भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
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Draft Comprehensive Framework for Sale of loan exposures

Introduction

Loan sales may be resorted to by lenders for any reasons ranging from strategic sales to rebalance their exposures or as a means to achieve resolution of stressed assets by extinguishing the exposures. A dynamic secondary market for bank loans will also ensure proper discovery of credit risk pricing associated with each exposure and will be useful as a leading indicator for impending stress, if any, provided that the volumes are sufficiently large. A need is thus felt to enable the same by providing a well founded regulatory framework governing sale of bank loan exposures.

Given the above, in exercise of the powers conferred by the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934, the Reserve Bank, being satisfied that it is necessary and expedient in the public interest so to do, hereby, issues the directions hereinafter specified.

Short title and commencement

1. These directions shall be called the Reserve Bank of India (Sale of Loans) Directions, 2020.
2. These directions shall come into force with immediate effect.

Chapter I: Scope and Definitions

A. Applicability and Purpose

3. The provisions of these directions shall apply to the following entities (collectively referred to as lenders in these directions):
   - (a) Scheduled Commercial Banks (excluding Regional Rural Banks);
   - (b) All India Term Financial Institutions (NABARD, NHB, EXIM Bank, and SIDBI);
   - (c) Small Finance Banks; and,

(d) All Non Banking Finance Companies (NBFCs) including Housing Finance Companies (HFCs).

4. These directions will be applicable to all loan sales, including sale of loans to special purpose entities for the purpose of securitisation, undertaken subsequent to the issue of these directions.

B. Definitions

5. For the purpose of these directions, the following definitions apply:

(a) "*clause*" means a clause of these directions;

(b) "*credit enhancement*" means a contractual arrangement in which an entity provides some degree of added protection to other parties to a transaction so as to improve the safety of their purchased exposures;

(c) "*funded participation*" means a loan participation transaction in which the participant funds the grantor in return for payments from the grantor equal to the principal, interest, and commissions, if any, under the loan agreement;

(d) "*grantor*" means the entity in whose books the loan exposure transferred through a loan participation agreement resides;

(e) "*loan participation*" means a transaction through which the grantor transfers all or part of its interest in a loan to a participant without the actual transfer of the loan contract, and may include funded participation or risk participation;

(f) "*minimum holding period (MHP)*" means the minimum period for which an originator must hold the exposures before the same may be transferred to a purchasing entity such that the project implementation risk is not passed on to the investors, and a minimum recovery performance is demonstrated prior to securitisation;

(g) "*original lender*" means the entity that has sanctioned and disbursed the loan exposure which is being transferred in accordance with these directions;

(h) "*participant*" means the entity to which the grantor transfers its interest in a loan exposure, fully or partly, through a loan participation transaction;

(i) "*risk participation*" means a means a loan participation transaction in which the participant agrees to reimburse the grantor in the event of a default by the borrower, in return for a fee paid by the grantor;

(j) *"stressed assets"* mean assets that are classified as NPA or as special mention account, and generally includes accounts which are in default as well as where lenders have given concessions for economic or legal reasons relating to the borrower's financial difficulty;

(k) "*transfer*" means a transfer of economic interest in loan exposures in the manner prescribed in these directions, and includes loan participations and transactions in which the loan exposure remains on the books of the transferor even after the said transaction;

(l) "*transferee*" means the entity to which the economic interest in a loan exposure is transferred under these directions, and wherever appropriate, may include grantors under a loan participation transaction;

(m) "*transferor*" means the entity which transfers the economic interest in a loan exposure under these directions, and wherever appropriate, may include participants under a loan participation transaction.

Chapter II: General Conditions applicable for all loan sales

A. General Requirements

6. In cases where loan transfers result in a change of lender of record under a loan agreement, all the parties involved should ensure that the existing loan agreement has suitable enabling clauses that allow for such transactions by laying down the required ground rules, including consent requirements, if any. If there is no such enabling clause in the existing loan agreements, the transaction shall require the consent of all the parties to the loan agreement, including the borrower, as a pre-condition.

7. Lenders should not offer credit enhancements in any form and liquidity facilities in the case of loan transfers.

8. A transferor cannot purchase a loan exposure, either fully or partially, that had been transferred by the entity previously.

9. A loan sale should result in immediate legal separation of the transferor from the assets which are sold to the extent that the interest has been transferred. The transferred interest should stand completely isolated from the transferor, after its transfer to the buyer, i.e., put beyond the transferor’s as well as its creditors' reach, even in the event of bankruptcy of the transferor. In case of any retained interest in the exposure by the transferor, the loan sale contract should clearly specify the distribution of the interest income from the transferred asset among the transferor and the transferee.

10. The transferee should have the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition to the extent of transfer of economic interest to them. The transferee shall have no recourse to the transferor for any expenses or losses except those specifically permitted under these guidelines.

11. Transferors shall not be permitted to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by the transferee or provide additional assets to the transferee at any time except those arising out of breach of warranties or representations made at the time of sale. The transferor should be able to demonstrate that a notice to this effect has been given to the transferee and that the transferee has acknowledged the absence of such obligation.

12. The transferor should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the transferee during or subsequent to the transfer of loan exposures.

13. The transferee shall, wherever applicable, ensure that the security interest, if any, underlying the loans purchased are properly registered, with the transferee as the beneficiary, directly or indirectly, and a mechanism for timely invocation of such interest, if the need arises, is properly documented and put in place.

14. An opinion from the transferor's Legal Counsel should be kept on record signifying that:

    a. all rights, titles, interests and benefits in the assets, barring the retained interest, if any, have been transferred to the transferee;

b. transferor is not liable to the transferee in any way with regard to these assets other than the servicing obligations as indicated in clause 19; and
c. creditors of the transferor do not have any right in any way with regard to the transferred interests even in case of bankruptcy of the transferor.

15. Any rescheduling, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the transferee, shall apply to the transferor to the extent of retained interest, if any.

16. The transfer of assets from transferor must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents from obligors (including from third parties, where necessary) should have been obtained.

17. Lenders can purchase external commercial borrowings lent by eligible ECB lenders provided that the losses / hair cuts, if any, occurring to the transferors on account of the loan sale should not be passed on to the transferees, and instead should be booked in the accounts of the transferors.

B. Representations and warranties by the transferor

18. A transferor that sells assets may make representations and warranties concerning those assets. Where the following conditions are met the transferor will not be required to hold capital against such representations and warranties:

    a. Any representation or warranty is provided only by way of a formal written agreement.
    b. The transferor undertakes appropriate due diligence before providing or accepting any representation or warranty.
    c. The representation or warranty refers to an existing state of facts that is capable of being verified by the transferor at the time the assets are sold.
    d. The representation or warranty is not open-ended and, in particular, does not relate to the future creditworthiness of the loans/underlying borrowers.
    e. The exercise of a representation or warranty, if any, requiring a transferor to replace asset (or any parts of them) sold, on grounds covered in the representation or warranty, must be:
        i. undertaken within 120 days of the transfer of assets; and

ii. conducted on the same terms and conditions as the original sale.

f. A transferor that is required to pay damages for breach of representation or warranty can do so provided the agreement to pay damages meets the following conditions:
    i. the onus of proof for breach of representation or warranty remains at all times with the party so alleging;
    ii. the party alleging the breach serves a written Notice of Claim on the seller, specifying the basis for the claim; and
    iii. damages are limited to losses directly incurred as a result of the breach.

g. A transferor should notify RBI (Department of Supervision) of all instances where it has agreed to replace assets sold to a transferee or pay damages arising out of any representation or warranty.

C. Transferor as servicing facility provider

19. A transferor performing the role of a servicing facility provider for the transferee after a loan sale has occurred should ensure that the following conditions are fulfilled:

a. The nature, purpose, extent of the facility and all required standards of performance should be clearly specified in a written agreement.

b. The facility is provided on an 'arm's length basis' on market terms and conditions, and subjected to the facility provider’s normal credit approval and review process.

c. Payment of any fee or other income arising from the role as a servicer is not subject to deferral or waiver.

d. The duration of the facility is limited to the earlier of the dates on which:
    i. the underlying loans are completely amortised;
    ii. all claims connected with the transferee’s interest in the underlying loans are paid out; or
    iii. the transferor's obligations are otherwise terminated.

e. There should not be any recourse to the transferor provider beyond the fixed contractual obligations.

f. The transferee has the clear right to select an alternative party to provide the facility.

g. The transferor should be under no obligation to remit funds to the transferee until it has received funds generated from the underlying assets.
h. The transferor shall hold in trust, on behalf of the transferee, the cash flows arising from the underlying and should avoid co-mingling of these cash flows with their own cash flows in case partial economic interest is retained by the transferor.

20. If the transferor of loans acts as the servicing agent for the loans under a separate servicing agreement for fee, such service obligations should not entail any residual credit risk on the sold assets or any additional liability for them beyond the contractual performance obligations in respect of such services. The transferor, in the role of the servicing agent, should be under no obligation to remit funds to the transferee unless and until such funds are received from the borrowers.

21. If the above conditions are not satisfied, the transferor shall maintain capital on the loans transferred as if the loans had never been transferred from its books.

D. Standards for due diligence and credit monitoring by lenders as transferees

22. For domestic transactions, lenders should ensure that the transferor has strictly adhered to the MHP criteria prescribed in the guidelines, wherever applicable, in respect of loans purchased by them. The overseas branches of Indian banks may purchase loans in accordance with the regulations laid down in those jurisdictions.

23. Lenders should have the necessary expertise and resources in terms of skilled manpower and systems to carry out the due diligence of the loans/portfolios of loans before purchasing them. In this regard the lenders should adhere to the following guidelines:

    a. Lenders with the approval of their Board of Directors, should formulate policies regarding the process of due diligence which needs to be exercised by their own officers to satisfy about the Know Your Customer requirements and credit quality of the underlying assets. Such policies should inter alia lay down the methodology to evaluate credit quality of underlying loans, the information requirements etc.

b. The due diligence of the purchased loans cannot be outsourced by the lender and should be carried out by its own officers with the same rigour as would have been applied while sanctioning new loans, if any, by the lender.
c. If a lender wishes to outsource certain activities like collection of information and documents etc., then this should be subject to the extant guidelines on outsourcing of non-core activities by banks, which would inter alia imply that such lenders would continue to retain full responsibility in regard to selection of loans for purchase and compliance with Know Your Customer requirements.

24. Before purchasing individual loans or portfolio of loans, and as appropriate thereafter, lenders should be able to demonstrate that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures commensurate with the risk profile of the loans purchased analysing and recording:

a. the risk characteristics of the exposures constituting the portfolio purchased (i.e., the credit quality, extent of diversification and homogeneity of the pool of loans, sensitivity of the repayment behavior of individual borrowers to factors other than their sources of income, volatility of the market values of the collaterals supporting the loans, cyclicality of the economic activities in which the underlying borrowers are engaged, etc.);
b. the reputation of the original lenders/transferors in terms of observance of credit appraisal and credit monitoring standards, adherence to MHP standards in earlier transfer of portfolios, wherever applicable, and fairness in selecting exposures for transfer;
c. loss experience in earlier transfer of loans/portfolios by the transferors in the relevant exposure classes underlying and incidence of any frauds committed by the underlying borrowers, truthfulness of the representations and warranties made by the original lender/transferor;
d. the statements and disclosures made by the transferors, or their agents or advisors, about their due diligence on the transferred exposures and, where applicable, on the quality of the collateral supporting the loans transferred; and

e. where applicable, the methodologies and concepts on which the valuation of loans transferred is based and the policies adopted by the transferor to ensure the independence of the valuer.

25. Lenders should regularly perform their own stress tests appropriate to the portfolios of loans purchased by them. For this purpose, various factors which may be considered include, but are not limited to, rise in default rates in the underlying portfolios in a situation of economic downturn and rise in pre-payment rates due to fall in rate of interest or rise in income levels of the borrowers leading to early redemption of exposures.

26. The lenders need to monitor on an ongoing basis and in timely manner performance information on the loans purchased and take appropriate action required, if any. Action may include modification to exposure ceilings to certain type of asset classes, modification to ceilings applicable to transferors etc. For this purpose, transferees should establish formal procedures appropriate and commensurate with the risk profile of the purchased loans. Such procedures should be as rigorous as that followed by them for portfolios of similar loans directly originated by it, if any. In particular, such procedures must facilitate timely detection of signs of weaknesses in individual accounts and identification of non-performing borrowers as per RBI guidelines as soon as loans are 90 days past due. The information collected should include the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis. Such information, if not collected directly by the lender and obtained from the servicing agent, if any, should be certified by the authorized officials of the servicing agent.

27. Depending upon the size of the portfolio, credit monitoring procedures may include verification of the information submitted by the servicing agent's concurrent and internal auditors. The servicing agreement should provide for such verifications by the auditors of the transferee, and wherever applicable, the transferor. All relevant

information and audit reports should be available for verification by the Inspecting Officials of RBI during inspections of the transferees and transferors.

Chapter III: Sale of Standard Assets

A. General requirements

28. The provisions of this Chapter do not apply to:

    a. transfer of loan accounts of borrowers by a lender to other lenders and vice versa, at the request/instance of borrower;
    b. inter-bank participations covered by the circular DBOD.No.BP.BC.57/62-88 dated December 31, 1988 as amended from time to time;
    c. trading in bonds;
    d. sale of entire portfolio of assets consequent upon a decision to exit the line of business completely;
    e. sale of stressed assets;
    f. consortium and syndication arrangements; and
    g. any other arrangement/transactions, specifically exempted by the Reserve Bank of India.

29. Transferors can transfer a single standard asset or a part of such asset or a portfolio of such assets to financial entities through an assignment deed, with the exception of the following exposures:

    (i) Revolving credit facilities (e.g. Cash Credit accounts, Credit Card receivables etc.)
    (ii) Assets with bullet repayment of both principal and interest.

    Explanation: Assets with bullet repayment of only either principal and interest are not included in the above exception.

30. Loans with tenor up to 24 months extended to individuals for agricultural activities (as described in Chapter III of Master Direction – Reserve Bank of India (Priority Sector Lending –Targets and Classification) Directions, 2016 and Master Direction - Reserve Bank of India - Priority Sector Lending – Targets and Classification - Small Finance Banks - 2019) where both interest and principal are due only on maturity and trade receivables with tenor up to 12 months discounted/purchased by lenders from their borrowers will be eligible for direct transfer through

assignment. However, only those loans/receivables will be eligible for such transfer where a borrower (in case of agricultural loans) /a drawee of the bill (in case of trade receivables) has fully repaid the entire amount of last two loans/receivables (one loan, in case of agricultural loans with maturity extending beyond one year) within 90 days of the due date.

> **Discussion Question**: ***Do you see any types of assignment transactions permitted under the current guidelines, which may not be possible under the revised guidelines?***

31. Transferors can transfer a single standard asset or a part of such asset or a portfolio of such assets to financial entities through novation without any exceptions. A single standard asset or a part of such asset or a portfolio of such assets can also be transferred to financial entities through a loan participation contract without any exceptions.

> **Discussion Question**: ***Do you see any concerns with regard to the legal modes of loan transfer that have been enabled for transfer of loan exposures from the lending institutions?***

32. Transferors' retention of interest, if any, in the loans transferred should be supported by a legally valid documentation. At a minimum, a legal opinion regarding the following should also be kept on record by the transferor:

    a. legal validity of amount of interest retained by the transferor;
    b. such arrangement not interfering with transferee's rights and rewards associated with the loans to the extent transferred to it;
    c. such arrangement does not result in the transferor becoming an agent, trustee, or fiduciary of the transferee, apart from servicing facilities extended by the transferor, if any, post such transfer; and
    d. the transferor not retaining any risk and rewards associated with the loans to the extent transferred to the transferee.

33. The transferors should apply the same sound and well-defined criteria for credit underwriting to exposures to be sold as they apply to exposures to be held on their book. To this end, the same processes for approving and, where relevant, amending, renewing and monitoring of credits should be applied by the transferors.

34. The sale shall be only on cash basis and the consideration shall be received not later than at the time of transfer of assets. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.

B. Minimum holding period for loan sales other than to special purpose entities for securitisation

35. Transferors can transfer loans only after a minimum holding period counted from the date of first repayment of loans for an activity/purpose; date of acquisition of asset (i.e., car, residential house etc.) by the borrower for which the financing had been extended; or the date of completion of a project financed by the loan, as the case may be, whichever is later. The minimum holding period that would be applicable depending upon the tenor and repayment frequency is given in the following table:

	Minimum number of instalments to be paid before loans can be transferred			
	Repayment frequency – Weekly	**Repayment frequency – Fortnightly**	**Repayment frequency – Monthly**	**Repayment frequency – Quarterly**
Loans with original maturity up to 2 years	Twelve	Six	Three	Two
Loans with original maturity of more than 2	Eighteen	Nine	Six	Three

years and up to 5 years				
Loans with original maturity of more than 5 years	-	-	Twelve	Four

Provided that where the repayment is at more than quarterly intervals, loans can be transferred after repayment of at-least two instalments.

Provided that in case of loans purchased from other entities by a transferor, such loans cannot be sold before completion of twelve months from the date on which the loan was taken to the books of the transferor.

36. In the case of loans with bullet repayments of only either principal and interest, the minimum holding period requirement specified in terms of minimum instalments repaid will be reckoned based on the repayment frequency of principal or interest, as the case may be, that has a periodic repayment schedule.

37. The MHP will be applicable to individual loans in case a pool of loans is being transferred as a result of a sale. MHP will not be applicable to loans referred to in clause 30.

C. Accounting provisions

38. Any loss, profit or premium arising because of a sale, which is realised, should be accounted accordingly and reflected in the Profit & Loss account for the accounting period during which the sale is completed. However, profits / premium, if any, arising out of such sales, shall be deducted from CET 1 capital or net owned funds for meeting regulatory capital adequacy requirements till the maturity of such assets.

39. In cases of retention of interest by the transferor upon transfer of a pool of loans, the transferor may, at its discretion, maintain a consolidated account of the amount representing the retained interest only if the transferred loans are retail loans. In all other cases, the transferor should maintain borrower-wise accounts for the interest retained in respect of each loan.

40. In cases of retail loans, if the transferor chooses to maintain a consolidated account representing the retained interest in the transferred loans, the consolidated amount receivable against the retained interest and its periodicity should be clearly established, and the overdue status of the retained interest should be determined with reference to repayment of such amount. In all other cases, the overdue status of the retained interest in individual loan accounts should be determined with reference to repayment received in each account.

D. Capital Adequacy and other prudential norms

41. The capital adequacy treatment for purchase of loans, in respect of the beneficial interests held by the transferor and transferee post such sale, will be as per the rules applicable to loans directly originated by the lenders.

42. Transferees may, if they so desire, have the pools of loans rated before purchasing so as to have a third party view of the credit quality of the pool in addition to their own due diligence. However, such rating cannot substitute for the due diligence that the transferees is required to perform.

43. In purchase of pools of both retail and non-retail loans, income recognition, asset classification, provisioning and exposure norms for the transferee will be applicable based on individual obligors and not based on portfolio. Lenders should not apply the asset classification, income recognition and provisioning norms at portfolio level, as such treatment is likely to weaken the credit supervision due to its inability to detect and address weaknesses in individual accounts in a timely manner.

44. If the transferee is not maintaining the individual obligor-wise accounts for the portfolio of loans purchased, it should have an alternative mechanism to ensure application of prudential norms on individual obligor basis, especially the classification of the amounts corresponding to the obligors which need to be treated as NPAs as per existing prudential norms. One such mechanism could be to seek

monthly statements containing account-wise details from the servicing agent, if any, to facilitate classification of the portfolio into different asset classification categories. Such details should be certified by the authorized officials of the servicing agent. The lender's concurrent auditors, internal auditors and statutory auditors should also conduct checks of these portfolios with reference to the basic records maintained by the servicing agent. The servicing agreement should provide for such verifications by the auditors of the transferee. All relevant information and audit reports should be available for verification by the Inspecting Officials of RBI during inspections of the transferees.

45. For banks/AIFIs, the purchased loans will be carried at acquisition cost unless it is more than the face value, in which case the premium paid should be amortised based on straight line method or effective interest rate method, as considered appropriate by the individual banks/AIFIs. The outstanding/unamortised premium need not be deducted from capital. The discount/premium on the purchased loans can be accounted for on portfolio basis or allocated to individual exposures proportionately.

46. The exposures that do not meet the requirements of this Chapter shall attract risk weight of 1250%.

Chapter IV: Sale of stressed assets

A. General Requirements

47. The instructions contained in this Chapter would cover sale of stressed assets undertaken as a resolution plan under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 issued vide circular DBR.No.BP.BC.45/21.04.048/2018-19 dated June 7, 2019 as well as standalone sale of stressed assets between transferors and eligible transferees.

48. All lenders should lay down detailed Board approved policies on sale of their stressed assets, which, inter alia, shall cover the following aspects:
    a. Financial assets to be sold;
    b. Norms and procedure for sale of such financial assets;
    c. Valuation procedure to be followed to ensure that the realisable value of financial assets is reasonably estimated;

d. Delegation of powers of various functionaries for taking decision on the sale of the financial assets; etc.

49. The policy on sale of stressed assets shall be based on the following principles:

    a. Identification of stressed assets beyond a specified value, as may be determined by a lender's policy, for sale shall be top-down i.e., the head office/corporate office of the lender shall be actively involved in identification of stressed assets;

    b. At a minimum, all assets classified as 'doubtful asset' above a threshold amount shall be reviewed by the Board/Board Committee on periodic basis and a view, with documented rationale, be taken on exit or otherwise. The assets identified for exit shall be listed for the purpose of sale as indicated above;

50. The transferors shall sell stressed assets to any regulated entity that is permitted to take on loan exposures by its statutory or regulatory framework. The transferee in the case of stressed assets need not be a financial entity. However, the transferors shall conduct necessary due diligence in this regard and clearly establish that the transferee is not a person disqualified in terms of Section 29A of the Insolvency and Bankruptcy Code, 2016. Additionally, the transferee should not be a person/entity/subsidiary/associate etc. (domestic as well as overseas), of the borrower or from the existing promoter/promoter group of the borrower. The exposure to the transferee should not be classified as a non-performing asset by any lending institution. Lenders should clearly establish that the transferee does not belong to the existing promoter group (as defined in Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018). Lenders should ensure that the requirements of clause 10 is complied with.

51. Lenders may also purchase stressed assets from other lenders even if such assets had been created out of funds lent by the transferee to the transferor subject to all the conditions specified in these directions.

52. In order to attract a wide variety of buyers, the bids should preferably be publicly solicited so as to enable participation of as many prospective buyers as possible.

Lenders may also use e-auction platforms, wherever available, for selling their loans.

53. The transferor must provide adequate time for due diligence by prospective buyers which may vary as per the size of the assets, with a floor of two weeks.

54. Transferors should have clear policies with regard to valuation of assets proposed to be sold. In particular it must be clearly specified as to in which cases internal valuation would be accepted and where external valuation would be needed. However, in case of exposures beyond Rs.50 crore, transferors shall obtain two external valuation reports. The cost of valuation exercise shall be borne by the transferor. The discount rate used by transferors in the valuation exercise shall be spelt out in the policy. This may be either cost of equity or average cost of funds or opportunity cost or some other relevant rate, subject to a floor of the contracted interest rate and penalty, if any.

55. The transfer of stressed assets may be done through assignment or novation. Transferors shall ensure that subsequent to sale of the stressed assets, they do not assume any operational, legal or any other type of risks relating to the transferred assets. The loan sale contract shall clearly specify that in the event an inter-creditor agreement (ICA) is required to be signed in terms of the Prudential Framework, the transferee, regardless of the nature of the entity, shall sign the ICA as and when required. The Reserve Bank may consider issuing further directions to ensure that the conditions of this Chapter shall be applicable to subsequent sales, if any, of stressed assets sold initially in terms of these directions.

<u>Discussion Question</u>: ***Do you see any concerns with regard to the legal modes of loan transfer that have been enabled for transfer of stressed loan exposures from the lending institutions?***

56. Transferors shall ensure that no transfer of a stressed asset is made at a contingent price whereby in the event of shortfall in the realization by the transferee, the transferors would have to bear a part of the shortfall. The transferor also should not provide any credit enhancement or liquidity facility to the transferred stressed asset subsequent to the sale.

57. Lenders shall sell stressed assets to transferees other than ARCs only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the transferor only on receipt of the entire sale consideration. If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall shall be debited to the profit and loss account of that year. If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/loss on account of sale of other stressed assets.

58. Lenders are permitted to sell/buy homogeneous pool within stressed retail assets, on a portfolio basis. Homogeneity should be assessed on the basis of common risk drivers, including similar risk factors and risk profiles. The nature of assets should be such that transferees would not need to analyse and assess materially different legal and/or credit risk factors and risk profiles when carrying out risk analysis and due diligence checks of each asset. The pool of assets shall be treated as a single asset in the books of the transferee.

59. The reporting obligations, if any, to credit information companies, in respect of the stressed assets purchased, will vest with the transferee.

60. If the transferee has no existing exposure to the borrower whose stressed loan account is acquired, the purchased stressed asset shall be classified as "Standard" upon acquisition. Thereafter, the asset classification status of the financial asset purchased, shall be determined by the record of recovery in the books of the purchasing lender with reference to cash flows estimated while purchasing the asset.

61. In case the transferee has existing exposure to the borrower whose stressed loan account is acquired, the asset classification of the purchased exposure shall be the same as the existing asset classification of the borrower with the transferee.

62. The lenders shall hold the purchased stressed assets in its books at least for a period of 12 months before selling it to other lenders. Lenders are generally prohibited from purchasing assets that had been sold as stressed assets in the previous 12 months.

B. Additional requirements for sale of NPAs

63. Excess provisions arising on sale of NPAs shall be eligible for Tier II status in terms of paragraph 4.2.5 of Master Circular DBR.No.BP.BC.1/21.06.201/2015-16 dated July 01, 2015 on Basel III Capital Regulations.

64. The selling lender shall pursue the staff accountability aspects as per the existing instructions in respect of the non-performing assets sold to other lenders.

65. The purchasing lenders shall adjust recoveries in respect of a non-performing asset purchased from other lenders against its acquisition cost only. Recoveries in excess of the acquisition cost, if any, can be recognised as profit.

66. Lenders shall assign 100% risk weights to the non-performing assets purchased from other lenders as long as the asset is classified as 'standard asset' upon acquisition. If the asset is classified as 'non-performing asset', risk weights as applicable to non-performing assets shall be applicable. In case of non-performing investment purchased from other lenders, capital charge for market risks will also be applicable.

67. The purchasing lender shall make provisions for such assets as per the asset classification status in their books upon acquisition.

C. Sale of stressed assets to asset reconstruction companies

68. Lenders are free to receive cash or bonds or debentures or security receipts (SRs) or pass-through certificates (PTCs) as sale consideration for the financial assets sold to ARC. Bonds/debentures/SRs/PTCs received by lenders as sale consideration towards sale of financial assets to ARC shall be classified as investments in the books of the lenders.

69. The securities (bonds and debentures) offered by ARC will have to satisfy the following conditions:
    a. The securities shall not have a term in excess of six years.
    b. The securities shall carry a rate of interest not lower than 1.5% above the Bank Rate in force at the time of issue.
    c. The securities shall be secured by an appropriate charge on the assets transferred.
    d. The securities shall provide for part or full prepayment in the event the ARC sells the asset securing the security before the maturity date of the security.

e. The commitment of the ARC to redeem the securities shall be unconditional and not linked to the realization of the assets.
f. Whenever the security is transferred to any other party, the ARC shall have to issue the notice of transfer.

70. In cases of specific stressed assets, where it is considered necessary, lenders shall be free to enter into agreement with ARC to share, in an agreed proportion, any surplus realised by ARC on the eventual realisation of the concerned asset. In such cases, the terms of sale should provide for a report from the ARC to the lender on the value realised from the asset. Lenders shall make no credits for the expected profit until the profit materializes on actual sale.

71. When the financial asset is sold to ARC at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall shall be debited to the profit and loss account of that year. Banks are permitted to use floating provisions for meeting any shortfall on sale of NPAs when the sale is at a price below the NBV. On the other hand, when the financial asset is sold to an ARC for a value higher than the NBV, lenders shall reverse the excess provision on sale of NPAs, to its profit and loss account in the year the amounts are received.

72. Lenders shall reverse excess provision arising out of sale of NPAs to ARCs only when the cash received (by way of initial consideration and / or redemption of SRs / PTCs) is higher than the NBV of the asset. Further, such reversal shall be limited to the extent to which cash received exceeds the NBV of the asset.

73. When lenders invest in the SRs/PTCs issued by ARC in respect of the financial assets sold by them to the ARC, the lenders shall recognize the sale in their books of at lower of the following:

    a. The redemption value of the SRs/PTCs; and
    b. The net book value of the transferred stressed asset.

    The investment shall be carried in the books of the lenders at the price determined as above until its sale or realization. Upon such sale or realization, the loss or gain shall be dealt with in the same manner as at clause 71.

74. SRs/PTCs which are not redeemed as at the end of the resolution period (i.e., five years or eight years as the case may be) shall be treated as loss asset in books of the lenders and fully provided for.

75. Where the investment by a lender in SRs backed by stressed assets sold by it under an asset securitisation, is more than 10 percent of all SRs backed by its sold assets and issued under that securitisation, the provisions held in respect of these SRs shall be subject to a floor. The aforesaid floor shall be progressive provisioning as per the asset classification and provisioning norms, notionally treating book value of these SRs as the corresponding stressed loans, assuming these had remained, without recovery of principal, on the bank's books. In effect, provisioning requirement on SRs shall be maintained at higher of the following:
    a. provisioning rate required in terms of net asset value declared by the ARCs; and
    b. provisioning rate as applicable to the underlying loans, assuming that the loans notionally continued in the books of the lender.

76. All instruments received by banks/FIs from ARC as sale consideration for financial assets sold to them and also other instruments issued by ARC in which banks/FIs invest shall be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time shall be applicable to bank’s/ FI’s investment in debentures/ bonds/ security receipts/PTCs issued by ARC. However, if any of the above instruments issued by ARC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme, the bank/ FI shall reckon the Net Asset Value (NAV) obtained from ARC from time to time, for valuation of such investments.

77. A lender offering stressed assets for sale shall offer the first right of refusal to an ARC which has already acquired the highest and at the same time a significant share (~25-30%) of the total exposure of all lenders to said stressed borrower, for acquiring the asset by matching the highest bid.

78. There is no prohibition on lenders from taking over standard accounts from ARCs. Accordingly, in cases where ARCs have successfully implemented a resolution plan for the stressed assets acquired by them, lenders may, at their discretion and

with appropriate due diligence, take over such assets after the a period equivalent to the 'monitoring period' as defined in Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 issued vide circular DBR.No.BP.BC.45/21.04.048/2018-19 dated June 7, 2019, provided that the account performed satisfactorily, as defined in the circular *ibid* during the said 'monitoring period'. Lenders shall lay down a Board approved policy containing various aspects governing such take overs viz., type of assets that may be taken over, due diligence requirements, viability criteria, performance requirement of asset, etc. If a lender has previously sold an exposure to an ARC, such lender should not, at any point of time, take over any exposure to the same borrower, from the same ARC.

79. ARCs are allowed to take over financial assets which cannot be revived and which, therefore, will have to be disposed of on a realisation basis. Normally, the ARC will not take over these assets but act as an agent for recovery for which it will charge a fee. Where the assets sold by the lenders fall under this category, the assets will not be removed from the books of the lenders but realisations as and when received shall be credited to the asset account. Lenders shall continue making provisions for the asset in the normal course.

D. Price Discovery

80. In order to bring down the vintage of NPAs sold by lenders as well as to enable faster debt aggregation by ARCs, lenders shall put in place board approved policy on adoption of an auction based method for price discovery. In particular, once bids are received, the lender shall first invite the ARC, if any, or in the absence of such an ARC, any other financial institution, if any, which has already acquired highest significant stake (as at clause 77) to match the highest bid. Ceteris paribus, the order of preference to sell the asset shall be as follows:
    a. The ARC, and in the absence of an ARC bidder any other financial institution, which has already acquired highest significant stake;
    b. The original bidder and;
    c. The highest bidder during the counter bidding process.
81. The lenders will then have the following two options:
    a. Sell the asset to winning bidder, as determined above;

b. If the lender decides not to sell the asset to winning bidder, the lender will be required to make immediate provision on the account to the extent of the higher of the following:
    i. The discount on the book value quoted by the highest bidder, and
    ii. The provisioning required as per extant asset classification and provisioning norms.

Discussion Question: ***Do you agree with the proposal to deregulate the price discovery process in the case of sale of stressed assets, or should the process be still prescribed by RBI as was the case with the Swiss Challenge method prescribed in the extant regulations?***

Chapter V: Disclosures and Reporting

82. The reporting requirements for every instance of loan sale undertaken under these directions, and any further instances of sale of such loans, and the manner of such reporting, shall be prescribed by the Reserve Bank.

83. The lenders should make appropriate disclosures in their financial statements, under 'Notes on Accounts', relating to the total amount of standard assets / stressed assets sold and purchased to / from other entities with breakups as to the category of the purchaser in case of sale of loans. The disclosures should cover aspects of aggregates such as weighted average maturity, weighted average holding period, asset classification break-up (including SMA classification), beneficial interest retained, tangible security coverage available, rating-wise distribution of rated loans, frequency distribution of LTV ratios (in case of housing loans and commercial real estate loans), industry and geographical distribution of assets etc. of the loans sold / purchased in a particular quarter / financial year, as the case may be. Specifically, a transferor should disclose all instances where it has agreed to replace assets sold to a transferee or pay damages arising out of any representation or warranty.

84. In addition to the existing disclosure requirements, lenders shall make following disclosures pertaining to their investments in security receipts:

Particulars		SRs issued within past 5 years	SRs issued more than 5 years ago but within past 8 years	SRs issued more than 8 years ago
(i)	Book value of SRs backed by NPAs sold by the lender as underlying			
	Provision held against (i)			
(ii)	Book value of SRs backed by NPAs sold by lenders as underlying			
	Provision held against (ii)			
Total (i) + (ii)				