



# Regulatory framework for Securitization Companies/Reconstruction Companies Certain amendments



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# Regulatory framework for Securitization Companies/Reconstruction Companies – Certain amendments

## Background & Objective

Prolonged slow growth has adversely affected the Indian economy. The banking system is sitting on pile of huge non-performing loans and coupled with restructured loans, they are estimated to be around 15 % of bank loans. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (“SARFAESI”) Act was passed in the year 2002 with an aim to provide a statutory framework to banks for bad loan recovery. With the BASEL III capital requirements kicking in soon, the PSU banks are severally undercapitalized and the NPA problem only aggravates the situation further. As per the earlier guidelines when an asset is sold off to an ARC, about 5% of value of asset sold is given back to bank in cash which is directly written back to the P&L account by the bank. The remaining 95% of the value is issued as Security Receipt (“SR”) by the Securitization Company (“SC”) or Reconstruction Company (RC). In the past few years the business of Asset Reconstruction Company (“ARC”) (also referred to as SC/RC) was booming and there were concerns raised by the regulator on the valuation of the loan book taken over by them. Also the management fee charged by them was linked to the value of outstanding SRs leading to high payout to the ARCs. The earlier model with back ended recovery was really attractive for the ARCs and seemed to disadvantageous to the Banks selling to them. However in order to create a balanced environment for both the ARCs and the Banks selling to them, RBI has revised the guidelines with more focus on the type of asset quality that is being transferred to them and also the valuation methodology around the same.

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## Extract of the regulation

**Investment of SCs / RCs in Security Receipts (SRs)** - At present, SCs/RCs have to mandatorily invest and hold minimum 5% of the SRs issued by them against the assets acquired on an ongoing basis. Henceforth, SCs/RCs shall, by transferring funds, invest a minimum of 15% of the SRs of each class issued by them under each scheme on an ongoing basis till the redemption of all the SRs issued under such scheme.

**More time for due diligence** - Before bidding for the stressed assets, SCs/RCs may seek the auctioning banks to give adequate time, not less than 2 weeks, to conduct a meaningful due diligence of the account by verifying the underlying assets.

**Change in definition of planning period** - Planning period will mean a period not exceeding six months (instead of twelve months as at present) allowed for SCs / RCs to formulate a plan for realization of non-performing assets of the

selling bank acquired for the purpose of reconstruction.

**Valuation of SRs** - The initial valuation of SRs should be done within a period not exceeding six months of acquiring the underlying asset (instead of one year as at present) to enable all the stake holders to realistically assess the value of SRs at an earlier date.

**Management fees** - Management fees should be calculated and charged as percentage of the net asset value (NAV) at the lower end of the range of the NAV specified by the Credit Rating Agency (CRA) (rather than on the outstanding value of SRs as at present), provided that the same is 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 NAV of SRs.

**Membership in Joint Lenders' Forum (JLF)** - In terms of Circular DBOD.BP.BC.No.97/21.04.132/2013-14 dated Feb. 26, 2014 on 'Framework for Revitalizing Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)', the banks have been advised that as soon as an account is reported by any of the lenders to 'Central Repository of Information on Large Credits' (CRILC) as SMA-2, they should mandatorily form a committee to be called JLF if the aggregate exposure (AE) [fund based and non-fund based taken together] of lenders in that account is Rs 100 crore and above. SCs/RCs also should be members of JLF and should be a part of the process involving the JLF with reference to such stressed assets.

**Reporting to Indian Banks' Association (IBA)** - In terms of the same circular on joint lending, banks are to report to IBA the details of the recalcitrant CAs, Advocates and Valuers who have committed serious irregularities in course of rendering their professional services. Likewise, the SCs / RCs are to report to IBA the details of such CAs, Advocates and Valuers for placing it on the IBA database of Third Party Entities involved in fraud. However, the SCs/RCs will have to ensure that they follow meticulously the procedural guidelines issued by IBA (Circ. No. RB-II/Fr./Gen/3/1331 dated August 27, 2009) and also give the parties a fair opportunity to explain their position and justify their action before reporting to IBA. If no reply / satisfactory clarifications are received from them within one month, the SCs/RCs may report their names to IBA. SCs / RCs should consider this aspect before assigning any work to such parties in future.

#### **Additional disclosure**

- At present it is mandatory for the SCs / RCs to disclose in their balance sheet the value of financial assets acquired during the financial year either on its own books or in the books of the trust. In addition, SCs / RCs will have to mandatorily disclose the basis of their valuation if the acquisition value of the assets is more than the Book Value (the value of the assets as declared by the seller bank in the auction). Similarly, SCs / RCs will have to disclose the details of the assets disposed off (either by write off or by realisation) during the year at substantial discount (say more than 20% of valuation as on the previous year end) and the reasons therefor. SCs / RCs are, also, to declare upfront the details of the assets where the value of the SRs has declined substantially below the acquisition value.
- SCs / RCs should put up in their website the list of wilful defaulters, (by adopting the process as defined in DBOD Master Circ. No. CID.BC.3/20.16.003/2014-15 dated July 1, 2014) at quarterly intervals. Further, in terms of DNBS (PD-SC/RC).CC.No.23/26.03.001/2010-11 November 25, 2010, each SC / RC is required to become a member of at least one credit information company (CIC) and provide to the CIC periodically accurate data/history of the borrowers. In this case, also, they should furnish the data of wilful defaulters to the CIC in which they are members.

## Impact Assessment

The release of the guideline has the following impact:-

- The ARCs will now have to mandatorily invest and hold 15 % of the SR in place of a limit of 5 % earlier. This will have an immediate impact on the cash flows for the banks which will receive 15% of the value of the sale amount of the NPAs and more realistic valuation from the ARCs as they will have to pay a fair sum of money upfront. Also structurally the ARCs will move from a more negotiation focused business model to a more recovery oriented model.
- The SC/RCs will have to conduct a due diligence within a period of two weeks to verify the existence of the underlying assets. Prior to this requirement, there was no time limit defined for conducting due diligence and hence the SCs/RCs had to make speedy decisions, which necessarily weren't the right calls and hence this revision definitely is a structural improvement in the right direction.
- The ARCs will now have to formulate a plan for the realization of non-performing assets within a period of 6 months instead of 12 months allowed earlier. Further they will have to do the valuation of the SRs within a period of 6 months instead of 12 months allowed earlier. This will enable all the stakeholders to realistically assess the value of the SRs at an earlier date rather than waiting till the year end. Structurally ARCs are meant to increase the liquidity in the system and facilitating price discovery through more frequent valuations helps meet that liquidity objective.
- The calculation of the management fees is more scientific and linked to the percentage of the NAV at the lower end of the range of NAV specified by the credit rating agency rather than on the outstanding value of SRs at present and the same should not be 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 NAV of SRs. This is a welcome change for the Banking system, as asset acquisition deals between the Banks and ARCs will be more fairly structured.
- The SCs/RCs should also form part of the Joint lending forums in terms of the circular issued by RBI on 'Framework for Revitalizing Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)'. This will ensure that the SCs/RCs are involved in the entire life cycle from an asset quality standpoint, enabling them to take a more balanced views at the time of asset acquisitions, should the JLF choose that route.
- The ARCs will also have to report to the Indian Banking Association the details of the recalcitrant CAs, Advocates and Valuers who have committed serious irregularities in course of rendering their professional services. They will have to follow the procedural guidelines issued in this regard by the IBA. Thus Banks would need to ensure that the relevant control framework is established within the credit administration functions of their institutional banking divisions to facilitate such periodic reporting.
- In order to make the valuation process of the ARCs more transparent, they will have to mandatorily disclose the basis of their valuation if the acquisition value of the assets is more than the Book Value (the value of the assets as declared by the seller bank in the auction). Similarly, SCs / RCs will have to disclose the details of the assets disposed off (either by write off or by realisation) during the year at substantial discount (say more than 20% of valuation as on the previous year end) and the reasons therefor. SCs / RCs are, also, to declare upfront the details of the assets where the value of the SRs has declined substantially below the acquisition value. These changes will go a long way in building mutual trust between the Banks and ARCs and thus help foster a much deeper relationship – an aspect that could go a long way in helping resolve the asset liability mismatches existent within the financial system.
- Further in tightening the screws around the wilful defaulters, the SCs/RCs are also required to put up the list of wilful defaulters on their website on a quarterly basis.

# Contacts



**Muzammil Patel**

Senior Director, DTTIPL  
[muzammilpatel@deloitte.com](mailto:muzammilpatel@deloitte.com)  
+91 22 6185 5490



**Vivek Iyer**

Director, DTTIPL  
[viveki@deloitte.com](mailto:viveki@deloitte.com)  
+91 22 6185 5558



**Rajeev Khare**

Assistant Manager, DTTIPL  
[rakhare@deloitte.com](mailto:rakhare@deloitte.com)  
+91 22 6185 5525

For further information, send an e-mail to [inri@deloitte.com](mailto:inri@deloitte.com)



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