



Asset Reconstruction Companies: As Viewed Through An "Indian Prism"

2004

1 Introduction

In December 2002 India enacted the "Securitisation & Reconstruction of Financial Assets & Enforcement of Security Interest Act" (the "*Indian Act*"). The Act provides for a number of matters including the registration and empowerment of asset reconstruction companies ("ARCs"), as well as the regulation of the marketplace for non-performing loans ("NPLs").

Resolution of NPLs can be achieved by utilising either a public or private sector approach. Indonesian (IBRA), Korea (KAMCO), Malaysia (Danaharta) and Thailand (TAMC) have adopted government owned and funded ARCs.

The Philippines and Taipei, China, have adopted a private sector approach.

Following a review of international models for ARCs, the Indian Government decided to adopt a private sector approach to the resolution of NPLs.

Whether a private or public ARC model is adopted, the issue which arises is; how can the market for NPLs be encouraged? Such an enquiry, in turn, invites attention to a number of more particular issues including:

- in the case of the private sector approach, what structural considerations are necessary to encourage third party investors' participation in an ARC?
- what incentives need to be provided to banks to assign their NPLs to an ARC?
- are there incentives to encourage third party participation in the market for NPLs?

These questions, at least so far as they impact on India, were addressed in the Technical Assistance provided by the Asian Development Bank; TA

No. 3943-IND-Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India ("TA"). The final report on the TA was presented in February 2004 ("Report"). This paper surveys a number of different approaches to common issues which arise in the design and implementation of ARCs. Whilst the regimes in each jurisdiction are unique, the differing approaches to issues such as foreign participation and the sale of NPLs provide usual points of comparison.

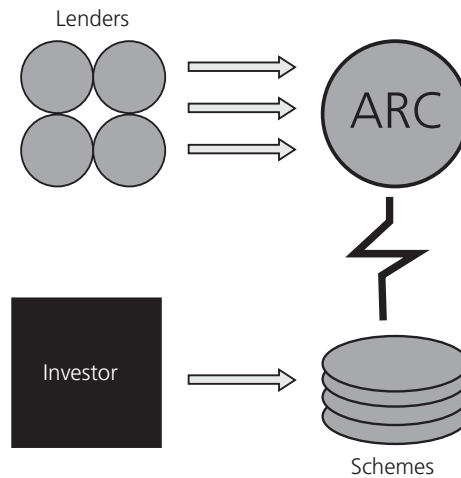
2 Structure of ARCs

2.1 Limitations on Shareholding and other Equity Participation

A policy concern addressed in the *Indian Act*, at least by necessary implication, is the possibility that an ARC may be used by a bank or other financial institution as a "warehouse" for its NPLs. Such a possibility is anticipated, at least in part, by a limitation to the effect that no shareholder in an ARC may have a controlling interest; s7, *Indian Act*. That limitation may impact upon the way in which ARCs in India can raise funds. One option which is available, other than through subscriptions for shares, is the issue of security receipts.

Assets held by an ARC as trustee for the holders of security receipts are not taken into account when assessing the adequacy of the ARC's capital. This consideration supports the conclusion that under the present Indian regulatory framework it is likely that an NPL will be acquired by an ARC as trustee of a scheme formulated for the purpose of acquiring that NPL and in which qualified institutional buyers have invested by way of a subscription for security receipts; s7(2), *Indian Act*. An ARC may be the trustee of a number of such schemes; s7(2), *Indian Act*.

Diagrammatically, that structure could be represented in this way:



The limitation restricting control of ARCs supports this conclusion.

As has already been noted, that limitation appears to be intended to preclude the possibility of a bank establishing what is, in effect, its own ARC and using it to "warehouse" the NPLs it wished to remove from its balance sheet. Even so, it is a limitation which may impede third parties participating in the NPL market to the extent that they wish to exercise control over the resolution strategy for the NPLs in which they have an interest. If that limitation remains, it will encourage third party investors to subscribe for security receipts in the scheme housing the NPLs which they wish to buy. In that circumstance, the ARC might delegate the exercise of its powers in respect of the NPL to that third party investor which would act as the ARC's agent.

Of course the possibility of "warehousing" NPLs is not an issue where the ARC is a public enterprise such as is, or has been, the case in each of Indonesia, Korea, Malaysia and Thailand. However, the possibility for warehousing exists in the private sector ARCs regimes established in each of the Philippines and Taipei, China.

In the case of Taipei, China, an ARC can be incorporated either under its Company Law, in which case there is no limitation on its shareholding, or the Trust Enterprise Law. Entities established under the Trust Enterprise Law must satisfy certain requirements as to their shareholding. Qualified financial institutions must hold 40% of the issued shares but no individual shareholder and its affiliates may hold more than 25% of those shares.

In the Philippines, a different approach has been adopted to mitigating the possibility of ARCs being used to "warehouse" NPLs. There, rather than limiting the ownership of ARCs, a

restriction is placed on the NPLs that an ARC may acquire which is imposed through the definition of "True Sale" which is:

"a sale wherein the selling FI [financial institution] transfers or sells its NPAs [non-performing assets] without recourse for cash or property to a SPV [special purpose vehicle] with the following results:

- the transferor relinquishes effective control over the transferred NPAs; and
- the transferred NPAs are legally isolated and put beyond the reach of the transferor and its creditors:

Provided that the transferring FI shall not have direct or indirect management of the transferee SPV: Provided further that the selling FI does not possess a claim of beneficial ownership of more than five percent (5%) in the transferee SPV."

2.2 Foreign Participation in ARCs

The *Indian Act* does not place any restriction on foreign ownership of ARCs. It may be, however, that the regulation of foreign investment in India, particularly in entities concerned with the provision of financial services, is such that it will discourage such ownership. One aspect of that regulation is the satisfaction of very substantial capitalisation requirements.

In the course of the Report, it is recorded that both the capabilities to facilitate the resolution of NPLs, as well as the funds needed for that purpose, will be sourced internationally, at least so far as India is concerned. As that was the conclusion of the research undertaken in the course of the TA, it was recommended that structural barriers to foreign investment in ARCs be removed.

In Taipei, China there are no restrictions on foreign ownership of ARCs. Indeed, a tax incentive is provided to encourage international participation in the regime established in that country for the resolution of NPLs. That incentive is given by way of a reduction in the rate of withholding tax from 35% to 20% on dividends distributed to foreign shareholders in ARCs.

Likewise, in at least the People's Republic of China and Korea, there has been international participation in the market for NPLs promoted by the ARCs in those countries. In the case of Korea's ARC, KAMCO, it has used international bidding to dispose of NPLs, and at the time of the Report had conducted seven such auctions. Some of those auctions have been conducted with put-back options enabling the successful bidder to resell NPLs to KAMCO as an additional incentive to investors to participate.

3 Sale of NPLs

The evolution of ARCs in the last few years, at least within the Asian region, has been a response to the so-called "financial crisis" in 1997. The relevant hallmark of that crisis was that it exposed the endemic weakness of the financial systems of a number of countries which required government intervention to sustain the integrity of those systems. Whilst that intervention might have resulted in changes of ownership or management of the financial institutions of those countries, it also dictated the need, in effect, for underwriting their balance sheets. This process was undertaken either by Government owned ARCs or creating an environment which facilitated the establishment of private sector ARCS. Such a difference in approach has been reflected, at least to some degree, in the circumstances surrounding the sale by financial institutions of their NPLs.

3.1 NPLs which may be sold

One difference concerns the identification of NPLs which will or may be sold to ARCs. In India the only NPLs which may be sold are:

- non-performing assets, being loans where there has been a default for at least 90 days; or
- standard assets in circumstances where 75% of the face value of the loans to the relevant debtor have been classified as non-performing and 75% by value of the lenders have agreed to sell their loans to an ARC.

Amongst NPLs which may not be sold under the *Indian Act* are those belonging to foreign banks. This may result in the loss of one of the

advantages which may accrue to an ARC, namely, its capacity to aggregate the debtor's financial obligations and then intervene in its affairs.

It appears that other jurisdictions in Asia do not prohibit the sale of NPLs belonging to foreign banks. In jurisdictions such as Malaysia, Korea and Thailand, parameters have been established for the decision making process for the purchase of NPLs. In Malaysia, Danaharta has acquired NPLs which have a face value of at least RM5 million, and has focused on debtors where it assesses that there is a potential to add value through restructuring, rehabilitation or the implementation of a workout strategy. It has also given first preference to loans which are secured, then to loans which are unsecured and finally to foreign currency or other facilities. Moreover, it has not acquired NPLs where the debtor is either in liquidation or subject to a formal restructuring scheme.

Under the Korean legislation establishing KAMCO a discretion was given as to the kind of assets it acquired first, but it was required to have regard to the following guidelines when determining the priority of its acquisitions:

- (1) NPLs deemed necessary for the public interest, such as the protection of management soundness of financial institutions;
- (2) NPLs whose resolution could have great effects because a number of interested persons were involved;
- (3) NPLs whose disposition were not subject to severe restriction by public laws; or
- (4) NPLs whose sale prices could be immediately collected because their sale was not restricted.

Following the establishment of the Thai Asset Management Company ("TAMC"), all state owned financial institutions and asset management companies were required to transfer all their NPLs (loss, doubtful of loss, doubtful and sub-standard) as at 31 December 2000 to TAMC. However, private institutions were given an option to do so. The TAMC has accepted the transfer of the NPLs from private institutions in accordance with the following criteria:

- NPLs as at December 31, 2000;
- NPLs secured by property;
- NPLs of those debtors which are juristic persons and are indebted to at least two Thai financial institutions;

- NPLs whose total value owed by a debtor is at least Baht 5 million;
- NPLs in respect of which no restructuring agreement in writing has been entered into by 9 July, 2001; and
- NPLs which are not part of a rehabilitation plan approved by the Bankruptcy Court before 9 June, 2001.

In addition to the above criteria, if the debtor whose NPLs are transferred to TAMC, holds 50% of the total shares of any company, then the debts of the related companies are also required to be transferred to TAMC.

3.2 Provisioning requirements for NPLs

The Report concluded that the development of an effective market for NPLs in India was inhibited as provisioning norms for banks do not meet international standards. If those standards are adopted, it is expected that this will provide an incentive for the sale of NPLs.

Similar "incentives" have been used elsewhere in the Asian region. In Taipei, China the Ministry of Finance announced in 2002 that banks were required to reduce their NPL ratios to 7% by the end of 2002 and to 5% by the end of 2003. Further, they were required to maintain a capital adequacy ratio of at least 8% by the end of 2003. Certain penalty clauses have been laid down by the Ministry for those institutions that fail to reduce their NPLs to the benchmark levels. These include restrictions on establishment of local and offshore branches, restrictions on the distributions of dividends and cancellation of existing branch licenses.

Whilst the transfer of NPLs to TAMC by private institutions has been voluntary, those that decided not to effect transfers have been ordered by the Bank of Thailand to have the collateral they hold revalued by an independent appraiser within 120 days and then set the full provision for the NPLs, net of the value of that collateral.

In Malaysia those banks who elected not to sell NPLs to Danaharta at the price which it offered have been required to write down the value of these assets to their "forced sale value" which was defined as 80% of the offer made by Danaharta. Additionally, banks are limited to carrying NPLs which represent no more than 10% of the total value of their receivables.

An issue in India concerns the requirement that, once an NPL has been sold, the bank must account for the difference between the price paid and the NPL's book value. As a further incentive, the Report recommends that the RBI

permit banks to amortise those losses over a period of years, thereby "cushioning" the impact of the sale of the NPLs on their balance sheets. Such relief has been made available in Malaysia (5 years) and Taipei, China (5 years).

3.3 Terms of sale of NPLs

Indian banks are required to effect sales of NPLs at their fair value. Moreover, whilst a bank may participate in the profit ultimately made by an ARC on the realisation of an NPL, the sale must be "without recourse" to the bank in the sense that it is not permitted to assume any liability if the ARC makes a loss. Such a limitation is appropriate and clearly designed to mitigate the possibility of a bank seeking to avoid the consequence to its balance sheet of recognising the true value of the NPL.

By way of contrast, in Taipei, China the establishment of the sale price for NPLs has been left substantially to the market with the bulk of NPLs being realised through auctions and only a small percentage of them being sold as a result of private treaty negotiations.

Another feature of arrangements under which NPLs are sold can involve profit sharing on the realisation of the NPLs. The *Indian Act* permits profit sharing but prohibits the transferor financial institution from, as it were, underwriting any loss on the sale of an NPL. In Malaysia, Danaharta also purchased NPLs on the basis that the selling bank could participate in any profit made from the resolution of the NPL. Similar arrangements were made in Korea.

3.4 Impediments to sale

India's revenue law contains a number of prospective impediments to the sale of NPLs. Stamp duty, on the assignment of an NPL, may either deter prospective investors or result in the price paid for an NPL being significantly discounted. It appears the *Indian Act* may have attempted to resolve this issue with a provision under s5(1) that an ARC may acquire an NPL by issuing debentures to the transferring bank. However, that section is not clearly expressed, leaving a doubt as to whether a transaction structured in this way would result in the ARC acquiring title to the NPL.

In the Philippines the transfer of an NPL to an ARC has been exempted from documentary stamp tax.

The realisation by an Indian bank of an NPL and the ultimate resolution strategy adopted by an ARC in respect of that NPL may result in the borrower becoming liable for a taxable capital gain. Given that the effective operation of the

Indian Act will be assisted if all available resolution strategies can be pursued, the Report recommends that this impost be lifted as it might otherwise make rehabilitation of the borrower's affairs an unattractive option for the resolution of its NPLs. Similar relief has been extended in Indonesia, the Philippines and Thailand.

Mention has already been made of the accounting treatment which should be allowed when a loss is crystallised by a bank selling an NPL. The Report recommends that this loss be treated as a trading loss for tax purposes, as is the case in the Philippines. Other recommendations concern:

- gains from the profit made by an ARC on the resolution of an NPL only being brought to account when those gains are realised; and
- bringing all NPLs to account as losses when provision is made for them rather than being limited in any year to 7.5% of the income of the bank for that year.

Relief from capital gains tax on the realisation of NPLs was made available for a limited period in Taipei, China.

3.5 Purchase of NPLs

It is expected, because of the limitation in India on control of an ARC, that third parties will subscribe for security receipts issued in those schemes holding the NPLs in which they wish to have an interest.

As third party investors may acquire NPLs directly from banks, this structure appears cumbersome. However, the ARC structure is attractive as the powers exercisable by such companies may not be available to the original lender. In particular, powers are conferred on ARCs including the powers to:

- [assume] the proper management of the business of the borrower, by change in, or takeover of, the management of the business of the borrower; and
- [effect] the sale or lease of a part or whole of the business of the borrower, s9, Indian Act.

The availability of such powers may give ARCs and, through them, investors, greater flexibility when structuring resolution strategies for particular NPLs.

The desirability of ARCs having special powers to assist with the resolution of NPLs has also been recognised in at least Taipei, China and Thailand.

In Thailand TAMC has been given unprecedented powers to carry out its

operations. It has been allowed to set up limited companies (fully owned or in partnership) to manage NPLs, to guarantee the credit of debtors and to lend money to debtors. This flexibility was provided to facilitate TAMC's operations in the then prevailing legal situation.

In addition, TAMC has been given other special powers while carrying out debt and corporate restructuring to manage NPLs, including:-

- In cases where the debtor or guarantor does not cooperate in the debt restructuring TAMC can petition the court for an absolute receivership of the debtor or guarantor's assets without any investigation. The court and the official receiver may proceed with the bankruptcy process forthwith in accordance with the bankruptcy law.
- The powers granted to TAMC in corporate restructuring appear to be more significant. In cases where the reorganisation plans of the debtor's business are sanctioned by the court, TAMC has the power to appoint a plan administrator. The plan administrator manages the debtor's business and exercises all the powers vested in the debtor's management. The debtor's management has the limited power to monitor the administrator's performance through the appointment of a representative. Further, TAMC can remove the representative if he or she hinders the working of the administrator.
- The administrator has been given the power to increase or reduce capital invested in the debtor's business. Further, he or she can merge the debtor's business or simply transfer security or properties to third parties to facilitate better management. In addition, the power to appoint or remove employees of the debtor.
- If the business restructuring is terminated and the debtor does not agree to the liquidation of its business, TAMC can file a bankruptcy petition and the court shall order the absolute receivership of the assets of both the debtor and any guarantor without a hearing.

The ARCs operating in Taipei, China have been conferred with certain special powers with regard to the resolution of NPLs. ARCs are allowed to use simplified auction procedures to divest NPLs instead of using the complicated and time-consuming court mechanism. The ARCs that have foreclosed a first priority mortgage on collateral are allowed to appoint an independent third party (with the approval of the Ministry of Finance) to conduct a public auction. In cases where the ARC is not a first priority creditor, the

Ministry of Finance can request the court to appoint an independent third party to handle the auction proceedings.

The Taipei,China ARCs are allowed to advise the court when consideration is being given to the debtor's application for reorganisation or bankruptcy and the ARC is also appointed as the reorganisation manager or bankruptcy trustee if it is the largest creditor of the company. This allows an ARC to acquire the NPLs of the company from different banks to make itself the largest creditor in order to exercise this right. The ARC has the power to take over the management of the company if it is appointed as the reorganisation manager and it can exercise all powers available to reorganisation managers under the company law.

If a Taipei,China ARC has been assigned the NPLs or compulsory execution has been initiated before a debtor is declared bankrupt or under reorganisation by the court, it can continue to exercise the claims against the debtor even after it has been declared bankrupt or under reorganisation. In such cases, the ARC is not restricted by the relevant provisions of the Company Law and the Bankruptcy Law.

Finally, just as the revenue laws can limit the effective operation of the NPL market, they might also be used to encourage participation in that market. The Report recommends that the ARC as a trustee for investors in an NPL should not be required to deduct any tax before effecting a distribution to those investors. It

further recommends that, as with investors in Indian infrastructure, the market for NPLs would be enlarged if investors were exempt from tax on gains or profits made on the realisation of NPLs.

Conclusion

If a government wishes to encourage the revitalisation of the financial system in its country, there is a need to provide incentives for both the sale and purchase of NPLs. This includes establishing a sensible environment for the resolution of those NPLs.

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This paper is written in Mr Fisher's capacity as the Chairman of Partners of Blake Dawson Waldron. Whilst, a large part of the materials upon which this paper is based are from a regional technical assistance for which Mr Fisher was an international consultant and legal expert (ADB RETA 3943: Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India) the views expressed in the paper are the views of Mr Fisher and do not represent the views of the ADB.

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