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# SCRUTINIZING RBI'S ARC MANDATE: IT'S OBJECTIVES, UTILITY AND LIMITATIONS

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## ABSTRACT:

*The concept of an Asset Reconstruction Company (“ARC”) was specifically introduced to tackle the issue of rising Non Performing Assets (“NPA’s”) within the Indian financial landscape. ARC’s have now become an invaluable part of the Indian financial landscape and play a prominent role in dealing with the stressed assets of the financial institutions. RBI has recently issued a consolidated master direction in an attempt to streamline and improve the regulation of ARC’s within India. The objective of this research assignment is to critically analyse the policy implications of this master direction on the viability of ARC’s and their ability to realise stressed assets. The authors have covered two prominent policy implications of the impugned master direction within this research assignment; **first** is the implication of allowing an ARC to apply as a Resolution Applicant (“RA”) under the Insolvency and Bankruptcy Code, 2016 (“IBC”) and; **second** is the impact on the internal governance regime of the ARC’s.*

## I. INTRODUCTION

The concept of an Asset Reconstruction Company (“ARC”) was proposed in the backdrop of the problems faced by the Indian banking system in the recovery of loan/credit facilities. Credit facilities or advances are granted by the financial institutions to the borrowers with expectation of some future returns (in form of interest etc.). Therefore these are assets for the financial institutions. NPA’s occur when such facilities no longer have the potential to generate any return for the financial institution. Inefficient loan recovery mechanisms, weak credit appraisal processes,

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ever-greening of loan accounts and wilful defaults by the borrowers exacerbated the issue of NPA's within India.

Specialised institutions were proposed for addressing the issue of rising NPA's. Ultimately, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 was promulgated which provided for the formation of Asset Reconstruction Companies. Banking and financial institutions can assign loan accounts to the ARC. The ARC'S purchase these bad assets from banks at a negotiable price allowing them to clean up their balance sheets. ARC's are empowered under SARFAESI to not only acquire the debts but to also restructure them for resolution and recovery. Additionally, ARC's are also empowered to raise funds through the issuance of security receipts to prospective investors.

The Reserve Bank of India ("RBI") decided to constitute a committee to review the overall working of ARC's, identify gaps and provide solutions to the same. The committee submitted its report to RBI and provided a slew of recommendation aimed at improving its efficiency.<sup>2</sup> Consequently, the RBI has now introduced a consolidated master direction for the regulation of ARC's in April 2024.<sup>3</sup> The authors have provided for a critical examination of this master direction in this research assignment.

## II. ARC'S IBC ODYSSEY: RESHAPING INDIAN SECURITIZATION FRAMEWORK:

The Master Direction allows ARC's to apply as resolution applicants under IBC. This is notable given the fact that ARC's role was previously limited by RBI to securitisation and reconstruction of stressed assets.<sup>4</sup> The master direction explicitly states that the ARC's need to fulfil certain conditions in order to be eligible for applying as a resolution applicant under IBC. The master direction only allows for ARC's having a net owned fund of at least 1000 crores to apply as resolution applicants under IBC. The ARC is required to have a board approved policy outlining the sector and the scope of the functions to be performed as a resolution applicant. Furthermore,

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<sup>2</sup> Sudarshan Sen, "Report of the Committee to Review the Working of the Asset Reconstruction Companies", Reserve Bank of India, September 14, 2021, Accessed at : <https://rbidocs.rbi.org.in/rdocs//PublicationReport/Pdfs/ARCS2021E90D0F2EBB0945BC8FC4293B67102F30.PDF>

<sup>3</sup> Reserve Bank of India, "Master Direction- Reserve Bank of India (Asset Reconstruction Companies) Directions, 2024", April 24, 2024, Accessed at: <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/115MD2404242C46DA28A8444FAE9BD210D08DC3D1C1.PDF>

<sup>4</sup> UV Asset Reconstruction Company v. Union of India & Ors, AIR ONLINE 2021 DEL 32

proposals regarding the submission of resolution plans have to be decided upon by a committee which must have Independent directors as its members in majority. Additionally, the ARC's are restrained from maintaining any form of influence within the corporate debtor after five years have elapsed from the date of the approval of the resolution plan.<sup>5</sup>

This approval under the master direction has been granted by RBI under section 10 (2) of SARFAESI. Section 10 (2) necessitates specific approvals from RBI for ARC's to undertake new ventures beyond the prescribed activities outlined under section 10 (1).<sup>6</sup> The circular renders section 10(2) inoperative as far as application of ARC's to insolvency courts is concerned. This change raises two serious issues; *first* regarding the competency of the RBI to issue circulars that may have overriding effects on other legislative frameworks; *second* is with regards the impact of this decision on the role of ARC's as primary tools for securitisation and reconstruction of stressed assets.

It is also pertinent to note that the extent of the powers inherent within RBI to issue directions via circulars has been conclusively decided by the apex court in the case of *Dharani Sugars*. The issue also pertained to directions issued by RBI mandating procedure for settlement of debts using insolvency proceedings. Restrictions were imposed on the creditors regarding the options available to them for settlement of debts. The direction issued by the RBI in its circular was in direct conflict with the scheme of the IBC Code. The court struck down the RBI circular and held that the powers to issue directions by the RBI under the Banking Regulation Act, 1949 and the RBI Act, 1934 are limited to the areas carved out under those legislations themselves. RBI lacks the competence to encroach upon the domain of other legislations.<sup>7</sup> Therefore imposing conditionality's on the manner in which an ARC would be liable to act as a resolution applicant encroaches upon the domain of the IBC.

The legislative scheme of SARFAESI tends to suggest that the role of ARC's must necessarily be limited to asset reconstruction and securitisation.<sup>8</sup> However, it is important to note that one of the

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<sup>5</sup> *Supra Note 2*

<sup>6</sup> Section 10 (2), The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, December 17, 2002

<sup>7</sup> *Dharani Sugars & Chemicals Ltd. v. Union of India*, 2019 (5) SCC 480

<sup>8</sup> Section 2 (b), The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, December 17, 2002

primary objectives of IBC is to ensure that the corporate debtor remains a going concern.<sup>9</sup> The courts have clarified time and again that IBC is not a debt recovery forum but a platform that allows for a revival of the corporate debtor under the strain of debts.<sup>10</sup> The role of the resolution applicant as envisaged under IBC is to therefore facilitate the CIRP process with the objective of ensuring that the corporate debtor remains a going concern. However, the focus of the master directions seems to be to ensure that the ARC primarily works towards recovery of the debt amount while acting as a resolution applicant.

Therefore concerns emerge regarding the impact of an ARC acting as a resolution applicant on the revivability of the business of the corporate debtor. The conditionality's imposed on the ARC's under this master direction militate against the role of a resolution applicant as envisaged under IBC. Conversely, allowing for ARC's to apply as RA changes the focus area of an ARC from debt recovery to insolvency resolution which may negatively impact their efficacy as specialised institutions to tackle bad debts. The authors are of the opinion that the RBI circular allowing ARC's to participate in insolvency proceedings as resolution applicants is liable to be challenged before the courts of law.

### III. ELEVATING STANDARDS: ARC'S EMBRACE NEW CORPORATE GOVERNANCE NORMS:

RBI's master circular also brings profound changes regarding corporate governance norms governing ARC's. The regulatory features improving corporate governance standards in ARC's can be summarised as follows:

Sr. No.	Corporate Governance Parameters	Incorporations made within the circular
1.	<b>Independence of the Board</b>	a) Meetings have to be mandatorily chaired by an Independent director;

<sup>9</sup> Swiss Ribbons v. Union of India, AIR 2019 (4) SCC 17

<sup>10</sup> Tottempudi Salalith v. State Bank of India & Ors, 2023 LiveLaw SC 914

		<p><b>b)</b> Minimum 2 independent directors are required to form a quorum for a board meeting;</p> <p><b>c)</b> Nomination and remuneration committee and auditing committee headed by non-executive directors to provide further check on arbitrary misuse of powers by the Board.</p>
2.	<p><b>Efficiency and stability of the Board</b></p>	<p><b>a)</b> Tenures of CEO’S/MD’S have been fixed to a 5 year term with an eligibility to be re-appointed twice;</p> <p><b>b)</b> a three year cooling period has been provided for after each term; proper board approved succession policy needs to be provided by the ARC;</p> <p><b>c)</b> age of board members has been restricted to a maximum of 70 years;</p> <p><b>d)</b> periodical review of the board has been mandated;</p> <p><b>e)</b> members of the board have to fulfil the fit and proper criteria prescribed by the RBI</p>
3.	<p><b>Transparency in Settlements</b></p>	<p>Independent advisory committee to decide on the settlement of dues under one-time settlement scheme which is to be headed by at least 2 independent directors.<sup>11</sup></p>

Even though the corporate governance norms have been introduced to provide a smooth functioning of ARC’s and improve their ability to reconstruct and securitize distressed assets; concerns arise regarding the burden being imposed on the ARC’s to comply with strict

<sup>11</sup> *Supra Note 2*

requirements when they are struggling to find enough capital. Additionally, the master directions have placed a lot of importance on the role of the Independent directors for improvement of corporate governance within an ARC. However, the master directions have failed to provide for the remedies/courses of action available to the independent directors in case of non-compliance with these directions by an ARC. Furthermore, these directions fail prescribe a time frame within which all the ARC's have to necessarily comply with these directions and appoint independent directors. Therefore, there are visible gaps in the current directions and the efficacies of these norms remain to be seen yet.

#### **IV. CONCLUSION:**

It is undeniable that the newly introduced master directions aim to improve the efficiency of the ARC's. Introduction of corporate governance norms were necessary given the need to attract more foreign investments into ARC's. However, these corporate governance norms can potentially act as a dual edged sword since it promises strengthened governance structures at the cost of burdening even smaller boutique ARC's with compliance obligations. Even though the governance provisions are necessary to fortify oversight and accountability within the ARC industry, careful calibration is still required to mitigate unintended consequences.

Among all the other stipulations, the requirement of minimum net owned funds requires further discussion. It is understandable that the objective behind prescribing a minimum NOF is to ensure that the ARC is equipped with enough funds and resources to successfully deal with the stressed assets that it has acquired for the purposes of realisation. However, these requirements will definitely impede the operational flexibility of smaller entities. It is pertinent to note that ARC's not only deal with corporate loan accounts but also with retail loan accounts.

However, the current master-directions have failed to take this important consideration into account by imposing blanket NOF thresholds for the ARC's to comply with. Furthermore, no rationale has been provided as to why a much higher threshold of Rs. 1000 crore has been fixed for ARC's to apply as resolution applicants under IBC. These NOF obligations may result in the marginalisation of smaller ARC's and impact their ability to deal with mid-corporate and retail level insolvency and Bankruptcy cases under the code.

Equitable and effective resolution of distressed assets requires a delicate balance between regulatory imperatives and operational viability. Therefore, the authors are of the opinion that the master directions can provide for different categories of ARC's and complementary compliance requirements in accordance with the extent of stressed assets that they would handle. Furthermore, the threshold for applying as a resolution applicant by ARC needs to be revisited.

