



*Government of India  
Ministry of Finance  
Department of Financial Services*

*Report of the Key Advisory Group  
on the Asset Reconstruction Companies  
(ARCs)*

*30<sup>th</sup> December, 2011*

**F.No.17/7/2011-BO.II**  
**Government of India**  
**Ministry of Finance**  
**Department of Financial Services**

**REPORT OF THE KEY ADVISORY GROUP (KAG)**  
**ON THE ASSET RECONSTRUCTION COMPANIES (ARCs)**

*Government constituted a Key Advisory Group (KAG) on the Asset Reconstruction Companies (ARCs) vide Order dated 30.09.2011. The constitution and terms of reference of the Group is in ANNEX. The Group had representation from all the stakeholders from the sector including the Reserve Bank of India, SEBI, the Indian Banks' Association, FICCI, CII, ASSOCHAM, ARCIL, Ernst & Young, prominent Law firms viz. Amarchand Mangaldas, Juris Corp., and also from ARCs. The terms of reference of the Group was as under –*

- i. Review of existing legal / regulatory / institutional framework for ARCs and its efficacy;*
- ii. Action plan including policy initiatives for orderly growth of the Sector;*
- iii. To recommend the legal / institutional / regulatory initiatives related measures required for orderly growth of the Sector.*

*2. The Group held its meetings on 22.10.2011, 3.11.2011 and 3.12.2011 and had extensive deliberations and consultation on a wide range of issues having a bearing on orderly growth of the sector and finalised a draft report. The draft report of the Group was circulated among all the Members inviting their comments. The report was appropriately modified taking into consideration the comments received from the Members. Accordingly, the 1<sup>st</sup> Report of the Group has been finalised on 30.12.2011.*

*3. The Group expresses its sincere gratitude to the Department of Financial Services, its officials and staff for putting in unstinting efforts in organising the meetings of the Group and finalising its Report.*

**(Alok Nigam)**  
**Chairman**  
**30<sup>th</sup> December, 2011**

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# 1. INTRODUCTION

## 1.1 Global Perspective

*“In recent decades many countries have experienced banking problems requiring a major and expensive overhaul of their banking system. By one count, 112 episodes of systemic banking crises occurred in 93 countries since 1970 (Caprio, Klingbeil 1999).*

*As cross country evidence indicates, stock solutions tend to be necessary where banking distress is systemic and often include liquidation of unviable banks, disposal and management of impaired assets and restructuring of viable banks. For the management and disposal of bad debt, governments have made extensive use of publicly owned Asset Management Companies (AMC) that either dispose off assets hived from bank balance sheets or restructure debt. AMCs have become very popular including in Asian Financial crisis.*

*On a conceptual basis, countries can use either flow or stock approach to resolving banking distress and the overhang of bad debt in the financial system. Whether a country should adopt a flow or stock solution depends, among other things, on the degree of distress in the system and extent of official safety net. (The use of Asset Management companies in resolution of banking crises cross country experience – Daniel Klingbiel)*

## 1.2 NPA in India

*Large and mid-size NPAs, mainly in industrial sector, account for more than 50% of total NPAs of the system. Resolution of these assets would largely be through operation of industrial assets over long timeframe. This requires in-depth skills for operational and financial restructuring either with the same promoters or change in hand. Recycling and improvement in capital efficiency is the overarching objective in any NPA resolution architecture, be it restructuring or liquidation / foreclosure particularly in growing economies needing more capital. Productive use of assets leverages the growth opportunities. The NPAs in Indian system have considerable going concern value. The challenge is to extract value from the underlying NPAs by adopting appropriate resolution strategies. Quicker resolution benefits all stakeholders. The experience suggests that NPAs, like a cube of ice, lose value over time and rather fast. The early stage resolution allows the value capture as the borrower may still have “going concern” value. A workout approach, where the cash flows from the assets are realized through operational and financial restructuring or change in the management of the borrower*

companies, through M&A or sale of business enables the lenders to benefit from the “going concern” value. At later stages, the NPA resolution options get limited to sale of assets in piecemeal, through creditor driven foreclosures or through liquidation of the borrower account resulting in considerably lower realizations for all concerned as compared to the realizations under the workout.

This has important ramifications for policy makers and regulators. A right kind of environment needs to be created for accelerated flow of NPAs to the ARCs well in time, so that value maximization in terms of capacity enhancement, employment generation and with sick units coming back to operations, contribution to state exchequer in terms of taxes and revenue can take place. This has to be reinforced with creating a legal and economic environment conducive for time bound workout based resolution and finally an effective foreclosure framework which could operate as credible “threat” for recalcitrant borrowers.

### **1.3 Genesis of ARCs in India**

By the late 1990's, the ballooning figures of NPAs set alarm bells ringing across the financial corridors of the country, responding to which, two committees were set up 1. Committee on Banking Sector Reforms - Narasimham Committee and 2. Restructuring of weak Public Sector Banks -Verma Committee. The Committees favoured creation of a separate vehicle to address rising NPAs. The Government of India after several deliberations with the key players, prudently enacted the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, (SARFAESI / the Act ) to pave the way for setting up Asset Reconstruction Companies (ARCs) in India.

Under the Act, it was envisaged that ARCs shall be registered with RBI and RBI would issue necessary guidelines to ARCs for conducting business. RBI came out with the guidelines in April 2003. The Act was, however, challenged by a group of borrower companies led by Mardia Chemicals and Industries Limited. After protracted litigation, the constitutional validity of the Act was upheld by the Supreme Court of India in April 2004.

In the meanwhile, Asian Development Bank (ADB), in consultation with Ministry of Finance, Government of India appointed PricewaterhouseCoopers(PwC) to carry out an engagement for ‘Developing the enabling environment for and structuring Asset Reconstruction Companies (ARCs) in India’. PwC conducted the work in association with Amarchand & Mangaldas & Suresh A.Shroff &Co. (AM) an Indian law firm and Blake Dawson Waldon, an international law firm, The scope of the project included, inter alia, a review of Indian NPAs and the existing legal and operational framework for ARC

operations including the SARFAESI Act and recommending suitable changes for effective functioning of ARCs in India.

The report was submitted to the Ministry of Finance in February 2004 and placed in their website. A number of recommendations have since been implemented.

## **1.4 Various ARC Models**

*There are broadly three categories of ARC models, salient features of which are as follows:*

### **A. Bank-based model**

*In Bank-based model, the NPAs effectively remain on the books of banks or are transferred to a specialized work-out unit or to a separate organization such as a subsidiary of the bank. The focus is typically on work-outs as opposed to rapid disposition. While this model does offer certain advantages such as focus on resolution and operational flexibility, it suffers from slow resolution progress on account of lack of debt aggregation in a multi-lender situation and varied skill sets to drive complex resolution. Moreover, the risk and reward of NPAs remain with the concerned bank itself.*

### **B. Non Governmental market based model**

*The Non-governmental or market based model is adopted essentially where there is absence of crisis but nature and size of NPAs could undermine the efficiency of the banks. Governments typically provide enabling legal and regulatory environment for market based exits at values determined through market forces between sellers (banks) and buyers (investors). Governments also provide selective capitalization support to banks for their clean-up programs. Governments may also provide for specialized intermediation in the form of ARCs for acquiring and resolving NPAs that may be set up by the banks or the investors. The model relies for success on participation by willing sellers and buyers and strong regulatory inducements in the absence of direct financial support.*

### **C. Government owned and supported model**

*The Government owned / sponsored approach is employed as a response to economic and banking crisis. The governments typically set up nodal ARCs to transfer the “stock” of NPAs from the banking system as a measure of system wide one time clean-up. The governments bear the cost of such clean-ups. ARCs raise money from third party investors (typically foreign investors) for acquisition of NPAs. Investors implement the resolution and carry the risks and rewards*

arising there from. The model was extensively used by several South-east Asian countries in the aftermath of economic crisis.

## 1.5 Indian Model

In India, however, there was no systemic crisis and ARCs were created as a proactive measure by the Government rather than a reaction to an engulfing crisis. ARCs in India are set up as a non-government vehicle rather than government owned/supported model. It provides for operation of multiple ARCs. Support from the banking system is an essential requirement for success of the model.

## 1.6 Evaluation of ARCs in the context of NPAs in banking sector

In the past 3 years (2008-2010) for which data contained in Trend and Progress of Banking (RBI) is available on date, the Gross NPAs of the banking system have been on a rise and the incremental growth shows acceleration. However, growth in book value of NPAs sold by banks/ financial institutions to ARCs, which were created as a systemic response to tackle the menace of growing NPAs, has not been able to keep pace. An area of concern that needs critical introspection-the incremental SRs issued since 2008 has been declining, even while NPAs are growing, as shown in the table below.

	Amount Rs. in crore			
	Mar-07	Mar-08	Mar-09	Mar-10
Gross NPAs	50,486	56,435	68,973	84,747
Incremental Gross NPAs		5,949	12,538	15,774
	Jun-07	Jun-08	Jun-09	Jun-10
Book Value Transferred to ARCs	28,544	41,414	51,542	62,217
Incremental flow		12,870	10,128	10,675
SRs issued	7,436	10,658	12,801	14,051
Incremental SRs issued		3,222	2,143	1,250

(Source- RBI Trend and Progress of Banking Nov 8, 2010)

The movement of Gross and Net NPAs in various categories of banks in last 3 years is given below.

Bank Group	Outstanding NPAs			Rs. In crore		
	Gross NPAs			Net NPAs		
	Financial Year			Financial Year		
	2009	2010	2011	2009	2010	2011
Public Sector Banks	44,991	59,927	73,481	21,155	29,644	36,074
Private Sector Banks	16,927	17,638	18,243	7,412	6,506	4,574
Foreign Banks	6,445	7,134	5,071	2,997	2,976	1,283
<b>TOTAL</b>	<b>68,363</b>	<b>84,699</b>	<b>96,795</b>	<b>31,564</b>	<b>39,126</b>	<b>41,931</b>

(Source: IBA)

The Gross as well as Net NPAs are on the rise, notwithstanding compliance of 70% PCR (provisioning coverage ratio) by most of the banks.

The situation in 2011-2012 is likely to be worse. In terms of a report by CRISIL published in September 2011, the banks' Gross NPA ratio is likely to touch 3% in March 2012 against 2.3% as at March 2011. The deterioration in asset quality will be driven primarily by slippages in the banks' corporate and SME loans portfolios. This is likely to be caused by increasing interest rates, high input prices, and an expected moderation in economic growth. The banks' migration to system-based recognition of NPAs will also result in higher NPAs over the near term.

An interesting observation by Reserve Bank of India in its Financial Stability Report (June 2011) states:

*"The change in category-wise distribution of NPAs during the year revealed an increase in doubtful assets vis-à-vis sub-standard assets, indicating that NPAs were becoming increasingly stickier. The trend was even more pronounced in case of new private sector banks which warranted monitoring."*

## 1.7 Development of Market

*"In many countries the Asset Management Companies (AMCs) failed because the creation of AMCs did not lead to the development of a market for NPLs. Such a market is typically missing in less developed countries because information asymmetries and a lack of creditor coordination make it very difficult to price NPLs. "(IMF working paper on the role of KAMCO in resolving Non performing Loans in Republic of Korea- Dong He). The development of a NPA market can, therefore, be hardly overemphasized.*

## 2. KEY FEATUTRES IN AMC IN OTHER COUNTRIES

	<b>Malaysia</b>	<b>Korea</b>	<b>Thailand</b>	<b>Taiwan</b>
<b>Causes of financial Crisis</b>	<ul style="list-style-type: none"> <li>• <i>Substantial credit for investment in property/stocks</i></li> <li>• <i>Fall of stock market by 50%</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Highly leveraged debt with directed lending</i></li> <li>• <i>Inadequate loan classification and provisioning standards</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Large exposure of finance companies to property sector</i></li> <li>• <i>Inadequate provisioning of NPL loan classification and interest accrual norms</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Excessive dependence on real estate loans whose value deteriorated</i></li> </ul>
<b>Magnitude of crisis</b>	<ul style="list-style-type: none"> <li>• <i>NPA level soared to 25% in 1998</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>NPA level soared to 35% in 1998</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>NPA level soared to 50% in 1998</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>NPA level soared to 8% in 2002 (from 3% in 1995)</i></li> </ul>
<b>Approach taken by Govt.</b>	<ul style="list-style-type: none"> <li>• <i>Fiscal and policy support at stabilizing financial structure and restructuring corporate structure through centralized management</i></li> <li>• <i>Danaharta, AMC, to acquire NPAs</i></li> <li>• <i>Govt to inject new capital in undercapitalized banks</i></li> <li>• <i>Introduced prudential norms for banking and finance sector</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Fiscal and policy support at stabilizing financial structure and placing NPAs into private sector through KAMCO, the government owned AMC</i></li> <li>• <i>Korea Deposit Insurance Corporation (KDIC) set up for deposit insurance and capitalization of banks</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Fiscal and policy support at stabilizing financial structure and restructuring corporate structure through centralized management</i></li> <li>• <i>Establishment of FRA – a Govt owned company to dispose of the assets of finance companies</i></li> <li>• <i>TAMC a Govt Agency to act as restructuring agency.</i></li> <li>• <i>Few banks set AMCs to take over and manage their NPAs</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Government policy support -placing NPAs into hands of private structure</i></li> <li>• <i>Establishment of Resolution Trust Corporation to take over all insolvent financial institutions</i></li> <li>• <i>Decrease in cash reserve ratio and business tax(0% from 2006)to provide additional income to write off loans</i></li> </ul>

	<b>Malaysia</b>	<b>Korea</b>	<b>Thailand</b>	<b>Taiwan</b>
<b>Governance</b>	<ul style="list-style-type: none"> <li>• <i>Danaharta Managed by a 9 member Board of Directors comprising non-executive chairman, MD, two non executive directors representing Government sector, three from Malaysian community and rest two from international community</i></li> <li>• <i>Supervised by the oversight committee.</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Earlier KAMCO conducted operations under Ministry of Finance and Economy (MOFE). Since 1998, placed under direct supervision of Financial Supervisory commission.</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>TAMC affairs supervised by Ministry of Finance</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>As Taiwanese AMC's private owned, dictated by their owners (single distressed debt investors)</i></li> </ul>
<b>Acquisition/ Transfer of Assets</b>	<ul style="list-style-type: none"> <li>• <i>Selected large loans that had potential value - small loan (consumer/residential) not taken up</i></li> <li>• <i>No Special power for acquisition- Acquired assets only after pricing and terms and conditions agreed with seller banks.</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Initially KAMCO focused on acquisition of NPAs from banks/FIs whose self rehabilitation plans were approved by Financial Supervisory Commission (FSC)</i></li> <li>• <i>KAMCO purchased NPAs from financial institutions at the purchase price on take it or leave it basis.</i></li> <li>• <i>Financial institutions who did not wish to transfer the assets to KAMCO were permitted to sell their assets directly to foreign investors</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>FRA acquired nonperforming assets of finance companies closed.</i></li> <li>• <i>Bank owned AMC's acquired NPAs from parent bank.</i></li> <li>• <i>In case of TAMC, all state owned banks were required to transfer their NPAs to TAMC.</i></li> <li>• <i>Private sector banks had the option to decide whether to transfer NPAs to TAMC</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Taiwan AMC's have acquired NPAs primarily through open bidding at auctions. In most of the cases selling bank has engaged financial advisor to assist in selling process.</i></li> <li>• <i>Taiwan AMC's have also entered into private negotiation with financial institutions to acquire NPAs</i></li> </ul>

	<b>Malaysia</b>	<b>Korea</b>	<b>Thailand</b>	<b>Taiwan</b>
<b>Incentive to facilitate acquisition/ transfer</b>	<ul style="list-style-type: none"> <li>• BNM, The regulator set up a 10% ceiling of NPAs that a bank can hold</li> <li>• Banks were required to write down loans to 20% below Danaharta offered price</li> <li>• BNM allowed banks 5 years to amortise loss upon transfer</li> <li>• Danaharta had special powers to resolve NPAs that were not available with banks</li> <li>• Danaharta paid in Tradable Government Bonds which had zero risk weight</li> </ul>	<ul style="list-style-type: none"> <li>• Participating institutions were provided with capital support by Government following disposition of their NPAs</li> </ul>	<ul style="list-style-type: none"> <li>• Where transfer criteria was satisfied, debtors could request TAMC to consider acquisition of their NPAs</li> <li>• Bank of Thailand required the private institutions that decided not to transfer the asset, to get the collateral valued by an independent appraiser within 120 days and then set full provision net of collateral</li> <li>• TAMC had special powers to resolve NPAs that were not available with banks</li> </ul>	<ul style="list-style-type: none"> <li>• MOF required banks to reduce their NPAs to 7% by end 2002 and 5% by end 2003</li> <li>• Banks that do not meet the above benchmark are subject to penalty such as restriction in opening of branches, distribution of dividend and cancellation of existing branch licence</li> <li>• Banks were allowed five years to amortise loss on transfer to AMC</li> </ul>
<b>Funding</b>	<ul style="list-style-type: none"> <li>• Government Guaranteed zero coupon redeemable bonds used to purchase NPAs</li> </ul>	<ul style="list-style-type: none"> <li>• NPA fund financed mainly through the issue of Government Guaranteed (variable coupon) bonds to finance purchase of NPAs.</li> <li>• In addition, contribution by Korea Development Bank also used</li> </ul>	<ul style="list-style-type: none"> <li>• AMC-partially Government Bonds have been used to finance purchase of FRA assets</li> <li>• Private AMCs were permitted to raise funds from bank loans, floating shares and debt issues.</li> <li>• TAMC- non negotiable callable debt instruments guaranteed by FIDF have been used to finance NPAs</li> </ul>	<ul style="list-style-type: none"> <li>• NPA acquisition funding has been secured from AMC's parent companies.</li> <li>• Some AMCs have also obtained loan from local commercial banks to finance purchase of NPAs</li> </ul>

	<b>Malaysia</b>	<b>Korea</b>	<b>Thailand</b>	<b>Taiwan</b>
<b>Valuation of Assets</b>	<ul style="list-style-type: none"> <li>• <i>Danaharta has valued the NPAs on the basis of fair market value assessment and has used a discounted cashflow method to arrive at this value.</i></li> <li>• <i>Due diligence exercise carried after obtaining information from the banks</i></li> <li>• <i>The discount used by Danaharta to arrive at the fair market value is the risk adjusted interest rate- risk factors differing for various types of loans</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Due to constraints of limited financial information and Government's request for expeditious resolution of NPAs, KAMCO decided to calculate the purchase price by estimating potential market price based on its past experience in dealing with similar asset transaction.</i></li> <li>• <i>Secured loans have been priced by adding/subtracting price fluctuation of collateral assets from recent average foreclosure rates.</i></li> <li>• <i>Unsecured loans have been priced @ 3% of face value</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>FRA- Assets of failed finance companies taken over. No price paid.</i></li> <li>• <i>TAMC has valued the assets differently depending on whether they were acquired from state or private financial institutions. Secured Assets from state financial institutions have been valued on the basis of fair value .Unsecured loans taken at zero value</i></li> <li>• <i>NPAs of private sector have been valued based on value of collateral and guarantees or book value of NPAs whichever is less.</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Taiwan AMCs acquired assets at fair market value determined in public auctions conducted by various banks.</i></li> </ul>

	<b>Malaysia</b>	<b>Korea</b>	<b>Thailand</b>	<b>Taiwan</b>
<b>Special Legal Powers</b>	<ul style="list-style-type: none"> <li>• <i>Appointment of Special Administrator (SA) who takes over management and control of assets of the borrower</i></li> <li>• <i>SA has to prepare a workout proposal to be approved by an independent advisor and majority of secured lenders</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>No special legal authority</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>TAMC allowed to set up limited companies to manage the NPAs</i></li> <li>• <i>Petition to court for absolute receivership of borrowers' assets, in case business reorganization is terminated</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>AMCs are allowed to use simplified auction procedure in stead of using court mechanism.</i></li> <li>• <i>AMCs are allowed to appoint independent third party (with approval of MOF) to conduct public auction of collateral</i></li> <li>• <i>Under certain circumstances AMCs are not restricted by the bankruptcy law and company law and can exercise their claims even after he has been declared bankrupt or under reorganization.</i></li> </ul>

	<b>Malaysia</b>	<b>Korea</b>	<b>Thailand</b>	<b>Taiwan</b>
<b>Resolution</b>	<ul style="list-style-type: none"> <li>• Resolution of viable loans through loan restructuring methods such as extension of loan tenures, one time settlement/ scheme of arrangement</li> <li>• For non-viable loans, asset foreclosures</li> <li>• Danaharta has foreclosed property sales without reference to court</li> </ul>	<ul style="list-style-type: none"> <li>• It formed portfolios by pooling together NPAs acquired from banks/Financial institutions and carried out bulk sales through international bidding and ABS issuances.</li> </ul>	<ul style="list-style-type: none"> <li>• FRA has disposed the assets (of closed finance companies) through series of auctions</li> <li>• TAMC- viable loans resolved through debt and corporate restructuring</li> <li>• For others, foreclosure of collateral or receivership of properties.</li> </ul>	<ul style="list-style-type: none"> <li>• Taiwan AMCs have relied on foreclosure of collateral and debt settlements.</li> <li>• Reorganization of debtors business has not been an attractive option because of inter-creditor issues and long delays observed.</li> </ul>

The above information on comparative position of AMCs has been obtained from "TA no, 3943-IND Developing the Enabling environment for and structuring ARCs in India" Published by PwC.

Danaharta in Malaysia and KAMCO of Korea are recognized as successful AMC models. A combination of factors seems to have worked in their favour. A few key support features that led to the success of the AMCs in cleansing the banking system of the NPAs and successfully resolving the assets so acquired are as follows:

- 1) Fixation of ceiling of maximum (%) NPAs that a bank can hold
- 2) Active encouragement of participation by foreign investors
- 3) Mark to Market based on price offer by AMCs
- 4) Amortization of loss on transfer of assets to AMCs
- 5) Special resolution powers
- 6) Tax exemption on acquisition of assets

## 3. REVIEW OF EXISTING ARC FRAMEWORK IN INDIA

### 3.1 Regulatory and Structural issues

#### 3.1.1 NPA auction sale process and price discovery

*Seller banks have generally adopted competitive bidding process for sale of their NPAs. However, despite adopting a process as defined by banks themselves, transactions are aborted / not closed even after running the defined process and receipt of multiple bids on the ostensible pretext that bids are lower than their expected price. It may be noted that ARCs spend considerable time and resources in conducting due diligence of the assets on sale. However, quite often the transactions are not consummated. At times the deal closure process is modified after the receipt of the bids and a different approach is adopted to close transactions.*

##### **Suggested Measure**

- ***Suitable Guidelines for evolving a standard sale process to be issued by Reserve Bank of India which, inter alia, should include disclosure of reserve price and conclusion of the deal if bids are received above reserve price.***
- ***After an auction, the best bid received can be treated as price discovery of underlying security. Banks to be mandatorily required to adopt it as reference value for mark-to-market.***

*In this connection, RBI has suggested that Association of ARCs (Association) and Indian Banks Association (IBA) have to arrive at an acceptable business behavior leaving no scope for complaints. IBA may take a lead role in evolving proper code of conduct but persuasion from RBI will accelerate the process substantially.*

*The Key Advisory Group on ARC (The Group) is, therefore, of the view that RBI's intervention will also be necessary.*

### 3.1.2 Gradual write off of loss on sale to ARCs

*Due to lower Provisioning levels on NPAs of banks/ Financial Institutions (FIs), the book values are higher compared to the realizable value or value at which ARCs will be willing to acquire the NPAs. Required higher write off for NPA sale to take place adversely impacts the profit of banks/ FIs in the financial year of sale to ARCs. Thus banks/ FIs prefer to have a “provide and hold” approach to avoid taking the knock immediately and the value of the underlying assets keeps on deteriorating.*

#### **Suggested measure**

- ***RBI may permit amortization of the loss on transfer to ARCs on a gradual basis to accelerate cleansing of the NPAs from bank/FI's books.***

*While RBI would perhaps prefer to continue with the obviously most prudent measure of providing for anticipated losses i.e. one time provision, the Group strongly feels that if the banks' books have really to be cleansed they should be provided some headroom and allowed to write off the losses incurred on account of transfer of impaired assets to ARCs, in two or three installments. Other countries like Malaysia and Taiwan have followed this methodology successfully (over a period of five years).*

*It may also be argued with same force that if provisioning norms for bad loans are time based and gradual, in order to ensure real cleansing of banks' books similar gradual write off may also be permitted when the losses have crystallized.*

*RBI is requested to kindly consider this favorably.*

### 3.1.3 Permission to acquire debt from other ARCs

*As per Section 5 of SARFAESI Act 2002, ARCs can acquire financial assets from banks and FIs only. It does not permit acquisition of financial assets from other ARCs. As per Section 13(4) of SARFAESI Act, secured creditors will be entitled to enforcement of security interest only when secured creditors representing three fourth by value agree for the same action. As multiple ARCs are in operation, without provision of Inter ARC transfer of Financial Assets, debt aggregation to the stipulated level will be difficult, with each ARC having a smaller pie of the financial asset hindering resolution process.*

### **Suggested measure**

- **ARC may be permitted to acquire financial assets from other ARCs.**

*In this context, it may be added that in the interest of ensuring that the bad debts in the system do not continue indefinitely, RBI has not been in favour of transfer (sale) of assets between ARCs. This reservation can be overcome by stipulating a maximum period beyond which, despite transfer of an asset from one ARC to another, it will be deemed as having no redemption value.*

*Presently an asset cannot be continued in ARC's books or in the books of Trusts for more than 8 years. This period may be marginally increased to say 10 years beyond which the asset will be treated as having zero NAV. This will permit transfer of assets from one ARC to another purposefully. For the aggregation at least, the ARCs need to be permitted transfer of assets from one ARC to another.*

### **3.1.4 Investment in SRs by Insurance Companies**

*IRDA Investment Regulations, 2000 permit investments by Life and Non-Life insurance companies in other than approved Investments to be governed by exposure/ prudential norms of IRDA. These include investments in equity, preference share, convertible debenture, loans and other financial assistance and in the units of venture funds etc.*

### **Suggested measure**

- **IRDA may modify the regulations expressly to permit investment in SRs as an eligible separate category for investment.**

### **3.1.5 Mark to Market based on ARC offer**

*Debt aggregation is the key to faster resolution and maximization of value of the underlying security. However, because of multiple and consortium banking arrangement with attendant inter-creditor issues, debt aggregation gets delayed resulting in opportunity loss to the economy in terms of capacity generation, employment creation, realization of overdue revenues etc.*

### **Suggested measure**

- **Where an ARC acquires 60% of the debt of a NPA account, the acquisition value of ARC could be treated as the fair value.**

***Accordingly, in case a bank / FI upon being made an offer by ARC, does not transfer the concerned NPA, the concerned bank / FI should be required to provide against NPA with the offer made by the ARC as the reference value with similar security and charge particulars.***

*RBI is requested to consider the suggestion/recommendation.*

### **3.1.6 Broadening of Market by inclusion of NBFCs**

*NBFCs are important part of the financial system. Facilitating sale of such NPAs to ARCs will be in sync with the underlying spirit of creation of ARCs as an institutional response to tackle growing NPAs in the financial system. Besides, it will help debt aggregation prospects, the key to resolution success and unlocking values in the underlying NPAs*

#### **Suggested measure**

- **Regulatory approval for enabling NBFCs to sell NPAs to ARCs.**

### **3.1.7 Modification in FII investment**

*To provide clean exit to banking system from NPAs, induction of new money into the system for the purpose of acquisition and thereafter resolution is essential. Foreign investors, with their experience and expertise in this field can play a critical role in this regard. The Reserve Bank of India accordingly issued Guidelines in November 2005 permitting:*

- *FDI in equity capital of ARCs up to 49%*
- *FII investment of 49% in the SRs issued by ARCs with sub-cap of 10% for participation by individual FIIs*

*In fact, in terms of the RBI Guidelines itself issued on November 11,2005, the policy on FDI was required to be reviewed after 2 years and that of FII investment was due for review after one year.*

#### **Suggested Measure**

- **Sub-cap of 10% for participation by individual FII needs to be removed.**

- FII may be permitted to invest in SRs upto USD 20 Billion(like in corporate bonds).
- Sub-accounts registered with the Securities Exchange Board of India(SEBI) which are otherwise permitted to invest in other Indian securities should also be specifically permitted to invest in SRs. If Sub accounts are permitted to invest in SRs, no sub-cap should be prescribed.

### 3.1.8 Removal of Sub-limit for FII Investment at tranche level

*Presently, FIIs are permitted to collectively acquire not more than 49% of SRs in a “tranche”. Such limit in each “tranche” restricts the FII investment to the fullest extent in a ARC scheme established on the basis of capital commitment received from QIBs (including FIIs) over multiple closings. This problem is accentuated where significant commitments from domestic QIBs have been received in earlier closings and have also been partly deployed by the ARC schemes for acquiring non-performing assets.*

#### **Suggested measure**

- RBI may dispense with such “per tranche” limit for FIIs.

### 3.1.9 Secondary Market making for SRs

*FEMA Regulations permit FIIs to acquire SRs issued to them by ARC schemes. However, FEMA Regulations do not permit FIIs to sell the SRs except through the stock exchange. Usually, the SRs are not listed due to the lack of liquidity.*

#### **Suggested Measure**

- *RBI may permit FIIs to sell the SRs to other QIBs outside the exchange. FIIs may also be permitted to buy SRs (which are already subscribed by QIBs or ARCs) from QIBs / ARCs in the secondary market outside the stock exchange to be reported to RBI.*

### 3.1.10 Conversion of debt into equity

*Section 5(2) of SARFAESI Act provides ARCs the rights of the lender bank/FI on acquisition of a financial asset. By virtue of this provision, ARCs can convert debt into equity as part of resolution strategy. In cases of the financial assets which have restructuring and turn around potential, it would be necessary to arrive at sustainable level of debt, on the basis of evaluation of detailed business plan with projected level of operations, which can be serviced by the company. A part of debt needs to be converted to equity for an optimal debt equity structure. The right to conversion of debt into equity in restructured companies is now derived from the original loan documents of the concerned borrower with the lender. However, there would be cases where such agreement may not have been executed with reference to the acquired debt.*

#### **Suggested measure**

- ***Measures for asset reconstruction be suitably amended to include conversion of part of debt into equity specifically in the SARFAESI Act.***
- ***Reserve Bank of India may empower the ARCs to convert debt acquired by them in usual course of business from banks/ FIs into equity of the defaulting company by way of a new contract subject to applicable law and regulatory guidelines.***

### 3.1.11 Issuance of Guidelines on Sale/Lease of Business

*While SC/RCs have been permitted to change/take over of management under section 9(a) of the SARFAESI Act, they are not permitted to lease or sell the business under Section 9(b). Exercise of this power needs to be read with power to lease or sell the business of the borrower. While exercise of such power under Section 9(b) requires RBI guidelines which have not been issued but similar power to secured creditors contained in section 13(4) permits exercise of such powers by secured creditors including ARCs. Requirement of restoration of management back to the borrower on realization of the debt is provided by Section 15(4) of the SARFAESI Act 2002 and any change in such requirement will need an amendment to the Act. The power to take-over management can be exercised by giving the business on lease for a definite period so that the lessee is aware at the outset that on expiry of the lease he has to surrender the business. If the debt is not recovered, the lease can be extended or power of sale can be exercised.*

#### **Suggested Measure**

- **To facilitate exercise of power to take-over management under section 9(a) of the SARFAESI Act, 2002, RBI needs to issue guidelines under section 9(b) of the said Act for the lease or sale of the business of the borrower**

### **3.1.12 Restructuring Support Finance- participation by investor**

*Value Maximization in NPAs occurs only after detailed workout involving restructuring. To make this exercise successful, infusion of fresh funds to scale up operations to optimal level is essential. While RBI has already issued Guidelines for disbursement of Restructuring Support Finance (RSF) by ARC's to scale up operational efficiency, source of funding is constricted due to paucity of funds with ARC's. To make restructuring viable, depth of liquidity is a necessary pre-condition. ARC's can contribute maximum to the growth of economy by successful turnaround of companies increasing capacity, boosting output and improving employment. Here ARC's should be permitted to draw upon deep pockets with necessary skill and resources to work out viable turnaround cases.*

*At present Funds mobilized from investors is utilized only for acquisition of financial assets.*

#### **Suggested measure**

- **In case funds mobilized from investors is utilized for acquisition of financial assets with restructuring as resolution strategy and with extending RSF for successful implementation of the restructuring package, draw down may be permitted from the Fund for extending RSF in addition to for acquisition of financial assets.**

### **3.1.13 Securitization of Assets**

*The Statement of Objects and Reasons of the SARFAESI Act, 2002, states that the law would enable banks and financial institutions to realise long-term assets, manage problem of liquidity and asset-liability mismatches. This object is clearly referring to securitisation of healthy assets.*

*From the title of the Act and provisions for registration of companies as "Securitization Company or Reconstruction Company" read with power conferred on such companies to acquire financial assets, it is clear that SARFAESI Act was enacted to facilitate securitisation of healthy assets also. The definition of*

*financial asset contained in the Act makes no reference to such asset being stressed or non-performing and hence Securitization Company can acquire healthy assets also.*

*In regard to securitisation to be undertaken by “Securitisaton company or Reconstruction company” (SC/RC) there are two aspects which need to be examined as under:*

- (a) Securitisation of stressed assets acquired by SC/RC for the purpose of reconstruction;*
- (b) SC/RC acting as Trustee or special purpose vehicle for acquiring and holding financial assets of banks/FIs for securitisation by raising funds from investors and servicing the investors till the securitized loans are realized.*

*As far as securitisation of stressed assets is concerned, it is for RBI to consider whether SC/RCs can be permitted to undertake such activity. However, SC/RCs may also have assets, which have been regularized by payment of defaulted installments which can be classified as Standard Assets. SC/RCs can be permitted to securitize such assets and in such cases the resolution period of 8 years stipulated in RBI directives will need suitable modification.*

*As far as SC/RC acquiring assets as Trustee/SPV for securitisation of standard assets by banks and FIs is concerned, there are distinct advantages for the Reserve Bank as Regulator as well as the Banks and FIs as under:*

- a) Trust set up for holding the assets for the benefit of investors will be under the management and control of SC/RCs which are subject to regulation by RBI;*
- b) The securitisation will be backed by statutory provisions conferring rights on the SC/RC which acquires the assets and holds them for the benefit of investors. Investors will have added comfort that in the event of default. the SC/RC as a trustee can realise the financial assets by enforcement of securities under the SARFAESI Act;*
- c) The Securities Contracts (Regulation) Act, 1956 has been amended to include securitized debt instruments in the definition of securities and regulations have been framed by SEBI for listing of such securities. Securitisation by SC/RCs can facilitate development of secondary market for securitized debt instruments;*
- d) If securitisation tool is available, banks will be willing to lend for infrastructure projects which otherwise locks up their funds long term.*

#### **Suggested measure**

- **SC/RCS may be permitted to undertake standard assets securitisation for banks and Financial Institutions and hold such assets as Trustee/Special Purpose Vehicle for the benefit of investors.**

### **3.1.14 Pledged Shares- substitution**

*Currently, in case of acquisition of financial assets by an ARC where underlying security is pledge of shares held in demat form, there is no provision for substitution of the name of ARC concerned in the records of Depository as pledgee in place of Originator Bank / Financial Institution. Hence, as per the prevailing system, Originator/ pledgee has to release the shares from the pledge and there after the pledgor shall have to repledge the shares in favour of the concerned ARC. This is a highly impractical proposition as the Borrower / pledgor may not cooperate with the ARC for repledge of shares in their favour.*

#### **Suggested measure**

- **Necessary guidelines to be issued for enabling substitution of the name of ARC as pledgee in place of Originator Bank / Financial Institution in the records of the depository at the time of assignment of the financial asset.**

### **3.1.15 Exemption from Takeover code**

*Conversion of loan into equity by an ARC attracts the provisions of the take over code. whereas, exercise of the same by the Public Financial Institutions (PFIs) from whom ARCs acquire such loans are exempt from the said restrictions. Initially, when SARFAESI Act was enacted, ARCs were notified as PFIs under section 4A of the Companies Act. However, the said status was withdrawn when the SARFAESI Act was amended in 2004.*

*Banks and FIs have certain exemptions under the Takeover Code in the context of creation of pledges in their favour. ARCs may be willing to restructure loans where additional collateral in the form of pledge of shares may be taken. Therefore the same exemptions should be made applicable to ARCs as well.*

*Further given the manner in which the demat mode operates; the shares are automatically transferred into the account of the pledgee. Depending on the percentage of shares pledged, it may trigger the provisions of the Takeover Code even though the intention is merely the invocation for the limited purpose of enforcement (by way of sale of shares) to recover money. Such invocations by ARCs should be exempt from the Takeover Code.*

**Suggested measure**

- **ARCs may be explicitly exempted from provisions of SEBI Takeover regulations in line with banks / FIs.**

### **3.1.16 Uniform Assignment Agreement**

*At present there is a lack of uniformity in respect of documentation particularly representations and warranties to ensure that it represents true sale and reflects fair disclosure in respect of such transactions and risks associated with assignment are properly evaluated, documented, and priced. Internationally there is a standard form of transfer agreements which are used. IBA and the Association of ARCs have been working on a common format for the Assignment Agreement but all the banks do not use it uniformly. There are vital clauses like indemnity, representations & warranties, counter claims and contingent liabilities, etc. where there needs to be uniformity and cannot be left at the discretion of individual bank.*

**Suggested Measure**

- **Association of ARCs / IBA to insist on their members for acceptance of the Assignment Agreement standardized by IBA.**

### **3.1.17 Allowing ARCs to go public**

*Since ARC industry is capital intensive, and the existing investors lack adequate resources to fund the expansions, ARCs may be allowed to tap capital market. This will also increase public scrutiny and higher disclosures.*

**Suggested Measure**

- **ARCs may be allowed to raise equity from market in public issue of shares.**

### **3.1.18 Immunity for Nominee Directors**

*In terms of Guidelines, a director of a public company shall not be eligible for appointment as a director of any other public limited company for a period of 5 years, if the person is a director of a company which has not filed annual returns/ failed to repay deposit/ interest etc. ARCs would be appointing nominee director in respect of companies which would mostly be defaulting on such scores. However, obviously they will be putting up their best efforts to improve these compliance requirements, which could have a time lag.*

*The Ministry of Company Affairs, vide General Circular No: 8/2002 dated March 22, 2002 exempted Nominee Director(s) appointed on the Boards of assisted concerns or other public companies by (a) public financial institutions within the meaning of Section 4A of the Companies Act, 1956; (b) Central or State Government; and (c) banking companies from the provisions of Section 274 (1) (g) of the Companies Act, 1956*

***Suggested Measure***

- ***Given the role of ARCs while dealing with NPAs, and in order to protect interest of ARCs as a secured creditor, it is imperative that the dispensation granted to the director(s) nominated by banks / financial institutions is also extended to the nominee director(s) appointed by SC/RCs.***

## 3.2 Legal Issues

### 3.2.1 Stamp duty payable on Assignment Agreement

*Currently, the stamp duty payable on Assignment Agreement for acquisition of financial assets by ARC varies from state to state. Some states have issued notification restricting the maximum stamp duty payable on Assignment Agreement to one lakh rupees, such a notification is yet to be issued by all the states. Further, even in cases where the notification is issued, the notification is not uniformly worded. In states like Maharashtra, the benefit of stamp duty is available only in case of assignment of debt with underlying securities.*

*Acquisition of assets by ARCs has multi-State effect. For instance ARC is located in State 'A' the Bank whose assets are to be acquired is in State 'B' and the location of the assets may be in State 'C'. In terms of the present stamp duty laws if rates of duty are different the difference has to be paid in each State. High rates of duty in different States make it difficult for ARCs to acquire assets. It is necessary to exempt stamp duty on deeds of assignment for acquisition of assets under section 5 of the SARFAESI Act. Such exemption can be extended to asset reconstruction as well as securitisation transactions effected by deed of assignment.*

#### **Suggested measure**

- **Amendment of Indian Stamp Act, 1899 to exempt stamp duty on asset reconstruction and securitization transactions effected by deeds of assignments.**

### 3.2.2 Priority to secured creditors over statutory dues

*Through recent amendments by the Finance Act, 2011, the claims of the secured creditors under the Recovery of Debts due to Banks and Financial Institutions Act, 1993 and the SARFAESI Act, 2002, have been provided priority over tax dues under the Customs Act, 1962, (52 of 1962), Central Excise Act, 1944 (1 of 1944) and the Finance Act, 1994 (32 of 1994) relating to Service Tax. A provision is added in the above laws by inserting Section 142A in the Customs Act, 1962, Section 11E in the Central Excise Act, 1944 and Section 88 in the Finance Act, 1994.*

**Suggested measure:**

- ***Similar provisions need to be inserted in the SARFAESI Act and RDDB Act in regard to state taxation dues---‘ Notwithstanding anything to the contrary contained in any Central Act or State Act, any amount of duty, penalty, interest or any other sum payable by an assessee or any other person under this Chapter, shall, save as otherwise provided in section 529A of the Companies Act, 1956 and the Recovery of Debts Due to Banks and the Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and the Enforcement of Security Interest Act, 2002, be the first charge on the property of the assessee or the person, as the case may be. (1 of 1956 51 of 1993.54 of 2002).’***

### **3.2.3 Reduction in bottlenecks in functioning of DRTs**

*The main forum for recovery of dues for ARCs is DRTs. While cases are expected to be decided within 6 months, in practice the defaulting borrowers are adopting dilatory tactics and it becomes difficult to adhere to time limit prescribed. There is a need to stress that as far as possible cases are decided within the stipulated period and various applications by borrowers are dealt with accordingly.*

**Suggested measure**

- ***The provision whereunder the DRTs are required to decide cases before them within a time limit needs to be strengthened***

### **3.2.4 Consent level for security enforcement actions**

*The consent requirement of 75% of secured creditors is a serious impediment as many large accounts have fragmented share of lending across various term lenders/ working capital bankers. On overall basis, majority requirement should be sufficient to ensure that creditors consult each other rather than take any unilateral action. Besides, the present Act does not differentiate between different classes of securities. While distribution of proceeds would continue as per priority of charge, secured creditors initiating enforcement action need to have consent of all charge holders ranking senior to and parri -passu with them only.*

#### **Suggested measure**

- **SARFAESI Act may be amended to prescribe threshold limit of consent requirement from senior and parri-passu charge holders with minimum requirement of 60% majority.**

### **3.2.5 Substitution of ARC in place of lender banks**

*ARCs are required to file substitution application with DRT / DRAT to substitute the ARC in place of the Bank. Thereafter, DRT / DRAT sends a notice to the borrowers (as defined under SARFAESI Act). Wherever notice is returned unserved, the ARC is asked to publish the notice in newspapers. Thereafter, any of the borrowers may raise objection to the Assignment on various grounds. As a result the process of recovery gets delayed.*

*Assignment of a financial asset by a bank to an ARC under the provisions of SARFAESI Act is now well settled and the present process of substitution being followed by DRT / DRAT, which is avoidably dilatory may be dispensed with in the interest of speedier NPA resolutions. Same applies to cases pending with all other courts where bank is impleaded including in cases under Sec 138.*

#### **Suggested measure**

- **Provisions of the SARFAESI Act, 2002 need to be amended to provide that on filing of notice of acquisition of financial assets jointly by the originator Bank and the concerned ARC, in the prescribed manner, the DRT or DRAT or any other Court or Authority shall transfer any proceeding pending before it in the name of ARC as the assignee of the financial asset.**

### **3.2.6 Registration of Assignment Agreement to be dispensed with**

*With the Central Government notification, the Central Registry has become functional, where the acquisition of financial assets by an ARC is required to be compulsorily registered. This gives the public notice of such securitisation / reconstruction transactions. In view of the above, registration of Assignment Agreement with the Sub Registrar of assurances can be dispensed with.*

#### **Suggested measure**

- **An amendment may be brought to The Registration Act, 1908, for exempting Assignment Agreement between bank/FI and ARCs from the requirement of registration and its registration with the Central Registry alone should be deemed as adequate.**

### **3.2.7 Delegation of power to officials below DM/CMM**

*In terms of SARFAESI Act, an application is required to be made for extending help in forcible physical possession of charged properties. But, as DM/CMM (s) are preoccupied with many other works, such application remain pending despite clear instructions of High Court to dispose of such petition in a time bound manner.*

#### **Suggested measure**

- **DM/CMM or any other official delegated by him should be required to pass suitable orders within 15 days of such application received from secured creditor.**

### **3.2.8 Legal forum for pursuing cases in respect of Assets from Co-operative Banks**

*Upon acquisition of financial assets from a co-operative bank by any securitization company or reconstruction company, any suit, appeal or other proceeding of whatever nature relating to the said financial asset pending by or against the co-operative bank shall not abate, or be discontinued or be, in any way, prejudicially affected by reason of the acquisition of financial asset by the securitization company or reconstruction company, as the case may be, but the suit, appeal or other proceeding may be continued, prosecuted and enforced by or against the securitization company or reconstruction company, as the case may be, before any authority established under any State Co-operative Societies Act or the Multi-State Co-operative Societies Act, However, fresh suit, appeal or other proceedings to be initiated by such securitization company or reconstruction company for recovery of debts due to co-operative banks shall be filed before the Debt Recovery Tribunals constituted under SARFAESI Act.*

#### **Suggested measure**

- **Necessary legal changes governing Co-operative Structure to be enacted for inclusion in the DRT purview. At the least, suitable amendments to the Multi-State Co-operative Societies Act.**

### **3.2.9 Modification of charge in respect of ‘dormant’ companies**

*When ARC acquires any corporate loan with the benefit of the underlying securities it is necessary to modify the registration of charges with Registrar of Companies. The recent notification issued by the Ministry of Corporate Affairs vide Circular No. 33/2011 dated 1.6.2011 made it compulsory to file updated Annual Return and Financials by the Companies as a necessary pre-condition for registering any charge/modification. The system does not permit any modification of charge in respect of dormant companies (those who have not filed the required returns for a certain period).*

*As most of the borrower companies are defaulters and are not expected to cooperate either with the banks or ARCs, it would not be possible to get the name of the ARC substituted in the records of ROCs for the financial assets acquired by the ARCs from banks/FIs. This poses difficulty in realizing dues for ARCs particularly in cases pending with OLs, BIFR etc.*

#### **Suggested measure**

- **Necessary exception in the Guideline may be made for ARCs (and their assignees) which acquire Non-Performing Financial Assets at a stage where compliance of this Guideline could be operationally difficult to comply with in respect of dormant companies.**

### 3.2.10 Transfer of Financial assets by Co-operative Banks

*In absence of clear Guidance Notes to co-operative banks for transfer of financial assets to ARCs, a large chunk of NPAs held by co-operative banks remain outside the ARC structure*

#### **Suggested measure**

- ***Issuance of detailed guidelines to Co-operative banks(both urban & rural) by RBI comprehensively covering all areas including valuation, investment guidelines etc on transfer of financial assets in line with norms applicable to commercial banks/FIs.***

## 3.3 Accounting and Tax Related issues

### 3.3.1 Income Tax treatment of Trusts set up by ARCs

*Section 7 of the Securitisation Act and RBI Guidelines provide that ARCs may raise funds from QIBs by setting up trusts, formulating schemes under the trusts for acquiring financial assets and issuance of Security Receipts ('SRs'). Further ARCs are required to keep and maintain separate and distinct accounts in respect of each trust / scheme for financial assets acquired out of investments made by QIBs and ensure that realizations of such financial asset are held and applied towards redemption of investments by Qualified Institutional Buyers ('QIBs'). The trusts set up by ARCs for asset reconstruction envisaged under the Securitisation Act and RBI Guidelines are similar to mutual fund schemes and the SRs would be similar to mutual fund units, in that they would represent the beneficial interest in the underlying assets held by the trust.*

#### **Suggested measure**

- ***Exemption of income in the hands of the trust set up by ARCs (due to pass through nature) may be brought in line with exemptions available for MFs.***
- ***Exemption from deduction of tax at source on income of such trusts may be brought in line with exemptions available for MFs.***
- ***Exemption from distribution tax on the dividend distributed by the trust of SC/RCs may be brought in line with exemptions available for equity oriented schemes of MFs.***

### 3.3.2 TDS on interest payment received from borrowers

*Interest payments made by borrowers on resolution to ARC Trusts (interest payment on restructured loans in particular) are subject to TDS. Although ARCs are stepping into the shoes of the banks they do not enjoy the specific TDS exemption.*

#### **Suggested measure**

- **Specific exemption like that enjoyed by banks/FIs on interest receipts may be granted in relation to payments in the nature of interest made to ARC by the borrowers.**

### 3.3.3 Income tax benefits on provisions

*Unlike banks, ARCs do not get any tax benefit on provisions on bad and doubtful debt made as per RBI guidelines/ accounting policies.*

#### **Suggested measure**

- **Provisions made by ARCs on bad and doubtful debts should be allowed as tax deductible expenditure.**

### 3.3.4 Accounting treatment at banks on sale of NPAs to ARCs

*The Guidelines to banks on transfer of NPAs to ARCs stipulate that if the sale is at a price below Net Book Value, the shortfall should be debited to Profit and Loss Account, while if the sale is for a value higher than Net Book Value(NBV), the excess provision will not be reversed but utilized to meet shortfall/loss of other financial assets to ARCs. Interpretation of the above suggests that even if the sale transaction between the bank and ARC is on cash basis and even if cash consideration is higher than the NBV, the bank cannot book surplus as profit, but can only consider the same as a special reserve to meet any shortfall in future sales to ARCs. In case the transaction with ARC is on SR basis and cash component of the transaction is higher than the NBV, the banks are not allowed to book the excess cash as profit and recognize the profits incrementally as the SRs are redeemed. This is a major disincentive to banks for sale to ARCs, as, where the banks settle with the borrowers or realize proceeds through other alternatives; they are able to book the excess as profit.*

***Suggested measure***

- **The present accounting guidelines for transactions involving receipt of cash considerations from ARCs towards the sale of assets may be suitably amended to bring them on par with treatment accorded to realizations from the defaulters / borrowers or sale of asset to other banks.**

### **3.3.5 Uniform Accounting Standards at ARCs**

*There is an imperative and urgent need to have a set of Accounting Standards uniform across all operating ARCs to bring uniformity, consistency and comparability while improving level of transparency.*

***Suggested measure***

- ***The Institute of Chartered Accountants of India (ICAI) in conjunction with ARC Association may be requested to draft the Guidelines keeping in view international best practices.***

## 4. GIST OF RECOMMENDATIONS

Reference	Recommendation	To be effected through	Initiating Authority	Priority
3.1.1	<i>NPA auction sale process &amp; price discovery</i>	<i>Notification</i>	<i>RBI/ IBA/ARC Association</i>	<i>Essential</i>
3.1.2	<i>Gradual write off of loss on transfer to ARC</i>	<i>Notification</i>	<i>RBI</i>	<i>Essential</i>
3.1.3	<i>Permission to acquire debt from other ARCs</i>	<i>Amendment/Notification</i>	<i>Govt of India/ RBI</i>	<i>Essential</i>
3.1.4	<i>Investment in SRs by insurance companies</i>	<i>Clarification</i>	<i>IRDA</i>	<i>Essential</i>
3.1.5	<i>Mark to Market based on ARC price offer</i>	<i>Notification</i>	<i>RBI</i>	<i>Desirable</i>
3.1.6	<i>Broadening of Market by inclusion of NBFCs</i>	<i>Amendment/Notification</i>	<i>Govt of India/RBI</i>	<i>Essential</i>
3.1.7	<i>Modification in FII investment</i>	<i>Notification</i>	<i>RBI/Govt of India</i>	<i>Essential</i>
3.1.8	<i>Removal of sub-limit of FII at tranche level</i>	<i>Clarification</i>	<i>RBI</i>	<i>Essential</i>
3.1.9	<i>Secondary Market making for SRs</i>	<i>Amendment/Notification</i>	<i>RBI/Govt of India</i>	<i>Essential</i>
3.1.10	<i>Conversion of debt into equity</i>	<i>Clarification</i>	<i>RBI</i>	<i>Essential</i>
3.1.11	<i>Issuance of Guidelines on Sale/Lease of Business</i>	<i>Notification</i>	<i>RBI</i>	<i>Essential</i>
3.1.12	<i>Restructuring Support finance-participation by investor</i>	<i>Clarification</i>	<i>RBI</i>	<i>Essential</i>
3.1.13	<i>Securitization of Assets</i>	<i>Clarification</i>	<i>RBI</i>	<i>Essential</i>
3.1.14	<i>Pledged Shares-substitution</i>	<i>Clarification /Notification</i>	<i>RBI</i>	<i>Essential</i>
3.1.15	<i>Exemption from Takeover code</i>	<i>Clarification</i>	<i>SEBI</i>	<i>Essential</i>
3.1.16	<i>Uniform Assignment Agreement</i>	<i>Notification</i>	<i>IBA/ ARC Association</i>	<i>Essential</i>
3.1.17	<i>Allowing ARCs to go public</i>	<i>Notification</i>	<i>RBI/SEBI</i>	<i>Desirable</i>
3.1.18	<i>Immunity for Nominee Directors</i>	<i>Notification</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.1	<i>Stamp duty payable on Assignment Agreement</i>	<i>Amendment in legislations</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.2	<i>Priority to secured creditors over statutory dues</i>	<i>Amendment in legislations</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.3	<i>Reduction in bottlenecks in functioning of DRTs</i>	<i>Various initiatives / Guidelines</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.4	<i>Consent level for Security enforcement actions</i>	<i>Amendment in Act</i>	<i>Govt of India</i>	<i>Essential</i>

<b>Reference</b>	<b>Recommendation</b>	<b>To be effected through</b>	<b>Initiating Authority</b>	<b>Priority</b>
3.2.5	<i>Registration of Assignment Agreement to be dispensed with</i>	<i>Amendment in legislations</i>	<i>Govt of India</i>	<i>Desirable</i>
3.2.6	<i>Delegation of powers to officials below DM/CMM</i>	<i>Amendment in Act</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.7	<i>Legal Forum for pursuing cases acquired from Coop Banks</i>	<i>Amendment in Act</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.8	<i>Modification of charge in respect of 'dormant companies'</i>	<i>Notification</i>	<i>Govt of India</i>	<i>Essential</i>
3.2.9	<i>Transfer of financial assets from Co-op Banks</i>	<i>Notification</i>	<i>RBI</i>	<i>Desirable</i>
3.3.1	<i>Income Tax Treatment of Trusts set up by ARC's</i>	<i>Notification</i>	<i>Govt of India</i>	<i>Desirable</i>
3.3.2	<i>TDS on interest payments received from borrowers</i>	<i>Notification</i>	<i>Govt of India</i>	<i>Desirable</i>
3.3.3	<i>Income Tax benefits on provisions</i>	<i>Notification</i>	<i>Govt of India</i>	<i>Desirable</i>
3.3.4	<i>Accounting treatment at Banks on sale of NPAs to ARC's</i>	<i>Clarification</i>	<i>RBI</i>	<i>Essential</i>
3.3.5	<i>Uniform Accounting Standards at ARC's</i>	<i>Notification</i>	<i>ICAI/ARC Assn</i>	<i>Essential</i>

## 5. CONCLUSION

The recommendations made in Chapter 3 and 4 of the Report are aimed at removing the bottleneck and introducing measures to support the functioning of the ARCs in the country. The Group is of the opinion that the recommendations are critical for the growth of ARCs and for reduction of NPAs in the financial system.

The Group appreciates the initiative of the Government and conveys its gratitude for the opportunity given to study the ARC sector and make recommendations for the orderly and systematic development of the ARCs enabling them to contribute to the development of Indian economy. Finally it is recommended that the Key Advisory Group on ARCs should function as a standing committee and meet at regular intervals to review the progress and developments on an ongoing basis.

Sd/ (Birendra Kumar) AARCSl	Sd/ (M.R. Umarji) Indian Banks' Association	Sd/ (Mukesh Mohan) ASSOCHAM	Sd/ (M.S. Verma) FICCI
Sd/ (K. Unnikrishnan) Indian Banks' Association	Sd/ (Suhan Mukerji) Amarchand Mangaldas	Sd/ (H. Jayesh) Juris Corp	Sd/ (Ashwin Parekh) Ernst & Young
Sd/ (V.K. Chopra) PHDCCI	Sd/ (S. Khasnobis) Retd. MD&CEO, Arcil	Sd/ (Neeta Mukerji) CEO, Arcil	Sd/ (P. Rudran) MD, ISARC
Sd/ (R Sridhar) MD, Sriram Transport	Sd/ (Jeevan J.S.) GM, SEBI	Sd/ (S.M.N. Swamy) GM, RBI	Sd/ (Dr. Shashank Saksena) Director (DFS) & Member Secretary

Sd/  
Alok Nigam  
Joint Secretary (BO), DFS and Chairman

**F.No.17/7/2011-BO.II  
Government of India  
Ministry of Finance  
Department of Financial Services**

*IIIrd Floor, Jeevandeep Building, Parliament Street,  
New Delhi, the 30<sup>th</sup> September, 2011*

**ORDER**

**Subject : Constitution of a Key Advisory Group on Asset Reconstruction Companies (ARCs).**

*A Key Advisory Group has been constituted under the Chairmanship of **Shri Alok Nigam, Joint Secretary (Banking Operations)** in this Department to examine the issues in ARCs. The composition of the Group is as under –*

*i. **Shri Alok Nigam, Joint Secretary (BO) - Chairman.***

**Members**

- ii. Shri S. M. N. Swamy, GM, DNBS, RBI.*
- iii. Shri K. Unnikrishnan, Dy. Chief Executive, IBA.*
- iv. A representative each of IIM and CII*
- v. Shri M. S. Verma, Chairman, IARC Pvt. Ltd. – FICCI Representative*
- vi. Shri V. K. Chopra, Sr. Consultant, Dhir & Dhir Asso.– PHDCCI Representative.*
- vii. Shri Mukesh Mohan, Co-Chairperson, ASSOCHAM National Council for SMEs – ASSOCHAM representative.*
- viii. Shri Suhaan Mukerji, Advocate & Partner, Amarchand Mangaldas.*
- ix. Shri H. Jayesh Shah, Founder Partner, Juris Corp.*
- x. Ms. Neeta Mukerji, President & COO, ARCIL.*
- xi. Shri Khasnobis, MD & CEO, ARCIL.*
- xii. Shri Ashvin Parekh, Ernst & Young.*
- xiii. Shri R. Sridhar, MD, Shriram Transport Finance Co. Ltd.*
- xiv. Shri M. R. Umarji, Chief Advisor (Legal), IBA – co-opted.*
- xv. Director (BO.II&PR), DFS, New Delhi – Member Secretary.*

- 2. The 'Terms of Reference' of the Group is at **Appendix**.*
- 3. The Group will meet at such places and intervals, as decided by the Chairman.*

**(D.D. Maheshwari)**  
**Under Secretary to the Government of India**  
**Tel: 23748750**

**To**

- i. Shri Alok Nigam, Joint Secretary (BO), DFS, New Delhi.*
- ii. Director (BO.II&PR), DFS, New Delhi.*
- iii. Shri S. M. N. Swamy, GM, DNBS, RBI.*
- iv. Shri K. Unnikrishnan, Dy. Chief Executive, IBA, Mumbai.*
- v. Shri Chandraji Banerjee, Director General, CII, New Delhi.*
- vi. Shri M. S. Verma, Chairman, IARC Pvt. Ltd., New Delhi.*
- vii. Ms. Jyoti Vij, Asstt. Secy. General, FICCI, New Delhi.*
- viii. Dr. Rajiv Kumar, Secretary General, FICCI, New Delhi.*
- ix. Shri V. K. Chopra, Sr. Consultant, Dhir & Dhir Associates, New Delhi.*
- x. Shri Girish Menon, Executive Officer, PHDCCI, New Delhi.*
- xi. Ms. Sushmita Shekhar, Dy. Secy. General, PHDCCI, New Delhi.*
- xii. Shri Mukesh Mohan, Co-Chairperson, ASSOCHAM, New Delhi.*
- xiii. Ms. Jyotimoy Jain, Advisorm ASSOCHAM, New Delhi.*
- xiv. Shri D. S. Rawat, Secretary General, ASSOCHAM, New Delhi.*
- xv. Shri Suhaan Mukerji, Amarchand Mangaldas, New Delhi.*
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- xvii. Ms. Neeta Mukerji, ARCIL.*
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- xix. Shri Ashvin Parekh, Ernst & Young, Mumbai.*
- xx. Shri R. Sridhar, MD, Shriram Transport Finance Co. Ltd., Mumbai.*
- xxi. Shri S Natarajan, Director, Shriram Capital Ltd., Chennai.*
- xxii. Director, Indian Institute of Management, Ahmedabad, Gujrat.*
- xxiii. Shri M. R. Umarji, Chief Advisor (Legal), IBA.*

**Copy for information to –**

- 1. PS to FM**
- 2. PS to MoS (E&FS)**
- 3. PPS to Secretary (FS)**
- 4. PS to AS(FS)**
- 5. PSs to JS(BA) / JS (BO) / JS(IF) / JS(VPB) / JS(P&I) / JS(AB) / EA**
- 6. All Directors / Deputy Secretaries / Under Secretaries**
- 7. All Sections in DFS**

**APPENDIX**

**F.No.17/7/2011-BO.II  
Government of India  
Ministry of Finance  
Department of Financial Services**

**The Terms of Reference of the Key Advisory Group  
on the Asset Reconstruction Companies (ARCs)**

- i. Review of existing legal / regulatory / institutional framework for ARCs and its efficacy;*
- ii. Action plan including policy initiatives for orderly growth of the Sector;*
- iii. To recommend the legal / institutional / regulatory initiatives related measures required for orderly growth of the Sector.*

\*\*\*

*Note of Dissent on Recommendation No.3.1.13 in respect of Securitisation of Assets on pages 22 to 24:*

*The final report includes the above recommendation which was not included in the final draft circulated for discussion. There was only a passing reference at draft recommendation No.3.1.14 wherein it was requested that ARCs may be explicitly included to originate securitization transactions in the context of acquisition of NPAs, more so retail, and to create a pool of assets, securitise and sell them to investors. While discussing this recommendation, the Bank's stand was made clear that there are guidelines for Securitisation transactions for healthy assets which fall outside the SARFAESI Act. Further it was made clear that the object of the Act is reduction of the NPAs in the system.*

*The recommendation in the Final Report now circulated for signature reads as under:*

*"The Statement of Objects and Reasons of the SARFAESI Act, 2002, states that the law would enable banks and financial institutions to realise long-term assets, manage problem of liquidity and asset-liability mismatches. This object is clearly referring to securitisation of healthy assets. From the title of the Act and provisions for registration of companies as "Securitization Company or Reconstruction Company" read with power conferred on such companies to acquire financial assets, it is clear that SARFAESI Act was enacted to facilitate securitisation of healthy assets also. The definition of financial asset contained in the Act makes no reference to such asset being stressed or non-performing and hence Securitization Company can acquire healthy assets also.....ARCs should be allowed to do securitization transaction on healthy assets".*

*In the first para of the Statement of Objects and Reasons, the rationale is set out in enacting this Act wherein it is mentioned ".....Our existing legal framework relating to commercial transactions has not kept pace with the changing commercial and financial sector reforms. This has resulted in slow pace of recovery of defaulting loans and mounting levels of non-performing assets of banks and financial institutions".*

*What is further missing in the interpretation of the object of the Act is the punch line at the end of the first para of Statement of Objects and Reasons for the SARFAESI Act, 2002 which is as under:*

*The Statement of Objects and Reasons of the SARFAESI Act, 2002, states that the law would enable banks and financial institutions to realise long-term assets, manage problem of liquidity and asset-liability mismatches and improve recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction.*

*Further it is not correct to state that the Act does not make any reference to financial asset being stressed or non-performing. A reference is invited to sub-section 2 of*

*Section 13 in respect of Enforcement of Security Interest which reads: “where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt or any instalment thereof (financial asset), and his account in respect of such debt is classified by the secured creditor as non-performing asset, then, the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights under sub-section (4).*

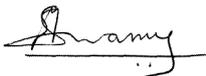
*It is eloquent that the Act deals with the problem of NPAs and ways to resolve, inter alia, through special vehicles.*

**In para 4 of the said recommendation it is mentioned that there are two aspects which need examination with regard to a) securitization of stressed assets acquired by SC/RC for the purpose of reconstruction and b) SC/RC acting as Trustee or special purpose vehicle for acquiring and holding financial assets of banks/FIs for securitization.....”**

**As far as securitization is concerned it is for RBI to consider whether SC/RCs can be permitted to undertake such activity. I wish to clarify that the above is already permitted ever since Act came into being and SC/RCs are registered with RBI.**

*I am of the view that the purpose of SARFAESI Act is to reduce the NPAs in the system through an institutional set up of ARCs which are expected to be specialists in resolving and reconstructing the non-performing assets. Since the ARCs are special vehicles mandated to do a specialized task of recovering and reconstructing the NPAs thereby reducing the NPAs in the system for aforementioned objects, it may not be proper to interpret that their role is not limited only to resolution of NPAs. If it is done, I am constrained to add that the spirit of the Act will be diluted. I am, therefore, of the considered view that the ARCs should play the role of resolving only NPAs in the system and they should not be allowed to deal in healthy assets.*

*I request that the above note of dissent may form part of the Final Report. I agree with all other recommendations.*



(S M N Swamy)

General Manager

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