ASSET RECONSTRUCTION AND SECURITIZATION

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The Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI or Act) primarily deals with three important concepts (1) Asset Reconstruction Companies (ARC) and their setup (2) Securitization of financial assets (3) Enforceability of secured creditors rights.

- ARC, globally referred as asset management companies (AMC) is a centralized approach of managing primarily Non Performing Assets (NPAs) i.e. financial assets of which the principal and interests have been overdue for more than 180 days as stipulated in RBI guidelines dated July 1, 2008 (The Securitization Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003). The centralized approach being a global phenomenon, signifies setting up of dedicated government, semi-government or wholly private sector corporate which would pool in the NPAs of banks and financial institutions and for the purpose of realization thereof, the ARC may adopt any of the several measures such as changing or taking over the management of the business, sale or lease of the NPA, rescheduling of debt payments of the borrower etc.

- Securitization, as explained by the RBI in its report of Credit Markets is a process through which illiquid assets are transformed into a more liquid form of assets and distributed to a broad range of investors through capital markets. In general, securitization under the SARFAESI, refers to the process of acquisition of financial assets of the lender (Originator) by a fund/trust setup by the ARC, by raising funds through issue of security receipts to Qualified Institution Buyers (QIBs) which represent an undivided interest of the QIBs in the acquired financial asset. Under this process, the lending institution’s assets are removed from its balance sheet and are instead funded by the QIBs through the security receipts.

- Securitization of standard assets (i.e. financial assets that are not NPAs): Apart from securitization under the SARFAESI, the RBI has also dealt with securitization of standard assets vide guidelines issued in February 2006 which are applicable to banks/financial
institutions/NBFCs but not ARCs. These guidelines primarily provides an opportunity to banks/FI/NBFCs to unlock the value of secured financial assets by pooling such assets in an bankruptcy remote SPV in return for immediate cash payment and subsequently repackaging and selling security receipts to third party investors.

**Enforceability — legal process and challenges**

Enforceability of rights of secured credits without intervention of judicial authority is the corner stone of SARFAESI. Under the operative provisions of the SARFAESI, if the borrower has defaulted on a loan and has failed to repay within the 60 days notice period OR to make a representation/objection acceptable to the secured creditor against the notice, the secured creditor is authorized to enforce its security. Such a right was aggressively challenged before the Hon’ble Supreme Court of India in the landmark case Mardia Chemicals vs Union of India (AIR 2004 SC 2371). However, the Hon’ble Court upheld such rights of the secured creditors owing to the need to have a speedy enforcement mechanism.

**Enforcing change or taking over of management of the borrower**

One of the effective modes of enforcing security interest available to the secured creditor is by taking over the management or the possession of the secured assets of the borrower with rights to transfer by way of lease, assignment or sale for releasing the secured asset. Towards this, the RBI has on December 5, 2008 notified draft guidelines to ensure fairness and transparency and to build in certain checks and balances for secured creditors to effect change/take control management of the business of the borrower and has invited comments from the banks/FI/NBFCs and general public on the said draft guidelines within 60 days of the notification. The draft guidelines proposes that secured creditors can resort to change or takeover of management only if the amount due is not less than 25% of the total assets of the borrower and that takeover could be enforced only if efforts for change in management has failed. The proposed guidelines tend to marginalize the impact of operative provisions of the SARFAESI relating to enforceability of security interests.

**Consortium lending**

The operative provisions of SARFAESI further provide that in case of more than one secured creditor or consortium lending, a secured creditor (proposing to enforce its security interest over an NPA) would need to obtain consents of other secured creditors representing at least three fourth (in value) of the outstanding debt and once consented the enforcement action of the secured creditor would become binding on all the other secured creditors. Legally speaking, any one of the secured creditor can commence independent enforcement proceedings against the NPA subject to seeking approval of the other secured creditors. However, commencing parallel enforcement proceedings against the same NPA which is already a subject matter of earlier proceedings may be practically difficult and would depend on active co-operation of the other secured creditors. The implication of this provision of SARFAESI necessitates a legal draftsman to capture the various probabilities of enforcement action in the loan documentation entered into by the secured creditors with its borrowers.

**Judicial machinery involved**

SARFAESI permits a secured creditor to seek assistance of the jurisdictional Chief Metropolitan
Magistrate/District Magistrate for taking possession or control of the NPA in accordance with the Act and the action taken by the Chief Metropolitan Magistrate/District Magistrate cannot be questioned in any court or before any authority. Further, appeals against the enforcement actions of the secured creditors can be made by any person (including borrower), before the Debt Recovery Tribunal (DRT) and subsequently before the Appellate Tribunal against any decision by the DRT. As mentioned, the right to appeal against the action taken by the secured creditor lies with any person and this would include other secured creditors of the borrower. Such right tends to broaden the chances of multiple litigators against the asset reconstruction/securitization processes.

« Vulture Funds □ What it signifies

Though not codified, Vulture Fund is conventionally used in the global parlance to mean funds that are metaphorically patiently circling, waiting to pick over the remains of a rapidly weakening company or, in the case of sovereign debt, the debtor (Source: Wikipedia). These funds are also referred to as distressed debt or special situations funds. A related term vulture investing or distress investing or funding signifies stocks in near bankrupt companies which are purchased on anticipation of asset divestiture or successful reorganization.

Vulture Funds usually purchase distressed assets or discounted debt of troubled companies in the expectation of their value increasing. In the normal scheme of a Vulture Fund, the fund will purchase a loan from the previous creditor at a discounted price. The Vulture Fund may seek to acquire a controlling interest or only the debt of the borrower with the expectation that its actual value will be higher than the purchase price or can be enhanced by a skillful owner. Taking a cue from global scenario, investors (in distressed assets) could be broadly classified into Investment Banks, Buyout PE (Private Equity) Funds, Hedge Funds and Turnaround Investors.

- **Investment Banks**: Worldwide, investment in distressed assets/companies is an asset class in itself for investment banks for investment purposes. The private equity arms of these entities generally carry out the investment.

- **Buyout PE Funds**: With rapidly drying opportunities for acquisition and investment in traditional areas, distressed asset has turned out become one of the major options for investment purposes by PE Funds.

- **Hedge Funds**: Have historically been active investors in distressed debt and are primarily event driven investors (Event driven would imply some form of corporate activity or catalytic change taking place such as mergers and takeovers, restructuring, reorganizations, spin-offs, asset sales, liquidations, bankruptcy and many others).

- **Turnaround Investors**: Those who acquire businesses with the presumption that they will be able to do a better job of creating value than existing management. They achieve this in one or more of the following ways: superior strategy; superior operating management; superior financial management; transactional activities; synergies.

**India scenario**: In India, investors in the distressed sector are mainly private equity arms of investment banks, PE Funds and QIBs as defined under the SARFAESI. QIBs are permissible investors in security receipts issued by ARCs and essentially cover those investors who can appraise the risks underlying NPAs and include domestic investors such as banks, financial institutions, asset management
companies representing mutual funds/pension funds and insurance companies.

Further, investments by distressed sector in India are primarily structured as single credit transactions rather than portfolio transactions. Single credit transactions involves investors targeting distressed assets of an individual company and then exiting once the plant is revived to make a quick profit. Whereas portfolio transactions aims at investments in sector specific distressed assets followed by issuance of security receipts to investors interested in investing in the scheme.

**Investments by foreign corporate:** Apart from the domestic investors, QIBs also include Foreign Institutional Investors (FIIs) who can invest up to 49% of each tranche of scheme of security receipts subject to the condition that investment of a single FII in each tranche of scheme of security receipts shall not exceed 10% of the issue.

FDI upto 49% is currently permitted in ARCs with prior FIPB approval but this does not include FII investments. Further, FIPB approvals are subject to the condition that investors (defined as Sponsors under SARFAESI if holding more than 10% share capital of the ARC) are not the holding company or do not hold any controlling interest in the ARC. Such a provision is also applicable to domestic investors in ARC.

**New Entrants:** Such a trend has lead to atleast five new ARCs obtaining licenses in the year 2008 from the RBI under the SARFAESI taking the total number of licensed ARCs to 11. A quick look at ownership composition of these ARCs registered in 2008 signifies the trend in the Indian industry towards the ARC business.

- **Reliance Asset Reconstruction Co. Limited**, being the ARC arm of the Reliance Capital Limited. The other shareholders being Corporation Bank, Indian Bank, GIC of India, Blue Ridge Limited Partnership and Dacecroft Limited. (Source: www.rarcl.com)
- **Phoenix Asset Reconstruction Private Limited**, being the ARC arm of **Kotak Mahindra Bank Limited** (Source: www.kotak.com)
- **JM Financial Asset Reconstruction Co. Private Limited**, being the ARC arm of the **JM Financial Group**. The other shareholders being Indian Overseas Bank, UCO Bank, Union Bank and other individuals. (Source: The Economic Times)
- **Prithvi Asset Reconstruction and Securitization Co. India Pvt. Ltd.** The shareholders include certain NRIs (Source: livemint.com, Oct 20 2008)
- **Invent Assets Securitization and Reconstruction Pvt. Ltd.** The shareholders include high profile...
individuals like Mr. M.N. Singh, former commissioner of Mumbai police; Mr. G.N. Bajpai, former chairman of SEBI; Mr. Pankaj Gupta of Shah Gupta and Co.; Mr. R.K. Singh, a former bureaucrat from the Haryana cadre; (Sources: Business Line, Aug 29, 2003 and livemint.com, Oct 20 2008)

- In addition to the above, Tata Capital have recently acquired 20% in International Asset Reconstruction Company, an ARC registered in 2007 by former Chairman of SBI Mr. M.S. Verma and former Bank of America CEO, Mr. Arun Duggal with other investors being HDFC. (Source: vccircle.com)

It is believed that the delinquencies in retail sector especially home and auto loan portfolios may rise further in the current fiscal due to the escalated interest rates. This has led to sudden surge in establishment and consolidation of ARCs in India and also attracted various foreign funds such as Clearwater, ADM, WL Ross, Spinnaker Capital and DE Shaw into the distressed funds market (source: Economic Times dated July 25, 2008).

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- **SHORTFALL IN MAINTENANCE OF SLR/ADDITIONAL LIQUIDITY SUPPORT UNDER LAF**
  RBI vide its circular dated November 3, 2008 has relaxed SLR requirements and extended additional liquidity support. RBI in its earlier circular permitted scheduled banks to avail additional liquidity support under the Liquidity Adjustment Facility (LAF) up to one per cent of the Net Demand and Time Liabilities (NDTL) and seek waiver of penal interest. By a press release dated November 1, 2008, RBI reduced statutory liquidity ratio (SLR) to 24 per cent of NDTL. Banks could apply to the Reserve Bank for waiver of penal interest for shortfall, if any, in maintenance of SLR arising out of availing the above mentioned Liquidity Adjustment Facility (LAF) up to November 7, 2008. In order to further extend liquidity support to banks to enable them to manage their funding requirements, RBI has decided to extend Liquidity Adjustment Facility (LAF) on a temporary and ad hoc basis subject to review. Accordingly banks are permitted for relaxation of SLR to the extent of 1.5 per cent of NDTL. This relaxation in SLR is to be used exclusively for the purpose of meeting the funding requirements of NBFCs and Mutual funds. Banks can apportion with flexibility the total accommodation allowed between MFs and NBFCs as per their business needs. Therefore, banks can apply to the RBI in writing with a request not to demand payment of the penal interest under sub-section (8) of Section 24 of the Banking Regulation Act, 1949 for the shortfall up to 1.5 per cent of NDTL in maintenance of SLR arising out of availing of this additional liquidity support under LAF.

- **PRUDENTIAL GUIDELINES ON RESTRUCTURING OF ADVANCES BY BANKS**
  RBI vide its circular dated November 3, 2008 stated that the housing loans granted by the banks would be eligible for special regulatory treatment, if restructured. A ceiling of 10 years on the repayment period of the restructured advances (other than infrastructure advances) has been stipulated for the restructured advances to be eligible for the special regulatory treatment. The aforesaid ceiling of 10 years, over the repayment period of the restructured advances, would not be applicable for restructured housing loans, subject to compliance with all other terms and conditions prescribed in the guidelines. Restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points to the risk weights prescribed vide paragraph 5.10.1 of the Master Circular Prudential Guidelines on Capital Adequacy and Market Discipline Implementation of New Capital Adequacy Framework, issued vide circular dated July 1, 2008.

- **REMITTANCE RELATED TO COMMODITY DERIVATIVE CONTRACT ISSUANCE OF**
STANDBY LETTER OF CREDIT / BANK GUARANTEE

RBI by its circular dated November 10, 2008 provided greater flexibility to resident entities who have such payment obligations related to commodity derivative contracts, the RBI decided that AD Category-I banks may issue guarantees/standby letters of credit to cover these specific payment obligations subject to the following conditions/guidelines:

- The standby letter of credit / bank guarantee may be issued for the specific purpose of payment of margin money in respect of approved commodity hedging activities of the company.
- The standby letter of credit / bank guarantee may be issued for an amount not exceeding the margin payments made to the specific counterparty during the previous financial year.
- The standby letter of credit / bank guarantee may be issued for a maximum period of one year, after marking a lien on the non-funded facility available to the customer (letter of credit / bank guarantee limit).
- The bank shall ensure that the guidelines for overseas commodity hedging have been duly complied with.
- The bank shall ensure that broker’s month-end reports duly confirmed / countersigned by corporate’s financial controller have been submitted.
- Brokers' month end reports shall be regularly verified by the bank to ensure that all off-shore positions are / were backed by physical exposures

Further, AD Category-I banks may issue guarantees / standby letters of credit only where the remittance is covered under the delegated authority or under the specific approval granted for overseas commodity hedging by the Reserve Bank. The issuing bank shall have a Board approved policy on the nature and extent of exposures that the bank can take for such transactions and should be part of the credit exposure on the customers. The exposure should also be assigned risk weights, for capital adequacy purposes as per the extant provisions.

- **UNION BUDGET 2008-09 □ AGRICULTURAL DEBT WAIVER AND DEBT RELIEF SCHEME, 2008 PRUDENTIAL NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION, PROVISIONING AND CAPITAL ADEQUACY**

RBI vide its circular dated November 11, 2008 stated that under the Agricultural Debt Waiver and Debt Relief Scheme, the Government of India decided to pay interest on the 2nd, 3rd, and 4th installments, payable by July 2009, July 2010, and July 2011 respectively, at the prevailing Yield to Maturity Rate on 364-day Government of India Treasury Bills. RBI has directed that the interest will be paid on these installments from the date of the reimbursement of the first installment (i.e. November 2008) till the date of the actual reimbursement of each installment. Further, banks need not to make any provisions for the loss in Present Value (PV) terms for moneys receivable only from the Government of India, for the accounts covered under the Debt Waiver Scheme and the Debt Relief Scheme.

- **REVIEW OF PRUDENTIAL NORMS □ PROVISIONING FOR STANDARD ASSETS AND RISK WEIGHTS FOR EXPOSURES TO CORPORATES, COMMERCIAL REAL ESTATE AND NBFC-ND-SI**

RBI vide circular dated November 15, 2008 has reviewed the above prudential norms and specified the following norms as a counter cyclical measure

a) Provisioning Norms: The provisioning requirements for all types of standard assets stand reduced to a uniform level of 0.40 per cent except in the case of direct advances to agricultural and SME sectors, which shall continue to attract a provisioning of 0.25 per cent.

b) Risk weights: The risk weights for the banks’ claims on corporate, those secured by commercial real estate and the claims on the NBFC-ND-SI stand revised as follows:

- Claims on corporate: All unrated claims, long term as well as short term, regardless of the amount of claim, on the corporate shall attract a uniform risk weight of 100 per cent.
- Claims secured by commercial real estate: Such claims would attract a risk weight of 100 per cent as against the extant risk weight of 150 per cent.
- Claims on NBFC-ND-SI: The claims on the rated as well as unrated NBFC-NDSI (other than
AFCs), regardless of the amount of claim, shall be uniformly risk weighted at 100 per cent. As regards the claims on AFCs, there is no change in the risk weights, which would continue to be governed by the credit rating of the AFC, except the claims that attract a risk weight of 150 per cent under the New Capital adequacy Framework, which shall be reduced to a level of 100 per cent. The above modifications would also apply to banks under the Basel I framework.

- **STCBs/DCCBs - AGRICULTURAL DEBT WAIVER AND DEBT RELIEF SCHEME, 2008-PROVISIONING**
  RBI vide its circular dated November 17, 2008 has issued instructions pursuant to Government’s decision to pay interest on the subsequent installments under the debt waiver and debt relief scheme. In its earlier circular, RBI issued guidelines pertaining to Income Recognition, Asset Classification and Provisioning, and Capital Adequacy as applicable to the loans covered by the debt waiver and debt relief scheme announced by the Finance Minister; After the issuance of the above named circular Government of India decided to pay interest on the second and subsequent installment/s of the 'eligible amount' (amount as specified under the debt waiver and debt relief scheme) at the prevailing Yield to Maturity Rate on 364-day Government of India Treasury Bills. The interest would be paid on these installments from the date of the reimbursement of the first installment (i.e. November 2008) till the date of the reimbursement of each installment. In the present circular it has been specified that the banks need not make any provisions for the loss in Present Value (PV) terms for moneys receivable only from the Government of India, for the accounts covered under the Debt Waiver Scheme and the Debt Relief Scheme.

- **STANDING LIQUIDITY FACILITIES FOR BANKS AND PRIMARY DEALERS**
  RBI vide its circular dated December 6, 2008
  1. Reduced the fixed repo rate under the Liquidity Adjustment Facility (LAF) by 50 basis points from 8.0 per cent to 7.5 per cent with effect from November 3, 2008.
  2. Accordingly, the Standing Liquidity Facilities provided to banks (export credit refinance) and Primary Dealers (PDs) (collateralized liquidity support) from the Reserve Bank would be available at the repo rate, i.e., at 7.5 per cent with effect from November 3, 2008.

- **REVIEW OF PRUDENTIAL NORMS -PROVISIONING FOR STANDARD ASSETS AND RISK WEIGHTS FOR EXPOSURES TO COMMERCIAL REAL ESTATE AND NBFC’S**
  RBI vide its circular dated 1st December, 2008 reviewed the prudential norms keeping in view the current market situations:
  a) Provisioning Norms: The provisioning requirements in case of Tier II UCBs for all types of standard assets have been reduced to a uniform level of 0.40 per cent except in the case of direct advances to agricultural and SME sectors, which shall continue to attract a provisioning of 0.25 per cent. Tier I UCBs will continue to make a general provision of 0.25% on all their standard assets.
  b) Risk weights: The risk weights for advances to corporates secured by commercial real estate and to NBFCs have been revised to the following:
    (i) Loans and advances secured by commercial real estate would attract a risk weight of 100 per cent as against the extant risk weight of 150 per cent
    (ii) UCBs shall not finance NBFCs other than those engaged in hire-purchase / leasing. Such companies now stand reclassified as Asset Finance Companies, vide DNBS circular dated September 15, 2008. The risk weights on exposure to such companies will remain unchanged at 100 per cent.

- **LOANS EXTENDED TO MFS/ISSUE OF IRREVOCABLE PAYMENT COMMITMENTS**
  RBI vide circular dated December 12, 2008 has extended transition time to comply with regard
to loans extended to Mutual Funds; In its earlier circular dated December 14, 2007 RBI issued certain guidelines for grant of loans and advances to Mutual Funds. It stated that banks grant loans and advances to Mutual Funds only to meet their temporary liquidity needs for the purpose of repurchase/redemption of units within the ceiling of 20% of the net asset of the scheme and for a period not exceeding 6 months. It specified that such finance, if extended to equity-oriented Mutual Funds, would form part of banks’ capital market exposure;

Further the guideline specified that Irrevocable Payment Commitments (IPCs) in favour of stock exchanges on behalf of Mutual Funds are in the nature of non-fund based credit facility for purchase of shares and are to be treated at par with guarantees issued for the purpose of capital market operations. Such exposure of banks will, therefore, form part of their Capital Market Exposure. Banks were advised that entities such as FIIs are not permitted to avail of fund or non-fund based facilities such as IPCs from banks. In the present circular RBI has extended the transition period to comply with the above guideline up to March 31, 2009.