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RBI revises ARC Framework towards increasing transparency and efficiency

The Reserve Bank of India (“**RBI**”) has amended the regulatory framework (“**Framework**”) for asset reconstruction companies (“**ARCs**”) on October 11, 2022. Since inception, ARCs have grown in number and size, however their potential for resolving stressed assets is yet to be realised. Accordingly, based on the recommendation of a committee, RBI has reviewed the existing regulatory regime applicable to ARCs and put forth the Framework.

The Framework has introduced certain important measures and has amended certain existing guidelines with an aim to increase the transparency and efficiency of these institutions. Some of the recommended measures introduced under the Framework are:

Minimum retention requirements

From the current limit of 15% of total security receipts (“**SR**”), the minimum investment in SRs by ARCs has been reduced to: (a) 15% of the transferors’ investment in the SRs; or (b) 2.5% of the total SRs issued, whichever is higher.

This minimum retention requirement has been considerably reduced for all cash transactions. If the transferor is not investing in the SRs, then the ARC’s minimum investment would be 2.5% of the total SRs issued (as compared to 15% of SRs). Even for transactions wherein the transferor is investing, there will be some reduction in the minimum investment through SRs. This is because now the percentage of minimum holding is linked to transferors’ investment rather than the total SRs issued under a scheme. This is a welcome step as ARCs were finding it difficult to infuse capital in all SRs transactions specifically when there were independent third-party investors.

Policy of management fees

As per the existing guidelines, the board approved policy in relation to management fees, expenses and incentives should be transparent and it should ensure that the management fee is reasonable and proportionate to financial transactions. Now, the Framework has additionally put the following conditions: (a) the fees and incentives will have to be recovered only from the underlying financial assets; (b) the policy should indicate a quantitative cap on the fees and incentives.

One time settlement

As per the Framework, the settlement of dues will have to be done only with the prior approval of an Independent Advisory Committee (“**IAC**”). It is important to note that the IAC was relevant for change or takeover of the management of the borrower. Although in practice, the change or takeover of the management of the borrower was

not very common. However, the IAC will now be an empowered and important function as settlement with the borrower would be possible only if all other steps of recovery have been exhausted.

Measures withdrawn

Buyback of assets from ARCs by defaulters and acquisition of assets by ARCs from sponsor banks were allowed with certain conditions. Now these exemptions have been withdrawn.

Minimum net owned fund

Minimum net owned fund of ARCs has been increased to INR 300,00,00,000 (Indian Rupees three hundred crores) on an ongoing basis from the existing requirement of INR 100,00,00,000 (Indian Rupees one hundred crore). For existing ARCs, this needs to be increased to INR 200,00,00,000 (Indian Rupees two hundred crores) by March 31, 2024, and INR 300,00,00,000 (Indian Rupees three hundred crores) by March 31, 2026. A new ARC will have to meet the requirement of INR 300,00,00,000 (Indian Rupees three hundred crores) from day one.

ARC as resolution applicant

In the past RBI has objected and raised concern on ARCs acting as resolution applicant under the provisions of Insolvency and Bankruptcy Code, 2016 (“**IBC**”). Now ARCs having minimum net owned fund of INR 1,000,00,00,000 (Indian Rupees one thousand crores) are allowed to act as the resolution applicant under the corporate insolvency resolution process initiated under the IBC. The ARCs are not allowed to retain a significant influence or control over the corporate debtor after 5 (five) years from the date of approval of the resolution plan under the provisions of IBC.

In addition to the above, RBI has also introduced certain corporate governance measures. The corporate governance measures have been aligned with that of the commercial banks. This shows that the roles and responsibilities of the ARCs will be important in the overall economic sector and especially in the effort of resolving stressed assets. Some of these important measures are as follows:

1. Enhancing governance of ARCs

The Framework proposes that the chair of the board will be an independent director and in the absence of chair, the meetings of the board of directors will be chaired by an independent director. The quorum of the board meetings is also specified.

The tenure of a managing director (“**MD**”) / chief executive officer (“**CEO**”) or whole time director (“**WTD**”) is fixed for 5 (five) years at a time and may be extended up to 15 (fifteen) years continuously by reappointment. Thereafter, the reappointment may be made after a cooling-off period of 3 (three) years. The age of the MD / CEO or WTD has been capped at 70 (seventy years). Additionally, the performance of the MD / CEO or WTD will be reviewed by the board of directors on an annual basis.

The aforesaid compliances are to be done by ARCs within 6 (six) months from the date of the Framework.

2. Committees of the board of directors

ARCs must constitute an audit committee and a nomination and remuneration committee within 6 (six) months from the date of the Framework. The audit committee will have the following functions: (a) as laid down in Section 177 of the Companies Act, 2013; (b) to periodically review and assess the effectiveness of internal control systems; and (c) to ensure that accounting of management fees / incentives / expenses are in compliance with the applicable regulations.

The nomination and remuneration committee will have following functions: (a) as laid down in Section 178 of the Companies Act, 2013; and (b) to ensure the ‘fit and proper’ status of the proposed and existing directors and sponsors.

3. **Prior approval for change in sponsor**

Any change in the sponsor of the ARC due to fresh issuance of shares requires the prior approval of the RBI.

4. **Fit and proper criteria**

ARCs are required to obtain necessary information and declaration from the appointed and existing directors, the MD / CEO in specified formats on an annual basis. The directors of the ARCs are required to execute a covenant in the specified format to discharge their responsibilities to the best of their abilities.

5. **Enhanced disclosures**

In order for the qualified buyers to make an informed decision, the following additional disclosures are required in the offer document: (a) financial information of the ARC for last 5 (five) years or since commencement, whichever is shorter; (b) track record of returns generated for all SR investors on the schemes floated in the last 8 (eight) years; and (c) track record of recovery rating migration and engagement with rating agency of the schemes floated in the last 8 (eight) years.

6. **Credit ratings**

There is a mandatory requirement to obtain recovery ratings of the SRs from credit rating agencies and disclose the same to the SR holders. The same credit rating agencies need to be retained for at least 6 (six) rating cycles (of half year each).

The aforesaid measures, especially on disclosures, will definitely increase the accountability of the ARCs with respect to the kind of assets that they will be acquiring and their recoveries. Moreover, the long demand to relax the minimum retention requirement has been favourably considered in the Framework. In fact, for all-cash transactions, the minimum retention requirement has been reduced considerably. Consequently, the Framework should certainly boost the industry and bring home palpable effects to make ARCs a relevant player in addressing India's stressed asset clean up.

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18 Ranked Lawyers



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