing

Phase 4 — August 2014 onwards
- High NPA – ~6.2 %
- Upfront investment increased to 15% to discourage the agency model. Management fee linked to NAV. Both measures intended to provide ARCs skin in the game.
- Volumes impacted adversely due to the above measures and increased regulator scrutiny

2. RBI. (2017). Statistical tables relating to banks in India – movement of non-performing assets of scheduled commercial banks. Retrieved from https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications#!4 (last accessed on 29 January 2018)

Phase 1 — **2002 to 2005**

Though NNPAs in the banking sector were very high at ~6%, few deals materialised as ARCs were at a nascent stage. In this period, there was no upfront investment requirement for ARCs and the SRs had to be almost entirely subscribed to by the NPA-selling bank itself. This essentially meant that the bank could never actually ring-fence itself from the stressed asset in a true sense.

Phase 2 — **2006 to June 2013**

Aided by macroeconomic growth, NNPAs fell to 2.6%, allowing banks to gun for all cash deals instead of going the SR way. In 2006, the RBI introduced a 5% upfront investment requirement by ARCs in their asset purchase, thereby increasing their capital needs (it had also allowed 49% FDI in ARCs in 2005). Vintage loans with significant provisioning and which were difficult to recover were sold during this phase at around 20%[3] of book value.

Phase 3 — **July 2013 to Aug 2014**

The third phase is a significant one for ARCs. The quality of assets held by the Indian banking sector, and particularly by public sector banks (PSBs), deteriorated sharply in this phase. In February 2014, with a greater emphasis on asset reconstruction, the RBI, rather than stripping assets, relaxed the guidelines for banks' asset sales to ARCs and allowed the sale of SMA2-labelled accounts in addition to that of formal NPAs. It also allowed banks to amortise losses on the sale of loans over a two-year period.

Large volumes of stressed assets, combined with relaxed guidelines, resulted in a significant increase in sales to ARCs, with around 40%[4] of the total volume of ARC transactions (in terms of book value) since their inception taking place in this short phase of 13 months. As banks started selling stressed assets with lower provisions and seasoning, the sale prices increased sharply. The acquisition cost to book value of stressed assets acquired by ARCs hovered at around 20% till 2013 but increased to above 40% after 2013.[5] However, the management-fee driven model ensured that ARCs were not deterred by this higher pricing.

Phase 4 — **August 2014 onwards**

The fourth phase witnessed a radical change in regulatory requirements—an increase in the mandatory contribution by ARCs to 15% and linking of management fees with the NAVs of SRs. The rationale behind the changes was to incentivise and expedite the recovery/restructuring process. The revised guidelines ensure that ARCs focus on redeeming SRs rather than just basing their business model on earning management fees.

3. Gandhi, R. (September 2015). Speech at Assets Reconstruction and NPA Management Summit. RBI. Retrieved from https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=974 (last accessed on 29 January 2018)

4. RBI. (2014). RBI releases Financial Stability Report (including trend and progress of banking in India 2013-14) December 2014. Retrieved from https://rbi.org.in/SCRIPTS/BS_PressReleaseDisplay.aspx?prid=32873 (last accessed on 29 January 2018)

5. Gandhi, R. (September 2015). Speech at Assets Reconstruction and NPA Management Summit. RBI. Retrieved from https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=974 (last accessed on 29 January 2018); ENS Economic Bureau. (9 July 2016). ARCs buy just 15% of Rs 1.3L cr NPAs put on block by banks. Retrieved from http://indianexpress.com/article/business/banking-and-finance/arcs-buy-just-15-of-rs-1-3l-cr-npas-put-on-block-by-banks-2902370/ (last accessed on 29 January 2018)

The management fee game

In the first three phases, the management fees earned by ARCs played a major role in their purchase considerations: a one-time investment requirement of 5%, compared to annual management fees of around 1.5% based on outstanding SR, ensured that ARCs received a return of around 20–30% on their investments, even with the low and slow recovery highlighted by the World Bank. Considering the high IRR (with no skin in the game), several ARCs bid aggressively during the September 2013 to August 2014 period, with a focus on the agency business model (with a view to building up their assets under management [AUMs] and earning management fees).

Aug 2014 – a tipping point – 15/85 scheme overturns IRR gravy train

The increase in ARC self-investment from 5% to 15% has brought about a paradigm shift in the profitability metrics of the industry. Earlier, ARCs were able to generate 20–30% IRR just by charging a 1.5% management fee YoY on the o/s SR and any actual recovery would be an added bonus. Hence, ARCs were content with enjoying management fees and had no real incentive to actually recover or rehabilitate a bad loan.

The above change, along with the linking of NAV to management fee, has sounded the death knell for the agency model of ARCs. Higher upfront investment now means that erstwhile IRRs are no longer possible without actual recoveries. This can be explained by a lucid example where an asset was sold to an ARC for 100 INR under the 5/95 structure and the management fee was 1.5%. Assuming that there is no recovery in five years, the ARC would lose its 5 INR investment. However, this is more than adequately compensated for by the management fee income for five years (i.e. 7.5 INR). In this case, the IRR for an ARC would be ~15% (under the old structure and without any tax and expenses adjustment). With the increased share of ARCs in transactions (15%) and the linking of management fees with the NAVs of SRs (compared to outstanding SRs issued previously), the IRR has come down sharply. For the same transaction mentioned above (assuming no markdown on SRs), the IRR would fall to -24%.

IRR under 5% and 15% investment model

	5/95 model		15/85 model	
	Without recoveries	With recoveries	Without recoveries	With recoveries
Sale consideration	80	80	80	80
Cash investment	-4	-4	-12	-12
Management fee				
Year 1	1.2	1.2	1.2	1.2
Year 2	1.2	1.2	1.1	1.1
Year 3	1.2	1.2	1	1
Year 4	1.2	1.2	0.9	0.9
Year 5	1.2	3.7	0.8	8.3
IRR	15%	25%	-24%	1%

Assuming recovery @62.5% of book value

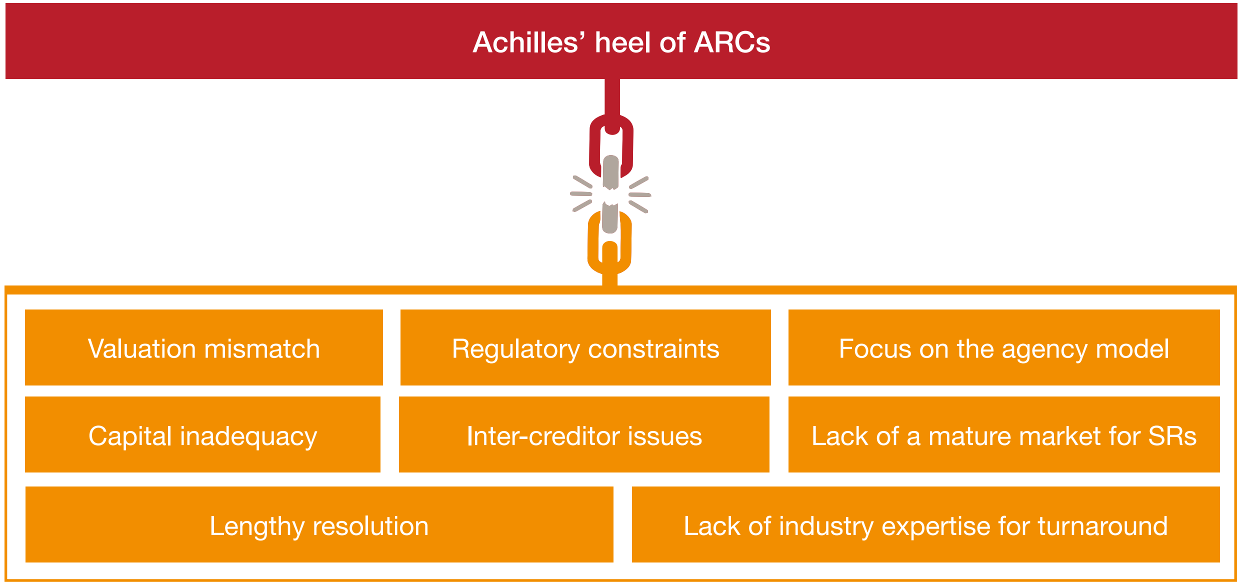
Key challenges plaguing ARCs

A widely held view is that little has been done by ARCs in the area of rehabilitating and turning around sick but potentially viable companies. It is rather difficult to contradict this view because the available information shows that successful turnarounds supported by ARCs have been few and far between.

The actual performance of ARCs has not been satisfactory and bears out the view mentioned above. As is evident from the table below, ARCs issued security receipts worth 20,410 crore INR in FY14,[6] which went up to 22,440 crore INR in FY15. Meanwhile, the security receipts redeemed by the reconstruction companies stood at merely 1,190 crore INR in FY14 and 1,650 crore INR in FY15. Also, these SRs were only 1/5th of the NNPA reported for this period.

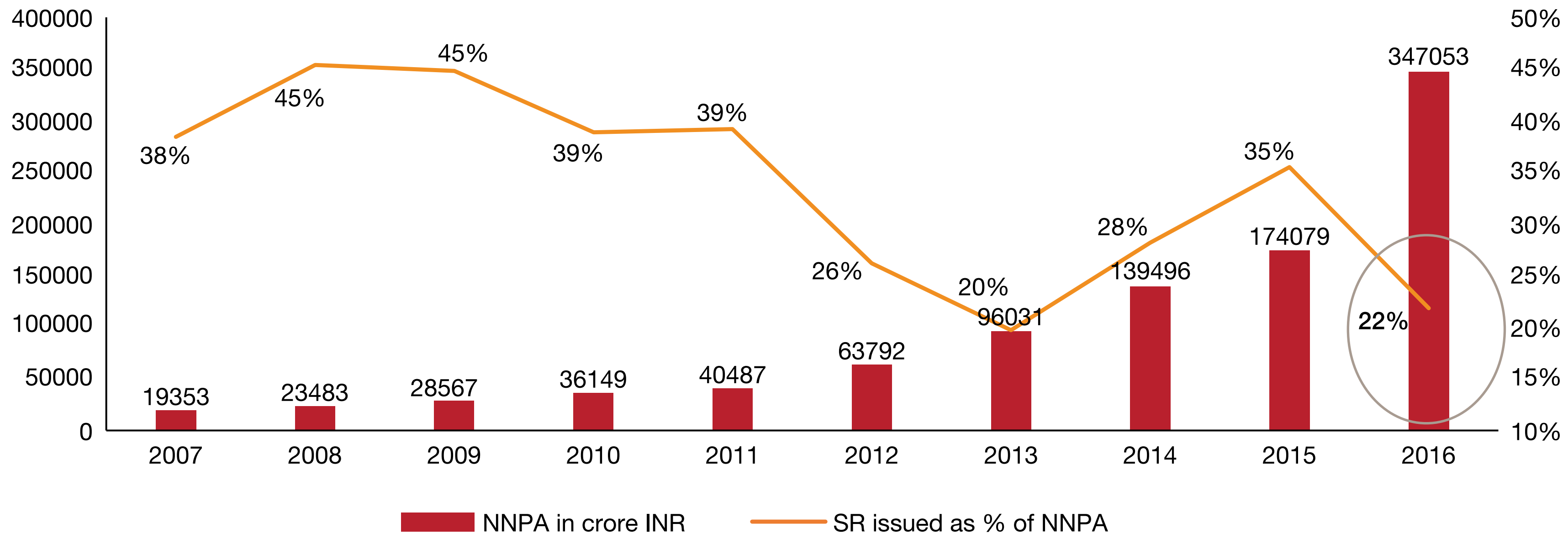
It is pertinent to note that the poor performance of ARCs in resolving stressed loan situations in the past has played heavily on the minds of banks and has affected the industry in two ways: the overall deals between ARCs and banks have reduced considerably and more banks have started preferring cash sale to SRs. In view of this, the option of exit through the sale of stressed loans to ARCs has been underutilised.

In this section, we outline the main reasons responsible for the tepid performance and below par efficacy of ARCs.



6. Shukla, S. (28 October 2015). Asset reconstruction companies no relief for banks that look to sell bad loans. Economic Times. Retrieved from: https://economictimes.indiatimes.com/industry/banking/finance/banking/asset-reconstruction-companies-no-relief-for-banks-that-look-to-sell-bad-loans/articleshow/49559935.cms (last accessed on 29 January 2018)

NNPA vs SRs issued



Source: RBI Trend and Progress – 2015-16; working paper 338 by the Indian Council for Research on International Economic Relations

1. Capital inadequacy

As per industry estimates, the current capitalisation of all the ARCs put together adds up to around 3,000 crore INR. With the upfront cash component having increased to 15% in August 2014, the current net worth of ARCs would be sufficient to acquire only 33,300 crore INR of stressed assets (assuming ARCs acquire NPAs at 60% of book value). With the gross NPA and restructured advances of banks touching approximately 8,00,000 crore INR, ARCs can acquire approximately only 3% of these assets from banks. Another key challenge for ARCs is the inability to fund the working capital needs of stressed loans. As a result, global distressed asset funds are increasingly seeing an opportunity in this space; however, this option comes with a rider. To enable the ARCs to take high risks, distressed asset funds require a cash flow priority, a clear first charge on assets and returns in excess of 25%. With a consortium of lenders who often act independently, bringing all the parties together and convincing them to agree to a plan will be a major challenge for a distressed asset fund.

It is hard to obtain working capital for a distressed asset and even when it is made available, the cost is very high. Therefore, there have been very few cases of genuine restructuring thus far.

2. Valuation mismatch between ARCs and seller institutions

New capital norms have significantly increased the cost of asset acquisition for ARCs. To offset this, ARCs have been seeking higher discounts to buy NPAs; however, banks are unwilling to reduce price, resulting in an expectation mismatch. This has led to a sharp decline in the transaction closure rate.

The main reason for this gap appears to be the vastly different discounting rate used by banks and ARCs. While banks use discount rates in the range of 10% to 15%, given their access to cheap capital in the form of public deposits, ARCs use much higher discount rates of 20% to 25% as their cost of funds is relatively higher than that of banks. Without realistic valuation guidelines, there is no incentive for private investors to participate in auctions as the reserve price tends to be high, given the low discount rate used by banks vis-à-vis ARCs and private investors.

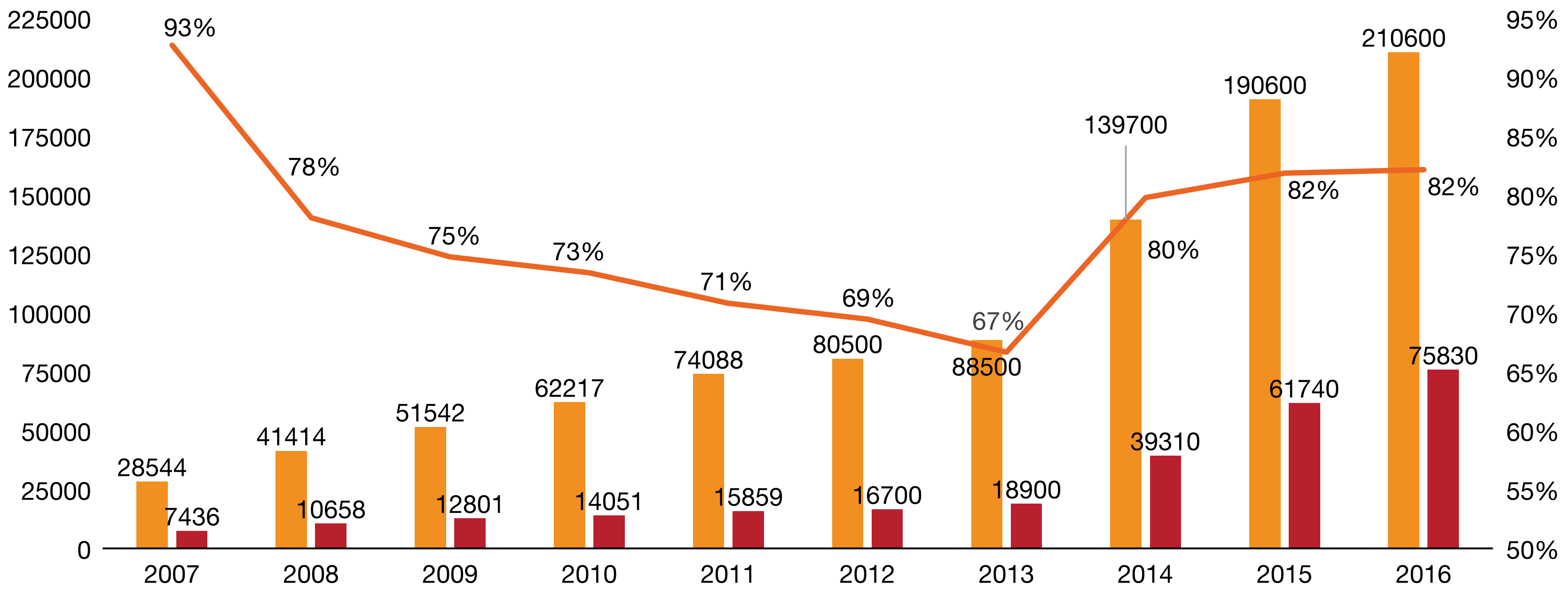
3. Prolonged focus on the agency model

Till August 2014, Indian ARCs were driven completely by the agency business model of generating plush internal rates of return (IRRs) based on the management fee, as described earlier in this paper. Since IRRs were topping 20%, ARCs had no real incentive to really opt for recoveries or rehabilitation. However, after the keynote change of increased investment to 15% and basing the management fee on the lower spectrum of NAV, ARCs are gradually turning to fund-based models, with a focus on recoveries and realistic pricing.

4. Lack of a mature secondary market for SRs

Due to an unrealistic pricing mismatch, intense scrutiny and regulatory changes, there is a general lack of investor appetite that is leading to the absence of a secondary market for SRs. Banks are hence forced to buy SRs backed by their own stressed assets. Currently, over 80% of SRs are held by seller banks themselves (refer to the table below).

ARC business snapshot



Source: RBI

5. Lack of professional expertise for turnaround

Professionals such as bankers, lawyers and chartered accountants who join ARCs usually expect employee stock ownership plans (ESOPs) as a major mode of compensation. Since any person with more than 9% shareholding in an ARC is designated a 'deemed promoter' by the RBI, this actually deters professionals from joining ARCs because of the responsibility associated with the 'promoter' status. This only increases the cost of functioning of ARCs. The general dearth of talent and skill sets required to revive and turn around a unit is also a big challenge.

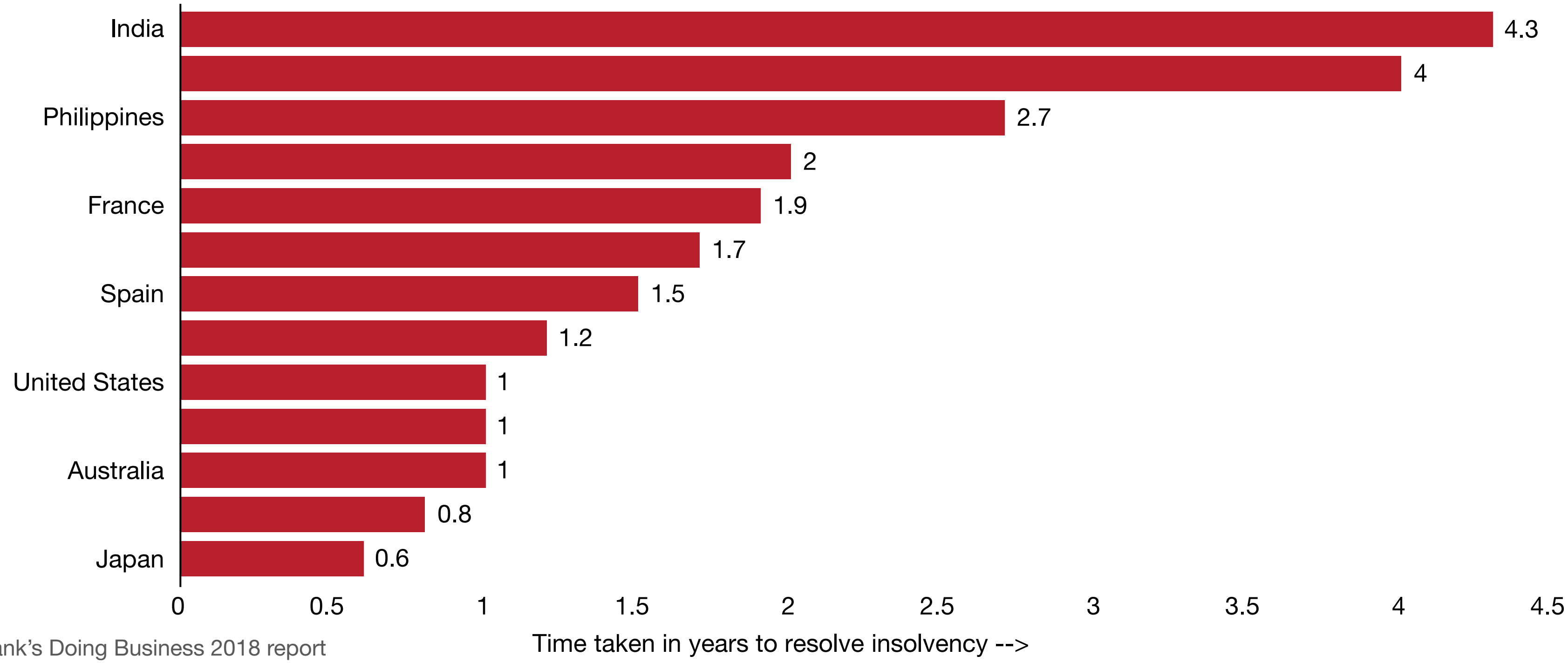
6. Inter-creditor issues

The Indian banking landscape is characterised by a consortium/multiple lending with different classes of security. This results in significant inter-creditor issues, which inhibits the prompt implementation of the most appropriate resolution strategy. Most resolution approaches require the consent of secured lenders, representing 75% of the total debt by value. The intermediation by ARCs towards aggregations and bringing all stakeholders to a common ground is often painstakingly slow and causes a loss of value to everyone concerned.

7. Lengthy resolution

NPA resolution in India is complex, tedious and time consuming. The World Bank's Doing Business 2018 report reveals that in terms of insolvency resolution, India holds a dismal 174th rank out of 212 countries. Further, it takes 4.3 years, on an average, for any resolution. Even economic laggards such as Latin America, South Asia and North Africa take between 2.9, 2.6 and 1.7 years, respectively.

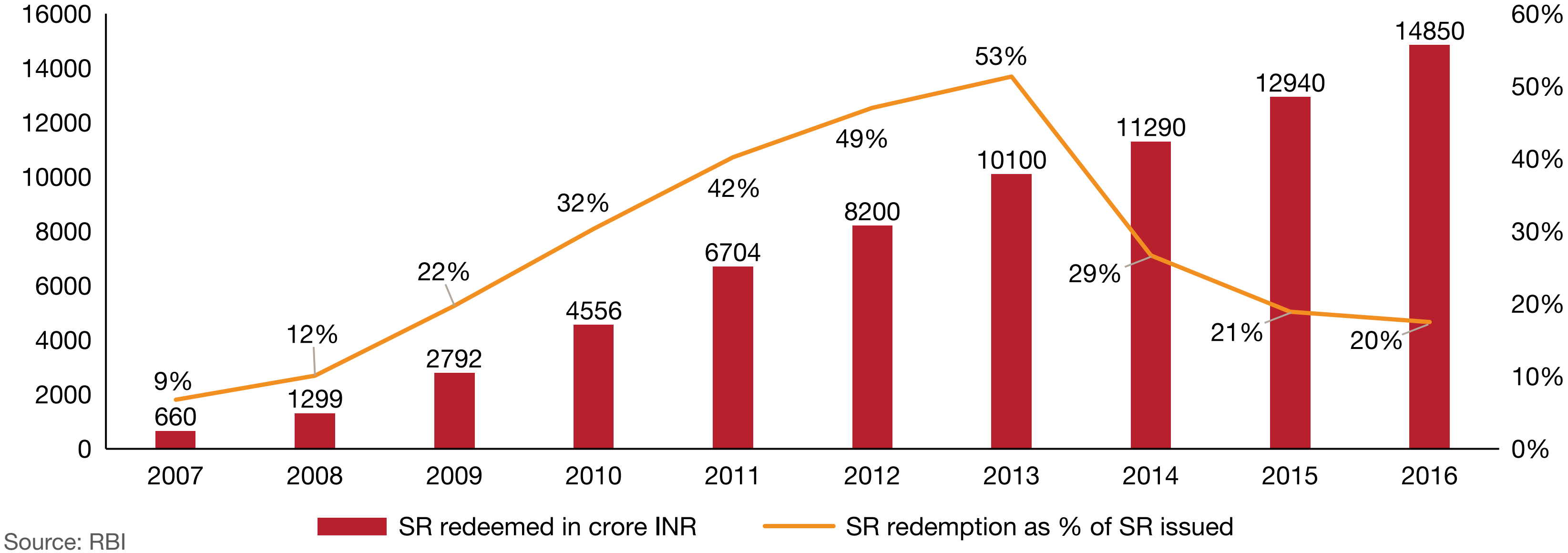
No immediate resolution for insolvency



Source: World Bank's Doing Business 2018 report

Also, India only recovers a mere 26% of its stressed assets compared to 92% by Japan and 81% by Germany.

Low redemptions



Source: RBI

The process is long mainly due to two factors: slow judicial processes with repeated protracted appeals in higher courts of law, thereby delaying judgements (corporates find grounds to drag debt recovery cases to civil courts and stall the proceedings of tribunals) and market value of stressed assets remaining much lower than what the banks currently reflect on their balance sheets. International experience shows that speedy judicial systems are imperative for effective asset resolution.

8. Regulatory constraints

ARCs have been subject to the scrutiny of regulators and some regulations have hampered their growth and viability.

Regulation	Impact
Net-owned funds requirement increased from 2 crore INR to 100 crore INR	Smaller players marginalised – consolidation in industry
Disclose valuation basis if the acquisition value is more than the book value	Cumbersome for stakeholders
Disclose reasons and details of the assets disposed of at a substantial discount during a particular year	Cumbersome for stakeholders
Upfront payment of 15% cash vs the earlier 5% due to which ARCs will face capital constraints	Magnifies capital inadequacy
Lack of power to change the management (due to the SARFAESI Act, 2002)	Ineffective and inordinately delayed resolution
Shareholding – sponsors can bring only up to 50% of share capital, which further limits their capital	Capital remains inadequate
Management fees are now to be calculated as a percentage of NAV instead of acquisition value	IRR even more difficult to manage

Insolvency and Bankruptcy Code, 2016 – a game changer?

The Insolvency and Bankruptcy Code (IBC [the Code]) is, undoubtedly, the most significant reform by the current government till date. Following the provisions of the code essentially necessitates a comprehensive turnaround, not just debt re-engineering.

Time-bound resolution

The Code recognises that it is normal for some businesses to fail; therefore, it emphasises decisive corrective action. It focuses on quick decision making (maximum 270 days), be it turnaround or liquidation, enabling the speedy release of scarce capital assets locked in a distressed asset for productive use and facilitating an early settlement of all stakeholder issues.

Creditor in control

The Code unifies the legal framework to deal with insolvency and prescribes a ‘creditor in control’ framework, as compared to the current ‘debtor in possession’ regime. The Code establishes that insolvency is a commercial issue and it is for creditors to decide if a business should be liquidated or revived, once it is insolvent. The court cannot intervene in this decision.

Single default trigger

The Code unambiguously states that the trigger for an insolvency resolution petitions can be a single default, which, if approved, will result in taking over the management of the defaulter by an IP on behalf of all financial creditors. Therefore, a valid insolvency petition filed by any creditor can push the entire business into the insolvency process.

Strong punitive action

The Code imposes imprisonment of up to five years, if asset stripping is noticed within 12 months before the default. This is a significant shift from a legal system that was heavily supportive of promoters and delayed recovery/revival under the cover of public interest or saving organisational capital.

Will the Code be the solution?

While the Code is well meaning and has kick-started an interesting journey, its true success lies in its strong implementation, including the effective creation of an enabling infrastructure and ecosystem. It will involve the setting up of an insolvency regulator, development of the skills of insolvency professionals, appointment of judicial officials and set-up of benches of the adjudication authority, and detailed procedural rules to standardise the use of the law, amongst other measures.

Another challenge lies in the execution of the operational turnaround of the borrower itself. Success hinges on three main aspects: timely acknowledgement of the current situation by all the stakeholders (including banks) and commitment to the necessary change; the ability of the turnaround team on ground; and an effective monitoring mechanism that ensures the long-term success of the turnaround plan.

The way these factors gear up will determine if the Code really becomes the silver bullet that the Indian banking industry is looking for or just another piece of comprehensive legislation.

Conclusion

The data points provided above indicate that the performance of ARCs has not matched the set expectations. As things stand, except for a few transactions, ARCs have not been able to acquire large cases with potential turnaround possibilities due to many constraints that have been discussed in this paper. Consequently, the importance of accurate valuations, turnaround options and speedier legal remedies cannot be overstated.

The Security Exchange Board of India's (SEBI's) nod to allow the listing of security receipts issued by ARCs on stock exchanges will be a welcome move at this juncture. This would actually bring in liquidity in the security receipts market and more money to ARCs, thereby resolving banks' NPA issues.

Also, with foreign capital flowing into the distressed market, ARCs may be willing to take more risks and bid for bigger assets. Foreign capital is coming in amid the hope that the implementation of the IBC will lead to faster resolution and recovery. Additionally, with likely industry consolidation, the opening up of the FDI route and the establishment of the insolvency code, the expectation now is that ARCs will morph into actual turnaround specialists, which is the need of the hour. Now is the most apt time for ARCs to transform themselves into special situation funds, with deep operational capabilities to bring about a long-term revival in the business.

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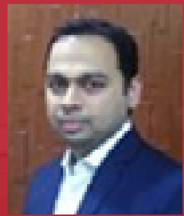

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