

Asset reconstruction business at crossroads

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ARCs will come of age only when the legal process turns highly efficient

The 15:85 structure introduced by Reserve Bank of India (RBI) in August, raising asset reconstruction companies' (ARC) minimum security receipts (SR) subscription to 15%, for acquisition of non-performing assets (NPAs) from banks, restored parity between NPA acquisition cost and the estimated recovery. As expected, barring few tactical acquisitions by the ARCs for consolidation, the NPA acquisition by ARCs has come to a standstill. Why? The erstwhile 5:95 structure provided capital protection often exceeding 100% to the ARCs from the management fee. Hence, the ARCs could bid aggressively for asset acquisition and realise fair returns with back-ended recovery even when the total recovery fell substantially short of the acquisition cost. Though the resultant losses on SRs impacted the banks, the transactions suited them since those resulted in back-ended provisioning by the banks. Under 15:85 structure, the capital protection to ARCs is limited, and hence ARCs have to seek NPAs at a significant discount to the anticipated recovery, entailing upfront provisioning by the banks.

Overall recoveries from NPAs average around 25% of the secured loans outstanding.

Hence, for 20% return over a 5-year horizon under 15:85 structure, the ARCs tend to quote an average of less than 20% of outstanding loans for NPA acquisition. Based on RBI provisioning norms, such deals require provisioning in excess of normal if the asset has been non-performing for up to two years. This tends to deter the banks from selling early NPAs, and limits the transactions only to the loss assets. But is this happening?

Regulatory hurdle

According to RBI guidelines, the banks are required to sell the NPAs at a (reserve) price, which should not be generally lower than net asset value (NPV) of estimated net realisation from the account. This is not workable since this does not leave any margin for the ARC, barring exceptions. No wonder the banks have

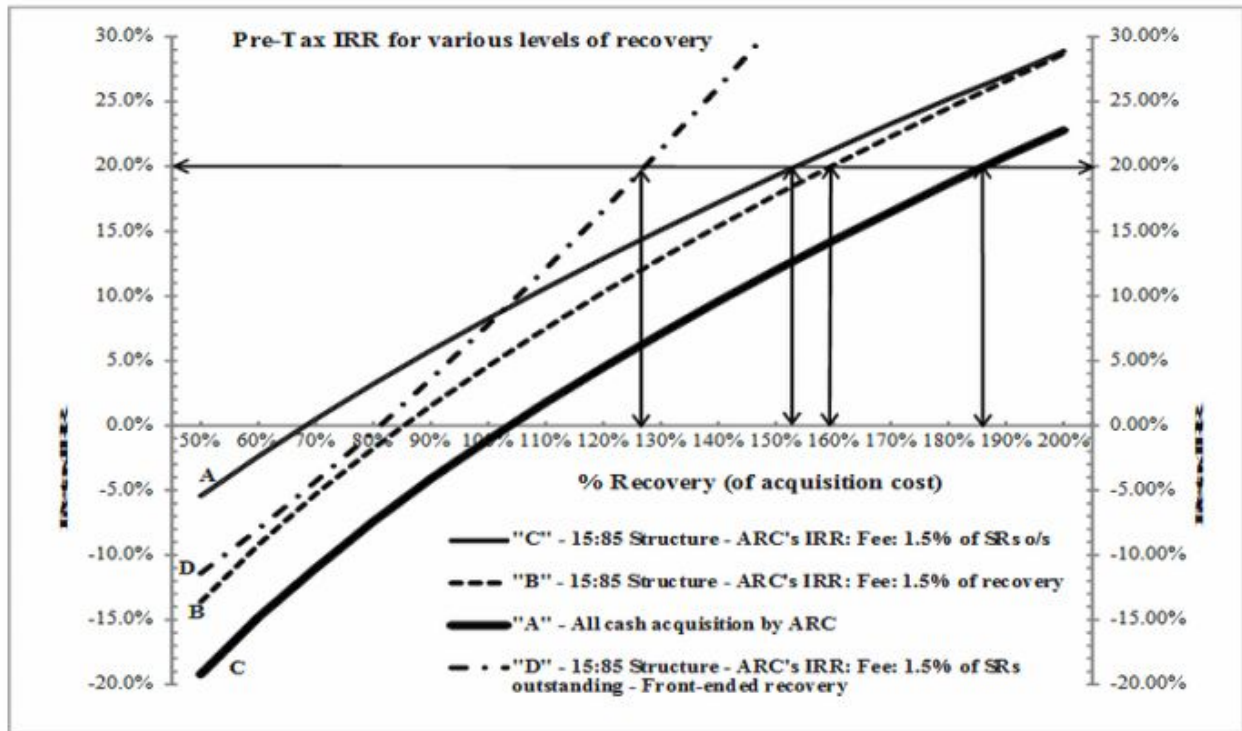
not been able to offer even loss assets at reasonable price to the ARCs under 15:85 structure.

Based on identical acquisition cost and 5-year back-ended recovery profile with 15:85 structure, reasonable returns to ARCs require high recovery ratios i.e. ratio of overall recovery to the acquisition cost. For 20% pre-tax internal rate of return (IRR), with management fee (1.5% pa) linked to SR value, the recovery ratio is 148% (see “A” in the figure). With management fee (1.5% pa) linked to recovery, the recovery ratio is 153% (see “B”). For all-cash acquisition, the recovery ratio is 182% (see “C”). It is evident that the 15:85 structure has resulted in fairly-efficient NPA price discovery, though the price discovery in all-cash acquisition is the most efficient. However, the acquisitions are not materializing owing to the regulatory constraint.

In the SR structure, the maximum recovery and hence the distribution is limited to the outstanding dues. Hence, if the stressed account turns around, a limited upside flows to the SR holders if in the portfolio, the recoveries leave surplus after paying for the expenses, management fee, SR redemption and yield if any. The ARCs are allowed to convert a part or whole of debt into, up to 26% of total equity. Such conversion can potentially provide significant upside to the ARC in case of all-cash acquisition. However, such upside tends to be nullified since the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 requires restoration of the management back to the defaulter after turnaround by the ARC.

Efficient legal process - A must for maximizing value

Owing to legislative loopholes, judicial pronouncements, and very tardy legal process, the DRTs, which adjudicate the Recovery of Debts Due to Banks & Financial Institutions (RDDBFI) Act 1993 and SARFAESI matters, take years to dispose of the cases. The recovery by ARCs, therefore, continues to be highly back-ended to which scenarios A to C relate. However, if the recovery is front-ended, ARCs’ returns increase substantially, and for 20% return, recovery ratio is just 122% (see “D”). Thus, banks can expect significantly higher valuations only with front-ended recovery. This, however, requires highly efficient legal process.



Way forward

RBI should withdraw the current NPA pricing methodology, which does not leave margin for the ARCs. The banks should sell the NPAs mandatorily to the highest bidder without reckoning the imprecise reserve price. Loss on sale to the ARCs should be allowed to be written off in three years, for the next five years. This will also catalyze all-cash transactions. ARCs should also be allowed 100% equity through conversion and exercise of pledge of shares if any.

ARCs will come of age only when the legal process turns highly efficient. Hence, for speedy clearance of the backlog of about 45,000 cases in DRTs with defaults exceeding 1.45 lakh crore, the government of India should urgently increase the number of current 33 DRTs and appellate tribunals adequately, and introduce e-governance in all the DRTs and tribunals / courts. The system should be backed by adequate judicial manpower and amendments to RDDBFI and SARFAESI acts, including section 15 of SARFAESI act, to allow permanent management change. The recovery suits must be disposed of within the statutory timelines, and any laxity should invite strict penalty. Adjournments sought by the parties should attract prohibitively high fee so that the defaulters' cannot adopt delay as a strategy.

The UK bankruptcy code is creditor-friendly, where over 50% of the distressed companies are sold as going concerns and over 40% of the companies are liquidated piecemeal. The liquidation process gets concluded in less than 1½ years and delivers to the lenders, recovery of about 75% with recovery cost of just 15% of the asset value. Overall, 75% of the distressed assets undergo bankruptcy and the balance is restructured, reflecting the lenders' preference for restructuring viable businesses. Speedy resolutions under UK's bankruptcy code show that the speed of judgments induces discipline among the borrowers. The government of India needs to appreciate merits of speedy adjudication and take immediate corrective action before it is too late.
