"Building Trust through Governance: The Backbone of Stressed Assets Reconstruction[1]"

(Keynote address delivered by Shri M. Rajeshwar Rao, Deputy Governor at the conference on 'Governance in ARCs – Towards Effective Resolutions' held on May 17, 2024 at Mumbai)

Deputy Governor Shri Swaminathan, Executive Directors, Chairmen of the Board and ACB of ARCs, MDs & CEOs of ARCs, my colleagues from RBI, ladies and gentlemen,

I am happy to be amidst you today to talk about the crucial topic of governance in ARCs. But before I address the issue of governance, let me briefly discuss the importance of credit risk management and the critical role envisaged for ARCs – both in terms of legislative intent and regulatory expectations, in India's financial landscape.

Role of ARCs in the Stressed Asset Management

We all know that books of our financial institutions are largely susceptible to credit risk as loans and advances constitute a large proportion of the asset portfolio. The credit risk weighted assets (credit RWAs), in fact, constitute around 80 per cent of total RWAs of the banking system. Therefore, any prudential regulation to safeguard the stability of financial system must remain alive to the credit risk in the books of financial entities, banks and non-banks alike.

The credit life cycle involves four distinct stages. These include the stage of sourcing of credit proposal; appraisal and underwriting; disbursal and monitoring; and, finally repayment which then starts off the next iteration of the credit cycle. If, however, for some reason, the borrower does not pay the dues on time and a loan does not enter the fourth stage, there could be a problem. ARCs have been institutionalised to play a crucial role at this juncture. They are the institutions to enable loan originators to focus on their core function of lending by taking over stressed financial assets. The ARC framework is also designed to help borrowers revive their businesses, if possible. This in some ways is also intended to preserve the productive asset generated out of the loan.

Reconstructing distressed assets is by no means an easy task. ARCs are expected to step in, armed with expertise in recovery and reconstruction of ailing assets, and help

[1] The inputs for this speech were provided by Anuj Sharma and Pradeep Kumar.

reduce the level of non-performing assets in the banking system by taking possession of the secured asset of the borrower.

However, efficacy of all such endeavours hinges upon the bedrock of governance. So, in today's address, let me dwell a bit on evolving regulatory framework for ARCs and why there is a need for robust governance structures for their transparent and effective functioning.

Regulatory Framework for ARCs

There are a few basic issues which regulations should seek to address for ARCs:

- First, ARCs should have sufficient resources to undertake asset reconstruction business.
- Second, the transactions have to be conducted in a transparent manner and on arm's length basis.
- Third, the manner in which ARCs can resolve an asset needs to be clearly laid down.

All our regulations are built to address the concerns around these issues.

On the first issue of having adequate resources, let me emphasize that since the ARCs are in the business of asset reconstruction, they are expected to have both – resources and the required skin in the game. To ensure that they have strong and sufficient resource base, the requirements of net owned funds (NOF) was increased from Rs. 100 crore to Rs. 300 crore[2]. Similarly, to ensure skin in the game, ARCs have been mandated to invest[3] some amount in each class of SRs issued by them under each scheme on an ongoing basis, *i.e.,* till the redemption.

On the second issue of transparency several regulatory requirements have been put in place. For example, the directions on Transfer of Loan Exposures (MD-TLE) provide for the checks in terms of price discovery of exposures, valuation of security receipts

[2] Ref: DoR.SIG.FIN.REC.75/26.03.001/2022-23 dated October 11, 2022 (https://website.rbi.org.in/en/web/rbi/-/notifications/review-of-regulatory-framework-for-asset-reconstruction-companies-arcs-12399)

[3] ARCs shall, by transferring funds, invest in the SRs at a minimum of either 15% of the transferors' investment in the SRs or 2.5% of the total SRs issued, whichever is higher, of each class of SRs issued by them under each scheme on an ongoing basis till the redemption of all the SRs issued under such scheme.

and transparent disclosure when assets are transferred by lenders to ARCs. In addition, taking over standard accounts from ARCs is subjected to specific conditions to avoid any transactions with malicious intent. Further, sharing of surplus from recovery of transferred exposures between the ARC and the lender is required to be made on a realisable basis.

Similarly, with a view to improve transparency, the revised framework has introduced a gamut of measures, including - (i) disclosures regarding the track record of returns generated for the security receipt (SR) holders in the offer document; (ii) increase in the disclosure period for the past performance of ARCs from 3 years to 5 years; and, (ii) disclosure of assumptions and rationale behind ratings of SRs to SR holders. These measures are expected to facilitate investments from a broader set of qualified buyers (QBs), address information asymmetry between the ARCs and SR holders, foster healthy competition among ARCs and nudge ARCs to focus on resolution of assets to achieve better returns for investors.

Third is the issue of resolution of the acquired assets. There is a regulatory framework in place, under the provisions of SARFAESI Act, which enables ARCs to undertake resolution. However, there are concerns around activities in this process chiefly relating to the ARC route becoming a vehicle for entry of the 'tainted' promoters, who in the first place were responsible for the default of the underlying entity. This aspect has become particularly relevant since the introduction of Section 29A in the Insolvency and Bankruptcy Code (IBC), which was specifically meant to keep out such promoters. However, often, entities meet this requirement by merely obtaining a declaration signed by the perspective buyer without undertaking any independent verification.

While the current regulations largely aim to address the three issues mentioned above, there are certain other areas which are engaging regulatory attention. One pertains to operational flexibility for debt aggregation. For instance, under extant guidelines, an ARC can acquire financial assets from another ARC but effectively the existing SR holders have to exit when the underlying financial assets are sold by one ARC to another ARC. In this context, there have been suggestions that a change in the trustee/

manager role from one ARC to another should be allowed, without necessarily extinguishing the SRs.

Moreover, for debt aggregation and better value realization, there is a demand that even the equity pertaining to the distressed company should be allowed to be sold by the lenders to ARCs along with debt. Further, in cases where ARCs are permitted to acquire equity and by extension ownership/ control of the borrower entities through various channels[4] such as IBC or conversion of debt into equity, they should be allowed operational freedom to take decisions, including sale/lease of business.

We are examining these issues and are in touch with the industry to firm up our views.

Role of Governance

But there is a key area which is a point of concern for us as regulators, namely the governance in ARCs.

Sound and robust governance provides a strong foundation for the ARCs to build a robust business model. Governance, in this context, transcends mere regulatory compliance; it embodies a philosophy of accountability, transparency, and ethical conduct. In case of distressed assets, where conflicts of interest looms large and fiduciary duties are tested, effective governance can serve to develop confidence in the processes adopted by the ARCs.

Sound governance can also act as both a shield and a sword. It shields the stakeholders from conflicts of interest, ensuring that the decisions are guided by prudence and sound business sense. At the same time, it wields the sword of transparency and accountability by holding decision makers accountable for their actions and fostering a culture of ethical leadership.

To build a strong bedrock of governance, following conditions are critical:

(i) A diverse and independent Board with effective oversight.

[4] At present, ARCs are permitted to convert part of their own debt into equity of a borrower entity and when acting as resolution applicants under IBC, they can acquire equity of the borrower entity

(ii) A robust risk management framework for identifying, assessing, and mitigating risks inherent in the portfolio of distressed assets.

(iii) Transparency regarding disclosure of information about the operations and decision-making processes and accounting practices.

(iv) Effective safeguards and robust policies to identify, disclose, and manage conflicts of interest in a fair and transparent manner.

(v) A comprehensive code of conduct that outlines ethical principles, professional integrity, and accountability.

Sound governance in ARCs, therefore, requires a multifaceted approach that encompasses all the above elements. The onus in this regard lies largely with the Boards of the ARCs and the top functionaries who will have to develop a strong and robust institutional culture based on these principles. Without robust governance mechanisms, it would be a challenging task for ARCs to instil confidence in their operations and decision-making processes.

ARCs also need to be conscious of their conduct vis-à-vis the distressed borrowers. Even a single incident of misconduct can potentially snowball into a controversy which the sector should guard against. While we acknowledge the rights of the ARCs to recover overdue loans, they or their recovery agents should not resort to harassment of borrowers. A comprehensive fair practice code (FPC) for ARCs has been put in place which requires ARCs to follow transparent and non-discriminatory practices. This becomes that much more critical at present juncture when the share of retail loans in the financial assets acquired by the ARCs has increased (from 9%, as of March 31, 2020 to 16% as of March 31, 2023).

Way forward

As you are aware, the regulatory framework of ARCs was comprehensively reviewed by a Committee constituted by the Reserve Bank (Chair: Shri Sudarshan Sen). Based on these recommendations we have issued a set of revised instructions in October 2022 and they have also been subsequently incorporated in the comprehensive Master Directions on ARCs issued on April 24, 2024. These instructions are aimed at having a robust governance system in place. With a view to enable this and in order to enhance Board oversight, it has been stipulated that ARCs need to appoint an

independent director as the Chair of the Board, and at least half of the directors in any Board meeting should be independent directors. ARCs are also required to constitute two committees of the Board viz., Audit Committee and Nomination and Remuneration Committee which are expected to enhance the efficacy of the Board and improve its focus on specific areas.

However, what we observe is that not all ARCs have implemented the revised guidelines on composition and functioning of the Board. I would take this opportunity to urge all ARCs to implement these guidelines in right spirit. Also, failure to meet regulatory guidelines and wilful violations would invite strict supervisory and enforcement action, if warranted.

Apart from the revision of ARC guidelines, the Reserve Bank has been undertaking several steps to create a vibrant market for credit risk transfer. The revised guidelines on transfer of loan exposures and securitisation of standard assets, credit default swaps (CDS) and formation of a secondary market loan association (SLMA) are some of the recent measures taken by the Reserve Bank towards this end.

The thrust of RBI regulations going forward is on developing a market for distressed assets by considering the inclusion of additional stakeholders with strong fundamentals and possessing expertise in resolution. This intention is reflected in the discussion paper on the Securitisation of Stressed Assets Framework. This is expected to increase competition among buyers of distressed assets, giving competitive advantage to the entities with superior resolution and recovery mechanisms capable of achieving optimal outcomes. Given their first mover advantage in this space, I feel ARCs are better placed to capitalize on this focus area and they should endeavour to explore options around this business segment in right earnest.

Concluding thoughts

To conclude, let me reiterate the fact that RBI regulations are intended to promote the integrity and effectiveness of the sector. As the leaders of the ARC sector, it should be your endeavour to ensure that the sector remains focused on course charted through legislative and regulatory intent and should ensure that any negative perception about the functioning and governance standards of the ARCs is dispelled.

To achieve that, it is important that ARCs have strong governance frameworks, robust internal controls, well developed risk management function, and strong compliance culture. As a regulator, our efforts would be to smoothen the operational difficulties and support the growth of the ecosystem for faster and efficient resolution of stressed assets. I am hopeful that ARCs would play the lead role in this process.

Thank you.