Report of the Committee to Review the Working of Asset Reconstruction Companies

Reserve Bank of India

September 2021

Letter of Transmittal

September 14, 2021

Shri Shaktikanta Das
Governor
Reserve Bank of India
Mumbai

Dear Sir,

We are pleased to submit the Report of the Committee to Review the Working of Asset Reconstruction Companies. The Committee was tasked to undertake a comprehensive review of the working of ARCs, including the applicable regulatory and legal framework. Working on this thematic topic of significant economic importance was a privilege for all of us. This opportunity allowed us to interact with various stakeholders, including several domain experts, which helped us in shaping the recommendations. We hope the recommendations of the Committee will go a long way in facilitating the further development of the ARC sector in India.

We sincerely thank you for entrusting us with this responsibility.

Yours sincerely,

(Sudarshan Sen)
Chairman

(P N Prasad)
Member

(Vishakha Mulye)
Member

(Rohit Prasad)
Member

(Abizer Diwanji)
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The Committee acknowledges, with thanks, the views/ suggestions received from various other ARCs, market participants and other stakeholders, through public domain/email.

Finally, the Committee would also like to convey its deep appreciation for the excellent support provided by the Committee's secretariat, comprising of Shri J P Sharma, Chief General Manager, Ms. Veena Srivastava, General Manager and Shri Parimal Kumar Shivendu, Assistant General Manager, in drafting the Committee's report, promptly responding to the complex information and analytical requirements of the Committee, and efficiently coordinating the meetings, which greatly facilitated the work of the Committee.

Abbreviations

List of Abbreviations used in the Report

AIF	Alternative Investment Fund
AMC	Asset Management Company
ARC	Asset Reconstruction Company
AUM	Assets Under Management
BIFR	Board for Industrial and Financial Reconstruction
BR Act	Banking Regulation Act, 1949
CAGR	Compound Annual Growth Rate
CERSAI	Central Registry of Securitisation Asset Reconstruction and Security Interest of India
CIRP	Corporate Insolvency Resolution Process
CoC	Committee of Creditors
CRAR	Capital to Risk-weighted Assets Ratio
DRT	Debt Recovery Tribunal
GNPA	Gross Non-Performing Asset
GoI	Government of India
FDI	Foreign Direct Investment
FI	Financial Institution
FPI	Foreign Portfolio Investor
FY	Financial Year
IBA	Indian Banks' Association
IBC	Insolvency and Bankruptcy Code, 2016
IRACP	Income Recognition, Asset Classification and Provisioning
IRR	Internal Rate of Return
KAMCO	Korea Asset Management Corporation
MF	Mutual Fund
NAMA	National Asset Management Agency, Ireland
NeSL	National E-Governance Services Limited
NAV	Net Asset Value
NBFC	Non-Banking Financial Company
NCLT	National Company Law Tribunal
NOF	Net Owned Fund
NPA	Non-Performing Asset
NPV	Net Present Value
OF	Owned Fund
PSB	Public Sector Bank
QB	Qualified Buyer
RA	Resolution Applicant
RBI	Reserve Bank of India
RDDBFI Act	Recovery of Debts Due to Banks and Financial Institutions Act,1993
RoC	Registrar of Companies
S4A	Scheme for Sustainable Structuring of Stressed Assets
SAREB	Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria, Spain
The Act	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002

SCB	Scheduled Commercial Bank
SEBI	Securities and Exchange Board of India
SICA	Sick Industrial Companies (Special Provisions) Act, 1985
SLMA	Secondary Loan Market Association
SMA	Special Mention Account
SR	Security Receipt

Executive Summary

1. Background

1.1. Against the backdrop of significant build-up of non-performing assets (NPAs) in the financial system, asset reconstruction companies (ARCs) are expected to play a critical role. The ARC framework is designed to allow originators to focus on their core function of lending, by removing sticky stressed financial assets from their books. ARCs act as the primary agent for recovery upon acquisition of such financial assets. The ARC framework is also designed to help borrowers revive their businesses, which protects the viable and productive assets of the economy and often ensures a better return to banks/ financial institutions (FIs), collectively referred to as 'lenders', from their stressed assets.

1.2. Data shows that the performance of the ARCs has been lacklustre, both in terms of ensuring recovery and revival of businesses. Banks and other investors could recover only about 14.29% of the amount owed by borrowers in respect of stressed assets sold to ARCs during the FY 2004 - FY 2013 period. Similarly, data shows that approximately 80% of the recovery made by ARCs has come through deployment of measures of reconstruction that do not necessarily lead to revival of businesses.

1.3. There are multiple factors behind the sub-optimal performance of the ARC Sector. These primarily include vintage NPAs being passed on to ARCs, lack of debt aggregation, non-availability of additional funding for stressed borrowers, difficulty in raising of funds by the ARCs on their balance sheet, etc. Also, ARCs have lacked focus on both recovery and acquiring necessary skill sets for holistic resolution of distressed borrowers.

1.4. Considering the challenges impacting the performance of the ARC Sector, the Committee to Review the Working of Asset Reconstruction Companies was constituted to undertake a comprehensive review of the working of ARCs. The terms of reference of the Committee were as under:

(i) Review of existing legal and regulatory framework applicable to ARCs and recommend measures to improve efficacy of ARCs;
(ii) Review of role of ARCs in resolution of stressed assets including under Insolvency & Bankruptcy Code (IBC), 2016;

(iii) Suggestions for improving liquidity in and trading of security receipts;

(iv) Review of business models of the ARCs;

(v) Any other matter relevant to the functioning, transparency and governance of ARCs.

2. Approach/ Methodology adopted by the Committee

The Committee extensively deliberated upon the matters under its remit. It held twenty-five meetings for this purpose, details of which are given in **Annex I**. The Committee met with various stakeholders to gain insight into the challenges faced by the ARC sector. Further, the Committee also invited[1] views/ suggestions from market participants and other stakeholders.

3. Findings and Recommendations of the Committee

3.1. The Committee's findings and recommendations cover all significant areas of functioning of ARCs. The recommendations particularly focus on matters related to acquisition, securitisation and reconstruction of financial assets and liquidity and trading of security receipts. Other areas of importance where the Committee has made recommendations include matters of governance and transparency, minimum Net Owned Fund (NOF) requirement, legal issues of significance and a few taxation issues. These recommendations are interlinked and interdependent and hence need to be examined in a holistic manner. While a summary of all recommendations made by the Committee is given in Chapter G, the following paragraphs highlight some of the key recommendations.

3.2. In the area of acquisition and securitisation of financial assets, the Committee argues for sale of stressed assets by lenders at an earlier stage to allow for optimal recovery by ARCs. In this respect, the Committee highlights the need for regulatory clarification on sale of all categories of special mention accounts (SMAs) to ARCs. Further, as a measure to incentivise lenders to sell their financial assets to ARCs at an early stage of stress, the Committee recommends a dispensation to lenders, on an ongoing basis, to amortise the loss on sale, if any, over a period of two years. To optimise upside value realisation by lenders, the Committee also recommends a higher threshold of investment in SRs by lenders below which provisioning on SRs

[1] Press Release dated April 28, 2021

held by them may be done on the basis of Net Asset Value (NAV) declared by the ARC instead of the IRACP norms.

Further, to streamline the process of sale of stressed assets to ARCs, the Committee recommends that for accounts of Rs.100 crore[2] and above, which are in default, the lender's resolution plan should explicitly evaluate sale/ auction of such accounts to ARCs as one of the options. In case of these NPAs which are (i) more than two years old and (ii) no active resolution plan is in place and are not included in the list of NPAs identified for sale, the reason for their exclusion from the list of NPAs identified for sale should be documented. (***Para D.1.7 to D.1.9 ibid***)

3.3. Recognising the need of transparency and uniformity of processes in sale of stressed assets to ARCs, the Committee feels that an online platform may be created for sale of stressed assets. Infrastructure created by the Secondary Loan Market Association (SLMA) may be utilised for this purpose. Further, considering the critical role played by the reserve price in ensuring true price discovery in auctions conducted for sale of stressed assets, the Committee recommends that for all accounts above Rs.500 crore, two bank-approved external valuers should carry out a valuation to determine the liquidation value and fair market value and for accounts between Rs.100 crore to Rs.500 crore, one valuer may be engaged. Also, the final approval of the reserve price should be given by a high-level committee that has the power to approve the corresponding write-off of the loan. (***Para D.1.13 to D.1.14 ibid***)

3.4. In the interest of debt aggregation, the Committee recommends that the scope of Section 5 of the SARFAESI Act, and other related provisions, may be expanded to allow ARCs to acquire 'financial assets' as defined in the Act, for the purpose of reconstruction, not only from banks and 'financial institutions' but also from such entities as may be notified by the Reserve Bank. Under these proposed powers, Reserve Bank may consider permitting ARCs to acquire financial assets from all regulated entities, including AIFs, FPIs, AMCs making investment on behalf of MFs and all NBFCs (including HFCs) irrespective of asset size and from retail investors. (***Para D.1.15 ibid***)

[2] A crore equals ten million

3.5. The Committee understands that providing additional funding to the stressed borrowers is a key requirement for reviving their businesses. Therefore, the Committee recommends that ARCs should be allowed to sponsor SEBI registered AIFs with the objective of using these entities as an additional vehicle for facilitating restructuring/ recovery of the debt acquired by them. (***Para D.2.3 to D.2.5 ibid***)

3.6. One of the main obstacles faced by ARCs in effecting reconstruction of stressed assets is lack of debt aggregation. In this regard, the Committee recommends that if 66% of lenders (by value) decide to accept an offer by an ARC, the same may be binding on the remaining lenders and it must be implemented within 60 days of approval by majority lenders (66%). 100% provisioning on the loan outstanding should be mandated if a lender fails to comply with this requirement. Given that the debt aggregation is typically a time-consuming process, the Committee also recommends that the planning period be elongated to one year from the existing six months.

The Committee also recommends that in cases where ARCs have acquired 66% of debt of a borrower, the Act should provide for two years of moratorium on proceedings against the borrower by other authorities. The Act should also provide that Government dues including revenues, taxes, cesses and rates due to the Central Government, State Government or local authority will be deferred in such cases. (***Para D.2.6 to D.2.9 ibid***)

3.7. The Committee recognises that in the interest of better value realization for originators and enhancing the effectiveness of ARCs in recovery, even the equity pertaining to a borrower company may be allowed to be sold by lenders to ARCs which have acquired the borrower's debt. The Committee recommends that ARCs may be allowed to participate in the IBC process as a Resolution Applicant either through a SR trust or through the AIF sponsored by them. (***Para D.2.10 to D.2.11 ibid***)

3.8. The Committee recognises that listing and trading of SRs will take off only if ARCs' ability to resolve the underlying stressed assets is strengthened to generate higher quantum of redemption and upside for investors. To this end, the Committee has made several key recommendations as mentioned above. Further, in the interest of giving impetus to listing and trading of SRs, the Committee recommends that the list of eligible qualified buyers may be further expanded to include HNIs with minimum investment of Rs.1 crore, corporates (Net Worth-Rs.10 crore & above), all NBFCs/

HFCs, trusts, family offices, pension funds and distressed asset funds with the condition that (a) defaulting promoters should not be gaining access to secured assets through SRs and (b) corporates cannot invest in SRs issued by ARCs which are related parties as per SEBI definition. (***Para E.1 to E.3 ibid***)

3.9. The Committee also underscores that the need for protecting the interest of investors and investing lenders (for which the requirement of 'skin in the game', i.e., minimum investment of 15% is prescribed for the ARCs), should be weighed against the need for distribution of risk among the willing investors. Therefore, it recommends that for all transactions, per SR class/ scheme, the minimum investment in SRs by an ARC should be 15% of the lenders' investment in SRs or 2.5% of the total SRs issued, whichever is higher. (***Para E.4 ibid***)

3.10. Considering the wider role envisaged for ARCs as the prime vehicle for resolution of stressed assets of the economy, the Committee recommends that the minimum NOF requirement for ARCs should be increased to Rs.200 crore wherein existing ARCs may be provided a glide path to meet this requirement. (***Para F.1.1 ibid***)

3.11. Recognising the critical role of Credit Rating Agencies (CRAs) in the valuation of SRs and, therefore, the need for continuity in engagement of CRAs, the Committee recommends that ARCs must retain a CRA for at least 3 years. In case of change of a CRA, both parties must disclose the reason for such change. (***Para F.2.2 ibid***)

3.12. Due to information asymmetry, foreign investors appear to draw comfort if the documents are standardised in some manner with embedded investor protection features. Therefore, the Committee recommends that the Indian Banks' Association (IBA) may review the standard Assignment Agreement and Trust Deed and update the same to reflect the changes and expectations of the investors. SLMA may also be appropriately engaged for standardisation of these documents. Further, the document (Offer Document or Prospectus as the case may be) for soliciting investment in SRs and its subsequent updates, if any, should indicate at least the track record of the ARC for at least 10 years. The track record should, inter alia, have information on return, rating migration and rating agency of past schemes. (***Para E.5 and F.2.4 ibid***)

3.13. In the interest of operational efficiency, the Committee recommends that the avenues for deployment of surplus funds on the ARC's balance sheet may be widened to include a variety of short-term instruments as the currently restricted investment opportunities generate low return for ARCs and result in overall inefficient cash management. Further, in order to allow ARCs to raise additional equity from strategic and foreign sources and attract more capital to the sector without additional regulatory burden, the Committee recommends that the threshold of shareholding for recognising a sponsor should be increased to 20% from the existing 10% with suitable safeguards. (***Para F.3.1 to F.3.2 ibid***)

3.14. To make enforcement of security interest under the Act more efficient, the Committee recommends that the definition of 'secured creditor' in the Act be expanded to include the acquirer of a financial asset (e.g., ARC) in whose favour security interest is assigned, even if the enforcement rights under the Act were not available with the assignor. (***Para F.4.1 ibid***)

3.15. In the matter related to taxation of income generated from investment in SRs issued by ARCs, the possibility of a 'pass-through' regime for AIF investors may be looked into by Central Board of Direct Taxes(CBDT). The Committee also recommends that CBDT may consider clarifying on the tax rate applicable to FPIs. (***Para F.5.1 to F.5.2 ibid***)

3.16. This Report is divided into seven chapters. Chapter A profiles the ARC sector and the terms of reference of the Committee. Chapter B records the genesis of the ARC sector and briefly analyses design aspects of its international counterparts. Chapter C describes the regulatory and legal framework under which ARCs operate. Chapter D analyses and makes recommendations on the acquisition, securitisation and asset reconstruction aspects of ARC business. Chapter E is dedicated to analysing and recommending measures for stimulation of trading and listing of security receipts. Chapter F covers various other issues pertaining to the ARC sector. The final chapter summarises the Committee's recommendations with appropriate action indicators.

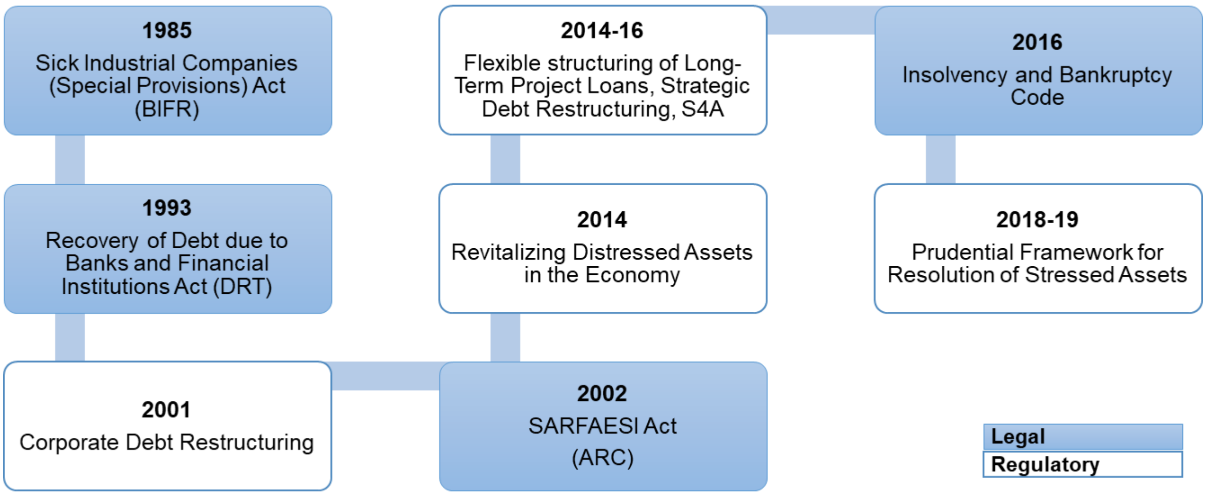
Chapter A. Introduction

A.1. 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 has led to some level of risk aversion among the banks and thereby deceleration of credit growth in the country in the 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 growth of credit in the economy and can potentially undermine the stability of the financial system.

A.2. 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.

A.3. 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.

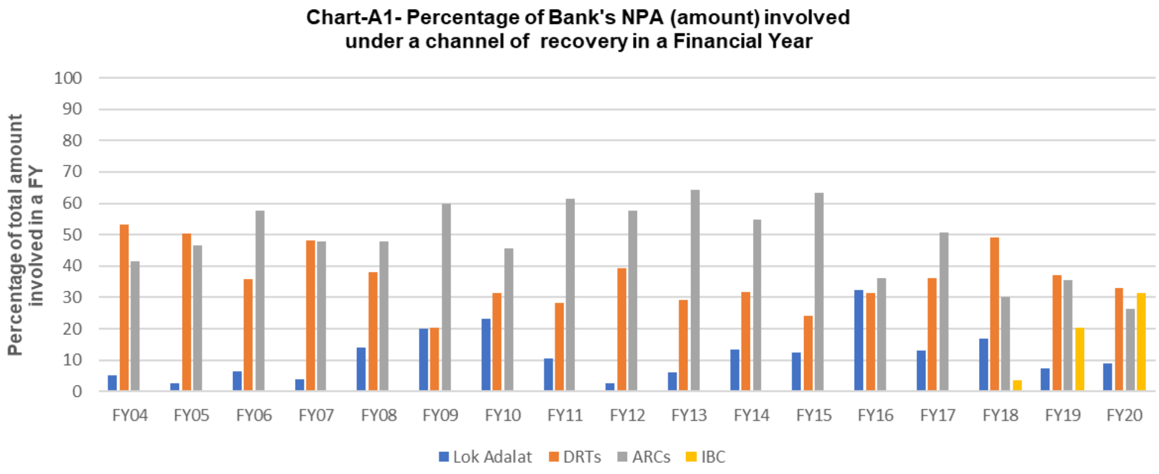
Figure A1: Evolution of legal and regulatory framework for handing the stressed assets of financial Sector

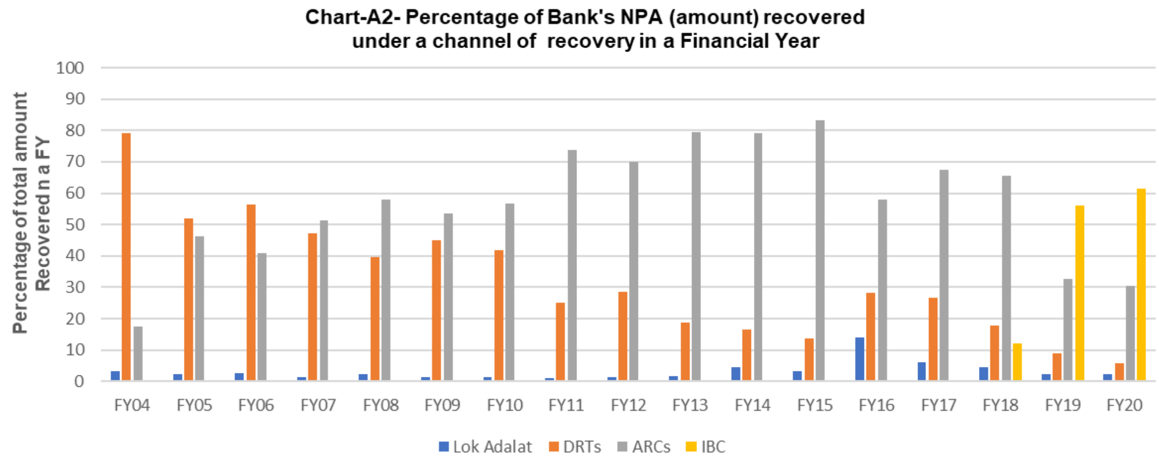


A.4. RBI has been providing regulatory frameworks to banks for efficient handling of stressed assets in their books. The Corporate Debt Restructuring framework envisaged vide circular dated August 23, 2001 provided a mechanism for timely and transparent restructuring of debt of viable entities, outside 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.

A.5. 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).





Amount recovered refers to amount recovered during a given year, which could be with reference to cases referred during the given year as well as earlier years
Source: Report on Trend and Progress of Banking in India

A.6. 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.

A.7. 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.

A.8. 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.

A.9. Overall recovery made by the ARC sector during the period FY04 to FY13[3] 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 assets acquired. Please refer to Table D1 on status of SRs for detailed breakup. 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

[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.

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.

A.10. 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.

A.11. 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.

A.12. It was in this context that the Committee was constituted to undertake a comprehensive review of the working of ARCs and to recommend suitable measures enabling ARCs meet the growing requirements of the financial sector. The terms of reference of the Committee were as under:

(a) Review of existing legal and regulatory framework applicable to ARCs and recommend measures to improve efficacy of ARCs;

(b) Review of role of ARCs in resolution of stressed assets including under Insolvency & Bankruptcy Code (IBC), 2016;

(c) Suggestions for improving liquidity in and trading of security receipts;

(d) Review of business models of the ARCs;

(e) Any other matter relevant to the functioning, transparency and governance of ARCs.

A.13. The Committee held twenty-five meetings to extensively deliberate on the matters under its remit. Details of the meetings are given in **Annex I**. During these meetings, the Committee met with various stakeholders including banks, ARCs, industry bodies, law firms, auditors and credit rating agencies to understand the challenges faced by the ARC sector and sought their suggestions for overcoming those challenges. Further, the Committee also invited views/suggestions from market participants and other stakeholders.

Chapter B. Genesis of ARCs in India and International Experience

Genesis of ARCs in India

B.1. 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.

B.2. 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.

B.3. 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.

B.4. 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.

International Experience

B.5. In the Indian context, ARCs mainly act as a private-sector led permanent institutional arrangement for handling of stressed assets. The world over, typically, stressed asset AMCs have been set up to play a similar role, though for a limited period. These AMCs are entities to which stressed assets are transferred from either for recovering their value (either through profit maximisation or loss minimisation) or for warehousing (insulating them from the market fluctuations, until market conditions normalise). These AMCs have been critical in resolution of stressed assets, especially in the wake of a financial crisis. Globally, AMCs typically are temporary entities and they generally do not keep the stressed assets in their own books for resolution. AMCs usually sell off the stressed assets to third party investors. On the other hand, ARCs in India not only take stressed assets in their books but even when they securitise it they remain solely responsible for resolution of the stressed assets. Like ARCs, AMCs also help revive credit expansion, preserve financial stability and help build a liquid market for stressed assets. The ARC mechanism also provides an alternate investment (with diversification benefit) opportunity for investors through securitisation.

B.6. Fundamentally, the design of these specialised institutions has been influenced by the nature and extent of the crisis faced by a country. However, there are some general key design principles, pertaining to ownership of AMCs, method of transfer of stressed assets, sourcing and valuation of stressed assets, etc., that underlie the international AMCs. A closer look at these principles may be useful in improving the current design of ARCs. A brief snapshot of the same is as follows:

(a) Ownership – There are various models of ownership across the world. Under these models, the ownership could be public, private or public-private partnership (PPP). The 'transfer price' (price at which NPAs are transferred to the AMC) plays a critical role in deciding whether an AMC is floated as a public or private entity. Setting up a private AMC implies that the 'transfer price' will be the 'market price' of the NPA. This in turn means banks may take large haircuts and thus will be recognising the loss upfront and thereby adversely impacting their level of capital. SAREB AMC in Spain was established in 2012 as a private for-profit company.

Setting up a public AMC would give the flexibility to have a 'transfer price' above the economic value of an NPA. It will however mean that the AMCs pays an excessive price for the stressed asset, eventually leading to loss for the AMC. It will help banks avoid upfront losses and depletion of capital but at the cost of masking their weakness. KAMCO in Korea and Danaharta in Malaysia are examples of public AMCs.

A similar trade-off also exists when AMCs are planned under the PPP model where a compromise between upfront provision of capital to banks and accepting eventual losses to AMC is made by the authorities. NAMA in Ireland set up in 2009 had an ownership that was private/public hybrid.

(b) Sourcing of NPA – Centralised AMCs are set up when the NPAs arise due to systemic problems. In such a case it is also highly likely that a public AMC is set up as the private sector may not have the financial wherewithal or coordination capability to mop up system wide NPAs, especially at the time of heightened stress. Centralised AMCs give the benefit of consistency in workout practices and may have greater bargaining power to drive any legal changes that may be required for speedy loan recovery. KAMCO in Korea and Danaharta in Malaysia were centralised AMCs. Bank-specific AMCs are set up when NPA issues are limited to a few individual banks. An example of a bank-specific AMC framework is Sweden where Securum and Retrieva were established in 1992 to work out the NPAs of Nordbanken and Gota Bank, respectively.

(c) Voluntary vs mandatory transfer – In order to counter the reluctance of banks to recognize losses upfront while dealing with a systemic NPA problem, the option of mandatory transfer to AMC is used. SAREB AMC in Spain used mandatory transfer. In other scenarios, voluntary transfer is used, especially if not all banks are affected by NPA problems. Voluntary transfer allows for a level playing field across banks so that banks transferring bad assets to the AMC do not gain an unfair advantage over the others, by strengthening their balance sheets more than their peers.

(d) Valuing of NPA in the books of AMC – When AMCs are used for warehousing of the assets, an important consideration is how to account for the assets acquired. If these are valued at fair value, short-term mark-to-market price variations can adversely affect their value, defeating one of the objectives of putting these in AMCs. On the other hand, keeping the assets at book value can reduce the AMC's incentive to dispose them off and, hence, unduly prolong the life of the asset.

B.7. Naturally, the varied design possibilities imply that the performance of an AMC/ARC like entity can be judged only against the objective for which it has been established. However, international experience suggests that the performance generally depends on the operational independence, adequacy of resources, technical competence and the type and quality of assets these specialised institutions acquire. In this respect, the technical competence of these entities becomes extremely important. Typically, these specialised institutions acquire bad assets which the originators had failed to keep at performing levels. Therefore, the only way they would be able to extract value from such assets is if they have some comparative advantage over the originators in terms of management skills. In the absence of any comparative advantage over the lenders, AMC will only serve the limited purpose of cleaning up banks' balance sheets and will eventually become ineffective. In this sense, it is imperative that these specialised institutions are differentially empowered though legal and regulatory frameworks.

B.8. The Committee has attempted to reflect these design principles in its recommendations. It is expected that a principle-based redesigning of the ARC model would go a long way in improving the performance and relevance of the sector.

Chapter C. Extant Legal and Regulatory Framework for ARCs

Legal Framework

C.1. 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-C1- 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

C.2. Section 2(1)(c) and Section 2(1)(m) of the Act define the terms ‘bank’ and ‘financial institution(FI)’, respectively. For the purpose of the Act, bank means a banking company as defined under Section 5(c) of the Banking Regulation Act, 1949 (B R Act), or a corresponding new bank as defined under Section 5(da) of B R Act, or the State Bank of India, or a multi-state co-operative bank. The Central Government has been empowered by the Act to notify any other class of banks for the purpose of this Act. FI under the Act includes public financial institution as defined in Companies Act, 2013, International Finance Corporation established under the International Finance Corporation (Status, Immunities and Privileges) Act, 1958, specified institutions under Section 2(h)(ii) of RDDBFI Act, a debenture trustee registered with

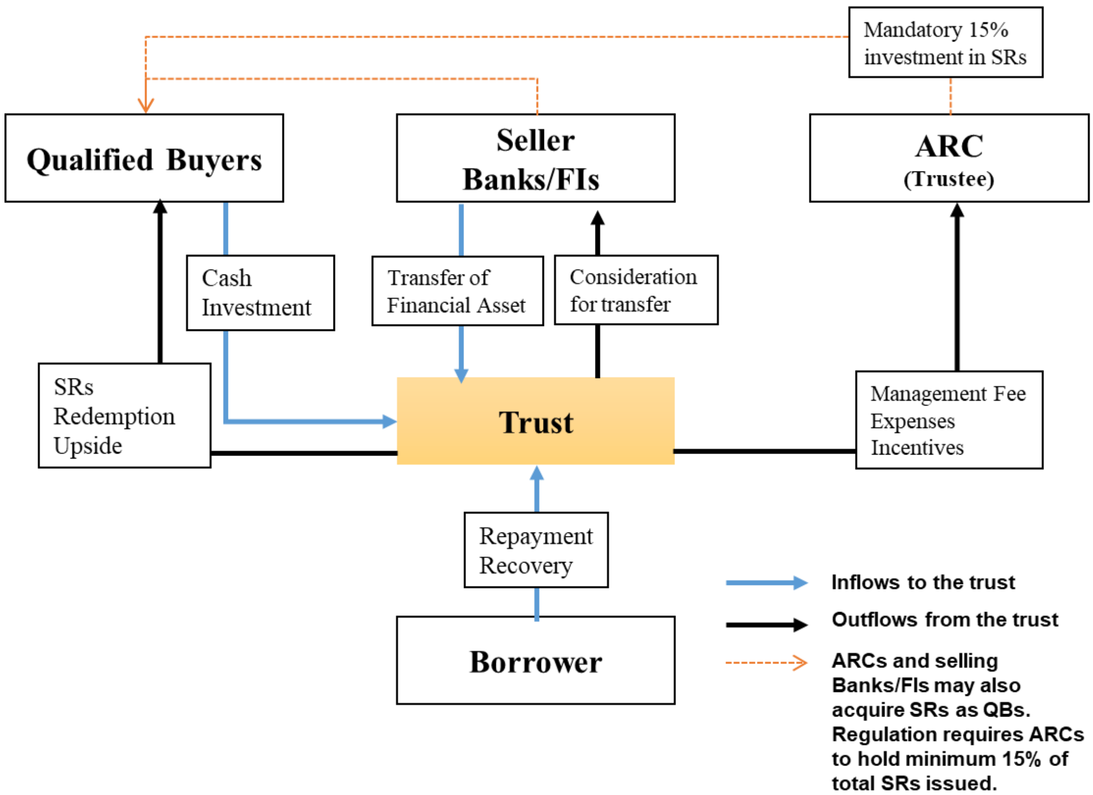
SEBI and appointed for secured debt securities and an ARC. Central Government has been empowered by the Act to notify other institutions including NBFCs as FI. Central Government has notified NBFCs (including HFCs) having asset size of Rs.100 crore and above as FIs.

C.3. 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.

C.4. 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.

C.5. 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. ARCs 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 C1 below.

Figure C1: Transactions involved in Securitisation



C.6. 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 these measure in accordance with RBI guidelines.

Regulatory Framework

C.7. RBI, in exercise of the powers conferred by Sections 3, 9, 10 and 12 of the Act has issued the "Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003". These guidelines cover the whole gamut of ARCs' functioning such as registration, measures of asset reconstruction, functions of the company, prudential norms, acquisition of financial assets and related matters. A list of important guidelines issued by RBI regarding the working of the ARCs is given in **Annex II**. These guidelines were last consolidated as of July 2015 and need to be updated.

Recommendation:

The various guidelines applicable to ARCs may be consolidated into a single set of Master Directions, which may be updated as and when regulatory changes are made.

C.8. Section 2(1)(zh) of the Act defines Sponsor as any person holding not less than 10% of the paid-up equity capital of an ARC. Section 3(3)(f) of the Act empowers RBI to specify fit and proper criteria for Sponsors of the ARCs. Accordingly, the RBI Master Direction dated October 25, 2018 enumerates the criteria for determination of fit and proper status of the sponsors and provides a framework for monitoring of such status. Among other things, assessment of sources and stability of funds is integral to this exercise. These requirements seek to ensure that sponsor's/management's/executives' integrity, reputation, track record and compliance with applicable laws and regulations meet the regulatory expectations. Further, the Act as well as regulation require prior approval of RBI for all appointment/re-appointment of directors/ managing director/ CEO or for change in Sponsors. Other important regulation pertaining to various prudential norms applicable to ARCs are given below in brief:

Table-C2- Important regulations relating to ARCs	
Net Owned Fund	Minimum Rs.100 crore on an ongoing basis
Acquisition of financial Assets	Not allowed on a bilateral basis from sponsor banks/ FIs or an entity in the Group. However, these entities are allowed to participate in public auctions
Investment in SRs	Minimum 15% of SRs in each class, under each scheme
Realisation of Assets	5 years, may be extended up to 3 more years with the approval of their Board
CRAR (%)	15%
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
Provisioning requirements	Sub-standard Asset: 10% of the outstanding Doubtful Asset: (i) 100% provision to the extent the asset is not covered by the estimated realisable value of security; (ii) In addition to (i) above, 50% of the remaining outstanding Loss Asset: (i) Entire asset shall be written off; (ii) If the asset is retained in the books, 100% shall be provided for
Income Recognition	a. Yield on SRs as well as Upside Income should be recognised only after full redemption of SRs b. Management Fee should be calculated as a % of net asset value (NAV) at the lower end of the range specified by Credit Rating Agency.

C.9. As mentioned above, the Act empowers the RBI under Section 9(2) to issue guidelines on measures for reconstruction of assets. Accordingly, detailed guidelines have been issued in this respect by RBI. A brief snapshot of these guidelines is as follows:

Table-C3 - Important Regulations regarding Measures for Asset Reconstruction

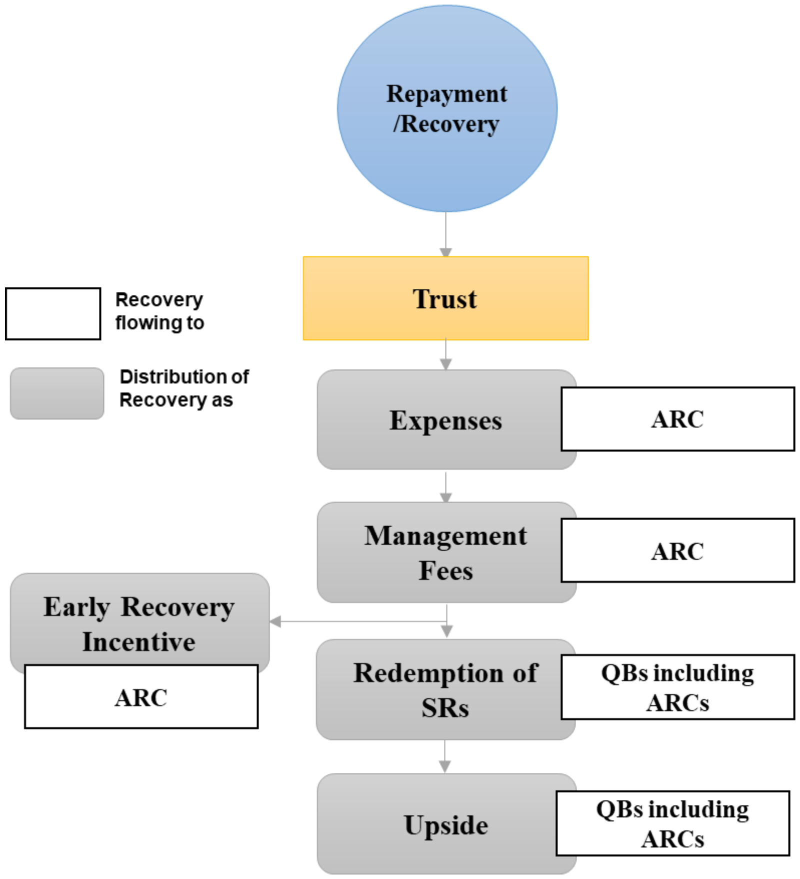
Measures	Regulatory provisions
Change in/ Takeover of Management of the Business of the Borrower	▪ In accordance with provisions of Section 15 of the Act and as per Board approved policy; ▪ If amount due to the ARC trust is at least 25% of the total assets owned by the borrower. If borrower is financed by more than one secured creditor (including ARC) holding not less than 60% of outstanding SRs agree to such action. ▪ Grounds - Wilful default, incompetent management or the management acting against the interest of creditors, fraudulent transactions, etc.
Sale/ Lease of Business of the Borrower	RBI has not issued necessary guidelines in this regard

Rescheduling of Debts payable by the Borrower	As per Board approved policy of the ARC
Enforcement of Security Interest	▪ In accordance with provisions of Section 13 of the Act. ▪ The ARC may acquire the secured assets, either for its own use or for resale, only if the sale is conducted through a public auction.
Settlement of Dues payable by the Borrower	▪ As per Board approved policy
Conversion of Debt into Equity in a Borrower Company	▪ Shareholding by the ARC/ trust shall not exceed 26% or sectoral FDI limit of the post converted equity of the company under reconstruction. The 26% limit can be exceeded provided the ARC meets certain criteria. ▪ As per Board approved policy

C.10. ARCs are permitted to deploy their funds for undertaking restructuring of acquired assets with the sole purpose of realising their dues. Trusts may also utilize a part of funds raised under a scheme from the QBs for restructuring of assets acquired under relative schemes subject to certain conditions. One of the conditions requires that the extent of funds that shall be utilized for reconstruction purpose should not be more than 25% of the funds raised under the scheme.

C.11. ARCs' efforts towards resolution of assets results in redemption of SRs. However, from the recovery made by ARCs, they claim the management fee for managing the assets, expenses and incentives, if any, from the respective trusts. Residual recovery is used to redeem the SRs issued to the QBs. Residual recovery in excess of the acquisition cost, generally referred to as 'upside income', is distributed among the QBs and ARCs as per the agreed terms. Figure C2 below depicts the typical distribution of recovery from the resolution of a securitised asset.

Figure C2: Distribution of recovery in Securitisation



C.12. Management fee of ARCs is based on the NAV of the SRs. NAV in turn depends on the rating obtained from a SEBI registered Credit Rating Agency (CRA). ARCs are required to obtain the initial rating within a period of six months of acquisition of assets. Thereafter, the rating is reviewed by a CRA on half yearly basis. Rating is given in terms of 'recovery rating scale' which has an associated range of probable recovery expressed in percentage terms. NAV is arrived at by multiplying the face value of outstanding SRs with the lower end of the said range. Management fee is to be recognised on accrual basis and is to be reversed, if not realised within 180 days or if

NAV falls below 50% of face value within the said period. Extant guidelines for ARCs provide that the rationale for the rating should be disclosed by CRAs to ARCs on an ongoing basis.

C.13. Prudential accounting norms require that SRs held by the ARC which have not been redeemed within the maximum permitted timeframe of 8 years are to be treated as loss assets. Under Section 7(3) of the Act, in the event of non-realisation of assets within the specified timeframe, QBs holding SRs of not less than seventy-five percent of the total value of SRs issued under a scheme are empowered to call a meeting of all the QBs and pass a resolution binding on the ARC.

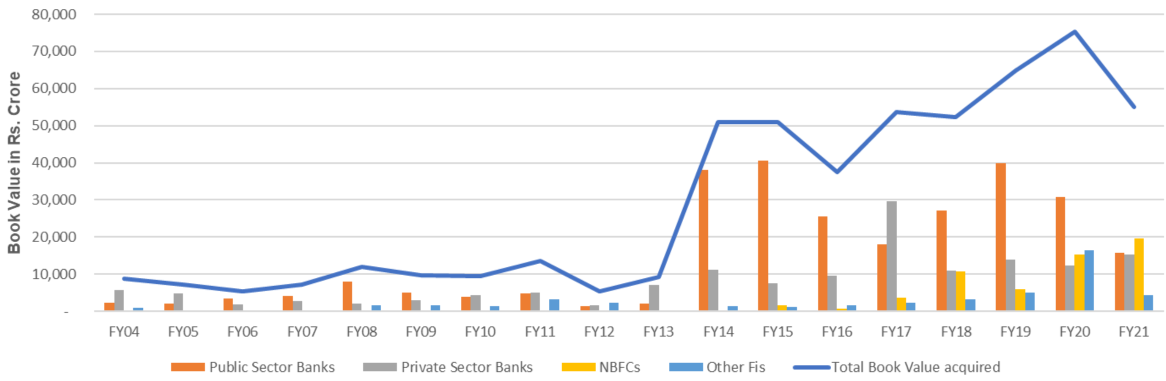
Chapter D. Business and Financial Model of ARCs

D.1. Acquisition and Securitisation of Financial Assets

D.1.1. 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 D1 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.

Chart D1-Acquistion of Financial Assets by ARC sector (classified under select categories)



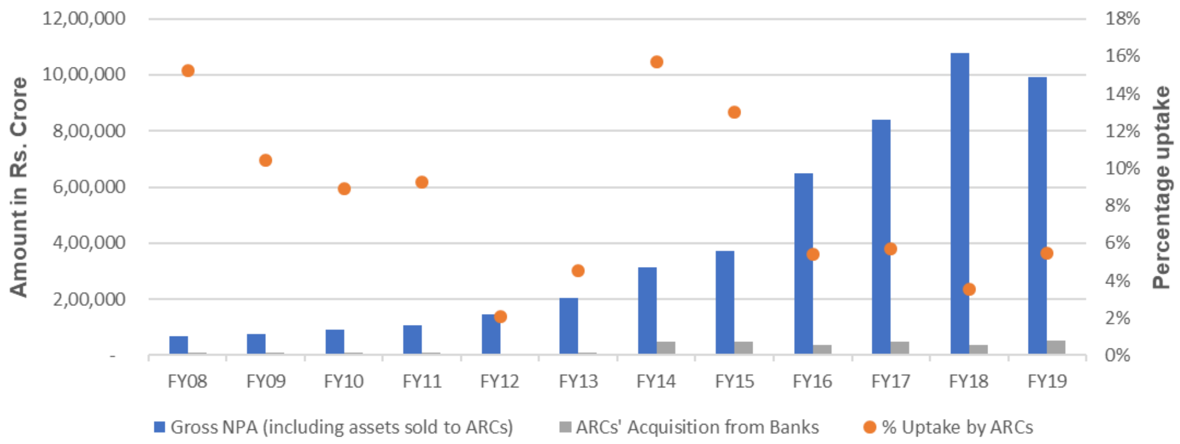
Source: Data submitted by all ARCs and RBI Staff calculations

D.1.2. 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.

D.1.3. 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 D2 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 alternative resolution mechanism may also have contributed to this trend.

Chart D2- Banks' use of ARC for management of Stressed Assets



ARCs' acquisition from banks is in terms of book value acquired by ARCs. Percentage uptake is calculated as ARCs' acquisition from banks divided by Gross NPA of SCBs (including assets sold to ARCs)

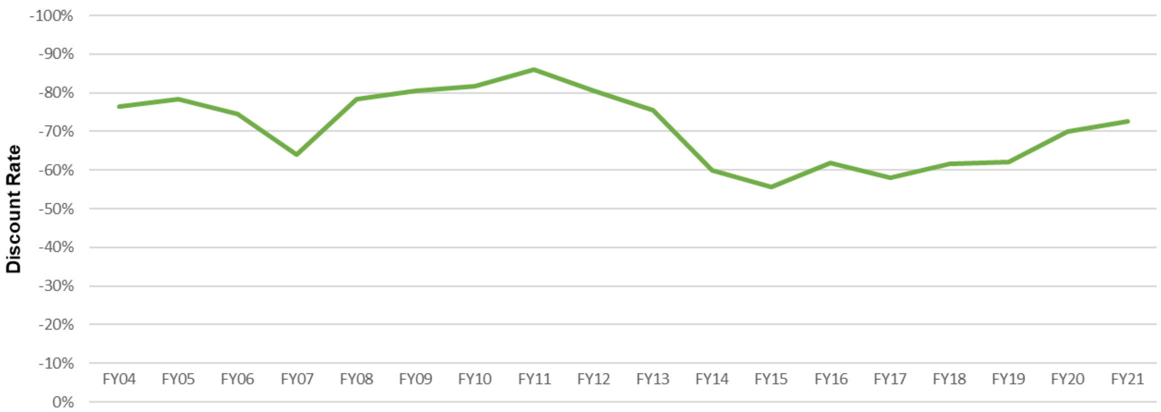
Source: Data submitted by all ARCs, Handbook of Statistics on Indian Economy and RBI Staff calculations

D.1.4. 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 D3 below highlights this decline. The decline

[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

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.

Chart D3-Year-wise Discount Rate

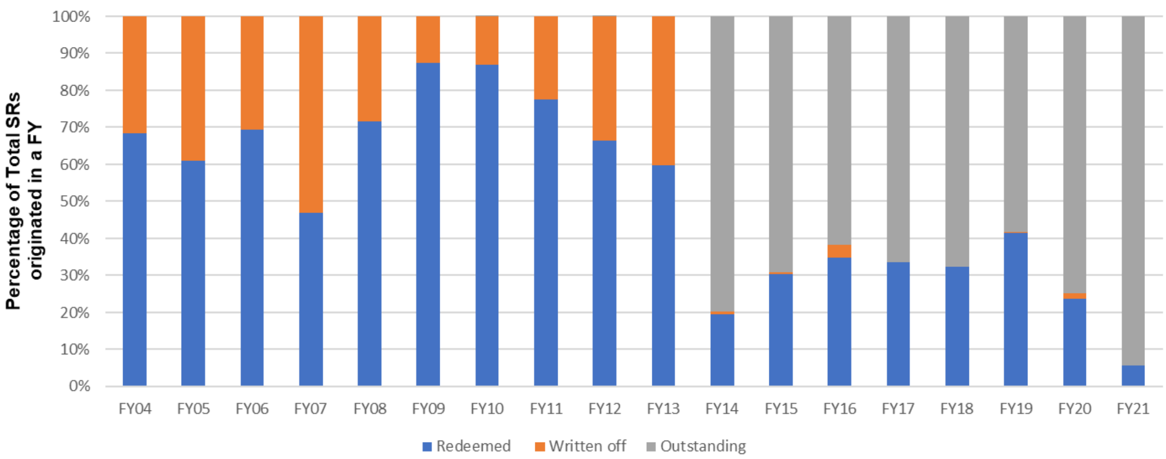


To arrive at Discount Rate for a FY, difference of total book value of assets acquired and the total cost paid for it has been divided by the total book value of assets acquired.

Source: Data submitted by all ARCs and RBI Staff calculations

D.1.5. 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 D4 below.

Chart D4- Status of SRs originated in a particular FY (as on March 31, 2021)



Source: Data submitted by all ARCs and RBI Staff calculations

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 borrowers[5]. A snapshot of the status of SRs originated during FY04-13 and FY14-21 is indicated in **Table D1** below.

Table D1- Status of SRs				
	FY04-FY13		FY14-FY21	
	as % of Total SRs 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%

D.1.6. 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

[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.

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.

Details of the model are presented in the **Annex III**.

D.1.7. One of the significant deterrents to sale of stressed assets by lenders to ARCs is that they are required to book the losses on immediate basis. This especially acts as a deterrent for the sale of recent (low vintage) NPAs with lower levels of provisioning on the lenders' books. On the other hand, when lower vintage NPAs are assigned to ARCs, the chances of revival/ maximization of recovery are higher. ARCs may be able to resolve such NPAs through revival of business before resorting to other legal options for recovery. In order to incentivize lenders to sell stressed assets, especially with focus on those assets with low vintage, certain options may be considered, as elaborated below:

(a) Currently, on sale of asset below Net Book Value, lenders are required to provide for the shortfall at the time of sale. However, as per guidelines dated February 26, 2014[6], as an incentive for early sale of NPAs RBI had given a dispensation to banks for amortising the shortfall on sale of NPAs to ARCs, over a period of two years. The dispensation was valid up to March 31, 2015 but was later extended till March 31, 2016 vide circular dated May 21, 2015. Subsequently vide circular dated June 13, 2016, for assets sold between April 1, 2016 to March 31, 2017, banks were allowed to amortise the shortfall over a period of four quarters. As an incentive for early sale of NPAs, the above dispensation may be extended further, and banks may be allowed, on an on-going basis, to spread loss on sale of financial assets to ARCs, over a period of two years, in line with the previous guidelines, subject to suitable disclosures in the published accounts.

Illustrative example –

[6] Circular on Framework for Revitalising Distressed Assets in the Economy - Refinancing of Project Loans, Sale of NPA and Other Regulatory Measures dated February 26, 2014

Gross Exposure (A)	Rs.100
Provisioning (B)	Rs.15
Net Exposure (C=A-B)	Rs.85
Sale Consideration (D)	Rs.50
Loss at the time of Sale (E=C-D)	Rs.35
Provisioning required in terms of current guidelines	Rs.35 on sale
Recommended guidelines	Provisioning: Year 1 @50% of Loss : Rs.17.50 Year 2 @50% of Loss : Rs.17.50

(b) As discussed above, with effect from April 1, 2018, where the investment by a bank is more than 10% of SRs backed by assets sold by itself, the provisions held in respect of these SRs will be subject to a floor; this floor shall be progressive provisioning as per extant asset classification and provisioning norms. Provisioning requirement in such cases will be the higher of the provisioning rate required in terms of NAV declared by the ARC and provisioning rate as applicable to the underlying loans, assuming that the loans notionally continued in the books of the bank.

The above provisioning requirements aim to promote investments in SRs by the non-originator entities, thereby ensuring a more realistic price discovery. In cases where majority investment in SRs (say 51% or more) is through external parties (ARC and investors, other than lenders), the economic model presented in Annex III suggests that market transactions would have ensured a realistic price discovery. For such transactions, the Committee recommends that provisioning on residual SRs held by the selling banks may be made on the basis of NAV declared by the CRA and not as per IRACP norms. This would incentivize banks to sell financial assets to ARCs. The threshold of 51% is sensitive to the cost of capital of the investors, the rate of management fees, and the value created by the ARC through its reconstruction activities. As the market matures, we expect the risk of holding SRs to fall, thus reducing the cost of capital. Consequently, the levels of management fees are likely to drop. Both developments would increase the threshold of investment by external parties that would ensure discovery of true value. In parallel, more effective reconstruction activities would decrease the threshold. Hence, the Committee recommends that the 51% threshold may be applicable for two years and increased to 76% after due consideration of the various factors involved.

Recommendations:

(a) *RBI may provide a dispensation to lenders on an ongoing basis for amortising the loss on sale of NPAs to ARCs, over a period of two years.*

(b) *When substantial investment in SRs (say 51% or more) is by investors other than the lenders, provisioning on SRs held by the lenders may be done based on net asset value declared by the ARC. The threshold of 51% may be applicable for two years and increased to 76% thereafter.*

D.1.8. As per RBI guidelines dated February 26, 2014, assets classified as SMA-2 are permitted for sale to ARC. Also, as per RBI guideline on Sale of Stressed Assets by Banks dated September 1, 2016, banks may identify stressed assets for sale, including assets classified as Special Mention Accounts; it is not specifically clarified whether SMA-0 and SMA-1 accounts may also be considered for sale. To enable early assignment of debt and better reconstruction of stressed assets, lenders may be permitted to sell accounts reported as SMAs to ARCs. This will also facilitate more efficient debt aggregation where the exposure to the same borrower is classified differently by different lenders, depending on the record of recovery. It is likely that SMA-0 and SMA-1 assets sold to ARCs could be reconstructed mainly through revival of the business whereas reconstruction of SMA-2 assets may also involve enforcement of security if the account is subsequently classified as NPA. At the same time, SMA borrowers need to be protected from precipitate enforcement of security interest by ARCs which may arbitrarily classify them as NPAs for enforcing security. (see paragraph D.2.13 in this regard).

D.1.9. Further, in order to ensure that banks/ FIs attempt to dispose of NPAs in time, there should be regulatory disincentives for delay by lenders in internally resolving the NPA assets. The idea is for banks/ FIs to make a genuine attempt to sell these NPAs, which they have been unable to resolve, to ARCs through an appropriate price discovery mechanism. This would also increase predictability in the amount and quality of stressed assets flowing into ARC sector and also improve the lenders' recovery on these NPAs.

For this purpose, the Committee notes that at the beginning of the year, banks are required to make a list of such NPAs which they intend to sell/ auction to other banks/ NBFCs/ ARCs/ other eligible entities. The Committee recommends that such a list should be prepared by all regulated lenders and disclosed to all ARCs after entering into a confidentiality agreement. An information memorandum of such assets should be kept ready and updated on a continuing basis.

Under RBI's Prudential Framework for Resolution of Stressed Assets, lenders are required to have Board approved policies for resolution of stressed assets. These policies need to include a policy on sale of stressed assets to ARCs, indicating the circumstances and parameters that will be considered for such a sale.

The Committee further recommends that for accounts of Rs.100 crore and above, which are in default:
(a) Bank's resolution plan should explicitly evaluate sale/ auction of NPAs to ARCs as one of the options;
(b) In case of NPAs which are (i) more than two years old and (ii) no active resolution plan is in place and are not included in the list of NPAs identified for sale, the reason for their exclusion should be documented.

D.1.10. Currently regulations prohibit banks from selling fraud accounts to ARCs. Since a fraud results in criminal procedures whereas recovery involves civil procedures, it makes economic sense not to hinder the recovery of debt despite a fraud being associated with the account. In fact, IBC allows insolvency proceedings in parallel with investigation into the fraud. Therefore, sale of fraud accounts to ARCs may be permitted with appropriate safeguards, without diluting the fixing of accountability at banks/ FIs level or affecting criminal proceedings against the responsible persons by competent authorities.

D.1.11. In the interest of debt aggregation, ARCs may be allowed to also acquire stressed loans to domestic borrowers from regulated overseas banks and financial institutions. This may require appropriate notifications by Government under the Act, or by RBI as proposed in Para D.1.15 below, as also enabling provisions in the forex regulations.

Recommendations:

(a) *It may be clarified that all categories of Special Mention Accounts can be considered for sale to ARCs. To protect the interest of borrowers, suitable safeguards may be provided through regulatory prescription on enforcement of security interest.*

(b) *At the beginning of the year, all regulated lenders, and not just banks, should make a list of such NPAs which they intend to sell/ auction to eligible entities, including ARCs. The list should be disclosed to all ARCs on entering into a confidentiality agreement. Data / information on such assets should be kept ready and updated on an on-going basis (live updated memorandum).*

(c) *Lenders' Board approved policies for resolution of stressed assets must include a policy on sale of stressed assets to ARCs, indicating the circumstances and parameters that will be considered for such a sale.*

(d) *For accounts in default with a lender for amount of Rs.100 crore and above,*

(i) *lender's resolution plan should explicitly evaluate sale/ auction of NPAs to ARCs as one of the options;*

(ii) *In case of NPAs which are more than two years old and no active resolution plan is in place and if such accounts are not included in the list as at (b) above, the reason for their exclusion should be documented.*

(e) *Sale of fraud accounts to ARCs may be permitted subject to appropriate safeguards to ensure that fixing of accountability at lender level and criminal inquiry by competent authorities are not affected by this transfer.*

(f) *In the interest of debt aggregation, ARCs may be allowed to also acquire stressed loans to domestic borrowers from regulated overseas banks and financial institutions.*

D.1.12. ARCs have been acquiring financial assets at substantial discounts. While the discount may reflect the quality of assets under acquisition, it may also reflect the information asymmetry between the seller (bank/ FI) and buyer (ARC). Better access to information at pre-deal stage and sufficient time for deal evaluation and due diligence to ARCs would go a long way in increasing offtake of stressed assets from lenders and better price discovery. Therefore, Committee recommends that the

Secondary Loan Market Association (SLMA) may be asked to provide lenders with a suitable comprehensive checklist on necessary information to be given for due diligence to ARCs. Also, the data room should be open for a minimum of 30 days.

D.1.13. In general, there is a need for streamlining and standardising the process of sale of stressed assets undertaken by the banks/ FIs. Certainty and transparency in such processes are critical for development of an efficient stressed assets market. The endeavour should be to make the auction process transparent and robust. Industry associations, such as the IBA, may provide a process document to selling banks/ FIs for ensuring certainty and transparency of auctions conducted by them. The auction mechanism should involve multidimensional bidding whereby winners should be decided based on qualitative and quantitative parameters. Such parameters may include total deal value, cash proportion being offered, quality of management, technical competence of ARCs, etc. Wherever possible, lenders should be in a position to convert these (qualitative) parameters into cash equivalents for deciding the winning bid.

For the purpose of ensuring transparency and uniformity of processes in sale of stressed assets, a separate online platform may be created. Infrastructure created by SLMA may be utilised for this purpose.

D.1.14. Many stakeholders have indicated that the reserve price, i.e., the price at which bidding begins, fixed by banks is much higher than the realizable value of the underlying financial assets. Fixing of the reserve price plays an important part in determining the efficacy of an auction process. A higher reserve price can lead to higher prices due to the exclusion of low value bidders and the upward revision of the expectations of the values of the remaining bidders. This is referred to as the exclusion principle (Krishna 2009). However, beyond a point, a high reserve price can also result in failed auctions. Given enough competition, the process of the auction is likely to reveal a final price that is significantly higher. Hence, the reserve price should be determined by the banks in a realistic manner and commercial considerations should take precedence in such determination. In fact, auction theory recommends that the reserve price set by a bank should reflect the value it could realize through its own restructuring capabilities (including resolution of the borrower through IBC), without trying to second guess what the ARC could realize given its capabilities in asset reconstruction. Therefore, the Committee recommends that in bidding process followed by a lender, for all financial assets of Rs.500 crore and above of the lender, two lender-approved external valuers should carry out the determination of liquidation value and fair market value. For financial assets between Rs.100 crore to Rs.500 crore, one valuer may be engaged. The determination of the reserve price should be influenced by the output of the external valuations. Further, the final approval of the reserve price should be given by a high-level committee that has the power to write off the loan.

Recommendations:

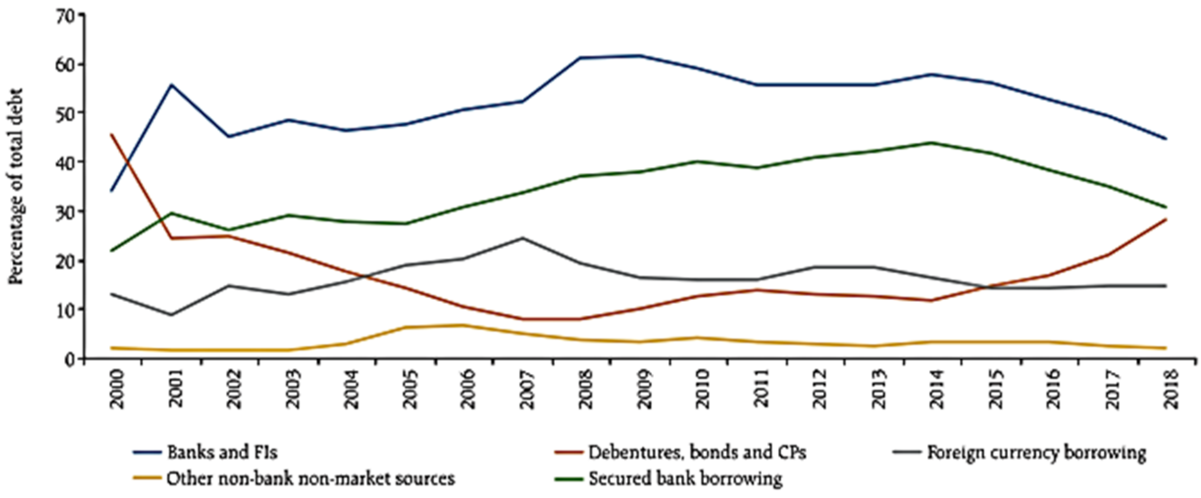
(a) *Via a regulation, SLMA may provide lenders with a suitable comprehensive checklist on necessary information to be given to ARCs at pre-deal stage for due diligence and deal evaluation. Further, data room should be open for a minimum of 30 days after all information is furnished.*

(b) *Via a regulation, the IBA may provide a model process document to lenders for ensuring certainty and transparency of auctions conducted by them. Also, for the purpose of ensuring transparency and uniformity of processes in sale of stressed assets, a separate online platform may be established. Infrastructure created by SLMA may be utilised for this purpose.*

(c) *In the bidding process followed by banks/ FIs, for all financial assets of Rs.500 crore and above, two bank-approved external valuers should carry out the valuation exercise of liquidation value and fair market value. For financial assets between Rs.100 crore to Rs.500 crore, one valuer may be engaged. The determination of the Reserve Price should be influenced by the external valuations. Further, the final approval of the Reserve Price should be given by a high-level committee that has the power to write off the loan.*

D.1.15. ARCs were envisaged primarily to manage the stressed assets of banks/ FIs. However, the nature of debt creation in the economy is slowly changing. Nowadays, non-financial firms are also increasingly tapping the market-based sources, apart from the non-bank lenders, for raising funds. While banks still dominate the landscape of credit creation, Chart D5 below indicates that the last decade has seen a gradual increase in the proportion of debt raised through market-based sources viz. (bonds, debentures and commercial papers). The number and nature of market-based lenders have also changed.

Chart D5- Composition of debt of Indian's non-financial firms



Source: Shromona Ganguly (2019), "India's Corporate Bond Market: Issues in Market Microstructure", RBI Bulletin January 2019

Today, AIFs, Mutual Funds, FPIs, etc. are actively providing funds to non-financial firms through subscription to debt securities. Retail investors are also investing in debt securities, including unsecured debt. It would, therefore, be useful to broad base the entities from which ARCs can purchase financial assets. This would give impetus to debt aggregation as well, which is a necessity for efficient resolution of stressed assets. Given that debt markets are continuously evolving, it seems fit to have a statutory provision that gives the Reserve Bank flexibility to specify, through regulations, entities from which ARCs can acquire financial assets, in addition to the banks and 'financial institutions' permitted under the Act. Under these proposed powers, Reserve Bank may consider permitting ARCs to acquire financial assets from all regulated entities and also retail investors.

***Recommendation**:*

The scope of Section 5 of the Act, and other related provisions, may be expanded to allow ARCs to acquire 'financial assets' as defined in the Act, for the purpose of reconstruction, not only from banks and 'financial institutions' but also from such entities as may be notified by the Reserve Bank. Under these proposed powers, *Reserve Bank may consider permitting ARCs to acquire financial assets from all regulated entities, including AIFs, FPIs, AMCs making investment on behalf of MFs and all NBFCs (including HFCs) irrespective of asset size and from retail investors.*

D.1.16. For enabling debt aggregation, ARCs can acquire debt from other ARCs. This is permitted under extant regulations subject to some conditions, which include a condition that the selling ARCs will utilise the sale proceeds for redemption of the underlying SRs. In the Committee's view, the aggregation of debt by an ARC from other ARCs need not always result in redemption of SRs. A scenario that does not necessitate redemption of SRs can be visualised as outlined below:

Multiple ARCs may have acquired portions of the distressed debt pertaining to a single borrower, leading to multiple trusts, managed by multiple ARC trustees, holding portions of the debt for the benefit of multiple and distinct classes of SR investors. It may be advantageous to bring these fragmented portions of the debt of the common borrower under the management of a common trustee ARC. In effect, only the trusteeship and the management of the trust assets would change hands from one ARC to another. Any purchase consideration for this transfer will necessarily be in cash. Any such transaction between ARCs should require approval by a specified majority, by value, of the SR investors concerned, or such other prescribed threshold as may be defined by the subscription agreement / trust deed.

The above transactions may not necessarily disturb any of the terms and conditions of the SRs issued, except a change in the trustee ARC. The selling ARC should not therefore be required to redeem the associated SRs. In fact, the acquiring ARC should be required to have 'skin in the game' by investing in the associated SRs to the extent of the prescribed minimum threshold. Furthermore, permitting the existing SR holders to continue holding their SRs may give them the benefit of an upside, the likelihood of which increases with debt consolidation.

Recommendation:

The regulations should permit a change in the SR trustee/ asset management role from one ARC to another, without necessarily extinguishing the SRs.

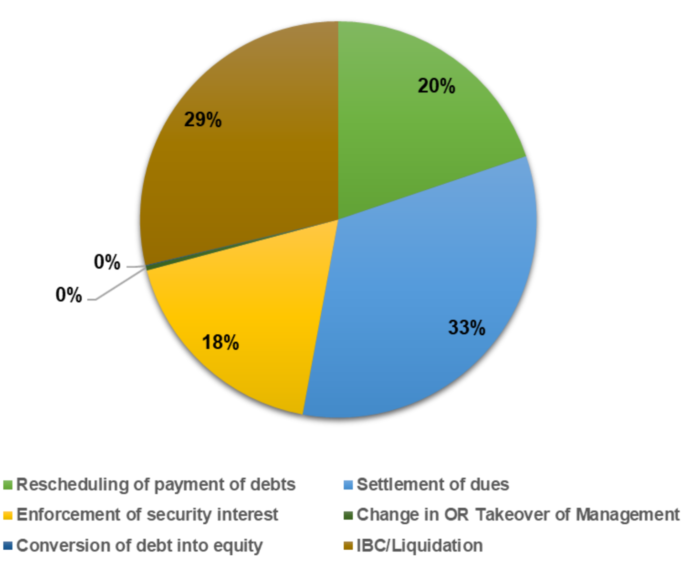
Any acquisition of management/ trusteeship of a financial asset by an ARC from another ARC must have the approval of a majority, by value, of the SR holders concerned or such other prescribed threshold as may be defined by the subscription agreement / trust deed.

It may be clarified that any ARC acquiring trusteeship/management from another ARC, where the SRs are not extinguished, will be required to purchase the associated SRs to the extent of the prescribed minimum threshold.

D.2. Measures for Reconstruction of Financial Assets

D.2.1. 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 D6 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.

Chart D6-Methods of reconstruction deployed (During FY04-FY21)



Source: Data submitted by all ARCs and RBI Staff calculations

D.2.2. 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, ARCs ability to fund the borrower, regulatory limitations and their skill sets. These also determine the methods of asset reconstruction that ARCs can gainfully deploy.

D.2.3. 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.

D.2.4. 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.

D.2.5. Given the limitation of traditional sources of financing for ARCs, the Committee recommends that, going forward, 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.

This recommendation is proposed as an alternative to the recommendation of the Task Force on the Development of Secondary Market for Corporate Loans to permit FPIs to invest in distressed loans, either directly or through securitisation trusts. FPIs can take exposure to distressed loans via investment in the AIFs set up by ARCs, as proposed above.

Recommendation:

Given the limitation of traditional sources of financing for resolution of stressed assets, as a way forward, ARCs should be allowed to sponsor a SEBI registered AIF, to be used as an additional vehicle for facilitating restructuring / recovery of the debt acquired by the ARC and a meaningful turnaround of the borrower. The enabling power under Section 10(2) of the Act may be utilised for this purpose.

D.2.6. As discussed above, aggregation of debt is critical in resolution of stressed assets. As per the current regulations, if 75% (by value) of lenders decide to accept an offer by an ARC, the remaining banks are obligated to accept the same. With a view to improve aggregation of debt and align with the IBC majority voting threshold i.e. 66%, the Committee recommends that the above threshold of 75% may be reduced to 66%. Further, the regulation may also prescribe a timeline of say, 60 days from the date of approval by majority lenders (66%), by which remaining lenders should comply. 100% provisioning on the loan outstanding should be mandated if any lender fails to comply with this requirement.

D.2.7. Debt aggregation is typically a time-consuming process. Stakeholders have highlighted that ARCs require time in excess of two to three quarters for aggregation of debt. The probability of success of a resolution plan without such necessary aggregation in place will be low. Current regulation requires that a resolution plan be formulated within six months of the acquisition of financial assets, without consideration of conditions precedent. While the requirement of planning period may not be kept open subjectively, the period currently permitted to formulate a resolution plan appears inadequate. The planning period may need elongation to reasonably allow for preconditions for effective planning to be satisfied. The Committee recommends that the planning period may be elongated to one year from the existing six months to allow for preconditions for effective planning to be put in place.

D.2.8. At the same time, it is necessary the ARC utilises this planning period meaningfully. It accordingly recommends that, for individual ARC exposures above a threshold, say, Rs.500 crore, a resolution plan that involves any restructuring of debt must satisfy a viability assessment analogous to that prescribed under the Prudential Framework for Resolution of Stressed Assets, i.e. an independent credit evaluation (ICE) by an authorised CRA with a credit opinion of RP4 or better for the residual debt.

D.2.9. Further, for effectiveness of resolution plan formulated by ARCs, in cases where an ARC has acquired 66% of aggregate debt pertaining to a borrower, the Act should provide for a two-year moratorium on proceedings against the borrower by other authorities. The Act should also provide that Government dues including revenues, taxes, cesses and rates due to the Central Government, State Government or local authority will be deferred in such cases.

Recommendations*:*

(a) *If 66% of lenders (by value) decide to accept an offer by an ARC, the same may be binding on all lenders and must be implemented within 60 days of approval by majority lenders (66%). 100% provisioning on the loan outstanding should be mandated for a dissenting lender who fails to comply with this requirement.*

(b) *Planning period may be elongated to one year from the existing six months to allow for preconditions for effective planning to set in.*

(c) *For individual ARC exposures above a threshold, say, Rs.500 crore, a resolution plan that involves any restructuring of debt must satisfy a viability assessment along the lines prescribed under RBI's Prudential Framework for Resolution of Stressed Assets, i.e. an independent credit evaluation (ICE) by an authorised CRA with a credit opinion of RP4 or better for the residual debt.*

(d) *In cases where ARCs have acquired 66% of debt of a borrower, Act should provide for two years of moratorium on proceedings against the borrower by other authorities. The Act should also provide that Government dues including revenues, taxes, cesses and rates due to the Central Government, State Government or local authority will be deferred in such cases.*

D.2.10. A restructuring exercise through debt to equity conversion leads to lenders holding equity in the borrower company alongside the debt. However, under the current regulatory and legal framework, only debt can be assigned to ARCs and therefore, in such cases, only partial interest (debt) in the borrower company is assigned to ARCs. The Committee believes that in the interest of better value realization for selling lenders and enhancing the effectiveness of ARCs in asset reconstruction, even the equity pertaining to a borrower company should be allowed to be sold by lenders to ARCs which have acquired the borrower's debt.

Recommendation:

For better value realization for selling lenders and enhancing the effectiveness of ARCs in asset reconstruction, both debt and equity pertaining to a borrower may be allowed to be sold by lenders to ARCs with suitable checks and balances.

D.2.11. While ARCs as secured creditors are allowed to resolve their financial assets through the IBC process, the current regulatory and legal framework does not allow them to act as Resolution Applicants (RA) under IBC. The fundamental reason behind the same is that the legal and regulatory design of ARCs is focused on recovery of debt from the borrower and not on resolution of the borrower's insolvency. At the same time, the Act does provide tools to ARCs which could be used for insolvency resolution (e.g. change in/takeover of management, debt to equity conversion, etc). However, as mentioned earlier, ARCs, in general, have not been using these tools. Envisaging ARCs as a prime vehicle for resolution of stressed assets, the regulations should allow ARCs to also use the IBC framework for this purpose. This can be facilitated by allowing ARCs to participate as a RA. Expertise acquired through IBC in resolving borrower insolvency will help ARCs in maximising recovery of dues. However, the ARC should remain asset-light in order to avoid conflict of interest in resolution of assets acquired in the trusts managed by them vis-à-vis acquired in their own balance sheet. Therefore, the Committee recommends that ARCs may be allowed to participate as RA, only in their capacity as SR trustees, or through their sponsored AIFs.

While permitting ARCs to set up AIFs for enhancing asset recovery and participate in insolvency resolution under IBC it would be necessary to ensure that they continue to focus on financial asset reconstruction as envisaged under the Act. Accordingly, a principal business requirement (PBR) should be made applicable to ARCs. PBR should be in terms of AUM by ARCs wherein AUM by the ARC acquired through AIF and IBC should not together exceed the AUM acquired via SR issuance at any time.

Recommendation:

In order to enhance ARCs' ability to be a prime vehicle for resolution, they may be allowed to participate in IBC as a Resolution Applicant either through their SR trust or through the AIF sponsored by them. This is subject to the condition that AUM by the ARC acquired through AIF and IBC should not together exceed the AUM acquired via SR issuance at any time.

D.2.12. Section 9(1)(b) of the Act provides for the sale or lease of a part or whole of the business of the borrower as a measure for asset reconstruction. However, RBI guidelines indicate that no ARC shall take this measure, until the RBI issues necessary guidelines in this behalf. RBI is yet to issue guidelines in the matter. Operationalizing Section 9(1)(b) would require guidelines to be issued by RBI under Section 9(2) of the Act.

Recommendation:

Suitable guidelines to operationalize Section 9(1)(b) of Act may be issued by RBI.

D.2.13. In the above context, Section 13 of the Act allows 'secured creditors' to enforce security interest only in respect of assets classified by them as NPAs. While RBI has issued guidelines on asset classification of stressed assets on the ARCs' own balance sheets, it has not issued any such guidelines on asset (specifically NPA) classification of assets held in trust structures managed by the ARC, such as the SR trusts or any other structure managed by the ARC. This is a regulatory grey area which could impede ARCs from enforcing security interest in fit cases, in respect of assets managed by them but not held on their own balance sheet. A case in point is SMA assets acquired by SR trusts for reconstruction purposes.

RBI may consider issuing guidelines under Section 2(1)(o)(b) of the Act for classification of assets managed by ARCs but not on their balance sheets. Since the classification is required only for the purpose of enforcement of security interest, it would suffice to distinguish between 'standard' assets and NPAs. Neither sub-classification of NPAs nor provisioning would be necessary.

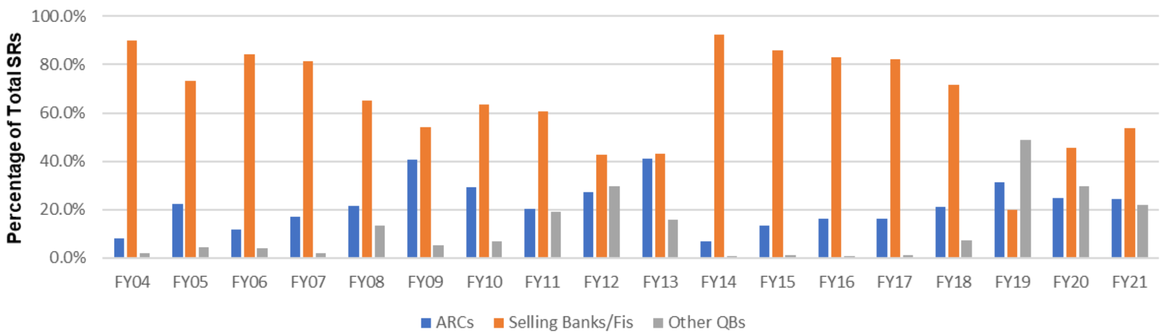
Recommendation:

RBI may consider issuing guidelines under Section 2(1)(o)(b) of the Act for 'standard' / NPA classification of assets managed by ARCs but not on their balance sheets.

Chapter E. Liquidity and Trading of Security Receipts

E.1. A vibrant secondary market for SRs is essential for many reasons. It is a prerequisite for providing an easy exit to QBs and to thereby attract more investors. Increased investor participation may also facilitate better price discovery in the stressed assets market. All this may, in turn, motivative lenders to sell stressed assets at an earlier stage and ARCs to attempt faster resolution. In this connection, SEBI has issued listing guidelines for the SRs vide Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) (Amendment) Regulations, 2018 dated June 26, 2018. However, despite availability of the listing framework, listing and consequent trading of SRs through the exchanges has not taken off. For all practical purposes, there is no secondary market for SRs. Data shows that the majority of the outstanding SRs are either being held by selling lenders as sale consideration or by the ARCs themselves due to regulatory requirement. Chart E1 below provides the distribution of SRs, issued in a financial year, among selling lenders, ARCs and other QBs. Overall 65.7% of total SRs were held by selling lenders, followed by 19.9% by ARCs and only 14.4% of total SRs were held by other QBs.

Chart E1- SRs held by certain class of QBs
(as a percentage of Total SRs issued in a FY)



Source: Data submitted by all ARCs and RBI Staff calculations

E.2. One of the reasons behind lack of trading in SRs is the nature of the SR itself. There is no definitive obligation on the part of ARCs as trustees to redeem the SRs issued. ARCs are only obligated to distribute whatever is recovered from the underlying debt. However, SRs do provide a possibility of high return through upside if ARCs can make recovery above the nominal value of SRs issued[7]. Data shows that

[7] Nominal value of SRs issued is typically equal to the acquisition cost of underlying debt

the upside provided by ARCs has been low and a significant portion of the same has been going to ARCs themselves. Overall upside achieved by ARCs stood at 4.44% of the total SRs issued for the period FY04-FY21. As mentioned earlier, even the redemption of SRs has not been very encouraging. Therefore, the lack of obligation to redeem the SRs and inability of ARCs to generate significant upside makes SR investment more risky and thereby limits its uptake. In the preceding chapters, the Committee has recommended various measures to strengthen the ARCs' ability to resolve the underlying stressed assets which will facilitate greater redemption and upside. Recommendations have also been made for realistic price discovery. It is expected that these recommendations will allow ARCs to generate attractive returns for SR investors and thereby help bring vibrancy in the secondary market for SRs.

E.3. In the matter of sharing of upside by qualifying buyers (QBs) and ARCs, the data shows a significant change in trend. During the period FY04-FY13 upside income was equally distributed among ARCs and other QBs. However, during FY14-FY21 overall 73.4% of upside seems to have gone to other QBs. This change can be explained by increased participation by varied classes of QBs. FPIs were allowed to make 100% investment (subject to regulatory cap) in the SRs issued by ARCs vide notification dated October 27, 2016. Further, through various notifications[8], AIFs of all categories have been notified as QBs by RBI and QIBs by SEBI. Further, as explained earlier, various new classes of selling FIs have also emerged in the last few years which may be subscribing to SRs pertaining to the financial assets they themselves would have sold. The change in the pattern of distribution of upside may also be indicative of change in the nature of contracts being executed between the ARCs and QBs. New classes of investors seem to extract better value from the SRs they invest in. The Committee believes that broad basing the QBs in itself may act as a catalyst for stimulating the secondary market for SRs. Therefore, to increase the investor base of SRs, the Committee recommends that the list of eligible QBs may be further expanded to include HNIs with minimum investment of Rs.1 crore, corporates (net worth-Rs.10 crore & above), NBFCs (including HFCs) even if not notified as FIs, trusts, family offices, pension funds, distressed asset funds with the condition that defaulting promoters should not be gaining access to secured assets through SRs. A further

[8] RBI Notification – March 10, 2021, May 16, 2018; SEBI Notification - August 3, 2012

safeguard would be to prohibit corporates from investing in SRs issued by ARCs which are related parties.

***Recommendation*:**

In order to broaden the investor base of SRs, the list of eligible qualified buyers may be further expanded to include HNIs with minimum investment of Rs.1 crore, corporates (Net Worth-Rs.10 crore & above), NBFCs/ HFCs which are not notified as FIs, trusts, family offices, pension funds, distressed asset funds with the condition that (a) defaulting promoters should not be gaining access to secured assets through SRs and (b) corporates cannot invest in SRs issued by ARCs which are related parties as per SEBI definition.

E.4. Another factor limiting the uptake of SRs seems to be the regulatory prescription whereby ARCs are required to invest in minimum 15% of SRs issued in each class under each scheme, even if there are other investors (i.e. other than selling lenders) investing in SRs issued by the trust. This requirement acts as a hindrance for participation by such QBs who may desire to hold, say, 100% of the SRs issued. Effectively, this regulation hinders willing and sophisticated risk takers from taking the risk they desire to take. Therefore, investor protection, for which this 'skin in the game' requirement exists, should be weighed against the need for distribution of risk among the willing risk takers. A balance between these two competing needs is required. Further, there is also a need to free up the ARC balance sheets, to enable participation in more deals. In order to leverage the existing capital of ARCs and enable more investor participation, the Committee recommends the following amendments to current regulations:

(a) For transactions on 100% cash basis, minimum contribution by an ARC may be reduced to 2.5% of total SRs issued in each class and scheme. Also, current regulation on the resolution period (i.e., maximum period of 8 years) may not be required for acquisitions where lenders get exit, i.e., do not hold any SR in respect of the asset sold by them.

(b) For transactions where lenders subscribe to SRs, the minimum contribution may be reduced to 15% *of the SRs subscribed by lenders* subject to a minimum of 2.5% of total SRs issued, in each class/scheme.

Illustrative examples –

Example 1

Total value of SRs issued	Rs.100
Investment in SRs by selling bank/ FI	Rs.40
Existing Guidelines: ARC's investment in SRs	Rs.15 (15% of purchase consideration)
Recommendation:	
Memo: 15% of Investment in SRs by selling bank/ FI	15% of Rs.40 =Rs.6
Memo: 2.5 % of total value of SRs issued	2.5% of Rs.100 = Rs.2.50
ARC's investment in SRs	Rs.6 (higher of Rs.6 and Rs.2.50)
Therefore, investment in SRs by investor	Rs.54

Example 2

Total value of SRs issued	Rs.100
Investment in SRs by selling bank/ FI	Rs.0
Existing Guidelines: ARC's investment in SRs	Rs.15 (15% of sale consideration)
Recommendation:	
Memo: 15% of Investment in SRs by selling bank/ FI	15% of Rs.00 =Rs.0
Memo: 2.5 % of total value of SRs issued	2.5% of Rs.100 = Rs.2.50
ARC's investment in SRs	Rs.2.50 (higher of Rs.0 and Rs.2.50)
Therefore, investment in SRs by investor	Rs.97.50

Apart from their minimum required investment in SRs, ARCs should be free to divest the remaining investment in SRs to QBs. Further, if an ARC ceases to be a manager/ trustee of an ARC scheme (e.g. as envisaged in para. D.1.16. ibid), it should be permitted to divest its entire investment in SRs of that scheme if it so desires. However, the extant regulations (para 5, proviso (iii) of the SC/RC Guidelines/Directions, 2003) stipulate that an ARC shall continue to hold the amount invested in SRs invested in SRs under each scheme until the redemption of all SRs issued under the scheme. It needs to be clarified that the holding requirement is only in respect of the minimum required investment and not the entire investment. Further, the minimum required investment in SRs under any scheme needs to be held by the ARC only so long as it is a manager/ trustee of the underlying assets in any scheme.

Recommendations:

For all transactions, minimum investment in SRs by an ARC, per SR class/scheme, should be 15% of the lenders' investment in SRs or 2.5% of the total SRs issued, per SR class/scheme, whichever is higher.

The minimum required investment may be held by the ARC only so long as it is a manager/trustee of the underlying assets in any scheme. Any investment in excess of the required minimum may be divested at any time.

E.5. Further, deepening of the SR market would not only require ARCs to generate attractive returns for their investors but also adequate historical return data for the consumption of prospective investors. We believe suitably anonymised disclosures on scheme wise returns would help ARCs to garner investments from the broader set of QBs being suggested by the Committee. These disclosures would also help foster healthy competition among ARCs and nudge ARCs to focus on resolution of assets to achieve better returns for investors. The Committee therefore recommends that the offer document for soliciting investment in SRs and its subsequent update, if any, should indicate the track record of the ARC for at least 10 years. The track record should, inter alia, have information on return, rating migration and rating agency of past schemes.

Recommendation:

Document (Offer Document or Prospectus as the case may be) for soliciting investment in SRs and its subsequent updates, if any, shall indicate at least a 10-year track record of the ARC. Track record, among other things, shall have information on return, rating migration and rating agency of past schemes.

E.6. Regulation should endeavour to create a level playing field to encourage participation of various classes of investors. It is observed that AIFs and FPIs, two eligible classes of QBs, are getting different regulatory treatment. All categories of AIFs set up as trusts have been notified as QBs by RBI vide notifications dated May 16, 2018 and March 10, 2021. These notifications put certain conditions on AIFs for investing in the SRs. One such condition is that the AIFs which have invested in an ARC shall not invest in the SRs issued by that ARC. Comparatively, no such condition has been imposed on investment by FPIs. Further, 100% FDI has been permitted into the ARC sector through automatic route. These stipulations have led to a non-level playing field for AIFs vis-à-vis FPIs. Regulation currently seems to allow global players who own and control an ARC (i.e. FDI investment) invest through their FPIs in the SRs issued by such ARCs, while such investment is prohibited for AIFs set up as trusts.

Recommendation:

RBI may suitably amend the participating conditions governing AIF and FPI investment in SRs to create a level playing field.

Chapter F. Other Matters

F.1. General Matters of Importance

F.1.1. The level of shareholders' equity acts as a barometer of the financial strength of a company. Shareholders' equity provides protection against losses and makes a company less reliant on external funding. An appropriate level of shareholders' equity also determines a company's ability to expand its business activities. ARC regulations prescribe minimum NOF of Rs.100 crore for registration as an ARC. ARCs are also required to meet this criterion on an ongoing basis. NOF is essentially a refined measure of shareholder's equity. Beyond this minimum prescription of NOF, it is desirable that ARCs have a higher level of NOF to meet the requirement of the capital-intensive nature of ARC business. Data as on March 31, 2021 shows clustering of ARCs wherein approximately 75% of the registered ARCs have NOF level between Rs.100-200 crore, 11% have their NOF level above Rs.1500 crore and rest of the ARCs have NOF level between Rs.200-400 crore.

The Committee envisages a wider role for ARCs and expects them to act as the prime vehicle for resolution of stressed assets. In order to measure up to these expectations, ARCs with stronger capabilities would be needed. Accordingly, the Committee recommends that the minimum NOF requirement for an ARC should be augmented to Rs.200 crore. Existing ARCs may be provided a glide path to meet this requirement.

***Recommendation**:*

The minimum requirement of NOF may be increased to Rs.200 crore from the existing Rs.100 crore. Existing ARCs may be provided a glide path to meet this requirement.

F.1.2. Government of India (GoI) has announced[9] formation of an ARC, namely National Asset Reconstruction Company Limited (NARCL), for cleaning the books of PSBs. This has added an interesting dimension to the prospective functioning of the ARCs and the overall ARC ecosystem. GoI has proposed an ARC and an Asset Management Company to consolidate and take over the existing stressed debt of

[9] Press release dated July 19, 2021, Ministry of Finance, Government of India

PSBs and then manage and dispose of the assets to AIFs and other potential investors for eventual value realization.

While a more nuanced perspective on the NARCL must await further official details, the Committee is of the view that there must be fair competition between the NARCL and private ARCs to promote the objectives of true price discovery through the market mechanism.

***Recommendation*:**

In respect of the proposed NARCL by Government of India for cleaning the books of PSBs, RBI should ensure fair competition between the NARCL and private ARCs to promote the objectives of true price discovery through the market mechanism.

F.2. Governance and transparency

F.2.1. ARCs manage the securitised assets on behalf of QBs and therefore all the decisions as well as matters pertaining to conflict of interest are decided by the ARC's Board and the committees formed by delegation of its power. Furthermore, the recommendations of this Committee envisage a much wider and involved role for ARCs in the reconstruction of financial assets and turnaround of borrowers, especially through the AIF route. This necessitates a high level of governance standards in ARCs. Considering this, the Committee recommends that the current requirement of a majority of Independent Directors, as applicable in the case of debt to equity conversion above a threshold, be made applicable if the ARC sponsors an AIF.

***Recommendation**:*

If an ARC sponsors an AIF, at least half the members of its Board should be independent directors.

F.2.2. The management fee of ARCs as well as the provisioning requirement for SR holders, typically, depend on the NAV of SRs. NAV, in turn, is determined using the rating provided by a SEBI registered Credit Rating Agency (CRA). In order to ensure continuity in engagement of CRAs, it may be made mandatory for ARCs to retain a Credit Rating Agency (CRA) for at least 3 years. If a CRA is changed, both parties must disclose the reason for such change. Assumption and rationale of rating, as indicated by CRAs, may be made available by ARCs to the investors whenever requested.

***Recommendations**:*

***(a)** In order to ensure continuity in engagement of CRAs, it may be made mandatory for ARCs to retain a Credit Rating Agency (CRA) for at least 3 years. If a CRA is changed, both parties must disclose the reason for such change.*

***(b)** Assumption and rationale of rating, as indicated by CRAs, may be made available by ARCs to the investors whenever requested.*

F.2.3. For better assessment of ARCs' performance, the regulatory return requirements may be reviewed to include flow data on relevant parameters of an ARC's functioning. An example is the data depicted in Chart D.4 ibid. Further, ARCs file many periodic returns to various agencies apart from RBI. Some of these include filing with the RoC (as per Companies Act, 2013), NeSL (as per IBC, 2016), CERSAI (as per Act, 2002), etc. Much of the data reported to these agencies is common and overlapping. Additionally, each of these agencies has a unique format for data submission. This creates a duplication of efforts and may lead to inconsistency of data. Therefore, it would be advisable to have a common data staging platform, which would help ensure more synergy and consistency of data definitions between the reporting formats for these agencies and interconnectivity of information between these agencies to ensure consistency of data.

***Recommendations**:*

***(a)** Regulatory return requirements may be reviewed to include flow data on relevant parameters of ARC functioning.*

***(b)** A common data staging platform may be devised that can cater to the periodic returns required by various agencies.*

F.2.4. In the process related to acquisition/ securitisation/ resolution of financial assets, ARCs typically generate three documents- Assignment Agreement (AA), Offer Document (OD) and Trust Deed (TD). Two of these documents, viz. AA and TD, were standardised by IBA during the inception of the sector. Also, at the time, RBI had stipulated certain disclosures in the OD to protect the interest of QBs. These standardised documents/ RBI stipulations still play a pivotal role in these processes.

As a principle, the modalities of a contract are best left to the parties concerned especially when they are sophisticated and capable enough to protect their own interest. However, due to apprehensions about information asymmetry, foreign investors appear to draw comfort if these documents are standardised in some manner with embedded investor protection features. Therefore, guidance through standardised documents that embed features for investor protection may help the ARC sector to be more effective in attracting a varied set of investors and also in effecting better resolution. Therefore, IBA may review the AA and TD and update the same to reflect the changes and expectations of the sector. SLMA may also be appropriately engaged for standardisation of documentation.

***Recommendation**:*

IBA may review Assignment Agreement and Trust Deed templates and update the same to reflect the changes and expectations of the sector. SLMA may also be appropriately engaged for standardisation of documents.

F.3. Operational Efficiency

F.3.1. Current regulations allow ARCs to deploy their surplus funds, in terms of a policy framed in this regard by their Board, only in Government securities and deposits with scheduled commercial banks, SIDBI and NABARD. These restricted investment opportunities generate low returns for ARCs and also result in inefficient cash management. The Committee recommends that avenues for deployment of surplus funds on the ARC's balance sheet may be widened to include a variety of short-term instruments such as cash equivalents, money market instruments, commercial paper or other short-term debt obligations, money market mutual funds and certificates of deposit maturing within one year from the date of acquisition**.**

Recommendation:

The avenues for deployment of surplus funds on the ARC's balance sheet may be widened to include a variety of short-term instruments such as cash equivalents, money market instruments, commercial paper or other short-term debt obligations, money market mutual funds and certificates of deposit maturing within one year from the date of acquisition.

F.3.2. Section 2(1)(zh) of the Act defines a *Sponsor as any person holding not less than 10% of the paid-up equity capital of an ARC*. Further, Section 3(3)(f) of the Act empowers RBI to specify fit and proper criteria for Sponsors. Accordingly, *Master Direction dated October 25, 2018 on fit and proper criteria for sponsors* has been issued by RBI. Due diligence on Sponsors at the time of registration of an ARC as well as on an ongoing basis is done based on criteria indicated therein. Through the process of due diligence, the sponsors' integrity, reputation, track record and compliance with applicable laws and regulations is assessed apart from their sources and stability of funds. While the objective of due diligence on the sponsors is indeed needed for promoting the robustness of the ARC sector, it is felt that the 10% threshold is too low for this purpose and increases the regulatory burden on the ARCs without a commensurate governance benefit. The Committee therefore, recommends increasing the threshold of shareholding for recognising a sponsor to 20%**.** This will be consistent with the level of shareholding corresponding to the rebuttable presumption of 'significant influence' specified in Ind AS 28. This will allow ARCs to raise additional equity from strategic and foreign sources and attract more capital to the sector with less regulatory burden. However, this recommended increase in threshold increases the possibility that an ARC may not have a 'sponsor' if shareholding is structured in a particular manner, i.e., an ARC may distribute shareholding in such a manner that shareholding by each of the shareholders is below the 20% threshold. This may defeat the regulatory objective of ensuring fit and proper sponsors. Therefore, identification of at least one sponsor may be made mandatory, irrespective of levels of shareholding.

***Recommendation*:**

In the interest of reducing regulatory burden on ARCs and thereby allow them to efficiently raise equity from strategic and foreign sources, the threshold level of shareholding for recognizing a sponsor may be increased to 20% from the current 10% through amendment to the Act. To curtail the consequent perverse incentive to peg each member's shareholding below 20%, identification of at least one sponsor may be made mandatory.

F.4. Streamlining of Legal Provisions and Processes

F.4.1. In terms of Section 13(1) of the Act, any security interest created in favour of any *secured creditor* may be enforced, without judicial intervention, by such creditor in accordance with the provisions of the Act. The definition of "secured creditor" in Section 2(1)(zd)[10] of the Act restricts such creditors to only those (listed in the definition) *in whose favour the security interest is created by the borrower*. A legal question has arisen as to whether ARCs are 'secured creditors', enjoying enforcement rights under Section 13 of the Act, in respect of the secured financial assets acquired from such entities which do not have enforcement rights under the aforesaid Section. Perusal of court judgments in the matter reflects that grant of such rights to ARCs has interpretational issues. Some judgments are indicative of conferring this right on ARCs whereas others are not. There seems no justification to fetter ARCs' ability to enforce security interest, particularly as they are well regulated, have mandatory reconstruction policies and are bound by the Fair Practices Code. Therefore, in the interest of efficient recovery of debt by ARCs, the Act should be amended to clarify that an ARC to whom a secured debt is assigned shall be a "secured creditor" under the Act, and therefore have enforcement rights under Section 13 of the Act, *even if the assignor did not enjoy enforcement rights under Section 13 of the Act.* To this end, the definition of "secured creditor" under the Act may be modified by amending the closing clause in Section 2(1)(zd) as follows: "in whose favour security interest is created by any borrower for due repayment of any financial assistance *or transferred pursuant to assignment, transfer, transmission, etc. of any financial assistance.*"

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[10] Currently Section 2(1) (zd) is as follows- "secured creditor" means-

(i) any bank or financial institution or any consortium or group of banks or financial institutions holding any right, title or interest upon any tangible asset or intangible asset as specified in clause (l);
(ii) debenture trustee appointed by any bank or financial institution; or
(iii) an asset reconstruction company whether acting as such or managing a trust set up by such asset reconstruction company for the securitisation or reconstruction, as the case may be; or
(iv) debenture trustee registered with the Board and appointed for secured debt securities; or
(v) any other trustee holding securities on behalf of a bank or financial institution,

in whose favour security interest is created by any borrower for due repayment of any financial assistance

Recommendation:

In the interest of efficient recovery of debt by creditors, the Act may be amended to ensure that enforcement rights under Section 13 of the Act would be available to an ARC to which a secured financial asset is assigned, irrespective of the availability of enforcement rights with the assignor under Section 13 of the Act. For this purpose, the definition of "secured creditor" under Act may be modified by amending the closing clause in Section 2(1)(zd)(vi) as follows : "in whose favour security interest is created by any borrower for due repayment of any financial assistance or transferred pursuant to assignment, transfer, transmission, etc. of any financial assistance."

F.4.2. Section 13(4)(b) of the Act empowers secured creditors to take over the management of the business of a borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset in case the borrower fails to discharge his liability. A proviso to this section indicates that the right to transfer by way of lease, assignment or sale shall be exercised only where the "substantial part of the business" of the borrower is held as security for the debt. However, Act does not define the parameter for determining "substantial part of business". Stakeholders have highlighted that lack of objective determination of "substantial part of business" has made it difficult for the ARCs to take over the management. Therefore, for the purpose of bringing clarity to the meaning of security being substantial part of business and thereby making the takeover of management practically achievable, an explanation under Section 13(4)(b) of Act may be added. Security for the purpose of this sub-Section can be evaluated to be "substantial part of business" if such security was responsible for generation of at least 20% revenue of the business in the preceding financial year or the current market value of such security as determined by an external valuer is more than the 50% of total assets of borrower as per the last audited balance sheet.

Recommendation:

For the purpose of bringing clarity to the meaning of security being a "substantial part of business" and thereby making the takeover of management practically achievable, an explanation under Section 13(4)(b) of Act may be added. One possible manner it can be explained is as follows:

Security for the purpose of this sub-Section can be evaluated to be a "substantial part of business" if such security was responsible for generation of at least 20% revenue of the business in the preceding financial year or the current market value of such security as determined by an external valuer is more than the 50% of total assets of the borrower as per the latest audited balance sheet.

F.4.3. The ARC sector has highlighted certain difficulties in meeting the requirement of charge modification in terms of the Companies Act, 2013 pursuant to acquisition of NPAs from lenders. The Companies Act, 2013 requires a borrower to sign and file the CHG 1 form within 30 days of modification in charge. However, the filing is delayed due to lack of co-operation from the borrowers. In many cases, the defaulting borrowers try to take delay matters by dragging ARCs into unnecessary litigation, thereby preventing them from enforcing their rights in respect the assets assigned to them. The inability/ delay in modifying these charges results not only in non-compliance but also in displaying incorrect information in respect of charges and thereby retarding ARCs' resolution efforts. There has also been a steep increase[11] in the fees payable on delay in modification of charge and, hence, such delays result in payment of exorbitant penalties. Further, the time given to register a modification of charge has been limited to 120 days and any further delay is not condoned.

Further, Section 77(3) of the Companies Act, 2013 states that no charge created by a company shall be taken into account by the liquidator appointed under Companies Act or the IBC or any other creditor unless it is duly registered under the Companies Act. Accordingly, this requirement exposes the ARCs to serious legal and financial risk, especially in cases where charge could not be modified in favour of ARCs, thereby leading to ARCs not being treated as a secured creditor by the liquidator.

Considering the difficulty faced by ARCs in modification of charge due to non-cooperative borrowers, GoI may consider carving out a mechanism for automatic transfer of charge without borrower's consent when lenders sell assets to an ARC.

[11] Pursuant to amendment dated 30th April 2019 to Companies (Registration Offices and Fees) Rules, 2014 (with effect from 1st August 2019)

Recommendation:

Considering the difficulty faced by ARCs in modification of charge due to reasons mentioned above, GoI may consider carving out a mechanism for automatic transfer of charge without borrower's consent when a lender sells assets to an ARC.

F.4.4. ARCs have highlighted the following difficulty with respect to SEBI regulations: As per Regulation 10(1)(b)(viii) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, invocation of pledge by scheduled commercial banks or public financial institutions as a pledgee is exempted from open offer requirements.

SEBI amended the ICDR Regulations, 2018 and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 in March 2019 to incorporate changes as RBI had withdrawn its previous debt restructuring schemes such as CDR, SDR, S4A, etc. After the amendment, SEBI defined "lenders" under Regulation 158(6) of SEBI ICDR Regulations and Regulation 10(1)(i) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 as all SCBs (excluding RRBs) and AIFIs.

Considering that ARCs, as pledgees of shares offered as security, may require the above dispensations for their debt restructuring activities, the Committee recommends that SEBI may (a) extend the exemption from open offer requirements, for invocation of pledge, to ARCs as well, in line with the exemption enjoyed by SCBs and public financial institutions under Regulation 10(1) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and (b) also modify the explanation of 'lenders' in Regulation 158(6) of SEBI ICDR Regulations and Regulation 10(1)(i) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 to include ARCs.

Recommendation:

The Committee recommends that SEBI may extend the exemption from open offer requirements, for invocation of pledge, to ARCs in line with by SCBs or public financial institutions under Regulation 10(1) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

Further, SEBI may also modify the explanation of 'lenders' in Regulation 158(6) of SEBI ICDR Regulations and Regulation 10(1)(i) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 to include ARCs.

F.5. Taxation

F.5.1. Various stakeholders have suggested changes/more clarity in the extant taxation provisions with respect to investment in the SRs issued by the ARCs. One of the matters pertains to the pass-through regime for AIF income from investment in SRs. AIFs as QBs invest in the security receipts issued by ARC trusts. Under the income-tax law, the ARC trusts enjoy a complete pass-through status and the income is taxable in the hands of the investors based on the characterization that is determined by the ARC trust. Typically, the ARC trust characterizes the income as 'business income'. The AIF loses its otherwise tax transparent status if it earns a business income and such income is taxed at the AIF level at the maximum marginal rate, i.e., at an effective tax rate 42.74%. The Committee proposes that all income from investment in SRs issued by ARC trusts earned by an AIF should also be considered as pass through and taxable in the hands of the investors of the AIF. The possibility of a 42.74% tax at the AIF level is a deterrent for this investment to flow into ARC trusts. Large pools of capital are required for large resolutions by ARCs. Hence a pass-through regime for AIF income from investment in SRs issued by an ARC Trust is critical to the success of a competitive market for these NPAs and for maximization of recovery for the ARC.

F.5.2. The other matter pertains to clarity on the tax rate applicable to FPIs when they invest in the SRs issued by ARC trusts. Under the income-tax law, no specific tax rate is mentioned for taxability of interest income or upside received by FPIs from their investment in the SRs. Presently, a concessional tax regime of 5% exists for taxability of income arising to FPIs and other non-residents (on Government securities, corporate bonds, ECB, etc.), subject to satisfaction of certain conditions. A similar tax treatment may be provided for interest income earned by FPIs from investment in SRs. Also, it may be clarified that any upside arising as business income may be taxed at the rate of 20% (as it is in the nature of income in respect of securities under Section 115AD of Income Tax Act). Given the risky nature of the investment in SRs as also the fact that significant foreign money is needed to resolve the NPAs in the Indian financial sector, it is essential that tax certainty is provided to foreign investors. The proposed changes will incentivize flow of FPI investment in SRs and help in resolution of bad loans.

***Recommendation*:**

Govt. of India may look into the matters given below for appropriate clarification/amendment in the extant tax provisions:

(a) *Similar to 'investment income', all income from investment in SRs issued by ARC trusts earned by an AIF should be considered as pass through and taxable in the hands of the investors of the AIF;*

(b) *Clarity on the tax rate applicable to FPIs when they invest in the SRs issued by ARC trusts: The concessional tax regime of 5% existing for taxability of income arising to FPIs and other non-residents (on Government securities, corporate bonds, ECB, etc.), may be also provided for interest income earned by FPIs from investment in SRs. Also, it may be clarified that any upside arising as business income may be taxed at the rate of 20% (as it is in the nature of income in respect of securities under Section 115AD of Income Tax Act).*

Chapter G. Summary of Recommendations

Sn	Recommendations (Action-taking agencies in parentheses)
	Chapter C- Extant Legal and Regulatory Framework for ARCs
1	The various guidelines applicable to ARCs may be consolidated into a single set of Master Directions, which may be updated as and when regulatory changes are made. (**RBI**)
	Chapter D.1- Acquisition and securitisation of Financial assets
2	RBI may provide a dispensation to lenders on an ongoing basis for amortising the loss on sale of NPAs to ARCs, over a period of two years. (**RBI**)
3	When substantial investment in SRs (say 51% or more) is by investors other than the lenders, provisioning on SRs held by the lenders may be done based on net asset value declared by the ARC. The threshold of 51% may be applicable for two years and increased to 76% thereafter. (**RBI**)
4	It may be clarified that all categories of Special Mention Accounts can be considered for sale to ARCs. To protect the interest of borrowers, suitable safeguards may be provided through regulatory prescription on enforcement of security interest. (**RBI**)
5	At the beginning of the year, all regulated lenders, and not just banks, should make a list of such NPAs which they intend to sell/ auction to eligible entities, including ARCs. The list should be disclosed to all ARCs on entering into a confidentiality agreement. Data / information on such assets should be kept ready and updated on an on-going basis (live updated memorandum). (**RBI**)
6	Lenders' Board approved policies for resolution of stressed assets must include a policy on sale of stressed assets to ARCs, indicating the circumstances and parameters that will be considered for such a sale. (**RBI**)
7	For accounts in default with a lender for amount of Rs.100 crore and above, (i) lender's resolution plan should explicitly evaluate sale/ auction of NPAs to ARCs as one of the options; (ii) In case of NPAs which are more than two years old and no active resolution plan is in place and if such accounts are not included in the list as indicated at para 5 above, the reason for their exclusion should be documented. (**RBI**)

8	Sale of fraud accounts to ARCs may be permitted subject to appropriate safeguards to ensure that fixing of accountability at lender level and criminal inquiry by competent authorities are not affected by this sale. (**RBI**)
9	In the interest of debt aggregation, ARCs may be allowed to also acquire stressed loans to domestic borrowers from regulated overseas banks and financial institutions. (**RBI & GoI**)
10	Via a regulation, SLMA may provide lenders with a suitable comprehensive checklist on necessary information to be given to ARCs at pre-deal stage for due diligence and deal evaluation. Further, data room should be open for a minimum of 30 days after all information is furnished. **(RBI, SLMA**)
11	Via a regulation, the IBA may provide a model process document to lenders for ensuring certainty and transparency of auctions conducted by them. Also, for the purpose of ensuring transparency and uniformity of processes in sale of stressed assets, a separate online platform may be established. Infrastructure created by SLMA may be utilised for this purpose. (**RBI, IBA, SLMA**)
12	In the bidding process followed by banks/ FIs, for all financial assets of Rs.500 crore and above, two bank-approved external valuers should carry out the valuation exercise of liquidation value and fair market value. For financial assets between Rs.100 crore to Rs.500 crore, one valuer may be engaged. The determination of the Reserve Price should be influenced by the external valuations. Further, the final approval of the Reserve Price should be given by a high-level committee that has the power to write off the loan. (**RBI**)
13	The scope of Section 5 of the Act, and other related provisions, may be expanded to allow ARCs to acquire 'financial assets' as defined in the Act, for the purpose of reconstruction, not only from banks and 'financial institutions' but also from such entities as may be notified by the Reserve Bank. Under these proposed powers, Reserve Bank may consider permitting ARCs to acquire financial assets from all regulated entities, including AIFs, FPIs, AMCs making investment on behalf of MFs, all NBFCs (including HFCs) irrespective of asset size and from retail investors. (**RBI & GoI**)
14	The regulations should permit a change in the SR trustee/ asset management role from one ARC to another, without necessarily extinguishing the SRs.

	Any acquisition of management/ trusteeship of a financial asset by an ARC from another ARC must have the approval of a majority, by value, of the SR holders concerned or such other prescribed threshold as may be defined by the subscription agreement/ trust deed. It may be clarified that any ARC acquiring trusteeship/management from another ARC, where the SRs are not extinguished, will be required to purchase the associated SRs to the extent of the prescribed minimum threshold. (**RBI**)
Chapter D.2- Measures for Reconstruction of Financial Assets	
15	Given the limitation of traditional sources of financing for resolution of stressed assets, as a way forward, ARCs should be allowed to sponsor a SEBI registered AIF, to be used as an additional vehicle for facilitating restructuring / recovery of the debt acquired by the ARC and a meaningful turnaround of the borrower. The enabling power under Section 10(2) of the Act may be utilised for this purpose. (**RBI**)
16	If 66% of lenders (by value) decide to accept an offer by an ARC, the same may be binding on all lenders and must be implemented within 60 days of approval by majority lenders (66%). 100% provisioning on the loan outstanding should be mandated for a dissenting lender who fails to comply with this requirement. (**RBI**)
17	Planning period may be elongated to one year from the existing six months to allow for preconditions for effective planning to set in. (**RBI**)
18	For individual ARC exposures above a threshold, say, Rs.500 crore, a resolution plan that involves any restructuring of debt must satisfy a viability assessment along the lines prescribed under the Prudential Framework for Resolution of Stressed Assets, i.e. an independent credit evaluation (ICE) by an authorised CRA with a credit opinion of RP4 or better for the residual debt. (**RBI**)
19	In cases where ARCs have acquired 66% of debt of a borrower, the Act should provide for two years of moratorium on proceedings against the borrower by other authorities. The Act should also provide that Government dues including revenues, taxes, cesses and rates due to the Central Government, State Government or local authority will be deferred in such cases. (**RBI & GoI**)
20	For better value realization for selling lenders and enhancing the effectiveness of ARCs in asset reconstruction, both debt and equity pertaining to a borrower

	may be allowed to be sold by lenders to ARCs with suitable checks and balances. (**RBI**)
21	In order to enhance ARCs' ability to be a prime vehicle for resolution, they may be allowed to participate in IBC as a Resolution Applicant either through their SR trust or through the AIF sponsored by them. This is subject to the condition that AUM by the ARC acquired through AIF and IBC should not together exceed the AUM acquired via SR issuance at any time. (**RBI**)
22	Suitable guidelines to operationalize Section 9(1)(b) of Act may be issued by RBI. (**RBI**)
23	RBI may consider issuing guidelines under Section 2(1)(o)(b) of the Act for 'standard' / NPA classification of assets managed by ARCs but not on their balance sheets. (**RBI**)
Chapter E- Liquidity and Trading of Security Receipts	
24	In order to broaden the investor base of SRs, the list of eligible qualified buyers may be further expanded to include HNIs with minimum investment of Rs.1 crore, corporates (Net Worth-Rs.10 crore & above), NBFCs/ HFCs which are not yet notified as FIs, trusts, family offices, pension funds, distressed asset funds with the condition that (a) defaulting promoters should not be gaining access to secured assets through SRs and (b) corporates cannot invest in SRs issued by ARCs which are related parties as per SEBI definition. (**RBI & SEBI**)
25	For all transactions, minimum investment in SRs by an ARC, per SR class/scheme, should be 15% of the lenders' investment in SRs or 2.5% of the total SRs issued, per SR class/scheme, whichever is higher. The minimum required investment may be held by the ARC only so long as it is a manager/ trustee of the underlying assets in any scheme. Any investment in excess of the required minimum may be divested at any time. (**RBI**)
26	Document (Offer Document or Prospectus as the case may be) for soliciting investment in SRs and its subsequent updates, if any, shall indicate at least a 10-year track record of the ARC. Track record, among other things, shall have information on return, rating migration and rating agency of past schemes. (**RBI & SEBI**)
27	RBI may suitably amend the participating conditions governing AIF and FPI investment in SRs to create a level playing field. (**RBI**)

Chapter F.1- General Matters of Importance	
28	The minimum requirement of NOF may be increased to Rs.200 crore from the existing Rs.100 crore. Existing ARCs may be provided a glide path to meet this requirement. (**RBI**)
29	In respect of the proposed NARCL by Government of India for cleaning the books of PSBs, RBI should ensure fair competition between the NARCL and private ARCs to promote the objectives of true price discovery through the market mechanism. (**RBI**)
Chapter F.2- Governance and transparency	
30	If an ARC sponsors an AIF, at least half the members of its Board should be independent directors. (**RBI**)
31	In order to ensure continuity in engagement of CRAs, it may be made mandatory for ARCs to retain a Credit Rating Agency (CRA) for at least 3 years. If a CRA is changed, both parties must disclose the reason for such change. (**RBI**)
32	Assumption and rationale of rating, as indicated by CRAs, may be made available by ARCs to the investors whenever requested. (**RBI**)
33	Regulatory return requirements may be reviewed to include flow data on relevant parameters of ARC functioning. (**RBI**)
34	A common data staging platform may be devised that can cater to the periodic returns required by various agencies. (**All relevant regulatory agencies**)
35	IBA may review Assignment Agreement and Trust Deed templates and update the same to reflect the changes and expectations of the sector. SLMA may also be appropriately engaged for standardisation of documents. **(RBI & IBA)**
Chapter F.3- Operational Efficiency	
36	The avenues for deployment of surplus funds on the ARC's balance sheet may be widened to include a variety of short-term instruments such as cash equivalents, money market instruments, commercial paper or other short-term debt obligations, money market mutual funds and certificates of deposit maturing within one year from the date of acquisition. (**RBI**)
37	In the interest of reducing regulatory burden on ARCs and thereby allow them to efficiently raise equity from strategic and foreign sources, the threshold level of shareholding for recognizing a sponsor may be increased to 20% from the current 10% through amendment to the Act. To curtail the consequent perverse

	incentive to peg each member's shareholding below 20%, identification of at least one sponsor may be made mandatory. (**RBI & GoI**)
Chapter F.4- Streamlining of Legal Provisions and Processes	
38	In the interest of efficient recovery of debt by creditors, the Act may be amended to ensure that enforcement rights under Section 13 of the Act would be available to an ARC to which a secured financial asset is assigned, irrespective of the availability of enforcement rights with the assignor under Section 13 of the Act. For this purpose, the definition of "secured creditor" under Act may be modified by amending the closing clause in Section 2(1)(zd)(vi) as follows : "in whose favour security interest is created by any borrower for due repayment of any financial assistance or transferred pursuant to assignment, transfer, transmission, etc. of any financial assistance." (**RBI & GoI**)
39	For the purpose of bringing clarity to the meaning of security being a "substantial part of business" and thereby making the takeover of management practically achievable, an explanation under Section 13(4)(b) of Act may be added. One possible manner it can be explained is as follows: Security for the purpose of this sub-Section can be evaluated to be a "substantial part of business" if such security was responsible for generation of at least 20% revenue of the business in the preceding financial year or the current market value of such security as determined by an external valuer is more than the 50% of total assets of the borrower as per the latest audited balance sheet. (**RBI & GoI**)
40	Considering the difficulty faced by ARCs in modification of charge due to reasons mentioned above, GoI may consider carving out a mechanism for automatic transfer of charge without borrower's consent when a lender sells assets to an ARC. (**RBI & GoI**)
41	The Committee recommends that SEBI may extend the exemption from open offer requirements, for invocation of pledge, to ARCs in line with by SCBs or public financial institutions under Regulation 10(1) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. Further, SEBI may also modify the explanation of 'lenders' in Regulation 158(6) of SEBI ICDR Regulations and Regulation 10(1)(i) of SEBI (Substantial

	Acquisition of Shares and Takeovers) Regulations, 2011 to include ARCs. **(RBI & SEBI)**
Chapter F.5- Taxation	
42	Govt. of India may look into the matters given below for appropriate clarification/amendment in the extant tax provisions: (a) Similar to 'investment income', all income from investment in SRs issued by ARC trusts earned by an AIF should be considered as pass through and taxable in the hands of the investors of the AIF; (b) Clarity on the tax rate applicable to FPIs when they invest in the SRs issued by ARC trusts: The concessional tax regime of 5% existing for taxability of income arising to FPIs and other non-residents (on Government securities, corporate bonds, ECB, etc.), may be also provided for interest income earned by FPIs from investment in SRs. Also, it may be clarified that any upside arising as business income may be taxed at the rate of 20% (as it is in the nature of income in respect of securities under Section 115AD of Income Tax Act). **(RBI & GoI)**

Annex I- Meetings held by the Committee

Sl. No.	Date	Internal Meeting/ External Participants Invited
1	April 26, 2021	Internal Meeting
2	May 01, 2021	Asset Reconstruction Company (India) Limited and it's sponsor, Avenue India Resurgence Pte. Limited, Edelweiss Asset Reconstruction Company Limited, JM Financial Asset Reconstruction Company Limited, Assets Care & Reconstruction Enterprise Limited and its sponsor, ARES SSG Capital Management (Singapore) Pte. Limited, Lone Star India Asset Reconstruction Private Limited, ANA ARC Private Limited
3	May 08, 2021	Indian Banks' Association, Finance Industry Development Council, Association of ARCs in India
4	May 15, 2021	AZB & Partners, CRISIL Ratings Ltd, Juris Corp, ICRA Limited, Cyril Amarchand Mangaldas, Acuite Ratings & Research Limited
5	May 22, 2021	State Bank of India, Indian Overseas Bank, IDBI Bank, Bank of Baroda, BSR & CO LLP and S R Batliboi & Co. LLP
6	May 29, 2021	Confederation of Indian Industry, Associated Chambers of Commerce and Industry of India, Yes Bank Limited, Axis Bank Limited, ICICI Bank Limited, Kotak Investment Advisors Limited
7	June 05, 2021	Internal
8	June 10, 2021	Internal
9	June 25, 2021	Internal
10	July 03, 2021	Internal
11	July 10, 2021	AZB & Partners, Federation of Indian Chambers of Commerce & Industry
12	July 14, 2021	Internal
13	July 16, 2021	Internal
14	July 19, 2021	Internal
15	July 21, 2021	Internal
16	July 30, 2021	Internal
17	August 04, 2021	Internal
18	August 05, 2021	Internal
19	August 10, 2021	Internal
20	August 13, 2021	Internal
21	August 22, 2021	Internal

22	August 24, 2021	Internal
23	August 30, 2021	Internal
24	September 04, 2021	Internal
25	September 14, 2021	Internal

Annex II- Important Guidelines issued to ARCs

Sl. No.	Date of Circular	Subject
1	July 01, 2015 Master Circular	The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003
2	July 01, 2015 Master Circular	Change in or Take Over of the Management of the Business of the Borrower by Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines, 2010
3	April 28, 2017	Requirement of Net Owned Fund for ARCs
4	November 23, 2017	Conversion of Debt into Equity - Review
5	January 04, 2018	Submission of Financial Information to Information Utilities
6	October 25, 2018 Master Direction	Fit and Proper Criteria for Sponsors - Asset Reconstruction Companies (Reserve Bank) Directions, 2018
7	June 28, 2019	Permission to acquire financial asset from other Asset Reconstruction Companies
8	December 06, 2019	Acquisition of financial assets by Asset Reconstruction Companies from sponsors and lenders
9	July 16, 2020	Fair Practices Code for ARCs

Annex III- Economic Model on True Value Market for NPAs

Designing a True Value Market for NPAs

Following paragraphs lay down the principles for designing a 'True Value Market for NPA' and make two propositions for it[12].

1. Defining true value market: At the time of NPA sale, both the bank and the ARC estimate the present value of future income streams against the NPA based on financial analysis and scenario building. We call the outcomes of these exercises the 'true value estimates' as per the bank and the ARC. We assume that the ARC's estimate incorporates a reconstruction premium over the bank's estimate, and therefore is greater than the bank's estimate. A 'true value market' is one where the deal value lies in between the estimate of true value by the bank and the estimate of true value by the ARC. The aim of market design has two objectives: a. incentivize true value deals and b. facilitate sufficient risk transfer out of the banking sector through high levels of investment by non-bank entities. In incentivising true value deals, one is especially concerned about avoiding the inflation of acquisition costs over true value. (The under-pricing of NPAs would be prevented by appropriate setting of the reserve price by the bank, and by competition in the course of the NPA auction). While aiming to achieve its twin objectives, the design must keep in mind the necessity of ensuring both parties must perceive gains to trade from the transaction.

2. Design Approach: The cash proportion of the deal and the deal value[13] are the two most important variables determining the attractiveness of the deal for the bank and the ARC. Hence the design approach is to find combinations of cash proportion and deal value that would incentivize both the bank and the ARC to transact. We refer to these as 'feasible' cash proportions and deal values and aim to nudge the market toward those feasible cash proportions and deal values that are consistent with true value transactions and sufficient transfer of risk out of the banking sector.

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[12] The model presented is a variation of the model in Prasad, R. & Mathur, Y, forthcoming, IIMB Management Review.

[13] "Deal value" is same as "cost of acquisition" of an ARC. 'Cash proportion" of the deal means the percentage of 'cost of acquisition' paid as cash to the seller (rest of the consideration is paid through issuance of security receipts)

First, we present the transaction level economics of the ARC to derive combinations of cash proportion and deal value that would incentivize the ARC to transact. This exercise will highlight the critical role of the bank's investment in SRs in facilitating true value deals. It also shows that while this investment is critical, it must be capped at a certain limit to avoid deal inflation.

Next, we present the transaction level economics of the bank to derive combinations of cash proportion and deal value that would incentivize the bank to transact. This exercise will highlight the fact that the current prudential norms with regard to provisioning for SRs held by the lender are not merely unjustified in the case of true value deals, but they can render the NPA market infeasible if they are allowed to persist.

3. Transaction level economics of the ARC and the Role of the Bank's Investment in Securities

3.1. We assume that the ARC makes estimates of the return on investment in the transaction and goes for the deal if the return is greater than the weighted cost of capital. The return on investment is the sum of the return on SRs held by the ARC, and the return on the management fee earned from the bank and the investor.

3.2. The following facts about the ARC's incentives can be derived.

(a) Fact 1: *Other things being equal, the ARC's return is inversely proportional to the deal value*.

The following example illustrates:

Table 1

	Scenario 1: Low Deal Value	**Scenario 2: High Deal Value**
Book Value	Rs.100	Rs.100
Deal Value (*V*)	Rs.30	Rs.36
Cash proportion ARC (*k1*)	15%	15%
Cash proportion External Investor (k2)	36%	36%
Bank investment	49%	49%

ARC investment (*V*k1*)	Rs.4.5	Rs.5.4
External Investor investment (*V*k2*)	Rs.10.8	Rs.12.96
Bank investment	Rs.14.7	Rs.17.64
Bank's Estimate of True Value	Rs.28	Rs.28
ARC's Estimate of True Value (reconstruction premium ~ 42%	Rs.40	Rs.40
ARC's Estimate of Value of SRs Held (A)	15% of Rs.40 =Rs.6	15% of Rs.40 =Rs.6
NPV of Management fees @10% paid by Bank [14](B)	10% of 49% of Rs.28=Rs.1.372	10% of 49% of Rs.28=Rs.1.372
NPV of Management fees @10% paid by External Investor (C)	10% of 36% of Rs.28=Rs.1.008	10% of 36% of Rs.28=Rs.1.008
Total Return to ARC (A+B+C)	Rs.8.38	Rs.8.38
ARC Return on investment (RoI) [Total Return to ARC/ *ARC investment*]	87%	55%
	RoI reduces as deal value increases	

This fact is not a priori obvious. Indeed, some stakeholders are of the view that since the ARC used to earn income mainly from fees, and since fees are directly proportional to deal value, the ARC had an incentive to increase deal value. This could be true for ARCs that wanted to develop high income streams in the early years of existence, without prioritizing returns. However, in general, ARC prefer lower deal values.

(b) Fact 2: *Other things being equal, the ARC's return is inversely proportional to the proportion of investment in SRs*.

The percentage of stake in SRs and hence the earning on SRs is directly proportional to the cash proportion. The investment is also directly proportional to the cash proportion. Hence the return on investment in SRs is independent of the cash

[14] We assume all management fees is estimated on the bank's estimate of true value. We believe our choice of the bank's estimate of true value being the basis for the estimated fees is well aligned to the current market practice of benchmarking fees to NAV.

proportion. The management fees collected from the investor is independent of the ARC's cash proportion[15] while the investment is directly proportional to the cash proportion. Hence the return on management fees collected from the investor is inversely proportional to the cash proportion. The management fees collected from the bank decreases as the ARC's cash proportion increases (and the proportion of SRs held by the bank decreases). Since the investment is directly proportional to the cash proportion, the return on management fees collected from the bank consists of a numerator that is inversely proportional and a denominator that is directly proportional to the cash proportion. Hence the return on management fees is inversely proportional to the cash proportion. In sum, the ARC's return consists of a set of additive terms that are either independent or inversely proportional to the cash proportion. The result follows.

[16] The following example illustrates:

Table 2

	Scenario 1: Low Cash proportion	**Scenario 2**: High Cash proportion
Book Value	Rs.100	Rs.100
Deal Value (*V*)	Rs.30	Rs.30
Cash proportion ARC (*k1*)	15%	20%
Cash proportion External Investor (k2)	36%	36%
Bank investment	49%	44%
ARC investment (*V**k1*)	Rs.4.5	Rs.6
External Investor investment (*V**k2*)	Rs.10.8	Rs.10.8
Bank investment[*V**(1-k1-k2)*]	Rs.14.7	Rs.13.2
Bank's Estimate of True Value	Rs.28	Rs.28

[15] We assume that the increase in cash proportion of the ARC is accompanied by a constant cash proportion of the External Investor and a declining cash proportion of the Bank. A similar proof works if the cash proportion of the Bank stays constant while the cash proportion of the External Investor declines, or if a combination of the above occurs.
[16] Note, this would hold even if the ARC's fees is computed on the basis of the nominal value of SRs as both the nominal value and the investment would be directly proportional to the deal value and would cancel out. This leaves the return on SRs held by the ARC which is inversely proportional to the deal value.

ARC's Estimate of True Value	Rs.40	Rs.40
ARC's Estimate of Value of SRs Held (A)	15% of Rs.40 =Rs.6	20% of Rs.40 =Rs.8
NPV of Management fees @10% paid by Bank (B)	10% of 49% of Rs.28= Rs.1.372	10% of 44% of Rs.28=Rs.1.232
NPV of Management fees @10% paid by External Investor (C)	10% of 36% of Rs.28=Rs.1.008	10% of 36% of Rs.28=Rs.1.008
Total Return to ARC (A+B+C)	Rs.8.38	Rs.10.24
ARC Return on investment (RoI) [Total Return to ARC*/ARC investment*]	87%	70.66%
	RoI reduces as Cash proportion increases	

(c) Fact 3: *Other things being equal, the ARC's return increases with the unit fees, and the reconstruction premium generated by the ARC, and decreases with the cost of capital*. The increase in fees increases the return on the management of securities. An increase in the reconstruction premium increases the redemption proceeds of securities, thus increasing the return on securities held by the ARC.

For any cash proportion it is possible to compute a threshold deal value above which the ARC would not want to transact.

(d) Fact 4: *(i)The threshold deal value decreases with an increase in the cash proportion. (ii)When the ARC's cash proportion is 100%, the ARC would not want to transact at a deal value higher than its estimate of the 'true value' of the security discounted by its cost of capital. (iii) When the cash proportion of the deal is zero, the ARC would be willing to transact at deal values much higher than the true value' of the security, or even the book value.*

(i) Let's say we start with a cash proportion and deal value at which the ARC is indifferent between investing and not investing, ie. we are at a threshold cash proportion and deal value. Suppose we were to increase the cash proportion. From the fact 2, the return would drop, thus disincentivizing the ARC from investing. From the fact 1, in order to restore the ARC's incentives, it would be necessary to reduce the deal value. In other words, the threshold value would need to come down.

The following example illustrates:

Table 3

	Scenario 1: Low Cash proportion	**Scenario 2:** High Cash proportion
Book Value	Rs.100	Rs.100
Threshold Deal Value (*V*)	Rs.46.55	Rs.42.65
Cash proportion ARC (*k1*)	15%	20%
Cash proportion External Investor (k2)	36%	36%
Bank investment	49%	44%
ARC investment (*V**k1*)	Rs.6.9825	Rs.8.53
External Investor investment (*V**k2*)	Rs.16.758	Rs.15.354
Bank investment[*V**(1-k1-k2*)]	Rs.22.8095	Rs.18.766
ARC's Estimate of True Value	Rs.40	Rs.40
ARC's Estimate of Value of SRs Held (A)	15% of Rs.40= Rs.6	20% of Rs.40= Rs.8
Bank's Estimate of True Value	Rs.28	Rs.28
NPV of Management fees @10% paid by Bank (B)	10% of 49% of Rs.28=Rs.1.372	10% of 44% of Rs.28=Rs.1.232
NPV of Management fees @10% paid by External Investor (C)	10% of 36% of Rs.28=Rs.1.008	10% of 36% of Rs.28=Rs.1.008
Total Return to ARC (A+B+C)	Rs.8.38	Rs.10.24
ARC Return on investment [Total Return to ARC/ *ARC investment*]	20%	20%
	As Cash proportion increases, threshold deal value decreases	

(ii) When the *cash proportion is 100%,* the ARC's return is exclusively through security receipts which would be valued as per the true value estimate of the ARC. The rate of return is the true value estimate divided by the deal value. The requirement that this return must be greater than the cost of capital leads to the conclusion. For instance, if the true value estimate of the ARC is Rs.35 and the cost of capital is 20%, then the highest deal value the ARC is able to afford in a 100% cash deal is Rs.35 divided by 1.2, which equals Rs.29.1. (iii) When the cash proportion of the deal is zero, the return of the ARC (which is exclusively based on management fees) is infinite. This follows from the fact that the ARC's investment is zero. Hence the ARC is able to transact at deal values much higher than the true value, or even the book value of the security. *A*s cash proportion is reduced from 100% to zero, the threshold deal value at which the ARC is willing to transact increases from the true value discounted by cost of capital to a value even larger than the book value.

Fact 4 implies Proposition 1.

Proposition 1: *In between cash proportion of 0% and 100%, there exists a cash proportion at which the ARC's threshold deal value is equal to its true value. If the cash proportion goes above this threshold, which we call the ARC's true value threshold, the ARC would be unwilling to transact at its true value.*

Proposition 1 implies that a deal takes place at an inflated value only if the cash proportion is less than *the ARC's true value threshold.* In Scenario 2 of Table 3, an ARC investment of 20% is accompanied by a cash threshold of Rs.42.65. A cash proportion of 26% would yield a threshold deal value that is equal to the ARC's true value of Rs.40, i.e. a return of 20% with a deal value of Rs.40. Hence 26% is ***ARC's true value threshold in this case.***

By Fact 3, if we start at a cash proportion such that the threshold deal value is equal to the ARC's true value, and if management fees increases or the cost of capital decreases, the ARC's return would increase. Thus, the ARC would be willing and able to offer a higher cash proportion at the same true value. Thus, the *ARC's true value threshold* increases with an increase in the unit fees and decreases with an increase in the cost of capital. As the reconstruction premium generated by the ARC-investor combine increases, the estimate of true value of the ARC increases. By Proposition 1, the *ARC's true value threshold would decrease*[17]*.*

[17] In our model the ARC's true value threshold is given by $\bar{k} = \frac{f}{PZ+f-P}$ where f is the management fees, P is the reconstruction premium, and Z is the cost of capital.

Proposition 1 indicates the limits of the investment an ARC is able to make when the deal value is close to its true value. However, one may suppose that the external investor could supply the remaining investment in the SRs, thus allowing the bank to get paid entirely in cash. To examine whether this hypothesis is robust, one has to analyze the incentives of the investor.

3.3. The Investor's Incentives - The incentives of the investor are similar to the incentives of the ARC: both obtain returns from their investment in SRs. However, there is one crucial difference – the ARC receives management fees on the SRs held by the bank and by the investor, while the investor pays management fees to the ARC. Hence, assuming the investor and the ARC bear the same cost of capital, the investment incentives of the investor are less attractive than the incentives of the ARC. This implies the following: *If the ARC is unwilling to transact at a certain deal value and cash proportion, then the investor would also be unwilling to transact at that deal value and cash proportion.*

Further, the realization of redemptions from the SRs, and the management fee payable to the ARC are directly proportional to the proportion of SRs held by the investor. So is the investment. Hence the return on investment of the investor is independent of the proportion of SRs held by the investor.

Let's take a simple example:

Table 4

	Scenario 1:	**Scenario 2:**
Deal Value	Rs.30	Rs.30
Investor investment	36% of deal value i.e, Rs.10.8	40% of deal value i.e, Rs.12
Investors Estimate of True Value	Rs.40	Rs.40
Bank Estimate of True Value	Rs.28	Rs.28
Investors Estimate of Value of SRs Held	Rs.14.4 (36% of Rs.40)	Rs.16 (40% of Rs.40)
Management Fee paid by investor (@10%)	Rs.1.008	Rs.1.12

	(10% of 36% of Rs.28)	(10% of 40% of Rs.28)
Return on investment (RoI) of the investor	24% (14.4-1.008)/ 10.8	24% (16-1.12)/ 12
	RoI has remained unchanged	

The fact that (i) the incentives of the investor are less attractive than the incentives of the ARC, and (ii) the return on investment of the investor is independent of the proportion of SRs held by the investor, leads to a remarkable conclusion*: If the ARC is unwilling to transact at a certain deal value and cash proportion, then the investor would be unwilling to transact at that deal value at any cash proportion.*

From this we conclude that if the ARC is unwilling to transact at its true value above the ARC's true value threshold, the investor would also be unwilling to invest at that value. Thus, our hypothesis that the investor could make up the shortfall of investment in SRs thereby allowing the bank to enjoy an all-cash deal is negated. This implies a deal at the ARC's true value requires investment in SRs by the bank.

Note, our conclusions are based on the assumption the cost of capital of the ARC and the investor are the same. While international investors are able to raise money at low rates of interest, there is also a risk premium associated with India, that equalises the cost of capital.

How do we square the current inflow of foreign capital for all-cash deals? It seems possible that the current phase of market growth is transient as it is focused on the prime NPAs on offer. It could also reflect speculative inflows of capital. Hence, we cannot rely on the current market design that incentivizes all-cash deals funded by foreign investors for long term solutions of the NPA problem.

3.4. Transaction at Bank's True Value- Recall, the bank's true value is lower than the ARC's true value on account of the reconstruction premium generated by the ARC-investor combine. One may believe that it is only necessary to transact at a deal value that is at least as high as the bank's true value. Is investment in SRs by the bank required for such a transaction?

From Fact 4, if the ARC's estimate of 'true value' of the security discounted by the cost of capital is greater than the bank's estimate of true value, then the ARC is willing to do a 100% cash deal at the bank's true value. In our example, the ARC's estimate of 'true value' is Rs.40 and the cost of capital is 20%. Thus, the ARC's estimate of 'true value' of the security discounted by the cost of capital is Rs.$\frac{40}{1.2}$ =Rs.33.33. This is greater than the bank's estimate of 'true value', i.e. Rs.28. Hence, the ARC is willing to do a 100% cash deal at the bank's true value.

However, if the ARC's estimate of 'true value' of the security discounted by the cost of capital is lower than the bank's estimate of true value, then the ARC is not willing to do a 100% cash deal at the bank's true value. For instance, if the ARC's estimate of 'true value' is Rs.32 (not Rs. 40) and the cost of capital is 20%, then the ARC's estimate of 'true value' of the security discounted by the cost of capital is Rs. $\frac{32}{1.2}$ =Rs. 26.66. This is lower than the bank's estimate of 'true value' Rs. 28. Hence the ARC is not willing to do a 100% cash deal at the bank's true value.

This is likely to be a plausible situation in the Indian market, at least for the next few years, as reconstruction activities have been hobbled by a variety of factors. In this situation, between the ARC's true value threshold and a 100% cash proportion, there exists a cash proportion at which the ARC's threshold deal value is equal to the bank's true value. We call this the Bank's true value threshold.

By Fact 3, if we start at a cash proportion such that the threshold deal value is equal to the Bank's true value, and if management fees increases or the cost of capital decreases, the ARC's return would increase. Thus, the ARC would be willing and able to offer a higher cash proportion at the same true value. This implies the Bank*'s true value threshold* increases with an increase in the unit fees and decreases with an increase in the cost of capital. As the reconstruction premium generated by the ARC-investor combine increases, the return of the ARC from the holding of SRs increases. Thus, the ARC earns returns greater than the cost of capital. By Proposition 1, the the Bank*'s true value threshold would increase*[18]*.*

[18] In our model the Bank's true value threshold is given by $\hat{k} = \frac{f}{Z+f-P}$ where f is the management fees, P is the reconstruction premium, and Z is the cost of capital.

For the deal value to range between the true value of the bank and the ARC, the market needs to converge to a cash proportion between the ARC's true value threshold and the Bank's true value threshold. With the present value of management fees at 10%, the cost of capital at 20%, and ARC reconstruction premium at 14%, based on the simple model described above, the ARC's true value threshold and the Bank's true value threshold are 30.4% and 62.5% respectively.

Thus, when the reconstruction premium is less than the cost of capital, the bank's investment in SRs is necessary to achieve deal values that align with the true value of the bank, and an even higher investment by the bank is needed to achieve deal values that align with the true value of the ARC.

Besides making true value deals possible, there are other reasons why the lender's investment in SRs is useful:1. Securitisation reduce the investment of the ARC and thereby limits reduction in overall surplus caused by the high cost of capital of the ARC relative to the bank. 2. It signals the Bank's continued interest in the underlying NPA, thereby mitigating the possibility that the bank's information advantage would result in a market for lemons. 3. It allows the bank to partake of the upside from the ARC's reconstruction activities by avoiding the impact of bidders bidding less than true value in NPA auctions (a common phenomenon referred to as 'bid shading').

4. Transaction level economics of the Bank and the Importance of Relaxing Prudential Norms on Provisioning

4.1. We assume a bank's decision to recover its NPAs through a sale to an ARC is based on a comparison with the alternative of internal restructuring or going to the IBC, and is a function of the following key factors: expected present value of recovery from the IBC process or internal restructuring, deal value in the ARC transaction, the proportion of upfront cash from sale to ARC, the expected present value of the returns from the reconstructed NPA, and the management fee charged by the ARC.

4.2. The bank's returns from a transaction with the ARC is composed of two components: a cash component, and a security receipts component, with management fees payable on SRs. To illustrate, with a 40% of cash and a deal value of Rs.40, the bank receives Rs. 16. The face value of security receipts received is Rs.24. The bank assesses the value of the SRs it holds not at their face value but at their true value. Thus, if the true value is Rs. 35, the holding of 60% of the NPA in the form of SRs would be valued at 60% of Rs.35, i.e. Rs.21. Management fees to the ARC are paid on the true value of the SRs held by the bank[19]. If the unit fee is 10%, then the total fee to be paid is 10% of the true value, i.e. 10% of Rs.21 = Rs.2.1[20]. The total return of the bank from a transaction with the ARC is Rs.16 (cash) + Rs.21 (SRs) – Rs.2.1 (fees) = Rs.34.9.

Table 5

	Scenario
Deal value (v)	40
Cash proportion ARC (*k*)	40%
Bank receives	
Cash (v*k) (A)	16
Face value of SR[v*(1-k)]	24
True value of NPA for the Bank (V_t)	Rs.35
True value of SR for the Bank [$SR_t = V_t * (1-k)$] (B)	Rs.21
Management fee on the true value of SR ($SR_t * 10\%$) (C)	Rs.2.1
Total Return for the Bank (A+B-C)	Rs.34.9

The bank's decision on whether to transact or not is based on whether the return of the bank from a transaction with the ARC is greater than the true value, Rs. 35. In the example given, the bank would prefer not to transact with the ARC and opt for internal restructuring. Note that the only element of *the Bank's return* that depends on deal value is the upfront cash payment. For any given cash proportion, this upfront payment increases with the deal value. This yields:

(a) Fact 5: *Other things being equal, the Bank's return is proportional to the deal value.*

This seemingly obvious fact crucially depends on the assumption that the management fees payable by the bank is assessed on the bank's true value rather than on the nominal value of SRs. In the event the nominal value was to be the basis

[19] The disadvantage of paying fees on the face value of SRs is highlighted later.

[20] Note the management fees we take into account is not the annual management fees which is of the order of 2% or even less. It is an estimate of the present value of the management fees over the lifetime of the holding of the SR by the bank which could last up to 5 years, extendable to 8 years.

for assessing management fees the bank's return function could exhibit anomalous behaviour at low cash proportions. The intuition is that when a deal is mainly transacted in security receipts, the additional management fees payable on those security receipts on account of an increase in the deal value may be greater than the additional cash received. Hence the bank prefers lower deal values. The anomaly disappears when the true value becomes the basis for calculating the payable fees.

At deal values significantly lower than the true value, the bank's value function declines with an increase in the cash proportion. The reason is that the cash component of the deal is proportional to the deal value, but the securities component is proportional to the true value. Hence, when the deal value is significantly lower than the true value, the bank prefers payment in securities rather than in cash. Of course, a higher securities component also attracts higher management fees. Hence, at low deal values, the bank would prefer securities to cash but only if the unit fee is low enough. This anomaly disappears at deal values close to or higher than the true value. This yields :

(b) Fact 6: *Other things being equal, at deal values close to or higher than the true value, the Bank's return increases with the proportion* of *cash in* the *deal.*

Given that the management fees reduce the net return on SRs, it is easy to see that o*ther things being equal, the Bank's return decreases with the unit fees. Further, an* increase in the bank True Value estimate reduces the attractiveness of a deal with the ARC*.*

For any cash proportion it is possible to compute a threshold deal value *below which* the Bank would not want to transact.

(c) Fact 7: *(i)The threshold deal value decreases with an increase in the cash proportion. (ii) When the cash proportion is 100%, the Bank would not want to transact at a deal value lower than its estimate of the 'true value' of the security (iii) When the cash proportion* of the *deal is zero, the Bank would be unwilling to transact even at deal values much higher than the true value' of the security, or even the book value.*
(i) Let's say we start with a cash proportion and deal value at which the Bank is indifferent between investing and not investing, ie. we are at a threshold cash proportion and deal value. Suppose we were to increase the cash proportion. From Fact 6, the return would increase from zero to a positive amount. From fact 5, it would

be possible to reduce the deal value while maintaining the Bank's incentive to transact. In other words, the threshold value would come down. (ii) When the *cash proportion is 100%,* the Bank's return is exclusively through cash which would need to at least equal to its true value estimate. (iii) When the *cash proportion is 100%,* the Bank's return is exclusively through securities. This return would equal the Bank's true value estimate minus the management fees. Given a strictly positive fee, this can never be greater than the Bank's true value estimate. Hence a transaction would not happen even at very high deal values.

4.3. The Role of Provisioning Gains- The Bank would be willing to transact with the ARC only if there exists a cash proportion such that the threshold deal value of the bank (which represents the minimum acceptable deal value for the bank) is lower than the threshold deal value of the ARC (which represents the maximum acceptable deal value for the ARC).

Proposition 2: *If the ARC's estimate of 'true value' of the security discounted by the cost of capital is less than the bank's estimate of true value, then there is no cash proportion between zero and one, such that the threshold deal value of the bank is lower than the threshold deal value of the ARC.*

A rigorous proof need not concern us. Here, it suffices to note that given the assumption that the ARC's estimate of 'true value' of the security discounted by the cost of capital is less than the bank's estimate of true value, no deal is possible at a 100% cash proportion. Further, it is intuitively obvious that when the ARC's estimate of 'true value' of the security discounted by the cost of capital is less than the bank's estimate of true value, and when the management fees is linked to the bank's estimate of true value, (not the deal value), then the ARC is unable to offer a deal value that would be attractive to the bank, no matter what the cash proportion. When the ARC's estimate of 'true value' of the security discounted by the cost of capital is greater than the bank's estimate of true value, a transaction is always possible. However, a transaction at the ARC's true value may not be possible.

This prospect needs to be addressed as it is likely to remain relevant for the NPA market over the medium term. To make a deal possible, the following measures need to be adopted: 1. Estimating True Value by the bank in a conservative manner, in line with its internal restructuring capabilities. 2. Facilitating a reduced cost of capital for the ARC. In addition, provided the deal does not take place at inflated values, the SRs should not inherit the capital provisioning requirements of the underline NPA. Hence, the Bank would save on capital provisioning that would be required in the absence of the deal. This saving would sweeten the transaction for the bank and, along with the other measures suggested, enable a transaction to take place even when the ARC's estimate of 'true value' of the security discounted by the cost of capital is less than the bank's estimate of true value. This relaxation is appropriate only if the cash proportion of the deal is high enough to ensure that deal values are not inflated above the true value of the ARC.

Proposition 1 tells us that inflation of deal value is only possible below the ARC's true value threshold. Hence, the relaxation of provisioning requirements should kick in at the ARC's true value threshold. This threshold is estimated at about 30-40% for the relevant range of parameters in our model. However, given the need to transfer a sufficient amount of risk out of the banking system, and ensure sufficient 'skin in the game' for non-bank investors, and keeping in mind various complementary measures to boost the market, the relaxation of provisioning requirements should kick in at 51%. Once reconstruction activities pick up, the threshold can be increased.

5. Creating a True Value Market

The analysis above suggests the following design principles for creating a true value market for NPAs: 1. Link management fees to the bank's estimate of true value or the market determined NAV. 2. Relax prudential norms on provisioning provided the investment in SRs by non-bank entities is not less than 51%.

5.1. Determine the actual cash proportion at which the deal occurs through the process of market activity. We should move from a one dimensional bid where the cash proportion is settled in advance and the ARC bids on the deal value alone, to a multi-dimensional bid, consisting inter alia of the cash proportion and the deal value, with the starting cash proportion bid set at close to the ARC's true value threshold and the starting deal value set at the bank's estimate of true value. This is the most important innovation proposed in the market design. The shift allows us to determine both the cash proportion (a proxy for the amount of risk transferred out of the banking sector) and the deal value via a process of bidding. Given that the ramifications of a deal for the ARC and the bank depend integrally on both these parameters, it is important to determine both through market activity. There are many obvious ways in which a two-dimensional bid can be converted into cash equivalent. These can be decided by the seller based on its needs and made public prior to bidding.

5.2. Incidentally, the proposed approach also takes us away from a binary view of cash proportion where all-cash deals and other deals (i.e. not- all-cash deals) are dealt with as two binaries, to a nuanced view that allows us to address the continuum of possibilities between an all-cash deal and a no-cash deal.

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