



## Concerns in Asset Reconstruction Companies (ARCs)

For Prelims: [Asset Reconstruction Companies \(ARCs\)](#), [Non Performing Asset \(NPAs\)](#), [Assets Under Management \(AUM\)](#), [Retail NPAs](#), [National Asset Reconstruction Company Ltd \(NARCL\)](#), [Insolvency and Bankruptcy Code \(IBC\)](#), [SARFAESI Act, 2002](#), [Maidavolu Narasimham](#), [Qualified Buyers](#).

For Mains: Challenges in Functioning of Asset Reconstruction Companies (ARCs) and Remedial Measures.

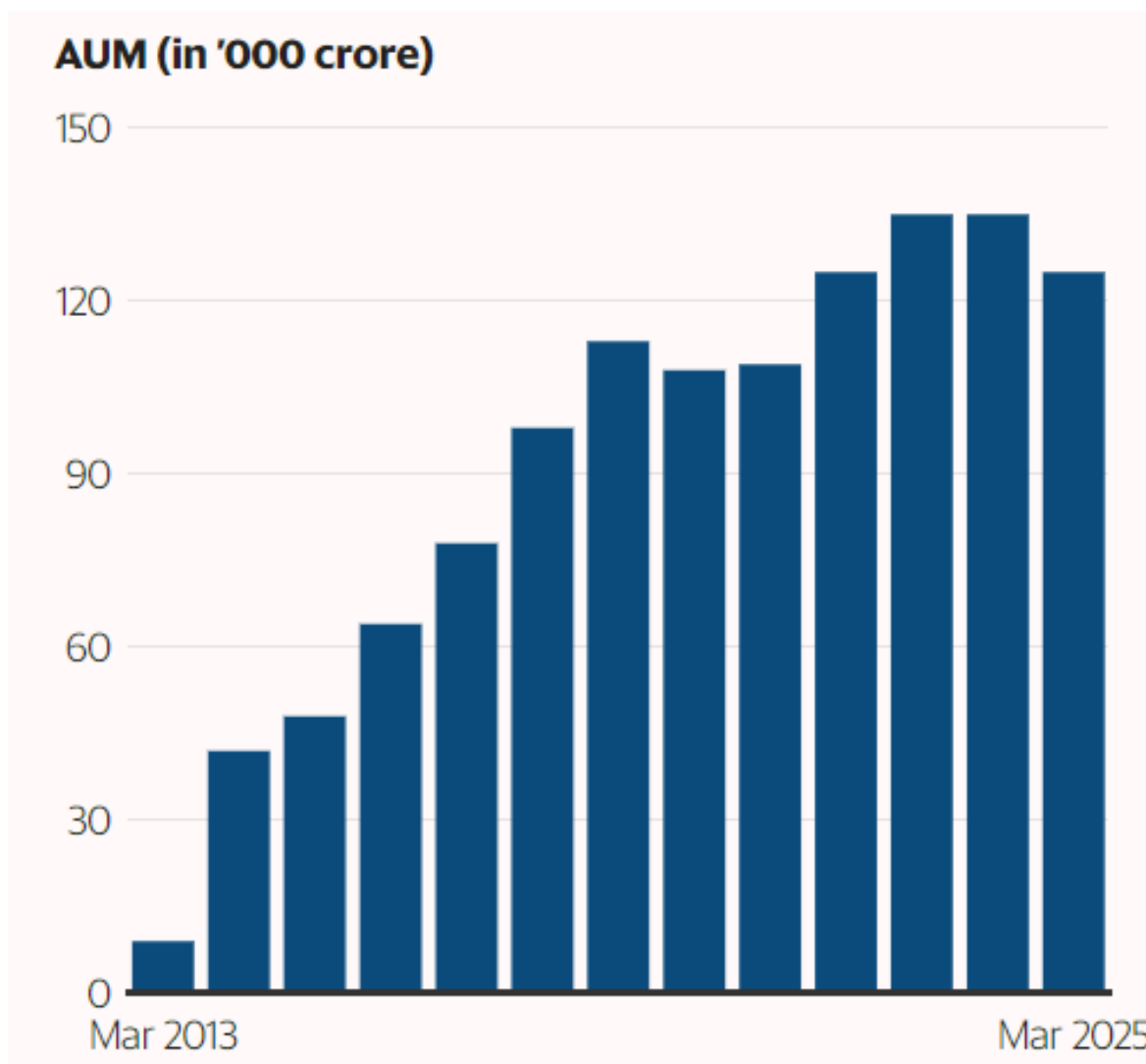
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### Why in News?

Recently, [Asset Reconstruction Companies \(ARCs\)](#) have experienced a slowdown in growth due to [Non Performing Asset \(NPAs\)](#) reaching a **12-year low of 2.8%** in March 2024.

- Ratings agency **Crisil** projects that **assets under management (AUM)** by ARCs will **contract by 7-10%** in 2024-25 after remaining unchanged in 2023-24.

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## What are the Concerns of Asset Reconstruction Companies (ARCs)?

- **Low Business Potential:** The decrease in new non-performing corporate assets has driven ARCs to focus on smaller, less profitable retail loans.
  - Despite this shift, there has not been a notable increase in [retail NPAs](#), which further restricts opportunities for ARCs.
- **Increased Investment Mandate:** In October 2022, the [Reserve Bank of India \(RBI\)](#), directed ARCs to invest at least 15% of bank investments in security receipts or 2.5% of the total security receipts issued, whichever is higher.
- **Net Owned Funds Requirements:** In October 2022, the RBI raised the **minimum net owned funds** requirement for ARCs from Rs 100 crore to **Rs 300 crore** to ensure that ARCs have robust balance sheets.
  - This decision imposed additional constraints on ARCs' capital usage, with many struggling to meet the ₹300 crore requirement, leading to potential mergers or exits.
    - **Net-owned funds are similar to net worth and are defined as the difference between what a company owns and owes.**
- **Competition from NARCL:** The establishment of the state-owned [National Asset Reconstruction Company Ltd \(NARCL\)](#) represents a significant challenge as NARCL offers **security receipts** that are guaranteed by the **government** which are more lucrative to financial institutions.
- **Regulatory Challenges:** The RBI also mandated that ARCs must obtain approval from an **independent advisory committee** for all settlement proposals.
  - This measure has led to **delays** in the approval of settlements, especially in retail loans, as advisory committees are cautious to **avoid future scrutiny**.

- Increased RBI scrutiny has hit major ARCs, with **Edelweiss ARC** banned from new loans for bypassing regulations through related group loans.
- **Trust Deficit:** A **trust deficit** seems to have emerged between the regulator (RBI) and ARCs.
  - The RBI has expressed concerns that some transactions may be helping defaulting **promoters** to regain control of their assets which amounts to circumventing the provisions of **Section 29A of the [Insolvency and Bankruptcy Code \(IBC\)](#)**.
    - Section 29A of IBC bars defaulting promoters from bidding for their insolvent firms.

## Why is RBI upset?

Some ARCs used “innovative ways” to structure transactions to circumvent regulations

Allowed themselves to be a conduit to evergreen distressed assets

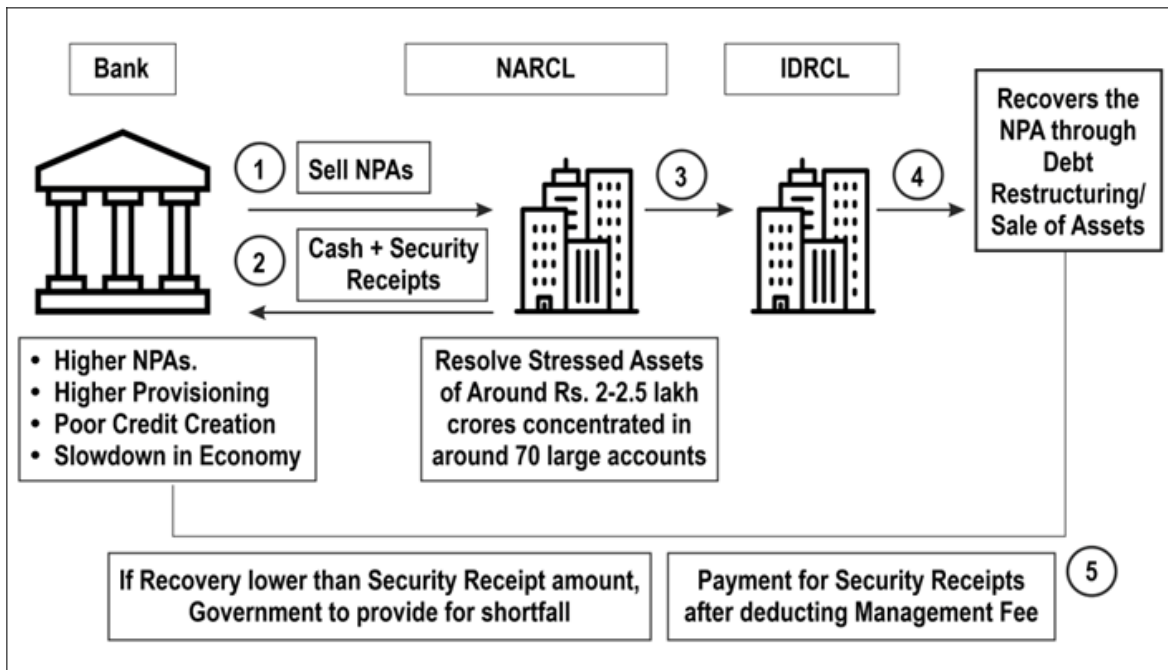
Frequently used one-time settlements with borrowers to resolve stress

ARC route being used by “tainted promoters” to regain control after default

## What are ARCs?

- **About:** An **asset reconstruction company (ARC)** is a special type of financial institution that **buys the debts** of the bank at a mutually agreed value and **attempts to recover the debts or associated securities** by itself.
- **Background of ARCs:** The concept of ARCs was introduced by the [Narsimham Committee - II \(1998\)](#), leading to the establishment of ARCs under the [Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 \(SARFAESI Act, 2002\)](#).
  - Presently, **27 ARCs** are registered with the RBI, including notable ones like **NARCL, Edelweiss ARC, and Arcil**.
- **Registration and Regulation of ARCs:** ARC is registered under the [Companies Act, 2013](#) and must also be registered with the RBI under **section 3 of the SARFAESI Act**.
  - They function as per the **SARFAESI Act** and guidelines issued by the **Reserve Bank of India**.
- **Funding for ARCs:** The required funds to purchase such debts (NPAs) can be raised from [Qualified Buyers \(QBs\)](#). QBs are the sole entities from whom an ARC can raise funds.
  - **QBs include** insurance companies, banks, state financial and industrial development corporations, trustees or ARCs registered under SARFAESI, and asset management companies registered with SEBI.
- **Working of the ARCs:**
  - **Asset Reconstruction:** It involves acquiring a bank's or financial institution's rights in **loans, advances, debentures, bonds, guarantees**, or other credit facilities for recovery purposes, collectively referred to as '**financial assistance**'.

- ARCs buy distressed loans at a discount for cash or a combination of cash and security receipts, which can be redeemed **within eight years**.
- **Securitisation:** It involves acquiring financial assets by issuing security receipts to Qualified Buyers.



## Non-Performing Asset (NPA)

- **About:** A loan is classified as an **NPA** when the loan payments have not been made for a **minimum period of 90 days**.
  - For **agriculture**, a loan is classified as an NPA if the principal or interest is not paid for **two cropping seasons**.
- **Types of NPAs:** Banks classify NPAs into **three categories** based on how long the asset has been non-performing and the likelihood of recovering the dues.
  - **Sub-standard Assets:** A substandard asset is an asset classified as an NPA for a period **less than or equal to 12 months**.
  - **Doubtful Assets:** A doubtful asset is an asset that has been non-performing for a period **exceeding 12 months**.
  - **Loss Assets:** Assets that are uncollectible and where there is little, or **no hope of recovery** and that need to be fully **written off**.

## Recent Changes in ARCs Regulations by RBI

- **Strengthening Governance Structure:** RBI mandated that the chair of the board and at least half the directors in a board meeting must be independent directors to enhance corporate governance at ARCs.
- **Enhancing Transparency:** ARCs must disclose their track record of returns generated for security receipt investors and collaborate with rating agencies for schemes launched over the past eight years to increase transparency.
- **Revised Investment Requirements:** ARCs must invest in security receipts (SRs) at **least 15%** of the transferors' investment or **2.5%** of the total receipts issued, whichever is higher, replacing the previous requirement of 15% of all receipts.

## What Measures Can Be Taken to Address the Challenges Faced by ARCs?

- **Diversification of Asset Portfolios:** ARCs should **diversify** their asset portfolios by exploring

opportunities beyond traditional corporate and retail loans.

- This could include sectors like **infrastructure, MSMEs, and stressed sectors** that still have potential for recovery.

- **Improving Regulatory Transparency and Collaboration:** ARCs should work closely with the **RBI** and other regulatory bodies to ensure transparent operations and compliance with all guidelines.
  - Establishing a **standard code of conduct** could also help improve trust and accountability.
- **Enhancing Efficiency in Settlements:** To counter delays caused by the mandatory approval from independent advisory committees ARCs can employ technology such as **AI-driven analytics** which could help in faster evaluation, thus minimising delays while maintaining compliance.
- **Adopting Strategic Competition with NARCL:** Private ARCs should focus on **differentiating their services** by offering specialised **solutions tailored to niche markets** or by focusing on faster recovery mechanisms.

**Drishti Mains Question:**

Q. Discuss the challenges faced by Asset Reconstruction Companies (ARCs) and suggest measures to enhance their effectiveness.

## UPSC Civil Services Examination, Previous Year Question (PYQ)

### **Prelims**

**Q. Which of the following statements best describes the term 'Scheme for Sustainable Structuring of Stressed Assets (S4A)', recently seen in the news?(2017)**

- (a)** It is a procedure for considering ecological costs of developmental schemes formulated by the Government.
- (b)** It is a scheme of RBI for reworking the financial structure of big corporate entities facing genuine difficulties.
- (c)** It is a disinvestment plan of the Government regarding Central Public Sector Undertakings.
- (d)** It is an important provision in 'The Insolvency and Bankruptcy Code' recently implemented by the Government.

**Ans: (b)**