

ARCs - at the crossroads of making a paradigm shift

July 2016



Foreword

Before the introduction of the Insolvency and Bankruptcy Code, the chances of turning around stressed assets and insolvent businesses principally hinged on the ability of the existing 15 asset reconstruction companies (ARCs). However, the number of ARCs has been inadequate vis-à-vis the need. These ARCs typically have low capital base and their methodology towards addressing needs of troubled companies has an overt financial focus. The average recovery rate for ARCs in India has been around 30% of the principal and the average time taken has been anything between four to five years.

However, that scenario is about to change. In the Union Budget 2016-17, 100% foreign direct investment (FDI) has been allowed for ARCs, which is expected to substantially improve their capital base. Moreover, the introduction of the Bankruptcy Code has now positioned ARCs as a very important intermediary between lenders and borrowers. To make the regulation of ARCs more effective, it has also been proposed to provide more powers to the Reserve Bank of India (RBI) in terms of audit and inspection, appointments to Boards, imposition of penalty for non-compliance and regulating fees charged by ARCs. To what extent these steps can improve the transparency in the functioning of ARCs remains to be seen.

There are a few more issues which need to be sorted out:

- ▶ **Cap on maximum shareholding** – With the maximum shareholding of a single entity within an ARC capped at 49%, there is a lack of drive and effective responsibility in the management of the ARC.
- ▶ **Deemed promoter status** – Professionals such as bankers, lawyers, chartered accountants, etc., who join ARCs usually expect ESOPs as a major mode of compensation. Since any person with more than 9% shareholding in an ARC is designated a “deemed promoter” by the RBI, this actually deters professionals from joining ARCs because of the responsibility associated with the “promoter” status. This only increases the cost of functioning of ARCs.
- ▶ **Need for business management expertise** – ARCs’ methodology usually focus on how much of the remaining value of the distressed company can be recovered and hardly anything is done towards resolving the problems emanating from improper management.

The timing of ASSOCHAM’s 2nd Summit on asset reconstruction companies could not have been better. I am very happy to note that ASSOCHAM, in partnership with EY and India Ratings & Research, has prepared this knowledge paper, which captures the status of the ARCs in India and the road forward. I hope more detailed discussions and deliberations take place at the event on the issues covered in this report so that the suggestions and recommendations emanating from these can enhance the level of efficiency of the functioning of ARCs in India. I wish the ARC Summit a grand success.

Thank You,

Sunil Kanoria
President
ASSOCHAM



Foreword

This second annual conference of ARCs (ARCON) is being held at a very appropriate time, with the financial markets and governmental and regulatory bodies being acutely concerned about the increasing volume of stressed assets in the banking sector. Serious debate has been taking place on this subject at the highest level to evolve lasting solutions to this issue. The government has already demonstrated its resolve to tackle the problem by enacting the Bankruptcy and Insolvency Code and introducing major amendments in the Parliament to the SARFAESI Act and the Debt Recovery Act. Although much work remains to be done to operationalize the Bankruptcy Code and reap the benefits, the very fact that such work is in progress augurs well for the financial sector.

Meanwhile the role that ARCs have played in cleaning up the system in a little more than a decade of their existence has also been a matter of debate, with a general feeling that ARCs are yet to rise to their full potential. One widely held view is that little has been done by ARCs in the area of rehabilitating and turning around sick but potentially viable companies. It is rather difficult to contradict this view, because available information shows that successful turnarounds supported by ARCs have been few and far between. Although there are specific reasons therefor. For the rest of the time, the ARCs have been busy enforcing recoveries through legal and quasi legal means.

This scenario is set to change shortly, for more reasons than one. On one hand, substantial improvements are on the anvil, as pointed out above, in the legal infrastructure that will encourage revival of accounts. On the other hand, with recent liberalization of investment norms, foreign investors with expertise in turning around companies and at the same time, which have adequate financial muscle are now keen on investing in this sector. The governmental and regulatory initiatives will also encourage domestic investors to pump in more funds into this sector.

Our knowledge partners for this annual conference have prepared very comprehensive and thought provoking reports on this occasion. These reports, along with the discussions during the conference should help us evolve objective strategies for the further evolution of the ARC sector.

I thank the knowledge partners for their valuable contribution and convey my best wishes for the success of the conference.

Thank you,

Birendra Kumar

Chairman,

Association of ARCs in India and Chairman

ASSOCHAM National Council on Asset Reconstruction



Foreword

Indian banks are suffering from stressed assets and incurred considerable losses due to mounting bad loans. The RBI has already stipulated a deadline of March 2017 for the full clean-up of bank balance sheets.

Banks hoped to overcome their bad loans problem through sale to ARCs. For the last few years the ARCs have been playing a vital role to resolve the bad-loan problems. ARCs focus on NPAs allow the banking system to act as a “clean bank” to improve their performance and profitability.

The role of ARCs in addressing the Indian banks' systems stressed assets problems has become more important. However, certain regulatory and operational issues still need to be sorted out.

In this backdrop, ASSOCHAM -Association of ARCs with support of EY and India Ratings & Research, have come out with this knowledge paper with the objective to contemplate the issues and challenges being faced by various stakeholders of the Indian financial system and suggest measures that can be taken to optimize their contribution thereto.

We hope that this study will help the regulators, market participants, government departments and other research scholars.

Thank you,

D.S Rawat
Secretary General
ASSOCHAM



Foreword

The distressed assets situation in India has gradually worsened over the past few years. The stressed loans issue in banks has resulted from a combination of factors including a) undercapitalised projects; b) continued focus on expansion by optimistic promoters who believed that India is decoupled from global trends; c) undercapitalised banks leading to delayed recognition of stressed situations and a consequent debt trap; and d) policy paralysis.

Consequently, bad loans (NPAs + restructured loans) at Indian banks have jumped to ~INR8 trillion representing ~11.5% of gross advances as of March 2016, and things are likely to get worse. This follows an official review in the last quarter of FY2016 by Reserve Bank of India, when India's banking regulator started a bank-by-bank review of stressed accounts as part of an asset quality review (AQR). For all the past few years of growth and reform, banks in India have continued rolling over troubled loans or restructured them, thus deferring the problem at hand. In view of this, Indian banks needed immediate and systemic approaches to ensure sustained recoveries and bring about a turnaround.

Most current slippages pertain to restructured assets that had a moratorium period of 2 years with respect to the repayment of principal. We expect the trend of failed cases coming out of moratorium to continue. Banks have three options: (a) immediately provide for these accounts by recognizing them as NPAs, or (2) put them through another round of restructuring under the Strategic Debt Restructuring (SDR) or 5:25 schemes or the more recently introduced Scheme for Sustainable Structuring of Stressed Assets (S4A), or (3) sell the accounts off to asset reconstruction companies (ARCs) at a discount, thereby providing for a loss. Of the three options, accounts involving large sums are increasingly being restructured either under SDR or 5:25 refinancing.

However, we expect the landscape to change. The recent changes proposed in the Union Budget 2016-17 allowing for 100% foreign direct investment in the ARC space will bring in the much needed capital for ARCs and provide a fillip to the industry. On the back of these developments, ARCs are at a crossroad to make a paradigm shift in their approach and functioning - from asset resolution vehicles to a platform for revival of large businesses by bringing in operational capabilities.

As a global thought leader in the turnaround and restructuring of stressed assets, EY has always been at the forefront in assisting stressed and distressed borrowers, creditors and policy makers. This report aims to outline the current status of the stressed asset market in India, key challenges faced by ARCs, a perspective of the accounting and taxation considerations and puts forth a few strong suggestions and recommendations that could help develop meaningful exit options for lenders and improve liquidity in the market for stressed assets. It also brings to the forefront, the new Bankruptcy Law which could help transform the stressed assets landscape in India, if implemented in the right spirit.

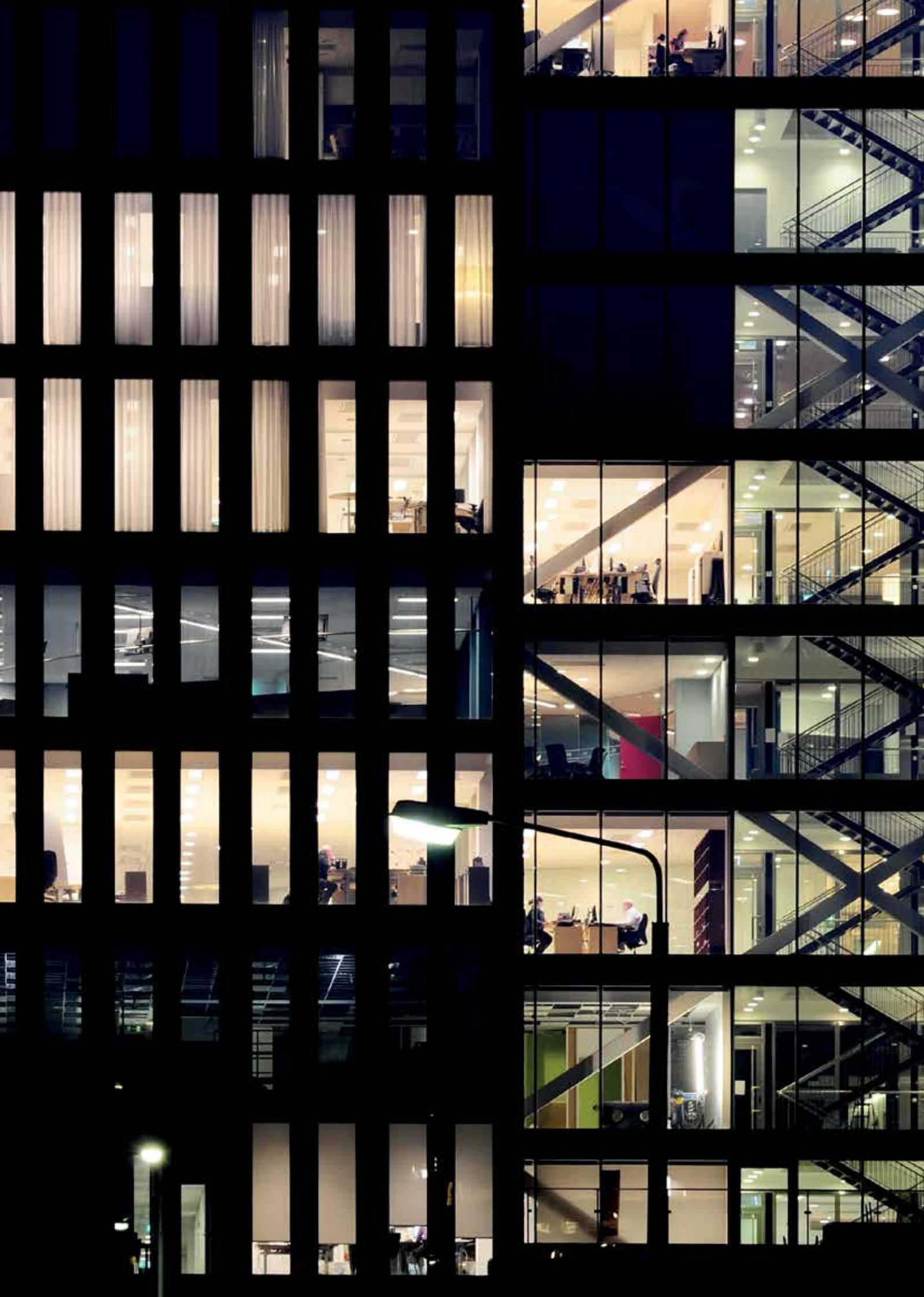
We hope this report will be of value to anyone with an interest in the stressed assets market and also to the decision makers who can genuinely influence a reversal in recent trends. The extent of success of turnaround will also depend on a mutual trust amongst promoters, borrowers and external stakeholders for the genuine revival of companies. As a firm, we remain committed to further developing the knowledge in this field through its wide experience in revitalizing stressed assets.

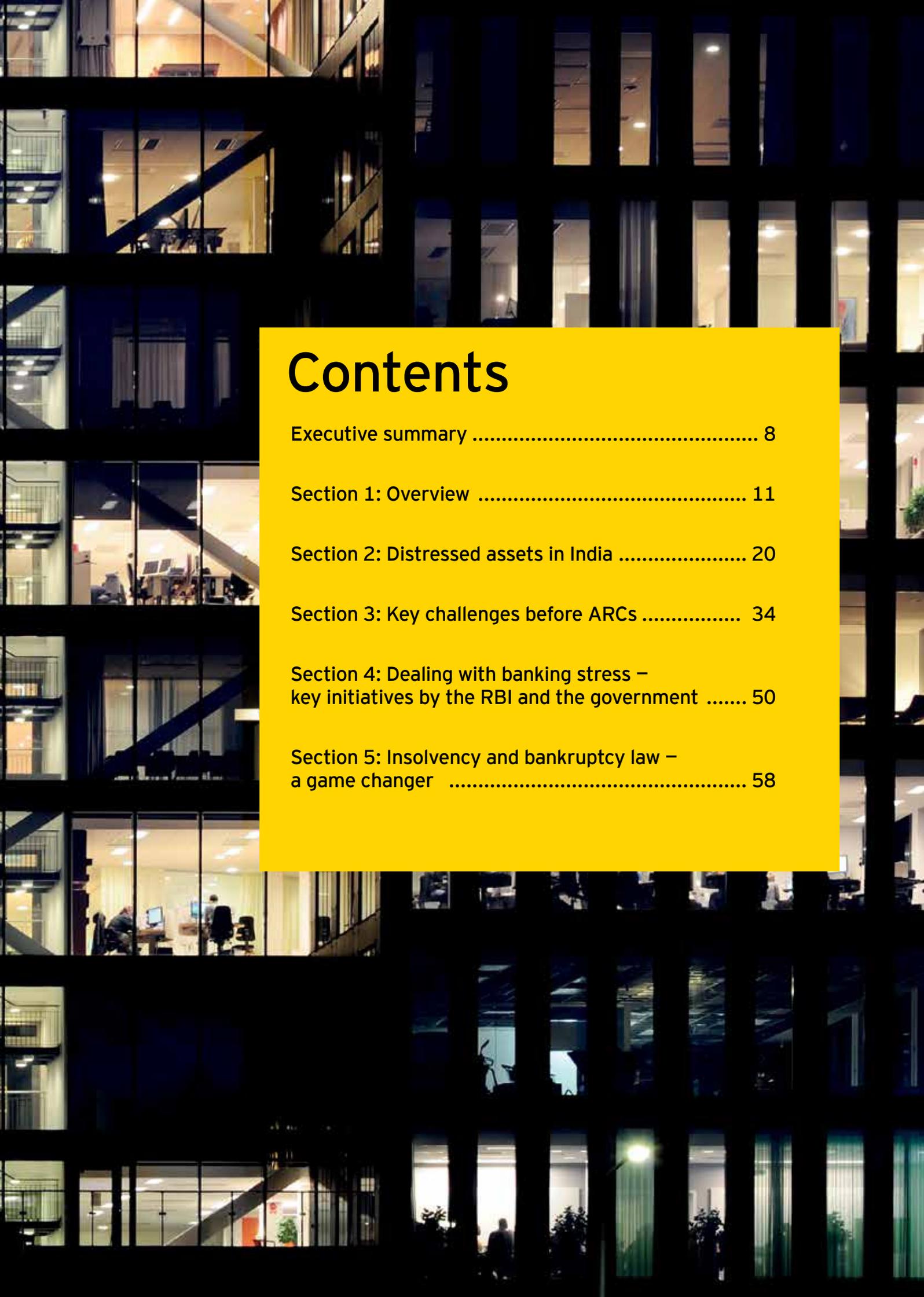
Thank you,

Abizer Diwanji

Partner & National Leader - Financial Services

EY





Contents

Executive summary	8
Section 1: Overview	11
Section 2: Distressed assets in India	20
Section 3: Key challenges before ARCs	34
Section 4: Dealing with banking stress – key initiatives by the RBI and the government	50
Section 5: Insolvency and bankruptcy law – a game changer	58

Executive summary



In the last few years, as the Indian economy registered a downturn, the banks have been straddled with high levels of stressed loans. Macro-economic dynamics have been a major contributor; however, inadequate credit assessments and monitoring are also partially responsible for this situation. Things are not likely to reverse very soon - this follows an official review during the quarter ended March 2016 by the (RBI), when India's banking regulator started a bank-by-bank review of stressed accounts as part of an asset quality review (AQR) - broadly on the lines of stress tests conducted by the US and European authorities after the global financial crisis.

Reviewing the trend of growth in the number of stressed loans, about 30% are from the infrastructure sector - with a significant portion emanating from the power sector. A large proportion of these loans are to government controlled power generation and distribution companies. Operational inefficiencies (technical and commercial), lack of adequate availability of cheaper domestic coal and inability to pass on the increased costs to consumers have impacted these companies adversely. In addition, there are certain issues that are discussed later in the report, which are specific to iron and steel, textiles, aviation and mining - sectors that, along with infrastructure, contribute to over half of the total stressed loans.

On the current distressed asset situation, the RBI Governor shares, "There are two polar approaches to loan stress. One is to apply band aids to keep the loan current, and hope that time and growth will set the project back on track. Sometimes this works. But most of the time, the low growth that precipitated the stress persists. The fresh lending intended to keep the original loan current grows. Facing large and potentially unpayable debt, the promoter loses interest, does little to fix existing problems, and the project goes into further losses. An alternative approach is to try to put the stressed project back on track rather than simply applying band aids. This may require deep surgery. Existing loans may have to be written down because of the changed circumstances since they were sanctioned. If loans are written down, the promoter brings in more equity, and other stakeholders chip in, the project may have a strong chance of revival, and the promoter will be incentivized to try his utmost to put it back on track."

Traditionally, banks have preferred to restructure the debt of stressed borrowers through the corporate debt restructuring (CDR) mechanism or the joint lenders forum (JLF). While the CDR mechanism was used extensively, the objective seems to have been to provide temporary relief to the borrower rather than making active efforts to revive businesses. CDRs have

met with limited success in reviving stressed assets due to poor evaluation of business viability and lack of effective monitoring. These "living dead" companies limp along, just about servicing their debts but with no hope of recovery or growth. In effect, banks have continued rolling over troubled loans or restructured them, thus postponing the problem at hand.

Initially, the system of selling NPAs to ARCs was popular - certain banks offloaded big chunks of stressed loans to ARCs via the security receipts route. However, in the past few years with a change in acquisition norms (upfront cash component increased from 5% to 15%), this option has not been exercised by the banks due to the expectation gap in the pricing of security receipts (SRs). While banks use discount rates in the range of 10% to 15% given their access to cheap capital in the form of public deposits, ARCs use much higher discount rates of 20% to 25%, as their cost of funds is relatively higher than that of banks. Without realistic valuation guidelines, there is no incentive for ARCs to participate in auctions as the reserve price tends to be high. As a result, banks are forced to continue holding these positions until most of their value has deteriorated, resulting in larger losses.

Poor performance of ARCs in resolution of the stressed loans has also affected the industry in two ways - first, the overall deals between ARCs and banks have reduced considerably; second, more banks prefer cash sale to SRs. In view of this, exit through sale of stressed loans to ARCs has been largely underutilized. With the exception of FY14/early FY15, wherein the banks resorted to mass sale of NPAs to ARCs, the overall ARC scenario has been subdued since then.

Until FY15, the RBI and the government had largely stayed away from devising a mechanism that will enable the banks/lenders to play a direct role in the turnaround of stressed borrowers. However, the strategic debt restructuring (SDR) introduced by the RBI in June 2015 and the Insolvency and Bankruptcy Code, 2016 (the Code) passed by both Houses of the Indian Parliament are significant actions that empower banks to deal with stressed situations rationally. Having said this, our analysis of the SDR cases suggests that this scheme is in no way a magic wand for addressing the Indian banks' deteriorating asset quality - instead it could bring in a high risk into the system by deferring ~INR 1.25 trillion of NPA formation to later years. We also estimate the haircut in case of an SDR exit to be high, resulting in higher provisions for banks even if the SDR is successful.

More recently, with a view to encourage alternative sources of capital, the Union Budget 2016-17 has increased the ceiling on foreign investment in ARCs to 100% (the same is subject to an amendment of the SARFAESI Act), that could provide the much needed fillip to the industry. Distressed asset funds have traditionally been wary of this market due to legal and regulatory issues. However, with the overhaul of the legal framework in the country, this scenario appears to be changing, with the investment by a Hong Kong based distressed and special situations fund in one of the ARCs in the third quarter of FY15. Further, a leading global investment PE firm is in the process of acquiring majority ownership in another ARC in a multi-stage transaction. In our estimate, there are at least 6-8 players that have applied for a license to RBI to operate as an ARC.

The distressed assets space in India is gaining traction on the back of a conducive environment. The regulator and the government have been constantly working on encouraging alternative sources of capital to come into the market, which is a step in the right direction. In order to further strengthen the lenders' ability to deal with stressed assets in an efficient manner and to put good operational companies back on track by providing an avenue for reworking the financial structure of entities facing genuine difficulties, the regulator has issued guidelines on a 'Scheme for Sustainable Structuring of Stressed Assets'. The new restructuring window allows lenders to bifurcate the debt of stressed borrowers into sustainable and unsustainable portions.

Going forward, we see ARCs participating in the revival of large borrowers that have a good turnaround potential by adopting this strategy. We expect to see a massive shift in the resolution mindset of ARCs - from merely liquidating assets to recover their dues to participating in the long term revival of borrowers by estimating sustainable debts and carving out core operational businesses from the non-core assets. However, to make this successful in the long run, it could be the most opportune time for ARCs to place greater emphasis on revival and strengthen capabilities around restructuring and reconstruction. While few ARCs are looking to build up operational skill-sets, others are looking to partner with credible turnaround professional firms with a view to bring in sectoral expertise.

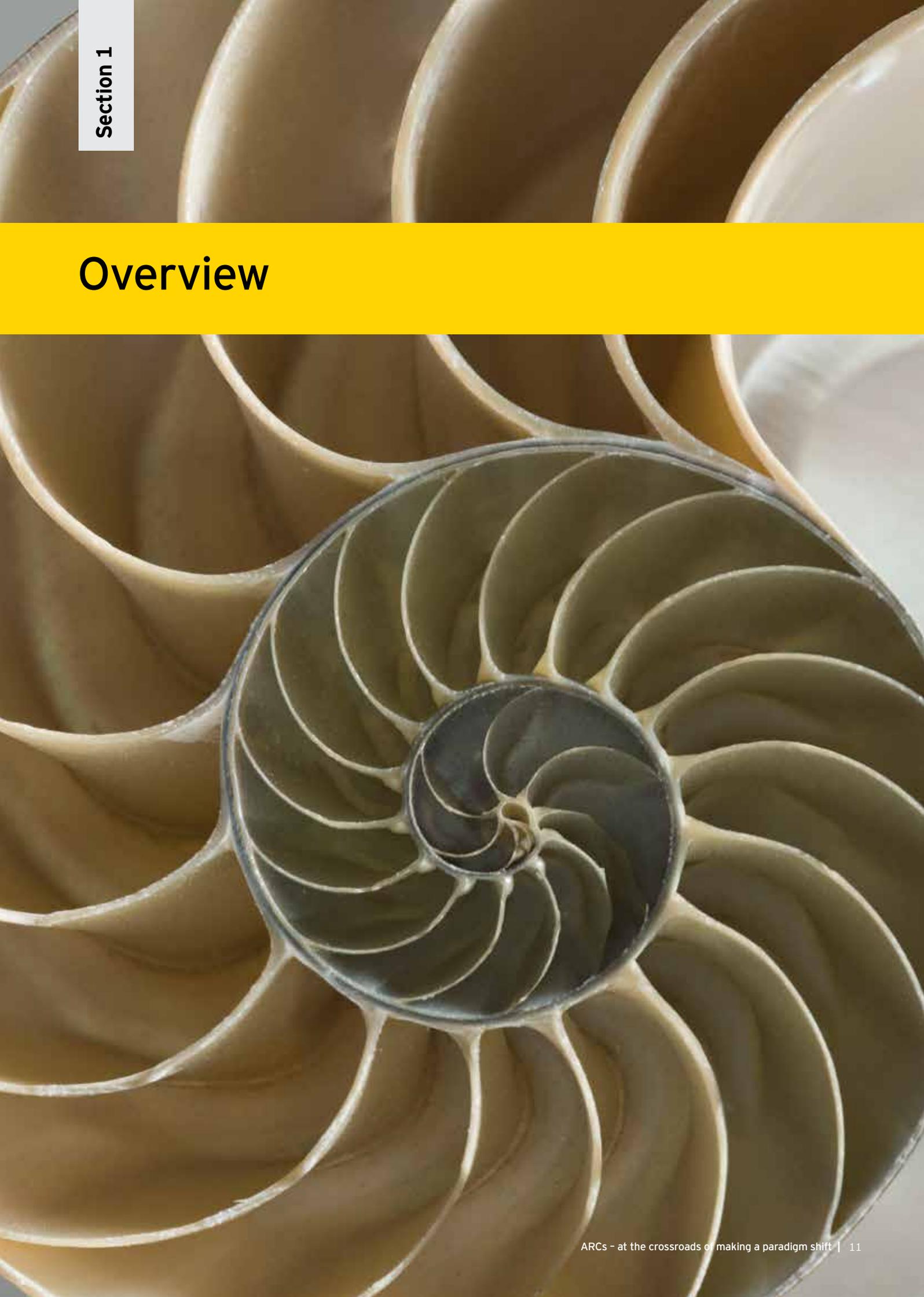
Further, in our view, ARCs should be brought on par with the banking system and be allowed to hold majority equity so as to have an alignment of interest. The success in sustained revival would lie in - ARCs aggregating a minimum of 75% aggregate debt from banks - convert part of the unsustainable debt into equity or other instrument - followed by induction of risk capital towards scaling up of operations/last mile funding. This would go a long way in providing the much needed stimulus to the industry.

The two main impediments to successful and timely resolution that we see on the ground are common decision making between lenders and a timely resolution. Aggregation of debt either in an ARC or for decision making takes over a year as respective Boards have to approve the same. The RBI/Ministry of Finance/government could work on two potential solutions:

- ▶ As discussed in Gyan Sangam (a yearly retreat for banks and financial institutions), all exposures over say INR5 billion needs to be aggregated in the top 5 bankers with all others selling their exposures under guarantee to these top bankers. This way decision making is restricted to five banks and the smaller exposures go with the larger majority.
- ▶ Banks do not believe their actions will not be judged at every stage. Given that they may be questioned on using discretion or innovation is a key impediment to constructive and quick decision making. It may be worthwhile considering forming an aggregating agency which will accumulate debts and then auction the same out based on bids by ARCs and special situation funds. The pricing would be based on commercial discovery and the aggregating agency would then pass on that pricing to the respective banks.

India has taken the bad debt issue very seriously. The RBI has unequivocally directed banks to "clean up" their balance sheets by March 2017 while empowering them with many tools to deal with the situation in the process. The Government has responded with a clear intent to bring about a bankruptcy law that will facilitate the revival and closure of businesses in a timely manner. With these initiatives being implemented in the right spirit, it would be important for ARCs to now transform themselves into turnaround funds with deep operational capabilities to bring about a long-term revival in business value of stressed companies.

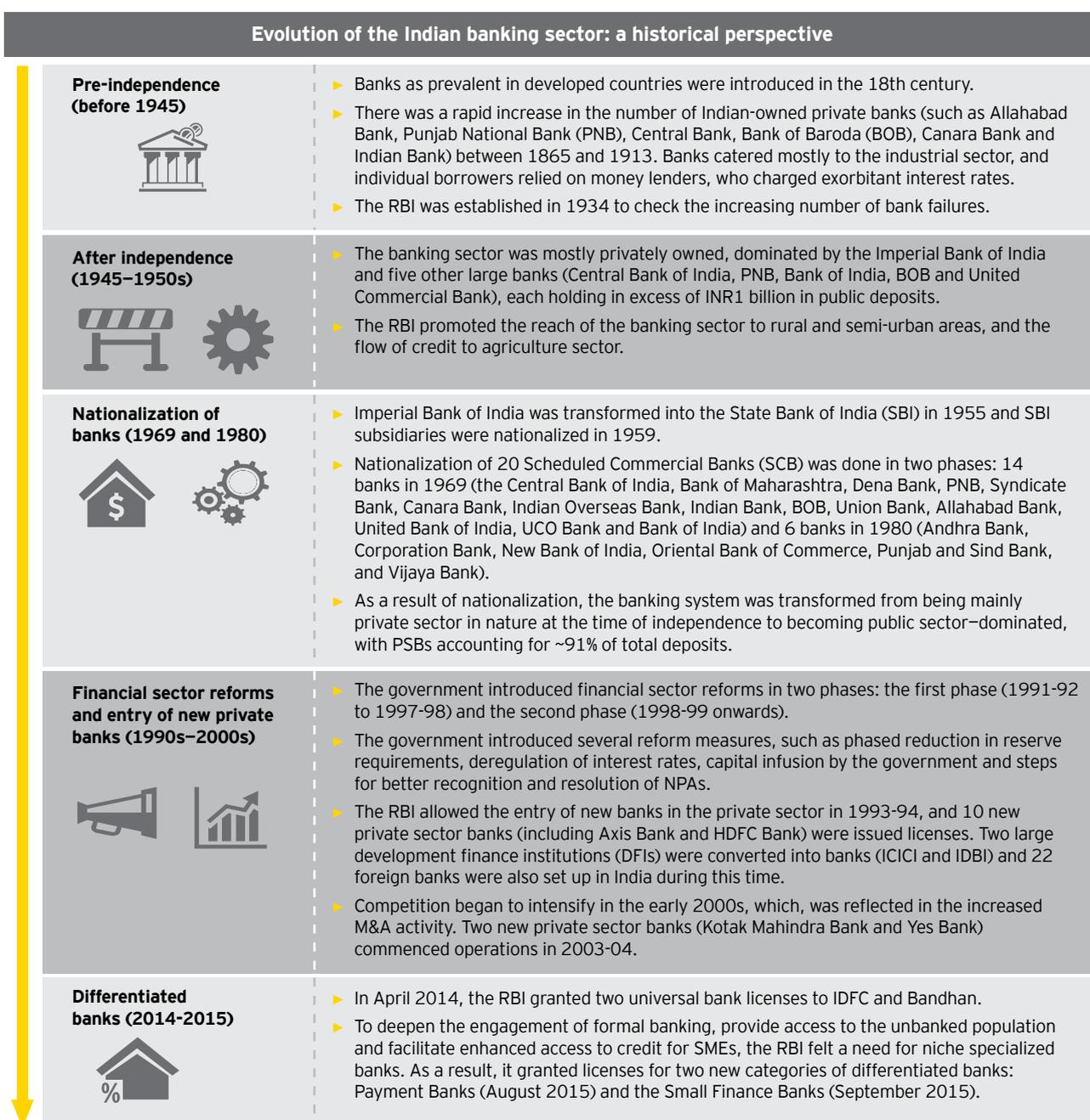
Overview



To appreciate the underlying system and issues around distressed debt resolution, we need to understand the evolution of the existing banking framework in India right from its genesis. These legacy and cultural issues significantly impact the source of distress and its potential resolution strategies.

I. Evolution of the Indian banking sector

a) Key phases in the development of banking sector in India

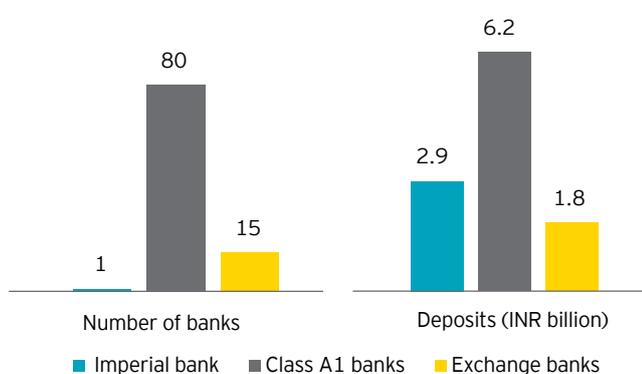


Source: RBI Evolution of Banking in India; "New bank licenses | The contenders", Mint, 24 May 2013; "23 new banking licenses granted under RBI Governor", Business Standard, 17 September 2015

b) India since independence – a socialist economy¹

At the time of independence, the Indian banking sector was relatively small, weak and concentrated in urban areas. The sector mainly consisted of private banks, which were largely localized and prone to failures. Increasing number of bank failures not only caused financial hardship to a lot of depositors, but also undermined the confidence in the banking system.

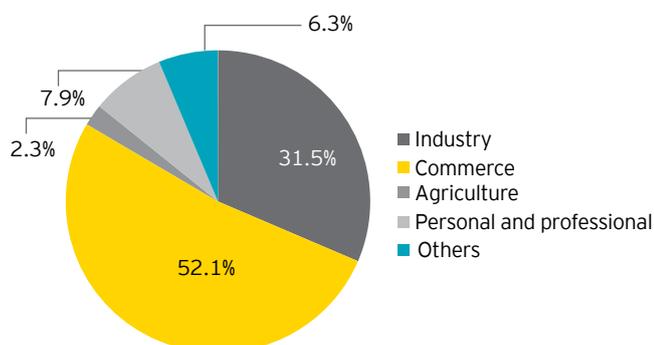
Indian banking sector at the time of independence: SCBs in 1947



Source: RBI Evolution of Banking in India. Note: Class A1 were banks with capital and reserves greater than INR0.5m; Exchange banks were foreign owned banks that engaged mainly in foreign exchange business.

Also at the time of independence, significant amount of bank credit was directed at the commerce and industry sector. As on March 1950, only 2.3% of the total bank credit of INR4.98 billion went to the agricultural sector. This was despite the fact that agriculture constituted about 55% of GDP in 1950. The total borrowings of farmers were estimated at INR7.5 billion.

Share in total bank credit (as on March 1950)



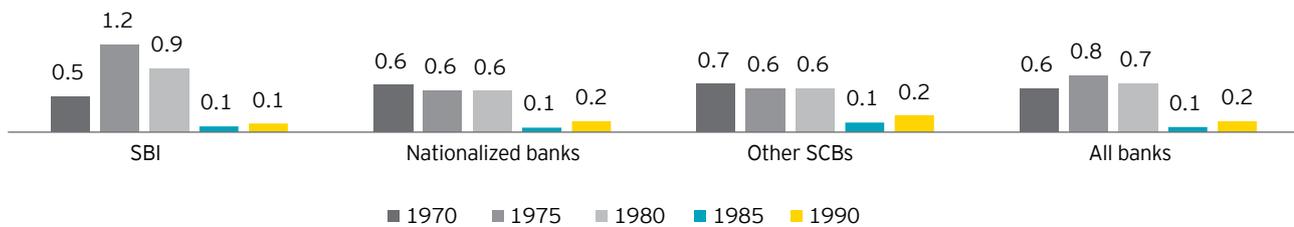
Source: RBI Evolution of Banking in India

1 RBI Evolution of Banking in India
2 RBI Evolution of Banking in India

The transformation of the Imperial Bank of India into the SBI in 1955 and its subsequent massive expansion (opening of 416 branches in unbanked centers within five years) spread institutional credit into the unbanked and underbanked regions. Moreover, proactive measures such as credit guarantee and deposit insurance promoted credit and savings habits in rural areas. The number of branches increased significantly from 4,061 in 1952 to 6,985 in 1967. However, the share of agricultural credit remained low at only 2.2%, in sharp contrast to the share of industry in total bank credit, which almost doubled from 31.5% in 1950 to 64.3% in 1967.

Era of social banking and nationalization: The government instilled the need to channel credit to certain priority sectors by imposing social control on banks (1967) followed by the nationalization of banks (in 1969 and 1980). The main objectives of social control were to achieve a wider spread of bank credit by directing a larger volume of credit flow to priority sectors, prevent misuse of bank credit and make bank credit a more effective instrument of economic development. The banking system underwent major structural transformation after nationalization. Specific emphasis was laid on making banking facilities available in the then unbanked areas and there was a considerable reorientation of bank lending to accelerate the process of development, especially of the priority sectors of the economy, which had not previously received sufficient attention from commercial banks. Public sector banks were directed by the RBI to ensure that their priority sector lending reached a level of at least one-third of outstanding credit by March 1979, and private sector banks were also required to do so by March 1980. Subsequently, the target was enhanced to 40% of aggregate advances. The share of SCB's advances to agriculture increased from 2.2% in March 1968 to 15.8% in June 1989. During this period there was also rapid branch expansion – the branch network of commercial banks increased from 8,187 in June 1969 to 13,756 in December 1990 – and the share of unorganized credit fell sharply. However, administered interest rates and the burden of directed lending, which also led to a surge in NPAs, constrained the banking sector significantly. Commercial banks had very little operational flexibility, and suffered from poor governance and low levels of profitability. The return on assets (RoA) of banks declined sharply between 1975 and 1985².

Trend in return on assets (%)



Source: RBI Evolution of Banking in India

c) Opening up of the Indian economy

Financial sector reforms: The financial reform process of the 1990s was undertaken with the prime objective of having a strong and resilient banking system. At the start of 1990s, banks were reeling under the dual problem of low profitability and rising non-performing assets, given years of social control and high level of low yielding reserve requirements (cash reserve ratio at 15% and statutory liquidity ratio at 38.5%). Several reform measures were introduced, such as:

- ▶ Phased reduction in reserve requirements.
- ▶ Deregulation of interest rates,

- ▶ Capital infusion by the government.
- ▶ Steps for better recognition and resolution of non-performing assets.

To encourage a more competitive environment in the banking sector, the RBI decided to allow the entry of new private sector banks and liberalize branch licensing for foreign banks. New generation private sector banks entered the economy in two phases³:

Phase 1: first round of licenses (1993–94)	Phase 2: second round of licenses (2003–04)
<ul style="list-style-type: none"> ▶ Capital requirement was fixed at INR1 billion ▶ 10 private banks were issued licenses in 1993–94; they were mostly greenfield banks ▶ Competition intensified in the banking sector with the transformation of two large development finance institutions (DFIs) into banks 	<ul style="list-style-type: none"> ▶ Initial capital requirement for new banks of INR2 billion was raised to INR3 billion in three years ▶ In 2003–04, two more private banks were issued licenses; they benefited from strong legacy support ▶ During 2000–08, the banking sector witnessed a surge in mergers and acquisitions; as a result, of the 12 banks given licenses only 7 banks survive now

Following this period, competition in the banking sector intensified. The new private sector banks predominantly adopted the “Universal Banking” model and entered into

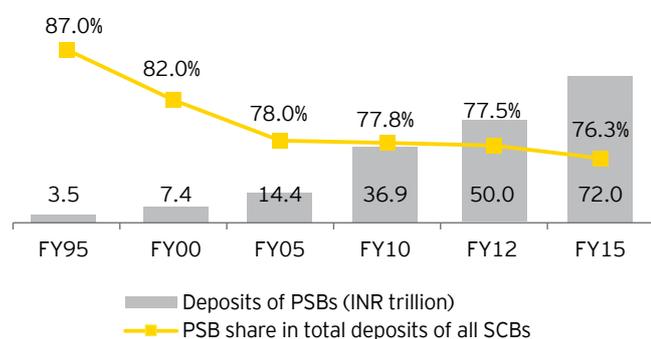
various segments of the financial sector through subsidiaries to take advantage of the severe under-penetration and augment the share of non-fund based revenue streams.

3 “New bank licenses | The contenders”, Mint, 24 May 2013

While the dominance of Public Sector Banks (PSBs) banks continues ...

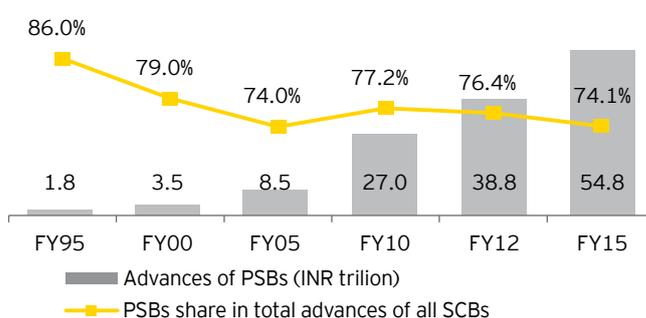
PSBs still continue to account for a significant portion of the banking sector business, holding more than 70% of advances as well as deposits. However, they are burdened by high asset quality stress and has recorded subdued growth in credit as well as deposits, which has resulted in a decline in the market share of PSBs.

Trend in deposits of public sector banks



Source: RBI Database of Indian Economy

Trend in advances of public sector banks

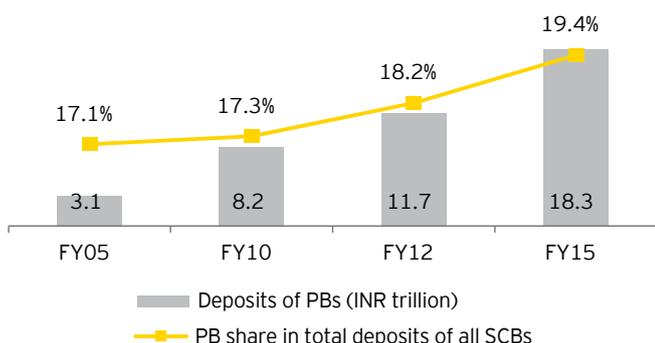


Source: RBI Database of Indian Economy

... the market share of private banks is steadily increasing

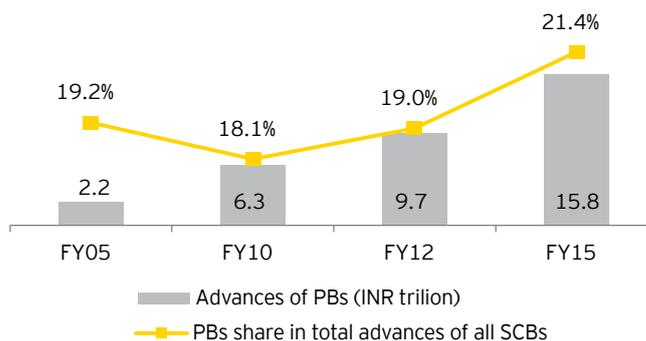
While PSBs still dominate the Indian banking system, private sector banks have outperformed in terms of business growth, asset quality and efficiency parameters. The market share of private banks has increased significantly in the past decade.

Trend in deposits of private banks



Source: RBI Database of Indian Economy

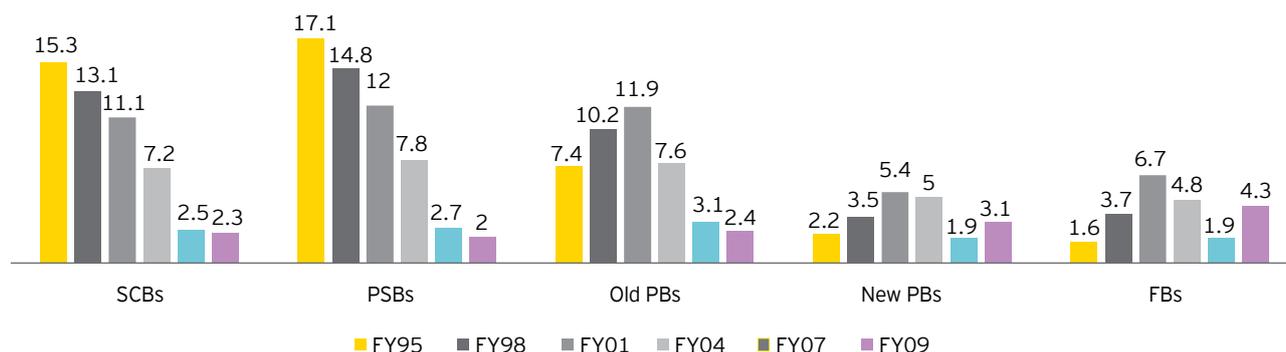
Trend in advances of private banks



Source: RBI Database of Indian Economy

After the economy opened up, there was a consistent decline in NPAs across bank groups, except the new private banks (established after 1993) and the foreign banks segment (which gained traction during the mid-1990s), from mid-1990s to FY09.

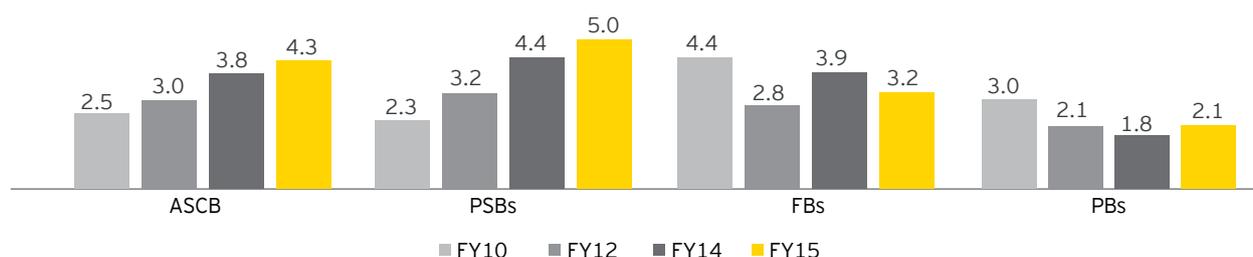
Trend in gross NPAs (%) across bank groups FY95-FY09



Source: RBI Financial Stability Report

In 2008–2009, the global financial crisis shook banking sectors worldwide. Although the Indian banking sector remained largely insulated from the severe impact of the crisis, macroeconomic conditions deteriorated in India leading to asset-quality stress for the banking sector from 2010 onwards.

Trend in gross NPAs (%) across bank groups FY10-15



Source: RBI Financial Stability Report

d) Rise of bank financing in India

During the mid-1990s, following the liberalization of the banking sector in India and the licensing of new private banks by the RBI, two major development finance institutions (DFIs), which were mainly involved in financing large projects, particularly infrastructure projects, converted into commercial banks.

Case study on DFI conversion into banks: The trend of DFIs converting into banks, which started post liberalization, continues.

At the end of the 1990s, besides banks, development financial institutions (DFIs) were also plagued by high levels of bad loans mainly due to the post-1997 economic slowdown and the East Asian crisis. Moreover, post liberalization these institutions no longer had access to low-cost-long-term funds from the government. This paved the way for DFIs transitioning into banks. In 2002, ICICI Ltd, the project finance institution that promoted ICICI Bank, was merged with the bank as the parent found it difficult to survive without access to cheap funds. IDBI also followed the same route and merged with IDBI Bank in 2004. On transitioning to a bank, DFIs benefited from several advantages such as ability to diversify into full range of financial service offerings as well as diversify loan portfolio, capitalize on fee revenues by offering fee based products to corporate as well as retail clients and build low cost CASA deposit base which would bring down cost of funds. Recently, in April 2014, RBI granted a banking license to IDFC, a DFI with a special focus on infrastructure financing and IDFC Bank started operations in October 2015. Recently, post RBI's issuance of draft guidelines on-tap banking licenses, industry experts believe there may be a reverse merger of IDFC with IDFC Bank in the near future⁴.

After DFIs converted into banks, the role of commercial banks as the key providers of project financing became critical, especially as a developing country like India lacked availability of other funding channels, such as a well-developed corporate bond market. During 1995–2007, senior debt accounted for 68% of project financing on average. Of the senior debt, approximately 70% was provided by commercial banks, four-fifths of which was provided by PSBs⁵.

With the increase in the proportion of banks' financing to large corporate projects, the RBI put in place single and group borrower exposure limits. Earlier banks could lend up to 25% of total capital to a single lender and 55% to a group lender. Under the revised guidelines, the large exposure limit has been brought down to 40% (which could go up to 50% for infrastructure exposure). The limits on a bank's exposure to a particular corporate or business group in India are well in excess of global limits. As per international standards, large exposure limits of 25% is considered as a good practice. According to Basel III standards, a 'large exposure' is defined as the sum of all exposures of a bank to a counterparty or to a group of connected counterparties. Lenient exposure limits may have led to increased risk to the banking system. For instance, the stress scenario given by the RBI indicates that the failure of a large corporate group could result in a total loss of over 60% of the banking system's capital (when the loss given default is 100%).⁶

Consortium lending: The rise of consortium lending in India in 2012 was mainly driven by PSBs, facing concerns in the asset

quality, seeking risk diversification in their loan portfolios. It was also a result of the failure of multiple lending, wherein a borrower would avail finance independently from more than one bank. In consortium lending, lenders would come together to give a loan to a corporate on the same terms, with each taking a fixed share. Most banks dubbed entering consortium lending as a means of ensuring credit discipline. Moreover, PSBs considered it safer to join a consortium as the onus of credit appraisal would fall on the lead bank⁷.

However, high value loans have gone bad in spite of large banks being part of consortiums. Moreover, the process of consortium lending has resulted in the creation of certain roadblocks in the revival of stressed assets. There are several execution difficulties, such as challenges in building consensus among creditors and lack of adequate legal rights/infrastructure. There is a lack of cohesiveness among consortium lenders, which impedes the recovery process. Banks also differ in terms of their approach and internal policies with respect to addressing stressed accounts. Moreover, banks with smaller exposure hold out for better deals. Some consortium creditors also do not want to sell to ARCs, which delays the stressed asset resolution process⁸. Notably, the disbursement of stressed advances of banks to asset reconstruction companies has commenced at a slow pace. As of March 2015, total distressed assets of banks amounted to INR7.7 trillion, of which only loans worth INR1.89 trillion had been sold off to ARCs⁹.

4 "IDFC Bank, parent merger on card", Business Standard, 7 May 2016; "In fact: When financial institutions evolved into banks," The Indian Express, 23 December 2015; "New bank licences | The contenders", Mint, 24 May 2013

5 "In fact: When financial institutions evolved into banks", The Indian Express, 23 December 2015; "Financing the boom in public-private partnerships in Indian infrastructure", Gridlines, December 2008

6 "Bank loan over-exposure to corporate groups may cause systemic collapse: RBI report", The Economic Times, 31 December 2013

7 "RBI for limiting lenders in consortium", The Times of India, 16 September 2015

8 "RBI Governor meets banks, ARCs and PE firms to accelerate bad loan sales", Mint, 31 July 2015; "Insolvency resolution in India plagued by wide range of problems: report", The Hindu, 22 November 2015

9 "Money from Junk", Business Today, 2 August 2015

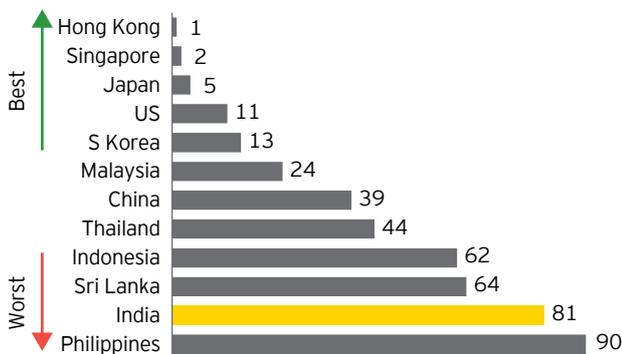
II. Increased credit offtake required to fund key sectors

Going forward, infrastructure financing and SME lending would be future loan growth drivers for the Indian banking sector as these two sectors have significant funding requirements. However, both these sectors, particularly infrastructure, are plagued by asset quality issues.

a) Infrastructure

India was ranked 81st out of 140 countries for its infrastructure in the World Economic Forum's Global Competitiveness Report 2015–2016. The country has been a laggard in infrastructure, especially in major infra sectors such as power and roads. Hence, financing infrastructure remains a top priority as improvement in infrastructure competitiveness remains crucial for India's growth.

Global competitive ranking on infrastructure

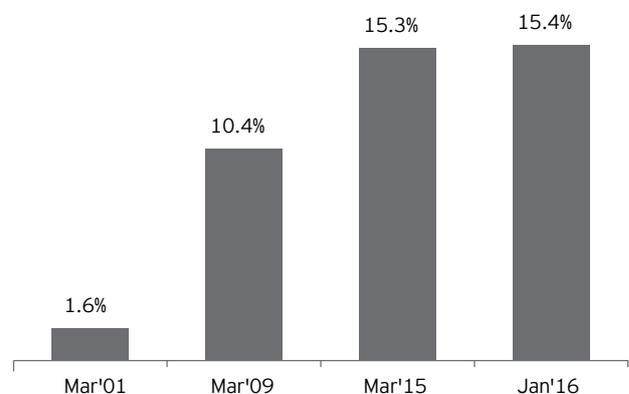


Source: World Economic Forum, Competitiveness Rankings 2015-16

Contribution of banks to infrastructure financing has steadily increased: Indian banks have played a pivotal role in providing finance to the infrastructure sector despite severe asset quality issues plaguing the sector. The outstanding bank credit to the infrastructure sector, which stood at INR95 billion in FY01, increased steadily to INR10 trillion in FY15, a CAGR of 40%, which is significantly higher than the overall bank credit. The share of bank finance to infrastructure in gross bank credit increased from 1.6% in FY01 to 15.3% in FY15¹⁰. In infrastructure financing, banks have played a strong role

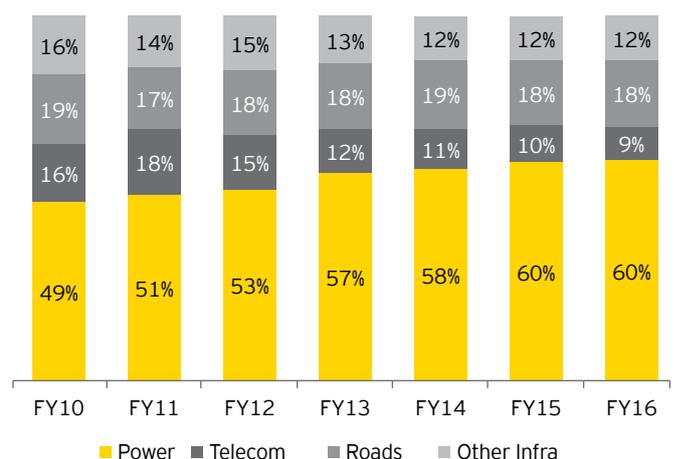
especially in sectors such as power and roads. The power sector accounts for more than 60% of total infrastructure loans of Indian banks, while in other sectors such as railways, ports and water infrastructure, banks have had a limited role. These sectors have largely been supported by state and center budgets and external commercial borrowings (ECBs) (especially the telecom sector).

Infrastructure credit as a percentage of total non-food credit



Source: RBI Database of Indian Economy, Infrastructure Financing By Banks In India: Myths and Realities", Dr. K.C. Chakrabarty, Deputy Governor, Reserve Bank of India at the Annual Infrastructure Finance Conclave, 9 Aug 2013

Mix of bank credit to infrastructure



Source: RBI Database of Indian Economy, Infrastructure Financing By Banks In India: Myths and Realities", Dr. K.C. Chakrabarty, Deputy Governor, Reserve Bank of India at the Annual Infrastructure Finance Conclave, 9 Aug 2013

¹⁰ Infrastructure Financing By Banks In India: Myths and Realities", Dr. K.C. Chakrabarty, Deputy Governor, Reserve Bank of India at the Annual Infrastructure Finance Conclave , 9 Aug 2013

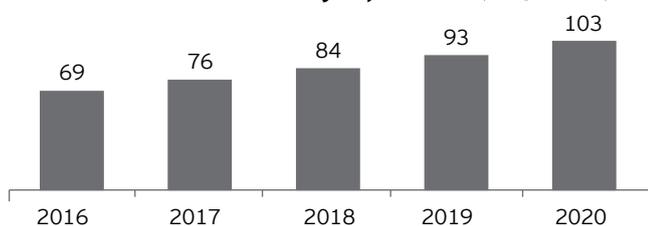
However, banks face many challenges in providing infrastructure financing

- ▶ **Asset Liability Management (ALM) mismatch:** Infrastructure loans generally have an average duration of 10–12 years, while the funding of banks in Indian is largely deposits-driven with average duration of 3–4 years. This duration mismatch has led to ALM challenges for banks in funding infrastructure projects.
- ▶ **Long gestation period:** Infrastructure projects have long gestation periods and they encounter many legal and procedural issues (such as land acquisition and environmental clearance) besides planning and execution issues. Moreover, the uncertainty due to these factors affects the risk appetite of lenders to extend funds for the development of infrastructure.
- ▶ **Elevated stress in the infrastructure portfolio:** The infrastructure sector suffers from weak balance sheets. With high exposure to this sector, the chances of having elevated levels of NPAs are also very high. Stalling of projects because of regulatory and policy issues, and cost and time overruns have increased stress in the infra loan book of banks. Stressed assets (gross NPA + restructured) in the infrastructure sector has increased considerably, from ~5% in FY10 to ~23% by June 2015¹¹. Moreover, the power sector, which accounts for ~60% of total infrastructure credit given by banks, is one of the most stressed sectors, suffering from asset quality issues due to bankruptcy of state electricity boards. Consequently, banks have slowed down infrastructure funding. Credit growth for the infrastructure sector declined from a high of 19.1% in June 2013 to 8.4% in December 2015.
- ▶ **RBI's proposal to cut exposure limits:** The RBI, to comply with the BASEL framework, has suggested that all exposures, individual as well as group, be capped at 25% of the Tier I capital (currently it is 40% for group exposure and 15% for individual borrower). Given the huge capital outlay of infrastructure projects, such a cap could act as an impediment to finance infrastructure projects.

Banks to play a critical role in funding infrastructure: India needs investment of ~US\$0.5 trillion over the next five years to fund its infrastructure needs. Given the government's fiscal constraints, funding infrastructure of such magnitude remains a challenge. Therefore, besides budget support, other sources of funds such as bank credit (including NBFCs), external borrowing, market bond borrowing and equity support from

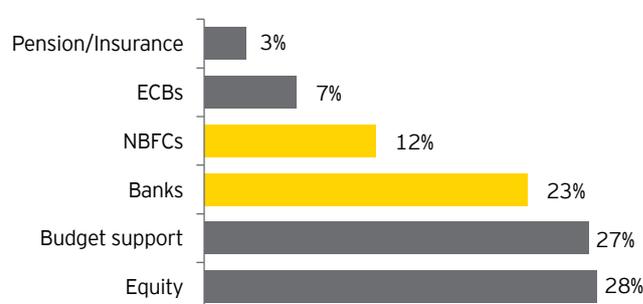
private sector will remain important. Among these sources, bank credit will continue to play a dominant role. As per the 12th Five Year Plan, bank credit (including NBFCs) will have to pitch in nearly 35% of total funding requirement. A weak corporate bond market and lack of depth in the insurance/pension market in India make the role of banks in infrastructure funding more prominent.

India's infrastructure funding requirement (US\$ billion)



Source: BMI, 12th Five year plan, EY Analysis

Sources to fund India's infrastructure



Source: BMI, 12th Five year plan, EY Analysis

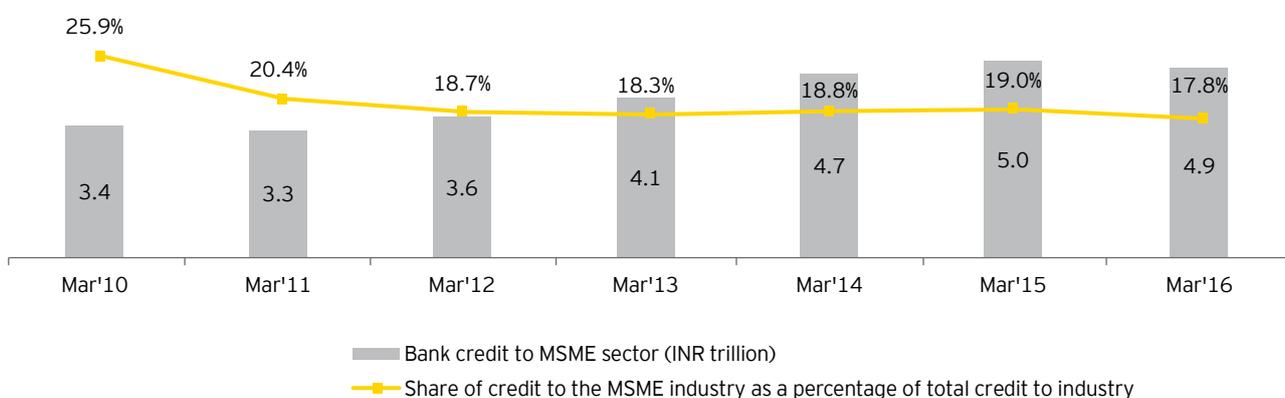
11 Financing for Infrastructure: Current Issues & Emerging Challenges, Shri Harun R Khan, Deputy Governor, RBI, 12 Aug 2015; "Infrastructure slowdown: Credit off-take continues on downward spiral; road sector the only silver lining", The Indian Express, 17 February 2016

b) MSME lending

Bank credit to the micro, small and medium enterprises (MSME) has increased moderately, at a CAGR of 6.2% from INR3.4 trillion in March 2010 to INR4.9 trillion in March 2016. Low capital levels, asset quality stress and defaults from mid-sized lenders have made banks reluctant to sanction loans to

entrepreneurs belonging to the MSME sector¹². Moreover, the relatively stronger ratings of larger companies allow banks to continue lending to them, while cutting back on lending to smaller firms. Hence, the share of credit to the MSME sector as a percentage of gross bank credit to industry declined from ~26% in March 2010 to ~18% in March 2016.

Bank credit to the MSME sector



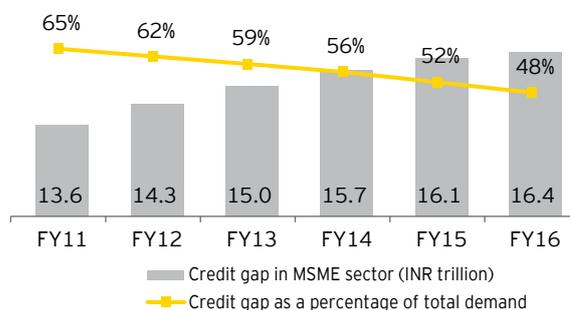
Source: BMI, 12th Five year plan, EY Analysis

Undercapitalized MSME sector holds huge potential for banks

There is a huge mismatch between the demand and supply of credit to the MSME sector: According to the 12th Five Year Plan, credit gap as a percentage of total demand was estimated at 56% in FY14 for the MSME sector. In absolute terms, this gap is of INR16 trillion, which is 25% of total banking credit. In the absence of alternate source of funding for the sector, the role of banks is very crucial in bridging this funding gap.

Government initiatives, such as Make in India, Skill India Mission, Digital India and Start-Up India will provide a strong push to the sector. As such, there will be a strong need for strong banking credit growth to the MSME sector.

Credit gap



Source: "Credit Scoring - An effective way to ensure availability of timely and adequate credit to Micro and Small Enterprises (MSEs)", Keynote address by Dr. K. C. Chakrabarty, DG, RBI, 4 Dec 2013

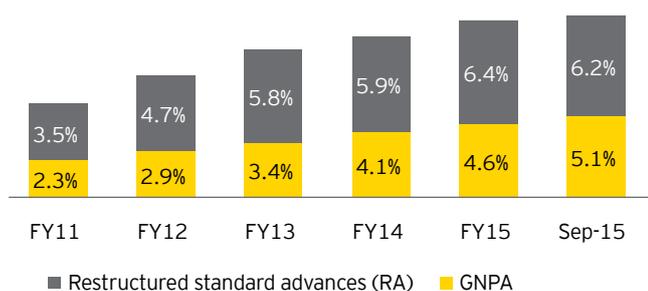
12 "Banks reluctant to lend to MSME sector: Mishra", Business Standard, 19 November 2014; "Banks squeeze out mid-size companies as bad loans rise", Mint, 16 November 2015

Distressed assets in India – an overview



The problem of stressed assets in the Indian banking sector has significantly worsened in the recent years. Consequently, the risk landscape for the banks in India has undergone a major change. The overall level of stressed assets has almost doubled in the last five financial years. Gross non-performing assets (NPAs) as a percentage of gross advances surged from 2.3% in FY11 to 5.1% in September 2015. Also, overall stressed advances (including restructured standard advances) increased from 5.8% in FY11 to 11.3% as on September 2015. The total banking credit outstanding as on 30 September 2015 was INR67.38 trillion, of which the stressed assets (Gross Non-Performing Asset (GNPA) + Restructured Advances (RA) size was INR7.6 trillion (11.3% of total).

Stressed assets as a percentage of total advances



Source: RBI Financial Stability report

According to the industry estimates, gross NPAs for Indian banks are expected to rise to 5.9% of total advances for FY16¹³. The biggest contributor to the pool of gross NPA is state-owned-banks where the stressed asset ratio is significantly high.

Elevated levels of NPAs, coupled with weak capital positions have dented overall credit growth of the Indian banking system. In the current scenario, it is imperative for banks to clean up their balance sheets and support lending to the productive sectors as the investment cycle revives in the Indian economy.

Asset quality review in India

During the past few years, the Indian banking sector suffered tremendous asset quality stress in its loan portfolio as a number of large projects ran into difficulties mainly on account of poor project evaluation, extensive project delays, poor monitoring and cost overruns creating pressure on borrowers to repay loans. Public sector banks, severely impacted by high levels of bad loans, witnessed a slowdown in credit growth. Non-food credit, industrial credit and lending to agriculture grew only by 6.6%, 3.3% and 10.4% for PSBs while private sector banks recorded a 20.2% growth in non-food credit, 14.6% industrial credit growth and 25.4% increase in lending to agriculture in calendar year 2015¹⁴. RBI prescribed several remedial measures for the banking sector to deal with stressed assets, including effective ways to reduce the project's financial stress such as the JLF, the SDR mechanism (entailing debt-for-equity swap by banks and management change in companies), and the 5/25 mechanism (whereby long-term project loans, mainly to infrastructure and core industries sectors, with tenure of up to 25 years are refinanced every five years). To assess how the various bad loan management schemes were working and to ensure banks were taking proactive steps to clean up their balance sheets, the central bank initiated an Asset Quality Review (AQR). The AQR exercise is a part of RBI's mandate for banks to clean up bad loans and improve the quality of banks' balance sheets by March 2017¹⁵.

RBI's AQR is broadly similar to the stress tests conducted in Europe after the European Central Bank (ECB) took control of the supervision of the euro area's biggest banks post the global financial crisis. 130 banks which accounted for 81.6% of all Eurozone assets were reviewed and it was found that lenders had overvalued their assets by approximately €48 billion¹⁶. However, unlike the RBI, the ECB conducted the AQR process through National Competent Authorities (NCAs) and their third party support. The European review was led by an NCA bank teams that involved third party audit firms and/or other asset appraisal specialists (depending on the capabilities of the auditor)¹⁷.

13 ICRA-http://www.business-standard.com/article/finance/icra-sees-npas-soaring-by-up-to-150-bps-to-5-9-in-fy16-115060900005_1.html

14 "Issues in Banking Today", Speech by RBI Governor, 11 February 2016

15 "On swachh balance-sheet mission, RBI to review banks' loan quality", Business Line, 9 December 2015; "RBI expects banks to clean up their balance sheets by March 2017", Mint, 1 December 2015

16 "ECB says banks overvalued assets by €48bn", Financial Times, 26 October 2014

17 Asset Quality Review - Phase 2 Manual, European Central Bank, March 2014

The European asset quality review

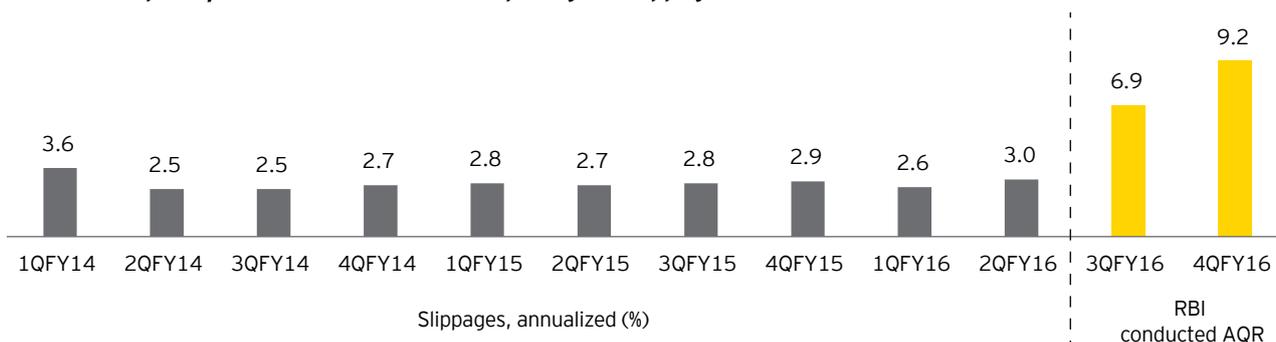
The European AQR complete assessment (CA) was a detailed review across the Eurozone in a very short period of time aimed at restoring trust in the European banking sector.

- ▶ 25 out of 130 banks technically failed the CA, with the total capital shortfall of €25billion.
- ▶ The CA identified an additional €136billion of non-performing exposures (NPEs).
- ▶ Banks' asset values were adjusted by €48billion.

- ▶ Adverse stress scenario would deplete banks' capital by €263billion in aggregate.

In India, the RBI initiated the AQR exercise in December 2015 by directing banks to classify 150 accounts as bad loans. Following the AQR, banks reported a ~70% surge in non-performing assets. Gross NPAs increased by INR2.41 trillion from INR3.49 trillion in September 2015, when RBI ordered the asset quality review, to INR5.91 trillion in March 2016. PSU Banks suffered a cumulative loss of INR179.95 billion in FY16 as they reported a steep rise in bad loans and had to increase their provisioning as a result of the impact of AQR¹⁸.

RBI's asset quality review resulted in a sharp surge in slippages



Source: "The Unknown Knowns", Spark Capital, June 2016 accessed via ThomsonOne

Understanding the problem: factors leading to the stressed assets predicament

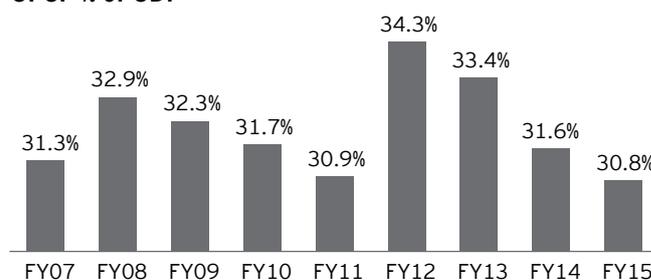
Multiple factors have led to the current high level of stressed assets, including macro-economic issues and bottlenecks related to specific sectors.

a) Excessive leverage and overinvestment during earlier strong economic phases

Indian banks resorted to aggressive lending practices during the boom period (from FY04 to mid FY09). Consequently, the corporate sector acquired excessive leverage to finance aggressive capacity addition. Also, it was widely perceived that the impact of the global financial crisis on the Indian economy was not significant. Consequently, banks started lending

aggressively to capital intensive sectors between FY09-11. There was a significant investment capacity expansion across key sectors such as infrastructure. Besides easy availability of credit, Indian corporates were also tempted by cheap valuation of assets in overseas markets amid the global slowdown.

GFCF % of GDP



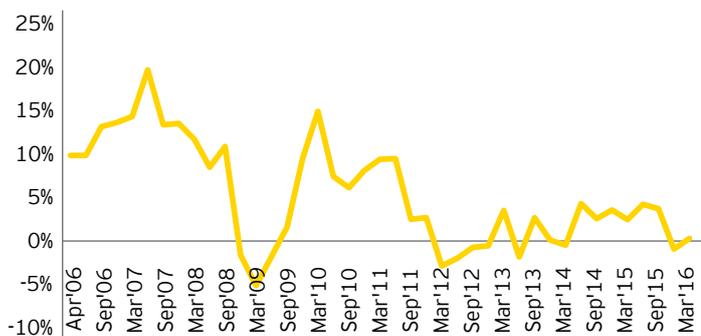
Source: Economic Survey 2015-2016

¹⁸ "RBI's asset quality review: Deep surgery starting to show results", The Indian Express, 7 June 2016; "Fresh asset quality review of banks unlikely soon, says RBI deputy governor", The Economic Times, 21 June 2016

b) Economic slowdown post FY11 impacted corporate demand

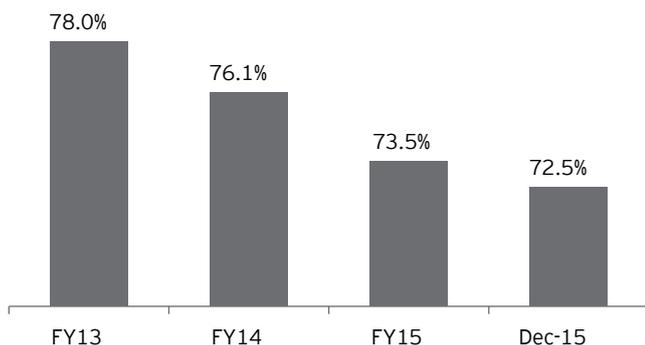
The Indian economy emerged largely unscathed post the global financial crisis. However, stress in the banking system could be attributed to the economic slowdown post FY10. This is indicated by the fact that double digit growth witnessed in IIP during the boom period had weakened significantly. This in turn negatively impacted demand in several key industrial sectors denting capacity utilization. Overall industrial capacity utilization declined from 78% during March 2013 to 72.5% during December 2015¹⁹.

Trend in IIP growth



Source: CSO

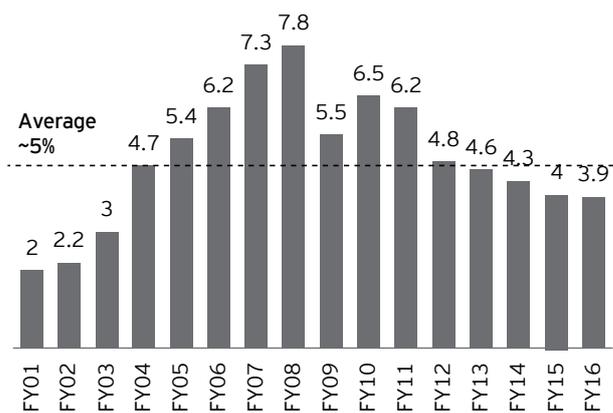
Capacity utilization



Source: CSO, IMF World Economic Database, Planning commission, RBI Quarterly Order Books, Inventories and Capacity Utilization Survey (OBICUS) October-December 2015

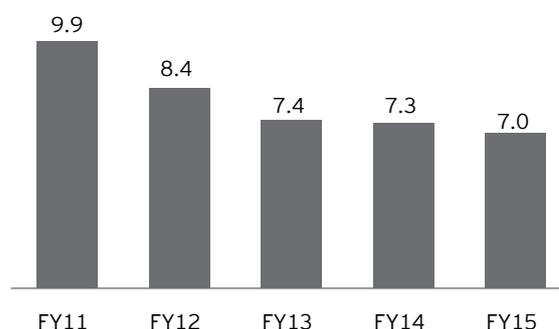
Balance sheets stress was further exacerbated by the dwindling corporate profitability due to slack demand, falling global commodity prices and weak revival of the investment cycle. Corporate profit as a percentage of GDP has consistently reduced since FY10. It is also lower than the long-term average of 5%²⁰. Dwindling corporate profitability, mainly due to a combined effect of underutilized capacities and higher indebtedness, has negatively impacted the ability to service debt. This is evident from the fact that the interest coverage ratio (PBIDTA/Total interest expense) of BT 500 companies stood at 7.0x during FY15 compared to 9.9x in FY11²¹.

Corporate profit (% of GDP)



Source: Motilal Oswal Securities; Note: FY16 estimated

Interest coverage ratio of BT 500 companies (times)



Source: Business Today

19 RBI Quarterly order book and capacity utilization report Oct-Dec 2015

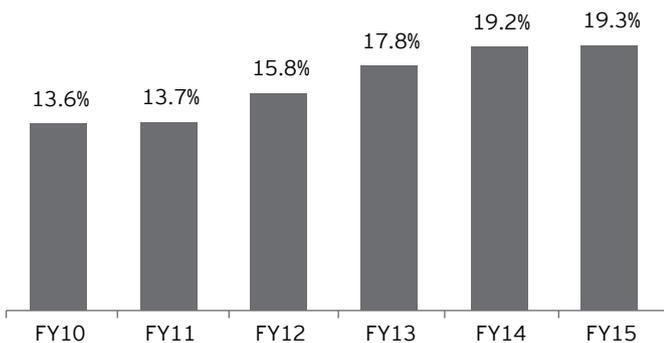
20 <http://www.livemint.com/Money/Vfc2yrxfzZMBIF8Vc2ytYP/Corporate-profit-to-GDP-are-we-bottoming-out-this-year.html>

21 <http://www.businesstoday.in/magazine/cover-story/bt-500-2015-growth-in-corporate-india-debt-levels-is-slowing/story/224942.html>

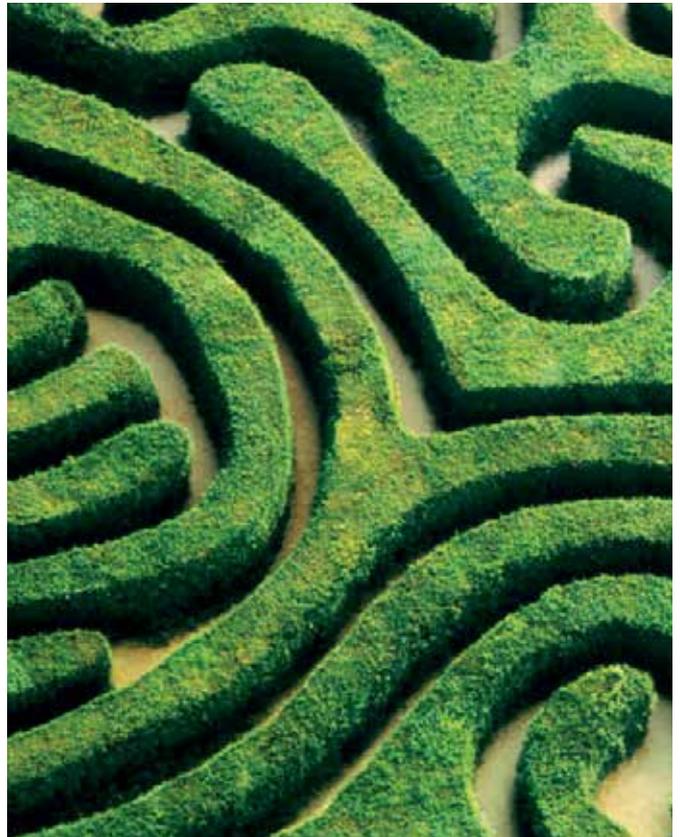
c) Easy access to the external debt market and rupee depreciation adding to the debt woes

Higher corporate leverage levels can also be attributed to increased access to the external debt market. Dovish monetary policy environment in developed markets post the financial crises led to Indian non-government external debt as a percentage of GDP to increase from 13.6% in FY10 to 19.3% in FY15²². High levels of external borrowings exposed Indian corporates to exchange rate vulnerability. Depreciation of the rupee against major currencies such as the US dollar and Euro increased debt obligation in rupee terms for the companies exposed to foreign currency loans.

Non-government debt (% of GDP)

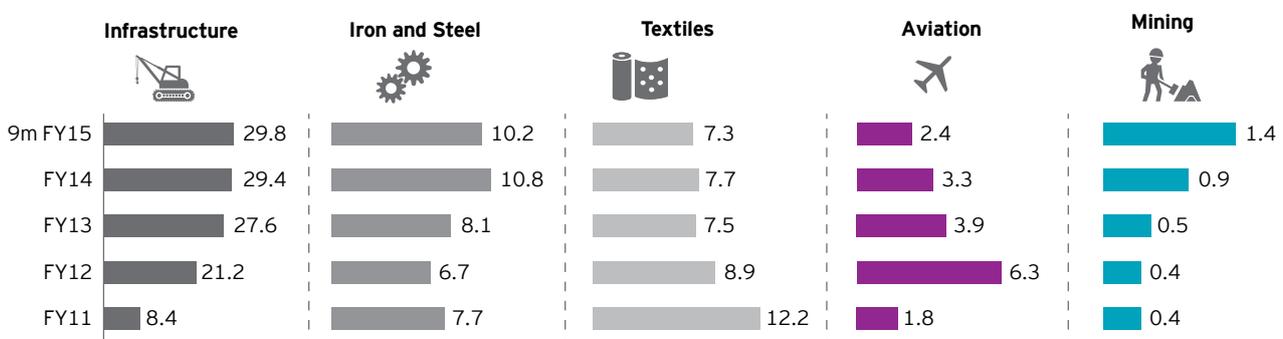


Source: RBI - India's External Debt



d) Industry-specific issues compounded the issue of stressed assets within banking sector

Besides overall economic slowdown and macro instability, certain sector-specific issues within five key sectors (infrastructure, iron & steel, textiles, aviation and mining) compounded the issue of stressed assets within the banking system. These five sectors which together accounted for just around 24% of total advances, accounted for over half of total stressed assets as of 9m FY15²³.



Source: RBI Financial Stability Report

²² RBI- https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=34314#T1

²³ RBI Financial Stability Report

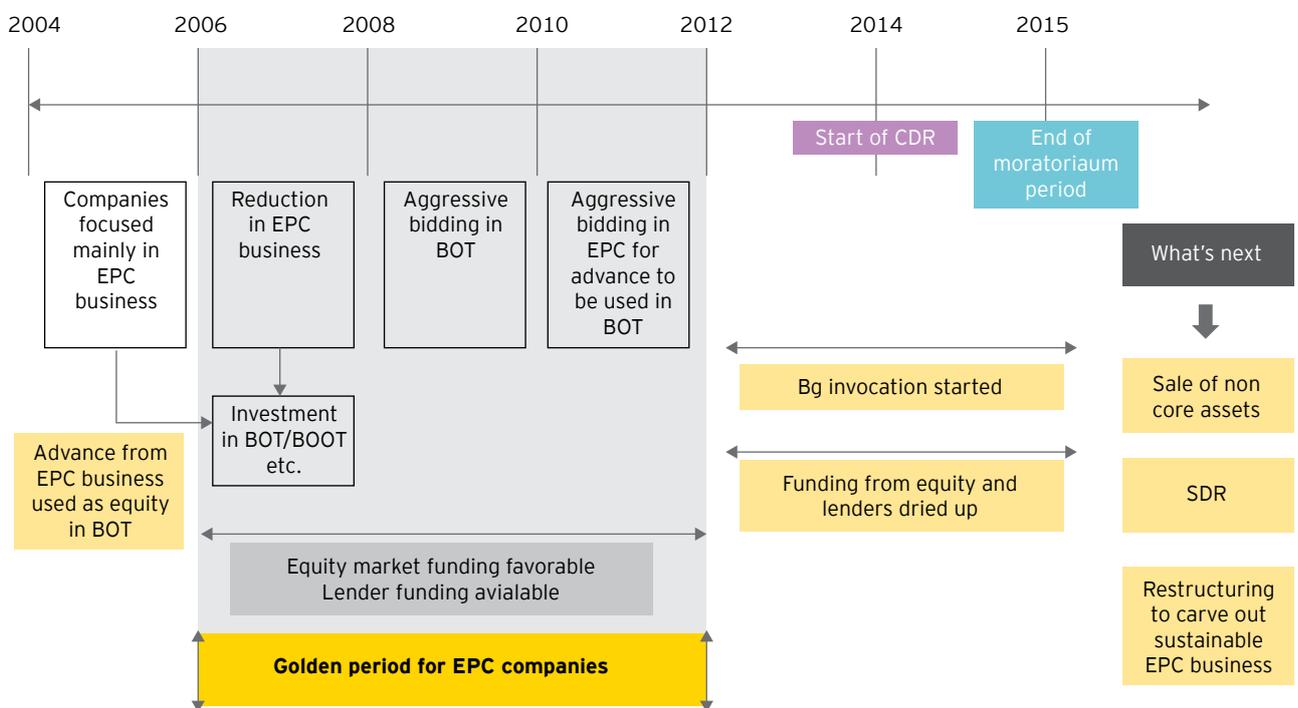
i) Infrastructure

Infrastructure continues to be the major concern in terms of overall stressed assets in the banking system. The share of stressed assets in the infrastructure sector to the total stressed advances increased to 29.8% in FY15 from just 8.4% in FY11.

EPC Sector

Companies in the engineering, procurement and construction (EPC) sector are faced with a myriad of issues following a slowdown in the domestic economy. A summary of this sector over the years is captured below:

Mobilization advance available



Consequently, the EPC sector in India is faced with a severe liquidity crunch. The crunch is created mainly due to following factors:

Key issues	Description
<p>Focus on non-core sectors and need for better strategic decisions</p>	<ul style="list-style-type: none"> ▶ Entering into many BOOT projects wherein unable to raise funds as required and in time ▶ Improper cash flow monitoring and budgeting ▶ Unable to foresee the potential risks and cater for risk management or put up a risk mitigation plan in time
<p>Government clearances</p>	<ul style="list-style-type: none"> ▶ Inadequate number of orders coming up ▶ Projects not taking off as envisaged due to inordinate delay in obtaining various required clearances from the government bodies
<p>Funds availability</p>	<ul style="list-style-type: none"> ▶ Timely funds not available with the contractor ▶ Significant delays in payments by clients/project owners
<p>Pricing/quotation</p>	<ul style="list-style-type: none"> ▶ Available orders were bid at low or negative margins for securing mobilization advances and gaining some utilization of otherwise idle equipment ▶ Inappropriate cash flow management - short-term funds used for long term uses; projects payments used for funding asset acquisition
<p>Operational issues</p>	<ul style="list-style-type: none"> ▶ Operational inefficiency ▶ Fight of talent
<p>Contract terms</p>	<ul style="list-style-type: none"> ▶ Contracts are not very clear or ambiguous and not understood properly. (i.e. in scope, specifications etc.)

Issues impacting projects – right from planning to operation stage – have made several of them unviable. Significant cost overruns, regulatory bottlenecks and aggressive bidding positions taken by a few market players are some of the key concerns affecting the EPC sector. Another important element synonymous to the sector is the buildup of claims that are receivable from various government entities. These claims could be on account of several factors - change of scope of work (quantity variation/extra items), idling of resources (manpower, overheads etc.), compensation beyond original the contract period, change in statute, loss of opportunity, etc. The claims go through an arbitration process that potentially delays the timing of cash flows.

In view of the increasing working capital requirements and the resultant increase in leverage, the construction players are left with limited opportunity to raise further capital to fuel growth in the current scenario. Private equity funds too are cautious with their new investments, since there are limited opportunities to exit due to unfavorable capital markets. Therefore, the sector is reeling under significant liquidity constraints.

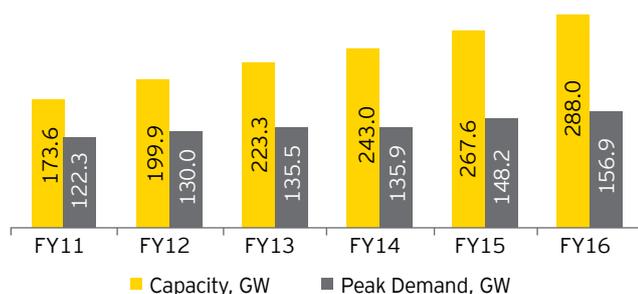
All above mentioned factors result in a vicious circle, which when timely attention is not given, becomes cancerous.

Power generation sector: overcapacity is the principal cause for stress

Within infrastructure, the power sector constitutes a major chunk with 16.1% of total stressed advances as of 9MFY15. The Indian power sector has witnessed significant distress in the last five years on account of both demand and supply side constraints. On the supply side, issues such as fuel shortages and Power Purchase Agreements (PPA) disputes and on the demand side, the biggest issue includes DISCOMs' curtailment of power purchases due to deterioration of their financial health.

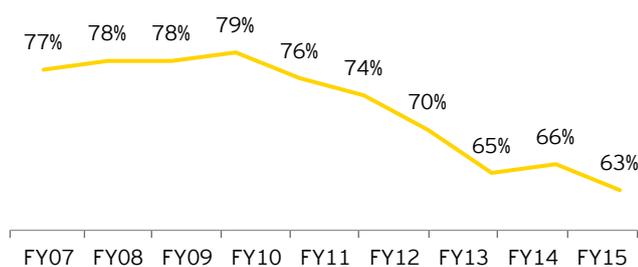
Significant overhang of the capacity is the biggest cause of stress within the power sector. India's power generation capacity increased by almost 1.7x during FY11-FY16 implying a CAGR growth of 10.7%²⁴. This is largely due to the significant investment committed in capacity addition during the boom period. On the other hand, demand for power has remained subdued largely due to inability of State Electricity Board (SEB) to purchase power at higher tariffs coupled with slack in industrial demand amid weak economic growth. The mismatch between demand and supply has resulted in lower Plant Load Factors (PLFs) for power generation companies, negatively impacting the profitability of many generation companies.

Capacity and demand mismatch



Source: Spark Capital research

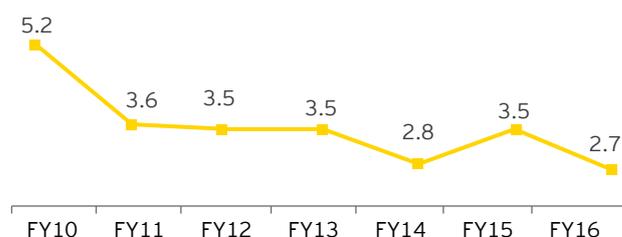
All India thermal PLF



Source: Spark Capital research

24 Spark Capital research report, March 2016

Merchant price (INR/unit)



Source: Macquarie research

Aggregate PLFs of thermal power plants has declined to ~63% in FY16 from a long-term average of ~72% and the peak in FY08 of 78%

Going forward, an uptick in economic recovery could stabilize PLFs of the power generation companies. However, the recovery is expected to be gradual as capacity utilization is expected to remain at current levels.

As per CRISIL estimates, debt to weak power generation projects stands at INR2.1 trillion. This includes INR1.6 trillion of loans to coal-based facilities that are either stalled or operating below optimal capacity and INR500 billion to gas-based plants that are at risk due to the lack of gas availability. The coal-based capacities are inoperative for three reasons:

(a) Off-take risks: These projects are yet to sign PPAs and/or have high generation and distribution costs, making them unviable for discoms to purchase. The debt to projects that have an offtake risk is ~INR120 billion.

(b) Aggressive pricing: These are projects that have signed long-term PPAs for 20-25 years at a low price of INR2.4/2.7 per unit. Their cost of generating power has increased substantially due to the changes in regulatory norms for imported coal or increase in prices of domestic coal. The debt outstanding to such operationally unviable power projects stands at a massive INR810 billion.

(c) Fuel shortage: Projects that are stalled, non-operational or running below optimal capacity due to a shortage of fuel availability have a debt of INR660 billion.

CRISIL believes that there are a moderate to high chances of reviving projects that have off-take risk or are in trouble due to non-availability of coal or gas. Raw material supply has improved substantially post government initiatives with regard to coal block allocation, imported gas availability and tariff revision. Thus, such projects can be revived with a reasonable haircut to their EV to account for project delay and increased debt levels.

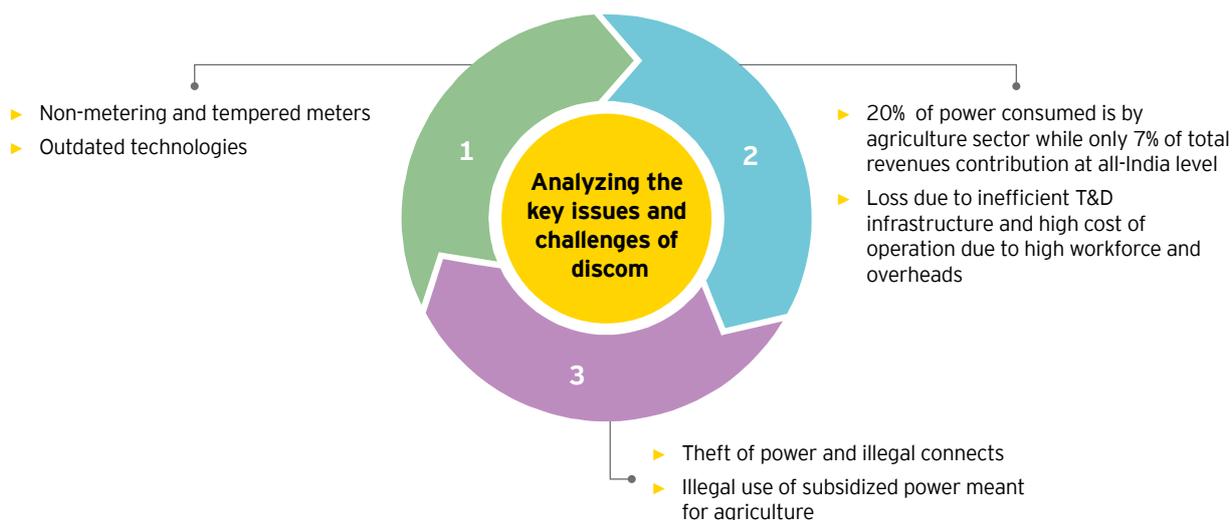
The weak financial position of discoms meant that they could not sign long-term PPAs with power-generation companies,

forcing them to buy power in the spot market at a higher price. This negatively impacted their profitability. Further, they were unable to invest in distribution infrastructure to curtail T&D losses amid weak profitability, which, in turn, resulted in a buildup of stressed loans on bank balance sheets.

Implementation of the UDAY scheme: benefits likely to accrue in the long run. The central government launched the Ujwal DISCOM Assurance Yojna (UDAY) scheme in 2015 to restructure the finances of discoms.

Issues at state discom

Analyzing the key issues and challenges of discom



A quick glance at UDAY

- ▶ 11 states have signed an MoU till date
- ▶ 75% of DISCOM debt as on 30 September 2015 to be taken over by states over two years (50% before March 2016 and 25% in FY17)
- ▶ States to issue non-SLR, including SDL bonds, in the market or directly to the respective banks/financial institutions (FIs) holding the DISCOM debt to the appropriate extent @GSEC rate + 50bps

Key reforms target

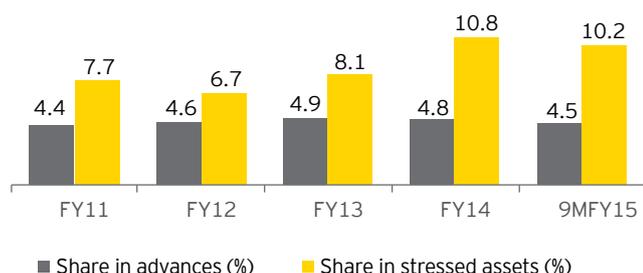
- ▶ Reduction of AT&C loss to 15% in 2018–19
- ▶ Reduction in the gap between the average revenue realized (ARR) and the average cost of supply (ACS) to zero by 2018–19

While the impact of UDAY on the banking sector in the long run is expected to be positive, it could have a negative impact in the near term. Conversion of 75% debt into state bonds, and the pricing of these bonds between 8% and 9% will entail a haircut on the interest income received by banks. Currently, these loans are priced at ~12%–13% and thus may result in a 350–400 bps reduction in the income accrued.

ii) Iron and steel sector

Iron and steel is another key sector contributing to stressed assets in the banking sector, with its share in total stressed advances increasing to 10.2% in 9MFY15.

Share of iron and steel sector



Source: RBI Financial Stability Report

Analysis of the issues within the iron and steel sector suggests that the sector has suffered primarily due to following reasons:

- ▶ **Global capacity demand mismatch** especially driven by overcapacity in China putting pressure on realizations. In FY15, Indian steel imports had increased to 9.3 million MT from 5.5 million MT in FY14, an increase of over 71%. A large proportion of these incremental imports was accounted for by cheap Chinese steel.
- ▶ **Sluggish recovery in domestic market** though there are signs of marginal improvement. India continues to be among the only large steel consumers globally registering any meaningful growth. The domestic finished steel consumption grew by 4.3% in FY16 as against a growth of 3.9% in FY 15. This growth was driven by a 3.7% y-o-y growth in the construction sector demand in the nine month period ended December 2015.
- ▶ The impact of this slow recovery was particularly severe due to major expansion undertaken by players in anticipation of strong demand growth. Most of the

domestic steel companies were highly leveraged due to the debt funded capacity increase. The debt levels for most mid-sized steel players have risen by 3 to 6 times in the last 5 years. The high debt coupled with lower capacity utilization due to delays in commissioning plants and a lack of adequate demand further increased stress build-up in the system.

- ▶ The domestic steel industry also saw supply side constraints due to suspension of iron ore mining in Karnataka, Odisha and Goa. India, which was a leading iron ore exporter, turned a net importer of the commodity. This increased the production costs for local steel companies, although the softer global prices cushioned the impact of this blow to some extent. Similarly in the aftermath of the alleged coal mining scam, approvals came to a standstill, mining leases were suspended and penalties imposed on some steel companies. The dual predicament not only impacted raw material procurement costs but also increased litigation costs for the manufacturers.
- ▶ While India is among the most competitive producers of steel, the domestic logistics network is not adequately prepared. The poor connectivity, rising freight and transportation costs has negatively impacted the competitiveness on the global stage. Internal freight rate in India is two to three times higher compared to countries such as China. Similarly, the interest rates in India for small and mid-sized players are much higher than those for similar sized players in other leading steel producing countries like China, Korea and Japan.

Government has taken policy measures to support the domestic steel industry

To improve the competitiveness and protect the domestic steel sector, the government has taken several proactive policy measures. India, like many other countries, has taken short-term measures to reduce the flood of imports. Some of the measures include:

- ▶ Declaration of a minimum import price in February 2016, in the range of US\$340-750 across 170+ products which constituted almost 98% of steel imports for the nine month period from March to December 2015.
- ▶ Imposition of a 20% safeguard duty on imports of specific steel products for 200 days (September 2015).

- ▶ Imposition of import duties for five years on stainless steel imports from China, EU, US, Thailand, South Africa and a few other countries

Similarly, to resolve the supply side issues, the government has taken numerous steps:

- ▶ A notable policy measure is the amendment to Mines and Minerals Development and Regulation (MMDR) Act which should drive consolidation in the sector with unviable players giving way to new and stronger sponsors.
- ▶ The coal block allocation process has been streamlined with a transparent auction based methodology. Some of the domestic steel companies including Usha Martin, Sunflag etc. have bid and secured coal blocks for their captive use.

To support the mining industry, the government has withdrawn the 5% export duty on iron ore. This step does not impact the domestic industry in the short term due to the continued softness in the global prices for ore. This step should however boost the prospects of iron ore miners that have been under pressure over the past few months due to the meltdown.

Despite imposition of duty on import of flat products, industry faces competition from steel imports from countries with Free Trade Agreements - such as Japan and South Korea - where duty is much lower at 1%²⁵. These are however high quality automotive and alloy steel which will need to be imported considering the growing domestic demand and lack of alternatives in the short term.

On the whole, while in the near-term the prospects of the domestic steel players look positive, a lot will depend on the global overcapacity situation being remedied with capacity closures in China. The high leverage however continues to be a proverbial milestone for most domestic steel players and stress on banking system could continue to remain at elevated levels. The policy measures taken by the government have been largely supportive for the sector and the Ministry of Steel has ambitious growth targets which can only be achieved if the current issues are resolved. The long-term future of the steel sector largely depends on firm domestic demand, favorable policy measures to boost manufacturing, proactive steps to prevent dumping and government spending to drive infrastructure growth.

iii) Textile sector

The Indian textile sector, which is highly dependent on exports, has been suffering from a lull in demand in its key export destinations such as the US and Europe. The sector is highly fragmented, with the presence of a number of small enterprises. This fragmentation can be attributed to the existence of tax, labor and regulatory practices that favor small and labor-intensive firms. As a result, competitiveness of the Indian textile players has deteriorated significantly against its Asian peers – such as in China, Vietnam and Bangladesh – which, in turn, has negatively impacted demand. This problem has been compounded by the fact that Indian yarn, fabrics and made-ups and garments attract export duties of 4%, 5% and 12%, respectively²⁶.

The sector has also been suffering from higher input costs. Apparel manufacturing costs in Bangladesh are 60% of those in India despite the infrastructural inadequacies in Bangladesh.

India-Bangladesh textile sector comparison

	India	Bangladesh
Cost of 1,00,00 sqft factory	US\$800,000	US\$500,000
Labour cost (monthly per head)	US\$180-200	US\$40-70
Length of working day	8 hours	10 hours
Share in country's total export	7%	74%

In a bid to address the slowdown, the government in 2012 had proposed a debt-restructuring package for the textile sector amounting to INR350 billion²⁷. However, the plan failed as the majority of the textile companies were already focusing on restructuring following the 2008–2009 slowdown. Any further restructuring would have rendered them as defaulters and deprived them of the benefits under the Technology Upgradation Fund Scheme (TUFS).

iv) Aviation

The profitability of the Indian aviation sector has been negatively impacted by the increase in jet fuel costs in the last decade. Fuel costs in the Indian aviation sector are significantly higher due to higher domestic taxes and an 8.2% excise duty²⁸. Consequently, fuel costs for account for approximately 40%–45% of the total operating expenses of Indian airlines compared

25 <http://www.dnaindia.com/money/report-steel-industry-braces-for-tense-2016-bets-on-domestic-demand-2160995>

26 <http://www.financialexpress.com/article/economy/textile-clothing-sector-unhappy-with-inadequate-ftp/60020/>

27 <http://www.thehindubusinessline.com/news/fresh-debt-recast-may-deprive-textile-units-of-benefits-under-upgradation-scheme/article5940804.ece>

28 IATA

to 20–25% of global airlines²⁹. High fuel costs have negatively impacted operating margins and cash flows, thus causing stress in the sector.

Recovery levels remain low: process needs to be strengthened

Banks have resorted to recovery under several methods over the years including Lok Adalats, Debt Recovery Tribunals (DRTs) and the SARFAESI Act. The World Bank data as of June 2015 indicates that India lags behind most of the emerging market economies in the time taken to resolve cases of insolvency. The below chart indicates that average recovery rate is about 26%

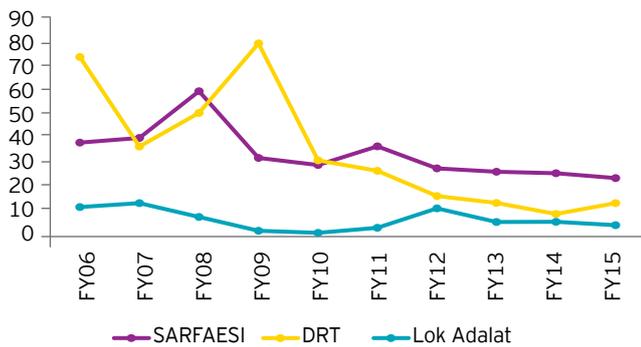
while the time taken to resolve has been over four years which is more than twice the time taken in China and in the US (1.7-1.5 years).

While SARFAESI has proved to be a big improvement over DRTs (as proceedings can be initiated without court intervention), its inefficient enforcement has rendered it less effective. The inefficiencies in the process have led to delay in attempts by lenders to liquidate assets or take management control of the entity in contention.

Deferring the problem at hand

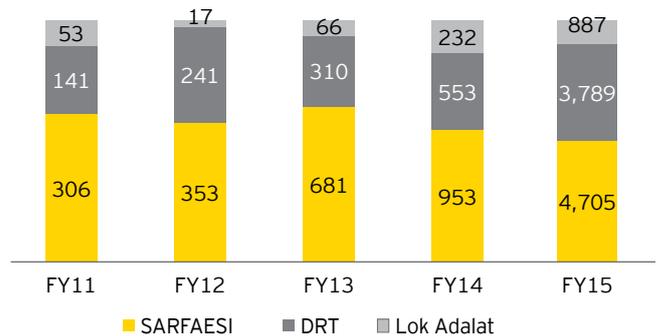
In an attempt to keep the loan account standard, majority of the Indian banks have been applying band aids with a hope

Gross NPAs recovery rate (%)



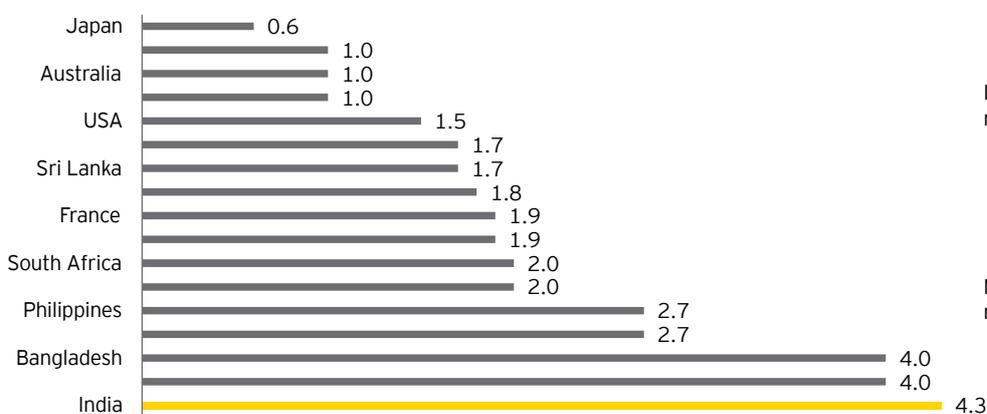
Source: RBI

Recovery mechanism - amount filed (INR billion)



Source: RBI

Time taken to resolve (in years)



Source: World Bank

Less time taken for recovery-favorable

More time taken for recovery-unfavorable

²⁹ <http://archivetavel.financialexpress.com/200801/aviationworld09.shtml>

that time and growth will set the stressed assets back on track. It is not uncommon for a bank to extend a short-term credit facility to a borrower to help him cover dues on an existing loan. Sometimes this works as a solution, but most of the times, the low growth that precipitated the stress persists. The fresh lending intended to keep the original loan current inevitably grows. Facing large and potentially unpayable debt, the promoter loses interest, does little to fix existing problems, and the project goes into further losses. These “living dead” companies limp along, just about servicing their debts but with no hope of recovery or growth.

In our estimate, the sustainable debt of majority of the large stressed accounts may not be more than 30-40% of the current debt levels. The key reasons are as follows:

- ▶ Generally, 40-50% of total debt outstanding today represents interest payments made during the last 4-5 years where cash flows from operations have been insufficient resulting in borrowings to pay interest. This portion of the debt is unsustainable.
- ▶ Further, at an average, stressed companies are operating at 30-40% of capacities; this further reduces sustainable debt on original borrowings by about 60%.
- ▶ Accordingly, on an intuitive basis, approximately 60-70% of the debt would remain unsustainable at current levels of operations.

Hence, an alternative approach should be to look at a long-term solution to put the stressed project back on track rather than simply applying band aids. This may require deep surgery. Existing loans may have to be written down because of the changed circumstances since they were sanctioned. If loans are written down, the promoter brings in more equity, and other stakeholders chip in, the project may have a strong chance of revival, and the promoter will be incentivized to try his utmost to put it back on track.

Emergence of ARCs as a key resolution mechanism

As the level of distressed assets within the Indian banking system reached an alarming level, ARCs emerged as an important resolution mechanism. ARCs have been successfully used as part of a comprehensive NPA management strategy globally. Countries such as Korea, Taiwan, Mexico and Thailand have successfully implemented different models of ARCs to

tackle the issue of NPAs. The governments of several countries have also encouraged transfer of assets to ARCs by creating a supportive regulatory environment.

ARCs function more or less like an asset management company, transferring the acquired assets to one or more trusts (at the price at which the financial assets were acquired from the originator). Then, the trusts issue security receipts (SRs) to qualified institutional buyers (QIBs) and the ARCs receive management fees from the trusts. Any upside between the acquired price and the realized price is shared between the beneficiary of the trusts (banks/FIs) and ARCs³⁰.

ARCs enable banks to focus on their core business by taking over the responsibility of resolving stressed assets. ARCs also help build up industry expertise in loan-resolution arrangements and enable the development of secondary markets for stressed assets. ARCs benefit the overall economy by trying to restore the operational efficiency of financially unviable assets after their acquisition to unlock their true potential value or disposing them of for more effective use of blocked funds.

ARCs in India

In India, the issue of low recoveries from NPAs became more prominent in the late 1990s. The Narasimhan Committee Report highlighted that the huge backlog of NPAs at that time continued to exert pressure on the banking sector and severely impacted profitability. The report recommended the creation of an asset recovery fund to take over the legacy NPAs from the banks at a discount³¹. After the enactment of The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), many asset reconstruction companies (ARCs) were formed in India. Unlike in many other countries where debt aggregation grew under a government-supported model, in India ARCs were set up as private vehicles, mainly with the support of banks. The RBI has granted certificates of registration to 15 ARCs³² with estimated total value of SRs issued amounting to INR630 billion³³.

30 <http://www.allbankingsolutions.com/Banking-Tutor/ARC.shtml>

31 <http://www.indiafilings.com/learn/asset-reconstruction-company-arc-india/>

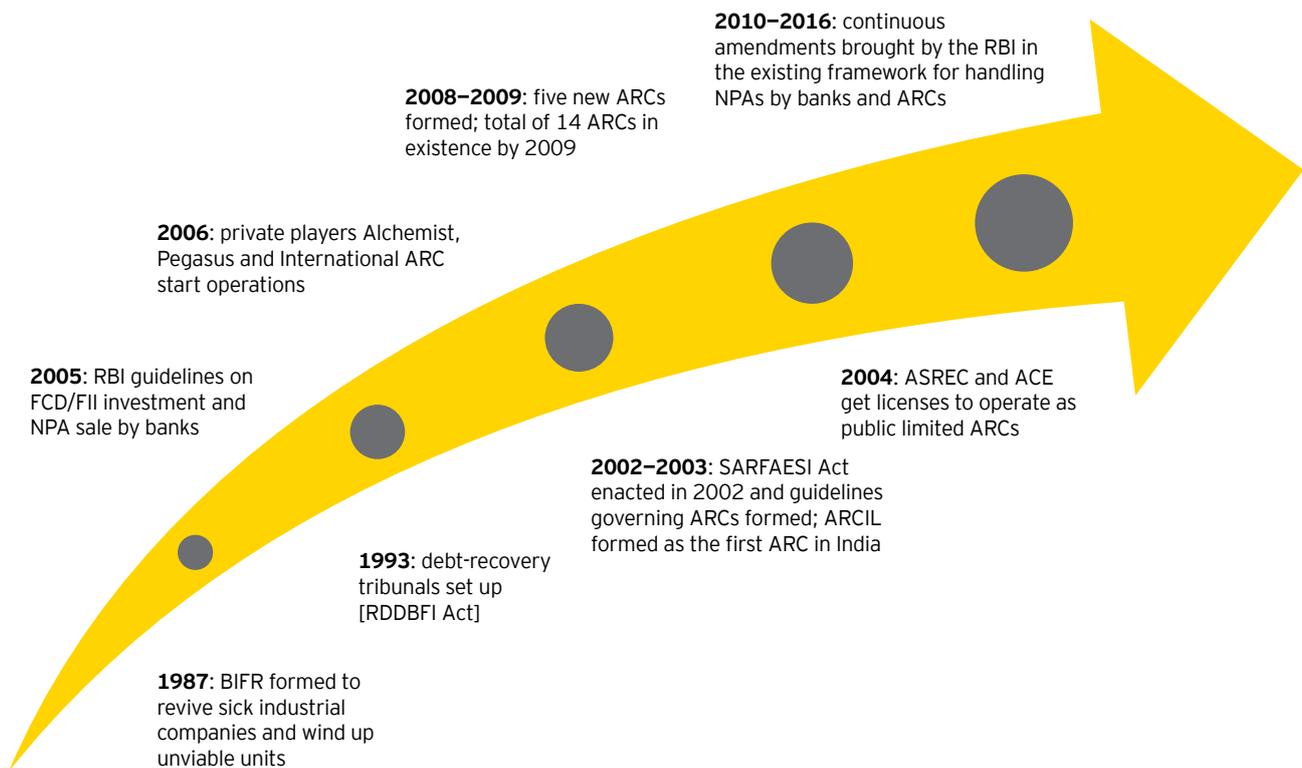
32 <http://www.arcindia.co.in/>

33 <http://www.businesstoday.in/magazine/cover-story/distressed-assets-market-in-india-witnessing-unprecedented-boom/story/221604.html>

Key challenges before ARCs



The evolution of the asset reconstruction industry in India can be summarized as below:



Banks are ready, but resources at ARCs are a key constraint

ARCs play a crucial role in the financial sector by relieving banks of the burden of NPAs and allowing them to focus better on managing their core business, including new business opportunities. After a prolonged lull (2008–2013), asset sales to ARCs surged by more than 3 times YoY in FY14, facilitated by a revision in guidelines by the RBI to allow the amortization of loss on sale to ARCs over an eight-quarter period.

This was a time when aggressive bidding by ARCs at prices closer to the face value of loans led to:

- ▶ More focus on management fees rather than recoveries.
- ▶ Unrealistic pricing by ARCs, resulting in potential mark-to-market losses on SRs in the long run.

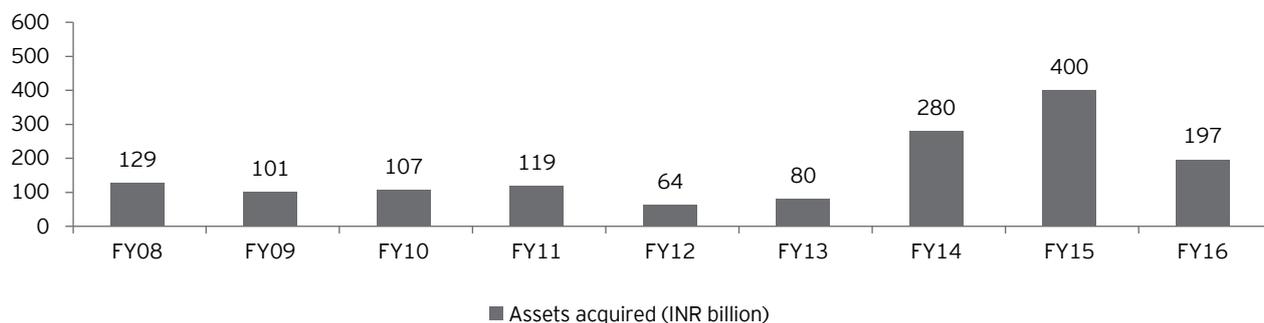
Thus, initially seen as a system that was popular with lenders to offload big chunks of stressed loans to ARCs via the SR route, later led to tightening of guidelines by the RBI in August 2014, which (among other things) increased the ARCs' minimum contribution from 5% to 15%. Consequently, the option of sale to ARCs has been explored sporadically by banks because of the expectation gap in the pricing of SRs.

A summary of the changes in acquisition norms and the consequent impact are captured below:

	Upto Sep 2006	Sep 2006 to Aug 2014	Aug 2014 onwards
Minimum investment required	None	5% of SR's	15% of SR's
Illustrative impact on ROCE	<ul style="list-style-type: none"> ▶ AUM : INR 1000 million ▶ Investment by ARC: NIL ▶ Mgmt Fees: 2% of o/s SR's ▶ RoCE: NA 	<ul style="list-style-type: none"> ▶ AUM : INR 1000 million ▶ Investment by ARC: 50 million ▶ Mgmt Fees: 2% of o/s SR's ▶ RoCE: 20 - 25% 	<ul style="list-style-type: none"> ▶ AUM : INR 1000 million ▶ Investment by ARC: 150 million ▶ Mgmt Fees: 2% of o/s SR's ▶ RoCE: <ul style="list-style-type: none"> ▶ Base Case - 5 - 10% ▶ Upside Case- 15-20%

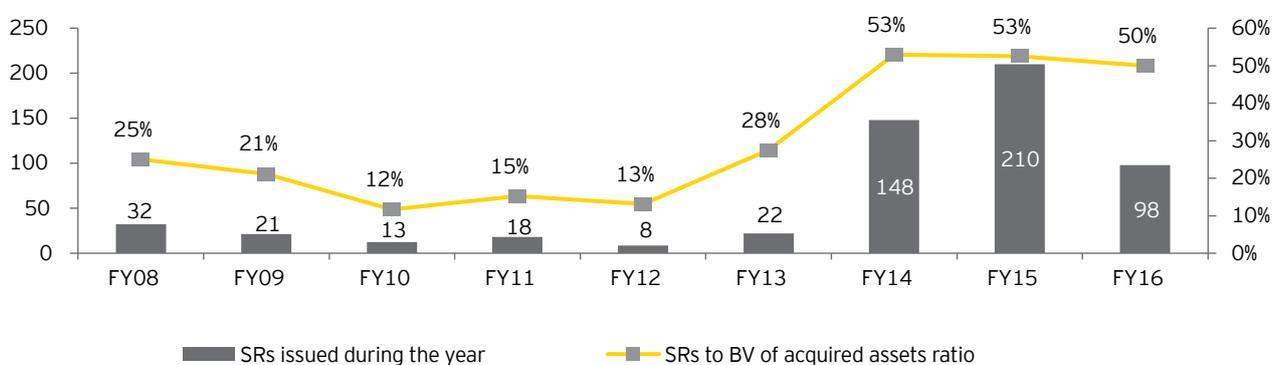
A historical comparison of the acquisitions done by ARCs is discussed below:

Book value of assets acquired by ARCs



Source: EY analysis

SRs issued (INR billion)



Source: EY analysis

- ▶ High growth in FY14 was mainly due to the RBI's dispensation allowing banks to amortize losses on the sale of loans over a two-year period.
- ▶ The deadline for this dispensation was March 2015, which was later extended to March 2016.
- ▶ Growth tapered after Q2FY15 mainly because of regulatory change, which increased the minimum mandatory contribution by ARCs in SRs to 15% (from 5% earlier).
 - ▶ About INR300 billion of bad loans sold before the regulation change in August 2014, as compared to only INR100 billion sold in the remaining seven months of the year.
 - ▶ ARCs' interest was muted during FY16, with select transactions that were closed out.

Regulatory changes led to slower growth after Q2FY15, although they are expected to improve price discovery in the long run

We recently noticed large PSBs such as the SBI and the BOI selling NPAs at a steep discount to book value. More than INR1.3 trillion worth of assets were put on the block to ARCs during FY16. Of this, there was an estimated deal closure in respect of assets with outstanding principal balance (OPB) of ~ INR200 billion. We estimate that against this, SRs were issued to the tune of ~ INR100 billion, with Edelweiss ARC garnering an approximately 50% market share. The following is the tabulation of the status by bank.

Category of banks	No. of accounts	OPB (INR billion)
Public sector banks		
- SBI and associates	757	357.88
- Central Bank of India	249	139.97
- PNB	287	129.28
- Other PSU banks	1,504	563.13
Private sector banks	177	113.38
Other banks	17	6.98
Total	2,991	1310.62

Source: EY analysis

This table clearly suggests that while banks have explored sale of assets to ARCs, the mismatch in price expectations has led to the majority of the auctions failing. Our interactions with industry players indicate a discount of ~40%–60% for future

transactions as compared to ~30% discount prior to guideline change in August 2014.

It is pertinent to note that the poor performance of ARCs in resolving stressed loans situations in the past has played heavily in the minds of banks and affected the industry in two ways: the overall deals between ARCs and banks have reduced considerably and more banks have started preferring cash sale to SRs. In view of this, the option of exit through the sale of stressed loans to ARCs has been underutilized.

While enablers may be in place, the following key challenges still remain for ARCs:

▶ **Capital remains a key challenge for the ARC industry:**

As per industry estimates, the current capitalization of all the ARCs put together adds up to around INR30 billion. With the cash component increased to 15%, the net worth of ARCs would be sufficient to acquire only INR200 billion of stressed assets. Assuming ARCs acquire the NPAs at 60% of book value, all the ARCs put together can garner ~ INR333 billion of NPAs. With Gross NPA and restructured advances of banks touching ~INR8 trillion, ARCs can acquire approximately only 3% of these assets from banks.

Another key challenge for ARCs is the ability to fund the working capital needs of stressed loans to enable a revival. As a result, global distressed asset funds are increasingly seeing an opportunity in this space, but this option comes with a rider. To enable them to take high risk, distressed assets funds require a cash flow priority, a clear first charge on assets and returns in excess of 25%. With a consortium of lenders who often act independently, bringing all the parties together and convincing them to agree to a plan will be a major challenge for a distressed asset fund.

▶ **Valuation mismatch between ARCs and seller institutions:**

New capital norms have significantly increased the cost of asset acquisition for ARCs. To offset this, ARCs have been seeking higher discounts to buy NPAs but banks are unwilling to reduce price, resulting in an expectation mismatch. This has led to a sharp decline in the transaction closure rate.

However, considering the changed dynamics on account of increasing stress in the banks' loan books, we expect more banks to become realistic about valuations/recoveries going forward and facilitate closure of transactions.

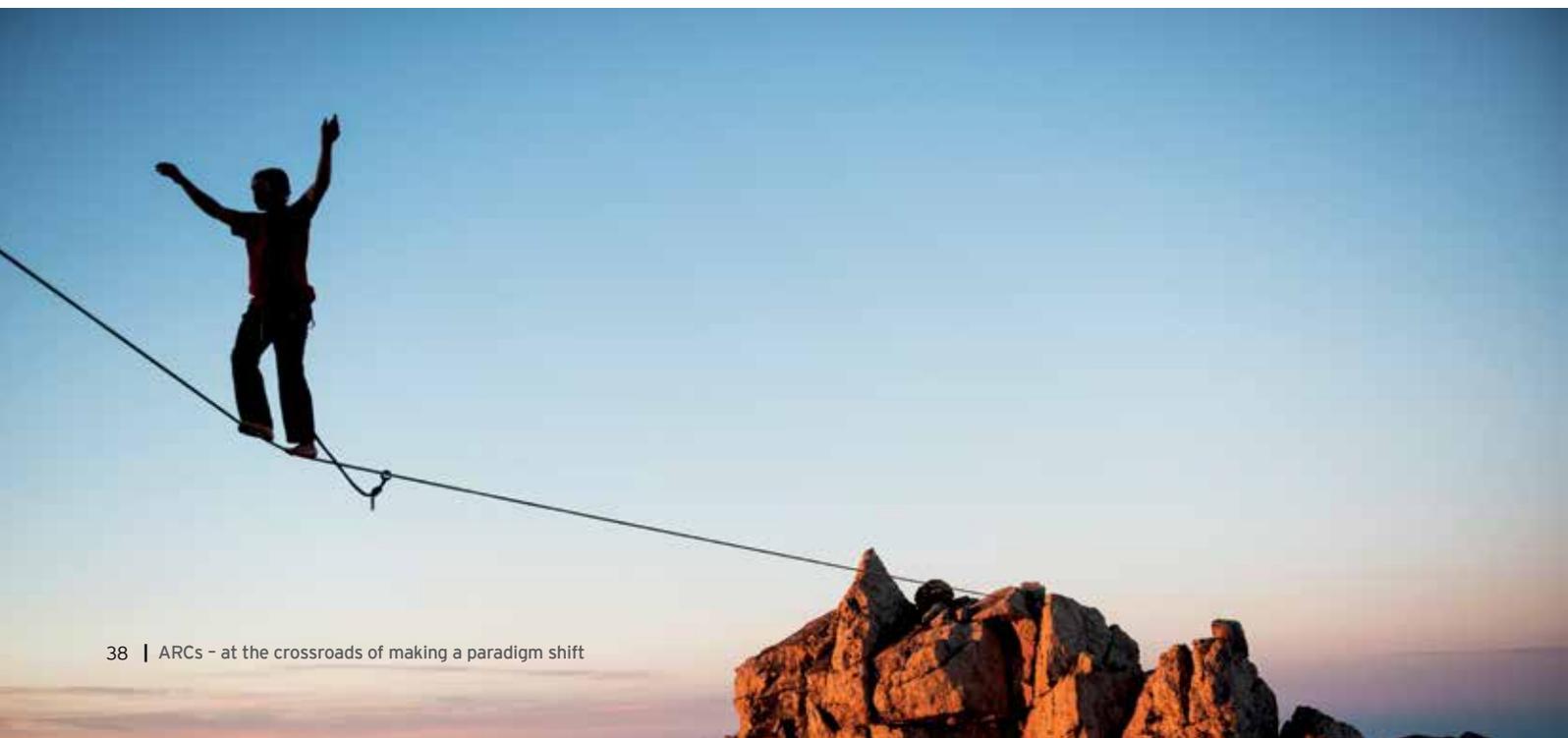
In a limited survey we undertook across banks and ARCs, the respondents cited a large gap in valuation expectations as the most significant hindrance to sales to ARCs. The main reasons for this gap are the quality of independent experts used by banks and the vastly different discounting rate used by banks and ARCs. While banks use discount rates in the range of 10% to 15% given their access to cheap capital in the form of public deposits, ARCs use much higher discount rates of 20% to 25% as their cost of funds is relatively higher than that of banks. Without realistic valuation guidelines, there is no incentive for private investors to participate in auctions as the reserve price tends to be high given the low discount rate used by banks vis-à-vis ARCs and private investors. As a result, banks are forced to continue holding these positions until most of their value has deteriorated, resulting in larger losses.

While almost 50% of the respondents felt that the banks' internal recovery teams have the expertise to do a better job at maximizing recovery, ARCs felt that a lack of ownership within the banking system led to the majority of the failed auctions. It is not out of place to mention here that poor performance of ARCs in resolving stressed loans in the past has effected the overall reduction in deals between ARCs and banks.

► **Acquisition of accounts under the SMA-2 category:**

During early 2014, the RBI released a regulatory framework for early recognition and revitalization of stressed loans, detailing steps for early recognition and quick action upon the first signs of stress in any account. The regulator further permitted the sale of Special Mention Account 2 (SMA-2), where the principal or interest is overdue between 61 and 90 days, to ARCs. We believe that these guidelines would aid in arresting the deterioration of the economic value of the stressed loans and increase deal flow to ARCs, special situation funds and stressed asset investors.

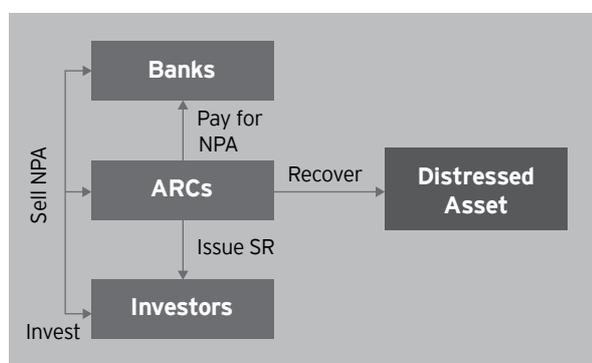
While a few such deals were concluded in the first half of 2014, ARCs are cautious about bidding for such accounts because of the lack of clarity in the regulations. Considering that the rights under the SARFAESI Act are applicable only to NPAs and not to SMA-2 accounts, ARCs prefer to avoid ambiguity and rather bid for NPAs.



Regulatory and legislative action would help resolve this issue and incentivize quicker action to tackle stressed assets before they become NPAs.

▶ Banks adjusting to the new reality; asset sale to drive stress loans lower:

After the sharp slowdown in the sale of NPAs to ARCs, activity picked up marginally during FY16, with the key



Investor challenges	Bank challenges
Mandatory to disclose the basis of valuations in case the acquisition value of assets is more than the book value	Mismatch in valuations at which banks want to sell and price at which ARCs want to buy distressed assets

ARC's have traditionally been funded by equity. Net worth of all ARCs put together would be approximately. INR3000 crores. With 15% upfront cash payment ARCs can acquire only INR20,000 crores worth stressed assets in India. Even if they acquire these assets at 60% of book value, all ARCs together would constitute only INR33,000 crores which is approximately 5% of the banking industry's restructured assets

change being banks (led by the SBI) willing to take higher discounts to principal value. Our industry interactions suggest that the ARC industry has structurally moved from the agency business (focus on fees for IRR) to fund-based business (focus on recoveries and realistic pricing for IRR). With banks willing to sell NPAs at a significant discount, headline stress loans on the balance sheet are likely to decline; however, credit costs will remain elevated due to amortization charges arising out of losses on sale.

Key statistics

As on 30 June 2014

- ▶ Principal debt acquired ~ INR90,000 crores
- ▶ Security receipts Issues ~ INR54,600 crores
- ▶ Security receipts redeemed ~ INR12,600 crores

Regulatory challenges

Mandatory to disclose the basis of valuations in case the acquisition value of assets is more than the book value	Disclose reasons and details of the assets disposed of at substantial discount during a year
Upfront payment of 15% cash vs 5% earlier due to which they will face capital constraints	Lack the power to change management (due to SARFAESI Act)
Shareholding- sponsors can bring only up to 50% which further limits their capital	Initial valuation of security receipts should be carried out within 6 months and not 1 year
Management fees is now to be calculated as % of NAV instead of acquisition value	Need to plan recoveries in 6 months unlike the earlier 1 year

Changes in the August 2014 guidelines

Higher skin in the game for ARCs after the guidelines changes

- ▶ The RBI has mandated ARCs to increase their share of investments in SRs to 15% from 5%
- ▶ **The computation of management fee has been linked with the NAV** of SRs rather than the outstanding SRs issued previously. Thus, any downgrade in the rating of SRs will directly impact the earning of ARCs
- ▶ **The threshold level of enforcing SARFAESI Act has been lowered** to 60% of the overall debt value from 75%
- ▶ Banks must give at least two weeks' time to conduct due diligence of accounts
- ▶ The time period for planning and reconstruction/realization of the NPA has been reduced to 6 months from 12 months
- ▶ **ARCs to be a part of JLF**

Following the regulatory changes, the assets offered-to-sold ratio decreased to 29% from 64%–65%

Banks would prefer to sell assets with three to four years vintage as the provisioning impact is limited

(INR)	NPA vintage (years)			
	1	2	3	>=4
Gross loan amount (secured)	100	100	100	100
Provisioning required	15%	25%	40%	100%
Provisions	15	25	40	100
Net book value	85	75	60	0
Assuming the loan is sold at INR50	50	50	50	50
Profit/(loss) on sale	-35	-25	-10	50

Agency model IRRs down sharply under the new regime

The industry is structurally moving from agency business to fund-based business

Increase in cash investment by ARCs has resulted in lower bid prices and higher management fee

- ▶ Let us take a simple example where an asset was sold to an ARC for INR100 under the 5/95 structure and the management fee is 1.5%. Assuming that there is no recovery in five years, the ARC would lose its INR5 investment. However, this is more than adequately compensated by management fee income for five years (i.e., INR7.5). In this case, the IRR for an ARC would be ~15% (under the old structure and without any tax and expenses adjustment). (Refer below table).
- ▶ Considering the high IRR (with no skin in the game), several ARCs bid aggressively during the September 2013 to August 2014 period, with a focus on the agency business model (with a view to build-up their AUM (assets under management) and earn management fees).
- ▶ With increased share of ARCs in transactions (15%) and the linking of management fee with NAVs of the SRs (compared to outstanding SRs issued previously), the IRR has come down sharply. For the same transaction mentioned above (assuming no markdown on SRs), IRR would fall to -24%. (Refer below table).

Easy money – not anymore; focus back on actual reconstruction/recovery (INR)

	5/95		15/85	
	Without recoveries	With recoveries	Without recoveries	With recoveries
Sale consideration	80	80	80	80
Cash investment by ARC	-4	-4	-12	-12
Management fee				
Year 1	1.2	1.2	1.2	1.2
Year 2	1.2	1.2	1.1	1.1
Year 3	1.2	1.2	1	1
Year 4	1.2	1.2	0.9	0.9
Year 5	1.2	3.7	0.8	8.3
IRR	15%	25%	-24%	1%

Assuming recovery of INR50 (62.5% of NBV)

Earlier, management fees could cover the risk of lower or no recoveries for ARCs and help banks defer the upfront hit of provisioning

Sale consideration = net book value reflected ARCs willingness to pay a higher price to earn a higher management fees

Particulars	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Loan value	100						
Provisions held	20						
Net BV	80						
Sale consideration	80						
SRs issued to ARC	4	4	4	4	4	4	
SRs issued to bank	76	76	76	76	76	76	
Realizable value	50						
MTM losses on SRs	0	6	12	18	24	30	
Profit loss impact							
ARCs' management fees (net of expenses): 1.5%	-4	1.2	1.2	1.2	1.2	3.7	4.5
IRR for ARC	25%						
Bank (write-down on SRs)	0	-5.7	-5.7	-5.7	-5.7	-5.7	-28.5
Impact on Bank P&L (write-downs + fees)	0	-5.7	-5.7	-5.7	-5.7	-11.7	-34.5

However, under the new structure, the economics change completely for an ARC

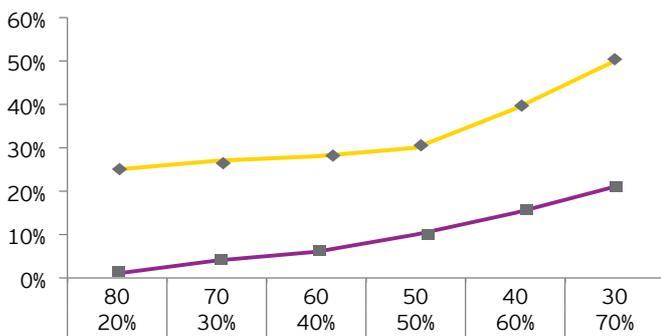
Under similar conditions, the new guidelines increase ARC investments and reduce management fees

Particulars	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Loan value	100						
Provisions held	20						
Net BV	80						
Sale consideration	80						
SRs issued to ARC	12	12	12	12	12	12	
SRs issued to bank	68	68	68	68	68	68	
Realizable value	50						
MTM losses on SRs	0	6	12	18	24	30	
Profit Loss Impact							
ARCs' management fees (net of expenses): 1.5%	-12	1.2	1.1	1	0.9	8.3	0.5
IRR for ARC	1%						
Bank (write-down on SRs)	0	-5.1	-5.1	-5.1	-5.1	-5.1	-26.0
Impact on bank P&L (write downs + fees)	0	-5.1	-5.1	-5.1	-5.1	-10.9	-31.0

IRR reduces sharply under the agency concept

- ▶ The chart below clearly illustrates that ARCs would no longer be willing to pay higher considerations (especially net book value). The fees charged would also have to increase as the revised guidelines link management fees to net asset value rather than outstanding SRs.
- ▶ **The IRR for an ARC under this scenario increases significantly if the sale consideration is lower than 60% of the realizable value. In the chart above, IRR is ~21% (under the 15/85 structure) when the sale consideration is INR30, i.e., 60% of the realizable value of INR50.**
- ▶ The SBI's recent transaction wherein an account was sold at 10% of the principal value is an example of how banks would need to set realistic reserve prices and accept lower sales considerations.
- ▶ Our interactions with several ARCs highlight the reduced price competition and increased incentives to ARCs for faster recoveries.

Business model no longer viable on management fees



Source: MOSL

Note: In the above chart, we assume gross loan value of INR100, net book value of INR80, realizable value of INR50, management fees of 1.5% constant under both 5/95 and 15/85 structures. We assume a 20% upside for the ARC on excess recovery under both the scenarios.

Impact of new guidelines at the system level

Positive in the long-term; the near-term remains challenged

In our view, the asset reconstruction business has structurally moved from agency business to fund-based business

- ▶ The rationale behind the changes was to incentivize and expedite the recovery/restructuring process. The revised guidelines ensure that ARCs focus on redeeming SRs rather than just basing their business model on earning management fees.
- ▶ From a long-term perspective, we believe the industry (after the new guidelines) is moving in the right direction where the proportion of cash is increasing and assets are priced closer to their true value. Favorable guidelines/regulations such as bankruptcy, S4A, lowering the threshold level of enforcing SARFAESI and membership to JLF, coupled with more experience in the resolution of NPAs, are likely to result in speedy recovery/restructuring.
- ▶ An area of interest for the ARCs could be in the EPC sector that is currently reeling under severe stress. The cash flows of majority of the EPC companies are stretched in view of the non-release of payments by government clients. The claims go through an arbitration process that potentially delays the timing of cash flows. To tide over the timing mismatch, the ARCs could be roped in to carve out such claims from the main entity and then offload to ARCs under an SR structure. ARCs could then work in a more focused manner partnering legal and techno commercial professionals to realize this money in a more time bound manner.
- ▶ Going forward, we see ARCs participating in the revival of large borrowers that have a good turnaround potential by adopting this strategy. We expect to see a massive shift in the resolution mindset of ARCs - from merely liquidating assets to recover their dues to participating in the long-term revival of borrowers by estimating sustainable debts and carving out core operational businesses from the non-core assets. However, to make this successful in the long run, it could be the most opportune time for ARCs to place greater emphasis on revival and strengthen capabilities around restructuring and reconstruction. While a few ARCs are looking to build up operational skillsets, others are looking to partner credible turnaround professional firms with a view to bring in sectoral expertise.

Industry moving in the right direction - the proportion of cash is higher and assets are priced closer to true value

- ▶ The RBI has unequivocally directed banks to "clean up" their balance sheets by March 2017, while empowering them with many tools to deal with the situation in the process.

- ▶ The NPAs in the banking sector have seen a big jump after the AQR by the RBI. Accordingly, majority of the banks have taken up adequate provisions to cover for unforeseen losses.
- ▶ In 4QFY15, the SBI Group sold assets at a significant discount to the net book value. We expect this trend to continue going forward as the stressed loan situation at banks remains challenging and the asset reconstruction industry remains capital constrained.

Key growth enablers for the asset reconstruction business

Removal of sponsor shareholding cap could bring additional resources

Removal of sponsor shareholding cap one of the key enablers of growth for the ARC industry

- ▶ **Highly efficient judicial system:** Recovery suits must be disposed of within the statutory timelines and any delay should attract a strict penalty. The Code and additions of new DRTs should help in strengthening the recovery process.
- ▶ Removing the 49% cap on sponsor shareholding will allow large private ARCs to raise equity capital and sustain the growth momentum seen in the market.
- ▶ **Loss on sale to ARCs should be written off over a two- to three-year period** (currently two years for sale till March 2016). This will allow more banks to clean up their books. The proportion of cash transactions may increase as the industry has moved from agency business to fund-based business under the 15/85 structure and IRRs are usually higher for ARCs in cash transactions. This will also be beneficial for banks as it will immediately free up capital.
- ▶ ARCs should be allowed to hold majority shares after the conversion of debt to equity and to invoke the pledged shares. Currently, ARCs' charter does not allow them to hold more than 26% equity in a borrower entity. However, ARCs should be brought at par with the banking system to play a meaningful role in the long-term revival of stressed companies. The success in sustained revival would lie in if the ARCs aggregating a minimum of 75% aggregate debt

from banks convert part of the unsustainable debt into equity to hold majority control, followed by the induction of risk capital towards kick starting of operations/last mile funding.

▶ **Absence of a secondary market for SRs**

Currently, over 90% of SRs are held by seller banks themselves. Considering the pricing of the majority of the SRs, there is a general lack of investor appetite leading to an absence of a secondary market for SRs. However, in our view, the establishment of a secondary market for SRs will improve liquidity and attract special situations funds and qualified institutional investors toward this market.

▶ **Intercreditor issues leading to delay in aggregation of debts**

The Indian banking landscape has traditionally been characterized by consortium/multiple lending with different classes of security. This results in significant intercreditor issues, which inhibits prompt implementation of the most appropriate resolution strategy, causing loss of value to all concerned. Most resolution approaches (under the SARFAESI Act, CDR mechanism etc.) call for the consent of secured lenders representing 75% total debt by value.

The intermediation by ARCs in the NPA resolution process becomes critical as ARCs have debt-aggregation capabilities and capabilities to build necessary skill-sets that are critical to successful resolution. ARCs with the ability to aggregate debt of different classes would be in a better position to address inter-creditor issues. Debt-aggregation capability would also provide better control/leverage over the creditor in implementing a desired resolution strategy.

A notable change in the market is the willingness of the lead bank to offer the aggregate loan exposure of all member banks (consortium/multiple lending) for sale to ARCs. The challenge has remained in terms of the time taken by ARCs for aggregation of debts. However, the lead bank, in the matter of Hotel Leela Venture and Arch Pharma sold the aggregate exposure of all member banks to a prominent ARC. Alternatively, it may be worthwhile considering forming an aggregating agency which will accumulate debts and then auction the same out based on bids by ARCs and special situation funds. The pricing would be based on commercial discovery and the aggregating agency would then pass on that pricing to the respective banks.

ARCs: accounting considerations

ARCs were created to administer and recover NPAs from the banking system. They isolate NPAs from the balance sheet of banks/FIs and allow them to focus on their core activities.

Transaction structure adopted by ARCs

Step 1

- ▶ ARC acquires NPA portfolios by floating an SPV which acts as a trust, with the ARC as a trustee and manager. NPAs are acquired from banks/FIs at fair value based on an assessment of the realizable amount tenor. The banks/FIs may receive cash/bonds/debentures as consideration or may invest in SRs issued by the ARC.
- ▶ The trust acquires NPAs from banks/FIs and raises resources by devising fund/ schemes for the financial assets taken over. SRs represent undivided right, title and interest in the trust fund. Subsequently, the ARC redeems the investment to the bank/FIs out of the funds received from the issued securities. After acquiring the NPA, the trust becomes the legal owner and the security holders its immediate beneficiaries. The NPAs acquired are usually held in an asset-specific or portfolio trust scheme. In the portfolio approach, due to the small size of the aggregate debt the ARC constitutes a portfolio of the loan assets from different banks and FIs. When the size of the aggregate debt of a bank/FI is large, the trust takes the asset-specific approach.

Step 2

- ▶ Thereafter, different fund schemes are pooled together in a master trust scheme and sold to other investors on an agreed-term basis. The ARC periodically declares the NAV of the respective schemes.

The RBI issued uniform accounting guidelines for asset reconstruction companies in 2014.

The key accounting considerations for ARCs relate to:

- ▶ **Acquisition costs for NPAs/financial assets acquired**

Expenses incurred at the pre-acquisition stage for performing due diligence should be expensed immediately by recognizing them in the statement of profit and loss for the period in which they are incurred. This requirement of immediately expensing acquisition costs rather than amortizing it over the

recovery period of the asset purchased leads to a significant impact on the income statement of ARCs.

- ▶ **Revenue recognition**

The yield and upside income should be recognized only after the full redemption of the entire principal amount of SRs. This time lag, meant as an anti-abuse provision and a mechanism to prevent front-loading of income, is quite onerous to ARCs as the income is only reflected in the profit and loss statement after a prolonged lag. This also impacts the valuations of ARCs that are based on revenue and gains.

Management fees should be calculated and charged as a percentage of the NAV at the lower end of the range of the NAV specified by the Credit Rating Agency (CRA) provided they are not more than the acquisition value of the underlying asset. However, management fees are to be reckoned as a percentage of the actual outstanding value of SRs, before the availability of the NAV of SRs. Management fees may be recognized on an accrual basis. Management fees recognized during the planning period must be realized within 180 days from the date of expiry of the planning period. Management fees recognized after the planning period should be realized within 180 days from the date of recognition. Unrealized management fees should be reversed thereafter. Any unrealized management fees will be reversed if before the prescribed time for realization, the NAV of the SRs fall below 50% of the face value.

The RBI has mandated hiking the initial investment by ARCs from 5% of the acquisition amount to 15% to encourage ARCs to move from the management fee model to the investment model.

In the 5/95 model, ARCs used to buy a bad loan at a discount from banks' book value by paying just 5% upfront in cash, while the balance was in the form of SRs issued by them. ARCs get a management fee of 1.5% every year on the overall AUM they manage. In the 5/95 scenario, on an investment of INR 5 (on an INR100 loan), ARCs were earning INR1.5, i.e., a 30% return.

However, in the new 15/85 model, the 1.5% management fee only amounts to a 10% rate of return on a cash investment of 15%.

▶ **Derecognition/true sale criteria for banks/NBFCs**

“True sale” (this term would hereinafter include direct sale, assignment and any other form of transfer of asset, but not include loan participation through inter-bank participation certificates, bills rediscounted, outright transfer of loan accounts to other financial entities at the instance of the borrower and sale of bonds other than those in the nature of advance) should result in immediate legal separation of the “selling bank” (this term would hereinafter include the direct selling bank, assigning bank and bank transferring assets through any other mode) from the assets that are sold. The assets should stand completely isolated from the selling bank after their transfer to the buyer, i.e., put beyond the selling bank’s as well as its creditors’ reach, even in the event of bankruptcy of the selling/assigning/transferring bank. The selling bank should effectively transfer all risks/rewards and rights/obligations pertaining to the asset and should not hold any beneficial interest in the asset after its sale except those specifically permitted under these guidelines. The buyer should have the unfettered right to pledge, sell, transfer, exchange or otherwise dispose of the assets free of any restraining condition.

These stringent criteria were introduced to permit derecognition of only those assets by banks in which they had no underlying involvement.

Earlier, any profit/premium arising on account of securitization of loans (i.e., sales to ARCs) had to be amortized over the life of the securities issued

or to be issued by the SPV. These instructions were intended to discourage the originate-to-distribute model. However, according to the revised RBI guidelines, a higher recognition of cash profits is permitted to be recognized during a year based on the amortization of principal and losses incurred as well as specific provision requirements.

The derecognition and booking of profit relaxations permitted to banks and NBFCs while accounting for the sale of asset portfolios to ARCs have been made by the regulator to encourage the ARC business.

ARCs: taxation considerations

Taxation of securitization vehicles

In India, securitization vehicles have historically been predominantly set-up via a trust structure with the underlying assets being transferred by way of sale to a trust. This has been the case irrespective of the regulatory regime under which such securitization vehicles have been set-up³⁴.

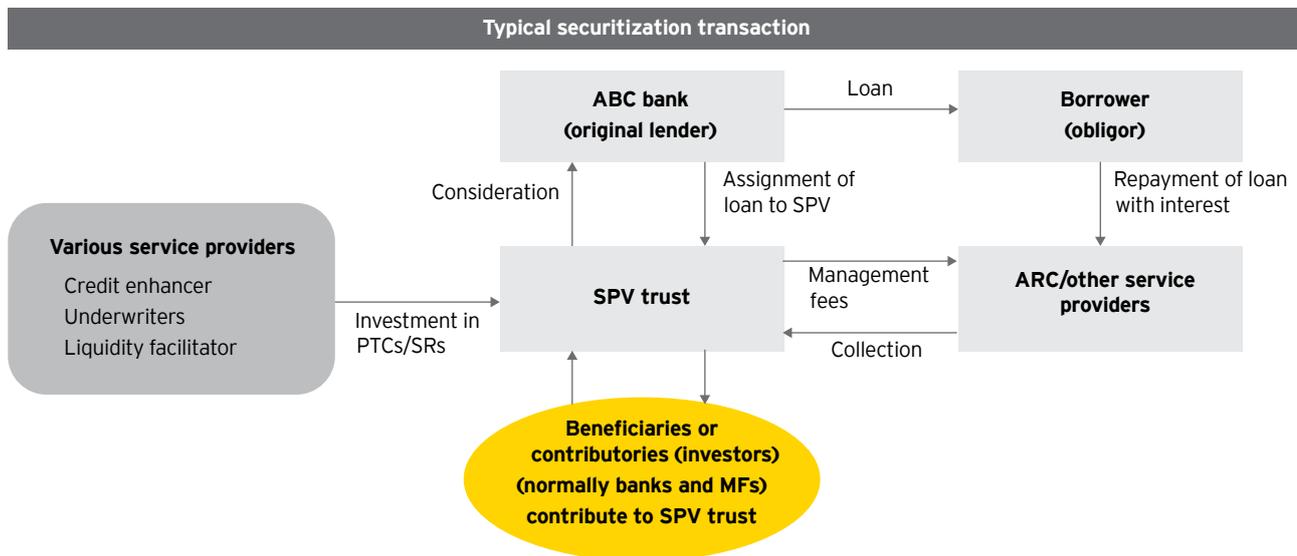
In a typical loan securitization transaction, the lender grants a loan to a borrower backed by an asset. The receivables are transferred by the lender to a SPV, formed as a trust registered under the Indian Trusts Act, 1882.

The trust thereafter typically issues a Pass Through Certificate (PTC) to the various investors. The investors are normally financial institutions such as banks, mutual funds and NBFCs. Investors holding PTCs are entitled to a beneficial interest in the underlying assets held by the trust as determined and specified in the trust deed.

34 The current regulatory framework for functioning of the securitization market is primarily governed by the following:

- ▶ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- ▶ The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003, as amended from time to time
- ▶ Guidelines on securitization of standard assets issued by the RBI
- ▶ Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008

The following is the structure of a typical securitization transaction:



a) Tax issues prior to amendments made by Finance Act, 2013 (FA 2013)

- ▶ Prior to 2013, the domestic tax law did not contain any specific provisions for taxation of the participants involved in a securitization structure – i.e., the trust and the beneficiaries of the trust. Accordingly, the taxation of the trust and the beneficiaries was governed by the prevailing provisions for taxation of trusts.

Taxation of trusts that are irrevocable³⁵

- ▶ According to the provisions dealing with trust taxation, the trustees of the trust are treated as a representative assessee who are subject to the same duties, responsibilities and liabilities as the beneficiaries, and the tax treatment of such people is the same as if the income received by the beneficiaries were the income received by or accruing to the representative assessee beneficially. Accordingly, the trustees may be taxed on the income received by them on behalf of the investors, and such tax is levied on the trustee in the same manner and to the same extent as it would be levied on the investors.

However, if the trust is held to carry on business, it is liable to tax at the maximum marginal rate (i.e., 30% plus applicable surcharge and education cess).

- ▶ Investors receiving income from the trust are ordinarily liable to tax on the income earned in proportion to their investment. Where the trustees are characterized as representative assessee and accordingly taxed, the tax paid by the trustees is deemed to be paid by the investors. In this case, the investors would again not be required to pay tax individually on the same income.
- ▶ It is pertinent to note that the domestic tax law empowers the tax authorities to assess either the representative assessee (i.e., the trustee) or the beneficiaries of the trust.
- ▶ However, where the beneficiaries of a trust are unknown or indeterminate, the income of such a trust is taxable in the hands of the trustee at the maximum marginal rate (i.e., 30% plus applicable surcharge and education cess).

³⁵ A transfer of assets to a trust is treated as revocable if it contains any provisions for the re-transfer of any part of the income or assets to the transferor or gives the transferor a right to resume power over any part of the income or assets.

Taxation of trusts that are revocable

- ▶ Where the trust is treated as a revocable trust, the income arising to the trust is subject to tax in the hands of the person assigning the loan to the trust.

Issues arising from these provisions

- ▶ The Indian tax authorities contested the position taken by securitization trusts, as discussed above, and raised questions on (a) whether trusts are the real “owners” of the receivables or “conduits” for the real owners, which are mutual funds or NBFCs and (b) whether the income that these trusts receive is taxable under the head “profits and gains of business or profession.”
- ▶ The tax authorities initiated scrutiny proceedings against certain securitization trusts with respect to AY 2009–2010 and AY 2010–2011. The tax authorities passed assessment orders and consequential demand notices to such trusts and contended that the interest received by them from loans is taxable under the head “profits and gains from business and profession,” at the maximum marginal rate.
- ▶ This stand taken by the tax authorities caused difficulties for PTC holders, particularly mutual funds, whose income is exempt from tax.
- ▶ This matter is under litigation and currently pending adjudication at the Income Tax Tribunal level.

b) Amendments made by FA 2013

- ▶ Acknowledging various representations of the industry in this regard, in order to facilitate the securitization process and address this controversy, the FA 2013 provided a special taxation regime in respect of taxation of income of securitization entities, set up as a trust, from the activity of securitization.
- ▶ The salient features of the regime were as follows:
 - ▶ In case of securitization vehicles set up as a trust and the activities of which were regulated by either SEBI or the RBI, the income from the activity of securitization was exempt from taxation.

- ▶ The securitization trust (ST) was liable to pay income tax on income distributed to its investors on the line of distribution tax levied in the case of mutual funds. The income tax was levied at 25% in case of distribution being made to individual investors and Hindu Undivided Families, and at 30% in other cases. No income tax was payable if the income distributed by the ST was received by a person exempt from tax under the domestic tax law (such as mutual funds).
- ▶ Consequent to the levy of distribution tax, the distributed income received by the investor was exempt from tax.
- ▶ These provisions still did not provide the much-needed impetus to the securitization market, which had come to a standstill subsequent to the approach adopted by the tax authorities. The concerns arising are summarized below:
 - ▶ The distribution received by the PTC holders attracted taxation on a gross basis at a significantly high rate of 30% (for taxpayers other than individuals and a Hindu Undivided Families).
 - ▶ As the income received by PTC holders was exempt from tax, according to the provisions of the domestic tax laws, a disallowance of expenses incurred in relation to this income would have to be made by the PTC holders in their tax returns.
 - ▶ Trusts set up by reconstruction companies or securitization companies were not covered (although such trusts also engaged in securitization activities). These companies were established for the purposes of the securitization and reconstruction of financial assets and the enforcement of the SARFAESI Act, with the RBI regulating their activities.

c) Amendments made by the Finance Act, 2016 (applicable with effect from 1 June 2016)

To address the concerns arising from the tax regime for STs introduced by FA 2013, the Finance Act, 2016 (FA 2016) has replaced the erstwhile special regime for STs by a new regime with the following elements:

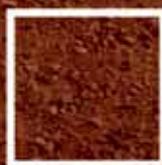
Particulars	Amendments made by FA 2016
Date of applicability	1 June 2016
Nature of STs covered	<ul style="list-style-type: none"> ▶ SEBI-regulated funds for securitization of debt or receivable ▶ as defined in the guidelines on securitization of standard assets issued by the RBI ▶ a reconstruction company/securitization company in accordance with the SARFAESI Act or in pursuance of any guidelines or directions issued for the said purpose by the RBI
Availability of pass through status to STs	Yes
Whether distributed income is deemed to be credited to investors at the end of the year	Yes
Whether investor enjoy exemption on distributed income	No; taxable at their own applicable rates
Distribution tax payable by securitization trust	Not applicable
Withholding tax obligation on STs while making payment to investors	<ul style="list-style-type: none"> ▶ 25% in case of payment made to individuals or Hindu Undivided Families (HUF) ▶ 30% in others case ▶ Rates in force (rate under the relevant tax treaty or under domestic law, whichever is beneficial) in case of payments to non-resident investors
Whether investor can apply for nil/ lower withholding certificate	Yes

We are confident that these amendments will provide a much-needed fillip to the industry.



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Dealing with banking stress – key initiatives by the RBI and the government

The RBI, from time to time, has come up with various initiatives to deal with the current banking stress. The regulator, through its discussion paper on early identification of distressed assets, has adopted an approach that would lead to early identification of stressed assets to enable credible and timely resolution of such assets.

While the RBI has also stressed on a review of the credit appraisal system with a focus on additional necessary due diligence, many of the restructured assets in India are a result of:

- ▶ A sharp slowdown in the domestic economy over the past few years led by the global slowdown.
- ▶ Projects stalled at various stages because of delays in clearances and issues in fuel linkages.
- ▶ Persistent policy paralysis delaying structural reform.
- ▶ Significant build-up of excess capacity financed mainly through excessive leverage.
- ▶ Inadequate focus on core competencies and overpriced overseas acquisitions.
- ▶ Infrastructure projects blocked at various stages because of heightened environmental concerns.
- ▶ Sharp slowdown of consumption in the domestic economy.
- ▶ Under-developed institutional equity market.
- ▶ Deficiencies in the credit appraisal and due diligence processes, particularly at PSU banks.
- ▶ Failure of Indian banks to take corrective action at the appropriate time.

Some of the prominent measures taken by the RBI are as follows:

▶ Changes in CDR

If an account was restructured under CDR, it was classified as standard and banks held only a 5% provision as long as the promoter contribution was brought in to meet the bankers sacrifice. Though well intended, CDR was used as a delaying mechanism and did not motivate banks to recognize the fact that there could be excess debt in the system that is unserviceable. Effective March 2015, the RBI has taken away the provisioning concession offered to CDRs. This move will go a long way in making sure we have more meaningful restructurings than just delayed payments.

▶ Focus on early warning signals

The RBI has asked banks to create a new asset classification called SMAs to identify early signs of stress in an account based on tangible events or indicators. This move will improve transparency and increase the accountability of banks and promoters alike. Early warnings and resolutions will also result in a higher probability of consolidation, turnaround or timely asset sell-off.

Banks as well as systemically important NBFCs will also have to report SMA accounts (with exposure of above INR50 million) to the Central Repository of Information on Large Credits (CRILC), to be set-up and maintained by the RBI.

Once an account is reported as SMA-2, all lenders, including NBFCs, have to form a JLF to formulate a corrective action plan (CAP), which would involve one of the following resolution options: rectification, restructuring and recovery. The spirit of these RBI guidelines was that while formulating a CAP, the focus should be to design a viable plan rather than opt for general restructuring terms such as repayment moratorium while hoping for economic revival to recover dues. However, unlike consortium lending, arriving at an effective resolution under a JLF structure could be a challenge in case of multiple banking arrangements, as different banks may have exposures of varying tenures with different underlying collateral.

While these guidelines will put a large procedural burden on banks in terms of monitoring and reporting requirements, they will also result in greater transparency and timely resolution plans to recover loans and enable rationalization in the industry. The RBI is now using these guidelines to make sure there is uniform recognition of NPAs across a corporate borrower in all banks.

However, given that JLFs does not require attendance of people from the senior management of banks, the process has not been as effective. As per the RBI guideline, while it has mandated senior level involvement and the presence of senior personnel from the SBI and ICICI in all JLFs, the process may not be effective.

▶ Strengthening of credit risk management at banks

Banks have been asked to pay special attention to the source and quality of promoter equity contribution and be particularly aware when debt raised by a parent company is infused as equity in subsidiaries. Banks have also been asked to engage auditors for specific certification of end use of funds.

► **Accountability of promoters**

Under the RBI guidelines, promoters have to infuse more equity or issue new shares before an account can be restructured. The guidelines also provide for promoters transferring their holdings to an escrow account to enable lenders to institute management change. In certain cases, banks can also stipulate that promoters divest non-core assets.

► **SDR**

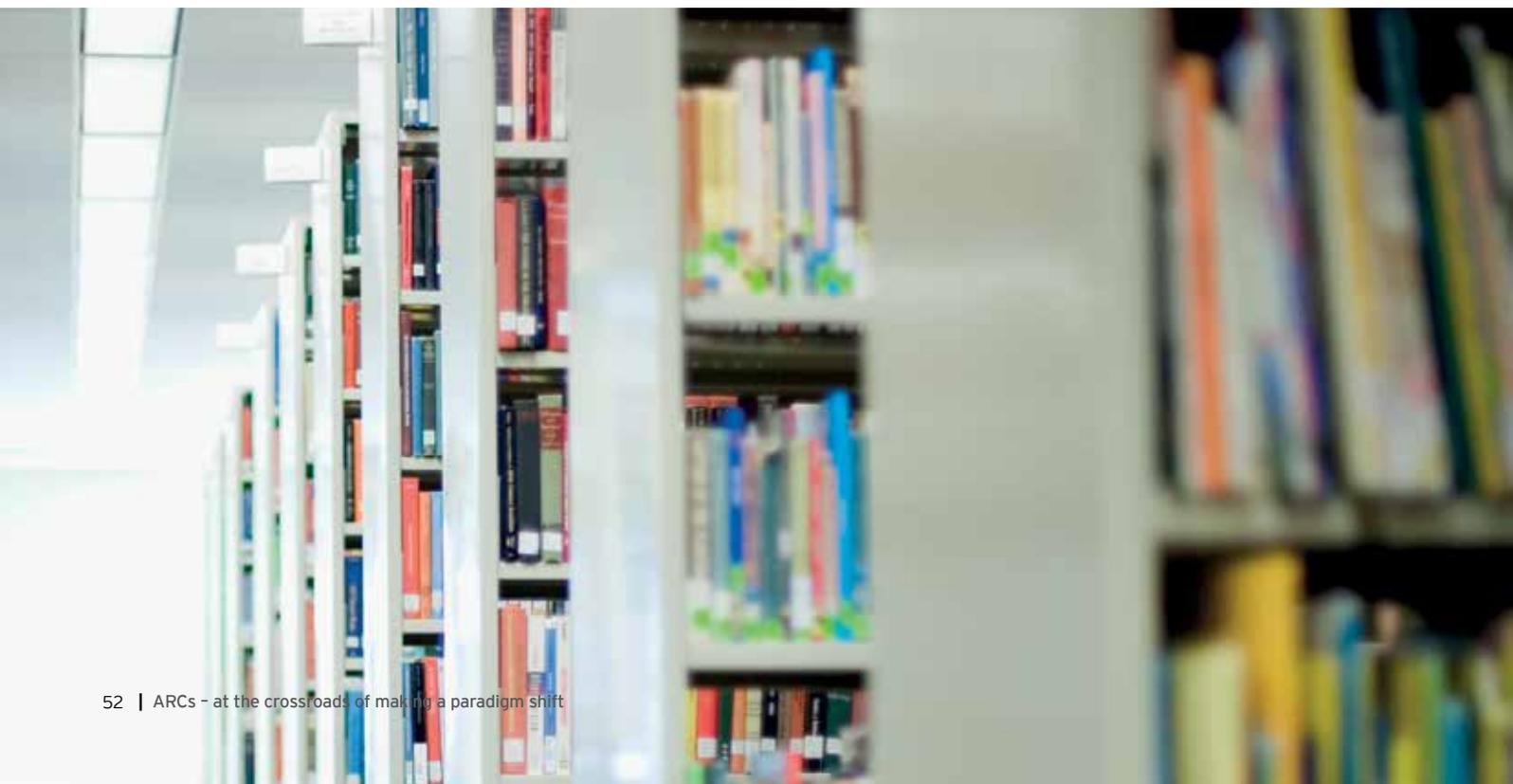
In line with its thought process that promoters who are unable to perform need to be replaced, the RBI introduced an SDR provision that enabled banks to collectively take a 51% stake and find a new buyer over an 18-month period and simultaneously restructure the loan. While the RBI has allowed banks to take a stake and SEBI has granted an open-offer waiver, there are many conditions, including those under the Companies Act and various other laws that can stall its implementation. Banks are also not fully confident of finding buyers in these times and hence this provision is implemented primarily with promoter consent and when a willing buyer is identified or in sight. This initiative would be more effective under the Bankruptcy Code when implemented.

According to estimates, SDR has been invoked in companies with ~INR 1041.85 billion of debts (details as below). However, there has not been much of headway post invocation.

Industry	Debt outstanding (INR billion)
Engineering, Procurement and Construction (EPC)	343.71
Steel	266.66
Automobiles	13.4
Mining	24.79
Oil and gas	38.19
Power	22.78
Textile	218.42
Shipping	105.19
Distilleries	7.37
Total	1041.85

Source: Religare report 2016

ARCs should be allowed to hold majority shares after the conversion of debt to equity and to invoke the pledged shares. Currently, ARCs' charter does not allow them to hold more than 26% equity in a borrower entity. However, this needs a relaxation and ARCs should be brought at par with the banking system to play a meaningful role in the long-term revival of stressed companies.



Our recommendation would be taking the top 50 to 100 exposures in the system and getting ED-level bankers involved in proposing resolutions. There is also a need for the government to recognize that these are complex situations and the officials involved should be allowed to take decisions that are best for the circumstances as long as a clear and transparent process is followed. The excessive fear of vigilance at times results in sub-optimal decision-making.

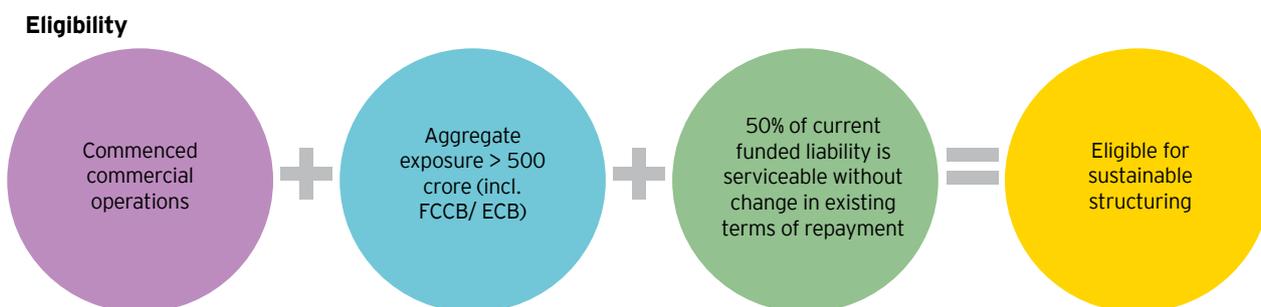
► **Scheme for sustainable structuring of stressed assets (S4A):**

As per a recent RBI guideline, in order to further strengthen the lenders' ability to deal with stressed assets

and to put real assets back on track by providing an avenue for reworking the financial structure of entities facing genuine difficulties, the RBI has issued guidelines on a S4A.

The new loan restructuring window allows banks to bifurcate the debt of stressed borrowers into sustainable and unsustainable portions. Part A would be based on servicing capacity and Part B on equity/quasi equity instruments. There will be an "overseeing committee" (OC) set up by the Indian Banks' Association in consultation with the RBI that will review the process and act as an advisory body.

The new guidelines are expected to be superior to the SDR scheme as the entire debt need not be classified as non-performing assets and the existing promoter manager can also continue.



Resolution scheme

- Aggregate exposure (fund based)
- As per clause 5 of circular "sustainable debt shall not be less than 50% of current funded liabilities"

Part A	Part B
<ul style="list-style-type: none"> ► Serviceable from existing level of operations (FCF) ► No change in terms of repayment ► Need based funding to be sanctioned within 6 months ► No security dilution (to check on cover/value) ► Promoter's personal guarantee for at least part A 	<ul style="list-style-type: none"> ► Converted into equity/OCRPS ► OCD (if no change in promoter) ► Equity to be MTM for listed company and lower of break up value or DCF for unlisted company ► Loss to be compensated by promoters by sale of equity
<ul style="list-style-type: none"> ► Outstanding loan to be taken facility wise ► No moratorium ► No change in interest rate ► No extension of tenor 	<ul style="list-style-type: none"> ► To be spelt in the scheme ► Coupon ► Time line to redeem ► Tenor

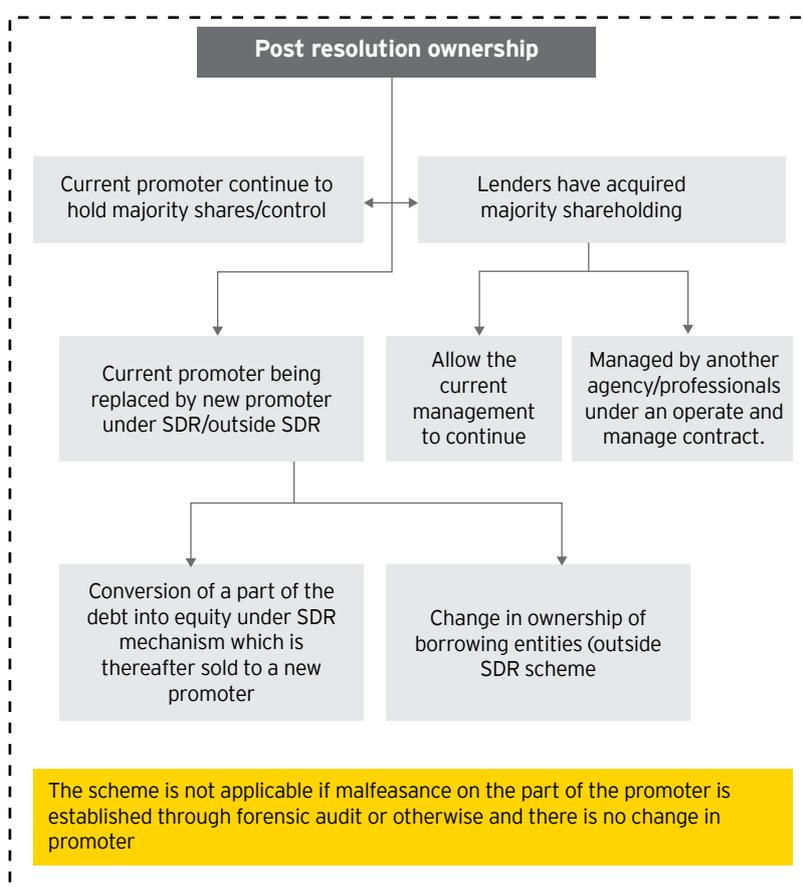
- JLF/consortium to conclude through independent TEV the sustainable level of debt as per the existing repayment schedule (Part A).
- Balance current outstanding debt shall be converted into Part B

Impact on borrowers

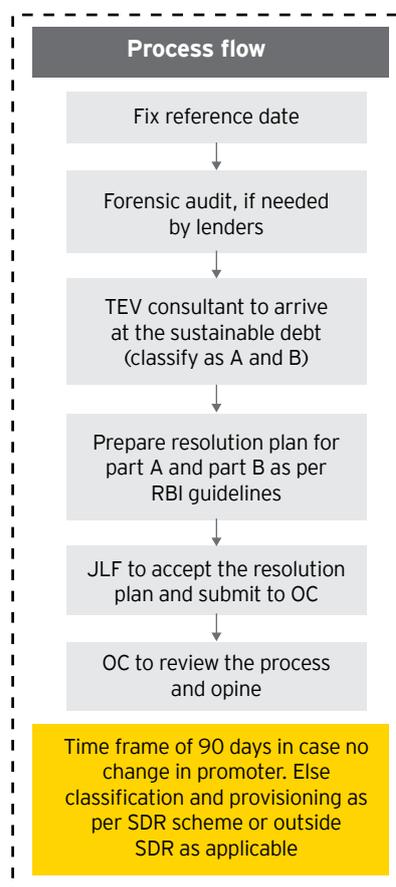
- ▶ Promoter contribution by way of conversion of debt to equity and pro-rata loss of lenders in cases where there is no change in promoter.
- ▶ A resolution plan to be agreed by a minimum of 75% of lenders by value and 50% by number.
- ▶ The scheme to be implemented within 90 days of the reference date.

- ▶ An OC, which will only be an advisory body, to be constituted by IBA; a resolution plan (backed by TEV (Techno economic viability) study) to be submitted by JLF to the OC, who will opine on it in light of these guidelines.
- ▶ Once the resolution plan is ratified by the OC, it will be binding on all the lenders as per extant guidelines on JLF/ CAP.

Eligibility



Process flow



Impact on lenders

- ▶ Banks are required to maintain a minimum of 20% provision on the total loan outstanding or 40% of the unsustainable portion of the debt at the time of S4A.
- ▶ Banks have to provide for 100% of the expected losses on the unsustainable portion (in excess of the minimum requirements prescribed, which is 20% of the total or 40% of the unsustainable portion) over the period of four

quarters (while the provisioning requirement for banks will increase in the next four quarters, the new norms will help reduce provisions substantially over a longer period of time).

- ▶ The new guidelines will help in reducing the reported gross NPA levels by 30–100 basis points, from the current level of 7.7% as on March 2016, after a lag of one year, following satisfactory performance of the sustainable debt portion.

EY's point of view on the recent RBI guideline

While we feel this could be a step in the right direction to revive companies, the following are our views on some of the points so as to achieve a meaningful and deep restructuring:

Applicability to ARCs

With regard to ARCs, the circular applies only on accounts that have been acquired on a cash basis. Considering that the majority of the large-value acquisitions (i.e., debts more than INR5 billion) have been made by ARCs on an SR basis, it would be prudent to extend these guidelines to such transactions as well.

Principal of proportionate loss-sharing

- ▶ Paragraph 7.3 of the guidelines refers to the principal of proportionate loss sharing. This clause provides for the issuance of equity shares to the lenders where a deep restructuring does not result in a change in ownership. The paragraph says that promoters need to dilute their shareholdings in the same proportion that part B bears to the total borrowings.
- ▶ This clause pre-supposes that part B would not have any yield. Where part B does not involve any sacrifice on an IRR basis, the clause for offering proportionate equity shares seems unjust. Maybe the paragraph ought to be amended to include the issuance of shares only to the extent of interest sacrifice. For any default in the proposed IRR, there should be a right to dip into the shares. An escrow mechanism to hold shares but release them on the payment of IRR may be a more prudent option.

Mandatorily 50% of the debt has to be sustainable

- ▶ Paragraph 5 states that sustainable debt should not be less than 50% of total debt for the deep restructuring norms to be applicable. Further, sustainable debt should be worked out based on the existing levels of cash flows (in other parts, we mention current levels plus another six months going forward). The paragraph also states that debts should remain sustainable at current maturity dates.
- ▶ While the aim of the clause seems to be to restrict subjectivity in TEVs (which may have been abused in the past), it would result in sustainable debt remaining at very low levels (and in most cases below 50%). The key reasons are as follows:
 - ▶ Generally, 40%–50% of total debt outstanding today represents interest payments made during the last four to five years where cash flows from operations have been insufficient, resulting in borrowings to pay interest. This portion of the debt is unsustainable.
 - ▶ On an average, stressed companies are operating at 30%–40% capacity, which further reduces sustainable debt on original borrowings by about 60%.
 - ▶ Accordingly, on an intuitive basis, approximately 60%–70% of the debt would remain unsustainable at the current levels of operations.
- ▶ In our view, the current and six months cash flows should be extended to cash flows between 18 and 24 months. TEVs should also allow at least a one-year moratorium of principal payments for any meaningful restructuring, as most of the cash generated from the restart of operations needs to be deployed in scale for early revival.

Fundamentally, restructuring of debt is very subjective and any prescription may not result in an optimal solution for banks. The key is turnaround implementation for the benefit of the bankers. The circular deals with financial parameters but needs to put in appropriate turnaround specialist requirements too. Also, the choice of consultants should be on the overall effectiveness of a turnaround. Conflicts, if any, should be minimal as the aim should be to reduce the information gap between the company and bankers with the help of specialists.

Summary of developments proposed in the Union Budget FY17 and their likely impact on ARCs

Particulars	Proposed change	Likely impact
Sponsor ownership	Sponsors can own a 100% stake in ARCs as compared to up to 50% earlier. This is, however, subject to amendment of the SRFAESI Act by the Parliament	<ul style="list-style-type: none"> ▶ It will bring in the much-needed capital into ARCs, which has been a major impediment to growth ▶ It could also enable ARCs to bring down their cost of funds
Account upgrade	Banks can upgrade an asset to the standard asset category if they divest at least 26% of the stake to the new promoter within the specified period of 18 months	<ul style="list-style-type: none"> ▶ Lenders would thus have the option to exit their remaining holdings gradually, with upside as the company turns around
FDI in ARCs	The ceiling for FDI in ARCs has been raised to 100% from the earlier 74%	<ul style="list-style-type: none"> ▶ With 100% FDI, ARCs will be able to raise more funds and improve their leverage ▶ FDI approval will now be via the automatic route
FII investment in schemes of SRs	FIIs can invest up to 85% in each tranche of schemes by SRs	<ul style="list-style-type: none"> ▶ It will have a positive impact, as ARCs could invite different partners to contribute to each SR scheme. ARCs will continue to invest their mandatory contribution of 15% of the SR value
Tax clarity on STs	The government provided clarity in the budget by stating that complete pass-through of income tax is allowed to STs, including trusts of ARCs	<ul style="list-style-type: none"> ▶ This is positive for ARCs because the income will now be taxed in the hands of investors instead of the trust

Source: Union budget and EY analysis

With the opening up of 100% FDI, we see ARCs participating in the revival of large borrowers that have a good turnaround potential going forward. We expect to see a massive shift in the resolution mindset of ARCs – from merely liquidating assets to recover their dues to participating in the long-term revival of borrowers by estimating sustainable debts and carving out core operational businesses from the non-core assets. The success in sustained revival would lie in - ARCs aggregating a minimum of 75% aggregate debt from banks - convert part of the unsustainable debt into equity or other instruments - followed by the induction of risk capital towards scaling up of operations/ last mile funding. This would go a long way in providing the much needed fillip to the industry.

The way forward

Recent changes make India an opportunity for value investments especially in case of distressed assets.

What is the opportunity?

- ▶ Previous RBI regulations resulted in an accumulation of stressed assets due to the unviable restructuring of loans. The recent changes in the regulation permitted ascertainment of sustainable debts in companies and working out a more realistic and achievable debt realignment package.
- ▶ Likelihood of such cases would increase with further slippages in the CDR cases where CDR was done only to avoid NPAs.

- ▶ The new regulations may become a deterrent for banks to restructure debt as these options do not help banks any further to reduce/prevent provisioning.
- ▶ The increased provisioning requirement, as also constant pressure from the regulator to clean up banks' books before FY17 will create a sizeable market for ARCs and distress asset funds.
- ▶ On the back of recent initiatives by GoI and RBI, the ARCs business model will gradually undergo a paradigm shift from asset sales to a platform for restructuring businesses to preserve long-term value.
- ▶ Consequently, there is an opportunity for ARCs to transform themselves into special situations funds to invest in distressed assets in India, i.e. invest in "overleveraged companies with good businesses" based on sustainable debt levels.

The distribution of stressed assets in the system follows the 80:20 rule - 20% by number of borrowers are responsible for 80% of value of impaired assets and vice versa. The large stressed loans are given to sizeable industrial houses having good restructuring potential. In value terms, more than 60% of the stressed loans are amenable to be restructured or sold as going concerns.

The seed of success of managing the stressed assets in any economy lies in the speed of recycling these assets and their realization into cash. In achieving this objective, it is important that an attempt should be made to discern incipient difficulties in an asset brewing at an early stage and to make attempts and transfer it to ARCs at that stage itself. This will ensure a much higher realization and a better chance for business turnaround and resolution. Strong and vibrant ARCs specializing in acquisitions and turning around the distressed assets has a key role to play in the economy.

Through introduction of various guidelines including the recent increase in FDI limits, the regulatory authorities and GoI have been constantly working on encouraging alternative sources of capital to enter the Indian stressed assets market, which is a step in the right direction. We feel that the move by the regulators will rationalize recent trends in the industry and will benefit various stakeholders. Valuations will become more realistic, and ARCs will focus more on asset quality and less on building up their asset under management. It could also be the most apt time for ARCs to place greater emphasis on revival and strengthen capabilities around restructuring and reconstruction. In our estimate, there are at least 6-8 players that have applied for a license to RBI to operate as an ARC with many more in the pipeline carrying out basic work on the opportunities that lie ahead.



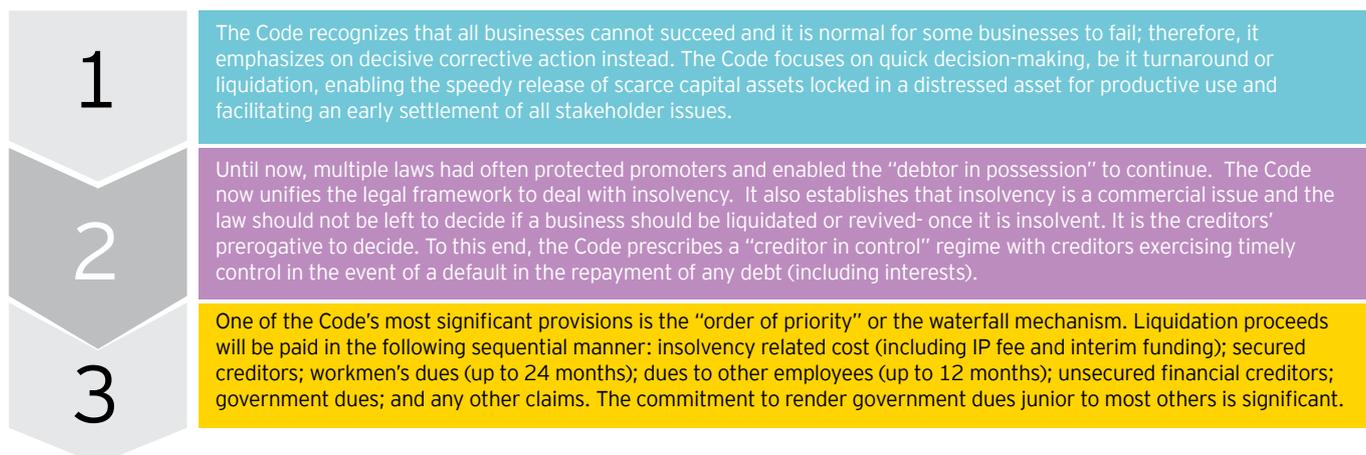
Insolvency and bankruptcy law – a game changer

The Insolvency and Bankruptcy Law (the Code) is, undoubtedly, the most significant reform by the current government till date. The speed at which the legislation was passed has surprised many – considering the delay in some of the other key reforms.

Apart from Prime Minister Narendra Modi's commitment that India will be among the top 50 countries for ease of doing business within three years, the Code acquired urgency because:

- ▶ Stressed assets in the Indian banking system have peaked at ~US\$120 billion or INR8 trillion (~11.5% of gross advances).
- ▶ There has been a heightened focus on the resolution of the problem by the RBI and the Supreme Court. The RBI Governor has said, "Our intent is to have clean and fully-provisioned bank balance sheets by March 2017."
- ▶ There is a dire need of capital today – not just for stressed companies but for growth in general. Neither is it an opportune time to tap the capital markets, nor are banks willing to provide liquidity and most promoters are not in a position to infuse capital. Private capital would need to flow from outside India and for that to happen, a strong legal framework is a pre-requisite.

The Code establishes some very basic principles of borrowing and doing business in India.



Having said that, the Code, at best, is an ambitious and innovative plan currently awaiting execution. Appropriate information flow, establishment of a tribunal process and the provision to bring in responsible professionals to manage the process are essential. The full benefits of the Code will be realized only when all stakeholders contribute to creating an ecosystem conducive to an effective, fair and expedient implementation of the Code. Also, it will be important to create filters to initially allow only more critical cases to enter the process, till the time entire machinery of the Code (insolvency practitioner (IP) courts etc.) is not completely geared up. Else, with the huge backlog of default cases, it might put enormous pressure on the new and untested system.

How should banks gear up for the Code?

The Code unambiguously states that the trigger for an insolvency resolution petition can be a single default, which, if approved, will result in taking over the management of the defaulter by an IP on behalf of financial creditors.

The term default means non-payment of debt when the whole or any part or instalment amount of debt has become due and payable. Therefore, if there is a default in the payment of an instalment or interest (more than INR 1 lakh), a valid insolvency petition filed by any creditor, can push the entire business into the insolvency process.

A key issue that banks would need to address as the Code becomes operational is to determine the nature and cause of the default. Banks will have to assess whether the default is on account of temporary problems or if there is probability of further default, and whether the entire loan outstanding should be recalled and an insolvency resolution application should be filed. If the default is likely to be rectified, it may not be worthwhile to commence the insolvency resolution process (the process). For assessing when to invoke the process, it may be necessary to define certain norms similar to the bankruptcy process in the UK, that take into consideration the following circumstances (only illustrative):

- ▶ What is the probability of reviving the business, or should the creditors directly go into liquidation.
- ▶ What is the probability of 75% of the creditors approving the resolution plan.
- ▶ Is the default one-off for valid and satisfactory reasons or is the default recurring coupled with delays/defaults in payment of other dues/liabilities.
- ▶ What is the possibility of getting interim funding during the moratorium period to continue to run the company as a going concern.
- ▶ Cost implication of putting the company through the process (cost of IP, lawyers, new management etc.).
- ▶ Whether the process would result in a better realization for the creditors as compared to other options like CDR, SDR, direct liquidation etc.
- ▶ If invoking the process would have a negative impact on the company's market image and potentially impacting the going concern.
- ▶ Whether the default is despite the capacity to pay or there are indications of diversion of funds and willful default.
- ▶ Whether the default is on account of delays in receipts for supply of goods/services to government departments, other public authorities and public sector enterprises or large undertakings.
- ▶ Whether the default is on account of some accident or force majeure, requiring a different treatment of default, including grant of debt relief.

Another related issue that needs to be considered is that if the default is rectified after the invocation of the process, whether the status quo would be restored or should the development of a resolution plan and its approval by 75% of the creditors committee be completed.

The answers are not straightforward and would require a detailed set of internal policies and directives, which could be used as guidelines by banks when evaluating specific situations. In addition, banks would also need to develop a sharp commercial outlook and a deeper understanding of their borrowers' economic environment before arriving at the appropriate solution. This would need a significant strengthening of their credit monitoring and the development of early warning mechanisms. Early identification of the problem and taking appropriate steps at an early stage would always be the best route to maximize all stakeholders' value in a distress situation.

In more developed economies, bankers specify a range of critical covenants linked to profitability and cash flows that

are monitored rigorously and periodically. Any breach of such covenants leads to an immediate and independent business review of the company by a specialized agency, resulting in an assessment of the short-term and long-term viability of the business. The outcome of such an independent business review (IBR) would provide banks an evaluation of various options – i.e., (a) allow the borrower to work out a revival or (b) agree with the borrower on an operational restructuring or (c) negotiate a financial restructuring or (d) to pull the trigger on the insolvency process.

The Code bestows tremendous powers to financial creditors, and a responsible exercise of these powers will require a

The following are a few other matters that banks and the RBI would need to consider:

- ▶ What are the categories of loan accounts where the Code should be invoked? In cases of loans to micro and small enterprises, it may be physically impossible to take possession of defaulting enterprises and manage them. Banks may consider restructuring the debt in these cases, if feasible, and recover the debts via debt recovery laws, as required.
- ▶ The current provisioning norms as defined by the RBI may need to be aligned with the Code. One of the possibilities could be that the RBI continues with the existing classification norms such that for the first 90 days after default, the account can be treated as an SMA and after 90 days as an NPA. If after approval of the resolution plan, the account is regular in the payment of restructured debt, the account can be classified as standard.
- ▶ Alternatively, a new category can be created for assets under the insolvency process and put a stand still on the provisioning till the time a resolution plan is either approved or rejected by 75% of the creditors.
- ▶ Loan documentation may have to be modified to provide that the bank shall be entitled to initiate an insolvency petition on a single default. Relevant covenants would also need to be determined and included for each case, empowering the bank to conduct an IBR when there is a breach. It should be incumbent on the borrower to inform the bank the reasons for default and the plan to mitigate it as soon as it realizes a likelihood of a loan default.

complete transformation of their outlook. In addition, credit monitoring systems and loan recovery procedures in the Indian banking system would need to be overhauled. Along with competent IPs, banks would also need to empanel experts across sectors that can assist the IPs in managing defaulting borrowers on behalf of the financial creditors.

How does it impact ARCs?

The banking sector remains hobbled by bad loans as the mechanism of selling them to ARCs, which traditionally recovered them by liquidating assets, has not proceeded as the regulators thought.

The SARFAESI Act empowers ARCs to resolve NPAs under distress. But given their powers to resort to several measures (including taking over the management and conversion of debt into equity) for recovering the value underlying those loans, ARCs can also help in the insolvency resolution of a company. The RBI guidelines specify that ARCs can take over the management only for the purpose of realization of their dues. The SARFAESI Act requires that the management of the company be restored back to the borrower after realization of the dues. Hence, the SARFAESI Act is largely seen as a debt-recovery tool and not an insolvency resolution mechanism (i.e., it does not facilitate rescue in practice), and it is for this reason that the bulk of the accounts sold to ARCs have lesser business value and more underlying asset value in the form of collaterals.

The opening up of 100% FDI in ARCs coupled with the Code has addressed a key challenge faced by ARCs – their ability to fund the working capital needs of stressed assets to enable a revival. There are global distressed asset funds that are increasingly seeing an opportunity here. As things stand, except for a few transactions in the market, ARCs have not been able to acquire large cases with potential turnaround options in view of the capital constraints and the absence of skill sets around and operational turnaround. It would be the most apt time for ARCs to transform themselves into special situation funds with deep operational capabilities to bring about a long-term revival in the business under the new Code.

On the resolution side, various analysis show that recoveries by ARCs have been low – about 36% – with the average resolution taking about five years. That is in line with a World Bank study, according to which it takes more than four years to wind up a sick company in India, or twice the time taken in China, with recovery at just about 25%, which is among the lowest in emerging economies. Right from borrowers challenging assignment of debt to ARCs to actual recoveries, ARCs lose a lot of time in the resolution of accounts as a result of a complicated legal system. The new Code should aid in

faster recoveries, thereby improving the overall track record of resolutions. A certainty in the legal framework should improve confidence among ARCs as they would be able to factor a more realistic recovery timeframe at the time of bidding for these assets.

The Code could also potentially address another important challenge that ARCs have been facing in multiple banking scenarios: debt aggregation. There is a clear shift in the mindset of banks to aggregate exposures of all lenders and auction them to ARCs so as to deliver a better resolution control to ARCs. The Code unambiguously states that the trigger for an insolvency-resolution petition can be a single default, which could result in taking over the management of the defaulter by an IP without any notice. Acquisition of the majority debt (more than 75% of total debt) by ARCs would allow them to control companies after filing the insolvency petition.

The Code necessitates a comprehensive turnaround, not just debt re-engineering

- ▶ The Code envisages a “creditor in control” regime, with financial creditors exercising control in the event of even a single default in the repayment of any loan or interest. This can be effected without any notice, and the law is very stringent as compared to the SARFAESI Act.
- ▶ This is a significant shift from a legal system that was heavily supportive of promoters and delayed recovery/revival under the cover of public interest or saving organizational capital. As a result, bad (and badly run) businesses continued to operate to the benefit of their owners. On the other hand, the Code imposes imprisonment of up to five years if “asset stripping” is noticed within 12 months before the default.
- ▶ It is, therefore, inevitable for stressed businesses and their owners to devise and implement a timely and effective turnaround plan to ensure that there are no defaults that trigger the Code. Such a turnaround plan should focus on operational improvement and sale of non-core assets, as much as on right-sizing the capital structure.
- ▶ Stressed/distressed businesses and their owners and managers should acknowledge the inefficiencies in their current business models in a timely manner and communicate any liquidity issues to financial creditors and other stakeholders well in advance – along with a turnaround plan. The blueprint to achieve an operational turnaround may seem simple – control cash, review pricing and renegotiate contracts, reduce costs, consolidate footprint, rationalize unprofitable operations and sell non-core assets, improve working capital and restructure the balance sheet.

- ▶ The challenge, however, lies in the execution of the operational turnaround. Success hinges on three main aspects: timely acknowledgement of the current situation by all the stakeholders (including banks) and commitment to the necessary change; the ability of the turnaround team on the ground; and an effective monitoring mechanism that ensures long-term success of the turnaround plan.
- ▶ An operational-turnaround exercise could possibly take a significant amount of time – a few months to even a year. To achieve a sustainable change, the business and its stakeholders should not focus only on quick-fix solutions. Instead, they need to understand that operational turnaround is a time and resource-intensive exercise that is critical to secure the future of a troubled business.
- ▶ In India, the revival of stressed assets has been hampered by the lack of credibility of owner-managers, consequent mismanagement of businesses and the inability of lenders to enforce change. In recent times, this has led to a breakdown of trust between lenders and borrowers, resulting in a stalemate situation in decision-making. Consequently, it has contributed to the dissipation of the value of underlying businesses. A recent example of a private Indian airline is a case in point. Timely intervention by lenders to enforce a change in the management, followed by operational revival efforts, could have perhaps yielded more success.
- ▶ However, in rare instances, the government has taken decisive measures to save distressed companies. In the case of one of the largest software developers in India, the board of directors was dissolved within two days of the discovery of fraud. A new board was constituted with individuals of repute, and liquidity was extended to support the operations, until the business was auctioned to a strategic buyer. While this case highlights how timely action can rescue companies, such examples are few and far beyond.
- ▶ Operational turnarounds in India have primarily been led by progressive owners of local businesses, MNCs in their Indian subsidiaries or PE houses in buy-out situations.
- ▶ Seeking assistance from external advisors or bringing in interim managers, often called chief restructuring officers (CROs), is a common practice in such situations in developed markets. Apart from bridging the trust deficit between the incumbent management and external stakeholders, the CRO can also be a catalyst for innovation, bringing a fresh perspective and stimulating the required change.

Will the Code be a game changer?

- ▶ Just like the Code, most regulations – be it the Companies Act 2013, CDR or SARFAESI Act – were all well-meaning to find a resolution in a systematic manner. However, they were misused by making the prescribed processes mere formalities. If this happens with the Code as well, it will become just another piece of comprehensive legislation.
- ▶ The Code has kick-started an interesting journey and is a step in the right direction but would only help in resolving the stressed-assets problem in the medium to long-term.
- ▶ For the Code's successful implementation, the government will have to ensure that the supporting infrastructure and ecosystem is effectively created. This includes the creation of an insolvency regulator, development of insolvency professionals, appointment of judicial officials and set-up of benches of the adjudication authority (the National Company Law Tribunal) and detailed procedural rules to standardize use of the law, among others.

In addition, the involvement and participation of the key stakeholders – the borrower and the lender – and how they gear up and contribute to the effective and intended functioning of the Code would be the most critical factors for the success of the Code.

Time is ripe

All the stakeholders have evolved and understand the steps taken to revive stressed assets. We believe that the recent developments would go a long way in the revival of the ARC market that will create significant value for all stakeholders involved.



About ASSOCHAM

THE KNOWLEDGE ARCHITECT OF CORPORATE INDIA

Evolution of Value Creator

ASSOCHAM initiated its endeavour of value creation for Indian industry in 1920. Having in its fold more than 400 Chambers and Trade Associations, and serving more than 4,50,000 members from all over India. It has witnessed upswings as well as upheavals of Indian Economy, and contributed significantly by playing a catalytic role in shaping up the Trade, Commerce and Industrial environment of the country.

Today, ASSOCHAM has emerged as the fountainhead of Knowledge for Indian industry, which is all set to redefine the dynamics of growth and development in the technology driven cyber age of 'Knowledge Based Economy'.

ASSOCHAM is seen as a forceful, proactive, forward looking institution equipping itself to meet the aspirations of corporate India in the new world of business. ASSOCHAM is working towards creating a conducive environment of India business to compete globally.

ASSOCHAM derives its strength from its Promoter Chambers and other Industry/Regional Chambers/Associations spread all over the country.

Vision

Empower Indian enterprise by inculcating knowledge that will be the catalyst of growth in the barrierless technology driven global market and help them upscale, align and emerge as formidable player in respective business segments.

Mission

As a representative organ of Corporate India, ASSOCHAM articulates the genuine, legitimate needs and interests of its members. Its mission is to impact the policy and legislative environment so as to foster balanced economic, industrial and social development. We believe education, IT, BT, Health, Corporate Social responsibility and environment to be the critical success factors.

Members - our strength

ASSOCHAM represents the interests of more than 4,50,000 direct and indirect members across the country. Through its heterogeneous membership, ASSOCHAM combines the entrepreneurial spirit and business acumen of owners with management skills and expertise of professionals to set itself apart as a Chamber with a difference.

Currently, ASSOCHAM has more than 100 National Councils covering the entire gamut of economic activities in India. It has been especially acknowledged as a significant voice of Indian industry in the field of Corporate Social Responsibility, Environment & Safety, HR & Labour Affairs, Corporate Governance, Information Technology, Biotechnology, Telecom, Banking & Finance, Company Law, Corporate Finance, Economic and International Affairs, Mergers & Acquisitions, Tourism, Civil Aviation, Infrastructure, Energy & Power, Education, Legal Reforms, Real Estate and Rural Development, Competency Building & Skill Development to mention a few.

Insight into 'New Business Models'

ASSOCHAM has been a significant contributory factor in the emergence of new-age Indian Corporates, characterized by a new mindset and global ambition for dominating the international business. The Chamber has addressed itself to the key areas like India as Investment Destination, Achieving International Competitiveness, Promoting International Trade, Corporate Strategies for Enhancing Stakeholders Value, Government Policies in sustaining India's Development, Infrastructure Development for enhancing India's Competitiveness, Building Indian MNCs, Role of Financial Sector the Catalyst for India's Transformation.

ASSOCHAM derives its strengths from the following Promoter Chambers: Bombay Chamber of Commerce & Industry, Mumbai; Cochin Chambers of Commerce & Industry, Cochin; Indian Merchant's Chamber, Mumbai; The Madras Chamber of Commerce and Industry, Chennai; PHD Chamber of Commerce and Industry, New Delhi.

Together, we can make a significant difference to the burden that our nation carries and bring in a bright, new tomorrow for our nation.

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