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A short take on RBI's Master Directions on Transfers of Loan Exposures, 2021, with a focus on Stressed Assets

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Introduction

The RBI had issued a draft regulatory framework for securitisation and sale of loans on June 8, 2020, to widen the market and refine extant regulations. Effective immediately, on September 24, 2021, RBI has published new guidelines, viz.

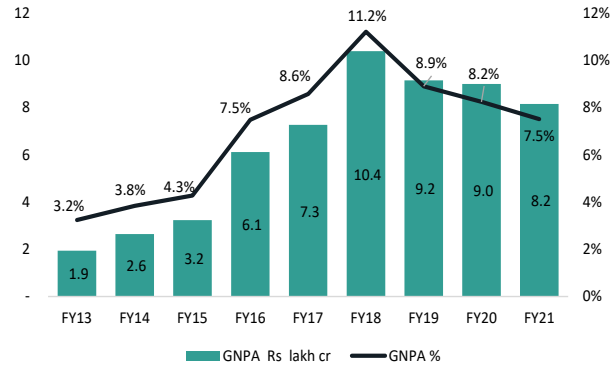
- Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021
- Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.

The current note focuses on sale of stressed assets, as an initial commentary for sale of standard assets, and securitisation has been covered in New Master Directions on Securitization and Transfer of Loan Assets.

Overview

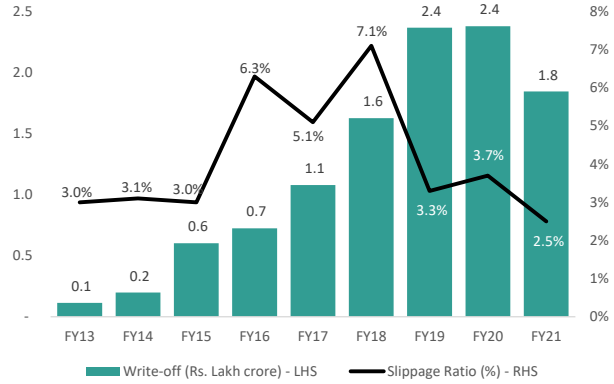
The banking system has been under severe stress due to several factors, however, even as they remain at elevated levels, the non-performing assets (NPAs) have been witnessing a general downward trend. During FY21, while there was a decline in wholesale NPAs with resolution of legacy accounts under Indian Banks' Association (IBA) and lower slippages in the corporate segment, there was a relative increase in retail NPAs and services. Within retail, there was rise in NPAs across segments during FY21 impacted due to Covid. Unsecured segments such as personal loans and credit cards witnessed higher NPAs.

Figure 1: Movement in GNPAs



Source: RBI, CMIE

Figure 2: Movement in Write-offs and Slippage Ratio



Source: RBI, CMIE, CARE Ratings

Additionally, asset quality challenges to the banking system caused by pandemic continues (though reducing), especially in the retail and the Micro, Small & Medium Enterprises (MSME) segments. In the absence of moratorium, etc., the second covid wave has increased the stress on comparatively weaker borrowers that had availed of restructuring/ECLGS and may see higher slippages than what was earlier expected, while recovery continues to be contingent on the broader economic growth and on any upcoming covid waves. Hence, recovery of these dues, whether by the banks or third parties, is of paramount importance. Furthermore, as per media disclosures, the cumulative bank loans categorised as fraud stood at approximately Rs.4.9 lakh crore as of March 31, 2021, which was approximately 4.5% of the total outstanding bank credit book.

In general, these guidelines cover sale of stressed assets undertaken as a resolution plan under RBI Directions, and standalone sale of stressed assets.

General Guidelines

- Lenders need detailed Board-approved policies on sale of stressed assets. The policy to cover identification of stressed (NPA + SMA) assets beyond a specified value, and NPA assets above a threshold amount to be reviewed on periodic basis for exit.
- Sellers can exit stressed assets to Scheduled Commercial Banks, Small Finance Banks (SFBs), All India Financial Institutions (AIFIs), Non-Banking Financial Companies (NBFCs) or Asset Reconstruction Companies (ARCs). In certain cases, under Resolution plan framework of RBI, certain corporate entities are entities permitted to take on the loan exposures.
- To attract buyers, lenders may use e-auction platforms, wherever available, for selling loans.

- The transfer of stressed assets may be done through assignment or novation and not through participation.
- No transfer of a stressed asset is permitted at a contingent price where in case of shortfall, compensation is realised from the seller
- Lenders are permitted to sell/buy homogeneous pool within stressed retail assets, on a portfolio basis

Additional requirements for transfer of NPAs

- The transferor shall continue to pursue the staff accountability aspects as per the existing instructions in respect of the NPAs transferred to other lenders.
- In respect of NPAs acquired from other lenders, the cash flows received by the transferee from holding such asset should first be used to amortise the funded outstanding in the books of the transferee in respect of the loan till the acquisition cost is recovered. The cash flows in excess of the acquisition cost, if any, can be recognised as profit.
- The lenders shall assign 100% risk weight to the NPAs acquired from other lenders if the loans are classified as 'standard' upon acquisition. If the loans are classified as NPA, risk weights as applicable to NPA shall be applicable.
- The lenders should not grant any credit facilities apart from working capital facilities (excluding term loans) to the borrower whose loan account has been transferred, for at least three years from the date of such transfer.

Guidelines for Sale to Non-ARCs

- Cash only sale which has to be fully received upfront before transfer of assets.
- Buyers must hold the assets for at least six months prior to selling the loan.
- Buyers must assign 100% risk weight to NPAs during purchase.
- Purchase of NPA to include market risks.
- If the buyer has no existing exposure to the borrower whose stressed loan account is acquired, the purchased stressed asset shall be classified as "Standard". Thereafter, normal classification standards will be followed, depending on the record of recovery.

Draft Guidelines	Final Guidelines	Comment
If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall shall be debited to the P&L account, however, if the sale is for a value higher than the NBV, *the excess provision would be utilized to meet the shortfall/loss on account of sale of other stressed assets.*	If the sale is at a price below the NBV, the shortfall shall be debited to the P&L account, however, if the sale is for a value higher than the NBV, *the excess provisions may be reversed.*	The sale could enable the transferor to recognize profits to the extent of the higher provisions instead of adjusting against other loans.

- The stressed assets can be sold to any class of entities only as a resolution plan under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019, which would result in an exit of all lenders. Furthermore, apart from scheduled commercial banks and NBFCs, such entities should be incorporated in India or registered with SEBI/ IRDAI/ PFRDA/ IFSCA. Furthermore, such an acquirer cannot itself be classified as an NPA or seek funding from the banks/ HFCs for acquiring such assets.

Guidelines for Sale to ARCs

- Loans classified as fraud can be sold to ARCs
- Sale consideration can include cash, bonds, debentures, security receipts, pass-through certificates.
- Securities (bonds and debentures) can be issued for a maximum period of six years, carrying an interest rate which is not lower than 1.5% above the Bank Rate in force at the time of issue.
- Securities to be secured by an appropriate charge on the assets transferred.
- ARCs will be required to fully redeem the securities, if they sell the underlying asset before the securities expire.
- In cases of specific stressed assets, where it is considered necessary, lenders shall be free to enter into an agreement with the ARC to share any surplus realized.
- SRs or PTCs which are not redeemed at the end of the resolution period shall be treated as a loss asset in books of the lenders and fully provided for.
- When the financial asset is sold to ARC at a price below the NBV (i.e., book value less provisions held), the shortfall shall be debited to the P&L account of that year. Banks are permitted to use floating provisions for meeting any shortfall on sale of NPAs when the sale is at a price below the NBV. On the other hand, when the financial asset is sold to an ARC for a value higher than the NBV, lenders shall reverse the excess provision on sale of NPAs, to its P&L account in the year the amounts are received.

There is no prohibition on lenders from taking over standard accounts from ARCs. Accordingly, in cases where ARCs have successfully implemented a resolution plan for the stressed loans acquired by them, lenders may, take over such loans after the period equivalent to the 'monitoring period' subject to satisfactory performance of the account.

However, a lender cannot at any point of time acquire from ARCs the loan exposures they have themselves earlier transferred.

Price Discovery

- Sale process would be on a bilateral basis, except in case of insolvency proceedings. However, if the aggregate exposure is more than Rs.100 crore, such a negotiation would necessarily have to be followed by an auction through Swiss Challenge method. However, the Swiss challenge method would be mandatory if the stressed assets are being transferred under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019, with the approval of signatories to the inter-creditor agreement (ICA), representing 75% by value of total outstanding credit facilities and 60% of signatories by number, for the exit of all signatories to the ICA from the stressed loan exposure.

The lenders need to make appropriate disclosures in their financial statements, under 'Notes on Accounts', relating to the total amount of standard assets / stressed assets sold and purchased to / from other entities with breakups as to the category, along with the disclosure of recovery ratings.

Transferors shall report each loan transfer transaction undertaken under these directions to a trade reporting platform as notified by the Reserve Bank subsequently.

Concluding remarks

While these directions summarise previous directions, they also break new ground in case of allowing the sale of loans classified as fraud and allowing non-ARCs to acquire the stressed loans. These directions are being implemented, and although assessing the impact can be quite difficult, there are certain aspects which can be inferred as below.

Opening of sales of loans classified as fraud: Advances classified as fraud are equivalent to nearly half of the gross non-performing assets (GNPAs). Earlier such loans could not be sold by banks, and they had to work on recovery themselves. However, now such loans can also be sold by banks, enabling third-party recovery specialists to acquire these loans. While banks undertake recovery efforts from such accounts, enabling their sale could transfer such responsibility to specialist organizations, banks could focus on their core business and upfront recover a portion of their dues.

Faster Identification and Resolution of Stressed Exposures: These directions mandate lenders to have a policy for ongoing identification and resolution of stressed assets across thresholds, hence, a robust and efficient pricing could develop for stressed assets as additional investors have been allowed to acquire the same.

Additionally, these Directions permit acquirers to classify the loans as standard, subject to certain conditions, which could lower the capital and provisioning requirements for such loans in the books of the acquirers increasing the attractiveness of these assets. Furthermore, post-acquisition, acquirers also have the ability to restructure these loans under the RBI's Prudential Framework for Resolution of Stressed Assets Directions, 2019. This move is likely to encourage players and work towards opening the secondary market for stressed assets.

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