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RESEARCH ARTICLE

AN EVALUATION OF PERFORMANCE OF ASSET RECONSTRUCTION COMPANIES

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Abstract

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Introduction

The origin of ARCs could be traced to a 1991 report on financial sector reforms by a panel chaired by former RBI Governor M. Narasimham. Till that time the corporate management policy was lax and there was no concerted effort in building up a fund that could look after the bad loans. When RBI issued a first set of instructions to the banks to identify and classify the NPAs, in October 1990, a large number of large number of NPAs were recorded in the public sector banks. [1]

The ills lay in the Indian political system. The government until then, were the sole owners of the banks and could do as they pleased. A large portion of bank deposits where used to finance the government bonds that were indirectly financing the budgetary fiscal deficits. Thus, since the banks were at the mercy of the government machinery, the loans to governments grew to an exorbitant amount which ultimately became nonproductive and hence NPAs.

The Narasimham panel recommended the establishment of an fund, which were named Asset Reconstruction Funds. This fund was to be funded by the government. The main aim of this fund was to eventually flush out the bad loans from the banking system and make it an efficient one. Though the idea was noble, like all other recommendations, the fund did not see the light of the day.

In the aftermath, the second report then modified the recommendations and coined the words Asset Reconstruction Companies which were separate entities that would act as the facilitators in recovering the bad loans from the sick companies, thereby reducing the burden on the Bank infrastructure

The Board for Industrial and Financial Reconstruction

As things could have it, there were a multiple number of Industries that turned sick and could not finance their loans. Thus the Board for Industrial and Financial Reconstruction re-construction agency, and its appellate body, was set up to speed up the recovery process. Still, this proved futile since the body was not that keen in tackling the problem. This gave birth to another establishment.

Debt Recovery Tribunals

Debt Recovery Tribunals were then set up to ensure quick and easy recovery of outstanding debts from the loanees. However, here too the procedures came up short because the tribunals were not experienced enough in interpreting and handling the myriad laws that were and are available to the sick companies to protect themselves from being liquidated easily. Also they had to handle the claims of the constituents, stakeholders and the State and Union Government interests. This the whole process was unduly delayed and the success rate took a beating. The DRTs could manage to issue recovery certificates only after nearly four year of taking up a case. The process of actual liquidation and recovery took even more time. Since the DRTs did not take on board the other stakeholders, they were forced to follow the long drawn out liquidation process so as to even get a whiff of their dues

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002(SARFAESI Act)

To overcome all these hitches, government passed the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002P, which envisaged the setting up of the Asset Reconstruction Companies which were charged with the responsibility of buying the NPAs from Indian banks and financial institutions. At the same time, some lesser banks were taken over by the government and a Corporate Debt Restructuring (CDR) platform was formed. ICICI reinvented itself as a bank as its business model was becoming unviable with the source of long-term cheap funds drying up fast. Industrial Development Bank of India (IDBI) also did the same and merged itself with IDBI Bank. Things were not so rosy, though, for two other development finance institutions. IFCI Ltd, India’s oldest financial institution, is barely alive but Industrial Reconstruction Bank of India quietly vanished.

Objectives

1. To outline the history of management of NPAs in India
2. To compare the ARCs of India with the AMCs of the world.
3. To bring out the advantages and the disadvantages of ARCs
4. To outline the various Government Policies that have been announced in the recent past.

Functioning Of Asset Reconstruction Company

As already mentioned, Asset Reconstruction Companies were set up with the passing of the SRFAESI Act in 2002. The responsibility of buying the bad debts from the banks and take step to recover them were entrusted to the ARCs. The ARCs could take over the assets of the defaulters without the requirement of the judiciary to authorize them.

Before we go into the functioning of the ARCs one should know the functioning of the Asset Management Companies (AMCs) in the rest of the world

Globally, to protect the commercial bank, one bad debt bank (AMC) takes over the NPAs of the entire system. Here, the government is the godfather and supports the AMC legally, by regulations, by fiscal support and administrative support. The prime idea is to protect the banks by transferring their NPAs which had to be financed by corpus funds created for the same thus ensuring that capital available could be better utilized. This is a one-time process and the AMCs cease to exist after the bad debts are recovered.

However, the ARCs differ from AMCs right from the aims of formation. On the one hand, AMCs are set up by the government as a one-time measure to get rid of the bad debts, but the ARCs are market driven and have no financial

support from the government whatsoever. The Banks are free to take a call and sell their NPAs to the ARCs, at a discount, else try to solve their problem by themselves. [2]

The Banks, on their part, did not support this concept of ARCs wholeheartedly. They chose and still do, to recover the bad debts by taking over the assets of the defaulters themselves. This is because they had to reflect losses when the NPAs were bought by the ARCs on a discount of upto 40% of present value.

Hitherto fore, the ARCs were left to fend for themselves with respect to capital formation. FDI was limited to 49% but this also could not attract investment because the ARCs are never listed. The only involvement of the government was in their supporting the security receipts (SRs) issued by the ARCs to the Banks.

The ARCs were tasked to take over the assets of the defaulters and recover the bad debts either by selling them or restructure the defaulter company and make them recover from their sickness. The profits gained would then be equally shared by the ARCs and the Banks. However, the losses had to be exclusively borne by the banks.

Latest Government Support Measures

To make the ARCs a much better option for the banks and facilitate the ARCs to be better positioned to play their part in the economic environment, the Government has announced a slew of measures.

Circular and Press Note of The Department Of Policy Promotion[3]

The Circular and the Press Note issued by the Department of Policy and Promotion ("DIPP")brought the following changes with respect to foreign investment in ARCs:

<u>FDI in ARCs</u>: FDI in the 'Capital' (defined to mean equity, and preference shares and debentures fully and mandatorily convertible into common equity) of ARCs has now been permitted up to 100% in the manner set out below.

- FDI up to 49% of the Capital of the ARC shall be under the automatic route;
- FDI above 49% in the Capital of the ARC shall require prior approval of the Foreign Investment Promotion Board ("FIPB"), an instrumentality of the Ministry of Finance, Government of India;
- No sponsor of an ARC may hold more than 50% of the shareholding of the ARC, either by way of FDI or by routing through an FII.

<u>FII in ARCs</u>: FII in ARCs has now been permitted up to 100% in the manner set out below.

- FII up to 49% of the Capital of the ARC shall be under the automatic route;
- FII above 49% in the Capital of the ARC shall require prior approval of the FIPB;
- The total shareholding of an individual FII shall not exceed 10% of the Capital of the ARC;
- No sponsor of an ARC may hold more than 50% of the shareholding of the ARC, either by way of FDI or by routing through an FII.

<u>Investment in SRs</u>: FIIs are now permitted to invest in SRs up to a limit of 74% as opposed to 49% earlier in each tranche of scheme of SR issued by an ARC or a trust sponsored by an ARC. The earlier limit of 10% investment by an FII into each tranche of scheme of SRs issued by an ARC has also dispensed with. Such investment must however be within the investment in corporate bond limits, and the sectorial caps under the FDI policy must be adhered to.

	Prior to December 2012	Prior To August 2013 (Changes introduced by the Circular)	Post August 2013 (Changes introduced by the Press Note)
Foreign Investments in ARCs			
FDI	49% Government route	74% Government route	49% - Automatic route; Beyond 49% - Government route.
FII	Not permitted		
Security receipts of ARC or scheme/ trust of an ARC			
FII	49% 10%- limit for individual FII	74%	No change

In The News

Debt conversion into equity

Another encouraging step ARCs came through the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Bill, 2011, which amends SARFAESI and the Recovery of Debts Due to Banks and Financial Institutions Act, 1993. By way of the amendment to section 9 of SARFAESI, a new clause (g) has been added by virtue of which an ARC now has the option to 'convert any portion of its debt into shares of a borrower company'. [4]

Analysis

The Positives

ARCs can now be financed by FDI to acquire assets from the banks.

Since ACRs are not listed, there is a doubt whether FIIs could be attracted. Time will only tell.

The removal of investment limits for individual FIIs for each tranche of a scheme of an ARC is welcome because it permits a single FII to subscribe to 74% of the SRs issued in the tranche.

Like banks convert their loans into equity (corporate debt restructuring process) ARC can also convert a portion of the debt into equity. Due to this amendment to SARFAESI, ARCs can now actively take part in the management of revival and restructuring of the company and exit by selling the equity holdings at a later date.

ARCs which have foreign investment of an amount exceeding 51% of its share capital, would require the approval of the FIPB to convert the debt into equity. Conversion of debt into equity might be an important consideration for ARCs in future.

The acquisition of bad loans by the ARCs having a sizeable FDI might be restricted in sectors where FDI caps are in place for such conversion.

The negatives

The defaulters with the active involvement of the ARCs may have a loophole by way of selling and buying back the equities at a reasonable price there by wriggling out of the bad debt as well as making a profit in the bargain, of course only if the participation of the ARCs is forthcoming.

Conclusion

The Government of India, way back in the early 1990s had been forced to consider the growing problem of Non-Performing Assets (NPA) with the Banking Sector. We can safely assume that the NPAs are a by-product or the errant child of the economic models being followed by individual economies. The more aggressive you are in furthering the interests of the Banking Sector or for that matter any financial organization, the more you fuel misplaced innovations and high risk decisions. The aim of this paper is not to be critical of the economic model being followed by India, but to outline a frank and honest history of this very annoying problem that has furrowed the brows of many a banker, and still does, and the birth and development of the Asset Reconstruction Companies in India.

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