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CRISIL Ratings

Asset reconstruction companies

Realigning growth arc

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Message from ASSOCHAM

India's stressed assets market is intrinsically linked to the asset quality of banks and non-banking financial companies (NBFCs; including housing finance companies). The significant growth in the assets under management (AUM) of asset reconstruction companies (ARCs) in the past came during a period of sharp rise in non-performing assets (NPAs) in the banking sector. While banks have been selling their stressed assets to ARCs for quite some time, NBFCs started doing so only recently. Hence, potential for growth from NBFCs presents an opportunity.

Given the scale of stressed assets in India, the role of stakeholders involved in their resolution becomes critical. While resolution mechanisms such as Debt Recovery Tribunal (DRT), the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), and Lok Adalat have been predominantly involved in resolution of stressed assets, entry of ARCs and the implementation of the Insolvency and Bankruptcy Code, 2016 (IBC), have dialled up the momentum.

Over the past two decades, ARCs have set up a robust infrastructure and nurtured skilled and professional manpower to manage stressed assets. This platform can contribute immensely if some challenges, such as ease of fund availability, price expectation mismatch between the selling institution and ARC, and issues in loan aggregation, are addressed.

The government has over the last few years taken a number of steps in addressing issues faced by various stakeholders and has amended the IBC from time to time. The IBC has improved the credit culture over the seven years since its inception by resolving a considerable amount of stressed assets and achieving better recovery rates than other mechanisms. However, there is still room for strengthening the credit resolution framework.

Keeping this imperative in mind, ASSOCHAM is organising its 7th National Summit on Stressed Assets under the theme 'Changing Regulatory Landscape and the Way Forward'.

In this background, ASSOCHAM and CRISIL Ratings have jointly prepared a comprehensive detailed report. We hope this report, along with the discussions during the summit, will help the regulators, market participants, government departments and research scholars in further development of the stressed asset reconstruction industry.

I thank our knowledge partner for its valuable contribution and convey my best wishes for the success of the summit.

Deepak Sood

Secretary General, ASSOCHAM

Message from Association of ARCs in India

The performance of ARCs improved considerably in fiscal 2023. As per the Trend and Progress of Banking Report of the Reserve Bank of India (RBI), 9.7% of the previous year's stock of gross non-performing assets (GNPAs) were sold to ARCs in fiscal 2023 compared with only 3.2% in the previous fiscal. The report also states that the amount of security receipts (SRs) completely redeemed, an indicator of recovery, increased during the fiscal. ARCs have played an important role in the acquisition of NPAs and their resolution. As of March 2023, ARCs had stressed loans of Rs 8.48 trillion in book value.

The growing stress in retail loans/small and medium enterprise (SME) segments provides opportunity for ARCs to diversify their business from the corporate segment to retail and SME. The reduction in mandatory investments by ARCs from 15% to 2.5% in case of full cash exit for sellers, will help ARCs scale up capability, duly supported by eligible qualified buyers (investors).

ARCs have been focussing on restructuring viable cases, for value maximisation and contribution to the economy at large. The rate of turnaround is higher if NPAs are sold to ARCs early, instead of after exhausting all means of resolution by the sellers, by which time there may be substantial erosion in value.

The Association of ARCs in India is the representative body for all ARCs operating in the country. It has been developing as a platform to share views and to plan a course of action to strengthen the industry in a sustainable manner through strict adherence to compliance and governance norms.

The National Summit on Stressed Assets is being held to engage with all stakeholders meaningfully to set a suitable roadmap for the sector. The deliberations will help synthesise the perspectives of stakeholders to develop a holistic solution to deal with the stress in the financial system.

R K Bansal

Chairman, Association of ARCs in India

Executive summary

ARCs, since their inception in 2003, have gone through many structural changes. With evolving regulations and changing business models, realignment of business strategies is the need of the hour. Revised regulatory guidelines around improved governance norms, better disclosures, lower funding requirement for asset acquisition, increase in net owned funds (NOF) and option to participate as a resolution applicant under the IBC are all expected to structurally fortify the sector.

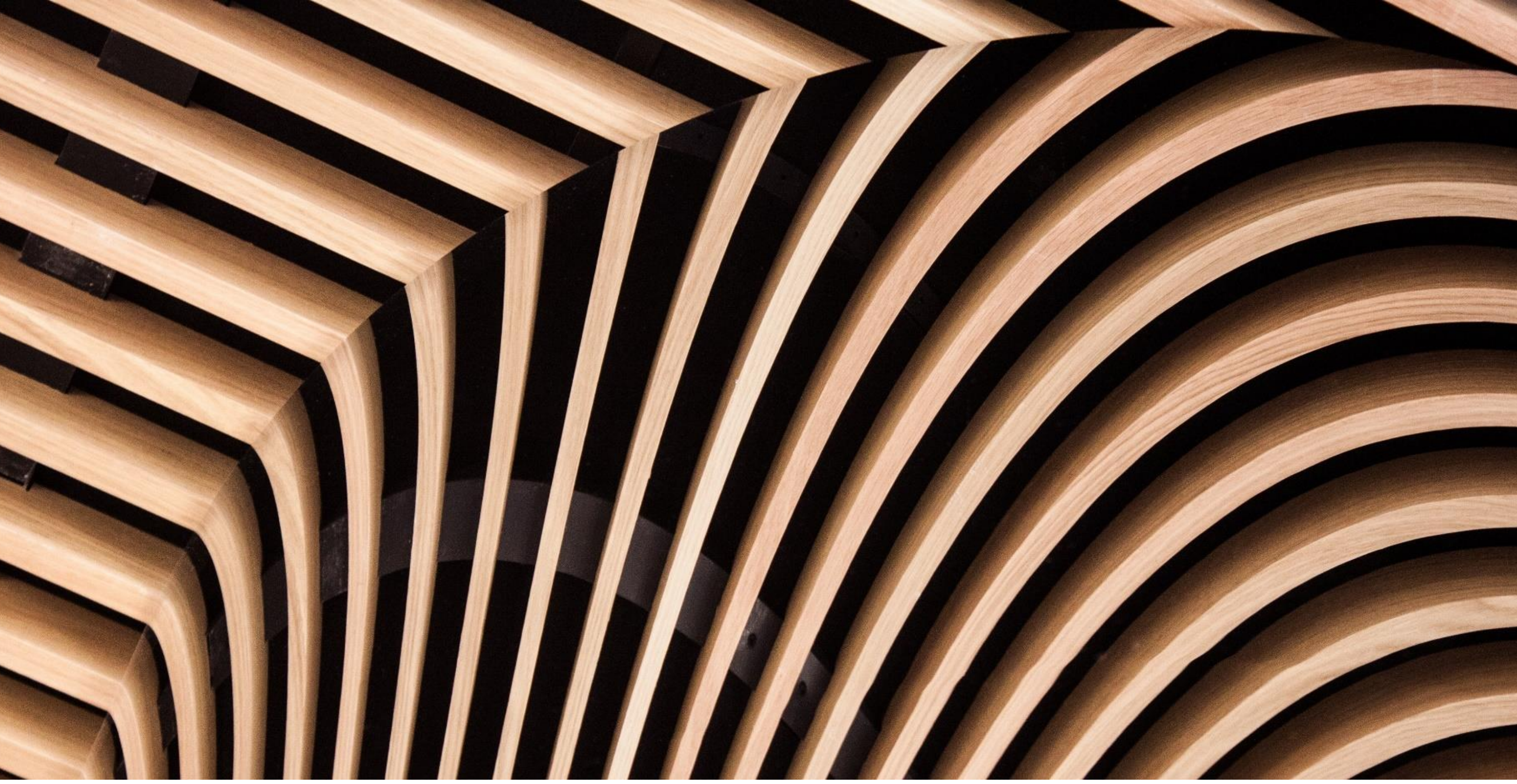
Growth is expected to moderate to 8-9% this fiscal from ~17% last fiscal. It is likely to further moderate to 5-6% next fiscal due to the cyclically low GNPAs in banks and NBFCs. Despite the reduced GNPAs, there are opportunities for the ARC sector, including expected increase in the proportion of retail acquisitions. Moreover, increasing contribution from the national ARC — National Asset Reconstruction Company Ltd (NARCL) — may support growth and enable faster debt aggregation of long-stuck assets.

Capital requirement for investing in SRs was a bottleneck in the past. The revision in the minimum investment in SRs has helped to free up 80-85% of funds for cash transactions (which involve no participation of the selling entity). Lenders' expectation of upfront exit has also fuelled increase in cash transactions. The rising share of cash transactions, with a strategic focus on the retail sector, will drive focus on execution through a partnership model in investment.

The cumulative redemption rate has been on an increasing trajectory, supported by faster settlement/ restructuring due to the deterrent effect of the IBC, increased share of cash deals, higher exposure to retail loans, and better recovery in recent acquisitions due to lower vintage with better-quality assets. This is reflected in the portfolio rated by CRISIL Ratings, where the cumulative recovery rate is expected to increase from 38% in fiscal 2023 to 55-60% by fiscal 2025.

Lastly, IBC has improved the credit culture over the seven years since its inception by resolving a considerable amount of stressed assets and achieving better recovery rates than other mechanisms. However, there is still room for strengthening the credit resolution framework.

Amidst all this, ARCs must continue to align the business strategies in light of the evolving stressed assets opportunity in the Indian market. This is important to strengthen their market position, with other alternatives (such as proposed amendments to Special Situation Funds and Securitisation of Stressed Assets Framework) in stressed assets markets likely to emerge over the medium term. Success on this front will remain critical for the long-term sustainable growth of the ARC sector.



Cyclically low GNPAs impacting ARC industry growth

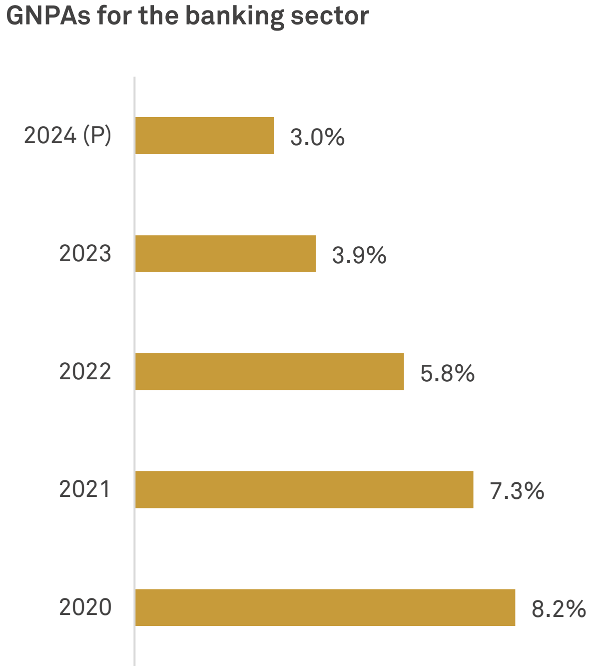
Opportunities in the Indian stressed assets market are intrinsically linked to the asset quality of banks and NBFCs (including housing finance companies). The significant growth in the AUM of ARCs in the past came during a period of sharp rise in NPAs in the banking sector, especially in the corporate segment — GNPAs of banks peaked at 11.2% as on March 31, 2018. For NBFCs, asset quality in the real estate financing book started displaying signs of stress starting fiscal 2019.

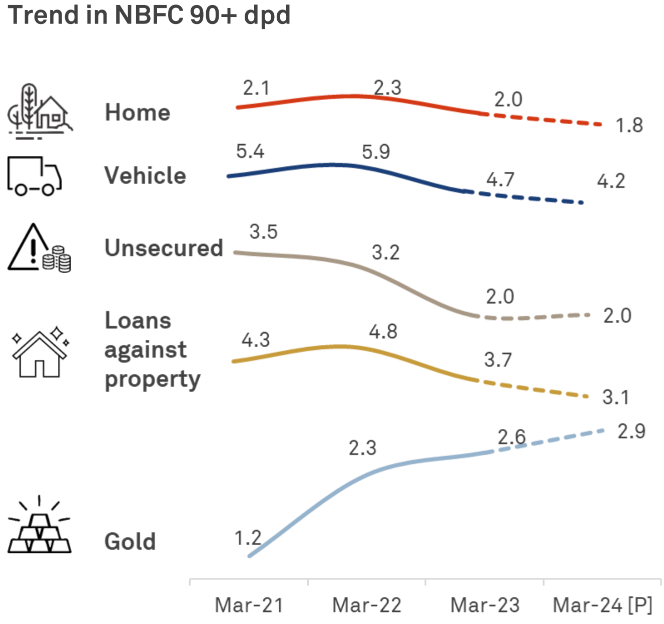
Today, however, the asset quality of the financial sector is at its healthiest. For banks, GNPAs are expected to touch a decadal low of ~3% this fiscal *(see Chart 1)*, riding on the post-pandemic economic recovery and higher credit growth. This follows significant clean-up of books by banks in recent years, as well as strengthened risk management and underwriting, which has led to higher preference for borrowers with better credit profiles.

Asset quality for NBFCs too has shown an improvement across segments and the fundamentals are expected to hold with higher economic activity.

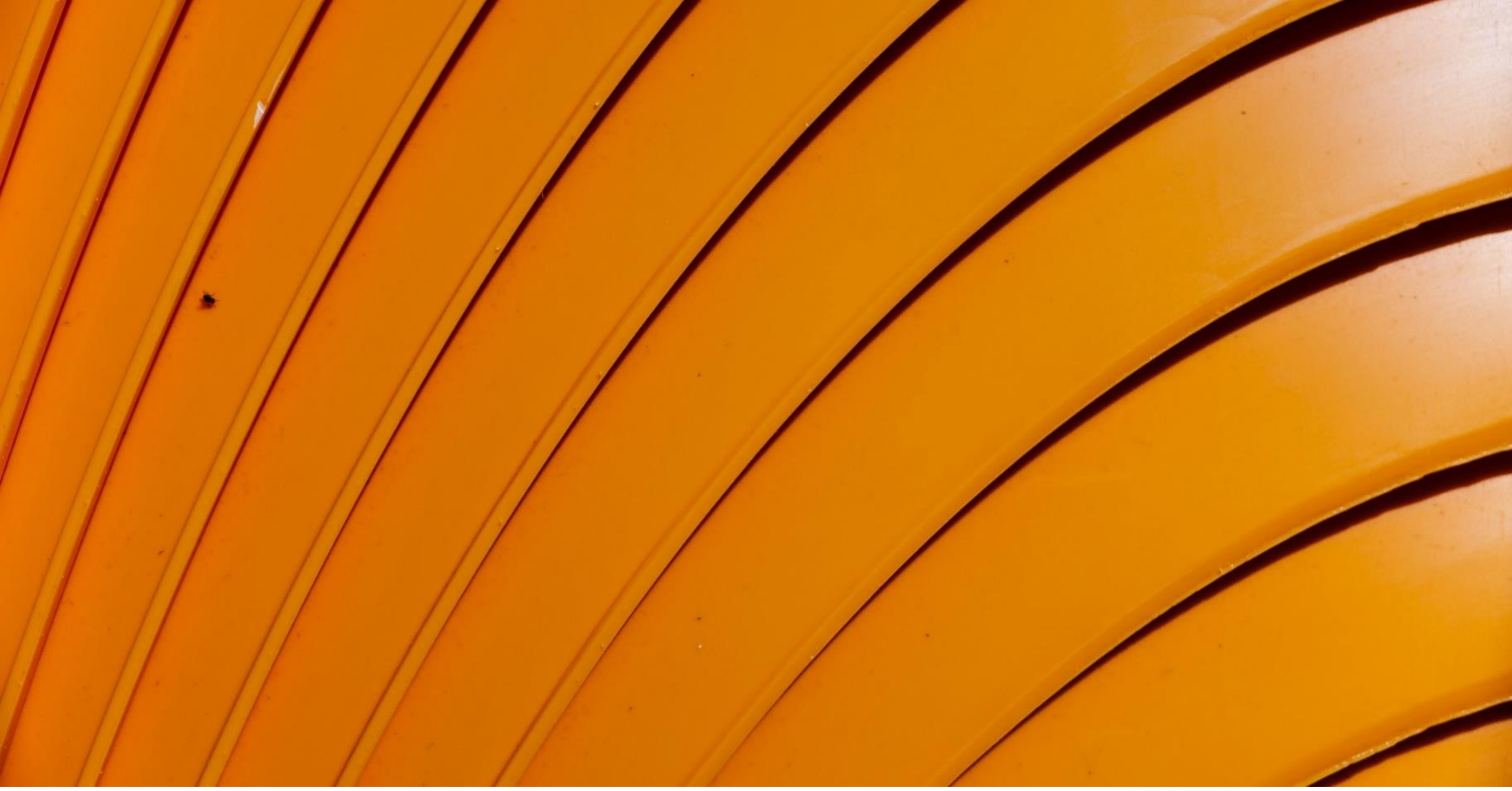
Overall, the sharp reduction in NPAs indicates that opportunity for ARCs – especially in corporate loans – is perhaps at a cyclical low. That said, retail assets, which have garnered more interest from ARCs in the past couple of years, continue to offer a meaningful opportunity. As do loans to micro, small and medium enterprises (MSMEs).

Chart 1: Trend in GNPAs in the banking and NBFC sectors





Source: Company data; CRISIL Ratings estimates



Evolution of ARCs in India, changing business models

Table 1: Evolution of ARCs in India

	Phase I 2003-14	Phase II 2014-17	Phase III 2017-22	Phase IV 2022 onwards	Remarks
Number of ARCs	1 → 14	14 → 24	24 → 28	27	Consolidation among ARCs likely
Proportion of cash deals vs SR deals	Low	Low	Moderate	Increasing	Cash deal proportion increasing
Percentage of SRs held by selling institutions	High	High	Moderate	Moderate to low	Lenders preferring cash
Equity investment in ARCs	~Rs 2,500 crore^	Rs 4,000-4,500 crore@	Rs 10,000-10,500 crore#	Rs 14,000-15,000 crore$	Equity investment increased over the years
Capital requirement for investment in SRs	Low	Moderate	High	Low	Decrease in capital requirement from 15% to 2.5% under certain conditions
Retail proportion	Low	Low	Low	Increasing	Opportunistic play by ARCs

**CRISIL Ratings estimate for networth of ARCs – ^ as on March 31, 2014; @ as on March 31, 2017; # as on March 31, 2021; $ as on March 31, 2023*

Growth of the ARC industry until now has been intrinsically linked to the evolving regulatory landscape. In fact, the growth can be mapped to key developments or regulations that came in during various periods.

The growth trend can be divided into four phases.

Phase 1 (2003-2014)

- The first growth phase coincided with the regulatory push for banks to clean up their balance sheets. Resultantly, AUM rose 4 times towards the end of Phase I. There were high discounts due to the vintage of assets, reflected in higher SRs/AUM.
- Minimum capital investment by ARCs for the acquisition of stressed assets was only up to 5% of the acquisition value, which also propelled growth. There were limited cash deals, with transactions largely through the 5:95 model (minimum investment by ARCs in SRs at 5%).

Phase 2 (2014-2017)

Capital requirement went up, but business picked up later due to corporate asset quality issues

- In August 2014, the minimum investment by ARCs in SRs was increased to 15% from 5%. This led to a slowdown in acquisitions initially, given the higher funding requirement.
- Acquisitions picked up subsequently, driven by the large opportunity presented by corporate stressed assets. Cash deals remained limited; discount rates were somewhat lower than in Phase I. IBC was enacted in 2016.

Phase 3 (2018-2022)

Partnerships becoming critical, retail assets coming in

- There was a structural shift with the RBI increasing the provisioning requirement for banks investing more than a certain share of the value of stressed assets sold by them in SRs issued. As a result, cash deals gained momentum. Even in SR deals, banks were holding much smaller proportion in SRs than in the past.
- With limited ability of ARCs to hold more than the minimum requirement, partnerships became critical. The latter half of Phase 3 also saw a larger proportion of pandemic-impacted retail assets coming into the market, as corporate asset quality started to improve.

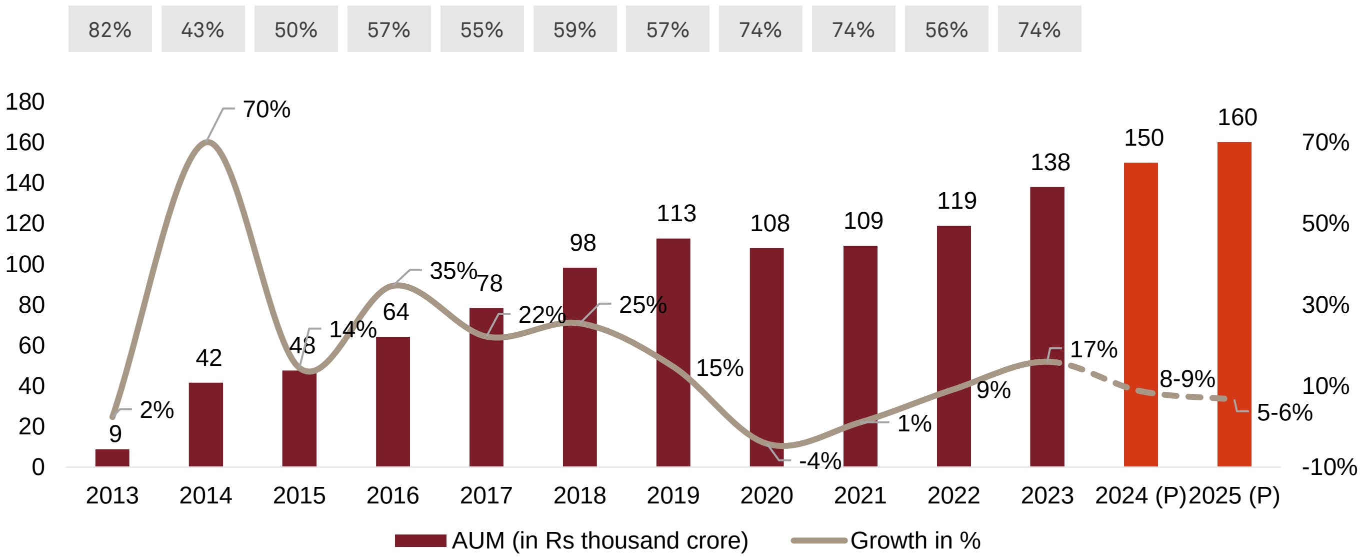
Phase 4 (2022 onwards)

- The RBI announced revised guidelines in October 2022 to structurally strengthen the sector. Chief among these was a lowered requirement of investment in SRs, thereby freeing up capital, and increasing scope for growth.
- Investments by ARCs in SRs are envisaged at a minimum 15% of the investment of the transferor in the SRs, or 2.5% of the total SRs issued, whichever is higher under certain conditions. This is a welcome step as ARCs were finding it difficult to infuse capital in all SR transactions, specifically when there were independent third-party investors. This lowers the capital requirement from ARCs, hence increasing scope of growth.
- While the funding requirement for acquisition has reduced significantly, partnerships with investors (stressed assets funds, AIFs) have become more critical given the higher benefit in such cases.
- Another key change was the increase in net owned funds (NOF) requirement from Rs 100 crore to Rs 300 crore which may herald consolidation in the sector.

AUM and expectations in the road ahead

ARCs were facing headwinds since 2020, with growth in AUM, as measured by SRs outstanding, dropping to low single digits till 2022 (*see Chart 2*). This was in sharp contrast to previous years — between fiscals 2014 and 2018 – when AUM had grown at a steady pace, initially driven by the supportive regulatory environment for banks to sell bad assets.

Chart 2: ARC industry AUM trend and expectations



*Source: RBI, CRISIL Ratings estimates, ARC Association *Private ARCs, excluding National Asset Reconstruction Company Ltd*
Numbers in boxes indicate the discount rate for acquisition

The slowdown could be partly attributed to the subdued macroeconomic environment, which had hindered consummation of deals and heightened risk aversion among investors, leading to lower acquisition. Few structural trends are also at play.

First, the stressed asset ecosystem has undergone a transformation. Lenders now have multiple options for resolution and enforcement frameworks. They are evaluating and utilising these options more actively.

IBC, with its subsequent modifications, has seen many takers. The Prudential Framework for Resolution of Stressed Assets, released by the RBI in June 2019, offers lenders the option to resolve stressed assets without going through other legal channels such as SARFAESI, DRT and IBC.

Second, due to stringent provisioning norms, banks prefer to retain only a limited share of SRs for assets sold. At the same time, amid shortage of capital, ARCs mostly hold only 15% of the SRs as mandated by the regulator. This funding gap needs to be bridged by bringing in external co-investors. This did happen in a few large assets where ARCs partnered with external investors. However, the trend has not been widespread across the sector as not all ARCs have been able to bring in co-investors, who are also selective in their approach.

In fiscal 2023, the industry growth was at ~17% largely driven by a large transaction of stressed assets being acquired from a bank by an ARC. However, excluding the same, growth was modest at 7%. For the current fiscal 2024, CRISIL Ratings expects the industry to grow by 8-9% and remain steady at 5-6% in fiscal 2025. This will largely be driven by higher acquisitions, though capped by quicker resolutions expected in retail assets. Acquisitions by NARCL are also expected to gather pace going forward thus supporting overall industry AUM.

Tapping into opportunities across lenders, asset classes

After scaling a peak in 2018, gross NPAs in the corporate sector started trending downwards, with fewer opportunities for ARCs. On the other hand, due to factors such as the Covid-19 pandemic, opportunities in the retail and MSME segment have been increasing *(see Chart 3)*. However, contrary to earlier expectations of retail assets marking a sharp rise, ARCs are now selectively choosing both corporate and retail deals, depending on opportunities available.

Within the retail segment, the market for stressed assets has become more diversified. Earlier, it was more concentrated on secured asset classes such as home loans and loans against property. In recent times, the proportion of unsecured personal loans and microfinance loans has been on the uptrend *(see Chart 4)*. However, the overall proportion of secured assets continues to form a sizeable component of retail SRs issued.

ARCs are also likely to have a competitive edge in retail and MSME loans. Other investor classes such as stressed assets funds are unlikely to be interested in these segments, as building an operationally intensive set-up, to manage retail stressed assets, will entail significant investment. Given the greater operating expenditure required, volume will be critical to profitability. Thus, ARCs that invest here will need to keep a close eye on achieving scale and strong execution efficiency.

However, ARCs themselves are exploring alternatives to setting up fully staffed in-house teams for resolution of retail assets, including deployment of external agencies and setting up servicing arrangements with selling institutions.

CRISIL Ratings believes that as retail asset acquisitions gather pace, the business models of ARCs will continue to evolve to tap the shifting business opportunity.

Chart 3: Segment-wise break-up of SRs issued

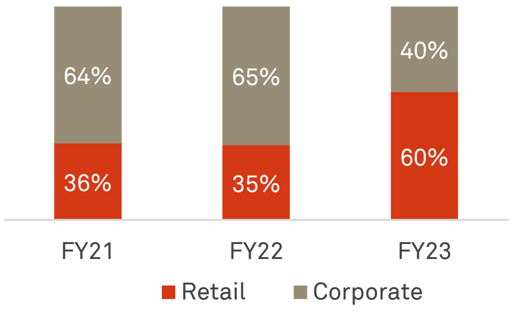
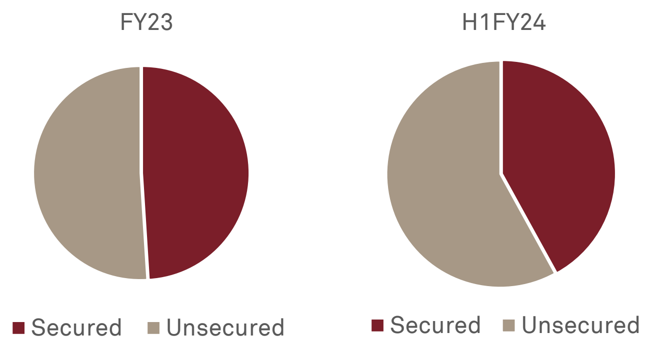


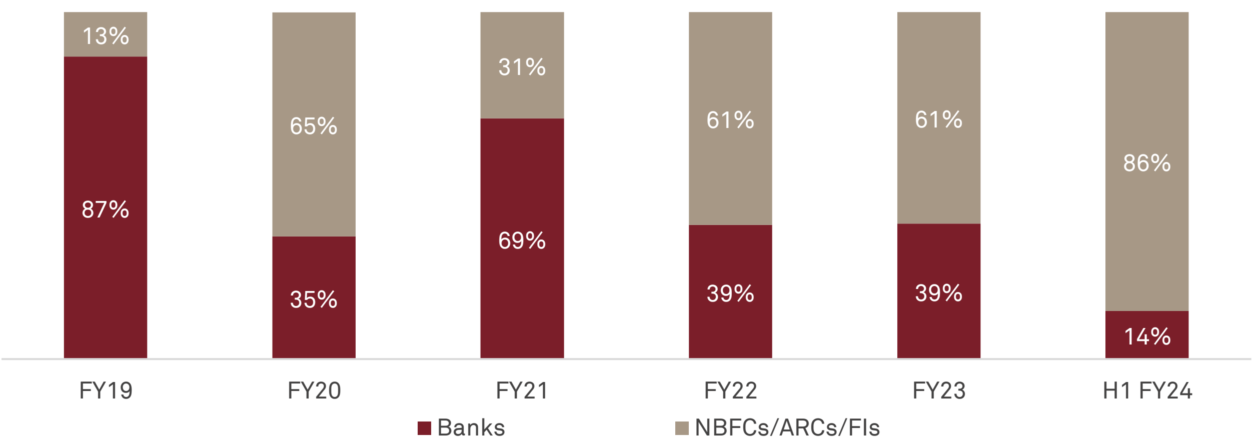
Chart 4: Break-up of retail portfolio



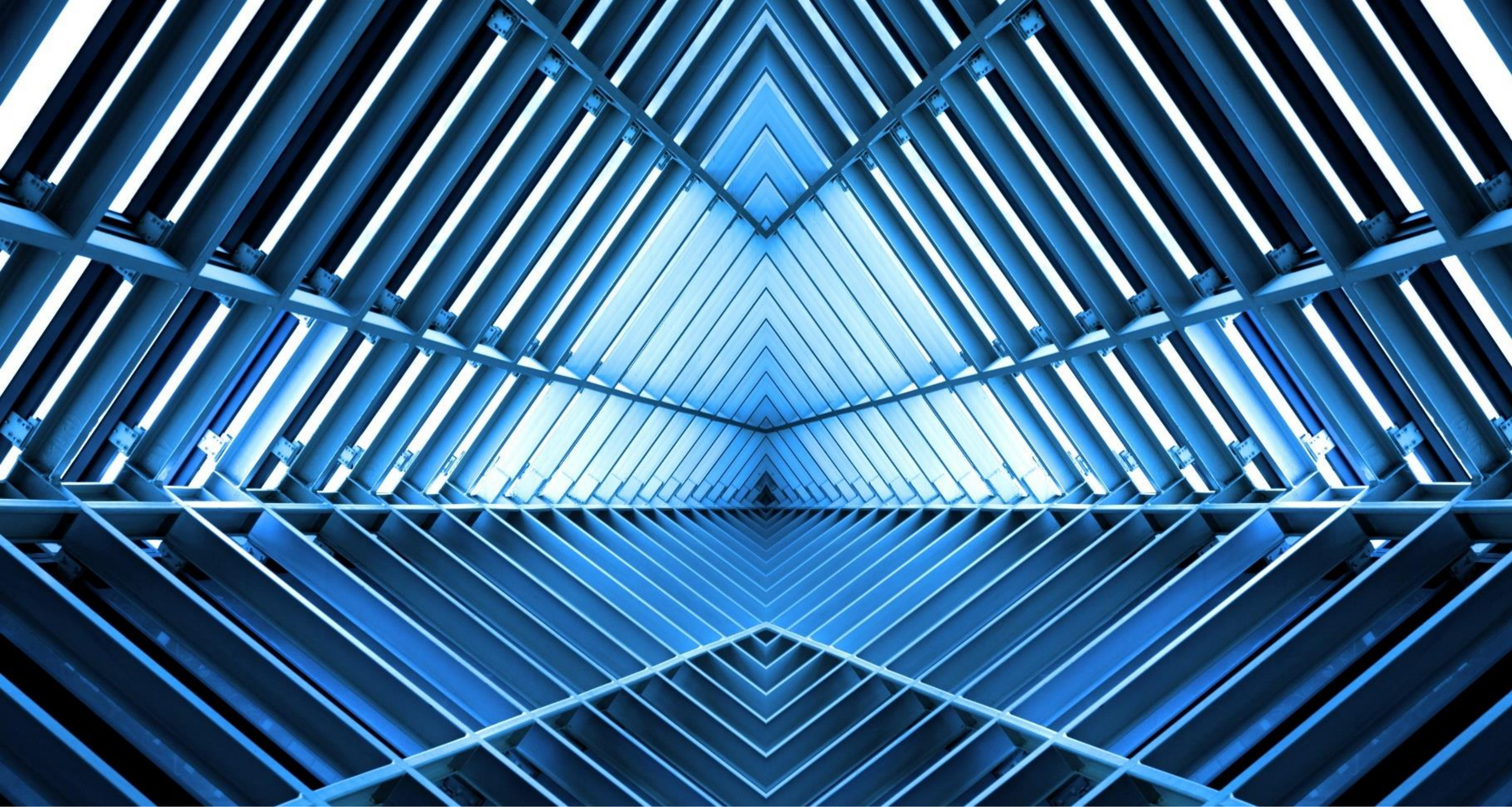
Source: RBI, company data, CRISIL Ratings estimates; covers ~60% of AUM

In terms of lender category, while banks have been selling their stressed assets to ARCs for quite some time, NBFCs have started doing so recently. Growth in recent times, has been coming from NBFCs *(see Chart 5)* selling their stressed pools. ARCs are also selling pools within themselves for the purpose of debt aggregation.

Chart 5: Lender category-wise break-up of SRs issued



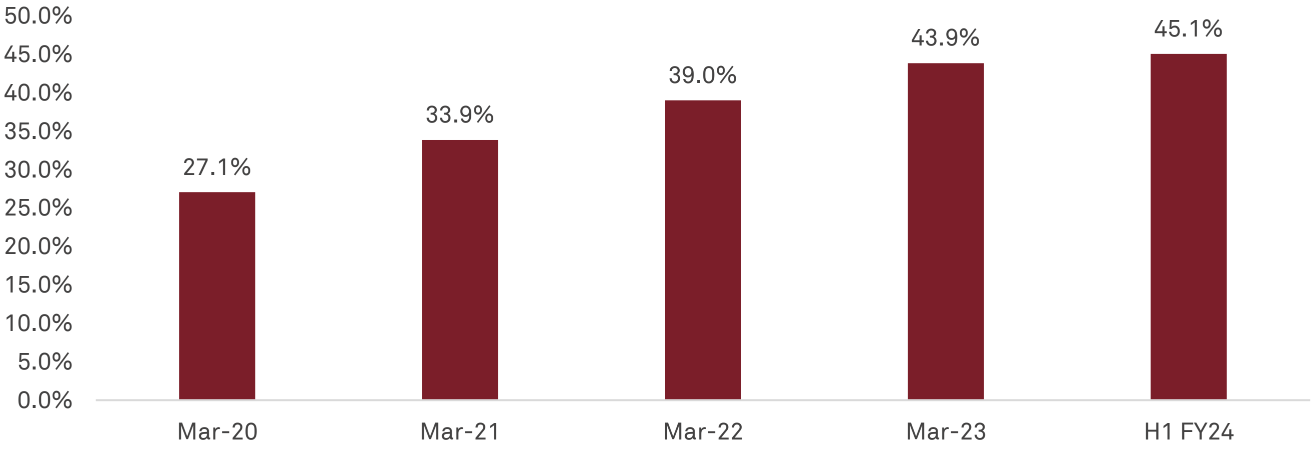
Source: RBI, company data, CRISIL Ratings estimates; covers ~60% of AUM



Redemption ratio, recent acquisitions better

The estimated cumulative SR redemption ratio for ARCs has increased in recent years, standing at 45% as on September 30, 2023, compared with 34% as on March 31, 2021 *(see Chart 6)*. The resolution of few large-ticket assets through IBC has helped, though overall recovery lags expectations. While recent originations have performed better, recovery remains below potential.

Chart 6: Trend in SR redemption ratio

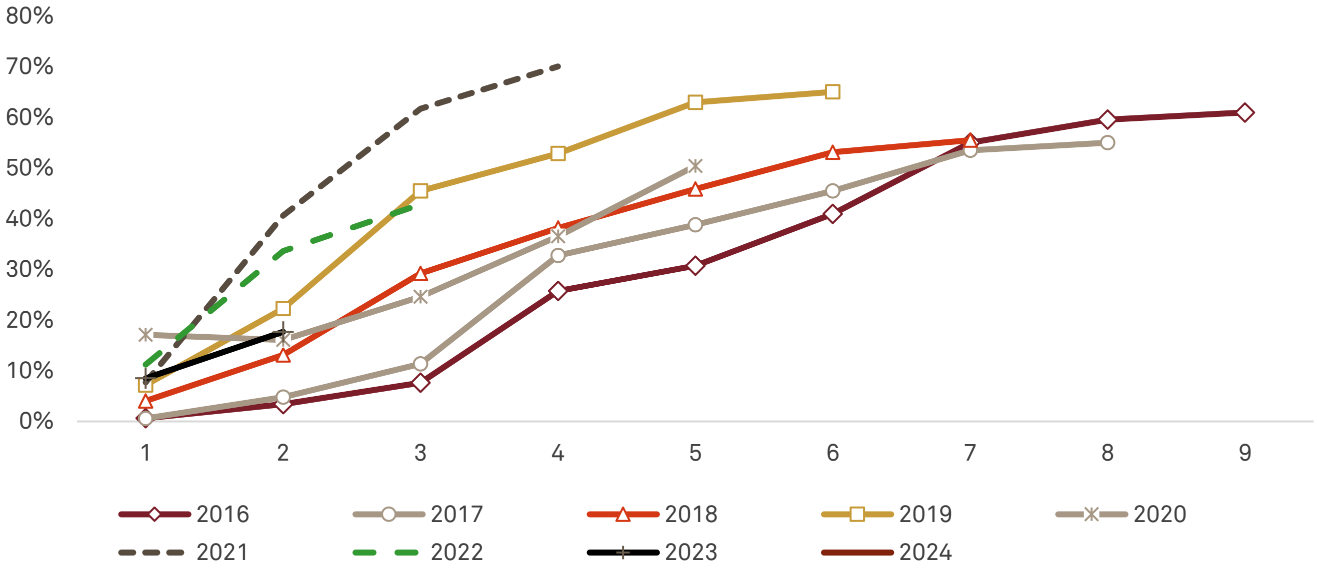


Note: Cumulative redemption ratio depicts total redemptions as a percentage of total SRs issued till date

Source: CRISIL Ratings estimate; covers ~60% of the sector's AUM

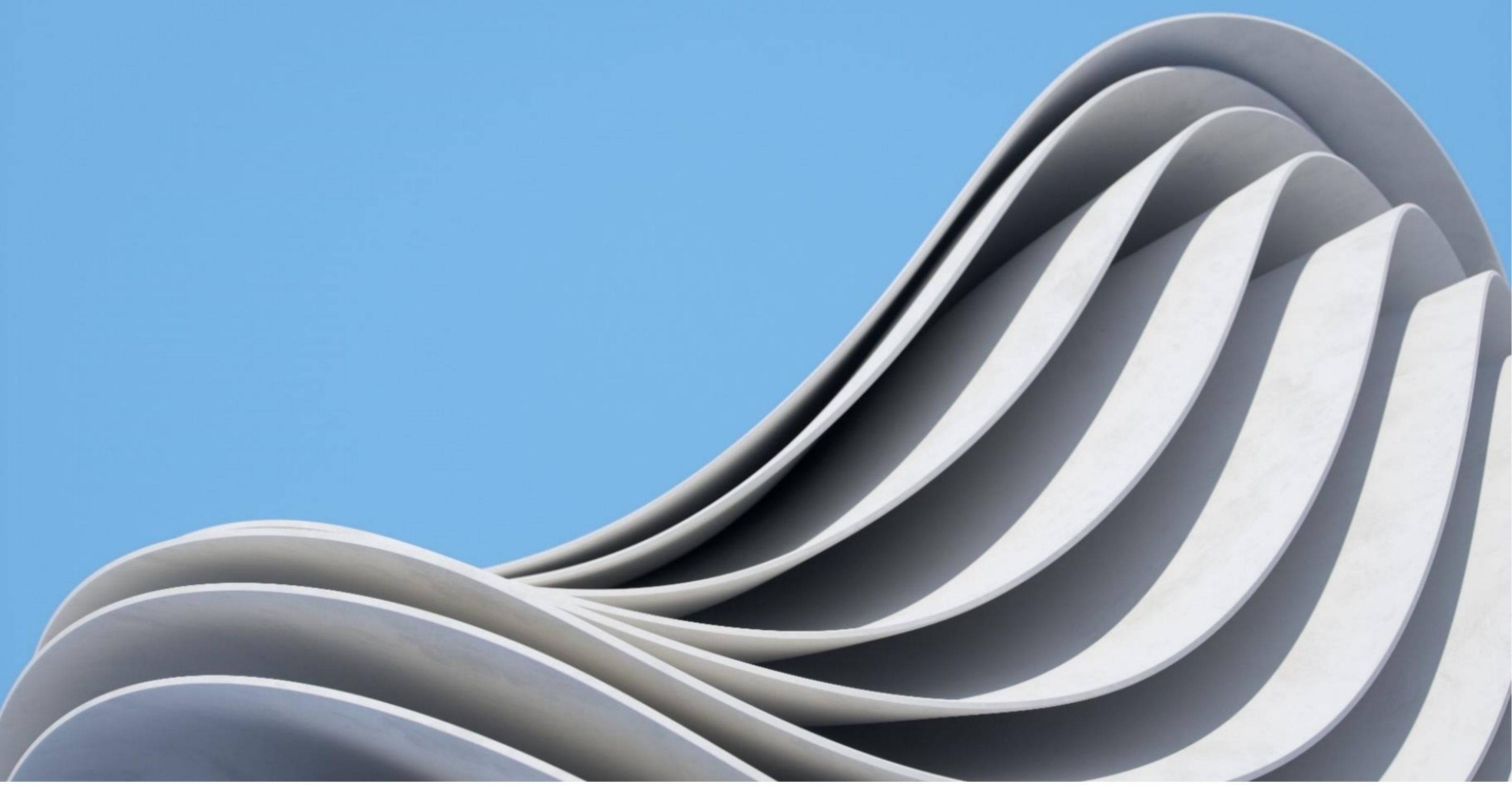
As per chart 7, SRs issued in recent years have seen a better redemption ratio trend. This has been mainly supported by faster settlement/restructuring, due to the deterrence effect of IBC, increase in share of cash deals, exposure to retail loans, and better recovery in recent acquisitions, due to lower vintage with better quality assets.

Chart 7: Issuance year-wise trend in redemption ratio



Note: Data is based on a representative set of ARCs. The x-axis refers to year from acquisition. Year 1 is the actual year of acquisition; Year 2 is the following year and so on.

Source: CRISIL Ratings estimates; covers ~60% of sector's AUM



Regulatory changes structurally strengthening sector

The RBI, in October 2022, amended the framework to structurally fortify the ARC sector. Few key amendments included lower funding requirement for acquisitions, increased Net Owned Funds (NOF) requirement for existing as well as new ARCs, option to participate as a resolution applicant (RA) under IBC, and a stricter settlement approval process and other corporate governance related norms.

Freeing up capital with increased partnerships

Investment in SRs by ARC to be higher of:

- Minimum 15% of transferors investment or
- 2.5% of SRs issued.

This will lead to savings of ~83% for ARCs in a cash deal and ~13% in structured deals.

This will also incentivise ARCs to build partnerships with QIBs/FIIs/AIFs.

Consolidation looms

- Existing ARCs to increase their NOF to Rs 200 crore by March 2024 and Rs 300 crore by March 2025
- 2 ARCs surrendered license post regulation
- 40% of the ARCs are still below threshold

Increased governance

Tenure of CEO/MD/whole-time director (WTD) fixed at maximum 15 years of continuous service

ARCs have set up independent advisory committee (IAC) to evaluate settlement proposals

Management fees are now recovered only from recoveries in the trust

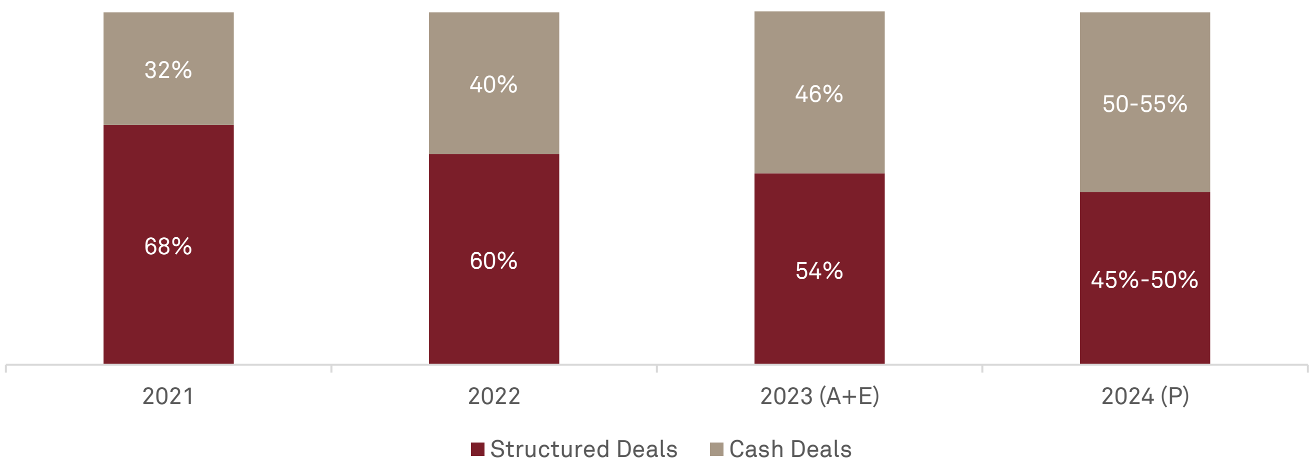
Most ARCs now adhere to settlement guidelines

Modified rules of settlement with requirement of IAC by taking blanket approvals up to certain threshold.

The impact of amendments can be seen on various fronts, ranging from a strategic change in the way ARCs acquire debt from original lenders to likely consolidation in the industry because of the higher minimum NOF requirement.

On the positive side, ARCs can save on capital to be invested in SRs. They were earlier required to fund a minimum of 15% of SRs issued. As per the new amendments, ARCs need to invest a minimum of 15% of lender's investment in the trust or 2.5% of SRs issued, in case of full cash deals. Lower funding needed for acquisition of debt, coupled with the lender's requirement of an upfront exit, has led to a rising proportion of cash deals vis-a-vis structured deals *(see Chart 8).*

Chart 8: Increasing share of cash deals



Source: CRISIL Ratings estimates

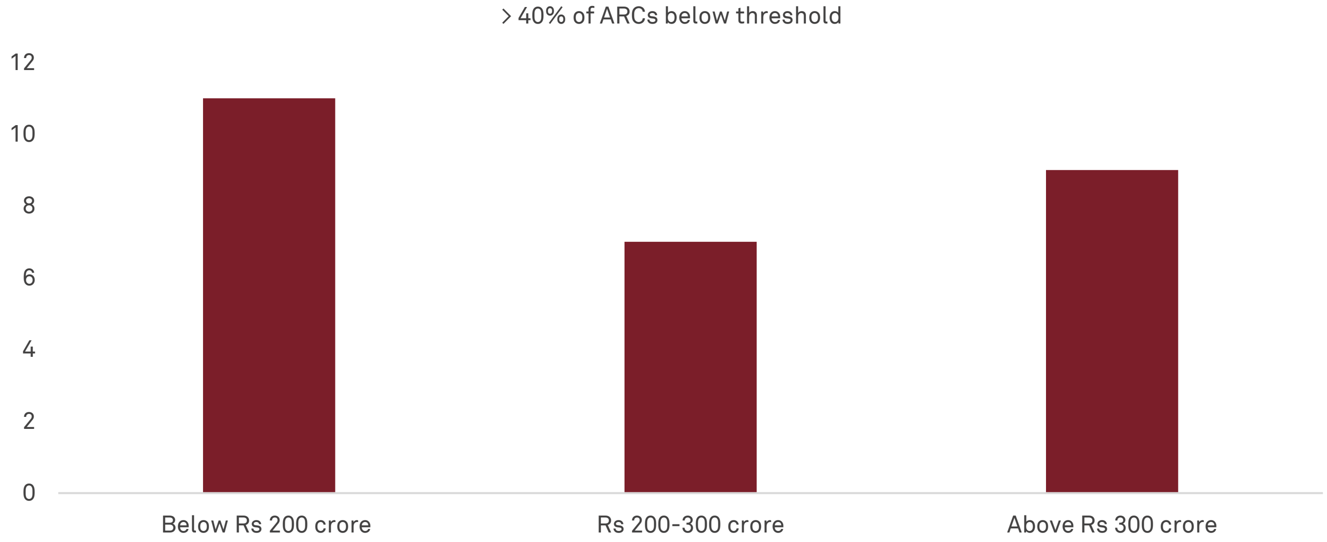
With increasing cash deals, ARCs are looking for external investors to provide funding for acquisitions, which creates an opportunity for private funds to contribute.

On the flip side, the RBI introduced stricter settlement norms so as to improve transparency in acceptance/rejection of settlement proposals. This could lead to delay in acceptance of few one-time settlement (OTS) proposals.

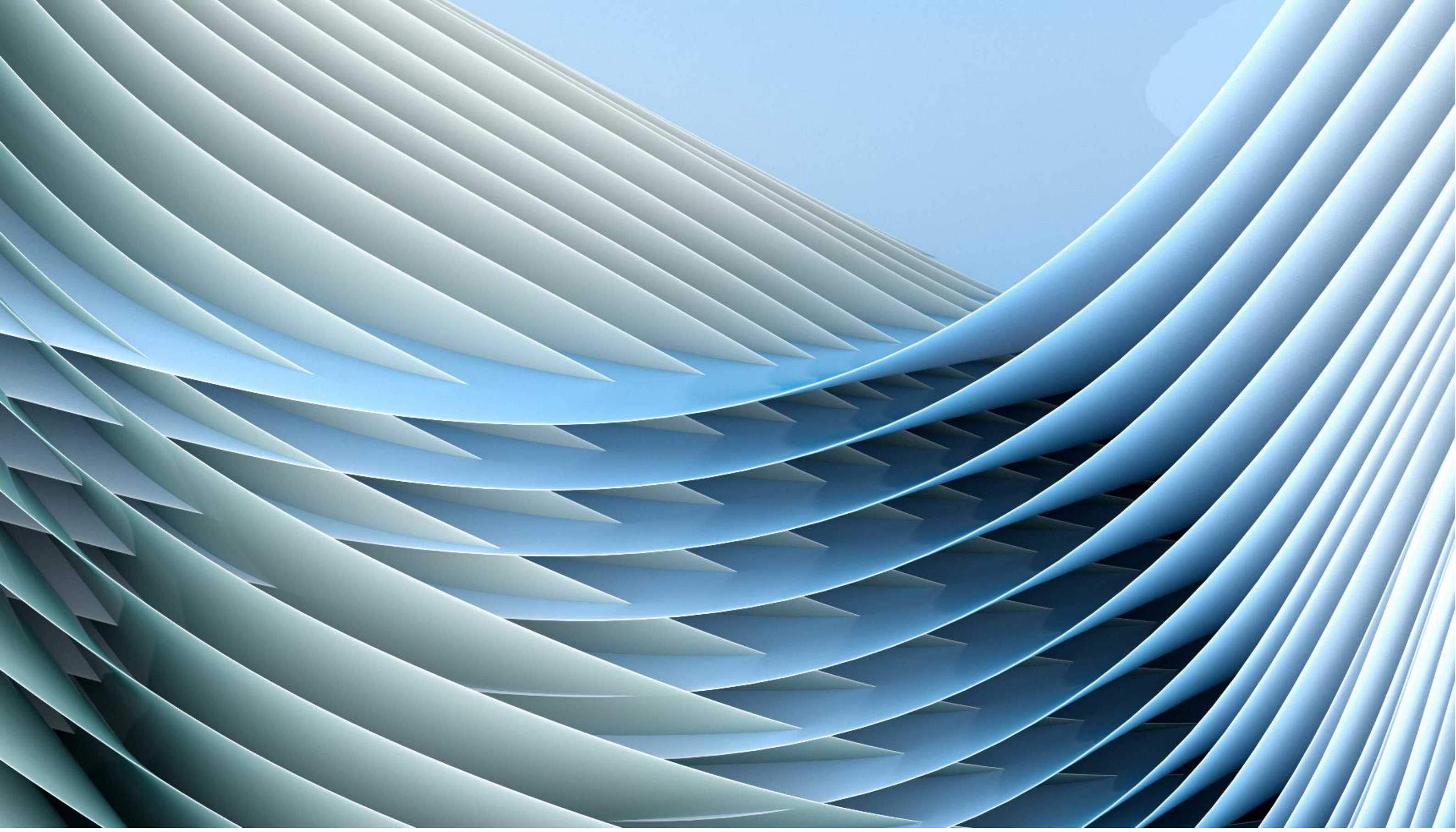
Approaching deadline for higher NOF could pave the way for consolidation

Though the lowered funding requirement for acquisition of debt brings in relief for ARCs, the higher NOF requirement has created an existential crisis for smaller ARCs, falling below the Rs 200 crore threshold as of March 2024. Effects are already visible, with two ARCs having surrendered their licenses and more likely to exit the space, as 40% of ARCs are still below this threshold *(see chart 9)*. If the guideline for higher NOF requirement is implemented, it may lead to consolidation, as small ARCs may find it difficult to raise capital to fulfil this criteria. Thus, we foresee big ARCs grabbing a larger share of the stressed assets pie.

Chart 9: NOF status of 27 ARCs



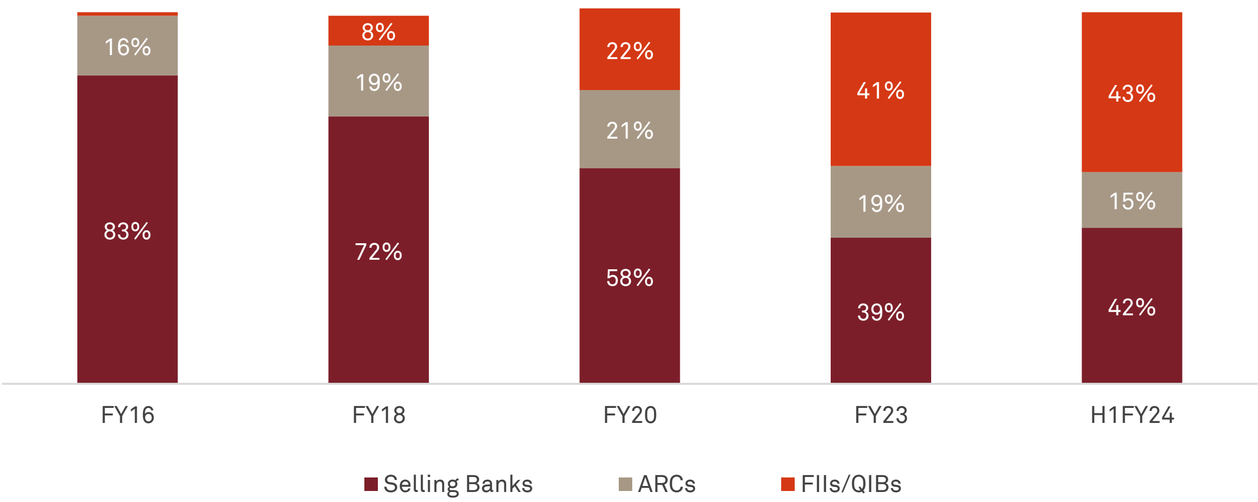
Source: Based on annual reports of ARCs for FY23



Increased participation of AIFs, QIBs in the SR market

With increased cash deals and limited ability of ARCs to raise large capital, partnerships with external investors are inevitable. Hence, many ARCs are building strong partnerships with qualified institutional buyers (QIBs) and large alternative investment funds (AIFs), both domestic and international. Chart 10 reflects the increased share of QIBs investing in SRs; this trend is expected to continue.

Chart 10: Declining share of investment in SRs by selling banks

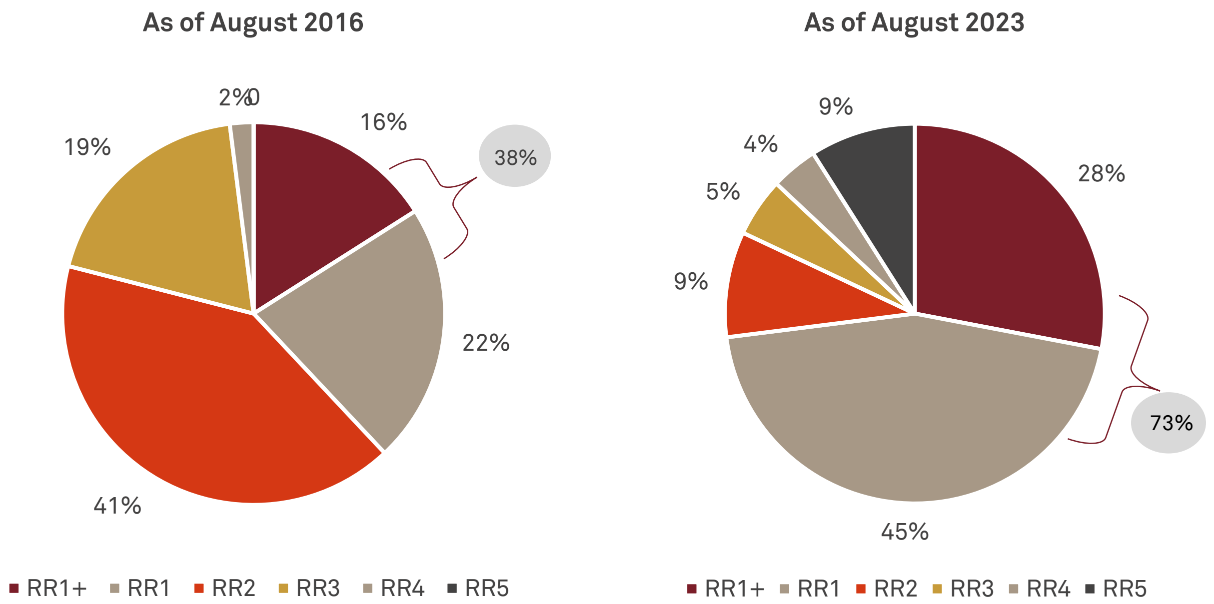


Source: RBI, CRISIL estimates

CRISIL Ratings view on SR portfolio

CRISIL Ratings has been rating SRs issued by ARCs since 2003; it has rated SRs of over Rs 40,000 crore issued by more than 550 trusts across the corporate, infrastructure (power, port, tele-tower, road assets), MSME and retail (Home loans/loan against property, commercial vehicle loans, credit cards, personal loans) loan segments.

Chart 11: Noticeable progress in recovery ratings of SRs



Source: CRISIL Ratings covers ~300 trusts

Over time, there has been steady improvement in the ratings of SRs. The proportion of SRs rated RR1 and RR1+ has increased over the past seven years, from 38% in August 2016 to 73% in August 2023 *(see Chart 11)*, led by higher share of cash transactions, better-quality assets and quicker implementation of resolution strategies.

Recent acquisitions in the CRISIL Ratings portfolio faring much better

Acquisitions done in 2015 (pre-IBC), 2018 and 2020 (post-IBC) have been analysed to understand the performance and recent trends of the CRISIL Ratings SR portfolio.

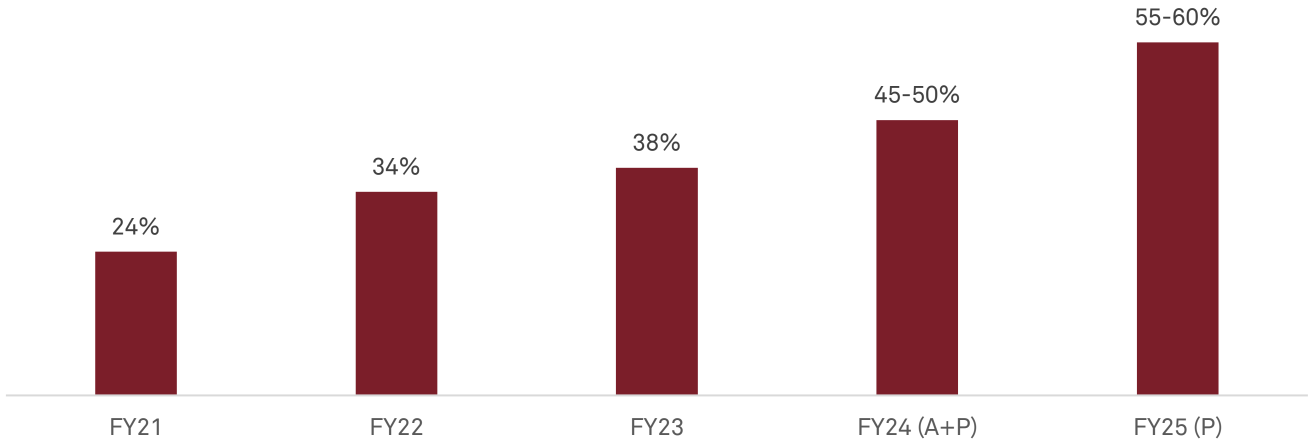
Table 2: Performance of SRs

SR acquisition year (CRISIL Ratings portfolio)	2015			2018		2020
Rating review as of	**Feb 2018**	**Feb 2020**	**Feb 2023**	**Feb 2021**	**Feb 2023**	**Feb 2023**
Transaction type	>95% SR deals			Cash: 45% SRs: 55%		Cash: 50% SRs: 50%
Average discount	38%			46%		56%
Cumulative recovery ratio (gross recovery/SRs issued)	10%	20%	31%	32%	54%	40%
Cumulative redemption ratio (SRs redeemed/SRs issued)	5%	16%	22%	30%	50%	35%
Average recovery timeline (years)	3	5	8	3	5	3

Source: CRISIL Ratings

Table 2 depicts the cumulative redemption ratio for the first three years for SRs issued in 2015 at merely 5%. Further, the redemption ratio for SRs issued in 2018 is 30% and for those issued in 2020 is 35%. This indicates that recent acquisitions are faring better than the older ones due to a higher proportion of cash transactions, quicker debt aggregation and lower vintage of NPAs with much better economic value and improving business outlook for some of the underlying sectors such as power, real estate and steel.

Chart 12: Trends in cumulative recovery rate



Source: CRISIL Ratings

The CRISIL Ratings corporate loan SRs portfolio is expected to demonstrate a cumulative recovery of 45-50% in fiscal 2024 and improve to 55-60% in fiscal 2025 *(see Chart 12)*.

This improvement can be attributed to several factors:

- **Acquisition of lower-vintage assets**

  ARCs are acquiring stressed assets that are recent NPAs and, in some instances, not yet classified as NPAs, thereby obtaining better-quality assets. This increases chances of revival, subject to other conditions being met in a timely manner, such as arrangement of working capital funds, capital infusion by the promoters and rescheduling of debt.

- **Revival of sectors such as power and infrastructure**

  The power and infrastructure sectors have significantly revived, driven by regulatory reforms, strategic investments and improved market conditions. Several stressed power assets have been resolved, driven by increased economic activity after the fading Covid impact, strong power demand outlook and government's interventions to support growth of the sector.

- **Deterrent effect of IBC**

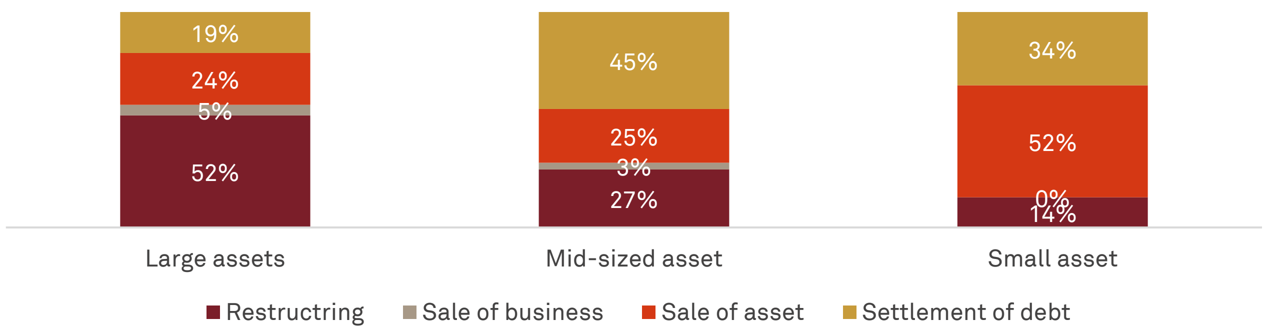
  The expedited settlement of cases, with promoters apprehensive of losing their companies under IBC, also played a pivotal role. The positive impact of regulatory changes is evident in the enhanced credit discipline among borrowers.

- **Increased cash transactions**

  With higher cash-based transactions backed by sponsors or investors, ARCs have been able to bring lenders on-board and persuade them for a one-time settlement. This results in better price discovery, quicker aggregation of debt and exit of lenders from the overall structure.

Debt restructuring fuels resolution for large accounts, while asset sale drives success for smaller loans

Chart 13: Resolution strategies as per asset size



Source: CRISIL Ratings

Asset classification is based on debt acquired. If the total debt acquired is more than Rs 100 crore, then it is classified as large asset; mid-sized if Rs 50-100 crore, and small if below Rs 50 crore.

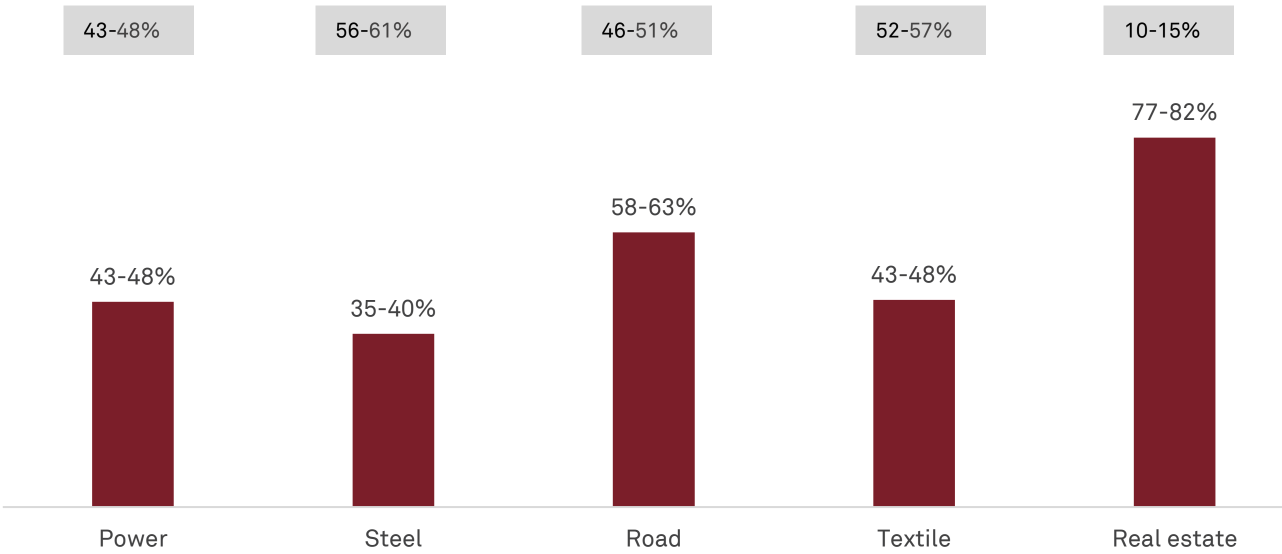
Debt restructuring is the most popular resolution strategy in large assets, while mid-sized ones usually prefer to settle over the negotiation table *(see Chart 13)*. ARCs are seldom left with no option other than the sale of assets for smaller loans.

Sector-wise recovery rates

CRISIL Ratings has analysed recovery across different sectors in its portfolio. Chart 14 represents the average recovery of stressed assets across the power, roads, textile, steel and real estate sectors over a period of eight years, that is, the trust life, as per the CRISIL Ratings portfolio analysis. Real estate is seen to recover 77-82% of the acquired debt over 8 years from acquisition followed by highway tolling with a recovery rate of 58-63%.

Based on CRISIL Ratings analysis in Chart 14, the debt under Real Estate sector is being bought at a very low discount because of rising investor interest due to the boom in this sector. For other sectors the discounts are in the range of 40-60%.

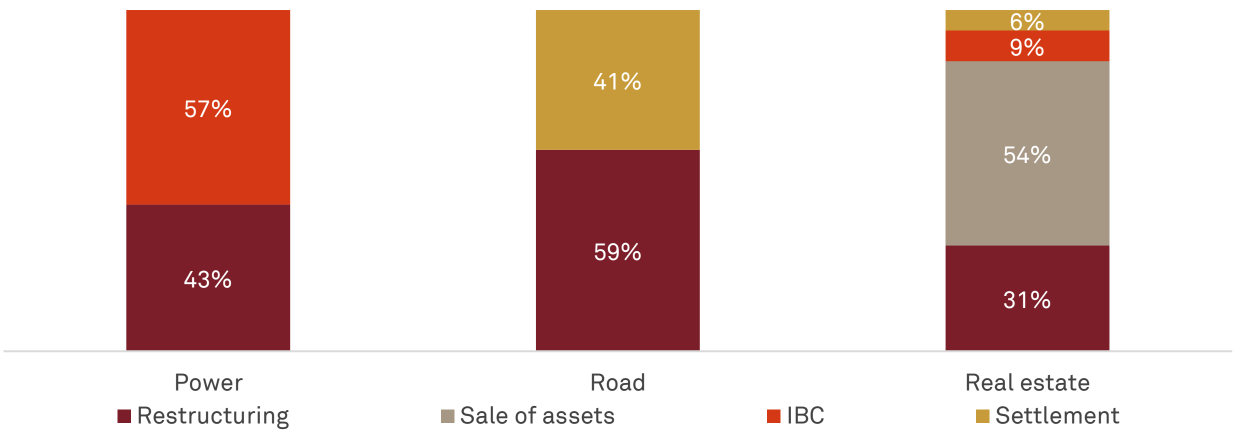
Chart 14: Average recovery rates for CRISIL rated portfolio



Source: Study of SR portfolio rated by CRISIL Ratings. Average recovery rate (as shown in maroon bars above) over 8-year timeline is a ratio of NPV of recoveries from underlying assets and acquired debt as on acquisition date
Average discount (as shown in grey boxes above) is calculated based on discount on Principal debt acquired at the time of acquisition.

Trends in key infrastructure sectors (power, roads, real estate)

Chart 15: Type of resolution strategies across sectors



Source: Study of portfolio rated by CRISIL Ratings, having ~Rs 3,800 crore debt in the road sector, ~Rs 21,500 crore in the power sector, and ~Rs 6,700 crore in the real estate sector.

Chart 15 illustrates that a larger share of debt in the power sector was resolved through IBCs, while restructuring remains the major resolution strategy for road assets and sale of assets was the main route for resolving real estate cases.

Power

According to the CRISIL Ratings portfolio analysis, stressed assets in this sector have the potential to recover 43-48% of the total debt acquired. This positive trajectory can be attributed to the escalating demand for power, favourable regulatory changes such as coal auctions through the Shakti scheme, ongoing restructuring initiatives and strategic investments. Resolution of assets primarily occurs through IBC, followed by restructuring, given that these assets are operational and generate sufficient cash flow to meet debt obligations.

Roads

The Government of India has taken many measures to develop the public infrastructure ecosystem, resulting in increased focus on revival of stressed road assets. Government initiatives, such as extension of concession period for build-operate-transfer-toll operators, release of retention money to the extent of work done have instilled confidence among stakeholders. Further, improving operational performance of road assets and annuity such as cash flow of road assets have drawn many strategic investors to refinance projects. As per the CRISIL Ratings portfolio analysis, stressed road assets have the potential to recover 58-63% of the total debt acquired. The counterparty payment risk is negligible as the counterparty in most large road projects is the National Highways Authority of India (NHAI), though there may be some delays in receiving payments. Hence, restructuring is the prominent resolution strategy in this sector, barring a few large cases that were resolved under IBC.

Real estate

Healthy economic growth and a number of corporates continuing with the hybrid working model will likely keep demand for residential real estate steady. The government has taken many initiatives to resolve the stress in the sector by providing funds to stalled projects. One such fund, SWAMIH Investment Fund, has provided last-mile funding for many stalled projects. These funds, along with partnerships (joint venture and development management models), sale of commercial assets and land and loan takeover by ARCs, have revived the stressed real estate projects, leading to better recovery for lenders.

Sale of assets remains the most preferred resolution strategy for the real estate sector, as once the project is completed, sale of units is the primary source for recovery. As the resolution timelines for real estate cases under IBC are stretching beyond expectation, lenders are looking for resolving these assets outside IBC by completing construction through a developer and selling the project under a revenue sharing model with the developer.

Deep-dive into retail loan asset classes

Acquisition trend has seen a shift from corporate to retail loans, given the saturation in corporate stressed assets and opportunity in retail stressed assets. However, contrary to earlier expectations of retail assets marking a sharp rise, the ARCs are open to selectively doing both corporate and retail deals, depending on the opportunities available. While some ARCs have invested in retail capabilities, many others are tapping this segment by working with originators and external agencies.

Table 3: Retail asset class-wise characteristics

Parameter/ Product category	Home loan & LAP	Vehicle finance	Credit Card	Micro finance
Haircuts on POS	Low High	Low High	Low High	Low High
Recovery trends				
Cost to servicer	Low to moderate	Low to moderate	High	High
ARC focus				

Source: CRISIL Ratings

Home loans/Loan against property (HL/LAP)

Based on the pools rated by CRISIL Ratings, HL/LAP stressed asset pools are acquired at moderate haircuts, considering the recovery is typically over 5-6 years, depending on the loan-to-value ratio, asset quality, market demand and perceived risk for the collateral. SARFAESI actions majorly drive recovery in this segment, with ARCs resorting to settlement with the borrowers simultaneously. Resolution cost has been observed to vary from low to moderate and is on the lower side if the SARFAESI action is in an advanced stage.

Vehicle loans

Vehicle loan pools have been acquired by ARCs at haircuts higher than HL/LAP pools due to the depreciating nature of asset, limited saleability and customers being typically from the informal sector. Recovery in these pools is generally seen over four years. These pools incur low to moderate cost to service, while being majorly serviced by the originators themselves.

Credit card receivables

Haircuts in this segment are high at over 85-90%. Recovery is over 3-4 years and its cost is high as the ARCs collect through third-party collection agents**.** The ticket size per loan is typically smaller and hence most collections happen through tele calling or digital platforms; on-ground collections are not feasible for this asset class.

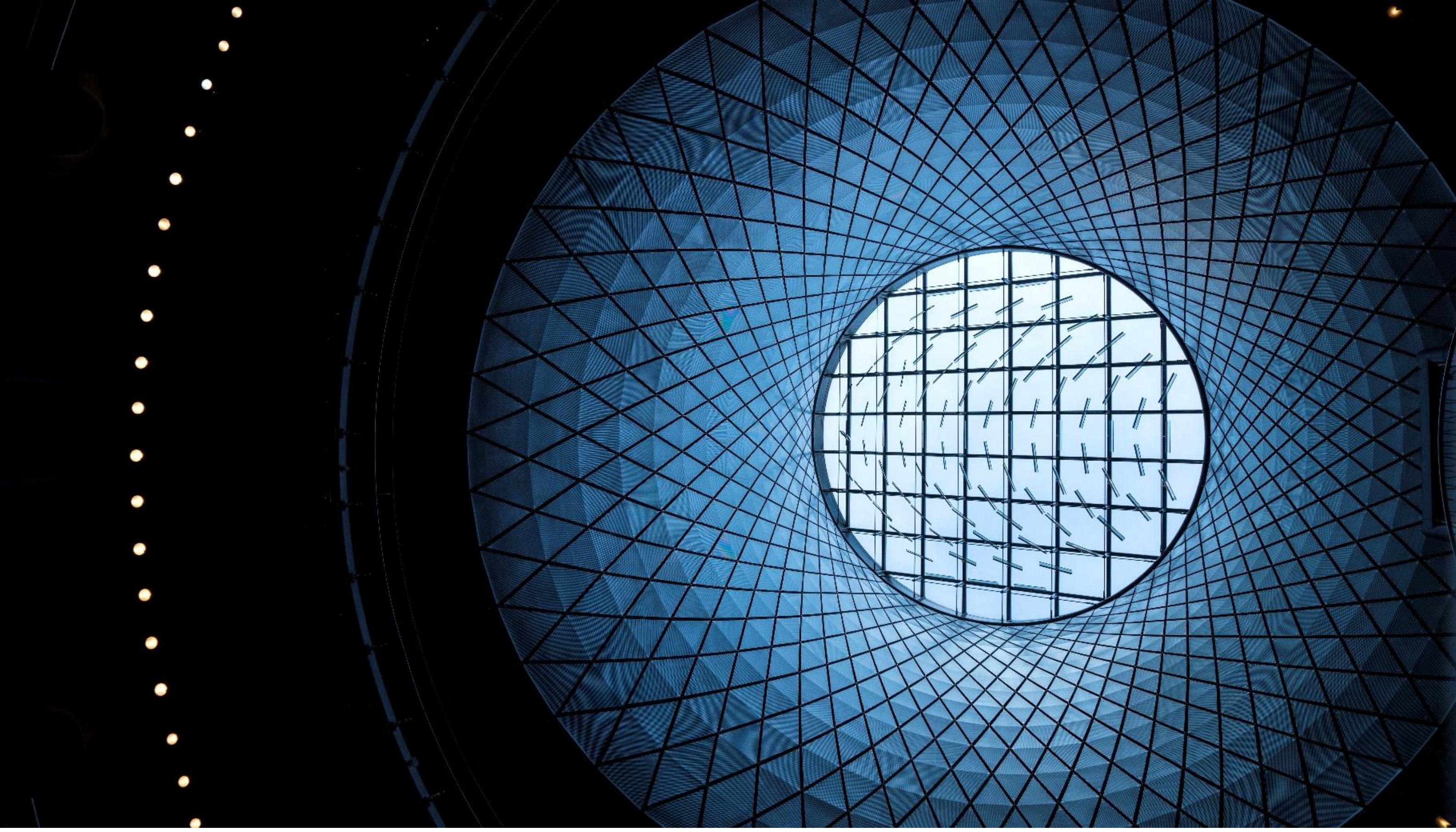
Microfinance

This asset class is mostly a regional play, with higher haircuts and ARCs depending on the originators for recovery, due to the concentration of culturally closeknit borrowers in a specific region and the high cost of recovery.

Based on the potential for growth and capability of ARC for resolution among different asset classes, HL/LAP and microfinance institutions will continue to garner higher interest from ARCs followed by credit cards/personal loans and vehicle finance.

In the CRISIL Ratings-rated portfolio, unsecured and microfinance portfolio asset classes churn faster with most of recovery in the first two years while others such as HL/LAP amortise over 5-6 years.

Some ARCs have developed in-house capabilities to support infrastructure as more manpower is required in the resolution process of retail pools, while others opt for outsourcing as a part of the resolution process.



Decoding modes of stressed assets resolution: IBC, SARFAESI emerging as powerful avenues

With the sizeable rates of credit growth in India, post opening of the economy in the early 1990s, the market for stressed assets in India has been growing in tandem. To address this issue, the policy environment has been evolving to have in place new resolution mechanisms or strengthening existing ones.

Historically, the RBI has introduced various frameworks for resolution. To name a few, Corrective Action Plan (CAP) by Joint Lender's Forum (JLF), Corporate Debt Restructuring (CDR), Scheme for Sustainable Structuring of Stressed Assets (S4A) and Prudential framework of RBI. This indicates the focus on resolution of stressed assets in India.

At present, the major resolution mechanisms available in the Indian stressed market sector are Debt Recovery Tribunal (DRT), SARFAESI Act 2002, civil laws enforced through Lok Adalat, the IBC, 2016 and Prudential framework of RBI.

Enactment of SARFAESI Act in 2002 has allowed setting up of ARCs, which has turned out to be a game changer for lending institutions. IBC and SARFAESI have together become the most prominent mechanisms of stressed assets resolution over time, enabling a shift to faster resolution and better value maximisation for stakeholders.

Table 4: Evolution of stressed assets resolution mechanisms

DRT (1993)

- Was a prominent recovery mechanism since 1990s.
- Used for cases with claim amount more than Rs 20 lakh
- Lengthy DRT processes and various stages of approval required for enforcement of assets created a need for enhanced rules.
- However, prominence remains for miscellaneous applications for invocation of guarantee, enforcement of agri-land parcels and bank account freezing orders etc.
- Not a time-bound resolution. Some cases takes years for issuance of recovery certificate

SARFAESI (2002)

- Prominent recovery tool for mortgaged stressed assets
- Faster mechanism as no court intervention is required for implementation
- ARCs have been set up under the Act with expertise in acquiring bad loans and resolving the same
- Lenders have been able to maximise value through sale of bad loans as well as collateral under this Act.

IBC (2016)

- Faster mechanism for resolution of asset rather than just recovery
- Can be used by financial creditors with claims above Rs 1 crore
- It is based on the principle of 'creditor in control', unlike previous frameworks. The management of the company loses control immediately upon admission.
- Has a strong deterrent effect as well

RBI Prudential Framework (2019)

- Provides a framework for early recognition, reporting and time-bound resolution of stressed assets.
- Lenders can implement a Resolution Plan without referring the borrower to NCLT.
- It can also act as a pre-cursor to pre-packaged resolutions or as an alternative to restructuring with change in management.
- Efficacy and practical applicability is to be tested in near term.

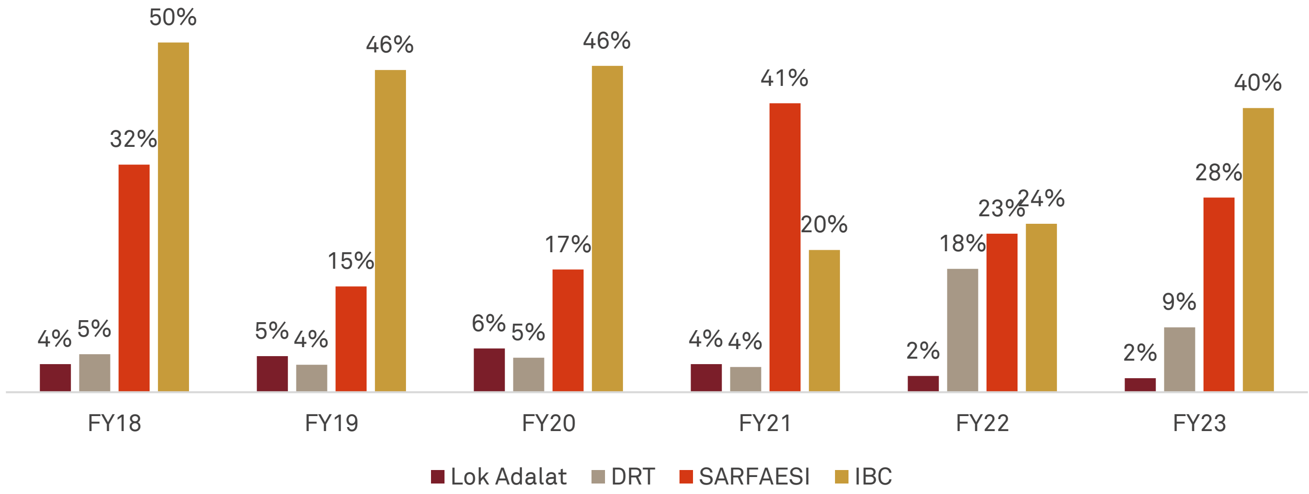
IBC has outperformed other legal recovery modes; business revival – a key differentiator

Chart 16 indicates average recoveries through each of the legal channels available at the disposal of a lender in case of bad loans. Amongst the legal channels, recoveries through the IBC route have been higher than others, barring in fiscal 2021, when SARFAESI had a higher recovery percentage. This is due to a sharp dip in cases referred to SARFAESI during the fiscal.

IBC had lower recovery rate in fiscals 2021 and 2022 due to the combination of slow functioning of courts and embargo[1] by the Supreme Court on fresh applications under it for a while after March 2020.

[1] Embargo – Limitation implemented by SC on filing of fresh cases in NCLT during the Covid-19 pandemic.

Chart 16: Recovery trends across resolution mechanisms



Note: Actual recovery data for ARCs is not available in the public domain. Hence, it is not included in the above chart.

The recovery rates mentioned in the chart are as per the RBI report and are on a year-on-year basis and not cumulative as of respective years

(P) – Provisional

Source: RBI, Insolvency and Bankruptcy Board of India (IBBI)

While IBC is a comparatively new mechanism, it has established itself as the prominent resolution tool on major parameters such as higher recovery rate and better resolution timelines.

The primary advantage of IBC over others has been the revival of business, thus creating value not only for lenders but also for all other stakeholders involved and, in the process, keeping the workforce intact. Revival of business has also led to greater credit growth as the stressed companies can take on further debt for revival. This was not the case with other resolution mechanisms, as they were mainly used as a tool for recovery rather than business revival, thus contributing mostly to the lender's recovery.

To continuously enhance effectiveness and efficiency of IBC, several reforms have been introduced since its inception, resulting in resolution of some of the large cases. Still, deliberations are on for bringing in improvements in many aspects, not only to keep the code relevant with changing times but also to maintain its premier position among all resolution mechanisms.

The IBC journey so far: Improving credit culture, but implementation needs to be streamlined

Lenders have used various legal channels and RBI frameworks for resolution of stressed assets for years prior to the IBC era. The peculiar characteristic of these measures was a ‘debtor in control’ architecture. IBC emerged with the need to bring in a comprehensive umbrella code with the ‘creditor in control’ paradigm. It has undoubtedly tilted the power equation in favour of creditors from debtors and improved the credit culture in India by recovering Rs. 3.16 lakh crore against admitted claims of Rs 9.92 lakh crore till FY23. As per IBBI, 26,518 cases having underlying default of Rs 9.33 lakh crore were resolved before their admission to IBC, demonstrating the deterrence effect of the code.

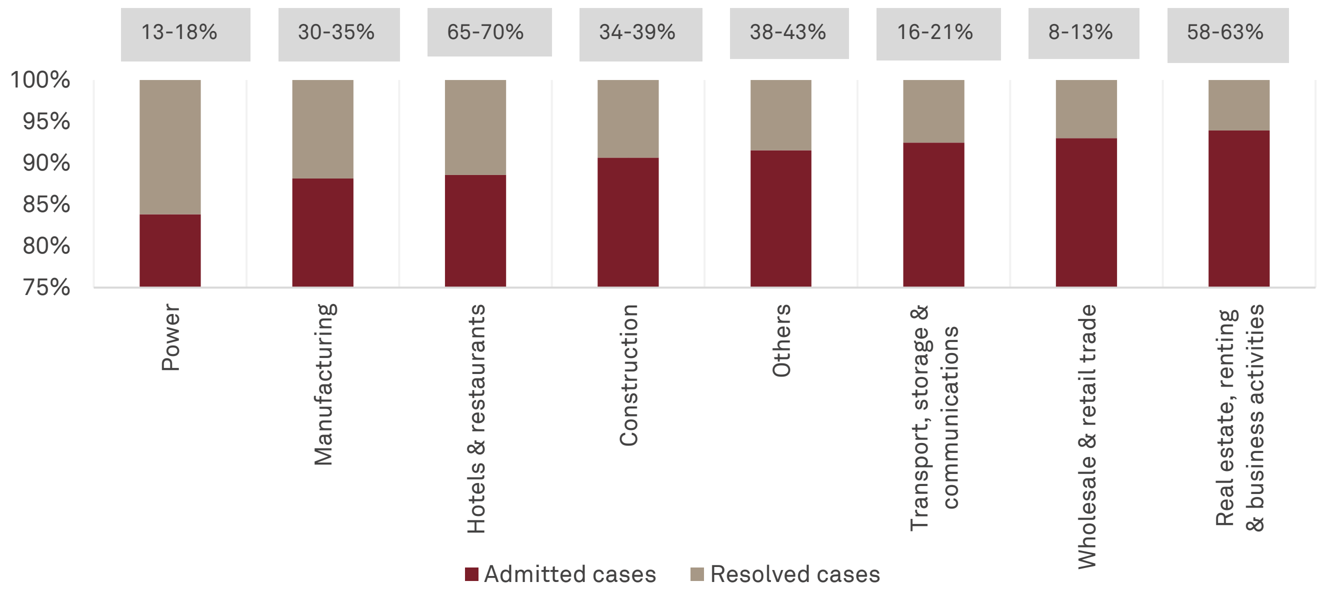
Average recovery rate under IBC was ~37% of admitted claims in the past five years, surpassing other legal mechanisms, including SARFAESI, DRT and Lok Adalat, which had recovery rates of 4% to 22% during the same period. Increasing number of IBC cases filed by financial creditors shows increased confidence in the code.

The secret to the success of IBC lies in its evolving nature, with more than 90 amendments made till date to improve resolution timelines and maximise value. Focussed implementation of some of the recent amendments related to capacity augmentation, digitalisation of IBC platforms and expansion in the scope of implementation of pre-pack resolution plans are critical to ramping up efficiency.

Sectoral dynamics: Manufacturing tops admission under IBC, power leads in resolution, while real estate struggles

As per Chart 19, In the power sector, IBC has resolved 19% of the admitted cases with recovery rate of 13-18%. In contrast, the real estate industry has exhibited lower investor interest, with resolution in 8% of admitted cases.

Chart 19: Comparison of resolved cases to admitted cases



Source: Insolvency and Bankruptcy Board of India (IBBI)

Average recovery rate under IBC (as shown in grey boxes above) is calculated based on Total value realisable divided by Total admitted claims of resolved cases.; Recovery rate for Real Estate sector includes amounts payable to homebuyers as Financial Creditors under IBC

Individual Insolvency Law falls short of lender expectations; calls for further amendments

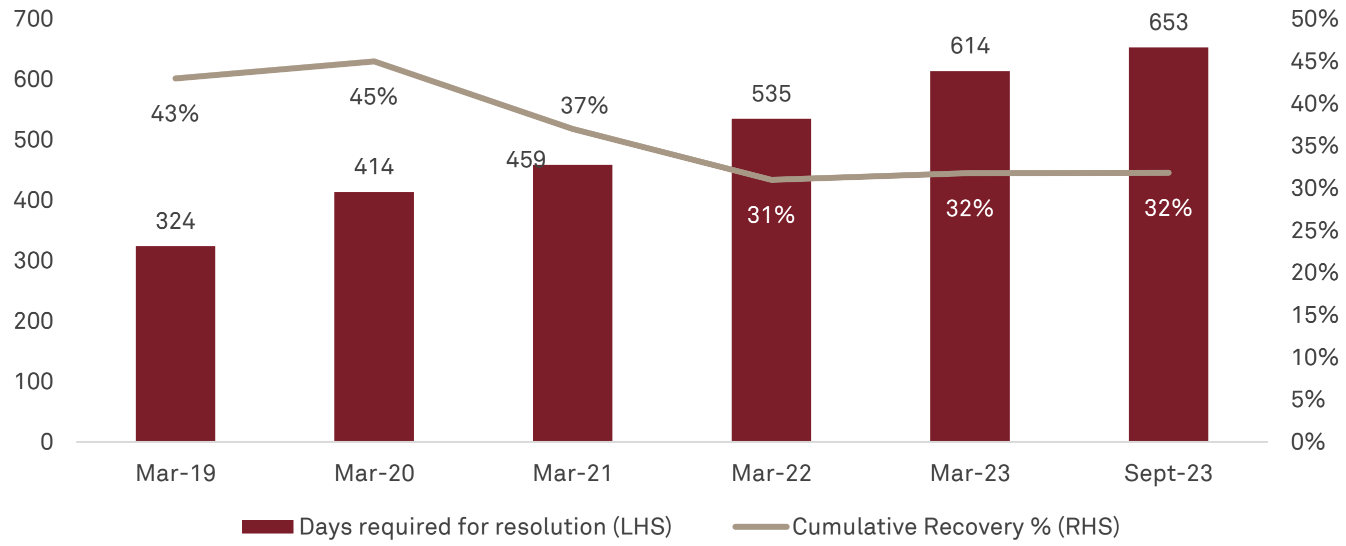
Recently apex court pronounced its order in November 2023 upholding the constitutional validity of provisions pertaining to initiating the insolvency proceedings against personal guarantors to corporate debtors. Though it gives creditors an additional safety net for recovery of dues but still there are some challenges such as immediate moratorium activation upon filing of application in NCLT thus restricting the lenders from pursuing any other legal actions, challenges with respect to declaration of assets as the law lacks provisions for strict actions against the individual for concealment of assets. In the absence of stringent regulations, individual insolvency may not be an effective recovery tool for lenders.

Areas of improvement under IBC

1. Recovery rates plateau with prolonged resolution timelines

Though IBC is performing consistently better than other mechanisms in terms of recovery rates, its performance with reference to its twin objectives of timelines and year-on-year recovery rates have room for improvement *(see Chart 20)*.

Chart 20: Recovery rates and resolution timelines under IBC



Source: Insolvency and Bankruptcy Board of India (IBBI)

One of the main reasons for the increasing number of days required for resolution can be attributed to the limited available judicial bench strength compared to the steady yearly increase in the number of cases filed, which has led to accumulation of cases in NCLT. With increase in timelines for resolutions, the value of the asset gets eroded, which is clearly visible in the recovery rates in the past three years being lower than that in the past.

2. Backlog of pending cases

As per the government's submission in Parliament, ~13,000 cases are pending at NCLT courts. Vacant benches in some locations and limited functioning of courts during the pandemic have contributed considerably to the creation of this backlog. Clearing the backlog would lead to an increase in number of resolutions being approved, thus boosting the recovery rates under IBC.

3. Focus on pre-packs for MSMEs and extending the scheme for specified corporate persons

The pre-pack scheme was introduced in 2021 to fast track the resolution process for MSMEs as such firms lose their intrinsic value at a quicker pace compared with large corporates. The scheme has seen limited traction over the two years since its introduction. Given its nascency, lenders and borrowers need to be educated on intricacies of the Pre-Packed Insolvency Resolution Process (PIRP) that keep the transparency and competitiveness of the process at par with the Corporate Insolvency Resolution Process (CIRP). This will lead to more cases being referred to and resolved under PIRP. Extending the scheme for specified corporate persons could lead to swift recovery of large assets, circumventing legal hurdles in the resolution process.

To address the above-mentioned issues, authorities have been proactive in bringing several amendments to the code while enhancing the infrastructure required for seamless implementation across the resolution process.

Though the amendments have strengthened and enhanced the credibility of IBC, their effective implementation is critical to see on-ground improvement in metrics.

Major amendments

The government, along with the regulator (IBBI), has been taken a number of steps in addressing issues faced by various stakeholders and has amended the code from time to time. As of September 2023, more than 90 amendments were made to the IBC code.

Amendments already enacted such as pegging the rights of homebuyers at par with financial creditors, reducing threshold voting criterion among creditors for taking key decisions, approving sale of assets on piecemeal basis and provision for audit of Corporate debtor, among others which have improved efficacy of the code. Other areas where code can be further improved include facilitation of cross-border insolvency processes, standardisation of valuation methodologies, introduction of specialised resolution frameworks for specific sectors where success has eluded IBC (such as real estate) and introducing pre-pack insolvency process for large Corporate persons which can help enhance the effectiveness of the code. In February 2024, IBBI has made further amendments towards operating separate bank accounts for real estate projects, flexibility in inviting resolution plans in real-estate cases amongst other which is likely to further strengthen the IBC process.

National ARC a step in the right direction; its efficacy will be tested in due course

Progress so far

- Acquired debt of Rs 40-42 thousand crore as on Dec-23
- ~Rs 6.5-7 thousand crore of SRs issued with 85% redemption guaranteed by the government of India
- Bids submitted for ~30 cases totaling to Rs 1.7 lakh crore debt

Positives

- Debt aggregation simplified
- Competitive pricing enabled by Swiss challenge
- Lenders showcased ~300 cases for diligence
- Old vintage cases expected to be cleaned up

Challenges

- Price discovery
- Reluctance of lenders to sell under structured deals
- Extended time taken for the guarantee paperwork
- Delay as lenders are unable to come to consensus due to difference in security charge position

Diversifying ways to resolution of stressed assets

The Securities and Exchange Board of India (SEBI) has proposed a Special Situation Fund (SSF) framework as a Category-I Alternative Investment Fund. Under this framework, SSFs will be allowed to acquire stressed loans by way of a resolution plan under RBI Prudential Framework, 2019. At the same time, RBI has come up with a discussion paper on Securitization of Stressed Assets Framework (SSAF) in January 2023, which is expected to enable the securitisation of NPAs as an alternative investment route in stressed assets. This framework allows for the resolution and recovery of stressed assets to be carried out by an independent Resolution Manager (RM) and envisions a portfolio approach towards recovery from a varied pool of stressed assets.

At present, ARCs are the primary purchasers for lenders to offload their stressed assets. The proposed regulations will provide an additional avenue to the lenders seeking to dispose their stressed loans.

Proposed regulation

For SSFs

- Upon being added to the RBI Master Circular, SSFs will be able to directly acquire stressed assets from financial Institutions
- SSFs shall provide complete exit to the lenders without violating Related Party norms

For SSAFs

- Lenders will be able to sell Non-performing loan pools directly to investors
- This framework will allow resolution and recovery of stressed assets to be carried out by an independent Resolution Manager(RM)

Impact	Increasing investment and competition in the stressed loan industry
	• More avenues for stressed asset management for lenders • Increased competition for ARCs • Continued dependence on ARCs for bilateral deals and recovery under SARFAESI Act

While these proposed regulations will lead to increase in competition for ARCs, it may also create new fee-based revenue streams for them going forward for their expertise in Recovery and Revival of stressed accounts. Enactment of these regulations and opening of new revenue streams shall bear watching.

Challenges that the ARC industry will need to manage

Lack of secondary market for trading of SRs	• Transparency and information availability will be key challenges
Partnership model remains a challenge	• Ability to attract co-investors under a multi-platform ecosystem will be critical for the growth of ARCs • While large ARCs have the option to go for this model, small ARCs may find it challenging
Requirement of NOF	• It will be tough for smaller ARCs to bring in additional capital • Inability of smaller ARCs to raise capital may lead to consolidation in the sector
Key challenges in recovery	• Prolonged legal issues • Lack of consensus among lenders • Small and mid-sized assets have limited market interest and low liquidation value
Increasing competition	• If SSAF and SSF are implemented, competition for ARCs to acquire NPAs will increase

The way forward

Sizeable opportunity for investors in stressed assets across various sectors

Private ARCs will continue to have a role to play, though business model may evolve

Cash share: With the proportion of cash share increasing significantly in recent years and becoming the industry norm, ARCs need to focus on resolution to stay relevant

NARCL is a positive step structurally; its efficacy will be tested in due course

Development of a secondary market for stressed assets will also aid liquidity

Annexures

Press release published by CRISIL Ratings in November 2023 on IBC performance

CRISIL Ratings

Press release

November 24, 2023 | Mumbai

In 7 years, IBC has improved credit culture; room for strengthening remains

Recent amendments augur well for ramping up efficiencies, implementation the key

Since inception in 2016, the Insolvency and Bankruptcy Code (IBC) has improved the credit culture in India by resolving a significant amount of stressed assets with better recovery rates compared with the previous mechanisms, such as the Debt Recovery Tribunal, the SARFAESI Act and Lok Adalat[1]. Importantly, it has set such deterrence that large bad-loan cases are getting sorted before reaching the IBC gates.

The IBC itself has been evolving, with more than 90 amendments made till date to improve resolution timelines and maximise value. Focussed implementation of some of the recent and proposed amendments related to capacity augmentation, digitalisation of IBC platforms and expansion in scope of implementation of pre-pack resolution plans are critical to further ramp-up efficiency.

In terms of value, the IBC has helped resolve ~Rs 3.16 lakh crore of debt stuck in 808 cases in the past seven years. On average, creditors have realised ~32% of the admitted claims and ~169% of the liquidation value. Other mechanisms had an average recovery rate of 5-20%, which underscores IBC as the one with higher recovery for lenders.

Says Mohit Makhija, Senior Director, CRISIL Ratings Ltd, "IBC is, undoubtedly, the most potent code in India's corporate loan history, and has brought about a behavioural change among borrowers. The fear of losing companies has led to over Rs 9 lakh crore of filed debt being settled before the cases arrived at the IBC doorstep for admission. This is ~three times the stressed debt resolved via the code in the past seven years, underscoring its deterrence effect."

But for IBC to continue succeeding, some impediments need to be removed. For example, recovery rates have fallen from 43% to 32% between March 2019 and September 2023, even as the average resolution time has increased from 324 to 653 days versus the stipulated 330 days *(see chart 1 in annexure)*.

There are two reasons for this. First, limited judicial bench strength and delays in identification and acknowledgement of default. Second, significant delay in the pre-IBC admission stage (650 days in fiscal 2022 increased from about 450 days in fiscal 2019) has suppressed recovery rates. This has led to a diminution in asset values and sub-optimal recoveries.

To improve efficacy, new amendments in the past 12 months have been made to the IBC. These include approval for sale of assets/resolution plan on a segregated basis, increasing the number of National Company Law Tribunal benches to 16 and extending timelines for filing claims, among others. Additionally, sector-specific amendments, provision for audit of corporate debtor, and modifications in Form-G[2] will also improve the process. These amendments and their effective implementation can reduce resolution times and backlog of cases over the near to medium term.

Says Sushant Sarode, Director, CRISIL Ratings Ltd, "The IBC's effectiveness can be increased using CDE approach, where C stands for Capacity augmentation, D for Digitalisation and E for Expansion of pre-pack resolutions to large corporates. Improved infrastructure, such as expanding bench strength of judges for higher throughput of cases, digitalisation of IBC platforms for connecting all stakeholders to eliminate data asymmetry, and expansion of scope of pre-pack insolvency resolution[3] for large corporates will prevent value erosion due to time. Implementation using this approach will help clear the backlog of ~13,000[4] cases stuck in various stages of IBC resolution."

[1] The average recovery rate for SARFAESI (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002), DRT (Debt Recovery Tribunal) and Lok Adalat during fiscals 2018 to 2022 were 21%, 5% and 4%, respectively.
[2] Prescribed format for publication of notice to invite expression of interest from potential bidders.
[3] Pre-pack insolvency is currently only applicable to MSMEs. This is a speedier, comparatively informal process wherein lenders and borrowers, by mutual understanding, can arrive at a resolution plan and approach NCLT for approval.
[4] Includes 2073 on-going CIRP cases and balance are cases filed but not yet admitted.

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About ASSOCHAM

The Associated Chambers of Commerce & Industry of India (ASSOCHAM) is the country's oldest apex chamber. It brings in actionable insights to strengthen the Indian ecosystem, leveraging its network of more than 4,50,000 members, of which MSMEs represent a large segment. With a strong presence in states, and key cities globally, ASSOCHAM also has more than 400 associations, federations and regional chambers in its fold.

Aligned with the vision of creating a New India, ASSOCHAM works as a conduit between the industry and the Government. The Chamber is an agile and forward looking institution, leading various initiatives to enhance the global competitiveness of the Indian industry, while strengthening the domestic ecosystem.

With more than 100 national and regional sector councils, ASSOCHAM is an impactful representative of the Indian industry. These Councils are led by well-known industry leaders, academicians, economists and independent professionals. The Chamber focuses on aligning critical needs and interests of the industry with the growth aspirations of the nation.

ASSOCHAM is driving four strategic priorities - Sustainability, Empowerment, Entrepreneurship and Digitisation. The Chamber believes that affirmative action in these areas would help drive an inclusive and sustainable socio-economic growth for the country.

ASSOCHAM is working hand in hand with the government, regulators and national and international think tanks to contribute to the policy making process and share vital feedback on implementation of decisions of far-reaching consequences. In line with its focus on being future-ready, the Chamber is building a strong network of knowledge architects. Thus, ASSOCHAM is all set to redefine the dynamics of growth and development in the technology-driven 'Knowledge-Based Economy. The Chamber aims to empower stakeholders in the Indian economy by inculcating knowledge that will be the catalyst of growth in the dynamic global environment.

The Chamber also supports civil society through citizenship programmes, to drive inclusive development. ASSOCHAM's member network leads initiatives in various segments such as empowerment, healthcare, education and skilling, hygiene, affirmative action, road safety, livelihood, life skills, and sustainability.

Shri Deepak Sood,

Secretary General

ASSOCHAM

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