

Setting the Right Tone from the Top

(Speech by Shri Swaminathan J, Deputy Governor at the Conference of Asset Reconstruction Companies (ARCs) held in Mumbai on May 17, 2024)

Deputy Governor Shri Rao, Chairpersons, members of the Board and CEOs of ARCs, my colleagues from RBI and ladies and gentlemen. A very good morning to all of you.

1. I am pleased to address you today at the inaugural conference of the Directors on the Boards of the ARCs organised by the Reserve Bank of India. The theme '*Governance in ARCs – Towards Effective Resolutions*' holds significant importance to the Reserve Bank. As you may be aware, the RBI has been engaging with its supervised entities regularly over matters of governance and assurance conveying the importance of strong corporate governance as well as the need to remain vigilant to ensure the continued stability of the financial sector.

2. ARCs enjoy a special place in the financial eco system by being the special purpose vehicles set up to help lighten the banking system from the high value NPAs and release the management bandwidth to the lenders for continuing with their normal banking activities. ARCs are also the specialised agencies for maximising recovery and reconstruction efforts. Today's conference for the Chairpersons, Directors and Chief Executive Officers of ARCs is also a recognition of the important role of ARCs in the banking ecosystem.

3. A perusal of the score card of ARCs during the last two decades¹ throws up a mixed bag. There seem to be more missed opportunities and less than optimal performance by ARCs in fulfilling the principal mandates under the SARFAESI Act². I would therefore like to take this opportunity to highlight certain key aspects, where I believe ARCs can deliver superior outcomes that could be beneficial to all concerned.

Tone from the top

4. Establishing the right tone from the top is crucial in fostering a culture of integrity and ethical conduct throughout an organization. This is where the Chairperson, Board of Directors and the Chief Executives can lead by example of doing the right thing, not only in their words but also through their actions.

5. When leaders prioritize ethical behaviour and compliance with laws and regulations, it permeates throughout the entire organization, guiding employees to make decisions aligned with these principles. This tone from the top builds trust with stakeholders, enhances the organization's reputation, mitigates risks, and ultimately contributes to long-term success.

¹ Asset Reconstruction Company (India) Limited was the first ARC to be set up in 2002. As at March 31, 2024 there were 27 ARCs registered with the Reserve Bank of India

² Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

6. Some ARCs, while enjoying the full benefits of the special position granted to them under the Act and the regulations, have been found to be using innovative ways to structure transactions in a manner to circumvent regulations.

7. During the course of our onsite examinations, we have come across instances where ARCs have been used or allowed themselves to be used, if I may say so, as a conduit to evergreen distressed assets. In many cases, there is a lack of transparency and consistency in the issuance and periodical valuation of Security Receipts (SRs). The practices surrounding levy of management fee leaves much to be desired.

8. It is also observed that a few entities find new ways of achieving their designs once a particular practice has been called out as a violation or deviation. Wherever it had come to our notice, we had directed the entities to arrange for remediation including setting aside capital charge on gains thereon but only a responsible conduct by the supervised entities themselves can bring the required efficiency to the system. In extreme cases, it may call for regulatory or supervisory actions which of course we would like to use only as a last resort.

9. With regulations shifting towards a more principles-based approach, supervision is required to focus more on the substance of transactions rather than their legal form. This means that supervisors, instead of relying on the technical compliance presented by the management, may have to scrutinise the economic purpose and the underlying unstated intent behind the transactions.

10. Very often we get representations to our observations stating this is industry practice or clarifications are pending from the RBI. Sometimes there are incorrect or intelligent interpretations of the circulars. These are not acceptable excuses for failing to do the right thing. Therefore, I would urge you all to adopt a regulation plus approach where you not only comply with the letter of the regulation but also its spirit.

11. Robust governance led by the Board is a pre-requisite to ensuring that ARCs fulfil their intended mandate. Towards this objective, I would like to share with you a few thoughts on the effective functioning of the board.

Effective functioning of the Board

12. Effective functioning of the board requires several elements including competent leadership, committed directors with diverse expertise, independence, clarity in roles and responsibilities and diligence.

13. The Chairperson of the Board is the guardian of governance acting as a lynchpin between the Board, the management, and the shareholders. A good chairperson facilitates constructive discussions, encourages diverse perspectives, and guides the board towards consensus on critical matters. However, it has been observed that in some ARCs, there were long vacancies in the post of chairperson along with instances of chair of the Audit Committee (ACB) also chairing the Board meetings as well as a non-independent Director chairing the Board meetings, contrary to the extant framework. These things only go to show that the governance has not been receiving the required attention.

14. Diverse expertise coupled with independence is necessary for a competent board. A board equipped with independent directors with varied backgrounds, skills and experience allows for richer discussions leading to informed decision making. While non-independent directors may take care of certain interests, independent directors bring an unbiased perspective and play a key role in safeguarding from conflicts of interest. However, we have come across instances where there were not enough independent directors on the Board or a sufficient number of independent directors did not attend board meetings.

15. Clarity of roles and responsibilities between the Board and Management is essential in ensuring the smooth functioning of the organisation and avoiding dysfunction. While the Board is intended to give a strategic perspective and exercise broad oversight over the management, the executive management is responsible for running the day-to-day operations. The MD & CEO is expected to function under the overall supervision, direction and guidance of the Board and at the same time, maintain independence in performance of his or her duties. It is also important that the sub-committees such as the Audit Committee, Nomination and Remuneration Committee, etc. are duly constituted and function in accordance with the statutory and regulatory requirements.

16. Prior preparation and diligence by board members is a *sine qua non* for effective governance and decision making by the Board. I would urge Board members to insist on receiving the agenda papers well in advance and thoroughly reviewing them. Rather than merely going through summaries or presentations made by the management, I would request directors to

meticulously review RBI supervisory letters and inspection reports, external audit reports as well as the reports provided by the internal assurance functions as they would provide valuable insights into the management's performance.

Business Model of ARCs

17. The ARC framework was intended to allow loan originators to focus on their core function of lending by removing the sticky stressed assets from their books. It also envisioned the revival of businesses through resolution of viable and productive assets.

18. A review of the data indicates that one-time settlements and rescheduling of debt are the predominant measures of reconstruction employed by ARCs. Arguably, these measures could have been taken by the lenders themselves. We have also come across instances where ARCs have warehoused the stressed assets, while the originator has continued to remain responsible for the collection as well as custody of the security provided by the borrower. ARCs may like to introspect whether they would like them to be a warehousing agency for a fee, which is certainly not in consonance with the underlying intent of the framework.

Independence of assurance functions

19. Boards should accord due importance to assurance functions, namely, risk management, compliance and internal audit. These functions play a critical role in identifying and mitigating risks, ensuring compliance with laws and regulations as well as safeguarding the organization's reputation. Boards should ensure that heads of assurance functions are positioned appropriately

within the organizational hierarchy and granted direct access to the Board. Dual-hatting, or combining assurance responsibilities with operational or management duties, undermines the independence and objectivity of assurance functions by creating conflicts of interest. Therefore, any dual hatting of assurance functions, should be avoided.

20. During the course of our onsite examinations, it was observed that there is very little appreciation of these requirements. The assurance functions are manned by junior level personnel and at times even left vacant! There is very little training and exposure to industry best standards. Consequently, they are often not able to stand up to senior management or report to the Board.

21. Another area that is receiving closer scrutiny and attention of supervisors is the process followed for disposal of assets. At times, the proposals are not even placed before the independent advisory committee, contrary to regulatory instructions. Assets are sold to group entities without following the arms length principle and without subjecting them to scrutiny under related party transactions. Another surprising behaviour is the '*Swiss challenge*', which often goes unchallenged! This has become a routine affair giving rise to a suspicion that there may be some implicit understanding among the various participants. It will not be out of place if I mention here that such happenings are necessitating the supervisors to lift the veil and examine the transactions more closely.

Conclusion

22. In conclusion, I would like to emphasise that the ARCs' potential for resolving stressed assets within the system can only be realised with sound governance and adherence to ethical practices by a responsible ownership and a professional management.

23. The Boards of ARCs should ensure that they do the right thing without needing the regulator to point it out to them. With strong governance, ARCs can not only recover but also revive businesses and rejuvenate the financial system, benefiting both the community and the institution.

24. I sincerely hope that the outcomes of this conference will not only benefit the participants but will also positively impact on the broader economic ecosystem. Thank you.
