RBI should not regulate asset reconstruction companies

Banking and stressed asset management are two separate businesses

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The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (also known as the Sarfaesi Act) facilitated the creation and regulation of Asset Reconstruction Companies or ARCs which purchase and manage stressed assets. A bill to amend the Sarfaesi Act is currently being reviewed by a Joint Parliamentary Committee JPC. The amendment proposes to increase the powers of the Reserve Bank of India to regulate ARCs. This is problematic for two reasons. First, recovery of stressed assets by ARCs has failed. The new Insolvency and Bankruptcy Code 2016, or IBC, seeks to correct this. Regulation of ARCs outside the new bankruptcy law is unnecessary. Second, banking and stressed asset management are two separate businesses. The banking regulator has a conflict of interest in regulating the stressed asset management industry and should not be given this responsibility. The JPC in its review should consider these aspects of the proposed amendment.

So far, ARCs in India have failed in their primary purpose. While gross NPAs have risen to 10 per cent of total advances made by banks, the total value of loans sold to ARCs in the last two years is less than two per cent of the banking system. One reason for this is poor recovery due to an ineffective corporate insolvency resolution framework. The IBC is set to correct this situation and improve the recovery rate. Additionally, foreign investors have recently been allowed to invest in ARCs under the 100 per cent automatic route. This sequence of positive developments is likely to get derailed by the amendment.

ARCs do not take deposits. They do not deal with retail consumers. Retail consumers cannot even invest in security receipts issued by ARCs, since they are not listed. There is no consumer protection concern. ARCs are too small to generate systemic risk for the financial system. Micro-prudential risk is also minimal. There is no market failure in the ARC industry that justifies heavy state intervention. From 2002 onward this industry has been repressed due to over-regulation. The proposed amendment makes it worse.

The amendment gives unfettered powers to the RBI to remove the chairperson or any director from the board of ARCs on vague grounds like 'public interest', and to issue directions on the fees charged by ARCs and other expenses incurred by them. While the government liberalised foreign direct investment or FDI norms to invite foreign investors to invest in ARCs, the amendment gives arbitrary discretion to the RBI to remove ARC board members without basic natural justice.

India has undergone a significant reform in the insolvency resolution space in the form of the IBC. Existing laws need to be in sync with the principle enshrined in the IBC to create a coherent framework for debt recovery and resolution. The IBC accords rights to every key stakeholder in the process without creating a bias among participants. The amendment goes against this principle by giving a special status to ARCs.

The usage of the term ARC in India is misleading. Emerging economies like Indonesia, Malaysia and Korea set up government-funded vehicles as a one-off solution to a banking crisis situation, such as after the East Asian crisis of 1997. They are not regulated by the respective banking regulators of these countries. On the other hand, the United States and UK have hedge funds (distressed debt funds) that use private money to buy bad loans from banks. These funds are not regulated by the banking regulators either. In India, the Sarfaesi Act has created a unique situation where the so-called ARCs are non-government vehicles funded by corporate money; they are regulated by the banking regulator and are not a one-off creation.

This regulatory architecture is fundamentally flawed. When an ARC buys a loan from a bank, it acquires the right to an assured cash-flow from the borrower. If the borrower defaults, the ARC can recover the due amount from the borrower. The business of stressed asset recovery is disconnected from the business of banking. There is no reason why the banking regulator should regulate the ARC industry in India, when globally it does not.

Asset reconstruction companies neither take deposits nor deal with retail consumers, and already are heavily regulated

The banking regulator has conflicting interests in regulating ARCs. If the regulator fails in micro-prudential regulation of banks, non-performing assets or NPAs will build up. If these NPAs are sold to independent ARCs at marked to market, the actual magnitude of prudential mismanagement of banks will be evident — a clear sign of the banking regulator's failure. Instead, if the banking regulator could "direct" the ARCs to absorb the NPAs at a higher price than what they are actually worth, the scale of the failure may not be fully evident. Thus, the banking regulator has perverse incentives in regulating ARCs.

Further, the amendment is unconstitutional in spirit. It proposes that penalty orders against ARCs by the RBI can be appealed before an Appellate Authority comprising only RBI officers. Effectively, the RBI will be the judge of its own cause! This violates the principle of independence of the judiciary, which is equally applicable in the regulatory context. Regulators are "mini states" and their quasi-judicial functions (including the appellate function) must be insulated from their executive role.

In the financial sector, an independent tribunal — the Securities Appellate Tribunal or SAT — hears appeals against orders by Sebi, Irdai and PFRDA. The Justice B N Srikrishna-led Financial Sector Legislative Reforms Commission had recommended that the RBI's orders should also be appealed to SAT. In this backdrop, creation of a parallel mechanism within the RBI to hear appeals against its own orders is a retrograde step and is potentially unconstitutional.

The amendment will stifle the development of the struggling ARC industry and hamper the reform process initiated by the IBC and the liberalised FDI norms. The JPC must rectify this, given the unfolding NPA crisis. ARCs should be regulated by Sebi-like private equity funds investing in stressed assets and not by the RBI. This industry needs room to grow, which only light-touch regulation can provide.

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