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ASSET RECONSTRUCTION IN INDIA - REGULATION INDUCED MORAL HAZARD

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Abstract: *India has a unique system for resolution of non-performing loans (NPA) of banks and financial institutions in which the banks can sell NPAs to Indian Asset Reconstruction Companies on payment of a part of acquisition cost in cash. The remaining cost is deferred and is payable from amount realized from resolution of the NPAs over a period of upto eight years, without interest, and without recourse to the Asset Reconstruction Company. Thus the deferred part of the asset acquisition cost is akin to quasi equity, and failure of the Asset Reconstruction Company in servicing it does not impact it. As asset manager, anAsset Reconstruction Companyis permitted to charge management fee for the asset resolution on the outstanding value of the acquisition cost, and recovery of the management fee has a priority over recovery of the acquisition cost. This potentially causes asset manager's moral hazard. The seller bank's anxiety to minimize provisions on the NPAs also tends to fuel the asset manager's moral hazard. This paper explains the phenomenon analytically, provides indications of its existence and suggests the way to address this.*

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INTRODUCTION

In 1985, India saw the enactment of the first ever legislation designed to adjudicateNPAs of banks and financial institutions *viz.* Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). SICA was meant to speedily identify the potentially viable accounts and restructure them, and; expedite the liquidation of unviable units through the quasi-judicial body Board of Industrial and Financial Reconstruction (BIFR). The recovery related legislation got a further boost with the enactment of Recovery of Debt Due to Banks and Financial Institutions Act, 1993 (RDDBFI Act) to provide for expeditious adjudication and recovery of dues of the lenders through the Debt Recovery Tribunals (DRT). Owing to the legislative loopholes and poor administration, BIFR and DRTs could not adjudicate the

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lenders' recovery claims efficiently. Hence, the government enactedSecuritisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), under which the lenders can seize specified secured assets from the defaulters directly and liquidate them to recover the dues. SARFAESI Act permitted setting up of Asset Reconstruction Companies (ARCs)to acquire NPAs and aid the banking system in NPA resolution. To maximize NPA acquisition by the ARCs, SARFAESI Act allowed ARCs to pay a regulated minimum percentage of the acquisition cost in cash, and the remaining was deferred, to be paid from the recovery of NPAs under an agreed cash flow waterfall, without recourse to the ARCs. Reserve Bank of India, the regulator provided incentive to the ARCs by allowing management fee at a rate agreed between the NPA sellers, linked to the acquisition cost which was not sacrosanct since there was no certainty in payment of entire deferred part of acquisition cost.

STRESSED ASSET MANAGEMENT WORLD OVER

Hotchkiss, Edith S., John, Kose, Mooradian, Robert M., Thorburn, Karin S. (2008), observe that the UK bankruptcy laws are creditor friendly. About 50% of the companies are sold as going concerns, and over 40% of the companies are liquidated piecemeal. The UK receivership code is fast and gets concluded in less than 1½ years and results in lenders' recovery rate of about 75%. In Sweden, the bankruptcy leads to a mandatory auction by a court-appointed receiver who sells the company in an auction, and the sale proceeds are distributed according to the priority of the claims, and results in approximately 70% recovery of secured debt. In France, the accent is on ensuring continuance of the distressed company's operations for continuance of employment. For this, a formal reorganization process is undertaken through the court and implemented. Yet over 60% distressed companies are eventually liquidated piecemeal (as against 40% in creditor friendly UK and 25% in Sweden).

The credit recovery of approximately 47% is lower than in in UK Sweden. In Germany, the distressed company gets three months to formulate a reorganization plan under court-appointed administrator. The reorganization plan which can include asset/financial restructuring or sale as going concern can be implemented after approval from majority of the creditors. It has been observed that about 57% of distressed German companies are liquidated piecemeal. The average time for the reorganization process is 3.8 years, and banks' average recovery is about 60%.

It is observed that European countries have managed to resolve the NPAs in the normal course without resorting to Asset Management Companies (AMCs)[1], since these countries have efficient legal administration. AMCs for NPA resolution in some of these countries were set up in response to systemic crises resulting in

NPAs, as special purpose vehicles (SPV) with sunset clauses, to be wound up after achieving resolution of distressed assets, except when such AMCs had wider mandate.

INDIAN ARC STRUCTURE

Unlike their counterparts world over, the Indian ARCs are perpetual entities which are supposed to acquire NPAs at a price discovered through competitive bidding. ARCs derive such pricefrom the anticipated cash flow profile and returns required by the ARCs, having regard to the risk profile of the NPA portfolio. The NPA acquisition structure isshown in Figure 1.

The process includes following steps.

- The NPA portfolio purchased by the ARC is held in a revocable trust devised as a pass-through entity,in which income tax does not arise at the trust level, but in the hands of the beneficiaries *i.e.* the SR holders such as ARC, seller bank, and qualified institutional buyers (QIBs) for their respective SR holdings.
- The ARC acts as settlor of the trust and trustee. The asset management and resolution is undertaken by the ARC in terms of the trust deed.
- In case of all-cash NPA purchase by the ARC, SRs of the 100% value are allotted to the ARC. The SRs being tradeable provide trading and risk sharing option to the ARC.
- As asset manager, ARC manages and resolves the assets over a period of time. For asset management, the ARC receives management fee as an agreed % of the value of outstanding SRs during the existence of the trust.

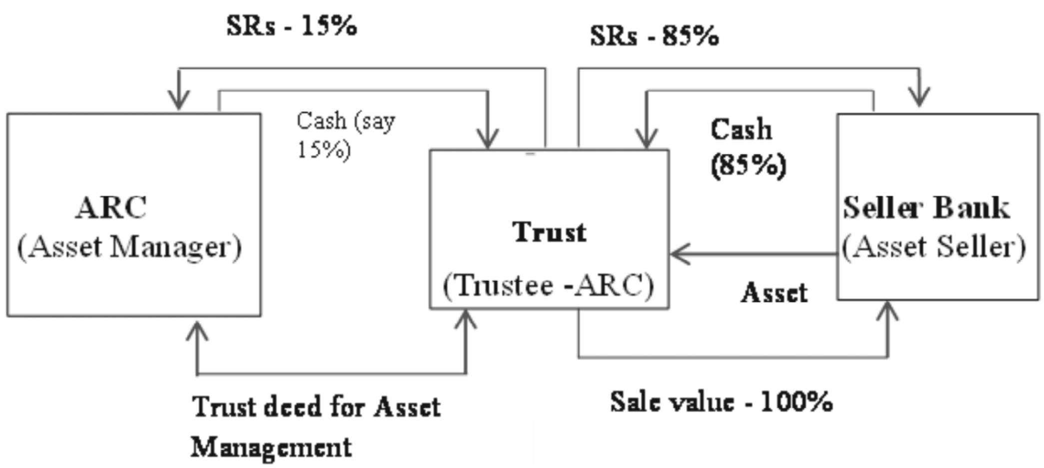

Figure 1: ARC Structure

- The trust is revoked once the asset portfolio is resolved.
- Proceeds from the asset are shared in the agreed waterfall every quarter. The waterfall emanates from the terms of the deal.

The period allowed for the resolution of assets is regulated by the RBI which has permitted a maximum resolution period of 5 years extendable upto 8 years except for accounts which are restructured under Corporate Debt Restructuring scheme, Corrective Action Plan devised by Joint Lenders' Forum, or sanction of restructuring package by the BIFR, where there is no time limit prescribed for the resolution.

UNIQUE FEATURES OF INDIAN ARCS

Apart from being perpetual entities, the Indian ARCs have three unique features.

(a) Unlike the AMCs internationally which were largely funded by the government, the Indian ARCs are funded by private capital. Hence maximization of the shareholders' value is the major objective of the ARCs. This impacts NPA acquisition pricing by the ARCs.

(b) The ARCs can acquire the NPAs with partial cash payment, and issue of quasi equity paper *viz.* SR for the remaining.

(c) SRs being tradeable can potentially result in primary and secondary market for SRs. Evolution of ARC structures which would release high quality SRs with requisite yield is, therefore, critical for the success of India's unique ARC model.

NPA acquisition by part payment of the acquisition value and the remaining value by issue of SRs has been designed to maximize asset acquisition by the ARCs with limited capital. The structure is bankruptcy remote as the SRs are serviced under an agreed cash flow waterfall only from the proceeds of the underlying asset.

CASH FLOW WATERFALL

Recovery from the NPA is deployed for meeting expenses, management fee, redemption of SRs, payment of probable/specified "yield"[2], and thereafter sharing of upside if any between the ARC and other SR holders in an agreed ratio. The probable yield at an agreed rate (generally 8-9% p.a.) is calculated on outstanding SRs per year, and is recognized only if surplus cash is available for distribution. In past, some structures also allowed issue of senior SRs to the ARCs, and specified yield on such senior SRs at a rate of 20-25% p.a. Such specified yield also had priority over the junior SRs subscribed largely by the banks, and probable yield thereon. Senior SRs issued to the ARCs and specified yield induced moral hazard since with such structure, notwithstanding substantial shortfall in recovery and servicing of SRs, the ARCs could earn high returns by virtue of priority in the cash flow waterfall. This led to the regulatory intervention in 2009, when the RBI stipulated ARC's minimum subscription of 5% of the acquisition cost (5:95 structure). In 2014, RBI raised[3] the ARC's minimum subscription further to 15% of the acquisition cost (15:85 structure), and made issue of senior and junior SRs to both the ARC and the seller bank, mandatory. Evolution of the cash flow waterfall is given in the table 1.

Table 1
ARCs – Evolution of Cash Flow Waterfall

Priority	*Component*	*Remark*
1.	Expenses	ARCs provide advances to the trust for meeting expenses. Upon recovery from the asset, ARCs recover expenses along with interest for the period of advance.
2.	Management fee	Management fee is charged on the outstanding value of SRs. With effect from August 5, 2014, RBI has linked payment of management fee to the lower of the range of Net Asset Value (NAV) of the NPA portfolio. The NAV is assigned by Credit Rating Agencies based on the asset classification. This regulation applies to assets acquired after August 4, 2014.
3.	Specified yield	Specified yield is calculated based on agreed % on outstanding SRs of the ARCs. Applicable rates for specified yield were 20-25% per annum. RBI regulation requires that SRs with such specified yield must be subscribed by both the parties *i.e.* the ARC and the seller bank. Specified yield is not prevalent now.
4.	Redemption of senior SRs	RBI regulation requires that senior SRs must be subscribed by both the parties *i.e.* the ARC and the seller bank.
5.	Redemption of junior/pari-passu SRs	Subscribed by ARC, seller banks and QIBs.
6.	Probable yield	Probable yield is calculated based on agreed % on outstanding SRs – junior or pari-passu subscribed by the seller banks and ARCs. Probable yield is not prevalent now.[4]
7.	Recovery incentive	Recovery incentive is paid by the seller bank to the ARC in terms of the contractual arrangement captured in the offer document for sale. At present, the recovery incentive is paid as 3-5% of bank SRs redeemed
8	Upside share	Any surplus remaining is shared in the agreed ratio between the seller bank and ARC. The prevalent ratio is 80:20 between the bank and the ARC.

ARC MORAL HAZARD

The Indian ARC structure is dichotomous. While the acquisition cost for NPAs in all-cash deal is unambiguous and precise, in part-cash deals where the deferred part of the acquisition cost is allowed to be serviced over a period, the acquisition cost is imprecise since there is no certainty of full repayment of the deferred cost which is required to be serviced only from realization of the specific asset portfolio, in terms of cash flow waterfall. While the part-cash acquisition cost does not carry explicit time value since there is no interest payable on the deferred part, it is, however, implied since the part-cash acquisition cost is higher than all-cash cost.

In all-cash acquisition, ARC's net cash flow, which provides return to ARC, is the recovery, net of expenses over the resolution period. Here, the ARC handles risk of recovery from the NPA, and bids for acquisition at a price which is the present value of the anticipated net cash flow, discounted at the ARC's required return, consistent with risk profile of the NPA portfolio. Thus all-cash acquisition presents no ARC moral hazard.

In part-cash acquisition, ARC first recovers expenses along with interest[5], management, fee, and other priority entitlements if any, after which the SRs are redeemed pari-passu among all the SR holders. Any cash remaining after 100% SR redemption constitutes "upside" which is shared between the seller bank[6] and ARC in agreed ratio[7]. Thus ARC's net operating cash flow comprises interest on the advance for expenses, management fee, other entitlements if any, and upside share. Since the management fee is charged on the outstanding value of SRs, over a period, the management fee can constitute substantial part of the ARC's cash flow and compensate for shortfall if any on SR redemption, and yet provide required return to the ARC. Such a scenario can induce ARC moral hazard where the ARC may manage the cash flows to maximize management fee and thus returns to it, at the cost of the NPA selling bank. Other priority entitlements such as specified yield on SRs held by the ARCs, and priority redemption of ARC's senior SRs can induce further moral hazard.

15:85 STRUCTURE

RBI regulations do not permit priority entitlements to only one participant. Thus all the senior and junior SRs have to be held by both the seller bank as well as the ARC, with ARC holding 15% of each type of SR. RBI has stipulated minimum SR holding by ARCs at 15% of the acquisition cost, the underlying assumption being that the banks would seek management fee at the prevalent 1.5% of the outstanding SRs. Value of SRs to which the management fee can be linked has beenstipulated

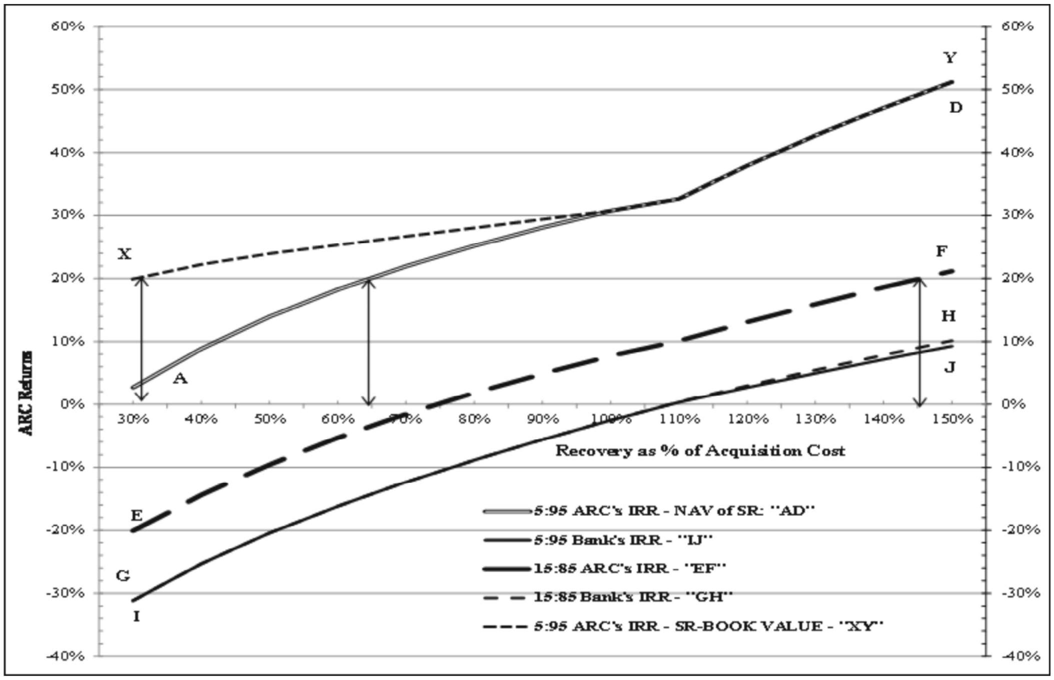

Figure 2: Returns to ARC under 5:95 structure with management fee linked to book value and NAV of SRs, and under prevalent 15:85 structure

as the lower band of the net asset value (NAV) emerging from credit rating of SRs by the credit rating agencies.The 15:85 structure is based on the assumption that that ARC's higherSR subscription would prevent the management fee from becoming the dominant part of ARC'scash flow.

The structure has been analyzed with the aid of financial model to test whether the minimum 15% SR subscription by ARCs translates to anticipated increase in ARC's cash contribution, and thus limits dominant share of management fee in the ARC cash flow, a condition necessary to minimize the ARC moral hazard.Assumptions underlying the model are given in the Appendix. Figure-1 shows returns to an ARC over a 5-year horizon under

(i) erstwhile 5:95 structure with management fee linked to book value of SRs,

(ii) erstwhile 5:95 structure with management fee linked to NAV of SRs as is applicable now, and;

(iii) 15:95 structure with management fee linked to NAV of SRs.

Assuming that the ARC's required return is 20%, the graph yields parameters as shown in the table below.

Table 2
Recovery and Bid Price needed for 20% return to ARC

	5:95: Mgmt fee linked to book value of SR	5:95: Mgmt fee linked NAV of SR	15:85: Mgmt fee linked NAV of SR
Recovery as % of NPA acquisition cost needed for 20% return	32%	64%	146%
Bid price for achieving 20% return ARC's investment	312.50 15.63	156.25 7.81	68.49 10.27

The analysis reveals that the revised guidelines lead to lower investment[8] by ARCs of Rs. 10.27 crore under the 15:85 structure with management fee linked to the NAV of the SRs, than that of Rs. 15.63 crore under the erstwhile 5:95 structure with management fee linked to book value of SRs. This is logical since required

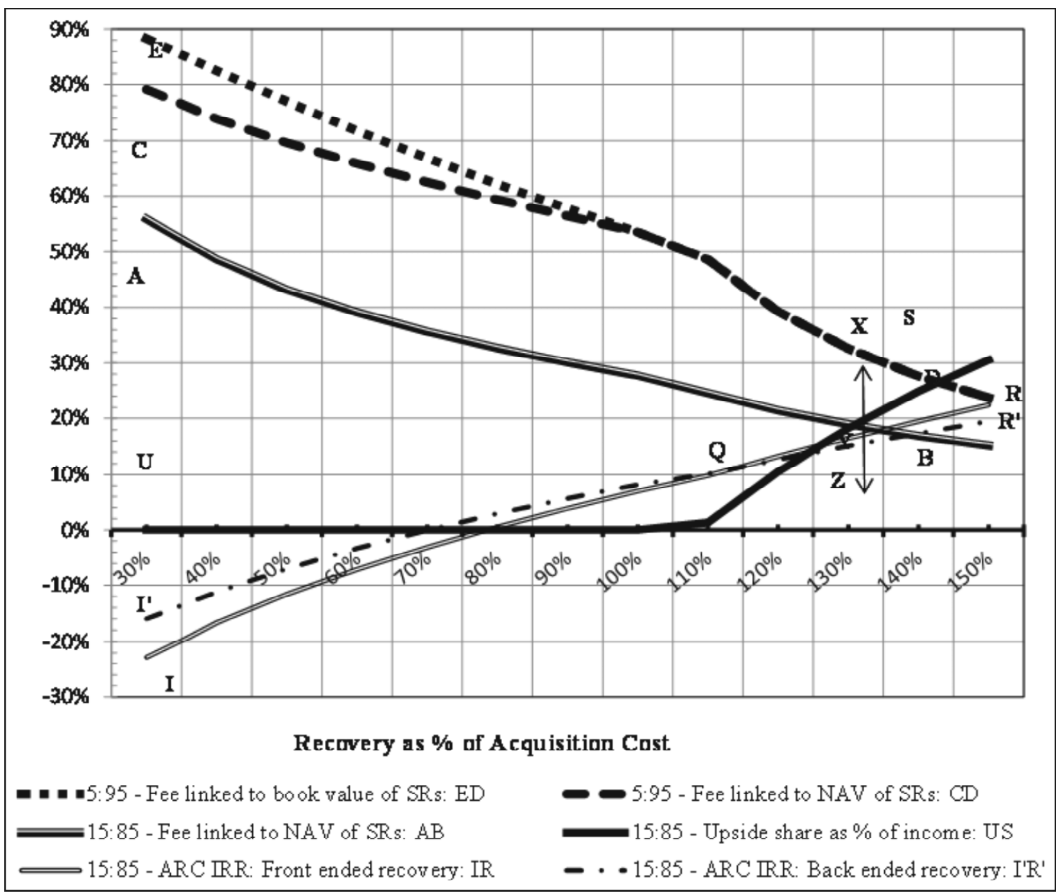

Figure 3: ARC's IRR and Management fee as % of ARC's total cash inflow

recovery of 146% of the acquisition cost ensures lower (and realistic)bid value in15:85 structure than in erstwhile 5:95 structure where anticipated return at 32% recovery induces highly aggressive bidding. In both 5:95 structure and 15:85 structure, the acquisition cost discovered give to the bank almost identical return as is evident from congruence of the curves "GH" and "IJ".

Figure 3 shows the ARC's IRR and management fee as percentage of total ARC cash flow. The line "XY" in the figure shows that for the required 20% return to the ARC under 15:85 structure, the following parameters emerge.

- Recovery as % of acquisition cost is 146% as mentioned in figure-1 and table-2 above.
- Management fee as % of total cash flow of ARC is approximately 16% ("Y"), and;
- Upside income as % of the total cash flow of ARC is also approximately 26% ("X")
- At approximately 115% recovery and above, the front ended recovery profile results in higher return to the ARC.

ARC can evenly spread the management fee to its benefit in case of sub-optimal recovery in which the back-ended (ballooning) recovery profile aids in maximizing the management fee and enhance recovery of the ARC. However, as seen in figure 2, (point "Q"), at approximately 110% recovery (with full SR redemption), the front-ended recovery results in maximum return to the ARC *vis-à-vis* back-ended recovery). Hence relatively efficient bid pricing under 15:85 structure with a management fee of 1.5%, which results in acceptable return to the ARC aided by 100% SR redemption and upside earning eradicates the ARC moral hazard since in such scenario, the ARC must expedite and adopt front-ended recovery. In other words, any ratio of SR sharing between the ARC and the bank which entails full SR redemption for the ARC to earn the required return eradicates ARC moral hazard.This implies that ARC's higher bid valuation induced by higher management fee and recovery incentive, and resultant sub-optimal recovery creates moral hazard since the management fee aids in enhancing returns to ARC, who can adopt structures[9] to expedite and maximize management fee.

BANK INDUCED MORAL HAZARD

The NPA selling bank can garner higher bid price by enhancing the ARC cash flow. During financial year ended March 31, 2016, the banks have offered aggressive management fee along with recovery incentives for redemption of SRs. In March 2015, Bank of Maharashtra offered management fee of 2% pa for the first three years, and 2.5% pa for the next five years, and recovery incentive as percentage of SR redemption of 10%, 7.5%, 5%, and nil for first, second, third, and fourth year onwards. Fee and incentive structure adopted by State Bank of India has emerged as industry standard and involves management fee of 2% pa for the entire resolution period of 8 years[10], and recovery incentive of 5%, 5%, 4%, 4%, 3%, and nil for first, second, third, fourth, fifth and sixth year onwards.

Higher management fee and recovery incentive enhances ARC's cash flow and induces higher bid price. Enhancement of ARC bid value by prevailing fee and incentive structure helps the seller bank to avoid or reduce immediate provisioning[11], and postpone it for the later years. Thus if the banks tend to adopt structures aimed at maximizing ARC bids, the structure induces ARC moral hazard. This in turn induces the bank moral hazard as Akiko Terada-Hagiwara and Gloria Pasadilla (2004) have observed, since the banks can avoid strenuous corrective actions and continue with lax ways.

SUMMARY AND CONCLUDING REMARKS

India's SR structure is innovative as it aids NPA acquisition by ARCs based on low part cash and major deferred payment. Since the deferred part is akin to quasi-equity, it can lead to maximization of NPA acquisition by ARCs. Linking of management fee to 100% outstanding SR values induced ARC moral hazard when the income from management fee constituted major part of the ARC's earnings, as in the case of 5:95 structure, since in such cases the ARCs could spread recoveries to expedite and enhance management fee at the cost of NPA selling banks. The 15:85 structure with management fee of 1.5% pa induces fairly efficient price discovery, and entails 100% SR redemption along with upside share for the ARC to realise the required return. Recovery beyond 100% SR redemption maximizes the ARC return when the recovery is front-ended. Hence such a structure potentially eradicates ARC moral hazard.

Under 15:85 structure, the banks' anxiety to maximize bid value by the ARC is leading to offer of higher management fee than 1.5% prevalent so far, with incentive on SR redemption. Such structures tend to yield for the ARC, required return with sub-optimal recovery, and resultant moral hazard. It is matter of time before the regulator will control the management fee.

Notes

1. Internationally, the entities created for NPA resolution are called Asset Management Companies (AMCs), while these are called Asset Reconstruction Companies (ARCs) in India. Both AMCs and ARCs are used interchangeably.
2. "Yield" at an agreed % per annum on outstanding SRs is akin to interest, but serviceable only if there is surplus cash available after meeting expenses and management fee. While

the "Probable" yield is pari-passu among all SR holders, the "Specified" yield is senior to SRs of the seller bank. Inclusion of yield in ARC structures is no more prevalent.

3. Through RBI circular of August 5, 2014, minimum SR subscription by ARCs was raised to 15%
4. Probable yield results in higher payouts to the seller banks who are major SR holders. This reduces cash flow to the ARC and reduces ARC valuation. Since the banks want higher valuation, they have stopped including probable yield in the offer documents
5. ARCs provide advance to the trust for meeting expenses. Out of the recovery from NPA, ARCs recover such advance along with interest for the period of advance. The rate of interest is generally 12% pa.
6. SRs sold by the seller bank to other approved agencies are treated pari-passu with seller banks holdings.
7. Generally the upside is shared between the seller bank and ARC in the ratio 80:20. The upside share is a contractual matter between the seller bank and the ARC.
8. Lower ARC's investment in 15:85 structure than in 5:95 structure can lead to higher acquisition with the same capital.
9. This can be done through "restructuring" of the NPA by the ARC for regular payments from which management fee can be recovered regularly
10. RBI has allowed maximum resolution period of 8 years except for NPAs under restructuring under BIFR, Corporate Debt Restructuring, and Joint Lenders Forum, where no time limit has been stipulated.
11. In terms of Income Recognition and Asset Classification norms of RBI, the NPAs require minimum provisioning of 15% in the first year, upto 40% in three years, and 100% in four years.

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APPENDIX

Assumptions Underlying Financial Model

1. RBI permits resolution period of 5 years extendable up to 8 years. Resolution period of realistic 5 years has been taken.
2. Yearly recovery has been assumed to be back-ended (ballooning) as has been the experience, starting from 5% in the first year, 10% in the second year, 15% in the third year, 25% fourth year, and 40% in the fifth year.
3. Resolution cost has been taken at 3% of the acquisition cost spread evenly during the resolution period. This is consistent with general experience for moderate sixe portfolios.
4. Resolution cost is assumed to be recovered from recovery along with interest at the rate of 12% pa for the relevant period, in line with the industry practice.
5. Service tax along with relevant cess has been taken at the prevailing rate of 15%.
6. Three scenarios of yearly recovery have been worked out as under:
   (a) Straight line recovery in which the yearly recovery is assumed to be received in equal quarterly installments.
   (b) Front-ended recovery in which the yearly recovery is assumed to be made in the first quarter.
   (c) Back-ended recovery in which the yearly recovery is assumed to be made in the last quarter.
7. Quarterly appropriation of recovery has been taken in terms of cash flow waterfall in the terms of the industry practice.
8. The management fee has been linked to the NAV from the third year. The NAV is the face value as % of the recovery assumed. For example, where the returns for the portfolio with total recovery of 30% is taken, the NAV is 30% of the face value of SRs (acquisition cost) from third year. This is consistent with the time lag which characterizes accurate estimation of the recovery prospects and credit rating downgrade.