

How has SARFAESI helped resolve bank NPAs? Roundtable on recovery and resolution mechanisms for corporate debt

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Insolvency, creditors rights and resolution

- ▶ Corporate insolvency could be due to:
 - ▶ A temporary liquidity crisis;
 - ▶ A fundamental problem of firm viability; and
 - ▶ fraudulent intent.
- ▶ Two elements of focus in a corporate insolvency:
 - ▶ Enforcing creditors' right to collect; and
 - ▶ Allowing viable businesses to continue.

Insolvency, creditors rights and resolution

- ▶ Creditor's alternatives in an insolvency:
 1. Race to collect – secured creditor's enforce their claims on assets and unsecured creditor's seek judicial relief;
 2. Holistic liquidation – creditor's act as a group and there is orderly liquidation and distribution of proceeds.
- ▶ But what about viable firms getting liquidated?

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In a creditor driven process, restructuring is an unlikely outcome, even if it maximises overall economic value.

The Indian framework

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 - ▶ Strengthen the recovery mechanism for the dominant creditors, banks,
 - ▶ Bypass the “slow” civil court system,
 - ▶ Override the provisions of any prior legislation.
- ▶ There has been little focus on creating/reforming mechanisms for corporate resolution.

The SARFAESI Act, 2002

- ▶ Addresses the interests of banks and specified financial institutions as secured creditors.
- ▶ Defines a three step process for recovery:
 1. Enforcement of security interest without court intervention;
 2. Securitisation of NPAs to a securitisation company (SC) or asset reconstruction company (ARC); and
 3. Asset reconstruction by SCs/ARCs.

Step 1: Enforcement of security interest

- ▶ Section 13 of the Act provides sweeping powers of enforcement to secured creditors to recover their dues from defaulting borrowers.
- ▶ They can:
 - ▶ After giving notice for 60 days, take possession of security interest without court intervention;
 - ▶ Takeover the management of the borrower's business, in case a substantial part of it is held as security by the creditor;
 - ▶ Sell, lease or assign right over the security;
 - ▶ Appoint a manager to manage the security; and
 - ▶ Ask the debtors of the borrower to pay their dues.
- ▶ Creditors can also recover the costs associated with the enforcement process from the borrower.
- ▶ In a multi-creditor set up, SARFAESI action requires approval of 75% of the secured creditors in value.

Step 1: Enforcement of security interest

- ▶ Section 17 and section 18 of the Act provide remedies to aggrieved borrowers. Both are tilted in favour of creditors.
- ▶ Section 35 of the Act over-rides other laws in favour of SARFAESI. For examples, matters before BIFR may abate if a SARFAESI action is initiated or an asset sold by a bank to an ARC.
- ▶ The borrower can file a writ petition with the High Court, under Article 226 of the Constitution. However, the Apex Court through its judgments, has asked High Courts to exercise restraint in entertaining such petitions.

Performance of SARFAESI as a recovery channel

- ▶ The success of SARFAESI, as a recovery channel has been limited.

	Unit	2008	2011	2013
Cases referred	No.	83,942	1,18,642	1,90,537
Amount involved	Rs. bn	73	306	681
Amount recovered	Rs. bn	44	116	185
Recovery	%	61	37.9	21.9

Source: RBI Report on Trends and Progress of Banking in India

Step 2: Sale of NPA to SC/ARC

- ▶ ARCs were created under SARFAESI to a) ease NPAs from banks' balance sheets, and b) resolve them to realise value.
- ▶ In India, unlike elsewhere in the world, they are private entities with no government support or backing.
- ▶ SARFAESI provides the structural framework and RBI provides the regulatory framework for ARCs.
- ▶ 14 ARCs registered with the RBI.

Step 2: Sale of NPA to SC/ARC

- ▶ The process of sale of NPAs to ARCs has been riddled with concerns. These are around:
 - ▶ Incentives of banks in selling assets to ARCs;
 - ▶ Sale value of assets and their recovery potential;
 - ▶ Financing of asset purchase by issuing security receipts to the seller bank itself;
 - ▶ Capital requirement for ARCs;
 - ▶ Management fee structure for ARCs and their incentives for resolution;
 - ▶ Transparency in the sale process.

Sale of NPA to SC/ARC

- ▶ Despite growing NPAs of banks, sale of assets to ARCs has remained limited till 2013.

Rs. in billion	2009	2010	2011	2012	2013
Gross NPA of banks	683	818	979	1,423	1,932
Incremental sale to ARCs	101	107	119	64	80

Source: RBI Report on Trends and Progress of Banking in India

Step 3: Asset reconstruction by ARCs

- ▶ Measures for reconstruction:
 - ▶ Enforcement of security interest;
 - ▶ Settlement;
 - ▶ Restructuring or rescheduling of debt;
 - ▶ Takeover of management of the borrower firm;
 - ▶ Conversion of debt to equity.
- ▶ Regulatory guidelines for these measures have been issued over time.
- ▶ The process of asset resolution by ARCs is not a level playing field. All these measures are also available to banks, with greater flexibility.

Challenges in asset reconstruction

- ▶ Several challenges in the asset reconstruction process:
 - ▶ Design of the ARC process to protect banks', rather than to resolve distressed assets.
 - ▶ Structural framework and the incentives of banks and ARCs and defaulters.
 - ▶ Excessive regulatory interference in the structure and the process;
 - ▶ Lack of a comprehensive insolvency resolution framework.

Creditor rights and resolution

- ▶ Two key question emerge:
 1. Has SARFAESI been successful in meeting its objectives of resolving distressed assets of the financial sector?; and
 2. Is insolvency resolution only about protecting the rights of dominant creditors?

Creditor rights and resolution

- ▶ Three elements of an effective insolvency resolution mechanism:
 1. Enforcement rights of creditors;
 2. Mechanisms for organised liquidation; and
 3. Restructuring of viable businesses.
- ▶ Indian legal framework is biased towards mechanisms for strengthening #1.
- ▶ However, the performance of these has been poor.
- ▶ There is no efficient mechanisms available for #2 and #3.
- ▶ Effective insolvency principles need to strike a careful balance between enforcement and resolution (*World Bank principles of effective insolvency and creditor rights system, 2005*)

Thank you.

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