

An Analysis of Asset Reconstruction Company as Resolution Applicant in Corporate Insolvency Resolution Process with Special Reference to Non-Performing Assets

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ABSTRACT

The growing engagement of Asset Reconstruction Companies (ARCs) in association with the banking sector in the recovery process of Non-performing Assets (NPAs) and a record of failure of several ARCs in the realization of assets has subsequently raised doubts about the capability of ARCs. In contrast, the RBI recently changed its policy, prompting the struggling ARCs to be allowed to act as resolution applicants in the corporate insolvency resolution process. This would enable the ARCs to create numerous barriers for the revival of insolvent companies, which would also undermine the very purpose of the Insolvency and Bankruptcy Code (IBC) of 2016.

The paper primarily focuses on the role played by ARCs and their scope in the realization process under the SARFAESI Act. Additionally, it creates instances where the experience of ARCs in reconstruction processes will be beneficial to the resolution process. The performance of ARCs with regard to NPAs has been a matter of scepticism and not up to the mark. Therefore, it is imminent to analyse the causes for such sub-standard performance. This study attempts to compile market data on ARCs and examines how the combined net value of all currently operating ARCs is insufficient to acquire all the stressed assets of Indian banks. Following this, the study shall also disclose the possible inefficiencies that the ARCs might face in assuming the position of a resolution applicant. The SARFAESI Act, which governs the creation and operation of ARCs, places restrictions on their function; however, ARCs are granted permission to act as resolution applicants under the Insolvency Code which was presumed to disregard the provisional restrictions under parent Act. The interpretative gap between two laws is necessary to be investigated.

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The paper also probes into how the ARCs in foreign nations, unlike in India, have generated positive results in restructuring the assets and what is the model that they have adopted to deaccelerate the growing NPAs. In the context of a corporate resolution, foreign ARCs have significantly outperformed domestic ARCs. Furthermore, the study will examine the incentives that ARCs receive, the factors that drive their growth in the resolution domain, and the differences between domestic and foreign regulations pertaining to their working in the resolution domain. Several recommendations and possible changes to regulations are also offered in this paper, with the goal of complementing the current corporate ecosystem of India and enhancing ARC operations in the country at the same time.

Keywords: Asset-Reconstruction, Insolvent Company, Revival, Liquidation, Regulations.

RESEARCH METHODOLOGY

The paper has employed the doctrinal research methodology wherein the researcher has excavated data from various books, journals, articles and other secondary sources of information like reports published by authorities and authoritative websites. The paper mainly gives a legal analysis to identify the problems and solutions but is not completely limited to the above sources. The paper will investigate other empirical data to substantiate the arguments whenever and wherever possible.

INTRODUCTION

One of the crucial factors determining any country's stability is their sound banking system and the deciding factor of such soundness is none other than the capability of banking system to manage the bad loans.³²⁶ The growing Non- Performing Assets (“NPA”) is causing the banks and financial institutions to write off the assets as bad loans, and it is emerging as an issue affecting the profitability of banks. The problem of NPAs is ultimately turning banks to some level of risk aversion, which is deaccelerating the availability of credit in the economy. The challenge of clearing the saddled NPA’s in banks is an intercontinental concern and has become accused, intense efforts were made globally to realize its NPAs and one among them was the creation of specialized bodies called ‘Asset Management Companies’ or ‘Asset Reconstruction

³²⁶ S.M.D. Azash & S.V. Pulla Reddy, *Role of Asset Reconstruction Companies (ARCs) in Handling Non-Performing Assets (NPA) in Banking*, 5 INT’L J.L. MGMT. & HUMAN. 1294 (2022).

Companies (“ARC”)³²⁷ The Indian model of Asset management entities are distinct in terms of their source, declaration and area of business. The concept of ARCs internationally holds their genesis to systematic crises. However, Indian model was developed as a separate business. The business of ARCs in India are regulated under special legislation Securitisation Asset Reconstruction and Enforcement of Security Interests Act (“SARFAESI”). The SARAFESI is the one which prescribes the limitations and necessary adherences that the ARCs are required to follow in their business. The ARCSs are registered companies with the Reserve Bank of India (“RBI”), which closely regulates the working of ARCs.

The ARCs are recognized as financial institutions which specifically deal in the NPAs accumulated with the banks. The NPAs are typically the assets which are in the form of advances that the banks have failed to recover from the borrower after a specified duration. The ARCs were obligated to re-capitalize the failed assets back to performing level by either realizing the assets or managing them. The ARCs are authorized under SARFAESI to acquire distressed assets from banks and financial institutions at discounted value and later take several measures to recover the value. The ARCs are permitted to incur investments for funding the purchased NPAs. In return the investors are awarded with agreed security receipts.³²⁸ The purchaser of security receipts is called qualified buyers. The idea of setting up ARCs was preliminarily conceptualized on the recommendations of Narasimhan committee of 1991, which suggested to establish separate institutions to realize the value of NPAs and let the banks concentrate on the business of lending.³²⁹

The working committee of RBI had recently proposed to permit ARCs to act as resolution applicants under the Insolvency and Bankruptcy Code (“IBC”). Resolution applicant is a person who is involved in the resolution process of an insolvent corporate, the person proposes a resolution plan which after the approval of the Committee of Creditors goes through the scrutiny of Resolution professionals and finally, the resolution process initiates. The two laws have come in conflict in the recent years as one proposes restrictive clauses for ARCs another permits them. Undoubtedly, RBI’s move is in the right direction to escalate the process of

³²⁷ VINOD KOTHARI, SECURITISATION: ASSET RECONSTRUCTION AND ENFORCEMENT OF SECURITY INTERESTS 348 (6th ed. 2020).

³²⁸ Neeraj Tiwari, *Resolution of NPA in India: The Role of Asset Reconstruction Companies*, 7 PRATT’S J. BANKR. L. 552, 570 (2011).

³²⁹ Reserve Bank of India, Committee on Banking Sector Reforms (Narasimham Committee II) - Action Taken on the Recommendations (1991), <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/24157.pdf> (last visited Feb. 11, 2023).

clearing the NPAs, but it is not achievable without challenges. There is a requirement for several alterations in the policy. While ARCs can be employed as resolution applicants under IBC, it also offers a chance to take use of their experience in resolving NPAs, assist banks and financial institutions in cleaning up their balance sheets, and provide troubled businesses a chance to be revived and become sustainable.

ASSESSING THE INTERPRETATIVE GAP

Ever since the enactment of IBC in 2016, the economic sector in India has been flourishing and had undergone a radical change in ease of doing business. According to 'Doing Business 2020' report, India has been ranked 63rd among 190 countries and one of the parameters is how the country resolves the insolvency problem.³³⁰ One of the significant causes for such an escalation from 142nd rank in 2014 to 63rd in 2020 is because of the timebound, efficient and successful corporate insolvency resolution process regulated by the Code of 2016.

The overall issue which had created uneasiness among the ARC and its stakeholders was due to the rejection from the RBI to approve UVARCL to act as Resolution Applicant ("RA") in the resolution process of AIRCEL.³³¹ The RBI while rejecting the application had highlighted the limitations under SARFAESI Act which prohibited ARCs to act as Resolution Applicant, and also unfolded the interpretative gap between the two legislations.³³² The SARFAESI Act states that the ARCS should be strictly indulged only in the business of Reconstruction and securitisation.³³³ Whereas the IBC which governs the resolution process explicitly allows the ARCs to act as resolution applicant.³³⁴ Despite SARFAESI and IBC being pursuant to clearing the bad loan portfolios of the banks or financial institutions, categorically, both these legislations differ in their primary purpose. The SARFAESI aspires to clean the NPAs from the accounts and entails a recovery approach through realization of such bad loans. However, the IBC aims to revive the corporate debtor and envisages on rescue approach. As both the

³³⁰ World Bank, Doing Business, <https://archive.doingbusiness.org/en/doingbusiness> (last visited Feb. 20, 2023).

³³¹ UV Asset Reconstruction Co. Ltd. v. Union of India, 2022 SCC OnLine Del 4289.

³³² Reserve Bank of India, Index to RBI Circulars, https://m.rbi.org.in/SCRIPTS/BS_CircularIndexDisplay.aspx?Id=12399 (last visited Feb. 25, 2023).

³³³ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 2(ba), No. 54, Acts of Parliament, 2002 (India).

³³⁴ The Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, § 29(A), No. 26, Acts of Parliament, 2018 (India).

regulatory frameworks and the majority of their stakeholders coincide with reach other thus considerably it would give rise to an interpretative gap.³³⁵

In spite of nearly six years of the Code of 2016, delayed resolutions are still being reported and the reasons for such delay are strict timelines, a lack of infrastructure and a plurality of cases. Meanwhile, it exposes financial institutions and banks to severe haircuts when cleaning up non-performing assets. The scenario of the resolution will undoubtedly change completely by permitting the ARCs to participate as resolution applicants. ARCs are adept at managing distressed assets and with their expertise, the ARCs shall bring smooth simulation to the resolution process. The entry of ARCs in the resolution space shall open the arena for several players to propose plans, which will ultimately create a competitive avenue for the bidders as every applicant shall strive to outbid others.³³⁶ Furthermore, it will increase the pool of bidders for stressed assets, which will reduce the haircuts that banks may otherwise have to bear by accepting a lower value for the asset. By widening the participant base the insolvent entities shall gain only the most potential resolution plan and that provides possibly less chances to reach the liquidation stage. Also, in circumstances where there are not sufficient plans at the table to choose, such an entry shall emerge as a market maker and improve the recovery. The banks will also enjoy it as a win-win a situation, as large base of the IBC beneficiaries are mid-corporates and if the ARCs regardless of their capital or at least a justified owned fund are allowed to participate it shall provide better realization value for the stressed assets.

In light of ARC's business model, it cannot be denied that the company deals predominantly in the realization sector and have the requisite experience, so ARC would perform well if allowed to participate as a resolution applicant. Due to RBI's advancement by invoking SARFAESI limits, the resolution process was delayed, resulting in discouragement for the ARC process. The non-obstante clause empowers the provisions of IBC to override other laws.³³⁷ The inadequacy between two laws developed the interpretative gap and the RBI seemingly ignored that SARFAESI did not absolutely prohibited, however, IBC clearly prevails over SARFAESI.³³⁸

³³⁵ Vinod Kothari Consultants, *Securitization of Non-Performing Loans*, <http://vinodkothari.com/npl/> (last visited Feb. 25, 2023).

³³⁶ Siddhi Nayak, *Will ARCs Join the IBC Bandwagon Following Reserve Bank's Latest Rule Change?*, MONEYCONTROL (Oct. 2, 2022).

³³⁷ The Insolvency and Bankruptcy Code, 2016, § 238, No. 31, Acts of Parliament, 2016 (India).

³³⁸ *Encore Asset Reconstruction Co. Pvt. Ltd. v. Charu Sandeep Desai*, 2019 SCC OnLine NCLAT 284.

Although the preliminary elucidation gives an impact of SARFAESI being prohibitive in allowing ARC to indulge in the resolution process as there subsists a limitation of acquisition of equity but on understanding the intricacies there precisely lies no bar on ARC's participation. The definition of ARC under the SARFAESI recognizes them as for the only purpose of asset reconstruction or securitisation.³³⁹ Apart from the two purposes, the ARCs are allowed to indulge in any other business only after obtaining the required approval from the RBI.³⁴⁰ Furthermore, asset reconstruction means acquisition of rights or interests while providing financial assistance to banks and financial institutions.³⁴¹ It implies that the infusion is strictly permitted to business only where some kind of reconstruction is involved, subsequently, on jointly reading the Sections 9(1)(a) and 9(1)(g) of SARFAESI, the ARCs are provided the liberty to assist the borrower or exceptionally also take over in order to properly manage the business. Hence, the ARCs are allowed to take over or look after the borrower's management and are entitled to convert the debt into equity.³⁴² However, if there exists no restriction to restore the business on realization the ARCs shall run the business in perpetuity, the same was also pointed in BLRC report.³⁴³ In order to avoid any such situation, an identical provision was inserted in the Act which obligated the realizers to restore the management on full realization of debt.³⁴⁴ Certainly, doing so shall lead to a hostile situation and degraded the ARCs security, therefore, a proviso was also added in 2016, which permitted the ARC or any other secured creditor to retain the management if the borrower fails.³⁴⁵ It is evident that there is no explicit bar on the ARC to infuse equity or become a shareholder, however, cannot hold it in perpetuity.

In converse to the provisions of SARFAESI, the IBC on the other hand, explicitly allows ARCs to dwell into the role of Resolution Applicant. The Resolution applicant is any person who

³³⁹ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 2(ba), No. 54, Acts of Parliament, 2002 (India).

³⁴⁰ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 10, No. 54, Acts of Parliament, 2002 (India).

³⁴¹ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 2(ba), No. 54, Acts of Parliament, 2002 (India).

³⁴² The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 9, No. 54, Acts of Parliament, 2002 (India).

³⁴³ Bankruptcy Law Reform Committee, The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design (2015), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf (last visited Feb. 18, 2023).

³⁴⁴ The Securitisation And Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 15(4)

³⁴⁵ *Ibid.*

individually or jointly submits the resolution plan.³⁴⁶ However, the person proposing the plan should not be disqualified under the criteria and list provided under Section 29A. The ARCs under the explanation of the proviso, have specifically exempted the financial entity which shall also include the ARC.³⁴⁷ The ultimate objective of the ode is to provide a mechanism for the revival and if the condition demands for the dilution or infusion of equity is not the matter of concern.³⁴⁸ As a result, there is no inconsistency between the laws and the circular which allowed the ARC to act as an resolution applicant stands valid, however the ARC cannot be permitted to participate free of constrains, and the conditions laid by RBI are necessarily important. Nevertheless, the directions should have evaluated considering the limitations on the working capability of ARCs and certainly should have brought as a legislative amendment.

THE GLOBAL SCENARIO

In order to tackle the problem of economic crises, the world economies have from time and again adapted to different models of ARC, however, the intent of having such models was predominantly to cure the NPAs out of the stressed economy. Asset managers are referred to as professionals or experts who escort bad loans and efficiently assist in cleaning the records, such persons commonly in the global scenario are recognized as Asset Management Companies (“AMCs”). In most cases, AMCs were created on an ad-hoc basis to deal with the rising NPA problem worldwide.

United States of America

One of the earlier experiments around the world was the Resolution Trust Corporation (“RTC”), which has become a revolutionary model for AMC till date. A federal law was passed in 1989 to revive the insolvent state-owned insurance corporation, which was one of the 1400 failed banks hit by the banking crisis of the 1980s. The model was created to provide financial stability to the state-owned insurance corporation, which was one of the 1400 failed banks of the 1980s. This model focused on disposing the bad assets of financial institutions through a rapid disposition strategy. Under this strategy the corporation sold these bad assets directly to private investors or by collecting the outstanding loans within the short span at a fair sell price. Some of the methods employed also included - Auctions and sealed bids, Contracting out the

³⁴⁶ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 15(4), No. 54, Acts of Parliament, 2002 (India).

³⁴⁷ The Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, § 29(A), No. 26, Acts of Parliament, 2018 (India).

³⁴⁸ Swiss Ribbons (P) Ltd. v. Union of India, (2019) 4 SCC 17.

asset management process through equity partnerships, Securitisation programs, Partnership programs and Direct Loan Sales.³⁴⁹ One of the factors which added as a catalyst to the process was the direct intervention of state and the intent to clear in the short span as it was created on an ad-hoc basis. Subsequently, RTC ceased its operation in 1996 after clearing about approximately US\$ 1 trillion of bad assets.³⁵⁰

Korea

In line with the centralized approach adopted by RTC, even the Korean model is essentially based on setting up a common state-funded and managed AMC under the name Korea Asset Management Company (“KAMCO”). The disposal device, KAMCO, was established in 1962 as a renowned Korean Development Bank subsidiary. The authorities often set up structural adjustment funds to assist in purchasing distressed assets to the KAMCO and the private players allowed to operate in the early 2000s. Such fund was principally deployed to extend new credit lines or roll over loans, indirectly facilitating the restructuring process initiated by companies.³⁵¹ The governing body of KAMCO consisted of banking experts, professionals from industries and representatives from the government. The composition being a full pack of persons from different domains was also a distinguishing feature for its overwhelming success. ‘KAMCO realized that its funds might not be enough to resolve the looming crisis, and thus, initiated the KRW40 trillion Restructuring Fund to ward off the pending catastrophe’.³⁵² If the funds that had been provided to support the company reached its goal, they were disposed off to the national treasury, creating a sense of accountability and responsibility on the company's part. ‘KAMCO’s purchase of NPAs was selective and based on certain eligibility criteria wherein it opted to purchase only saleable loans whose security rights and transfer were legally executable, from among loans classified as substandard and below’.³⁵³ KAMCO had adopted a unique mechanism of selling the distressed asset through

³⁴⁹ Wayne M. Josel, *Resolution Trust Corporation: Waste Management and the S&L Crisis*, 59 FORDHAM L. REV. 343 (1991).

³⁵⁰ VINOD KOTHARI, SECURITISATION: ASSET RECONSTRUCTION AND ENFORCEMENT OF SECURITY INTERESTS 348 (6th ed. 2020).

³⁵¹ Dong He, *The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea*, IMF Working Paper, Asia and Pacific Department, Sept. 2004, <https://www.imf.org/external/pubs/ft/wp/2004/wp04172.pdf> (last visited Feb. 4, 2023).

³⁵² VINOD KOTHARI, SECURITISATION: ASSET RECONSTRUCTION AND ENFORCEMENT OF SECURITY INTERESTS 348 (6th ed. 2020).

³⁵³ Amulya Neelam, Deepti George, Dwijaraj Bhattacharya & Madhu Srinivas, *A Brief Comparison of the Bad Bank Experience Across Jurisdictions* (Dvara Research, Dec. 2021), <https://www.dvara.com/research/wp-content/uploads/2021/12/Policy-Brief-A-Brief-Comparison-of-the-Bad-Bank-Experience-across-Jurisdictions.pdf> (last visited Feb. 4, 2023).

online portal, ONBID, which opened the space for multiple bidders and in return provided effective value to the bad loans. ‘With regard to the disposal of these assets, KAMCO used traditional methods such as competitive auctions, collection of rescheduled repayments and recourse to the original seller, and also developed innovative techniques that broadly include bulk (pooled) sales, individual sales, Asset Backed Securities (“ABS”) and joint venture partnerships’.³⁵⁴ As per data, KAMCO successfully cleared approximately 1 trillion of NPLs (Non- Performing Loans) which constitutes disposing almost 48 percent of total NPLs.³⁵⁵

Sweden

The Swedish mechanism for clearing the NPLs is recognised as one of the world's most successful models. The model, to an extent, strives to avoid the generation of NPAs by striking it at its origin. The model dates to 1992. ‘When it closed in 1997, Securum had disposed of 98% of its portfolio of assets and utilized private sales and initial public offerings to dispose of property portfolios’.³⁵⁶ To solve the problem of NPLs, the Swedish model established an ordinary company named Securum which emerged as an icon in the field of asset management. Unlike the other models, Securum was not brought through a statute instead was established as an ordinary company by formulating an independent board which looked after the restructuring operations.³⁵⁷ The board was equipped with an operational flexibility as the board was majority represented by experts which avoided any kind political intervention which also boosted the process. The Securum was immune of the regulations which the other financial institutions were bound to follow, additionally, the company was also offered substantial equity as to break the over dependency of the management on the investors for additional funds.³⁵⁸ The company excelled in its process because it was offered an opportunity to run numerous sector-specific subsidiary companies which concentrated on its process by keeping a sectoral cleaning. This approach also benefitted as ever sect separately managed the NPLs of different companies by deploying sector experts. It was also helpful in efficient negotiations as different sectors had distinct reasons for such generations. The companies which were running with a low profitability, low interest coverage or high debt ratio were recognized and the Securum paid

³⁵⁴ Dong He, *The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea*, IMF Working Paper, Asia and Pacific Department, Sept. 2004, <https://www.imf.org/external/pubs/ft/wp/2004/wp04172.pdf> (last visited Feb. 4, 2023).

³⁵⁵ *Id.*

³⁵⁶ Dreyer M, *Swedish AMCs: Securum and Retriva*, 3 J. FIN. CRISES 247 (2021).

³⁵⁷ *Id.*

³⁵⁸ Lars Jonung, *The Swedish Model for Resolving the Banking Crisis of 1991-93*, Econ. Papers, Directorate-General for Economic and Financial Affairs, Feb. 2009.

special attention and if there existed a potential, such were reorganized hence shows the preventive notion to maximize the value.

Malaysia

The Malaysian model is popularly known as Danaharta. Identical to the other famous model, even the Dhanaharta was a state initiative, however it is known for its neutral approach wherein it opted for the rapid disposition strategy nor the warehousing agency mechanism.³⁵⁹ Warehousing means subscribing to a minimal approach to maximize the distressed assets. Instead of bulk realization, it preferred to manage the NPL on an account- to account basis. Danaharta appointed special administrators to deal with the problem and were allowed for foreclosure of property collateral, also at times efficiently took legal action against non-viable borrowers.³⁶⁰ It also, at times to convert the non-recovery assets, it also employs open tender exercise. In order to escalate the sale of distressed assets accumulated with the financial institutions the Danaharta model also contain a provision like profit sharing arrangement.³⁶¹

After examining the performance and the mechanism of different AMC's throughout world economies, it is proven that the state's financial support and the operational flexibility to choose an instrument of their choice have played a significant role in their success. Doing so shall also require a solid political willingness on the part of the government. The compelling market scenario which overall increased the competitiveness and the supportive legal infrastructure at times has encouraged for the maximization of assets. It was also observed that most of the model embraced on creating a centralized fund which supported the AMC's to operate with being risk averse. In general the AMC's were provided with limited tenure so as to avoid the sitting on the assets for long period of time for fear of realising large assets.³⁶²

Taking inspiration from all the models, it is evident that the RBI has adopted to a mix of all the experiments, however the concept of establishing a centralized fund has been a long time since the concept of establishing a centralized fund has been implemented. India used private entities to deal with the problem of NPA but one of the minor scepticisms on such private AMC's was put forth by Asian Development Bank. Under the spear of private AMC or ARC the natural

³⁵⁹ Malaysia: Dana Harta, *Final Report: Pengurusan Danaharta Nasional Berhad 1998-2005* (2005).

³⁶⁰ *Id.*

³⁶¹ *Id.*

³⁶² Ben Fung, Jason George, Stefan Hobl & Guonan Ma, *Public Asset Management Companies in East Asia*, Financial Stability Institute, Bank for International Settlements, Feb. 2004.

intent of these entities shall be to acquire the assets which are more promising off the books, however this would defeat the purpose of recognising them as nursing home.³⁶³ The RBI, through its circular has tried to improve the transparency and also subscribed to the time-bound manner. The concept of centralized ARC with financial assistance from state was recently established in the name of NARCL in the Union budget 2021. However, it is too early to evaluate or predict its performance.

PERFORMANCE OF ARCS

The ARCs in India were introduced with an objective of serving the banks and financial institutions in clearing off the NPAs off their books. Unlike the secured lenders, the ARCs were provided extensive liberty in their operations. Nevertheless, the data reveals that the performance of ARC has not been up to the mark and the inefficiency of ARCs is becoming a critical problem which started coming to limelight after 2008.³⁶⁴ The ARCs are striving hard in terms of helping the banks to relieve them of their distressed assets but there are few challenges which hold their pace. The ARC framework was enabled with flexibility so that the originators shall focus on their primary business of lending and not on recovery.

The data also shows that the ARC, within the span of ten years starting from the financial year 2004- FY 2013, were able to recover only about 14.29% of the total amount owned by the borrower in terms of stressed assets, out of which approximately 80% of the recovery was by employing the reconstruction methodology thus leaving less scope for the revival of businesses.³⁶⁵ The lacklustre performance of ARCs pertaining to realizing the NPAs and low conversion ratio is developing a sense of distrust among the top banks or financial institutions. 'Two factors primarily drive the recent shift towards IBC, firstly, IBC promises both time-bound and optimal recovery for creditors, other factor was the lacklustre performance of ARCs.³⁶⁶ Especially after the introduction of IBC, the secured creditors prefer the IBC process over such reconstruction in order to recover their distressed assets. The recent data shows that as per FY- 2020, the total NPA stands at approximately 74,2431 Cr, in which ARCs share the

³⁶³ Asian Development Bank, *Memo on Technical Assistance to India for Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India* (Oct. 2002).

³⁶⁴ VINOD KOTHARI, *SECURITISATION: ASSET RECONSTRUCTION AND ENFORCEMENT OF SECURITY INTERESTS* 348 (6th ed. 2020).

³⁶⁵ RBI, *Report of the Committee to Review the Working of Asset Reconstruction Companies* (2021), <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188> (last visited Jan. 30, 2023).

³⁶⁶ *Id.*

recovery at 26%, whereas at the same time the dependency on IBC holds 46% of the total amount involved.³⁶⁷

The reasons for such sub-optimal performance are mainly due to the non-availability of funds, weak bankruptcy process and lack of legal immunity from unwanted obstacles which are essential to achieve flawless performance.³⁶⁸ In addition to that, the biggest challenge was to realize the vintage NPAs passed by the banks as after a while, reconstructing such age old NPAs was nearly an impossible task. 'Price expectations of banks are driven by extent of current provisioning instead of future recoverability and at the same time large reconstructing have been taking place since 2009 onwards, thereby avoiding imminent defaults'.³⁶⁹ The balance sheets of ARCs also made it difficult to raise additional funds and which again caused deficiency in their funds.³⁷⁰

LIMITATIONS OF THE FRAMEWORK

Statutorily, ARCs are not allowed to undertake any other business without the permission of RBI. Many ARCs since the IBC allowing them to participate had applied and the RBI denied quoting that the SARFAESI did not allowed them to participate in the process. However, recently RBI took a U-turn by allowing ARCs to act as Resolution Applicant. RBI issued 'circular' under the name Review of Regulatory Framework for Asset Reconstruction Companies dated October 11, 2022. The circular prescribed minimum net owned fund of Rs 1000 Crore, Board approved policy for decisions, majority independent directors, sector specific firms, time- bound control in 5 years and additional disclosures.³⁷¹ The RBI's initiative of permitting the ARCs is in the right direction and the conditions stated are necessary in order to maintain a sense of transparency, accountability and responsibility over ARCs. However, the conditions stated come with few lacunes and challenges that ARC would face while dealing in the resolution process. The conditions prescribed are too prescriptive and business models

³⁶⁷ RBI, *ARCs in India: A Study of their Business Operations and Role in NPA Resolution*, RBI BULLETIN (Apr. 2021), https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/02AR_26042021568788EADB07475AACD1100AD7C06766.PDF (last visited Feb. 4, 2023).

³⁶⁸ Meher B.K. & G.L. Puntambekar, *Asset Reconstruction Companies: An Analysis of Growth (A Case Study of ARCIL)*, 36 ABHIGYAN 1, 16 (2018).

³⁶⁹ VINOD KOTHARI, *SECURITISATION: ASSET RECONSTRUCTION AND ENFORCEMENT OF SECURITY INTERESTS* 348 (6th ed. 2020).

³⁷⁰ RBI, *Report of the Committee to Review the Working of Asset Reconstruction Companies* (2021), <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188> (last visited Jan. 30, 2023).

³⁷¹ Reserve Bank of India, Index to RBI Circulars, https://m.rbi.org.in/SCRIPTS/BS_CircularIndexDisplay.aspx?Id=12399 (last visited Feb. 25, 2023).

turn unsustainable in such environment, thus the frameworks should go hand in hand with the operational dynamics of business.

The ARCs were established for the debt recovery and were never foreseen to act in the resolution process. The BLRC report had recommended a thin difference between the rescue and the realization and opined that it could never take up the role of resolution.³⁷² Moreover, the Narsimha committee, which was preliminary attempt to recommend on ARC, ultimately said that the objective was to clear the NPA and escort banks.³⁷³ Also, the expert committee of 1999 said that the goal of resolution could be met other way round through securitization.³⁷⁴ Hence, the concept of ARC was specifically designed for clearing the NPA and if a new domain is unlocked for ARCs than the prime motive of the ARCs would be diluted. The ARC would concentrate on the management of borrower company if allowed for resolution applicant rather than focusing on distressed assets of banks, but this shall pile up the NPA, leading to worsen the situation.

The SARFAESI permits ARCs to perform the functions of securitization and reconstruction particularly, however, the provision 10(2) of SARFAESI Act states that ARC must obtain permission from the RBI to commence any other business.³⁷⁵ This section is restrictive in nature and allows RBI to decide only on the permission sought, and not to issue directions in general. There lies a difference between permitting a specific ARC and allowing it all at once. The circular failed to act on this aspect and the necessary legislative backing is not availed while issuing such orders. Therefore, required legislative amendments should be brought.

The study has revealed that the performance of ARCs was not good enough and had not discharged its responsibility. The problem of NPA was expected to be settled after the establishment of ARCs, but it happened the other way round and hence, the ARCs failed to build a confidence among the stakeholders. In line with this, if they are permitted to act as resolution applicant, to enhance the pool of bidders, such a step, due to the undue influence of

³⁷² Bankruptcy Law Reform Committee, *The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design* (2015), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf (last visited Feb. 18, 2023).

³⁷³ Reserve Bank of India (RBI), *Committee on Banking Sector Reforms (Narasimham Committee II) - Action Taken on the Recommendations* (1991), <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/24157.pdf> (last visited Feb. 11, 2023).

³⁷⁴ RBI, *Report on Trend and Progress of Banking in India 2000-01* (2001), <https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/24385.pdf> (last visited Feb. 15, 2023).

³⁷⁵ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 10, No. 54, Acts of Parliament, 2002 (India).

ARCs would outbid other potential applicants. As a result, there lies mere chances of revival, and as the ARCs out of the total realization 80% was via selling and hence, ultimately the creditors shall opt for liquidation which would weaken the objective of IBC.³⁷⁶

The IBC, under its explanation II of Section 29A has placed the ARC in the non-disqualified list. The proviso says that the conditions laid under the Section will not be applicable to ARC. Even here, the Arc were not explicitly allowed to be Resolution Applicant instead, it merely absolves ARC against the disqualification that the companies shall face if permitted. Therefore, the IBC and its provision were not categorically aspiring for ARC to act as Resolution Applicant.

Other critical issues, like developing a legal framework to protect ARC from unnecessary lawsuits and delays, are not addressed in the framework. The international model analysis has shown that for AMCs to succeed, legal backing is required; otherwise, they will be ineffective and defeat the purpose of quick and meaningful resolution if unnecessary legal barriers and lawsuits surround AMCs.

One of the conditions prescribe that there shall be no significant influence of ARC after five years over the borrower company, and the ARC shall not retain any relationship with the debtor.³⁷⁷ The experts have expressed their view of such a time period being sufficient to turnaround the corporate debtor, provided if the plans get quick approval. The resolution Applicants are expected to propose a plan to revive the debtor, but not to downsize and resolution Applicant should strive towards resolution does not aspire to sell it.³⁷⁸ However, such a time-limit could motivate the ARCs to sell the assets of insolvent instead of reviving it and pursuant to this the ARCs shall attempt to invest only in order to achieve high value. A cap on the significant influence is vague and does not prescribe to what extent or what is the commercial transaction that shall be maintained, because in such period it is difficult to make structural changes and ultimate resolution shall not be enforced. The IBC constrains the resolution process to get over within 180 days or exceptionally, 270 days with permission, however in this case if ARC is permitted to run for five years and after that cut all the relations

³⁷⁶ RBI, *Report of the Committee to Review the Working of Asset Reconstruction Companies* (2021), <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188> (last visited Jan. 30, 2023).

³⁷⁷ Reserve Bank of India, Index to RBI Circulars, https://m.rbi.org.in/SCRIPTS/BS_CircularIndexDisplay.aspx?Id=12399 (last visited Feb. 25, 2023).

³⁷⁸ *Superna Dhawan v. Bharti Defence and Infrastructure Ltd.*, 2019 SCC OnLine NCLAT 270.

it would create an interpretative gap between laws.³⁷⁹ The circular mandatorily asks the ARC to divest in the corporate debtor after the end of five years which shall lead to prospective buyers offering low price and the ARCs would have to sell it at non-fair price.

It is also required that the ARCs shall have to turn their approach by forming sector specific committee and hire experts in running companies. It is an excellent condition because it would enable proper management of corporate debtor. However, it will incur an additional expense and the conflict of interest within internal management of ARCs, as they never envisaged on adopting sector specific approach in reconstruction or securitization. The conditions laid is silent about proposing an insolvency professional on the board of ARCs, doing so shall make the resolution easy.

The RBI framework recommends that the ARCs settlement proposal be examined by a board comprised of independent directors, as well as an independent advisory committee. The problem with this guideline is that the approval and examination delay the resolution process. Another problem with the regulation is that it makes it difficult for the ARCs to enter into spot settlement with the borrowers, though the role of independent directors is crucial with regards to transparency of the AMCs but the RBI should consider that following the examination and borrower process for each borrower, even for small transactions, can be a roadblock in the development of ARC, hence, the RBI should consider exempting small transactions from procedural requirements to give AMCs some leeway in their organic growth.

The prescribed net owned fund that any ARCs willing to participate as resolution applicant need to be at least Rs 1000 Crores. In general, the IBC remains quit regarding such minimum owned criteria and it is always the call of Committee of Creditors to decide on. Moreover, the circular is not clear whether the minimum owned fund shall be in case there is a joint application which is now allowed under the Code.³⁸⁰ The ambiguity revolves around whether the criteria is for individuals or shall be applied on joint qualification. If the criteria of minimum net owned fund (NOF) are strictly followed, than only a very few out of all the existing ARCs shall stand eligible for resolution applicant. Currently, only three out of 28 registered ARCs

³⁷⁹ The Insolvency and Bankruptcy Code, 2016, § 12, No. 31, Acts of Parliament, 2016 (India).

³⁸⁰ The Insolvency and Bankruptcy Code, 2016, § 5(25), No. 31, Acts of Parliament, 2016 (India).

possess the required NOF, which could pave the way for cartelization.³⁸¹ The new guidelines have reduced the issuance of security receipts from 15% to 2.5%, however, the required NOF for the Resolution Applicant goes to Rs 1000 Crore, resulting in a challenge in convincing the investors (qualified buyers) to invest in the ARC trust if the requirement isn't changed. The unlocking process will improve the clearance of NPAs, but at the same time, several obstacles might hinder its efficiency. In the short term, this effort would increase bidders, but in the long run, it is encouraging a lacklustre performance. Changes are therefore required.

SUGGESTIONS FOR POSSIBLE ALTERATIONS IN THE FRAMEWORK

Unquestionably, the RBI's move of issuing a circular of allowing the ARCs to act as Resolution Applicant shall improve transparency in the system and would hold the ARCs responsible. Moreover, the revised regulations mandatorily ask for financial disclosures which would enhance corporate governance in the reconstruction sector. In the end, only by adhering to the right policy can all measures be effective in responding to a problem, and it is the approach of ARCs towards strict adherence that may help in this regard.

The guidelines impose a minimum cap on the ARCs to participate in Resolution process. Since ARCS are in a risky business, financial institutions rely on the realization, but their balance sheets frequently make it difficult to arrange funds from qualified buyers. They must maintain such minimum NOF levels as it creates a security for all the investments infused by the qualified buyers. Considering such requirement and the vulnerability of ARC, it is significant that some sort of alternate investment fund or a centralized fund should be created which would divert financial support to ARCs. It was also observed in the global models that one of the features which improved their performance was the supportive fund. Nonetheless, even the Verma committee report of 1999 had suggested creating of alternate reconstruction fund.³⁸² The RBI had constituted a special committee to analyze the working of ARCs, and corresponding it was suggested that there was a need of such protective source of finance and the renowned system of Alternative Investment Fund could be extended to ARCs.³⁸³ The governments

³⁸¹ Mukesh Chand, *In A Big Policy Shift RBI Allows Asset Reconstruction Companies To Be Resolution Applicant Under Insolvency And Bankruptcy Code, 2016*, MONDAQ, <http://surl.li/fbghw> (last visited Feb. 8, 2023).

³⁸² Ghosh D.N., *Verma Committee Report on Weak Public Sector Banks*, 34 ECON. & POL. WKLY. 3356 (1999).

³⁸³ RBI, *Report of the Committee to Review the Working of Asset Reconstruction Companies* (2021), <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188> (last visited Jan. 30, 2023).

intervention through funds would enable them to perform efficiently. The ARCS should be empowered to utilize the funds however a regulatory body should be constituted to manage the allotment of funds. The ARCs can avail financial support from such common fund by pledging their assets. In this manner, they would achieve the goal of maintaining a minimum net owned fund and at the same time would not be burdened with searching for funds and could concentrate on realizing assets.

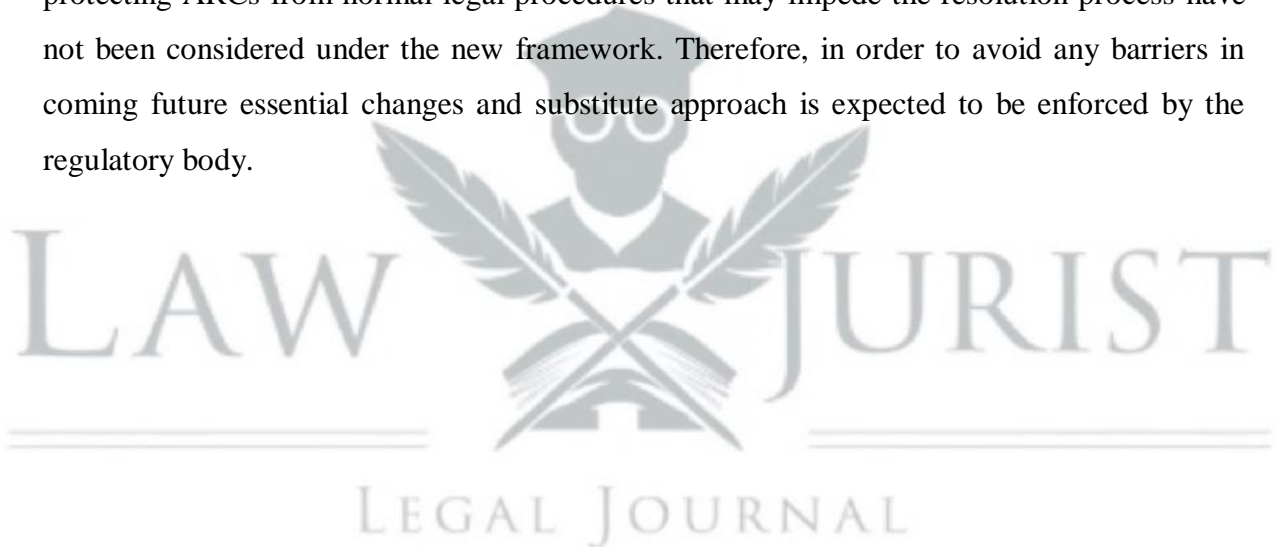
The revised guidelines are ambitious of building accountability in the decisions and thereon all the decisions are strictly to be taken by independent directors. Instead of committee consisting of majority independent directors it is suggested that even a insolvency professional or a member from a panel of such resolution specialists should be also included as this would possibly improve possibility of making right choices. A bit more clarity pertaining to the minimum NOF and ratio of support that ARCs can avail from the centralized fund, if created, to be provided. Because the NOF in this area for ARCs rises significantly and it would be challenging to inculcate investor belief, the requirement for minimum maintenance of security receipt should be raised in cases where any ARCs are seeking for resolution. If the facility of centralized fund id enabled than all the potential ARCs can utilize to participate in resolution and, which would avoid cartelization.

After the rejection of application by RBI to allow UVARC to participate in resolution, it was realized that there lies an inconsistency and interpretative gap between two laws. The SARAFAESI gives an impression of being restrictive, however, IBC explicitly allows ARCs to participate. In such overlapping disparity a direction or guidelines will not suffice, also there is a possibility of prospective obstacles in the working of ARCs. There is also a possibility of unnecessary disputes in near future. Therefore, in order to resolve the disharmony between laws it is also healthier to enact amendments or bring legislative changes to provide certainty in the regulation mechanism. The conditions manifest for a transparent mechanism and in the name turn out to be too prescriptive in nature. It is essential that there are sufficient disclosures from ARCs, however if the ARCs are allowed to operate in free hand, feasibly shall perform better. One of the issues that the ARCs face due to asymmetrical information about the potentiality of distressed assets, is to determine the accurate value of such assets.³⁸⁴ The same

³⁸⁴ George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

irregularity ignited troubles in the market of lemons. Hence, an inspiration can be drawn from the model of KAMCO wherein online selling of NPAs were enabled and thus by virtue of competitive market, at least distressed assets will get better value. One of the ways to resolve such value determination problem is by employing international techniques such a market multiples and discounted cash flows.³⁸⁵

Additionally, the ARCs should be further facilitated with a fast-track mechanism to acquire the distressed mechanism. Resolution-friendly measures like altering a borrower's management or protecting ARCs from normal legal procedures that may impede the resolution process have not been considered under the new framework. Therefore, in order to avoid any barriers in coming future essential changes and substitute approach is expected to be enforced by the regulatory body.



³⁸⁵ Neeraj Tiwari, *Resolution of NPA in India: The Role of Asset Reconstruction Companies*, 7 PRATT'S J. BANKR. L. 552, 570 (2011).