IBC: Developing a Market for Distressed Assets

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price"

- Warren Buffet

The smart investor perceives a range of opportunities through participation in the distressed asset markets as it provides plethora of options to enhance the value of his investments in leaps and bounds promptly. However, at macro level 'Pareto optimal' solutions elude the market as demand and supply side bottlenecks act as impediments in development of the balanced market for the stressed assets.

A 'market' is a coordinating mechanism that allows determination of price and conveys information among economic entities. A market for distressed assets does precisely so. In the absence of such markets, the risk associated with credit extension tends to crowd out funds critical for economic growth. State intervention for alleviation of this risk, by facilitating coordination among economic agents for trading of distressed assets, plays a crucial role in maintaining the financial health of an economy.

India is one of the fastest-growing, economy and the fifth largest in the world. The average growth rate over the last three decades has been about 7 percent. After the adverse pandemic impact, there is growing evidence of V shaped economic recovery. International Monetary Fund has projected the Indian economy to grow at 9.5 percent in 2021 and 8.5 percent in 2022 in its latest World Economic Outlook of October, 2021. The country has witnessed improved investment climate with enhanced competitiveness and innovation over the years. It is but natural to see a continuous flow of distressed assets into the market given the large size of the economy and its growth. This warrants effective mechanisms for their resolution. With cherished goal of achieving milestone of $ 5 trillion economy in sight, systematic efforts are required to be in place for release of the large number of investments locked up in the stressed assets for productive usage.

Problem of distressed assets in India

In India, the Economic Surveys shed light on the issue of the twin balance sheet problem of rising indebtedness of Indian firms and rising non-performing loans in the banking system during 2015-16. It drew attention to the state of public sector banks and some corporate houses. The primary reasons as observed by Reserve Bank of India (RBI) for spurt in stressed assets have been observed to be, inter alia, aggressive lending practices, willful default / loan frauds / corruption in some cases, and economic slowdown.

Pertinently, recent supervisory data suggests that numerous efforts made by the RBI in firming up its regulatory and supervisory agenda and the resolution mechanism founded through the Insolvency and Bankruptcy Code, 2016 (Code/IBC) are leading to fruition in resolution of non-performing assets (NPAs). As per the various issues of RBI Financial Stability Reports, there has been a substantial decline in gross non-performing asset (GNPA) ratio of scheduled commercial banks (SCBs) from as high as 11.5 percent in FY 2018 to 7.5 percent in FY 2021. There also has been an improvement in provision coverage ratio of SCBs from 66.2 percent in March, 2020 to 68.9 percent in March, 2021, according to RBI data. As of March, 2021 the total NPAs in the economy stand at ` 8.34 lakh crore.

Developing a market for distressed assets is important for an emerging economy like India where the corporate bond market is under penetrated and market participants are heavily reliant on loans from banks. With banks reeling under mounting NPAs, the need of the hour is to have a well-developed distressed assets market to offload these NPAs effectively.

India's journey

India, post-independence, witnessed increased levels of credit growth and government investments which fueled the development plans. In confluence with global economic boom in the early to mid-2000s, the Indian economy experienced a rapid expansion, especially its manufacturing sector and non-financial corporates. Monetary and fiscal policies were conducive to this expansion and credit expanded to support this boom. This increased the overall indebtedness and increased the ratio of NPAs as loan repayments dwindled.

Attempts at monitoring and regulating distressed assets were made since 1980. Committees like Tiwari Committee (1981) and Narasimham Committee (1991) were formed to address the challenge of rising distressed assets. Based on the recommendations of Narsimham Committee, Debt Recovery Tribunals (DRTs) were established. These developments first formalised a market for distressed assets in India. Measures to reduce NPAs included rescheduling and restructuring of loans, corporate debt restructuring and facilitating recovery through the Asset Reconstruction Companies (ARCs) established under Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, Lok Adalatas, DRTs, and Civil Courts.

Need for market for distressed assets

To deal with the problem of NPAs effectively, one of the many strategies is to develop a market for distressed assets. A secondary market for NPAs would reduce the debt collection burden on banks and free up resources and capital to support new lending. It would also enhance bank's risk management strategy by providing another instrument to manage credit and market risks.

A market for distressed assets would also support corporate restructuring and expand sources of financing. It would improve secondary market liquidity for loans and attract a wider range of institutional investors to assist in corporate restructuring. In the near term, a market for distressed assets could support a faster recovery by facilitating the exit of non-viable firms and supporting the growth of viable ones. Over time, it would enable reallocation of resources towards more productive corporates and assist their reorganisation and expansion.

Distressed assets investment firms have appeared on the horizon, as part of a global asset management industry. They are adept at generating capital from sophisticated investors in specialist investment purpose vehicles. These firms have played an integral role in some of the major corporate resuscitations over the last three decades - Sunbeam-Oster, Samsonite, National Gypsum in the junk bonds predicament during 1990–91; big financial organisations in East Asia in the Asian crisis of 1997-98; and more recently General Motors, Chrysler, and Nine Entertainment (Australia).

IBC and market for distressed assets

The enactment of the IBC has created an efficient market for resolution of distressed assets. The law has given the distressed asset investment landscape in India a legal structure, well-defined processes, responsibilities, and timelines. Distressed asset investment in India can be seen to have come of age, offering astute investors to seize the opportunities to pick 'value' assets. Such investors had largely been shying away from this space given the lack of robust and efficient regulatory framework. With the implementation of the Code and the ensuing progress in the resolution process for NPAs, there is a genuine interest amongst investors in the distressed assets investment markets with their inherent 'buy low-sell high' potential. Businesses are looking for opportunities for buying good underlying assets with potential for a turnaround, at reasonable valuations.

The Code has paved the way for investors looking for business expansion through a process which is time bound, information intensive and ends with a plan that is binding on all stakeholders. It has expanded the scope of resolutions wherein extant businesses can be acquired through mergers, amalgamations, and demergers; free of the past misdeeds of the erstwhile promoters. Capital-intensive companies from infrastructure and power sectors that have come into corporate insolvency resolution process (CIRP) can now be bought by investors at competitive prices. Electronic platform for distressed assets, which have recently been launched by NeSL and Mjunction, with four elements: (a) market for interim finance, (b) virtual data room, (c) invitation and evaluation of resolution plans, and (d) auctions during liquidation have furthered the development of market for distressed assets.

Most recent development of provision of a simplified mechanism for resolution of stressed micro, small and medium enterprises (MSMEs) corporates in the form of pre-packaged insolvency resolution framework have set the wheels of revival and recovery in motion.

The rise in stressed assets has also prompted the establishment of a National Asset Reconstruction Company Limited (NARCL) towards building and strengthening a secondary market for NPAs. The NARCL will provide the aggregation and consolidation of stressed assets of banks worth ` 2 lakh crore in phases. Further, India Debt Resolution Company Ltd. is expected to resolve it as a going concern or liquidate it. This credible alternative is specifically targeted towards developing expertise to deal with the stressed assets and cut the procedural delays. In long run, such an initiative is expected to facilitate quick resolution of distressed assets with a view to stem the erosion of value of such assets during the process.

The RBI set up a committee under the chairmanship of Shri Sudarshan Sen to undertake a comprehensive review of the ARCs in the financial sector ecosystem and recommend suitable measures for enabling such entities to meet the growing requirements of the financial sector. The committee has suggested creation of online platforms for sale of ARCs. The committee observed that participation of ARCs in resolution process can increase the pool of potential resolution applicants (RAs) under the IBC to resolve stress. It is expected that the new set of frameworks will accelerate the turnaround of NPAs thereby improving financial health and overall growth prospects of the economy.

Going forward, the existing mechanisms and the recently suggested initiatives are expected to facilitate quick resolution of distressed assets with a view to stem the erosion of value of such assets during the process.

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