Asset Reconstruction Industry in India

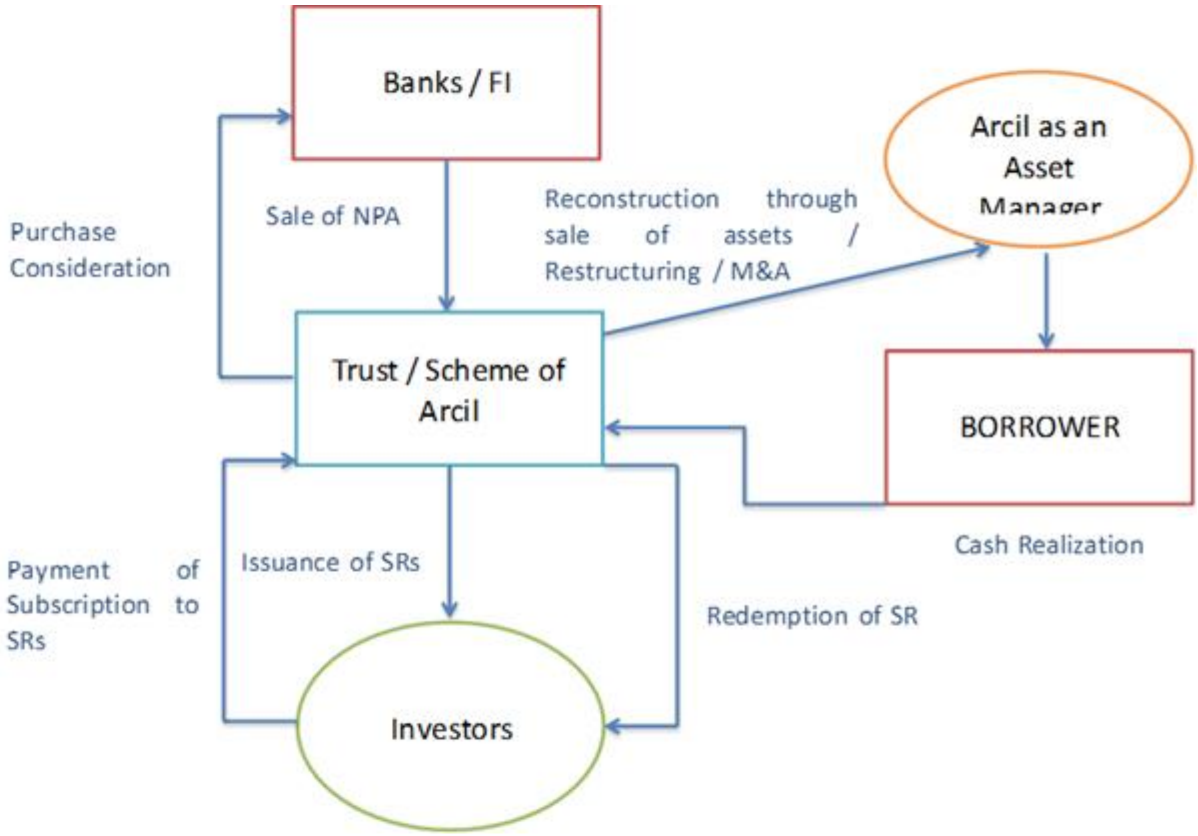
Definition

- Asset Reconstruction Company (ARC) means a company registered with Reserve Bank of India, under Section 3 of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) 2002, for the purposes of carrying on the business of asset reconstruction or securitisation or both;
- "Asset reconstruction" means acquisition by any asset reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance.

Background and Rationale for setting up Asset Reconstruction Companies (ARCs)

- The Indian banking industry, saddled with Non-Performing Assets (NPAs) in the late 1990s with Gross Non-Performing Assets (GNPAs) as a percentage of advances for Scheduled Commercial Banks was at 15.7% as on March 1997. The existing legal framework relating to commercial transactions had not kept pace with changing commercial practices and financial sector reforms. This resulted in slow pace of recovery of defaulting loans and led to mounting NPAs.
- The Central Government appointed Committees – Narsimhan Committee I and II and Andhyarujina Committee for examining banking sector reforms suggested the need for changes in the legal system. These committees recommend enactment of a new legislation for empowering banks and financial institutions to take possession of the securities and sell them without intervention of Courts. Acting on these recommendations, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act, 2002) was approved by the Parliament.
- The Committee on Banking Sector Reforms (Narasimhan Committee II) recommended setting up Asset Reconstruction Companies (ARCs) to transfer NPAs from Banks. Acting on these recommendations, the Union Budget of 2002-2003 proposed the establishment of ARCs by public and private sector banks, financial institutions and multilateral agencies to take over NPAs and develop markets for securitized loans.
- The SARFAESI Act provided for the establishment of ARCs. Accordingly, on April 23, 2003, the RBI issued guidelines under the SARFAESI Act, 2002, for setting up Securitisation Companies or Reconstruction Companies (SCs/RCs).
- Accordingly, in August 2003, Asset Reconstruction Company (India) Limited (Arcil) sponsored by State Bank of India, IDBI Bank Ltd., ICICI Bank Ltd. and Punjab National Bank was set-up as the first ARC in India.

Business Model of Asset Reconstruction Companies



(Source: Arcil)

Acquisition process of NPAs

Under Section 5 of SARFAESI Act, 2002, Any ARC may acquire financial assets of any bank or financial institution: "By issuing a debenture of bond or any other security in the nature of debenture, for consideration agreed upon between such ARC and the bank or financial institution or by paying in cash"

Banks auction NPAs to ARCs at a pre-determined Reserve Price and the same is sold to the Highest Bidder. However, instead of paying full acquisition cost to the Bank, ARCs pay the acquisition price to the Seller Banks under hybrid structure i.e. Cash & Security Receipts (SRs).

Special Features of SRs

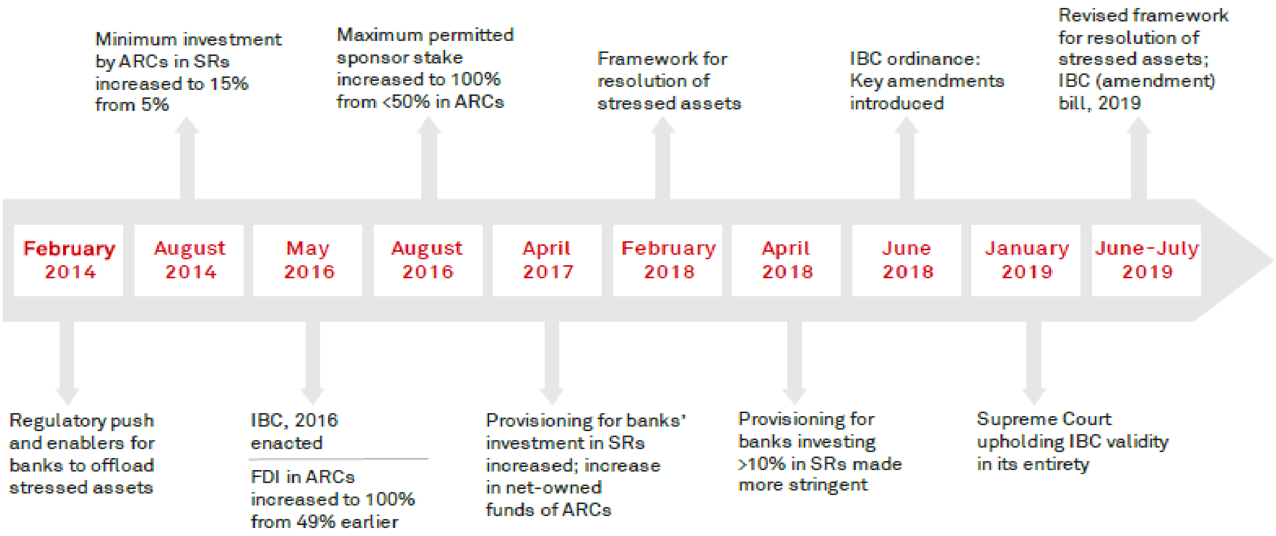
The SRs issued by ARCs are predominantly backed by impaired assets. These SRS have following unique features:

- SRs cannot be strictly characterised as debt instruments since they combine the features of both equity and debt. However, these are recognised as securities under Securities Contracts (Regulation) Act, 1965
- The cash flows from the underlying assets cannot be predicted in terms of value and intervals
- The investment in SRs is restricted to QIBs only
- These investments when rated would generally be below investment grade. These investments are generally privately placed and presently not listed.

- In the event of non-realisation of the financial assets, the SR holders representing 75% of the total value of SRs issued by the SC/RC can call for a meeting of all the SR holders in a particular scheme and every resolution passed in such meeting shall be binding on the SC/RC.

CONTINUOUSLY EVOLVING REGULATORY LANDSCAPE

Regulatory timeline chart



Source: CRISIL analysis

Key Phases in the ARC market

	Phase I FY03-FY14	Phase II FY14-FY17	Phase III FY18 onwards
Number of ARCs	1→14	14→24	29 ARCs Consolidation* & new entrants
Proportion of cash deals versus SR deals	Low	Low	Moderate to high
Percentage of SRs held by banks	High	High	Moderate to low
Discount on acquisition	High	Low to moderate	Moderate to high
Magnitude of regulatory changes	Moderate	High	High
Capital requirement	Low	Moderate	High

Phase I (2003 – 2014)

Though the first ARC was set-up in 2003, the ARC Industry did not scale-up till 2014. This was due to the push by Reserve Bank of India to Banks to clean up their balance sheet. During this phase, the minimum capital investment in SRs evolved from 0%-5% of the acquisition price, while the balance 95% was contributed by the Seller Banks in the form of SRs (5:95 model). The initial capital investment by ARCs was low. The Assets Under Management (AUMs) of ARCs increased more than 4 times between June 2013 – June 2014 due to large acquisitions under this model.

Phase II (2014-2017)

During this phase, the minimum capital investment in SRs was increased from 5% to 15% by the regulator in August 2014. This was done to ensure that the ARCs have more 'skin in the game'. This led to a threefold increase in capital investment by an ARC and a shift from the 5:95 model to 15:85 model. This led to an initial decline in the pace of asset acquisition by ARCs with low cash deals and saw improvement after setting up of new ARCs. The recoveries made by ARCs saw an improvement over Phase I, due to regulatory changes coupled with a lower cost of acquisition.

This phase saw a number of regulatory changes:

Key regulations	Impact
Management fees to be calculated on NAV rather than the acquisition value	• Leads to decline in earnings of ARCs • Incentivises ARCs to recover more
ARCs to be the members of joint lenders forum	• Helps ARCs gain access to NPA sales, thus quickening the recovery process • Quicker debt aggregation
Requirement of rating in six months (versus twelve months earlier)	• Quicker fair-value assessment for banks
Insolvency and Bankruptcy Code	• Shifts from 'debtor in possession' to 'creditor in possession' • Instils credit discipline and attracts investors
Changes in regulatory norms for foreign direct investment (FDI) and foreign institutional investment (FII) in SRs and sponsor holdings in ARCs	• Boost capital flows • Addresses low capital issues of ARCs • Attracts foreign distress-asset funds • Leads to price discovery
RBI guidelines for banks for the sale of stressed assets (stricter provisioning norms and valuation norms)	• Helps banks diversify investment risk in SRs • Brings more transparency in valuation and better price discovery
Increase in the net-owned funds requirement for ARCs to Rs 100 crore from Rs 2 crore	• Will lead to consolidation
Listing of SRs in the secondary market	• Helps improve liquidity, subject to active trading

Phase III (2017 onwards)

Key regulatory changes and implementation of Insolvency and Bankruptcy Code, 2016 (IBC) marked the beginning of the third phase. The regulatory change was higher provisioning requirement for banks. With effect from April 01, 2017, RBI increased the provisioning requirements for Banks investing more than 50% of the value of stressed assets sold by them in SRs. This limit was subsequently reduced to 10% from April 01, 2018. Further, the implementation of IBC has been a game changer in resolution of NPAs.

Assets sold by banks to ARCs – A declining scenario

Apart from recovery through various resolution mechanisms, banks also clean up their balance sheets through sale of NPAs to ARCs for quick exit. During 2019-20, Asset sales by SCBS to ARCs declined which could probably be due to SCBs opting for resolution channels such as IBC and SARFAESI Act, 2002. The acquisition cost of ARCs as a proportion to the book value of assets declined suggesting lower realisable value of the assets.

Table IV.13: NPAs of SCBs Recovered through Various Channels

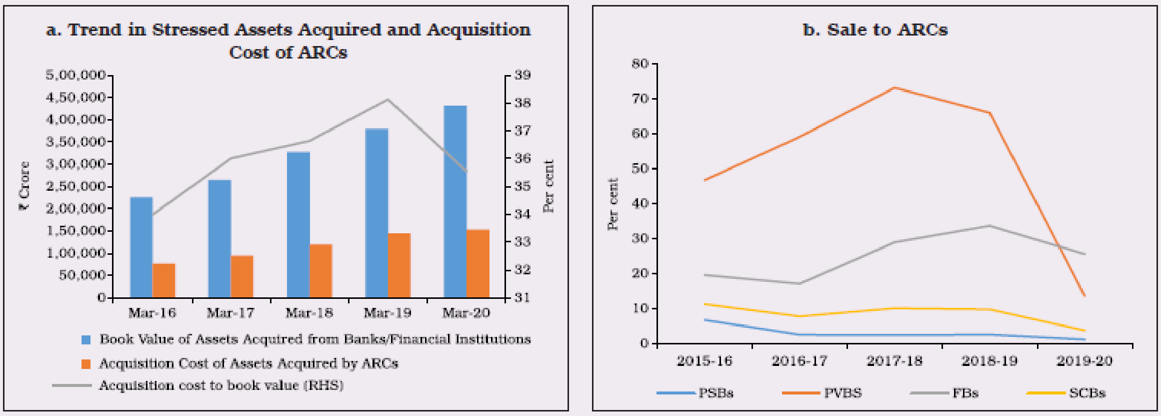
(Amount in ₹ crore)

Recovery Channel	2018-19				2019-20			
	No. of cases referred	Amount involved	Amount recovered*	Col. (4) as per cent of Col. (3)	No. of cases referred	Amount involved	Amount recovered*	Col. (8) as per cent of Col. (7)
1	2	3	4	5	6	7	8	9
Lok Adalats	40,87,555	53,484	2,750	5.1	59,86,790	67,801	4,211	6.2
DRTs	51,679	2,68,413	10,552	3.9	40,818	2,45,570	10,018	4.1
SARFAESI Act	2,35,437	2,58,642	38,905	15.0	1,05,523	1,96,582	52,563	26.7
IBC	1,152@	1,45,457	66,440	45.7	1,953@	2,32,478	1,05,773	45.5
Total	**43,75,823**	**7,25,996**	**1,18,647**	**16.3**	**61,35,084**	**7,42,431**	**1,72,565**	**23.2**

Notes: 1. Data are provisional.
2. DRTs: Debt Recovery Tribunals
3. *: Refers to the amount recovered during the given year, which could be with reference to the cases referred during the given year as well as during the earlier years. In the case of IBC, the realisation does not include amount realisable for operational creditors, from guarantors of corporate debtors and disposal of avoidance transactions.
4. @: Cases admitted by National Company Law Tribunals (NCLTs) under IBC. However, figures appearing for amount involved and amount recovered are for cases whose resolution plan was approved during the given financial year *i.e.* 81 cases for 2018-19 and 135 cases in 2019-20. Also, the amount recovered refers to realisables by all financial creditors, not just SCBs.
5. The resolution plan of Essar Steel India Ltd. was approved in 2018-19. However, as apportionment among creditors was settled in 2019-20, the recovery is reflected in the latter year data.

Source: Off-site returns, RBI and Insolvency and Bankruptcy Board of India (IBBI).

Chart IV.20: Stressed Asset Sales to ARCs



Source: Quarterly statements submitted by ARCs and off-site returns (domestic operations), RBI.

The share of SRs subscribed to by banks steadily declined, reaching 66.7% by end of March 2020 from 80.5% at end of March 2018 as ARCs were incentivised to increase their skin in the game and diversify the investor base by bringing in other financial institutions.

Table IV.14: Details of Financial Assets Securitised by ARCs

(Amount in ₹ crore)

Item	March-2018	March-2019	March-2020
1. Book Value of Assets Acquired	3,27,400	3,79,383	4,31,339
2. Security Receipt issued by ARCs	1,18,351	1,42,885	1,51,435
3. Security Receipts Subscribed to by			
(a) Banks	95,299	99,840	1,00,934
(b) ARCs	18,924	26,470	29,435
(c) FIIs	505	1,681	10,366
(d) Others (Qualified Institutional Buyers)	3,622	14,895	10,700
4. Amount of Security Receipts Completely Redeemed	8,413	12,240	17,947
5. Security Receipts Outstanding	98,203	1,12,651	1,07,877

Source: Quarterly statements submitted by ARCs.

Sources:

- Crisil Report on Bolstering ARCs dated August 2019
- RBI Report on Trends and Progress in Banking dated 29.12.2021
- Asset Reconstruction Company (India) Ltd.