Sale of Non-Performing Assets by Multi-state Co-Op. Banks to ARCs

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Executive Summary

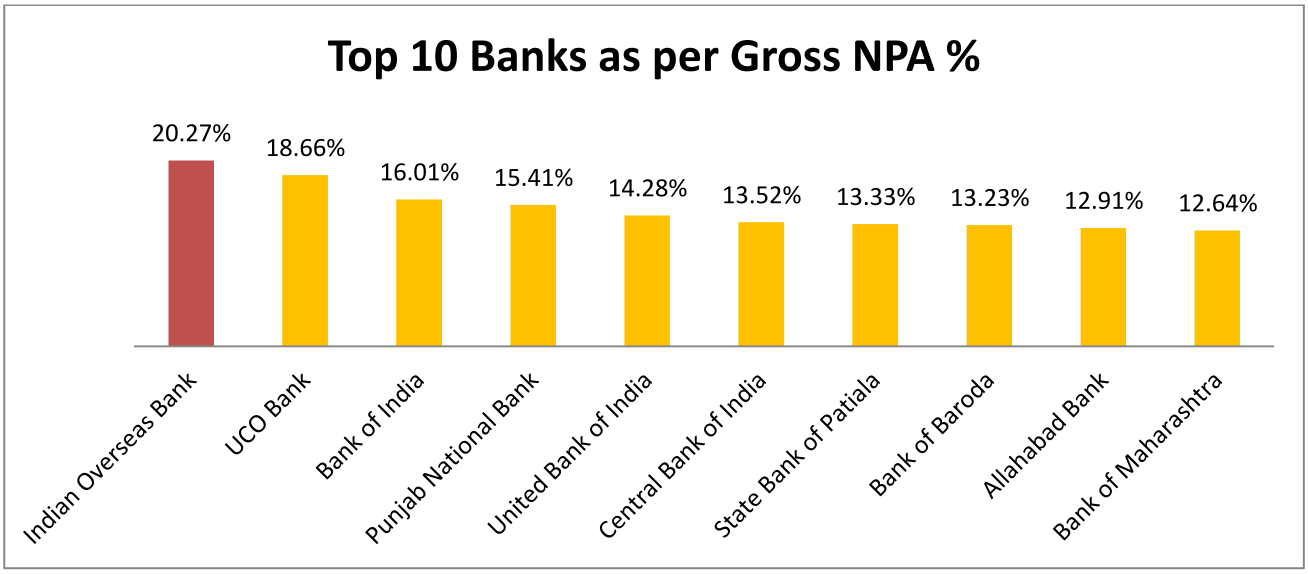
RBI Master Circular No. RBI/2015-16/43 dated July 01, 2015 prescribed regulations for the Urban Co-operative Banks for making different investments. Clause No. 13.2 and Annexure V of the said Master Circular prescribed Guidelines for Multi-state Co-operative Banks for selling their Financial Assets (Loans & Advances) to Securitisation Companies / Asset Reconstruction Companies. The guidelines speak about a four-way structure which includes – Identification of Financial Asset to be sold, Procedure for sale of financial assets, Prudential Norms with respect to Provisioning, Capital Adequacy & Exposure and Other Disclosure Requirements.

Through this write-up, an attempt has been made to simplify the procedure for Sale of Financial Assets by Multi-state Co-operative Banks to Securitisation Companies / Asset Reconstruction Companies.

NPA in India

The problems with respect to Non-Performing Assets in the Indian Banking System have always been rising. Government has been trying to facilitate NPA Management & Resolution by way of various methods like Debt Recovery Tribunals, Securitisation Legislations, Lok Adalats etc.

As per the Figures presented in the parliament[1], position of NPAs in the country in the hands of total 49 Scheduled Commercial Banks as at the quarter end of June 2016 was something worry-some. Total Gross NPAs amounted to 8.84% of Total Advances. The position of top 10 banks as per the Gross NPA % stood as under:



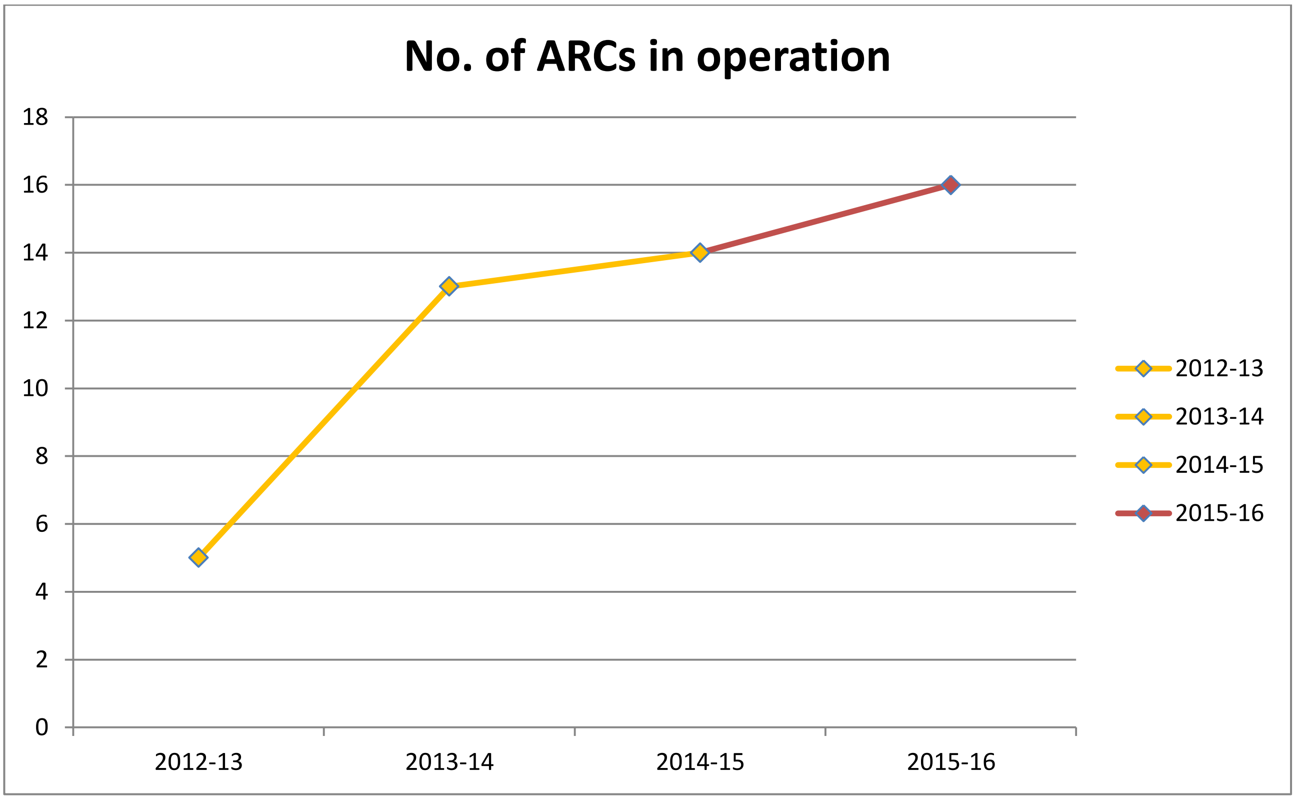
As per RBI Annual Publication - Report on Trend and Progress of Banking in India 2015-16[2], the amount recovered by all SCBs during 2015-16 reduced to INR 22,768 Crores as against INR 30,792 Crores during the previous year. PSBs, which are burdened with a high proportion of the banking sector's NPAs, could recover only INR 19,757 Crores as against INR 27,849 Crores during the previous year. The deceleration in recovery was mainly due to a reduction in recovery through the SARFAESI channel by 52 per cent from INR 25,600 Crores in 2014-15 to INR 13,179 Crores in 2015-16. On the other hand, recovery through Lok Adalats and DRTs increased.

[1] http://www.thehindu.com/data/Details-of-NPA-figures-of-public-private-sector-banks/article16670548.ece
[2] https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0FRTP16A120A29D260148E58B484D4A60E381BB.PDF

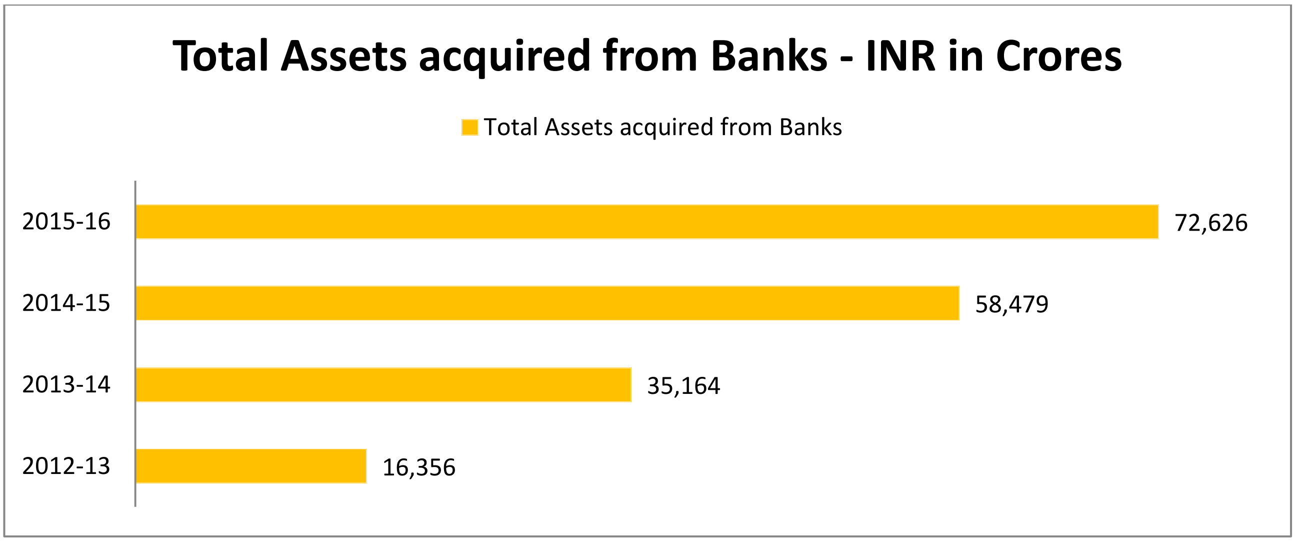
[SCBs: NPAs recovered through various channels (Amount in INR Crores)

Channel	2014-15			2015-16		
	No. of Cases	Amt. involved	Amt. recovered	No. of Cases	Amt. involved	Amt. recovered
Lok Adalat	29,58,313	30,979	984	44,56,634	72,033	3,234
DRTs	22,004	60,371	4,208	24,537	69,341	6,365
SARFAESI	1,75,355	1,56,778	256	1,73,582	80,100	13,179

On the other hand, recovery through ARC route showed an increasing trend. Banks also reduced their stressed assets by selling them to asset reconstruction companies (ARCs). This has been increasing since March 2014 because of the regulatory support extended to banks under the Framework to Revitalise the Distressed Assets in the Economy.



As compared to only 5 ARCs permitted to operate in 2012-13, total 16 ARCs are currently in operations in 2016. Some of these have been sponsored by different PSU Banks, some are sponsored by Private Banks; while some are financed by HNIs and Foreign Institutional Investors.



Similarly, total amount of NPAs sold to ARCs also experienced significant growth. As compared to 16,356 Crores of NPAs sold to ARCs in 2012-13, total 72,626 Crores worth of NPAs were sold to ARCs in 2015-16. This number is expected to grow further in 2016-17.

As such, it is clearly evident that the recovery through Asset Reconstruction Companies is the new trend and is being followed widely by all the Banks now.

Asset Reconstruction Scenario in Indian Context

The NPA Management started attracting attention of stakeholders around 1994. The problem of recovery of NPAs was officially recognised in 1997 when Narshiman Committee's report mentioned that important aspect of economic reform was to reduce overall high volume of NPAs. A combination of policy and institutional development will help to lower the overall NPAs in the banking sector. However, huge backlog of NPAs kept pulling the banks and as such, banks were forced to waste their valuable resources on recovery instead of concentrating on their core business functions. The Report proposed creation of a fund for Asset Recovery which could be used for removal of bad loans from the books of the Banks and thereby improving their financial position.

Accordingly, the concept of Asset Reconstruction Companies was introduced by virtue of section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI Act, 2002). ARCs are regulated by RBI and they operate as Asset Management Companies.

As per RBI Notification dated April 23, 2003, ARCs execute following functions:

- Acquisition of Financial Assets from Banks / FIs
- Change / Takeover of Business of the Borrower
- Rescheduling the Debts
- Enforcement of Securities Interest
- Settlement of Dues payable by the Borrower

In a nutshell, ARCs have a focussed approach to isolate Non-Performing Assets from Performing Assets; Letting the Financial Institutions concentrate on their core business activity of banking and Facilitating Recoupment / Rejuvenation of Sick Businesses.

Following are the prime Asset Reconstruction Companies operating in the country[3]:

1. Asset Reconstruction Company (India) Limited
2. Asset Care and Reconstruction Enterprise Limited
3. ASREC India Limited
4. Pegasus Asset Reconstruction Private Limited
5. Alchemist Asset Reconstruction Company Limited
6. International Asset Reconstruction Company Private Limited
7. Reliance Asset Reconstruction Company Limited
8. Pridhvi Asset Reconstruction and Securitisation Company Limited
9. Phoenix ARC Private Limited
10. Invent Asset Securitisation and Reconstruction Private Limited
11. JM Financial Asset Reconstruction Company Limited
12. India SME Asset Reconstruction Company Limited
13. Edelweiss Asset Reconstruction Company Limited
14. UV Asset Reconstruction Company Limited
15. Meliora Asset Reconstruction Company Limited
16. Omkara Assets Reconstruction Private Limited

In late 2016, another 3 ARCs were given a nod to operate:

17. Prudent ARC Ltd
18. MAXIMUS ARC Limited
19. CFM Asset Reconstruction Private Limited

[3] https://rbidocs.rbi.org.in/rdocs/content/pdfs/LSCRCRBI07092016.pdf

How ARCs Work

As it is known, ARCs purchase bad loans from the Banks. These acquired assets are transferred to a separate trust created under section 7 of the SARFESI Act, 2002. Most of these deals are executed at discount.

Against these acquired assets, ARCs pay an upfront amount of up to 15% of total consideration to the Bank. This figure of 15% differs from case to case. For rest of 85% amount, ARCs issue Securitisation Receipts / Bonds to the Banks which are usually repayable in a period of 5 years. All the securities mortgaged with the bank then vest with the ARC. Distinction can be made between Prime Security and Collateral Security which may differ from case to case.

Before the Asset is acquired from the bank, ARCs often undertake Detailed Due Diligence exercise on the basis of which, they make an offer to the Bank.

After acquisition of the asset from the bank, ARC steps into the shoes of the banker for the borrower. At times, ARCs give a cooling off period to the borrower so that borrower can come up with a rejuvenation plan. Sometimes ARCs also offer additional funds to the borrowers to restart the business operations.

Borrower once re-establishes its business operations, has to repay the loans to the ARC as per the terms agreed between the ARC and the Borrower. If borrower fails to do so, ARC can take harsh action against the borrower by selling its Assets by way of enforcement of securities interest.

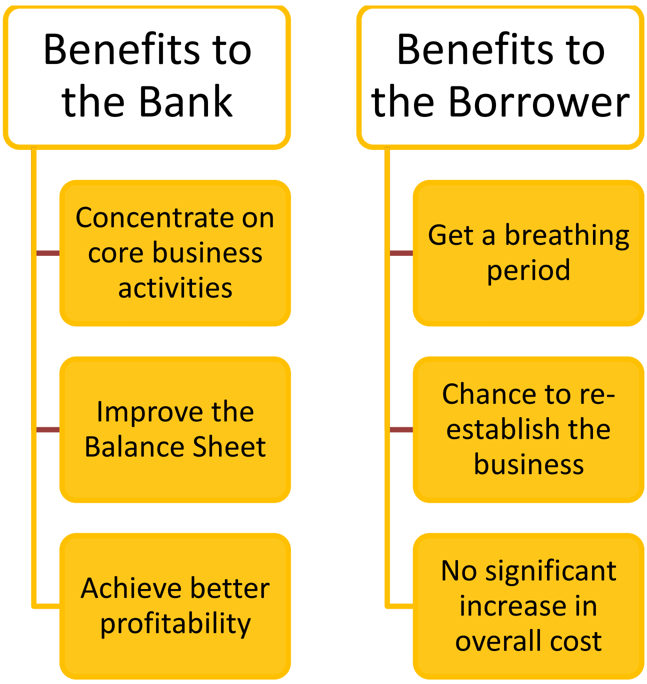
"It may kindly be noted that each case is a different one. The terms of the deal depend broadly on the type of business, severity of the NPA, value of the underlying security and chances of revival. Accordingly, deal size, offer price to the Bank and Ratio of Cash Consideration to Consideration in SRs may change."

In some cases, ARCs also pay a nominal coupon on the SRs issued to the Banks. Also, ARCs may agree on sharing on future profits with the bank.

Benefits to the Bank and to the Borrower

Speaking from Bank's point of view, banks can sell the NPAs to ARCs and then can concentrate on core banking activities rather than wasting resources on recovery. Further, Balance Sheet of the Bank experience significant improvement as the Bad Loan gets removed from the books and is replaced with the Cash and Investment in SRs of Asset Reconstruction Companies. At the same moment, provisioning on the bad loan is no more required which ultimately leads to better profitability for the bank.

From Borrowers' point of view, they get a breathing period. Borrowers get a chance to restart their business operations and thereby repay the loan normally. Once the dues are completely repaid, Borrower can become eligible for further sources of funding.



ARCs often turn to be a confidence booster for entrepreneurs and as such, businessmen can envisage another option for revival rather than going for insolvency / bankruptcy. Business recovery ultimately contributes to the economy and thus ARC model becomes useful in a Macro Economic Environment.

Guidelines for Sale of Financial Assets to ARCs

The guidelines as per Annexure V to the RBI Master Circular on Investments by Primary (Urban) Co-operative Banks apply to Multi-state Co-operative Banks for sale of their Non-Performing Advances to Securitisation Companies / Asset Reconstruction Companies under the SARFAESI Act, 2002.

These guidelines have been framed under the following headings:

1. Financial Assets which can be sold
2. Procedure for sale including valuation and pricing aspects
3. Prudential Norms as to provisioning, capital adequacy and exposure
4. Disclosure Requirements

Financial Assets which can be sold

Multi-state Co-operative Banks can not only sale NPAs, but also standard assets subject to the conditions prescribed. Accordingly, on a broader level, following assets can be sold to ARCs:

A Non Performing Asset, including a non-performing bond / debenture

Standard Asset only if it is under Consortium / multiple banking; 75% of value has been treated as NPA by Consortium Partners and 75% partners by value give consent for sale to ARC

As such, a Standard Asset under Consortium / Multiple Banking can also be sold to ARC subject to 75% value is treated as NPA by other banks and 75% banks by value give consent.

Procedure for Sale of Financial Asset

(1) The Sale of Financial Asset from Banks to ARCs is subject to the Terms & Conditions as agreed upon between the Bank and the ARC. Such sale can be on Recourse Basis as well as on Non-recourse Basis. However, it must be ensured that the Asset is taken off from the books of the banks and there should not be any known liability devolving around the bank.

(2) Sale is to be conducted by such policy approved by the Board of Directors. The Board of Directors of the Bank needs to frame a policy covering the following points.

(a) Financial Assets to be sold
(b) Norms & Procedures for sale of financial assets
(c) Valuation Procedures to ensure Realisable Value is reasonably estimated
(d) Delegation of Power various functionalities for taking decisions w.r.t. sale

(3) Banks need to ensure that after the sale, no operational, legal or any other type of risk is attracted by the bank.

(4) Every Bank has to make an independent assessment of the value offered by the ARC and decide whether to accept the offer or not. Transfer should not be conditional as to bearing / sharing future loss incurred by ARC.

(5) Banks can receive Cash / Bonds / Debentures / Security Receipts as a Sales Consideration for transfer of the Financial Assets. Such securities received by the bank shall be classified as Investments in the books of the bank. There can be an agreement between the bank and the ARC to share profits if any accruing as a result of eventual realisation of the Financial Asset transferred to ARC.

Prudential Norms

(1) Provisioning / Valuation

(a) After the Sale of the Asset, it should be removed from the books of the bank. If the sale is below the Net Book Value (NBV), the difference is to be treated as a loss and should be debited to the Profit & Loss Account for the year.

(b) Banks can reverse the excess provisioning to the Profit & Loss Account only when cash + consideration on realisation of SRs exceeds NBV of the Asset.

(c) The investment in the Security Receipts is to be recognised at lower of Redemption Value and Net Book Value of the Financial Asset. Profit / Loss on this investment can be realised only after the redemption of the Security Receipts.

(2) The securities (Bonds and Debentures) issued by ARCs should satisfy the following criteria:

(a) Term should not be in excess of 6 years
(b) Rate of interest should not be lower than 1.5% above bank rate
(c) Security must be secured by appropriate charge on the asset transferred
(d) Security must be partly / fully paid if ARC sells the underlying security before maturity date / redemption
(e) ARC should make an unconditional commitment of redemption / repayment and there should not be a precondition of realisation of Financial Asset
(f) Whenever such security is transferred to other persons, notice in writing should be given to the ARC.

(3) The Debentures / Bonds / Security Receipts issued by ARC to the Bank should be treated as a Non-SLR Investment. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable. However, if the bonds / debentures issued by ARC are limited to actual realisation of these instruments, then banks are required to reckon the Net Asset Value (NAV) of such instruments for valuation of the same.

(4) For the purpose of capital adequacy, banks should assign risk weights as under to the investments in debentures / bonds / SRs issued by SC / RC and held by banks as investment :

(a) Risk weight for credit risk: 100%.
(b) Risk weight for market risk: 2.5%
Applicable risk weight = (i) + (ii)

(5) From case to case basis, bank can take a call as to the Exposure Ceiling. The reason is very simple. As there are few ARCs, Bonds / Debentures / SRs may go beyond their prudential exposure ceilings.

Disclosure Requirements

Banks selling their Financial Assets to Securitisation Companies / Reconstruction Companies need to make following disclosure in their Financial Statements:

a) No. of Accounts sold
b) Aggregate value (net of provisions) of accounts sold to SC / RC
c) Aggregate consideration
d) Additional consideration realized in respect of accounts transferred in earlier years
e) Aggregate gain / loss over net book value.

Other Important Points

Sometimes, ARC takeover such as asset which cannot be revived and the only option available is to sale / dispose off that asset. Under such circumstances ARC simply realises the security. When the ARC acts merely as a Recovery Agent, Asset will not be removed from the books of the bank.

Action Plan for a Multi-state Co-operative Bank

Step - 1

- Draft Policy for Sale of Financial Assets to Asset Reconstruction Companies
- Get the Policy approved from the Board of Directors as prescribed in the RBI's Master Circular

Step - 2

- List out Hardcore NPAs and ascertain value as per the Policy approved by the Board of Directors of the Bank

Step - 3

- Send Preliminary Fact Sheet with Basic Information.
- After Acceptance by ARC, approach the Asset Reconstruction Company with all the details abou the Asset proposed to be trnasferred .

Step - 4

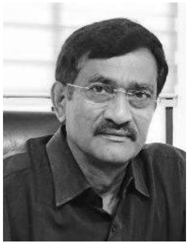
- Assist the ARC for conducting Due Diligence.
- Obtain Offer from the ARC on the basis of Due Diligence and Valuation Exercise undertaken by the ARC.

Step - 5

- Discuss and Negotiate the offer with the ARC.
- Get Approval from the Board of Directors of the Bank if necessary and complete the sale transaction by executing all the documents.
- Give proper accounting treatment in the books of the bank.

Why DRBM

DRBM Corporate Consulting Private Limited DRBM is a team of Expert Professionals with a legacy of 30+ years. DRBM is well-known for specialised NPA Management and Financial Advisory Services. With eminent experience of our advisory team and good connect with several Asset Reconstruction Companies; we can boast having an edge over others. Our Advisory Team for NPA Management includes:

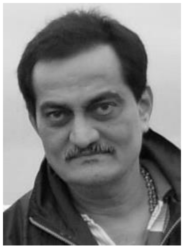


Vithal Deshmukh, FCA
Chairman & Managing Director

>> Fellow Chartered Accountant
>> Over 31 years of Financial Advisory Experience
>> Significant Experience of working with the State Government

Aalhad Deshmukh, FCA
Director & Chief Executive Officer

>> Fellow Chartered Accountant, Master in Business Finance and Diploma holder in International Financial Reporting from ACCA-UK.
>> Shrewd Professional with 6+ years of experience in Financial Advisory



Vishwas Raje, FCA
Director – Head of Div. Operations

>> Fellow Chartered Accountant, Qualified Company Secretary and also a graduate of the Institute of Cost & Management Accountants of India
>>More than 35 years of experience in Financial Sector

Our innovative methodologies, skillsets and core competence help us create ideal NPA Management solutions for the banks. Our rapport with the Renowned Securitisation and Reconstruction Companies and Other Players in the industry helps us secure better deals for the clients.

Contact us to know more about our service offerings.

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