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Asset reconstruction companies

Realigning business models as opportunities evolve

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Message from ASSOCHAM

Asset reconstruction companies (ARCs) play an essential role in the financial ecosystem. Since they take over bad loans from banks, reconstruct/ resolve them, and put them back to work for the economy, ARCs are recognised as resolution institutions globally. Given the high level of stressed assets in the financial system in India, the opportunity pie for ARCs is enormous.

The stressed assets industry has evolved over the years in step with the changing landscape and regulations. There is now an entire ecosystem for attracting and resolving stressed assets in terms of players and resolution frameworks.

With the introduction of the Insolvency and Bankruptcy Code 2016 and a series of accompanying regulatory measures, the scope and functioning of ARCs are undergoing a structural shift. In this evolving ecosystem, ARCs need to reinvent themselves to be systemically relevant and play an effective role in the resolution of non-performing assets (NPAs).

Though private ARCs have been around for a long time, the objective of setting up National Asset Reconstruction Company (NARCL) was to establish a government-backed ARC that will not face issues in raising start-up capital, unlike private ARCs. This will aid in the planned acquisition of larger assets and speed up debt aggregation. The banking sector's asset quality will also benefit from the proposed sale of NPAs to NARCL.

Keeping this imperative in mind, the ASSOCHAM is conducting its 5th National Summit on Asset Reconstruction Companies.

ASSOCHAM & CRISIL Ratings Ltd. have jointly prepared a comprehensive knowledge paper on 'Asset Reconstruction Companies: Realigning business models amidst evolving opportunities'. We hope this report, along with the discussions during the summit, will help regulators, market participants, government departments, and research scholars to further develop financial services.

I thank the knowledge partner for its valuable contribution and convey my best wishes for the success of the summit.

Deepak Sood
Secretary General, ASSOCHAM

Message from Association of ARCs in India

The Association of ARCs in India pursues the common interest of all ARCs with regulators and government agencies with a view that all its members grow and strengthen the asset resolution/ reconstruction mechanism in the country.

The ARC framework is beneficial for both the lenders and borrowers. While it helps the lenders focus on their core business by removing the stressed assets from their balance sheet, it helps borrowers revive their business by suitable reconstruction of their account.

ARCs have played an important role in the resolution and reconstruction of stressed financial assets. As of March 2022, they have purchased NPA loans of approximately Rs 6.13 trillion in book value, investing their own funds to the tune of Rs 0.43 trillion to purchase these. They have also mobilized a substantial amount from qualified buyers to purchase these assets. Many assets have been actively revived and turned around. The contribution of ARCs is also reflected as the government encouraged banks to promote NARCL; one of the Indian banks not only transferred all its stressed assets to an ARC (JC Flowers ARC), but also invested in the ARC's equity.

Over the past two decades, ARCs have set up a robust infrastructure and nurtured skilled and professional manpower to manage the stressed assets. This platform can contribute immensely if some challenges, such as fund availability, price expectation mismatch between the selling institution and ARC, loan aggregation, etc., are addressed.

The recent regulatory changes and the proposed special purpose entity route to undertake securitisation of NPAs through the Securitisation of Stressed Assets Framework route may induce some challenges. However, it could also open new opportunities for coordinated functioning and optimal utilisation of the already established infrastructure and skillset of the ARC platform.

ARCON 2023 is being held against this background to engage with all stakeholders to work out an efficient and appropriate roadmap for sustainable contribution by ARCs in the space of stressed asset resolution.

RK Bansal
Managing Director and CEO,
Edelweiss Asset Reconstruction Company Limited

Executive summary

The ARC industry has been navigating a very dynamic external environment, especially from 2014 onwards, from a macroeconomic and a regulatory perspective. ARCs have been refining their business models over time to manage these developments.

First, after a period of sizeable acquisitions of corporate assets, the past two years have been seeing a shift, with a rising share of retail stressed assets driven by lower incremental slippages from corporate segment. This mirrors what we are seeing in the banking industry — gross non-performing assets (NPAs) in the corporate segment are seen falling to ~2% next fiscal from a peak of ~16% as on March 31, 2018. In fact, overall asset quality itself is at the healthiest in the recent times, and gross NPAs are expected to fall to a decadal low of ~4% by March 31, 2024. The asset quality of the NBFC sector is also recovering with improving economic activity and collections.

Second, the revised guidelines for ARCs announced by the Reserve Bank of India in October 2022, which reduced the funding requirement for asset acquisition, are a sectoral game-changer. This has enhanced the competitiveness of ARCs, with capital no longer a constraint in acquiring larger assets. However, this has made partnerships even more crucial. Further, while the capital requirement for acquisition has tapered, a key monitorable is the impact of the revised regulatory guidelines for ARCs from a minimum networth perspective.

Third, and this has been a shift over time, the availability of alternative resolution mechanisms such as the Insolvency and Bankruptcy Code (IBC) and alternative investor segments such as stressed assets funds, has meant increased competition for the ARC industry.

Nevertheless, the assets under management (AUM) of ARCs are expected grow ~10% this fiscal after a period of relative stagnation, driven by a few large transactions.

Amidst all this, ARCs must again realign business models in light of the evolving stressed asset opportunity in the Indian market. This is crucial both to capitalise on the shifting opportunity set, as well as to demonstrate their effectiveness vis-à-vis other alternatives in resolving the acquired stressed assets in a timely manner. Success on this front will remain critical for the long-term sustainable business growth of ARCs.

The stressed assets opportunity is shifting from corporate to retail and MSME loans

Opportunities in the Indian stressed asset market are intrinsically linked to the asset quality of banks and non-banking financial companies (NBFCs; including housing finance companies). The significant growth in the AUM of ARCs in the past came during a period of sharp rise in NPAs in the banking sector, especially in the corporate segment — gross NPAs of banks peaked at 11.2% as on March 31, 2018. NBFCs, after a good run, started facing funding access challenges after a large infrastructure financier defaulted in September 2018. Asset quality in the wholesale book of NBFCs also started displaying signs of stress.

Today, however, the asset quality of the financial sector is at its healthiest in recent times, specifically because of the sharp reduction in NPAs in corporate loans, indicating that opportunity for ARCs in corporate loans is perhaps at a cyclical low. That said, retail assets, which have garnered more interest from ARCs in the past couple of years, continue to offer a meaningful opportunity. As do loans to micro, small and medium enterprises (MSMEs).

For banks, gross NPAs are expected to decline 90 basis points (bps) year-on-year to ~5% this fiscal, and by another 100 bps to a decadal low of ~4% by March 31, 2024 (see Chart 1), riding on the post-pandemic economic recovery and higher credit growth. The biggest improvement will be in the corporate segment, where gross NPAs are seen falling below 2% next fiscal from a peak of ~16% as on March 31, 2018. This follows significant clean-up of books by banks in recent years, as well as strengthened risk management and underwriting, which has led to higher preference for borrowers with better credit profiles. The steady improvement in corporate asset quality is clearly manifested in key indicators such as the credit quality of bank exposures. The proposed sale to the newly formed National Asset Reconstruction Company Ltd (NARCL) should also support reduction in gross NPAs.

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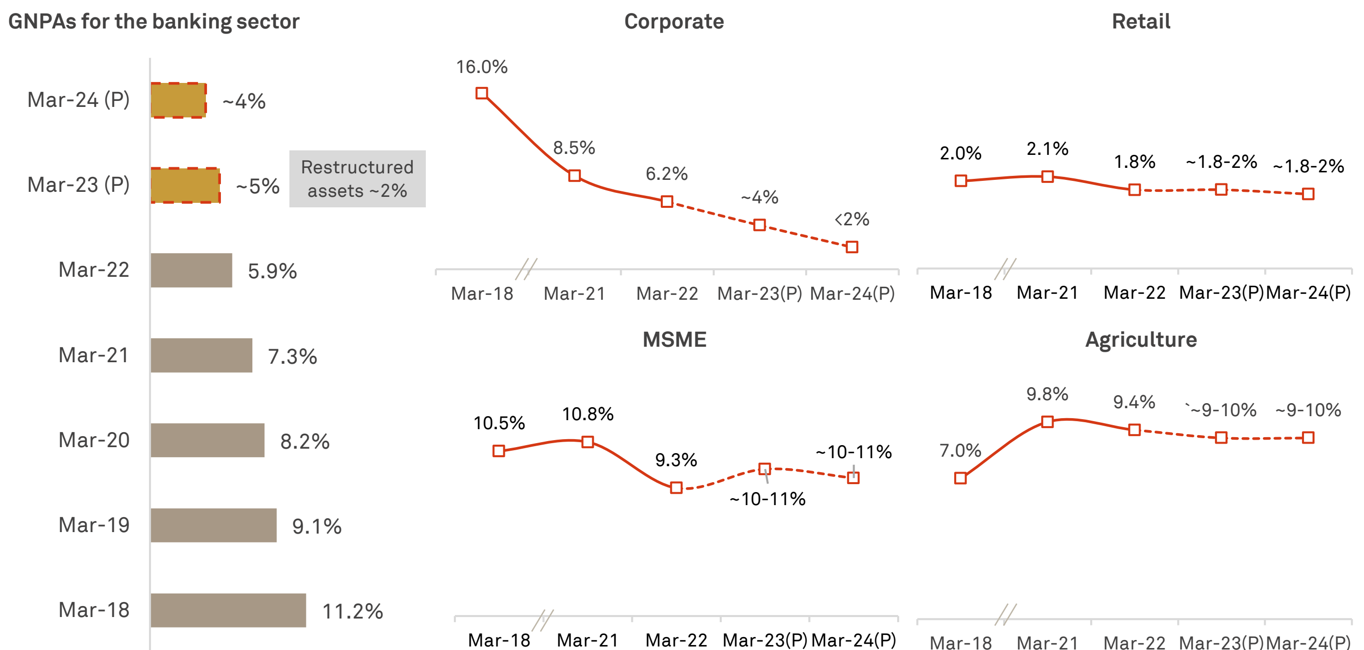
Gross NPAs in the MSME[1] segment, which suffered the most during the pandemic, may rise to 10-11% by March 2024 from ~9.3% as on March 31, 2022. While relief measures did help contain asset quality deterioration last fiscal, the segment saw the most restructuring, at ~6%, compared with ~2% for the overall banking sector. About a fourth of the restructured accounts could slip into NPAs.

The retail segment has maintained steady asset quality with gross NPAs expected to be rangebound at 1.8-2.0% over the medium term. While the impact of higher interest rates and inflation on cash flows of individual borrowers will need to be monitored, almost half of the retail loans are home loans, where borrowers that banks cater to have relatively better credit profiles. That said, segments such as unsecured loans may see some pressure. Also, while retail NPAs are expected to remain steady on a percentage basis, the absolute quantum of NPAs may rise given the sharp growth in the portfolio, thus providing opportunity for ARCs.

Chart 1- Trend in gross NPAs in the banking sector



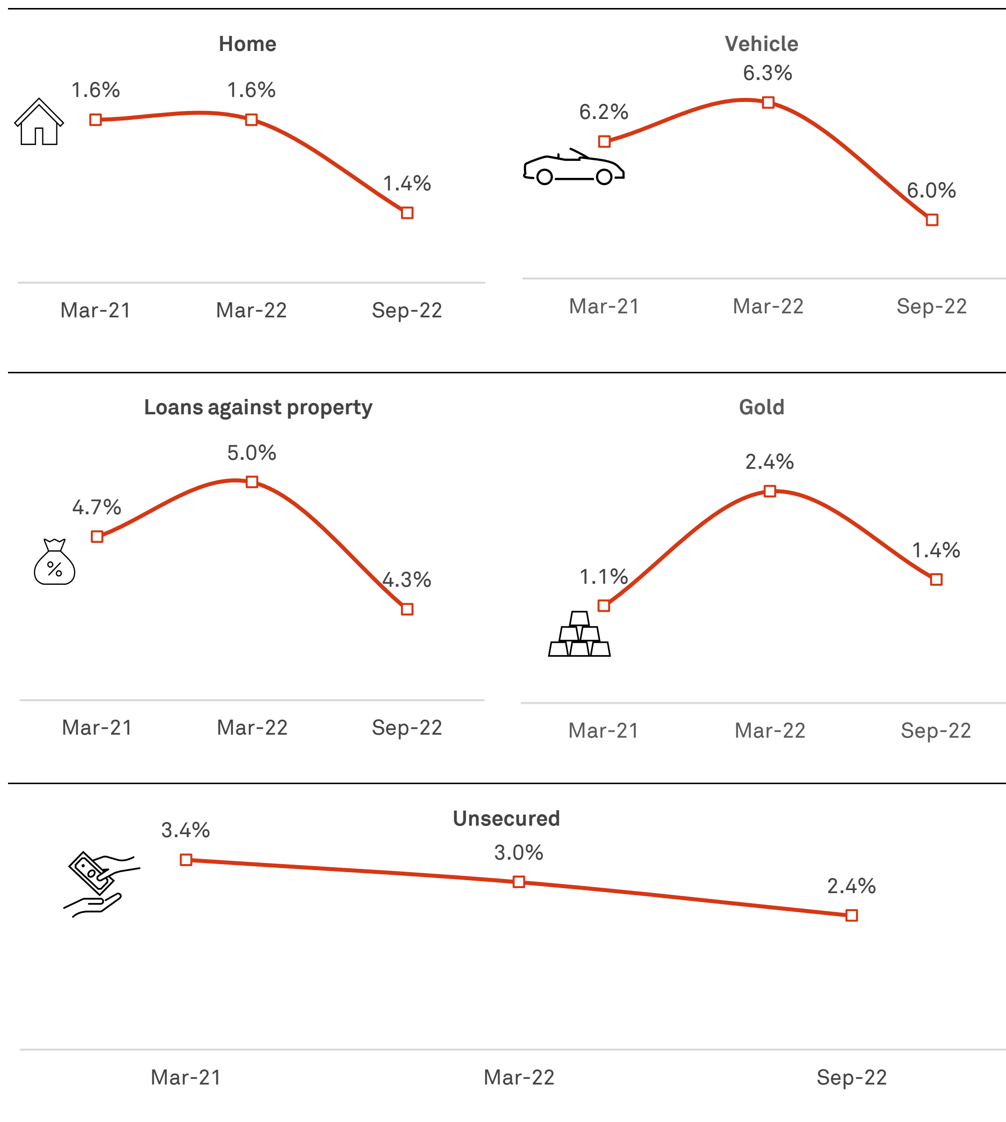
Source: RBI; Company data; CRISIL Ratings estimates

For NBFCs[2], too, asset quality concerns are receding with metrics across segments showing a clear improvement in the first half of this fiscal and the fundamentals expected to hold with an improving macroeconomic environment. That said, the restructured portfolio is a key monitorable and the better asset quality should be read in conjunction with the movement of the restructured book. Unsecured loans have seen the maximum reduction in the restructured book — due to either repayments or write-offs. On the other hand, the restructured portfolio in vehicle finance has reduced but the residual book has potential for slippages. Existing delinquencies, expected residual restructured book and underlying fundamentals for each segment

[1] Micro, small and medium enterprises
[2] Incudes housing finance companies, but excludes government owned NBFCs

indicate how asset quality may move. Unsecured loans will remain a key monitorable due to the inherent underlying concerns of inflation and unemployment.

Chart 2- Trend in 90+ day-past-due for NBFCs



Source: Company data; CRISIL Ratings estimates

There was a marginal increase in 90+ days past due (dpd) for a few segments between March 2021 and March 2022. While underlying asset quality, as depicted by 90+ dpd, is likely to improve, reported gross NPAs will rise in some segments. This is given the Reserve Bank of India (RBI) clarification on November 12, 2021 on the prudential norms on Income Recognition, Asset Classification and Provisioning (IRACP), which, after an extension, came into force on October 1, 2022.

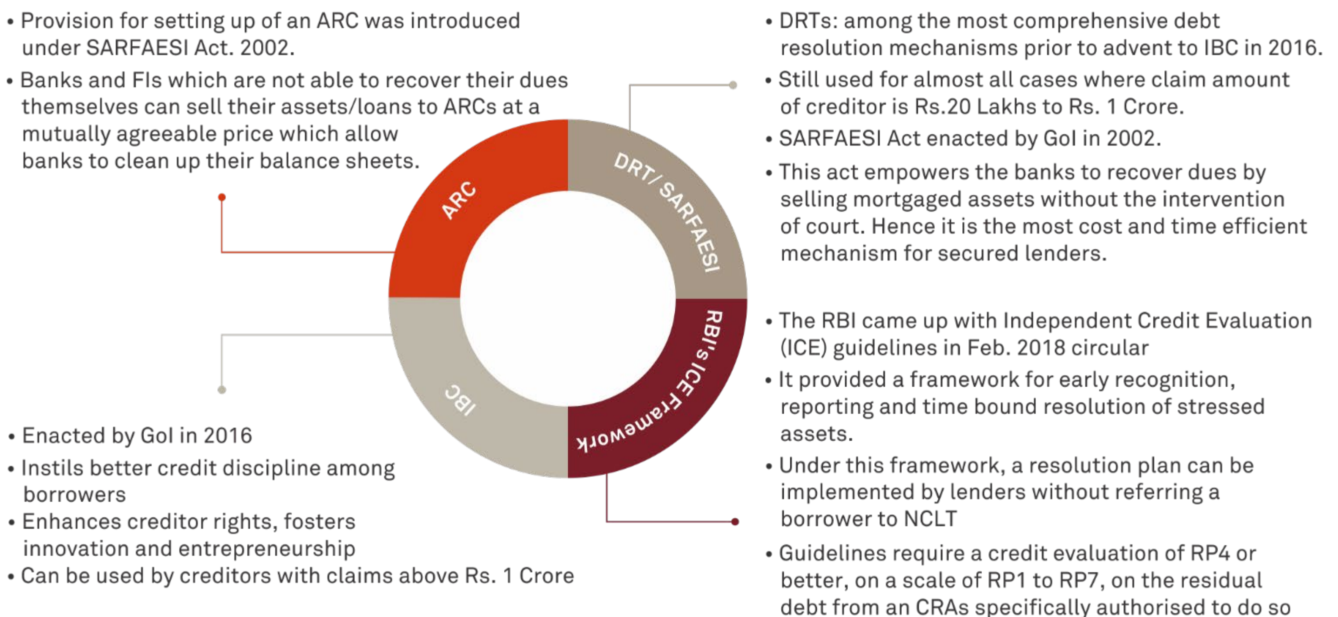
Overall, this means there may be fewer opportunities for stressed asset players in the large corporate segment over the medium term. The MSME segment, however, continues to offer opportunities. On the retail side as well, certain segments, especially unsecured loans, could see more offers for sale. Between banks and NBFCs,

the latter are becoming increasingly active as sellers, and this is expected to continue in the wake of the revised IRACP norms.

Nevertheless, it must be noted that over a longer period, asset quality is cyclical, and if the past is any indication, NPAs are expected to go up again after the current decline continues and they bottom out. As growth picks up and banks move out of their extremely cautious stance towards the corporate segment in recent years to meet credit demand and as leverage levels among borrowers go up, NPAs are likely to rise again, offering an opportunity for stressed assets players. The same holds true for NBFCs, too.

Stakeholders resolving stressed assets in India

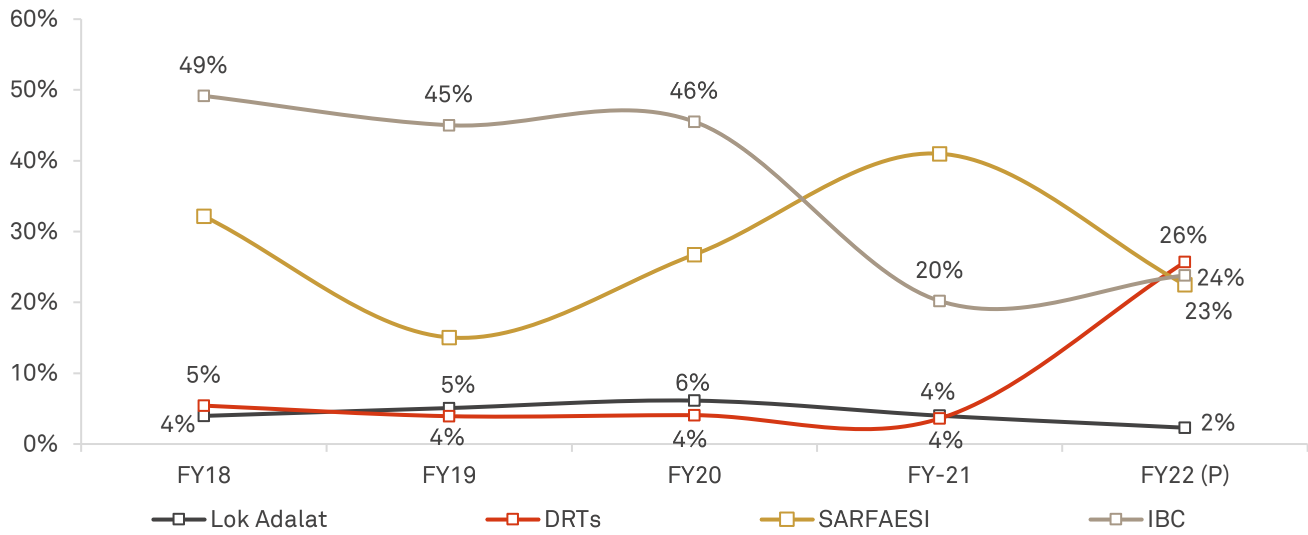
Given the scale of stressed assets in India, the role of stakeholders involved in their resolution becomes critical. While resolution mechanisms such as Debt Recovery Tribunal (DRT), the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), and Lok Adalat have been predominantly involved in resolution of stressed assets, entry of ARCs and the implementation of the Insolvency and Bankruptcy Code, 2016 (IBC) have dialled up the momentum.



A snapshot of recovery trends across resolution mechanisms

If we compare recovery through the various mechanisms, IBC has fared better at an overall level. However, the recovery rate through IBC has come down in the recent past, while recovery through SARFAESI has improved significantly. SARFAESI and IBC have helped financial institutions recover the maximum portion of dues.

Chart 3: Recovery trends across resolution mechanisms



Note: Actual recovery data for ARCs is not available in the public domain; hence, it is not included in the above chart

Recovery numbers for Lok Adalat, DRT and SARFAESI for March 2022 are yet to be published by RBI

The recovery rates mentioned in the chart are as per the RBI report and are at an on-year basis and not cumulative as on respective years

(P) – Provisional

Source: RBI, Insolvency and Bankruptcy Board of India (IBBI)

Before IBC, there were varied mechanisms to deal with the insolvency and bankruptcy of firms; each had their own set of rules and regulationsand different tribunals on a number of occasions gave contradictory orders, thus creating opacity and complexities. This resulted in unusually long delays in resolution, which negatively impacted the value of assets. Thus, consolidating the various extant frameworks under one law for quicker, consistent and transparent resolution was the need of the hour. The IBC was a result of this scenario.

Having a single code helps balance the interests of all stakeholders, thus maximising the value proposition for all involved.

ARCs are key players in stressed assets, with regulatory changes enhancing competitiveness

The stressed assets industry has evolved over the years in step with the changing landscape and regulations. As outlined in the previous section, there is now an entire ecosystem for attracting and resolving stressed assets, both in terms of players and resolution frameworks.

ARCs, the original players in the stressed-assets segment, have gained in scale and prominence. Since their inception, they have been nimble-footed in realigning their business models and keeping pace with the demands of the evolving macroeconomic environment and regulatory changes.

The section below outlines the various phases of the evolution of the business model of ARCs.

Evolution of ARCs

	Phase I 2003-14	Phase II 2014-17	Phase III 2018-2022	Phase IV 2022 onwards
Number of ARCs	1 → 14	14 → 24	24 → 28	28
Proportion of cash deals vs SR deals	Low	Low	Moderate	Increasing
Percentage of SRs held by banks	High	High	Moderate	Low to moderate
Investment in ARCs*	~Rs 2,500 crore^	Rs 4,000-4,500 crore@	Rs 10,000-10,500 crore#	Rs 11,000-11,500 crore$
Discount on acquisition	High	Low to moderate	Moderate	Moderate
Capital requirement for investment	Low	Moderate	High	Low

*CRISIL Ratings estimate of networth of ARCs – ^ as on March 31, 2014; @ as on March 31, 2017; # as on March 31, 2021; $ as on March 31, 2022

Phase I (fiscals 2003 to 2014): ARCs began to scale up mainly from the second half of fiscal 2014, when there was a regulatory push for banks to clean up their balance sheets. During this period, the minimum capital investment by ARCs for the acquisition of stressed assets was only up to 5% of the acquisition value, while the balance 95% could be invested by banks in the form of security receipts (SRs). Towards the end of Phase I, between June 2013 and June 2014, the AUM of ARCs increased over 4 times. Discounts were higher during this period since banks were mainly selling old assets. Cash deals were limited with transactions mainly through the 5:95 model.

Phase II (fiscals 2014 to 2017): CRISIL Ratings believes Phase II began when amendments to regulations resulted in the minimum requirement for ARC investments in SRs increasing to 15% in August 2014; the 5:95 model, therefore, shifted to a 15:85 model. As a result, the capital required by ARCs increased significantly. This initially led to a decline in the pace of asset acquisition by ARCs, since they became selective in acquiring assets. AUM growth fell sharply during the beginning of the phase, but picked up subsequently. It was supported by the large opportunity provided by mounting bank NPAs, especially in corporate assets even as the retail segment held up. The sellers were banks and there was limited NBFC participation. Cash deals remained low — ARCs only invested 15% of the acquisition value and banks continued to hold a large proportion of SRs in the assets sold by them. The discounts on acquisition were lower compared with Phase I because of valuation mismatch, especially for larger assets.

Phase III (fiscals 2018 to 2022): Structural changes driven by regulatory push marked the beginning of the third phase. The key regulatory change was a higher provisioning requirement for banks — with effect from April 1, 2017, the RBI increased the provisioning requirement for banks investing more than 50% of the value of stressed assets sold by them in SRs issued in lieu. The limit was reduced to 10% from April 1, 2018. As a result,

the proportion of cash deals increased and has risen even higher in recent years. Even in SR deals, banks were holding a much smaller proportion of SRs than in the past. However, with more cash deals, the capital requirement for ARCs increased, making partnerships critical, be it for bringing in capital or for co-investing. The market did see transactions with external investors co-investing with ARCs for certain large assets, and their share in acquisitions went up. The IBC , implemented in 2016, gathered momentum and brought about a significant shift in the overall resolution landscape.

The past couple of years have seen another shift: a bigger flow of retail assets for sale into the market, while sales of large corporate assets, other than legacy assets, are limited.

Furthermore, given the high capital requirement and limited ability of many ARCs to raise more capital, equity or debt, a structural shift to a retail-focused business model seemed inevitable for private ARCs.

Phase IV (2022 onwards): The revised guidelines for ARCs announced by the RBI in October 2022, which reduced the funding requirement for asset acquisition, are a game-changer. Investments by ARCs in SRs are envisaged at a minimum 15% of the investment of the transferor in the SRs, or 2.5% of the total SRs issued, whichever is higher, in each asset class under each scheme on an ongoing basis until the SRs are redeemed. Earlier, ARCs had to invest at least 15% of the SRs issued in each class under each scheme even if there were other investors (other than the selling lenders). For cash transactions, the saving could be as high as 80-85%. Even where the selling entity participates in the transaction, the funding requirement is somewhat lower than the earlier regime.

This has enhanced competitiveness of ARCs, with capital no longer a constraint in acquiring larger assets.

However, this has made partnerships even more crucial because the benefit is significantly higher for a cash transaction where the selling lender does not retain any SRs and these are held by other investors instead.

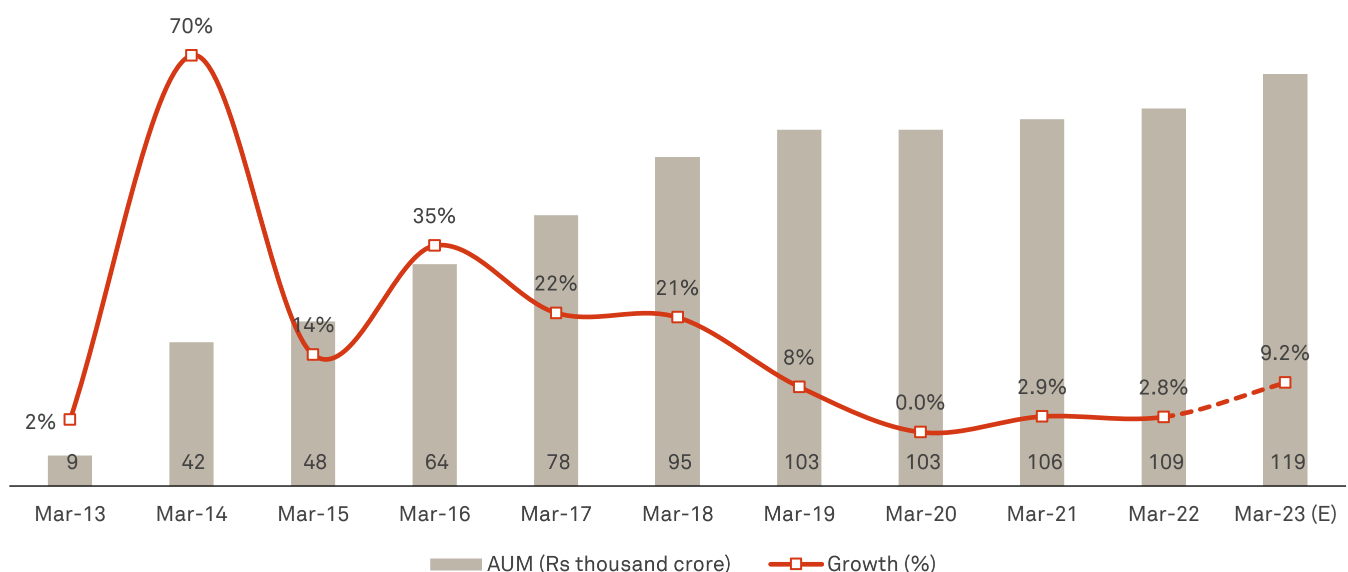
Further, while the capital requirement for acquisition has come down, a key monitorable is the impact of the revised regulatory guidelines for ARCs from a minimum networth perspective. The increased minimum networth requirement may see some players give up their licences and there could also be some consolidation, allowing the remaining players to corner a larger share of the industry pie.

Also, given the multiple options available to lenders for resolution of stressed assets, the ability of ARCs to demonstrate their effectiveness in resolving acquired stressed assets in a timely manner remains critical for their long-term sustainable business growth.

AUM of ARCs to grow almost 10% this fiscal after a period of relative stagnation

ARCs have been facing headwinds in the past three fiscals, with growth in assets under management (AUM), as measured by security receipts (SRs) outstanding, dropping to low single digits in the past 4 years (*Refer to Chart 3*). This is in sharp contrast to previous years — between fiscals 2014 and 2018, AUM had grown at a steady pace, initially driven by the supportive regulatory environment for banks to sell bad assets.

Chart 4: Trend in AUM of ARCs



Source: CRISIL Ratings estimates based on rated ARCs constituting over 75% of industry AUM

The slowdown is partly attributable to the subdued macroeconomic environment, which had hindered consummation of deals and heightened risk aversion among investors, leading to lower acquisition. A few structural trends are also at play.

First, the stressed asset ecosystem has undergone a transformation. Lenders now have multiple options for resolution and enforcement frameworks, and are evaluating and utilising these options more actively. IBC, with its subsequent modifications, has seen many takers. The RBI's June 2019 Prudential Framework for Resolution of Stressed Assets gives lenders the option to resolve stressed assets outside the legal process. So, an ARC may not necessarily be the first port of call for lenders.

Second, due to the stringent provisioning norms, banks prefer to retain only a limited share of SRs for assets sold. At the same time, given the limited capital availability, ARCs in most cases hold only the regulator-mandated 15% of SRs. This gap has to be bridged by bringing in external co-investors. This did happen in a few large assets and ARCs did partner with external investors. However, the trend has not been widespread across the sector since not all ARCs have been able to bring in co-investors; co-investors have also been selective.

CRISIL Ratings expects the growth of ARCs to touch a 5-year high this fiscal . The market has seen a large transaction for acquisition of a portfolio of NPAs from a bank. NARCL also kick-started the acquisition of NPAs with its first transaction in January 2023, and this should pick up pace further going forward.

Proportion of retail assets in ARC acquisitions is rising

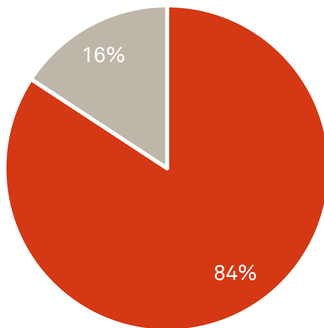
With corporate sector gross NPAs trending downwards since hitting a peak in 2018, the opportunity in this segment has been coming down for ARCs. On the other hand, due to factors such as the Covid-19 pandemic, opportunities in the retail and MSME segment have been increasing.

Many ARCs have been quick to capitalise on this. Therefore, the share of retail in overall debt acquired by ARCs has gone up significantly in fiscals 2021 and 2022. (*Refer to Chart 5*).

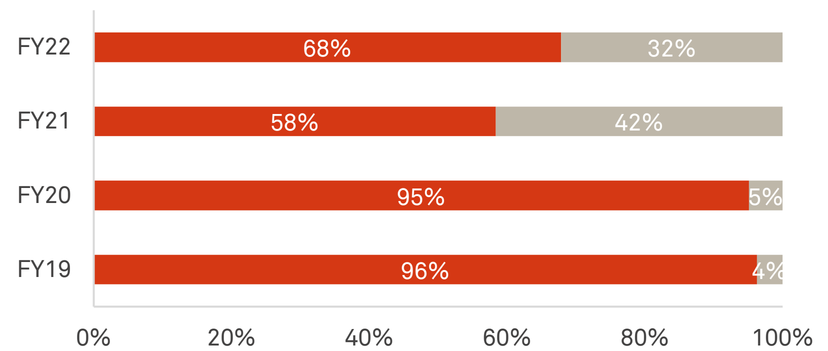
In fact, the market for retail stressed assets itself is getting more diversified- while till a couple of years ago, it was more concentrated towards secured assets classes such as home loans and loans against property, recent quarters have seen an increasing proportion of segments such as unsecured personal loans and microfinance loans.

Chart 5: Composition of debt acquired by ARCs

Break-up of cumulative debt acquired until March 2022



Break-up of debt acquired until the fiscal



Source: CRISIL Ratings estimates based on rated ARCs constituting over 75% of industry AUM

This trend is expected to continue, with private ARCs focusing more on the retail and MSME segments, even as NARCL scales up business in line with its state mandate of acquiring large corporate loans.

ARCs are also likely to have a competitive edge in retail and MSME loans. Other investor classes such as stressed assets funds are unlikely to be interested in these segments since building an operationally intensive set-up to manage retail stressed assets will entail a significant investment. Given the greater opex required, volumes will be critical to profitability; thus, ARCs that invest here will need to keep a close eye on achieving scale and strong execution efficiency.

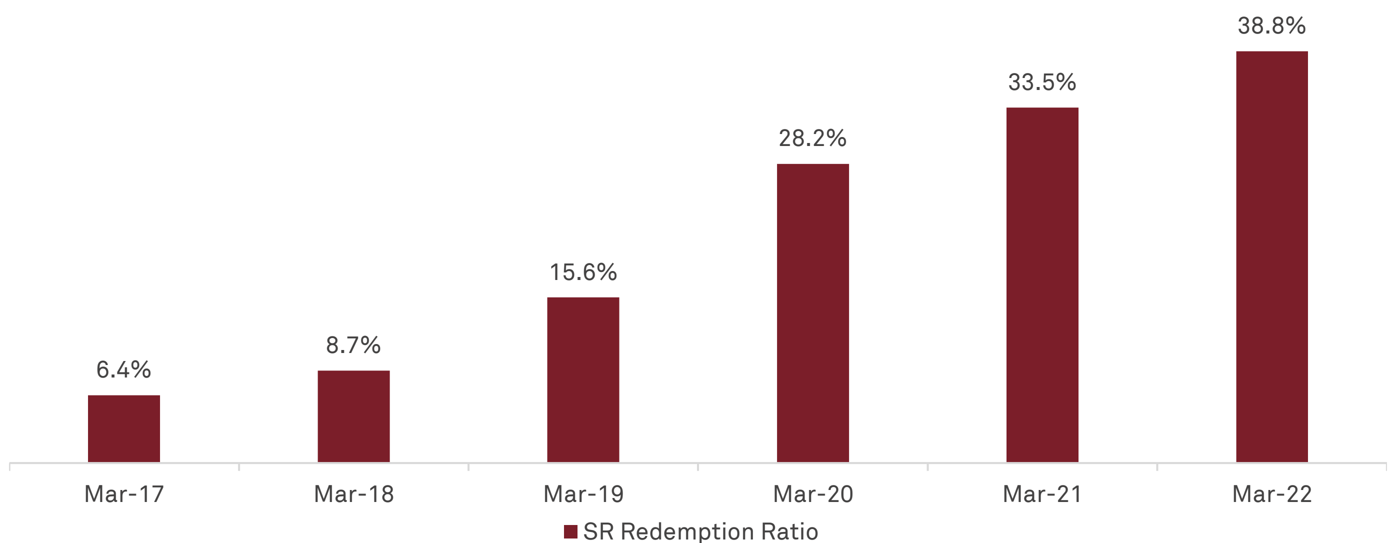
However, ARCs themselves are exploring alternatives to setting up fully staffed in-house teams for resolution of retail assets, including using external agencies and also setting up servicing arrangements with selling institutions.

CRISIL Ratings expects that as retail asset acquisitions gather pace, the business models of ARCs will continue to evolve to tap the shifting business opportunity.

While the redemption ratio is improving, it remains below potential

The estimated cumulative SR redemption ratio for ARCs has increased in recent years, standing at 39% as on March 31, 2022, compared with 16% three years before. The resolution of a few large-ticket assets through IBC has helped, though overall recovery remains lower and slower than expected. While recent originations have performed better, recovery remains below potential.

Chart: Trend in SR redemption ratio



Source: CRISIL Ratings estimates based on rated ARCs accounting for over 75% of industry AUM

Recent regulatory changes and their impact on ARCs

The revised guidelines for ARCs announced by the RBI would structurally fortify the sector through improved governance norms, better disclosures, lower funding requirement for asset acquisition, and more robust balance sheets. Following are the key amendments and their impact on ARCs:

The business risk profiles of ARCs will benefit from two crucial changes: lower funding requirement for acquisitions and option to participate as a resolution applicant (RA) under IBC.

Several measures to strengthen the governance framework of ARCs have also been introduced, such as enhanced Board independence, and stipulation of tenure and performance review for Board members. The debt settlement process has also been made more rigorous.

The revised guidelines mandate enhanced disclosure norms pertaining to financial information, track record of returns generated, and recovery ratings on SRs in offer documents. This is expected to bring in more transparency and boost investor interest.

Additionally, clear guidelines on charging management fees only from recovery of underlying assets should persuade ARCs to focus on faster resolution. The RBI circular also requires ARCs to retain a rating from a credit rating agency (CRA) for at least three years.

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Recent regulations and their impact

Net owned fund (NOF)

Regulations

- Minimum NOF requirement raised to Rs 300 crore on an ongoing basis from Rs 100 crore
- Existing ARCs shall have NOF of Rs 200 crore by March 2024 and Rs 300 crore by March 2026
- Minimum NOF of Rs.300 crore to obtain new certificate of registration for conducting ARC business

Probable impact on ARCs

- Big Players will remain in the market
- Small players may find it challenging to bring in the additional capital requirement
- This may eventually lead to consolidation in the industry

Investment in SRs issued by ARCs

Regulations

- Investment by ARCs in SRs are envisaged as
  - Minimum 15% of the transferor investment in SRs or
  - 2.5% of total SRs issued,

whichever is higher, of each class of SRs issued under each scheme on an ongoing basis till the SRs are redeemed

Probable impact on ARCs

- This will free up funds and support growth over the medium term
- This will encourage more cash transactions

ARCs as RA in IBC

Regulations

- Only ARCs with minimum NOF of Rs 1,000 crore can act as RA
- ARCs shall not retain significant control over the corporate debtor after 5 years from date of approval of the resolution plan
- Board of ARC should approve the policy to act as RA; Board committee should comprise independent directors
- There should be disclosure in financial statement

Probable impact on ARCs

- This will enhance the business options available and open up a new revenue stream.
- Only a few of the 28 ARCs that have NOF of more than Rs 1,000 crore may be able to garner business
- Time frame of 5 years of ownership by ARC may lead to forced exit, which may not maximise value of asset

Transfer of stressed loan to ARCs

Regulations

Stressed loans that are in default in the books of transferor are permitted to be transferred to ARCs

Probable impact on ARCs

- This will free up bank capital from provisions, which can be used for lending to increase business and credit growth
- It will allow ARCs to purchase any asset 'in default', including SMA-0 along with existing SMA-1 / SMA-2 / NPA

Management Fee

Regulations

- The fees and incentives will have to be recovered only from the underlying financial assets
- Board-approved policy should indicate a quantitative cap on fees and incentives under various scenarios

Probable impact on ARCs

- ARCs to focus on faster resolution of assets
- This will increase fairness and transparency of fees.

Improving governance

Regulations

- Tenure of an MD/ CEO/ wholetime director (WTD) shall be a maximum of 5 years at a time and a total of 15 years continuously, including all reappointments
- Thereafter, a cooling period of 3 years is mandated to reappoint the same person as MD/CEO/WTD in the same ARC
- Maximum age limit for MD/ CEO/ WTD is 70 years. ARCs are allowed to keep any age limit lower than this as per their internal policies
- Performance of MD/ CEO/ WTD to be reviewed by the Board annually
- The person heading the board to be an independent director
- ARCs to obtain fit and proper criterion

Probable impact on ARCs

- These steps will increase transparency in the management of an ARC, as decision-making power will not be concentrated in the hands of a few for a longtime.
- Continuous change in management personnel will bring in different perspectives across Board membership

Stringent norms pertaining to rating of SRs

Regulations

- ARCs have to mandatorily obtain recovery ratings of SRs from a CRA along with the rating rationale, and disclose the same to SR holders
- ARCs cannot shift to a new CRA before completion of 6 rating cycles with the same CRA. Should an ARC choose to do so, it has to disclose the reason for the change

Probable impact on ARCs

- The requirement of rating rationale will throw light on the critical aspects CRAs consider to arrive at a particular rating, thus enabling SR investors to take more informed investment decisions
- Continuation of a CRA will bring about consistency in the periodical ratings given to a SR trust
- Any negative trends in the progress of recovery procedures will be better highlighted

Evaluation of one-time settlement (OTS) proposal

Regulations

- ARCs to set up an Independent Advisory Committee (IAC) that will go through the settlement proposal and provide its recommendations to the Board regarding acceptability of the same
- Board of Directors to evaluate all the recovery options available, including settlement (taking into consideration the IAC recommendations), and choose a recovery mechanism best suited to the respective borrower, one which can maximise recovery through best time and cost efforts
- For most cases, ARCs should follow the principal of net present value (NPV) of settlement amount, which should be greater than the realisable value of securities

Probable impact on ARCs

- With the implementation of IBC, more borrowers are now approaching lenders to settle the account at the pre-admission stage, which saves time and effort for all stakeholders involved. However, the increasing regulations in OTS proposals will bar many borrowers from settlement and force lenders to adopt other resolution mechanisms that may not always result in maximisation of recovery, and may be less time- and cost-efficient

Increasing disclosure requirements

Regulations

- Summary of financial information of the ARC for the last 5 years or since commencement of business, whichever is shorter
- Track record of returns generated for all SR investors on the schemes floated in the last 8 years
- Track record of recovery rating migration and engagement with rating agency for schemes floated in the last 8 years

Probable impact on ARCs

- These steps will enable the ARC to garner investments from a broader set of qualified buyers
- This will also foster healthy competition among ARCs

The impact of these new regulations will be seen in due course. Besides changes in operating methodology, a key change will be the way ARCs invest in SRs over the medium term. This is envisaged at a minimum 15% of the investment of the transferor in the SRs, or 2.5% of the total SRs issued, whichever is higher, in each asset class under each scheme on an ongoing basis until the SRs are redeemed.

The revision in minimum investment in SRs is a significant benefit for ARCs as it will free up funds and support growth over the medium term. For cash transactions, the savings could be as high as 80-85%. Even where the selling entity participates in the transaction, the funding requirement is somewhat lower than the earlier regime. The proportion of cash-based transactions in SRs rated by CRISIL Ratings has been increasing steadily, and stood at 36% as of February 2022, compared with 4-5% as of February 2017. This momentum is expected to continue with a lower requirement of funds for cash-based transactions.

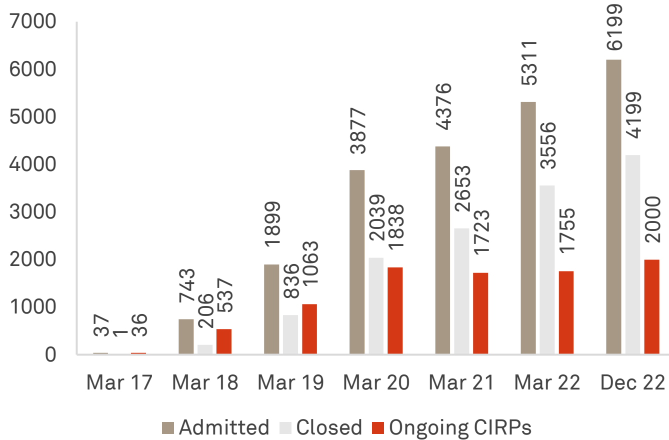
The IBC journey so far: Impact and challenges

Since its inception in 2016, IBC can be credited with many path-breaking changes in the insolvency resolution process. Undoubtedly, the code has tilted the power equation in favour of creditors from debtors, and helped strengthen India's insolvency resolution ecosystem.

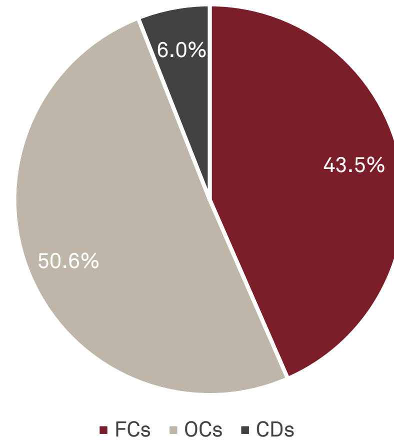
The intent of IBC is to provide a time-bound market mechanism for the reorganisation and insolvency resolution of a corporate debtor (CD) in distress. The objective is to maximise the value of assets of persons to promote entrepreneurship, enhance availability of credit, and balance the interests of all stakeholders. In case of corporate insolvency, the creditors assess the viability of the CD and endeavour to rescue it through a resolution plan. The corporate insolvency resolution process (CIRP) ends up with either an approval of a resolution plan rehabilitating the CD or an order for its liquidation.

While its implementation was swift, IBC and its associated ecosystem have evolved over the past six years. There has been an increase in cases admitted under IBC from diverse sectors and a shift in power to creditors from debtors — operational creditors (Ocs) triggered ~51% of CIRP, followed by ~44% by financial creditors (FCs), and the remaining by the CDs themselves. The number of insolvency professionals and registered valuers has also increased steadily. With the recent amendment, insolvency professional entities (IPEs) are now allowed to act as insolvency professionals, thus broadening the scope of resolution.

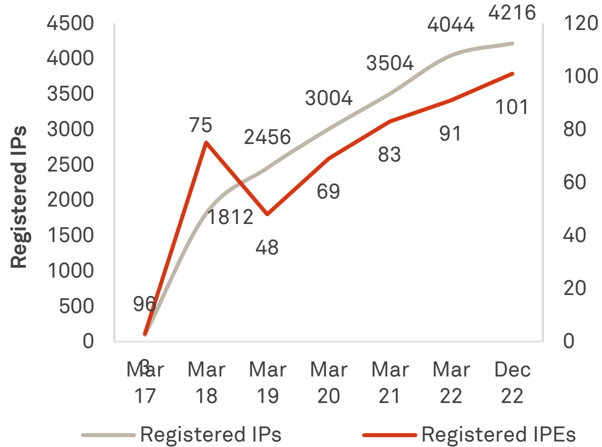
Rapid increase in cases admitted



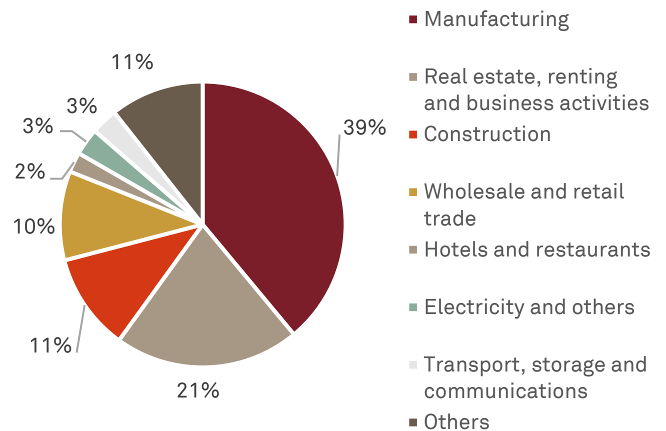
More than half of the cases filed by Ocs



Increase in IPs and IPEs over the years



Bulk of cases admitted is from manufacturing

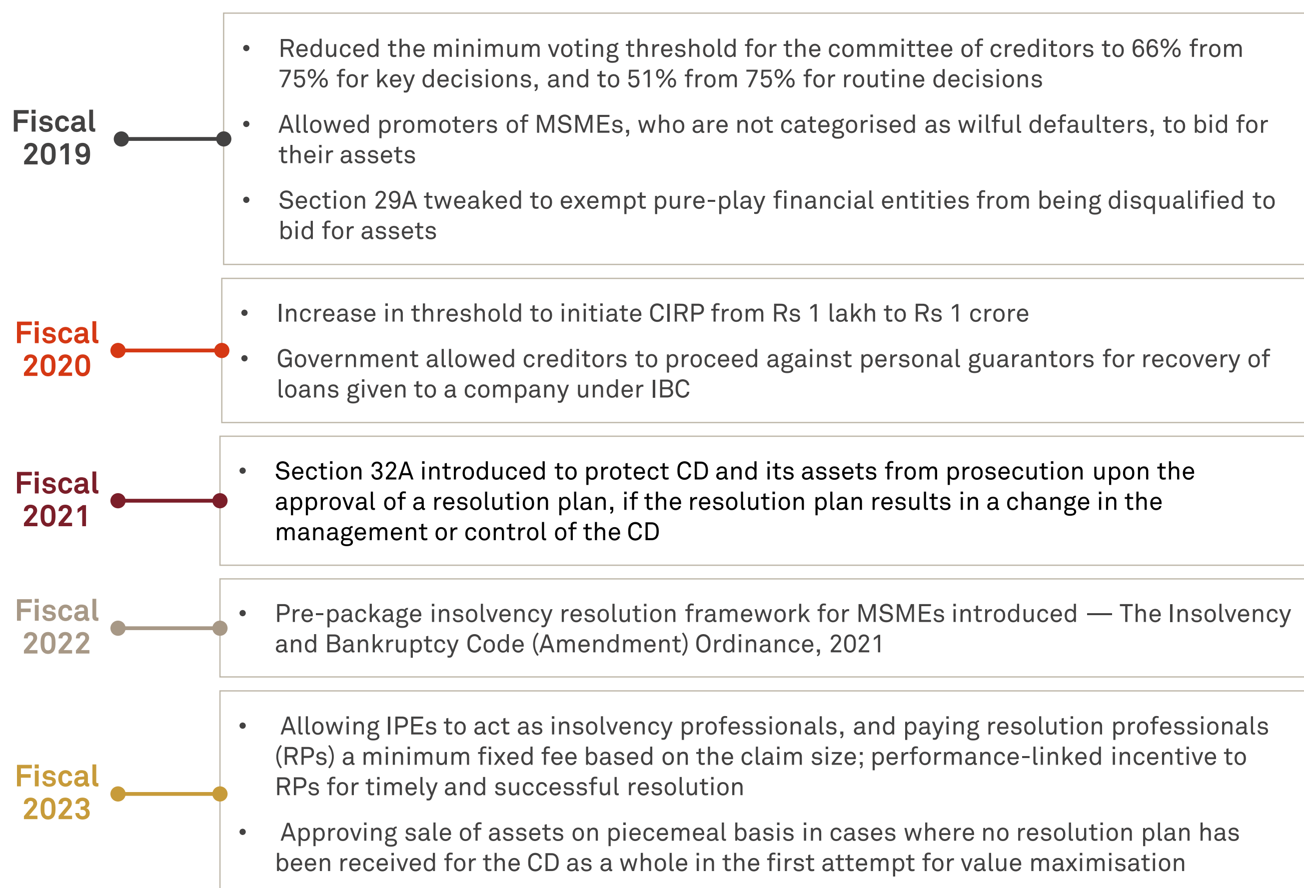


Source of all the charts: IBBI. *Figures mentioned in the charts are cumulative (as of December 2022) since IBBI inception

Major amendments

The government, along with the regulator (IBBI), has been proactive in addressing issues faced by various stakeholders and has amended the code from time to time. As per the September 2022 IBBI quarterly newsletter, 84 amendments have been made to its 18 regulations under IBC so far.

Some of the major amendments are listed below:



Impact of IBC

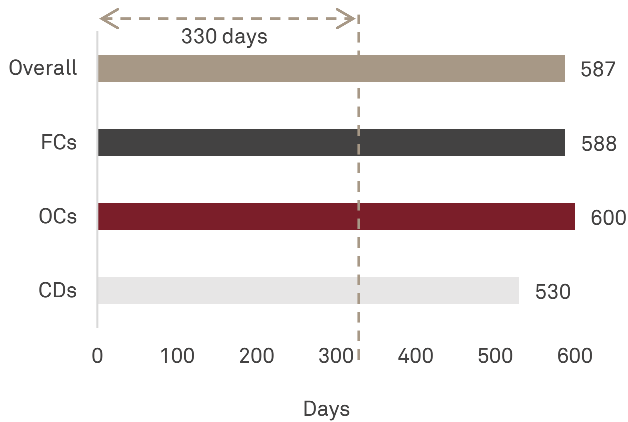
As of December 2022, IBC has helped recover ~Rs 2.53 lakh crore against admitted claims of ~Rs 8.31 lakh crore (or around one-third of the admitted claims) from insolvent firms (for the 611 cases resolved out of the total 6,199 admitted), marking a significant shift in the insolvency resolution process.

IBC has also led to a behavioural change in borrowers to opt for settlement with creditors, having a fear of getting referred to IBC. As per the December 2022 quarterly IBBI newsletter, 24,222 cases having underlying default of Rs 7.69 lakh crore were resolved before their admission to IBC, which underlines the efficacy of the code.

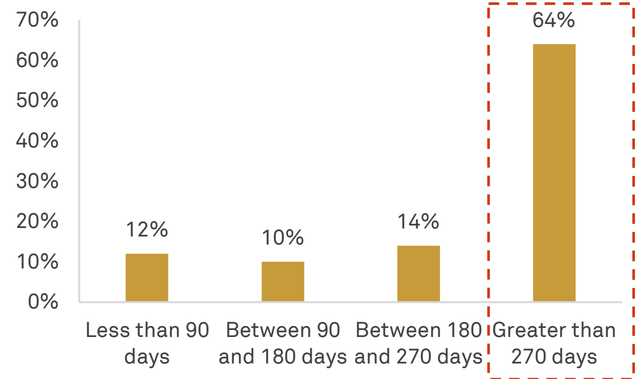
Challenges and way forward

The performance of IBC against its twin objectives — maximisation of recovery and time-bound resolution — has been a mixed bag. This is reflected in its lower-than-expected recovery rate (30.4% as on December 30, 2022) and significantly stretched resolution timelines (587 days for 611 resolved cases as of December 2022, vis-à-vis the stipulated timeline of 330 days), along with substantial delay in admission of cases into IBC (in fiscal 2022, average time from date of filing to admission was 650 days). Furthermore, 64% of the outstanding 2,000 cases as of December 2022 are pending beyond 270 days. Hence, adherence to timeline remains a challenge.

Average timeline crosses 330 days across categories



Of the 1,947 outstanding IBC cases, 64% pending for more than 270 days



Source: IBBI. *Figures mentioned in the charts above are as of December 2022 since IBBI inception

While a low recovery rate and longer time frame (pre- and post-admission) have been the key challenges, along with elevated liquidation cases, the effectiveness of IBC will continue to be tested, given the level of stressed assets in the country. IBC has played a key role in the resolution of stressed assets so far vis-à-vis other resolution mechanisms such as DRTs, SARFAESI, and Lok Adalat.

All the amendments seek to address the issues in IBC as the intention is to fast-track the resolution process while maximising the underlying value of the asset. That said, timely implementation of these amendments is critical. Furthermore, strengthening the ecosystem by improving the infrastructure through increasing bench strength of judges, digitalisation of IBC platforms, implementation of cross-border insolvency, and allowing pre-packs for corporates can help IBC gear up for the next phase.

The Ministry of Corporate Affairs has also recently proposed some changes to IBBI regulations and sought suggestions from stakeholders. Critical suggestions such as the use of technology in the IBC ecosystem, increasing reliance on the record submitted with information utilities (IUs) during the admission process, pre-packaged insolvency resolution framework extension to prescribed categories of CDs, and project-specific resolution in the real estate sector are steps in the right direction, which should further strengthen the code. That said, implementation at the ground level is critical.

While IBC has made a mark since its inception in resolving stressed assets, with other resolution mechanisms also contributing, ARCs have established themselves at the forefront of the resolution process on the back of their market presence, expertise, and understanding of the challenges in stressed-assets resolution. Further, the market has witnessed a good number of cash-based acquisitions by ARCs in the recent past.

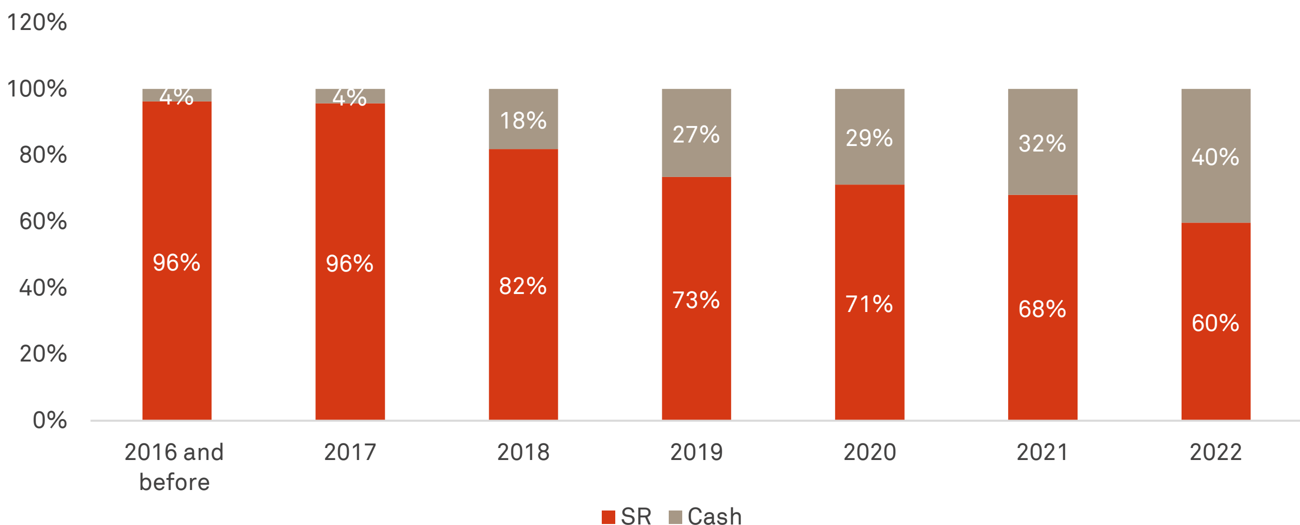
CRISIL Ratings view on its SR portfolio

CRISIL Ratings has been rating SRs issued by ARCs since 2003. During 2003-2007, SRs were rated on the 'probability of default' rating scale, and the recovery rating scale was launched in 2007. Cumulatively, CRISIL Ratings has rated SRs of over Rs 30,000 crore issued by over 450 trusts across the corporate, infrastructure (power, port, tele-tower, road assets), and retail (MSME corporate pool and home loans/loans against property, commercial vehicle loans, credit cards, personal loans) loan segments.

Cash transactions gaining momentum in SR portfolio of CRISIL Ratings

The proportion of cash-based transactions in SRs rated by CRISIL Ratings has been increasing steadily and stood at 40% in 2022 against just 4% in 2016. This momentum is likely to continue on account of recent changes implemented by the RBI.

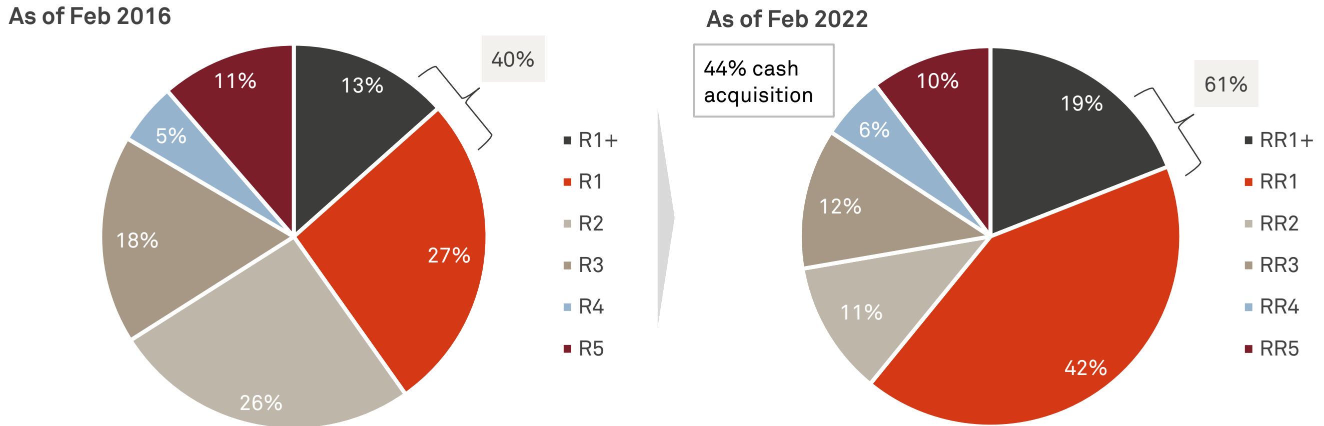
Cash vs SR transactions (cumulative)



Source: CRISIL Ratings

Furthermore, the share of RR1+ and RR1 ratings increased to 61% in February 2022 from 40% in February 2016 because of a higher share of cash transactions, better-quality assets, and quicker implementation of resolution strategies.

Improved recovery ratings with higher cash-based transactions



Source: CRISIL Ratings

Recent acquisitions in CRISIL Ratings portfolio are faring much better

To understand the performance of SRs, recent trends of the SR portfolio of CRISIL Ratings have been analysed for the acquisitions done in 2015 (pre-IBC) and 2019 (post-IBC).

SR acquisition year (CRISIL Ratings portfolio)	2015		2019
Rating review as of	Feb 2018	Feb 2021	Feb 2022
Transaction type	>95% SR deals		Cash: 44% SRs: 56%
Cumulative recovery ratio (gross recovery/SRs issued)	6%	20%	42%
Cumulative redemption ratio (SRs redeemed/SRs issued)	3%	17%	44%
Average recovery timeline (years)	2.5	5.4	2.5-3

Source: CRISIL Ratings

As seen in the table above, the cumulative redemption ratio in the first three years of SRs issued in 2015 is merely 3%; however, the redemption ratio is 44% for the same time frame for SRs issued in 2019. This shows that recent acquisitions are faring better than the older ones due to a higher proportion of cash transactions, quicker debt aggregation, and lower vintage of NPAs with much better economic value.

In the past, though ARCs successfully reconstructed a few large accounts and demonstrated their ability to recover through asset sales, the recovery rate was not up to the potential due to pendency in legal issues, delay in debt aggregation, and acquisition of high-vintage assets.

Over the past few years, recoveries have improved for the following reasons:

1. Quicker debt aggregation, backed by cash-based transactions

With higher cash-based transactions backed by sponsors or investors, ARCs have been able to bring the lenders on-board and persuade them for a one-time settlement. This results in better price discovery, along with quicker aggregation of debt and exit of lenders from the overall structure.

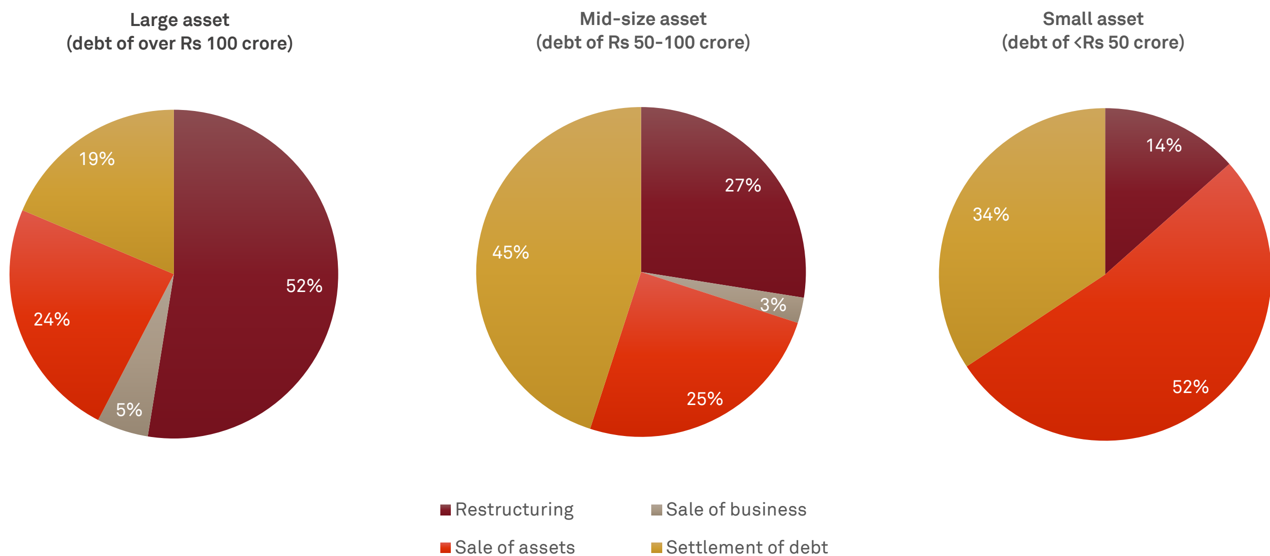
2. Acquisition of lower vintage of assets

ARCs are acquiring stressed assets that are recent NPAs and, in some instances, not yet classified as NPAs. This increases the chances of revival, subject to other conditions being met in a timely manner, such as arrangement of working capital funds, capital infusion by the promoters, and rescheduling of debt.

3. Direct and indirect resolution through IBC

Resolution through IBC and the fear of IBC have also contributed to faster resolution.

Resolution strategies adopted by ARCs across various asset sizes



Source: CRISIL Ratings

- For large trusts (debt of over Rs 100 crore), debt restructuring is the most preferred resolution strategy
- For mid-sized trusts (debt of Rs 50-100 crore), settlement of debt and sale of assets worked well
- For small trusts (debt of below Rs 50 crore), sale of assets worked well

National ARC: Strategy in place, execution to drive AUM growth of SRs

Though private ARCs have been around for a long time, the intent of setting up NARCL was to establish a government-backed ARC that will not face issues in raising start-up capital, unlike private ARCs. This will aid in the planned acquisition of larger assets and speed up debt aggregation.

The asset quality of the banking sector will also benefit from the proposed sale of NPAs to NARCL.

Furthermore, as different segments (such as large and mid-sized corporates, retail, and SMEs) require different skillsets for resolution, having a clear niche for NARCL and the associated asset management company (AMC), which usually comprises large corporates, should help build focused resolution strategies.

What could also work well for NARCL is the much talked about government guarantee for SRs, which would limit the downside risk for sellers and other SR holders. While it could also help develop a secondary market for SRs, this guarantee could be a potential moral hazard.

As assets worth Rs 90,000 crore (out of the total projected acquisition of Rs 2,00,000 crore) will likely be bought in Phase I, the recovery will immediately boost the balance sheets of banks. This will also result in addition of SRs at the industry level and help drive AUM growth of SRs in the long run.

The current resolution tools and legal framework available to ARCs will apply to NARCL as well. Though the strategy for NARCL is in place, successful implementation of resolution for the assets acquired will be key to its success.

Challenges in the ARC industry and the way forward

Challenges

Challenge	Details
Lack of secondary market for trading of SRs	• Transparency and information availability will be key challenges
Industry composition, capital constraints and growth	• Among the 28 ARCs, the top six account for ~80% of the industry AUM • Limited capital base (~Rs10,000 crore as on March 31, 2021) constrains ability to acquire large stressed assets
Partnership model remains a challenge	• Ability to attract co-investors under a multi-platform ecosystem will be critical for growth of ARCs • While large ARCs have the option to go for this model, small ARCs may find it challenging
Requirement of NOF	• It will be tough for smaller ARCs to bring in additional capital • Over time, this will lead to consolidation in the industry, which may lead to monopoly of a few ARCs
Key challenges in recovery	• Prolonged legal issues • Lack of consensus among lenders • Small and mid-sized assets have limited market interest and low liquidation value

The way forward…

- **Sizeable opportunity** for investors in stressed assets across various sectors
- **Private ARCs** will continue to have a role to play, though business model may evolve
- **Cash share:** With the proportion of cash share increasing significantly in recent years and becoming the industry norm, ARCs need to focus on resolution to stay relevant
- **NARCL** is a positive step structurally; its efficacy will be tested in due course
- **Development of a secondary market for stressed assets will also aid liquidity**

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Annexures

Press Release published by CRISIL Ratings in October 2022 on the revised ARC guidelines issued by the RBI.

Ratings
CRISIL Ratings Limited (A subsidiary of CRISIL Limited)

CRISIL
An S&P Global Company

Press Release
October 17, 2022 | Mumbai

Revised RBI guidelines to structurally strengthen ARCs

More stringent norms could lead to consolidation in the sector

The revised guidelines for asset reconstruction companies (ARCs) announced by the Reserve Bank of India (RBI) last Tuesday would structurally fortify the sector through improved governance norms, better disclosures, lower funding requirement for asset acquisition, and more robust balance sheets.

However, the guidelines also require ARCs to increase net owned funds[1] to Rs 300 crore from Rs 100 crore in a phased manner by end of March 2026, which could be challenging for some of the smaller ones.

The business profiles of ARCs will benefit from two crucial changes: one, lower funding requirement for acquisitions (see annexure for *illustrations*) and two, an option to participate as a resolution applicant under the Insolvency and Bankruptcy Code (IBC).

Investments by ARCs in security receipts (SRs) are envisaged at a minimum 15% of the investment of the transferor in the SRs, or 2.5% of the total SRs issued, whichever is higher, in each asset class under each scheme on an ongoing basis until the SRs are redeemed.

Earlier, ARCs had to invest at least 15% of the SRs issued in each class under each scheme even if there were other investors (other than the selling lenders) present.

Says Subha Sri Narayanan, Director, CRISIL Ratings, "The revision in the minimum investment in SRs is a significant benefit for ARCs. This will free up their funds and support growth over the medium term. For cash transactions[2], the saving could be as high as 80-86%. Even where the selling entity participates in the transaction, the funding requirement is somewhat lower than the earlier regime. The proportion of cash-based transactions in CRISIL-rated SRs has been increasing steadily and stood at 38% as of February 2022 compared with 4-6% as of February 2017. We expect this momentum to continue with lower requirement of funds for cash-based transactions."

Allowing ARCs to become resolution applicants in the IBC process is also a step in the right direction. This will enhance business options available and potentially opens a new revenue stream. However, to be a resolution applicant, ARCs will need net owned funds of more than Rs 1,000 crore, which only a few of the 28[3] may be able to garner.

Several measures to strengthen the governance framework of ARCs have also been introduced. With respect to Board processes, these include enhancing the Board's independence, stipulation of tenures of Board members as well as a performance review process for them. The debt settlement process has also been made more rigorous.

The revised guidelines mandate enhanced disclosure norms pertaining to financial information, track record of returns generated and recovery ratings on SRs in offer documents. This is expected to bring in more transparency and ultimately boost investor interest.

Additionally, clear guidelines on charging management fees only from recovery of underlying assets should persuade ARCs to focus on faster resolution of assets. The RBI circular also requires ARCs to retain a rating from a credit rating agency (CRA) for at least three years.

Says Gautam Shahi, Director, CRISIL Ratings, "While the revised guidelines are clearly aimed at strengthening the sector, it could throw up a few challenges for ARCs. More than half of the ARCs have net-owned funds lower than the increased requirement of Rs 300 crore. A number of them may not be able to bring in additional capital. Further, the other governance measures are likely to increase compliance and operational costs, which could be challenging for some of the small-sized ARCs. Therefore, over time, these developments could lead to consolidation in the industry."

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[1] *Net owned funds = share capital + share premium + reserve and surplus – accumulated losses*
[2] *Transactions involving no participation by selling entity*
[3] *Excluding National Asset Reconstruction Company Ltd, less than 5 ARCs have net owned funds greater than Rs 1,000 cr as on March 31, 2022*

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About association of ARCs in India

Association of ARCs in India (Association) is a representative body of all 29 ARCs operating in India. The Association is a platform for exchange of ideas among members and it represents common issues affecting functioning of ARCs in various fora. It organizes various programmes for interaction among all stakeholders pertaining to ARC Sector.

About ASSOCHAM

The Knowledge Architect of Corporate India

The Associated Chambers of Commerce & Industry of India (ASSOCHAM) is the country's oldest apex chamber. It brings in actionable insights to strengthen the Indian ecosystem, leveraging its network of more than 4,50,000 members, of which MSMEs represent a large segment. With a strong presence in states, and key cities globally, ASSOCHAM also has more than 400 associations, federations, and regional chambers in its fold.

Aligned with the vision of creating a New India, ASSOCHAM works as a conduit between the industry and the government. The Chamber is an agile and forward-looking institution, leading various initiatives to enhance the global competitiveness of the Indian industry, while strengthening the domestic ecosystem.

With more than 100 national and regional sector councils, ASSOCHAM is an impactful representative of the Indian industry. These councils are led by well-known industry leaders, academicians, economists, and independent professionals. The Chamber focuses on aligning critical needs and interests of the industry with the growth aspirations of the nation.

ASSOCHAM is driving four strategic priorities - sustainability, empowerment, entrepreneurship and digitisation. The Chamber believes that affirmative action in these areas will help drive an inclusive and sustainable socio-economic growth for the country.

ASSOCHAM is working with the government, regulators, and national and international think tanks to contribute to the policy-making process and share vital feedback on implementation of decisions of far-reaching consequences. In line with its focus on being future-ready, the Chamber is building a strong network of knowledge architects. Thus, ASSOCHAM is all set to redefine the dynamics of growth and development in the technology-driven knowledge-based economy. The Chamber aims to empower stakeholders in the Indian economy by inculcating knowledge that will be a growth catalyst in the dynamic global environment.

The Chamber also supports civil society through citizenship programmes, to drive inclusive development. ASSOCHAM's member network leads initiatives in various segments such as empowerment, healthcare, education and skilling, hygiene, affirmative action, road safety, livelihood, life skills, and sustainability.

Shri Deepak Sood,

Secretary General

ASSOCHAM

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CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

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It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong, UAE and Singapore.

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