CHAPTER-6

ARC, ITS GUIDELINES AND CRITICAL ANALYSIS

Estelar

6.1 Introduction

In the present study, we are concerned with the banking system affected by the disease of non performing assets and a medical definition is quite appropriate for this as:

Rehabilitation : The process of restoration of skills by a person who had an illness or injury so as to regain maximum self-sufficiency and function in a normal or as near normal manner as possible. For example, rehabilitation after a stroke may help the patient walk again and speak clearly again. The word comes from the Latin "rehabilitare" meaning to make fit again.

In the present era when non performing assets in every bank become a serious problem, some public sector banks' find themselves weak to weaker and hence rehabilitation of them is necessary for their survival between strong public sector banks and private sector banks and financial institutions.[1]

6.2 Asset Reconstruction Company (ARC)

The word ''asset reconstruction company'' is a typical Indian word. The global equivalent of this word is ''asset management company''. The word "asset reconstruction" in India owes its origin to Narsimham-I which envisaged the setting up of a central Asset Reconstruction Fund with money contributed by the Central Government, which was to be used by banks to shore up their balance sheets to clean up their non-performing loans. This idea never worked: so Narsimham-II thought

Estelar

of asset reconstruction companies, the likes of which had already been successful in Malaysia, Korea and several other countries in the World. To keep the tune same, as the original idea of asset reconstruction fund, as also to give an impression that ARCs are not merely concerned with realisation of bad loans but they are going to do "reconstruction", that is, try and resurrect (bring back to life) bad loans into good ones, the word ARC has been used in India.[2]

6.2.1 ARCs : Reconstruction or Merely Realisation

By the name 'Asset Reconstruction Company' one can imagine generally that it will be a company which operate a heavy-weight work of reconstruction of assets. But, in actual practice, ARCs not doing substantially more than mere realisation of bad loans. Even the definition of the word "asset reconstruction" in the Ordinance talks of mere realisation and not reconstruction. As ARCs would anyway not have the capital to do any further funding of bad loans, it is difficult to see them doing any such "reconstruction" to qualify for that term.[3]

6.3 Origin of Asset Reconstruction Company

In the last decade several countries, especially in Asia, experienced crisis in their economy and consequently in banking and financial sector. This has led to widespread financial sector reforms in most of the countries. One of the major crisis associated with the financial sector is growth of non performing assets and loans in the banking sector. Quality and performance of advances has a direct

Estelar

bearing on profitability and viability of banks. Problem often manifests itself in an accretion to the stock of NPAs. In several countries NPAs assumed alarmingly large proportion of their aggregate loans and also of their GDP.

NPA problem in our country has not assumed such magnitude that it can be termed as a crisis situation. However, the burden of NPA is certainly having a serious impact on the viability and efficiency of the financial sector and the growth of credit to industry. The transformation from pre-liberalisation era of controlled economy and regulated financial sector to post-liberalization period of privatization and financial sector reforms has led to increase in domestic and foreign competition, greater autonomy in operations for existing players, increased industrial and entrepreneurial activity and more efficient resource allocation. This resulted in historic capacities becoming uneconomic, low operating margins and strain on the industry. The seeds of credit excesses sown in the boom time conditions led to bad loans in downswings of economic cycles, which in turn compounded the NPA problem.[4]

From the RBI Reports on Trend and Progress of Banking, it may be observed that although the net NPAs of the commercial banks in India have witnessed a decline over the past several years, they are still high as compared to developed country standards of around 1 per cent. Prompt remedial actions are, therefore warranted in this regard. There is a decline in the Net NPA figure, but it still remains high at 4.4%. The provision coverage for loan losses in India stands at 52.4%, which is low as compared to international standards, where it is as high as 167%.[5]

Estelar

The policy for management of NPA problem in the system has to tackle ‘Stock’ (accumulation of NPAs) and ‘Flow’ (accretion) problems. NPA management approach needs to be upgraded at different stages of the credit process. Several measures like Lok Adalats, DRTs, strengthening of credit appraisal and monitoring system, establishment of CIBIL etc. have been initiated by the regulators to tackle the ‘flow’ problem. Towards resolution of the ‘stock’ problem of NPAs, Government of India took proactive steps and enacted the Securitisation and Reconstruction Act 2002 in December 2002. Subsequent to the enactment, RBI has issued guidelines for Asset Reconstruction Companies and also for the Banks/FIs proposing to transfer the financial assets to these companies.[6]

This has set the ball rolling for the emergence of Asset Reconstruction Companies (ARCs) in the Indian Financial Sector and is expected to result in development of market for Non Performing Loans, which was, so far, non existent in the country.

6.3.1 Establishment of ARCs

<< Established under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, (SARFAESI Act) 2002.

<< Established to acquire, manage and recover illiquid or ‘Non-Performing’ Assets [NPAs] from Banks / Financial Institutions.

Estelar

- Recovery value with optimal costs through its innovative NPA resolution methods.

6.3.2 Background of ARCs

- Recommended by Narsimham Committee-I and II to clean up balance sheets.
- ARC is a company which is set up with the objective of taking over distressed assets (Non performing assets) from banks or financial institutions.
- To reconstruct or re-pack these assets to make them assets saleable.

6.3.3 Need of ARCs

Asset management companies or asset reconstruction companies have been set up in various countries internationally as an answer to the global problem of bad loans.

Bad loans are essentially of two types[7]: (1) bad loans generated out of the usual banking operations or bad lending, and (2) bad loans which emanate out of a systematic banking crisis.

It is in the latter case that banking regulators or governments try to bail out the banking system of a systematic accumulation of bad loans which acts as a drag on their liquidity, balance sheets and generally the health of banking. So, the idea of AMCs or ARCs is not to bail out banks, but to bail out the banking system itself.

Estelar

There are essentially two approaches for taking care of these systematic bail out efforts: one, leave the banks to manage their own bad loans by giving them incentives, legislative powers, or special accounting or fiscal advantages. The second approach is to do the same thing on a concerted, central level, through a centralised agency or agencies.

The former approach is called the decentralised approach and the latter approach is called centralised approach. AMCs arise out of the second approach - that is, a centralised agency for resolving bad loans created out of a systematic crisis.

Each approach has its own advantages and disadvantages and there is no clear evidence of any of the two being better over the other. Various countries have tried either of the two approaches with success stories and failures in either case.

In India, level of non-performing assets with banks and FIs alarmingly high due to:

Economic condition

Poor repayment environment

Government intervention in loan sanctions

Loan waivers

The Government of India has proactively taken steps to clean up bad loans in the banking system.

Process of Acquisition

Can acquire financial assets of non performing asset companies

Estelar

on their own balance sheet.

Can issue bonds or debentures for acquisition.

6.3.4 Objectives of ARC under SARFAESI Act, 2002

According to SARFAESI Act, 2002, an asset reconstruction company has following two main objectives[8] :

Improve the recovery and reduce NPA, and

Acquisition of Interest.

In other words, it can be said that the role of ARC for banking and financial institution system is to reduce NPAs by improving the recovery performance, negotiation and settlement etc., and to acquire interest.

Working Mechanism of ARC

Purchase the non performing assets from banks and financial institutions at a discount which may be as high as 75 percent of the original value of the loan.

NPAs can be assigned by banks and FIs. In turn these assets will be reconstructed /re-packed and then sold in the market in various forms or recovered through securitization and reconstruction of enforcement of security.

Measures for Reconstruction Specified u/s 9(a) to (f) of the Ordinance

Proper management of business of borrower.

Sale or lease of a part or whole of business of borrower.

Rescheduling of payment of debts payable by borrower.

Estelar

Settlement of dues payable by borrower.

Taking possession of secured assets.

Issues of Attention in establishing ARCs

Must have an operational independence and sufficient authority.

There should be some kind of fiscal incentives.

Cost control occupies an important place.

There should be a mechanism to review the working of ARC.

Advantages of an ARC approach

There are several advantages of an ARC approach as follows :

Centralisation of bad loans in one or a few hands and therefore obviously more clout.

It is possible to give special legislative powers to a few AMCs rather than to each bank.

Banks are left with cleaner balance sheets and do not have to deal with problem clients. Regular banking relations with the group are not affected.

Because it deals with a larger portfolio, it can mix up good assets with bad ones and make a sale which is acceptable to buyers.

It is easier to do a capital-market based funding for an AMC (i.e. ARC) than for the banks themselves.

Foreign Investments in Asset Reconstruction Companies

Estelar

Government decided to permit Foreign Direct Investment (FDI) in equity.

Foreign Investment Promotion Board (FIPB) to consider applications from persons/entities eligible to invest in India in equity capital.

Maximum foreign equity shall not exceed 49% of the paid up capital.

FDI along will be permitted, investments by FIIs will not be permitted.

6.4 Role of Asset Reconstruction Company

ARCIL is the first Asset Reconstruction Company in the country to commence business of resolution of non-performing financial assets (NPAs) upon acquisition from Indian banks and financial institutions. It commenced business immediately after enactment of the Securitisation Act, 2002. As the premier ARC, Arcil has been playing the pioneering role in setting standards for the industry in India. Arcil has recently launched a retail NPAs resolution initiative through Arcil-Arms (a division of Arcil).[9]

Asset Reconstruction Company (India) Ltd (Arcil), which buys bad loans from banks for cash or security receipts, says banks are increasingly averse to selling such loans. If one reason for fewer deals in the bad asset market is valuation, the other is the central bank's norms to have 70 per cent provision coverage ratio (PCR).[10]

Estelar

The Reserve Bank of India has allowed banks to include technical write-offs while calculating the ratio. Technical write-offs are those which, after being written off the bank's book, can still be chased for recovery from the branch level. According to Arcil, banks are not willing to sell written-off accounts, as they use the write-off amount in PCR calculations.

This has made Arcil the role of recovery advisor for a fee, as compared to outright purchase of the bad loans. However, Arcil is following the strategy for retail loans only, through its retail non-performing loan division, called Arms. Arcil had launched Arms in 2008, for buying out retail loans from the banks.

The Arms of Arcil are handling about 60,000 accounts. These are going ahead on an agency basis. That is, these will not buy from the banks but do the recovery on behalf of the banks.

Despite the global financial crisis, which resulted in a rise in stressed assets in the banking system, the asset sale market didn't get a boost. This is mainly because the Reserve Bank of India gave a one-time dispensation to banks in which they could re-structure bad loans without classifying these as NPAs. Commercial banks' ratio of gross NPA to gross advances in 2009-10 marginally went up to 2.5 per cent from 2.4 per cent in the previous year, while the net NPA ratio remained flat at 1.1 per cent.[11]

6.5 International Models for A.R.C. in Indian Context

Estelar

ARCs have been used by several countries across the globe for management of their Non Performing or distressed assets. Different countries have adopted different models of ARCs to resolve their NPA bugbear with varying degree of success depending upon a verity of factors ranging from the type of assets to the political climate prevailing there. Typically, there have been two models[12];

A central disposition agency (i.e. takes bad loans from all financial institutions) or

An entity specific to a particular bank (or group of banks).

Globally ARCs have adopted two main approaches for resolution of the NPAs;

<< As a rapid disposition agency or

<< Corporate restructuring vehicle.

ARCs are normally government-owned and financed, although private capital can be introduced into the process as well. Keeping in view that ARCs are there to tackle the 'stock' problem, generally it has a limited life cycle over which it repays its initial and subsequent investors. Some of the major ARCs in Western and Asian countries have adopted the following approaches while acquiring the financial assets[13] :

Sale of assets at fixed price for equity participation in ARCs - tax motivated (Japan model)

Sale at 100% of NBV for interest bearing notes in ARCs - to protect the banks (China model)

Estelar

Central Bank negotiated sale value for interest bearing notes in ARCs - capital adequacy driven (Korea model)

Govt. controlled ARCs purchased NPAs at negotiated values - aggressively managed NPAs using third-party specialists (Thailand model)

ARCs have shown a mixed performance in resolution of NPA problem in different countries. Amongst the global ARCs, Securum of Sweden and RTC of USA have been the most successful ones. While Securum followed the corporate restructuring approach, RTC adopted the rapid disposition agency approach. The assets transferred to Securum were mostly commercial real estate of large size while those in RTC related to real estate and consumer loan assets which could be sold off through wholesale disposition.

In the Asian market Danaharta of Malaysia and KAMCO of Korea have shown better performance in recovery as compared to other countries. NPAs market in China has also picked up, after the initial slow progress. China has no domestic institutional investors (other than the banking system) with pools of capital big enough to absorb such a large portfolio of assets, or with the management know how to pursue resolve and administer such a mass of bad loans. Therefore, they needed the foreigners to invest in their NPA portfolio. Huarong, one of the four AMCs of China, has conducted bulk sale of NPAs and auctioned loans to foreign investors like Merill Lynch, Deutsche Bank etc. and has shown a remarkable recovery.[14]

Estelar

6.6 Indian Approach

The system envisages multiple ARCs as non Government entities with equity support of promoters. The Government is expected to have minimal participation in NPA resolution process. The ARCs in the country are not supported through Government funding and are not structured like a Central disposition agency, since NPA problem is not systemic for us. ARCs shall be governed by the provisions of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (Securitisation Act) and shall operate within the purview of RBI guidelines.[15]

RBI shall grant registration to the ARCs without which no ARC can conduct business. The empowerment of ARCs and strengthening of creditor's right has been brought into the system through the Securitisation Act. The Act provides a framework for recovery by the secured creditors without the impediments of lengthy legal wrangles.

Invocation of provisions under this Act abates the BIFR proceedings, which had become a shield to some recalcitrant borrowers (who willfully disobey the rules and instructions). The salient features of the Securitisation Act in respect of ARCs are as follows:

- Unfettered rights to the lenders acting in majority (>>75% by value) to enforce security rights without judicial intervention
- Establishment and empowerment of ARCs
- No single investor / sponsor to have majority control over ARCs
- Paves way for debt aggregation in ARCs by enabling acquisition of assets

Estelar

Accords ARCs the rights of the lenders

Additional rights to ARCs - not available with lenders

Sale or lease of businesses by superceding board powers

Enables foreign investor participation

Measures for reconstruction (Section 9)

Change in or takeover of management of business of the borrower

Sale or lease of part or whole business of the borrower

(Above two powers not available as of now, because RBI guidelines have not been issued for the same)

Rescheduling of payment of debt

Enforcement of security interest in accordance with the Act

Settlement of dues payable by the borrower

Taking possession of secured assets in accordance with the Act

Enforcement of Security Interest

Any security interest created in favour of secured creditor can be enforced without intervention of court or tribunal

Borrower required to discharge liability within 60 days

Secured creditor entitled to take possession or management of secured assets including right to transfer

Borrower can seek protection in DRT by depositing 75% of the amount claimed

In case of financing of financial asset by more than one secured creditors, exercise of rights under the Act can be done after

Estelar

securing agreement of 75% of the secured creditors.

6.6.1 Need and Importance of ARC

The ARCs will enable speedier resolution of NPA problem and unlock productive capacities in the industry. It leads to healthier balance sheets for the banks which allow them to raise resources globally. ARCs, the new initiative has tremendous potential to bring about a medium-term structural banking sector solution to the financial sector and allows bankers to focus on their core activity- dispensation of credit to industry and other sectors of the economy.

6.6.2 Organization Design and Management of ARCs

Several players have applied to RBI for registration in order to commence business. The major ones are, Asset Reconstruction Company (India) Ltd. (Arcil) and Asset Care Enterprise (ACE).

Arcil is sponsored by SBI, IDBI, ICICI Bank and HDFC group while ACE is promoted by IFCI, LIC and PNB.

The share holding pattern of Arcil is such that SBI and IDBI each, hold 24.5% of equity and ICICI Bank holds 24.5% out of the balance 51% held in private sector. This enables Arcil to retain the private sector character which gives greater freedom of decision making, flexibility of operations and faster resolution of NPA problem. Arcil has opted for a decentralized 'bank-based' model and is modeled as a 'Resolution Agency' as opposed to Rapid Disposal Agency.[16]

Estelar

Arcil is set to take on business immediately after the registration from RBI is received. Arcil's area of focus includes acquisition of stressed/NPAs, from Banks/FIs and rapid resolution of acquired assets in order to maximize the recovery value of acquired financial assets.

Arcil aims to unlock value and distribute majority of it back to the financial system and create vibrant investor market for NPAs in the country.

Key Issues before ARCs : The concept of ARCs is evolving in our country and therefore certain issues pertaining to valuation of financial assets, legal and regulatory measures, funding of the transaction and some other operational matters will get resolved gradually over a period of time.

Valuation : The valuation of financial assets proposed to be acquired is one of the major issues required to be resolved satisfactorily by ARCs. ARCs are required to pay 'fair market value' for the loan being acquired. Although there are a number of established international valuation techniques, like Market Multiples, Discounted Cash Flow, determining 'fair market value' is a complex task. Valuation of NPAs has inherently higher uncertainties and subjectiveness and lack of information is a major constraint. The discount rate to be adopted in valuation exercise leading to realistic pricing and allocation of loan value to different classes of secured lenders is a complex process. Resolving these issues and convergence of views of sellers (originators of the loan) and Arcil on transfer price is essential to conclude the deal. The

Estelar

sellers have their balance sheet management issues in view of lower provisions and some of the sellers may not be in a position to absorb up front losses arising out of transfer of financial assets to Arcil.

Debt Aggregation : In order to achieve a meaningful resolution, ARCs should have the ability to aggregate debt from various lenders and resolve inter creditor issues effectively. In the Indian context, this achieves higher degree of importance due to multiple/consortium funding arrangements and prevalence of different agreements with borrowers.

Legal and Regulatory Measures : Stamp Duty on Transfer of assets is a major road block for acquisition of assets by ARCs. So far only Maharashtra and Gujarat have given the desired reliefs for which all other states must follow suit. In order to give impetus to the business of ARCs for quicker and efficient clean-up of the financial system, it should be provided with adequate regulatory support from the Government.

Some other measures suggested in this regard are:

Distribution Tax exemption for the dividend declared

Income of trust set up by ARC to be tax exempt

Capital subscription in ARCs may get exemption and deducted from income

Section 9(a) & (b) of the Securitisation Act to be made operational.

Funding of Transaction : In absence of funding sources, the sellers are expected to be investors as Qualified Institutional Buyers (QIBs) in

Estelar

the initial phase of the transaction. The market for NPAs is not developed and as such the domestic players do not have the resources whereas foreign investor has appetite only when high returns are available. Contrary to Global experience Government funding/Guarantee not available for transfer of assets to ARCs.

Other issues like liquidity needs of the restructured unit, moral hazard for banking system, perceived risk in shift of decision making power from lenders to ARC, loss of opportunity of bilateral settlement for Banks/FIs will have to be overcome in the days to come for carrying forward the process of asset transfer to ARCs.

6.7 R.B.I. Guidelines for Securitisation and Asset Reconstruction Companies

Nearly 11 months after the SARFAESI law 2002, came into effect and nearly 1 month after a ridiculous deadline for making application for registration, the Reserve Bank of India (RBI) brought into force guidelines relating to securitisation and Asset Reconstruction Companies (ARCs).

Unsurprisingly, the muddling up of securitisation and asset reconstruction activities became all the more evident in the Guidelines as the RBI said that the same company could take up both asset reconstruction and securitisation activities - so, one would have securitisation and asset reconstruction companies (SARCs) in the country.

Estelar

In all, there are 6 notifications or circulars that bring the regulatory framework for SARCs into place together, these guidelines define the net worth and capital adequacy requirements for SARCs, provide for NPA recognition and consequent provisioning for the SARCs, and quite significantly, define the norms for transfer of assets by banks to the SARCs.

SARC (Reserve Bank's) Guidelines and Directions

Under various provisions of the SARFAESI Act, the RBI has issued the 2003 Guidelines and Directions. Precision of language is not a great virtue with lot many draftsman these days, but one is intrigued by the dual words "guidelines" and "directions". Obvious to a layman, directions implies something which is mandatory, while guidelines are a guide to good conduct, but not necessary mandatory. Sec. 12 of the Act empowers the RBI to give directions - guidelines, being merely for guidance or help, does not need a statutory power as such. Thus, the use of the words "guidelines" and "directions" would fix all those who are more careful about words and want to tell those parts of the said Guidelines and Directions which are mandatory from those that are not. For example, Rule 7 which goes into the niceties of operations of an ARC and prescribes biblical rules of good behaviour (thou shall be a good boy) is more like a guideline than a direction.[17]

The most curious exception to the scope of the Directions is that most of the operative part of the Directions applies to a direct acquisition of assets by a SARC, but does not apply only if such assets are held as

Estelar

a trustee for a trust. To fall outside the discipline of the Directions, all that the SARC has to do is to settle a trust, be a trustee to such trust, and acquire assets as a trustee. So, the obvious question is: what is it that would motivate a SARC from holding any of the financial assets it acquires directly? So, if everyone will choose the easy way out anyway, what is the relevance of the Directions, if at all?

Another, and even more curious, provision is in para 4 (iii) of the Directions which says: “Any entity not registered with the Bank under Section 3 of the Act may conduct the business of securitisation or asset reconstruction outside the purview of the Act.” Section 3 of the parent law clearly puts a bar on a business of securitisation and asset reconstruction without being registered with the RBI. Of course, the words “securitisation” and “asset reconstruction” only relate to certain assets under that law - for instance, they relate to assets of a bank originator. So, quite obviously, the provisions of the Act do not apply if someone were to securitise assets of a non-banking originator. But if the Directions, where the meaning of the words “securitisation” or “asset reconstruction” could not be different from what it is under the Act, say that business of securitisation or asset reconstruction can be carried outside the purview of the Act, it defies the very purpose of the mandatory nature of Sec. 3 of the Act. By settled rule, a subordinate instrument cannot travel beyond the parent law: therefore, Sec. 3 should remain unaffected by Rule 4 (iii) of the Directions and the latter should be simply read down.

Estelar

Modes of Acquiring Assets

The Directions seem to be suggesting that securitisation transactions will be done by acquiring assets in the name of trusts to be settled by the SARC. So, it is the SARC which is the entity. The Directions seem to be suggesting that the SARC will first buy the assets and then transfer the same to the trust - this does not literally make sense because the trust is, in fact, nothing but the SARC itself. Instead of first acquiring assets as a beneficial owner, and then declaring trust, the SARC might acquire assets as a trustee in the first place.

The only new provision relating to security receipts in the Directions is that the transferability of the security receipts is restricted, they can only be transferred to QIBs.

Reconstruction Activities

The Directions also provide, what we have earlier construed to be, rules of good conduct for reconstruction activities. This is Rule 7. This requires formation of various sets of policies by the SARC on issues like acquisition of assets, valuation, disposal, settlement, realisation cycle, etc. This rule essentially lays down various policies, all of which are internally to be framed and implemented. It should not have been necessary for the RBI to put in such basic rules of business in a quasi-legislative instruments: no regulator should make the mistake of substituting corporate governance by such rudimentary rules.

Estelar

Capital Adequacy

A 15% capital adequacy has been prescribed for SARCs on risk-weighted assets. The risk weights are similar to those under the Basel I convention.

SARCs are supposed to deploy their "surplus" funds only in G-secs and bank deposits. "Surplus", of course, is what is not invested in accordance with the scheme of investments. For instance, many revolving securitisation transactions may provide for investment in a particular mode as a part of the scheme of investments itself, which is not a surplus money anyway.

It is interesting to note that this requirement also, like most of the operative requirements of the Directions, does not apply in case of acquisition of assets in the name of trusts.

Another curious part of the Directions is its approach to NPA recognition by SARCs. It is a common knowledge that ARCs are really "bad banks" -they represent a bunch of bad assets hived off from the originating banks. By presumption, the assets must have been non-performing (though the Act or the Directions do not limit ARCs to buy bad loans only) from the very start. But they turn into performing assets from the very day they are bought up by the ARC, and remain performing for at least 6 months. It is only after failure of interest and/or principal after 6 months of acquisition that they become non-performing.[18]

Once they become non-performing, they will start coming for provisioning requirements. This, coupled with the requirement that the

Estelar

securities of the ARC must be interest-bearing, is a sure prescription that the ARC will soon be having losses on its own balance sheet. By mandatory requirements of the Act, if an ARC does not make profits for 3 consecutive years, it must be disqualified to be an ARC, and therefore, wind up.

It would not be surprising, therefore, that the combined effect of the Directions would be to make the whole business of ARCs unviable except for vulture financiers.

Directions to Transferring Banks

Importantly, the RBI has also given Directions to banks which contain both a provision for regulatory capital relief, as also issues like recognition of profit/losses, etc.

Para 3 of these Guidelines gives an impression that banks can sell only non-performing loans to SARCs. Once again, the RBI has made the elementary mistake of confusion that all securitisation to be reconstruction or vice versa, since securitisation, as different from asset reconstruction, is done in case of performing assets rather than non-performing assets. But most likely, bankers, who swear by the letter and not spirit of the RBI directives, are unlikely to take these Guidelines only limited to asset reconstruction.[19]

These Guidelines contain certain important clarifications that will help the securitisation market:

> That banks may invest in security receipts or other securities issued by the SARCs, which will be regarded as investments in the hand of the banks.

Estelar

That the exposure will be regarded as exposure in the SARC and not the underlying obligors.

That banks may remove the assets transferred by them to SARCs from their books thus achieving capital relief.

However, the Guidelines also put some extremely impractical limitations on the nature of the securities of the SARCs. Para 5A(b) says that the securities of the SARC must not have a term exceeding 6 years, must be non-contingent (unconditional undertaking to pay, not related to realisation of the assets by the SARC), and must carry a minimum rate of interest of Bank Rate plus 150 bps. Bankers will take this to mean that zero coupon bonds cannot be issued by the SARC. At the same time, the bond/debenture must not be subordinated, as the condition of an "unconditional undertaking to redeem" cannot be satisfied by a subordinated instrument. Apparently, this requirement is applicable in case of bonds and debentures, but it would be ridiculous to think that what is expressly imposed by the RBI in case of bonds and debentures may be skipped in case of pass-through certificates.

ARCs are not money-banks: they are not financial intermediaries.

They are recovery devices. There is no way ARCs can externally fund their acquisitions except by bringing in external investors. Such external investors are unlikely to accept a subordination to the transferring banks, as that does not make commercial sense. Therefore, there is no option but for the originating banks to accept a subordination of their bonds/debentures. Since the RBI guidelines expressly provide

Estelar

that the debentures cannot have a legal final maturity beyond 6 years, and they must be redeemable in cash, the only way would be to take the ARC to bankruptcy after 6 years if the assets have failed to pay off completely by then. And a complete pay off within 6 years will be extremely difficult to expect.

It can be understand from above description that RBI guidelines provide a framework for ARCs to become operational and also issue directions to Banks/ FIs to sell their financial assets. RBI requires all ARCs to have minimum owned funds of Rs. 2 crores and maintain a Capital Adequacy Ratio (CAR) of at least 15% at all times. Provisioning norms for ARCs are more stringent than those for banks. A planning period of maximum one year is provided during which the financial asset is classified as standard in the books of ARCs. A financial asset can be sold by Banks/ FIs to ARCs, where it is:

Classified as NPA or a Standard Asset and

(i) it is under a consortium

(ii) at least 75% (by value) is NPA in the books of other banks/FIs, and

(iii) at least 75% (by value) of banks/ FIs in consortium/ multiple banking arrangement agree to the sale.

The sale of financial assets to ARCs has to be conducted in such a manner that no known liability devolves on the seller bank/ FI. The asset acquisition shall take place in a transparent manner and at a fair price in a well informed market, executed at arm's length in exercise of due diligence.

Estelar

Concludingly, the ARCs will play an instrumental role in resolution of NPA problem that is looming over the financial sector in the country. The private sector model adopted in case of Arcil has certain inherent advantages like freedom of decision making and greater operational flexibility than a Government entity. It adds value by the following measures:

Single Point resolution of problem loans and assets

Resolution of inter creditor issues, after 75% debt aggregated

Expert management of problem loans through reconstruction and other measures

Allows specialist asset rehabilitation and management skills to be focused on distressed asset value enhancement

Expert and focused management of the process of maximising net returns (i.e. after costs) over a reasonable timeframe.

Estelar

Reference

1. Saxena K.S., "Management of Non-performing Asset", Journal of Banking and Finance, Vol.33, No. 6., 2009.
2. Prof. G.V. Bhavani Prasad and D. Veena, "NPAs in Indian Banking Sector- Trends and Issues", Volume 1, Issue 9, 2011.
3. Bhattacharya H., "Banking Strategy, Credit Appraisal and Lending Decisions", Oxford University Press, New Delhi, 2010, p.354.
4. Mohan R. "Transforming Indian Banking - In search of a better tomorrow", Reserve Bank of India Bulletin, January 2003.
5. Ibid.
6. Saxena K.S., "Management of Non-performing Asset", Journal of Banking and Finance, Vol.33, No.6., 2009.
7. McGoven J., "Why Bad Loans happen to Good Banks", The Journal of Commercial Lending, Philadelphia, February 2008, Vol.88.
8. rbidocs.rbi.org.in/rdocs/notification/PDFs/SC413R2104210.pdf
9. Dudeja V.D., International Business Environment, Commonwealth, New Delhi, 2002, p.431.
10. Ibid.
11. Gupta L.C., "Financial Ratios for Monitoring Corporate Sickness", Oxford University Press, New Delhi, 2003, p.221.
12. Chaitanya V.K., "Causes of Non-performing Assets in Public Sector Banks", Economic Research, 17(1), 2004, pp.16-30.
13. Desia Vansant, "Indian Banking : Nature and Problems", Himalaya Publishing House, Mumbai, 2004, p.339.
14. Das S. and Bose S.K. "Risk Modelling - A Markovian Approach, The Alternative", Vol.IV, No.1, March 2005, pp 22-27.
15. Desia Vansant, op.cit., p.427.

Estelar

16. Rajaraman Indira, Bhaumik Suman and Bhatia Namita, "NPAs Variations across Indian Commercial Banks", Economic and Political Weekly, 2009, Jan.16-23, pp.161-168.

17. Chakravarty S. "Report of the Committee to Review the Working of the Monetary System", Mumbai: Reserve Bank of India, 2005.

18. Munehisa Kasuya, (1998). "Non-performing Assets of Banks and Financial Intermediation: Experinecs of Japan in the Inter-War Period", Kobe Economic and Business Review, 2008, 53, pp.119-46.

19. Chakravarty S. "Report of the Committee to Review the Working of the Monetary System", Mumbai: Reserve Bank of India, 2005.

*****

Estelar