

# Nangia Andersen LLP



## Stressed Assets in India - Opportunity for Investors

February 2022



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## Abbreviations

AA	Adjudicating Authority
AIFs	Alternative Investment Funds
AMCs	Asset Management Companies
ARCs	Asset Reconstruction Companies
CDs	Corporate Debtors
CIRP	Corporate Insolvency Resolution Process
CoC	Committee of Creditors
ECB	External Commercial Borrowings
FBs	Foreign Banks
FDI	Foreign Direct Investment
FIs	Financial Institutions
FMV	Fair Market Value
FPI	Foreign Portfolio Investment
GNPA	Gross Non-performing Assets
GoI	Government of India
HFCs	Housing Finance Companies
HNIs	High net-worth Individuals
IBBI	Insolvency and Bankruptcy Board of India
IBC	Insolvency and Bankruptcy Code
IPs	Insolvency Professionals
IRP/RP	Resolution Professional
IT Act	Income-tax Act, 1961
MAT	Minimum Alternate Tax
MFs	Mutual Funds
NBFCs	Non-Banking Financial Companies
NCLT	National Company Law Tribunal
NPA	Non-performing Assets
Prudential Framework	Prudential Framework for Resolution of Stressed Assets
PSBs	Public Sector Banks
PVBs	Private Banks
RBI	Reserve Bank of India
SARFAESI Act	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
SCBs	Scheduled Commercial Banks
SEBI	Securities and Exchange Board of India
SMAs	Special Mention Accounts
SRs	Security Receipts
SSFs	Special Situation Funds



## Foreword



## Foreword

India's regulatory framework to deal with Stressed Assets has matured over more than three decades, beginning with the Sick Industrial Companies (Special Provisions) Act, 1985. Since then, the three major objectives of each new regulatory scheme have remained the same - early detection of corporate sickness, speedy resolution/revival, or if that is not possible, speedy liquidation.

The most revolutionary regulatory development came in the form of the IBC in 2016, which made several big changes in several statutes and sweeping changes in the way corporate insolvencies were resolved or liquidated. The biggest change wrought is that the Board of the defaulting company is superseded by a 'Resolution Professional' with the company's creditors calling the shots, thus eliminating a huge conflict of interest. In 2019, the RBI announced the Prudential Framework for Resolution of Stressed Assets that applied to Banks and NBFCs, with the key focus being early detection of potential loan defaults and their resolution.

These reforms, along with the growth of specialized financial intermediaries like ARCs and AIFs, have made it increasingly feasible for sophisticated investors to bring in resources for reconstruction, and take the trouble of recovering dues from NPAs off the banks' hands. This has given rise to a new investment class - Stressed Assets. Stressed Assets as an investment class are set to take off and are a rich source of 'value buy' investment opportunities for foreign FIs looking to invest in India.

In this publication, Nangia Andersen LLP takes a bird's eye-view of the Stressed Assets market and zooms in on the profit potential for foreign investors in stressed assets. We take a balanced view of the opportunities open to foreign FIs for potentially high-profit investments in India, and also list the further reforms desirable in the coming months and years to attract big-ticket investments in Stressed Assets.

Our team at Nangia Andersen LLP would endeavour to advise and handhold different stake holders at various stages of the entire process and provide holistic solutions keeping in mind the Indian regulatory environment and commercial aspects of the transaction.



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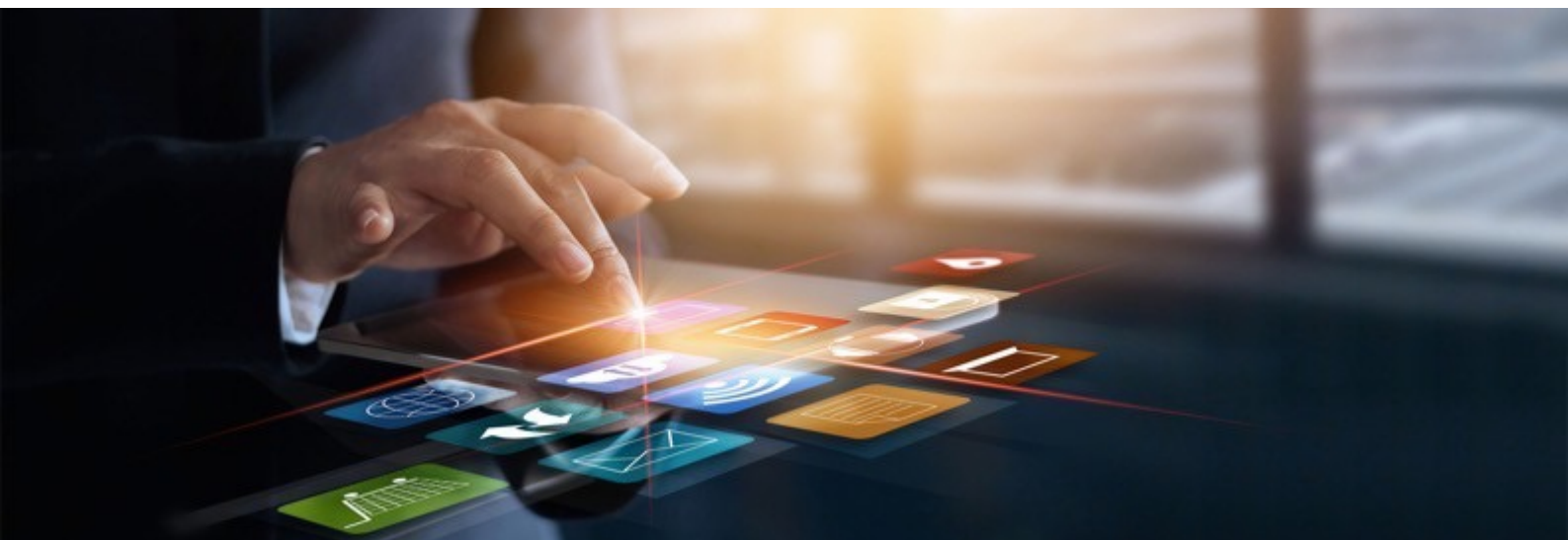
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## Background

# Background



## Introduction to Stressed Assets

Deterioration of asset quality has emerged as a big economic risk for the Indian banking sector in the post-COVID-19 times, leading to increased attention to ‘stressed assets’.

Stressed assets present opportunities for investors to purchase operational and good quality underlying assets at attractive valuations with turnaround potential. They can enable strategic investors to expand capacity in a cost- effective manner.

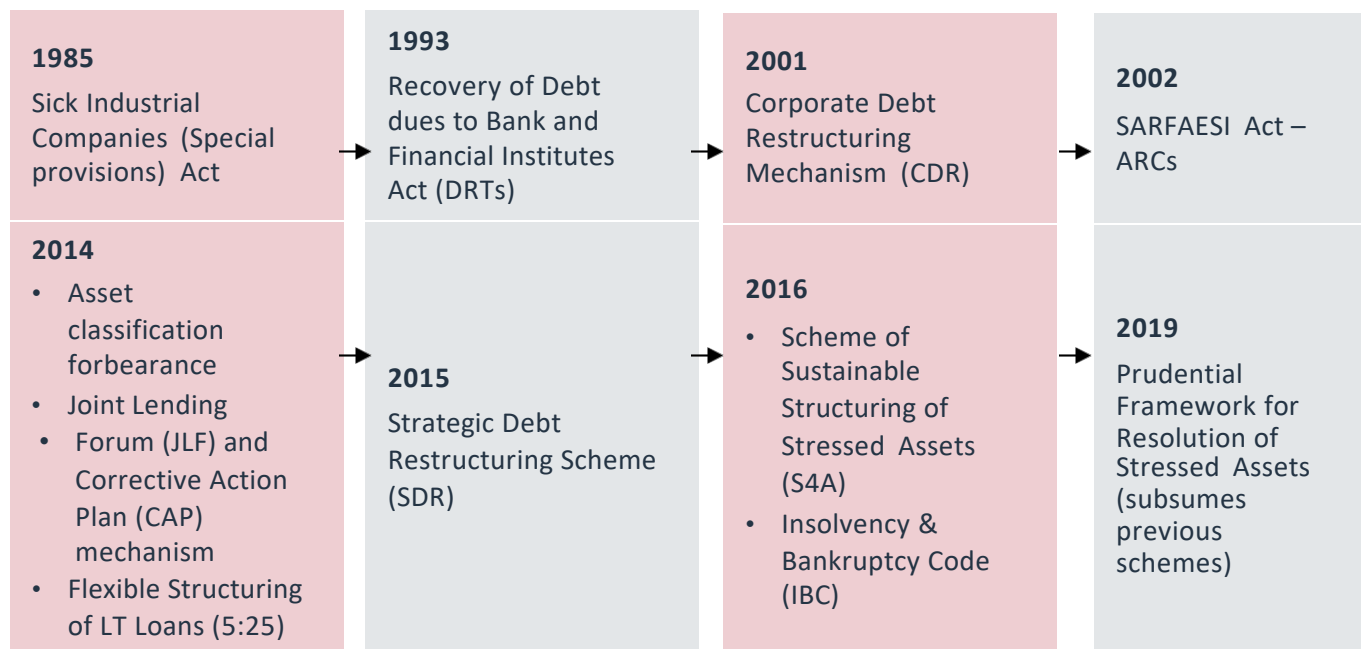
From a banker’s perspective, “stressed assets/loans” mean loan exposures that are classified as NPAs or SMAs. SMAs have been categorized by the Prudential Framework for Resolution of Stressed Assets issued by the RBI vide circular dated June 7, 2019<sup>1</sup>, and further clarified vide circular dated November 12, 2021<sup>2</sup>, requiring lenders to classify the accounts immediately on default of principal or interest or any other amount wholly or partly overdue or, in case of revolving credit facilities, the outstanding balance remains continuously in excess of the sanctioned amounts or drawing power, whichever is lower. SMAs are further classified as SMA-0, SMA-1 and SMA-2 based on the no. of days of default. A loan whose interest and/ or installment of principal have remained ‘overdue ‘ (not paid) for a period of 90 days or more is considered as an NPA.

RBI categorizes types of Stressed Assets into three baskets:

- Sub-standard Assets - If borrower fails to repay the installment, interest on principal or principal for 90 days the loan becomes NPA, and it is termed as SMA. If it remains SMA for a period less than or equal to 12 months, it is termed as a Sub-standard Asset.
- Doubtful Assets - If the Sub-standard asset remains so for 12 months or more, then it would be termed as a Doubtful Asset.
- Loss Assets – A loss asset is one where loss has been identified, but the amount has not been written off wholly. In other words, such an asset is considered uncollectable and of such little value that its continuance on the books as a bankable asset is not warranted, although there may be some salvage or recovery value.

## Stressed Assets Recovery – India’s Journey over the Last Decade

Currently, the banking industry in India follows the RBI prescribed Prudential Framework to resolve the Stressed Assets outside the IBC mechanism and enforcement process. Prior to introduction of the Prudential Framework, the resolution process for Stressed Assets evolved over 35 years with the RBI introducing the following:



**Sick Industrial Companies (Special Provisions) Act** was enacted to address sickness in the industry. The prime objective of the SICA was timely detection of sick or potentially sick companies owning industrial undertakings, and their speedy revival, wherever possible, or closure thereof. It was under this enactment that the Board for Industrial and Financial Reconstruction (BIFR) was formed to oversee the rehabilitation of sick units.

**Corporate Debt Restructuring Mechanism (CDR)** was purely a voluntary agreement between the debtor & creditor or the creditor & creditor, whereby approval of 75%/60% of creditors by value was required and the aggregate outstanding exposure was INR 100million or higher. The main objective of CDR was to ensure timely and transparent mechanism to restructure corporate debts of viable entities facing problems outside the purview of BIFR, Debt Recovery Tribunals and other legal proceedings, for the benefit of all concerned parties by various means including reduction in interest rate, extension of length of payment tenure, conversion of uncovered portion of debt into equity or preference shares, payments out of promoter’s contribution / sale of surplus assets etc.

**SARFAESI Act** was enacted to allow banks and financial institutions to more easily enforce securities held by them by auctioning commercial or residential properties when a borrower failed to repay the loan. Asset Reconstruction Company of India Limited, India’s first ARC, was established under this Act.

**Joint Lending Forum (JLF) and Corrective Action Plan (CAP)** was a dedicated grouping of lender banks and financial institution formed to speed up decisions when an asset (loan) of INR 1 billion or more turns out to be a Stressed Asset. As soon as an account is reported as SMA-2, all lenders formed a lenders’ committee called JLF under a convener chosen from among them and formulated a joint CAP for early resolution of stress in the account. According to the JLF amended framework, at least 60% of creditors by value of the loan and 50% by number of lenders in the JLF needed to agree on the restructuring plan. This reduced the efficacy of JLF, as obtaining consensus of creditors was a major obstacle.



**Flexible structuring of long-term loans (5:25)** allowed banks to extend long-term loans of up to 20-25 years to match the project cash flows, while refinancing them every five or seven years. The scheme aimed to increase long term viability of infrastructure and core industries projects, reduce Asset-Liability Management issues, reduce repayment stress, encourage efficient sharing of exposures by banks and NBFCs at various stages of the economic life of the projects and improve the credit ratings of such projects. The scheme applied to exposures aggregating more than INR 5 billion.

**Strategic Debt Restructuring Scheme (SDR)** provided banks who have given loans to a corporate borrower the right to convert the full or part of their loans into equity shares in the loan taken company. The rationale of SDR was to ensure more stake of promoters in reviving stressed accounts and providing banks with enhanced capabilities to initiate change of ownership, where necessary, in accounts which fail to achieve the agreed critical conditions and viability milestones.

**Scheme of Sustainable Structuring of Stressed Assets (S4A)** aims at deep financial restructuring of big debt projects by allowing the bank to acquire equity of the stressed project. The scheme envisaged financial restructuring of large projects while at the same time helping the lender's ability to deal with such stressed assets. It was intended to restore the flow of credit to critical sectors, including infrastructure. The scheme was applicable to projects which had total loans by all institutional lenders in excess of INR 5 billion, where the project has commenced commercial operations.

In 2016, the RBI piloted the **Insolvency and Bankruptcy Code**, a landmark reform in India. IBC has repealed and amended several laws and regulations and introduced 'One' law for bankruptcy in India. With the introduction of IBC, RBI abolished the CDR, JLF, CAP, S4A, SDR and Flexible structuring of existing long-term project loan schemes.

In 2019, the **Prudential Framework** was introduced, which provided for early recognition and reporting of default of large borrowers by banks, FIs and NBFCs. It further provided complete discretion and flexibility to lenders in the matter of design and implementation of resolution plans in supersession of all earlier resolution schemes (explained above), subject to a specified timeline and independent credit evaluation.

Since resolution plans are formulated on a case-to-case basis, the Prudential Framework may turn out to be more efficient option for lenders as they typically have control and authority to decide the resolution process in comparison to IBC i.e., court driven process. Also, in case of failure to resolve Stressed Assets under the Prudential Framework, the lender still has the option to resolve the Stressed Assets under IBC and then proceed to liquidation. By contrast, failure of resolution under IBC will directly lead to liquidation of Stressed Assets.

Having said that, introduced in 2016, the IBC is a game changer, providing more power to lenders. With the objective of ensuring speedy resolutions, i.e., within 180 days extendable to 270 days, IBC has been appreciated by the World Bank and the International Monetary Fund and helped raise India's ranking in the World Bank's Ease of Doing Business Survey from 100<sup>th</sup> place in 2018 to 77<sup>th</sup> place in 2019 to 63<sup>rd</sup> place in 2020, as India's score under the 'Resolving Insolvency' parameter almost doubled from 32.6 to 62.0.

Banks and FIs are looking to sell NPAs to investors at attractive discounts to release capital. Also, stressed companies are looking to raise capital from funds for last-mile funding for projects or for settlement with banks. This has resulted in a wave of interest in India from distressed debt and SSFs.



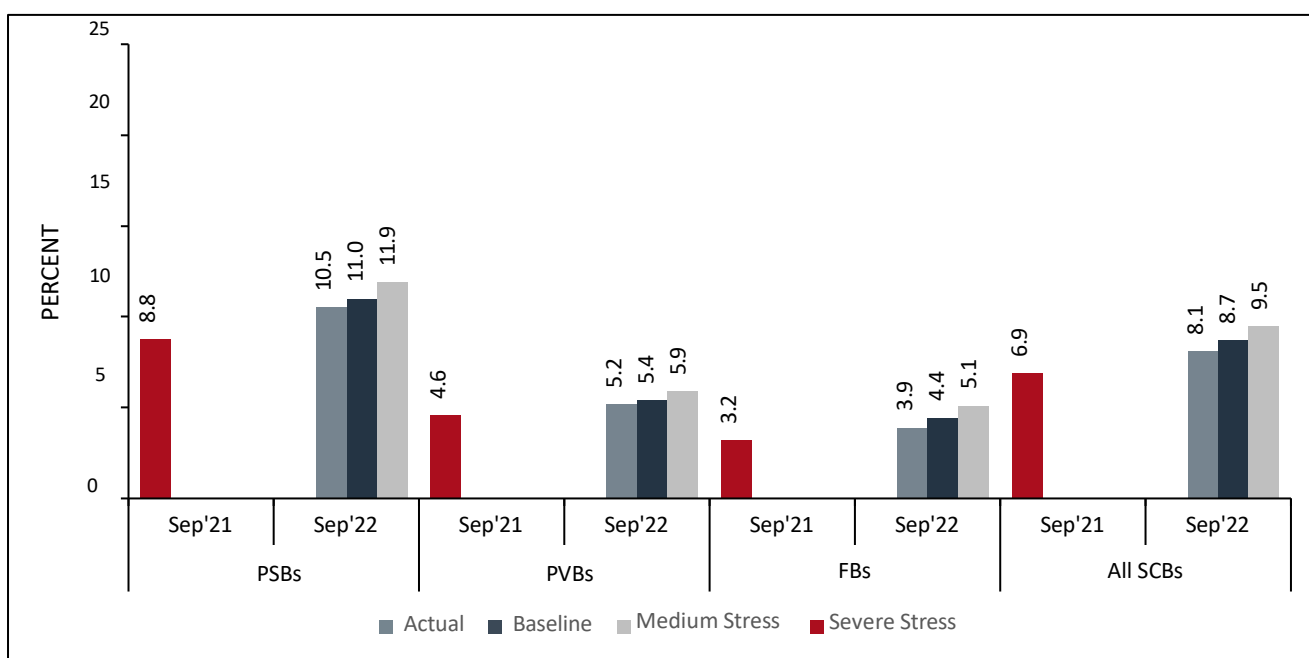
## Market Potential for Stressed Asset Investors

# Market Potential for Stressed Asset Investors

## Key statistics of stressed assets

According to RBI's Financial Stability Report 2021<sup>3</sup>, the asset quality of banks showed improvement, with the GNPA declining to 6.9% in September 2021 from 9.3% in March 2019. However, the macro-stress tests for credit risk show that SCBs GNPA ratios may increase from 6.9% in September 2021 to 8.1% by September 2022 under the baseline scenario, and to 9.5% under a severe stress scenario. The GNPA ratio of NBFCs, which had declined in September 2020 reflecting the standstill on asset classification prevalent then, rose to reach 6.5% as at the end of September 2021. GNPA in the industries sector, which forms the largest share of NBFC exposure, rose from 6.7% in March 2021 to 7.9% in September 2021.

**Chart 1: Projection of SCBs' GNPA Ratios under Stressed Scenarios**



The Report further states that 'During April-October 2021, all the deficit indicators of the central government exhibited improvement from their pre-pandemic levels. The borrowing program has proceeded smoothly. The Indian corporate sector has gained strength and resilience through the pandemic and key financial parameters of listed non-financial private companies indicate improvement. Bank credit growth is showing signs of a gradual recovery, led by the retail segment, although flow of credit to lesser rated corporates remains hesitant'.

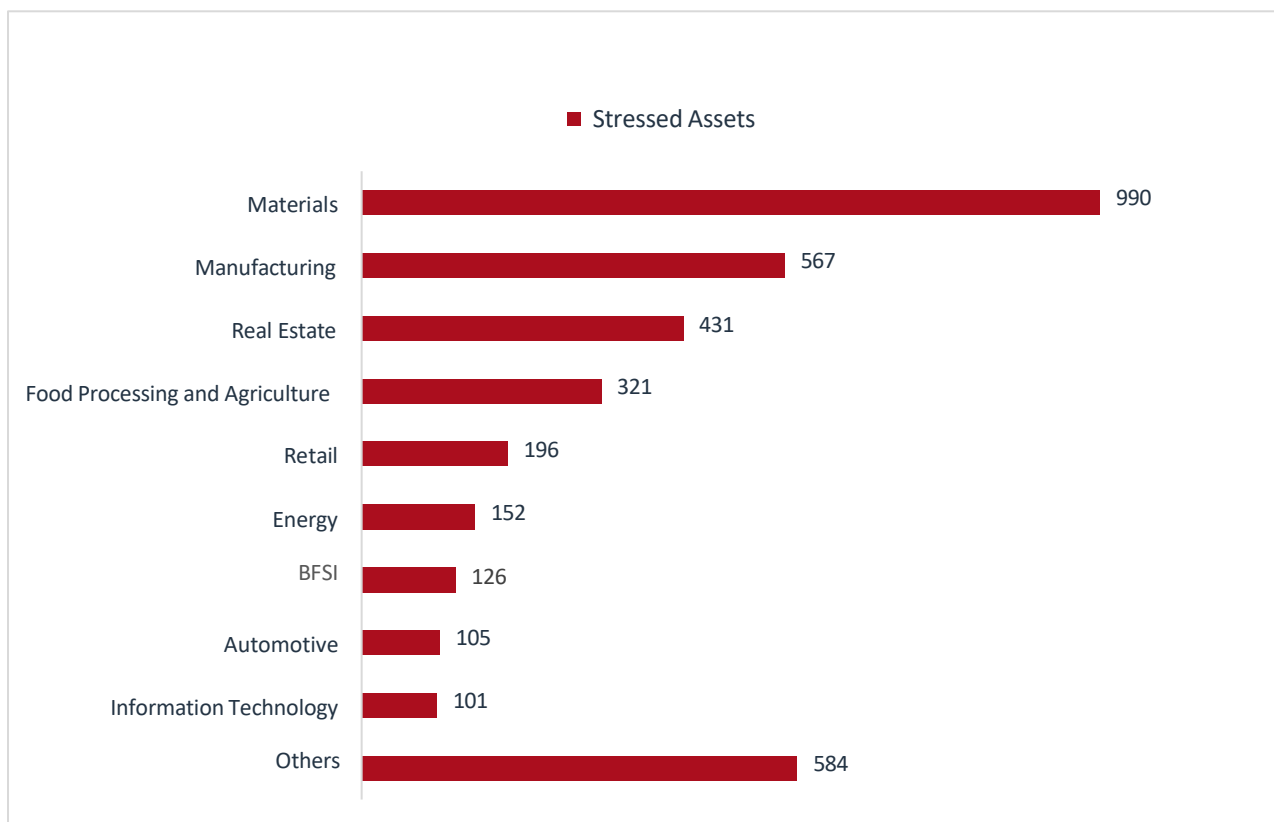
For an emerging economy like India, where market participants are strongly dependent on loans from banks and where the corporate bond market is under-penetrated, developing a market for distressed assets is vital. With banks stumbling under mounting NPAs of INR 8,340 billion as on March 31, 2021, the need of the hour is to have a well-developed distressed assets market to offload these NPAs effectively.

To free up banks so they can focus on new lending and to reduce the burden on their resources for debt collection, there is a dire need to develop a secondary market for NPAs. 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.

<sup>3</sup> Financial stability report Issue no. 24 dated 29 December 2021

## Chart 2: Sector-wise Stressed Companies

Stressed Assets by Sector



Source: <https://indiainvestmentgrid.gov.in/opportunities/stressed-assets> as on December 31, 2021

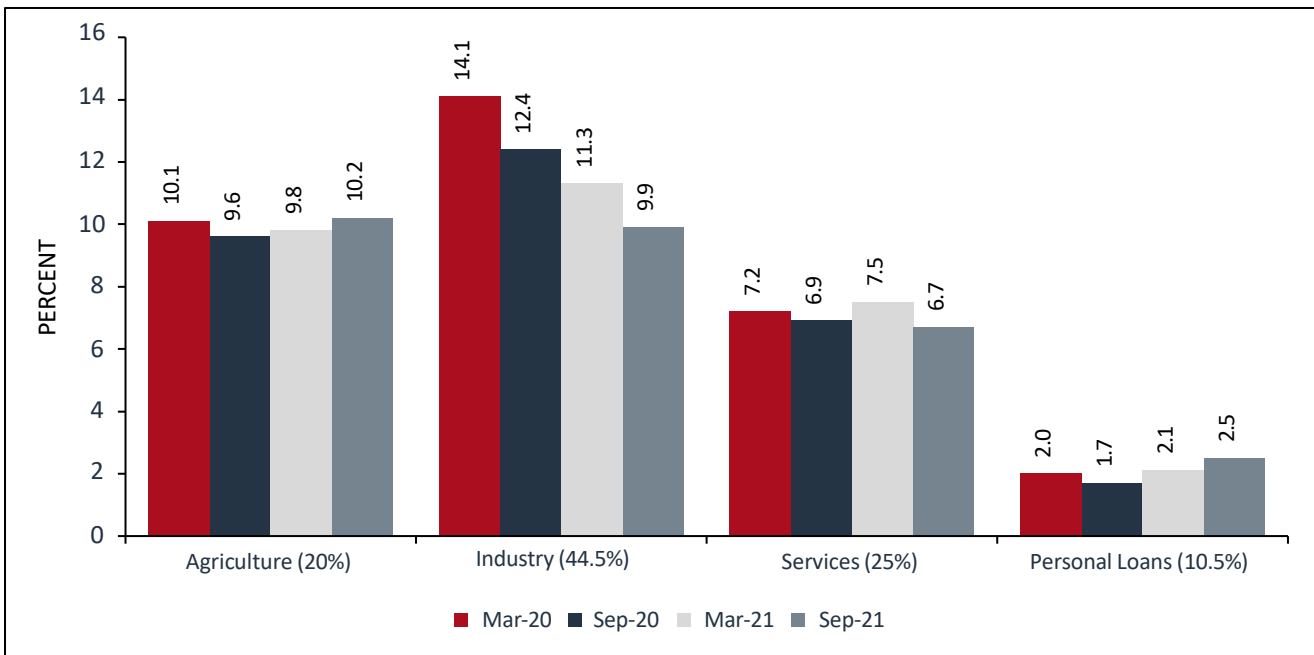
Materials to include 379 Metals & Mining, 333 Construction Materials and 278 Chemicals & Petrochemicals companies

Manufacturing to include 276 Textiles, 154 Machinery & Equipment, 107 Electronics among Others

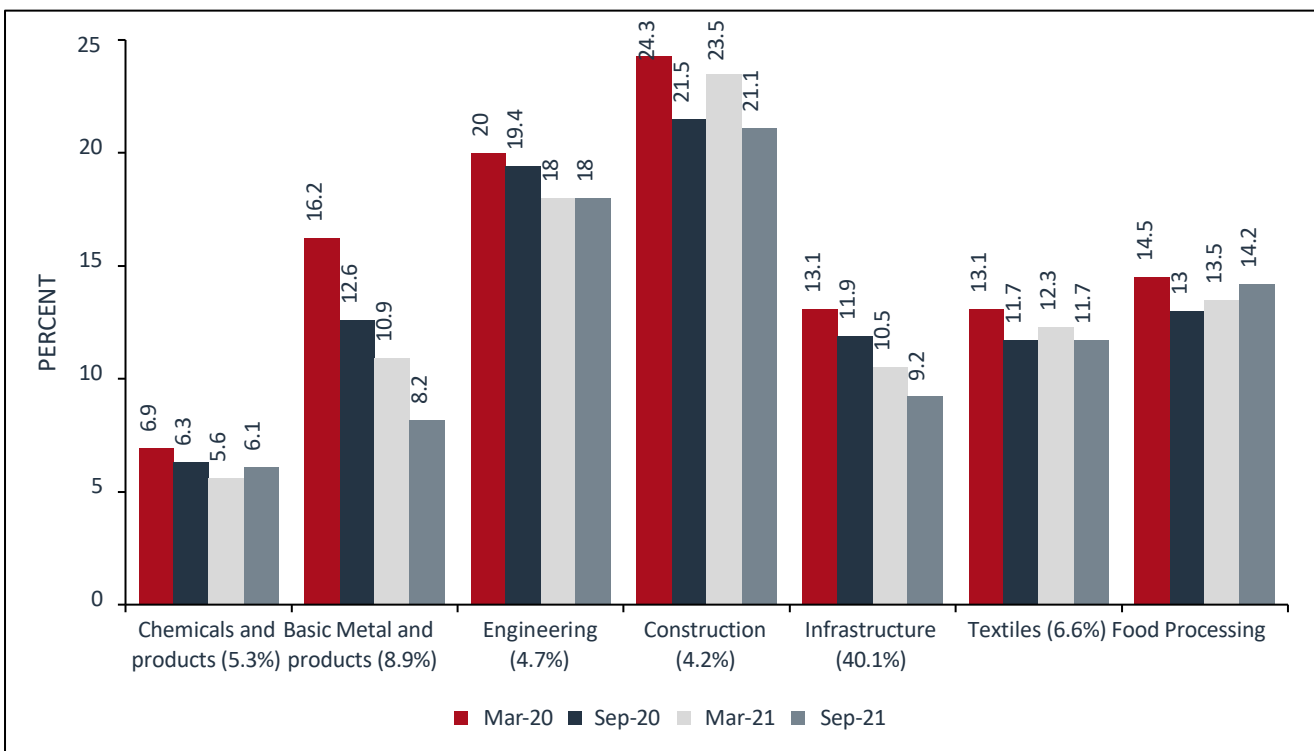
Others includes various sectors including Tourism, Pharma, Media, Transport, Communication, Logistics and more.



**Chart 3.1: Sector wide GNPA Ratio**



**Chart 3.2: GNPA Ratios of Industrial sub-sectors**



Based on the above and on discussions with various stressed asset funds, it is apparent that ‘Infrastructure’ is the sector with the highest number of stressed asset borrowers. Infrastructure sector is a key GDP driver for the Indian economy. Given that infrastructure projects are capital-intensive and great job-creators, reviving them is a high priority for any government. The Infrastructure sector in India covers construction and developmental projects in various other sectors, like Social Infrastructure, Transportation Infrastructure, Extraction Infrastructure, Manufacturing Infrastructure etc.

Infrastructure projects in India are infamous for delays and disputes. Significant time and cost overruns in projects are very common. Projects often suffer from cost overruns of 50-100 %, primarily due to delays, and this leads to financial stress in this sector.

Infrastructure sector is responsible in large measure for propelling India's overall development and enjoys intense focus from GoI for initiating policies that would ensure time-bound creation of world class infrastructure in the country. In the Union Budget 2021, the GoI has given a massive push to the infrastructure sector by allocating INR 2,330 billion to enhance the transport infrastructure.

Huge investment in telecom infrastructure (Reliance Digital Fibre Infrastructure Trust's investment of INR 75 billion) has provided a momentum to Private Equity investment into India. With India requiring investment worth INR 50 trillion by 2022, there are ample opportunities for stressed asset investors, offering promise of attractive returns in the long term.

Distressed assets investment firms are miniscule in the large pool of the 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 restructurings 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). With strategic factors like plentiful supply of stressed assets, regulatory transparency, favourable currency rates and robustness and potential for greater returns on investment as compared to global stressed assets, the Indian stressed asset market is very attractive for foreign investors.

## Regulatory windows for investment

Foreign investment can be in various forms such as FDI, FPI, commercial loans, etc. One other such route of international investment is *via* ECBs. We have discussed in detail various avenues through which an offshore fund/ investor can invest in Indian stressed assets.

### Offshore fund buys out the distressed company under the FDI route as a part of insolvency proceedings or *via* ECB route

Offshore investors/ funds participate in this corporate insolvency process under the IBC either as bidders (or by providing funding to bidders) or as creditors on the CoC. In 2019, the RBI has afforded a new avenue for resolution applicants. The RBI has rationalized ECB norms and permitted borrowing *via* approval route from approved foreign entities/ lenders for repayment of domestically availed rupee loans, on the pre-condition that if such borrowing is permitted by the Resolution Plan, an eligible corporate borrower can avail a loan to repay and revive itself. Therefore, such debt instruments can not only be used by eligible Indian companies to raise capital, but can also aid the process of bidding for stressed assets. The RBI's liberal approach in structuring regulations for ECBs provides a wide window for investment *via* the ECB route.

### FPI/ARC Route

For an investor seeking to gain access to distressed debt portfolios, the commonest way of achieving this is by investing in securitized instruments known as SRs issued against non-performing loans acquired by debt aggregation vehicles known as ARCs.

### Investment into NBFC in India

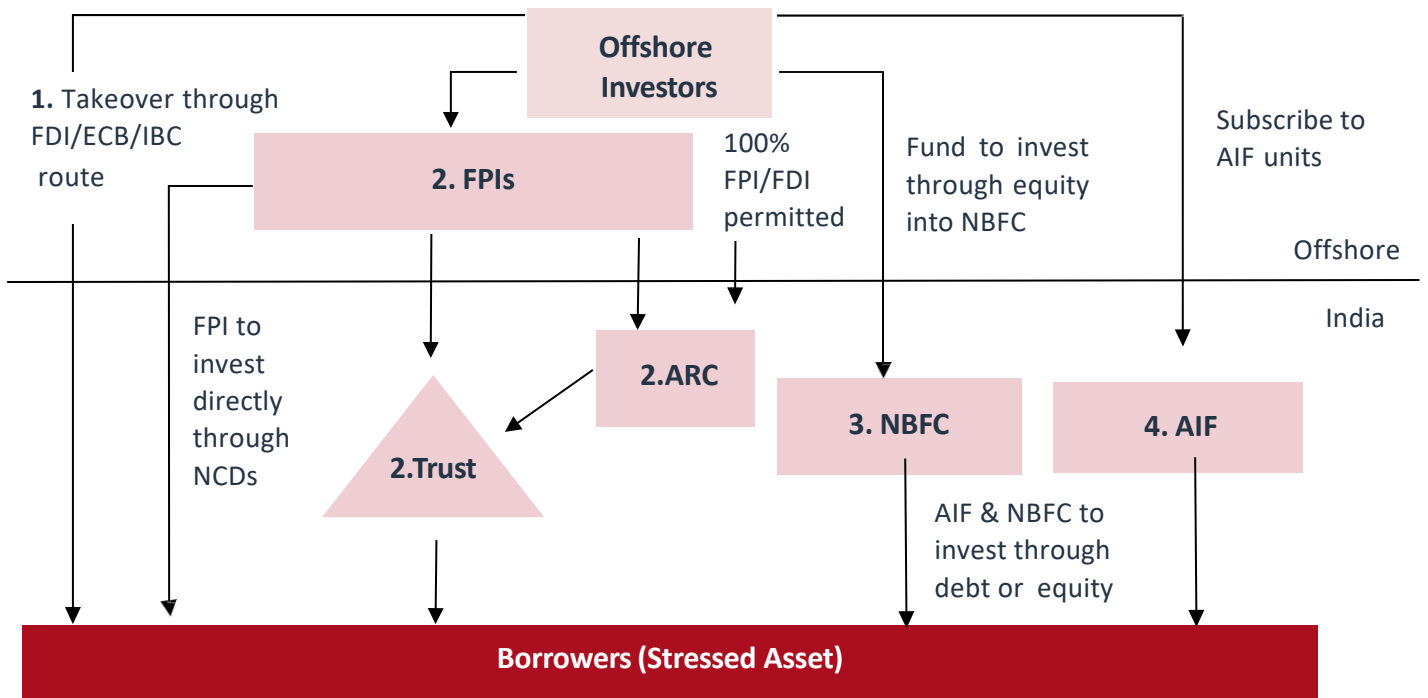
With easing of minimum capitalization requirement for foreign investors, direct equity investments into NBFCs is also gaining in popularity

### Lending through Cat II AIF (domestic fund) set up in India

Subscribe to non-convertible debentures (NCDs) issued by Indian Companies



**Diagrammatic representation of various investment routes**







## Asset Reconstruction Companies



## Asset Reconstruction Companies

### The ARC Industry

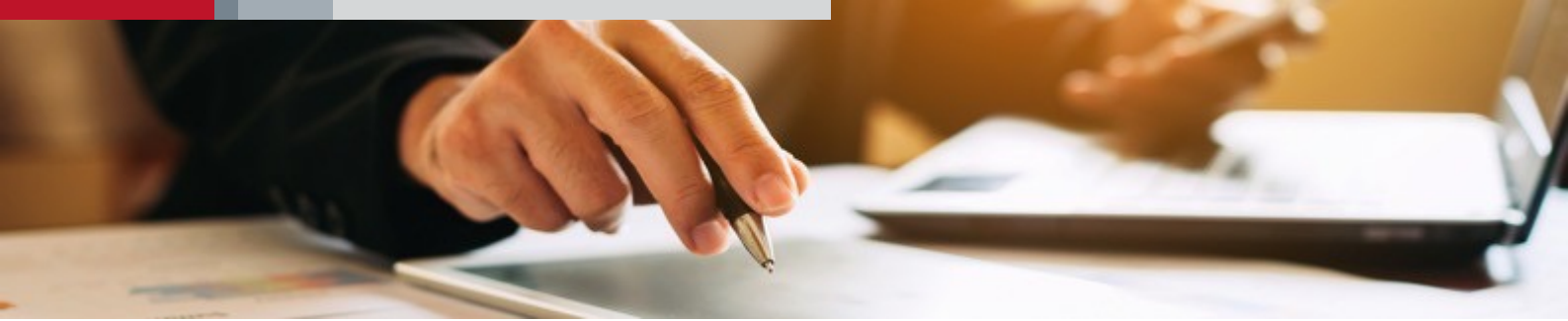
ARCs are specialized asset managers that acquire debts from original lenders, securitize them and help recover the debts. Though ARCs were introduced in 2002, as per an RBI report the evolution of ARCs has been neither smooth nor steady. There have been phases of growth and lull for these institutions, explained by changes partly in macro- financial conditions and partly in regulatory environment surrounding these institutions.

As part of the SARFAESI Act, ARCs were set up as another institutional alternative for NPA resolution in India. ARCs, regulated and supervised by the RBI, are specialised FIs that facilitates securitisation and asset reconstruction of NPAs of banks, thereby facilitating early resolution and bringing liquidity into the system. They enable revival of projects staring in the face of financial ruin, and often create significant employment when closed projects and units are revived.

Asset Reconstruction means acquisition of any right or interest of any bank or financial institution in loans, advances granted, debentures, bonds, guarantees or any other credit facility extended by banks to help realise the borrower's dues and in the process securitizing the debts. Securitisation means acquisition of financial assets either by way of issuing SRs to Qualified Buyers or by any other means.

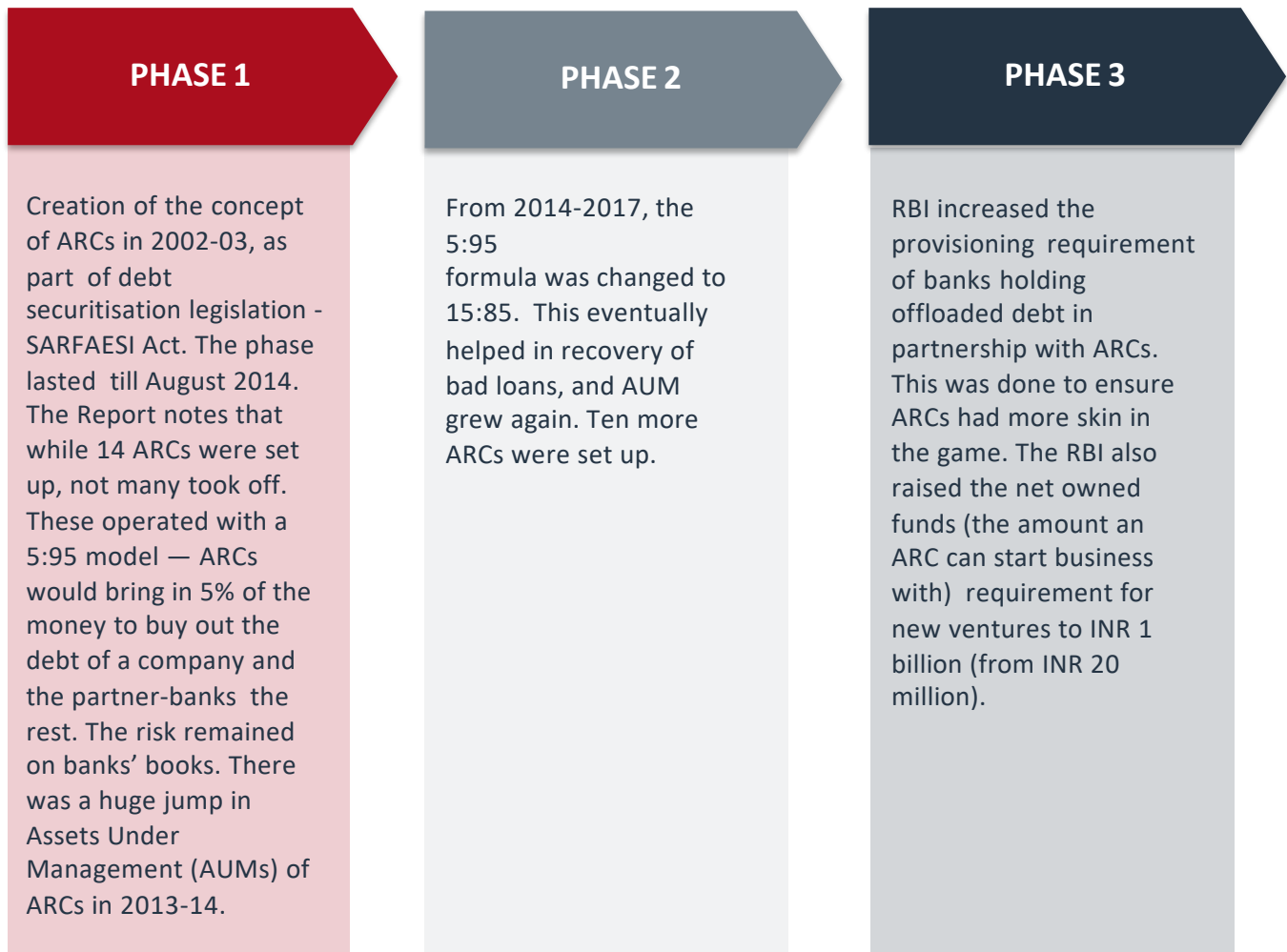
The term ARC has been in usage in the Indian context. However, its global parallel is an AMC with a focus on bank resolution, and those dealing with NPA resolution. Based on various instances of NPA resolution globally by the AMC (private and government owned), the common learnings are that:

- 1 AMCs in most countries were set up following a domestic and/or global banking crisis or crisis-like situation that led to a surge in banks' NPAs
- 2 Most AMCs were in existence for a pre-defined period
- 3 Most AMCs were set up with either direct equity participation or with support from the government



## Evolution of Indian ARCs

A January 2018 report, “ARC of Change”, prepared by CRISIL and the Associated Chambers of Commerce and Industry of India (ASSOCHAM), shows three phases.



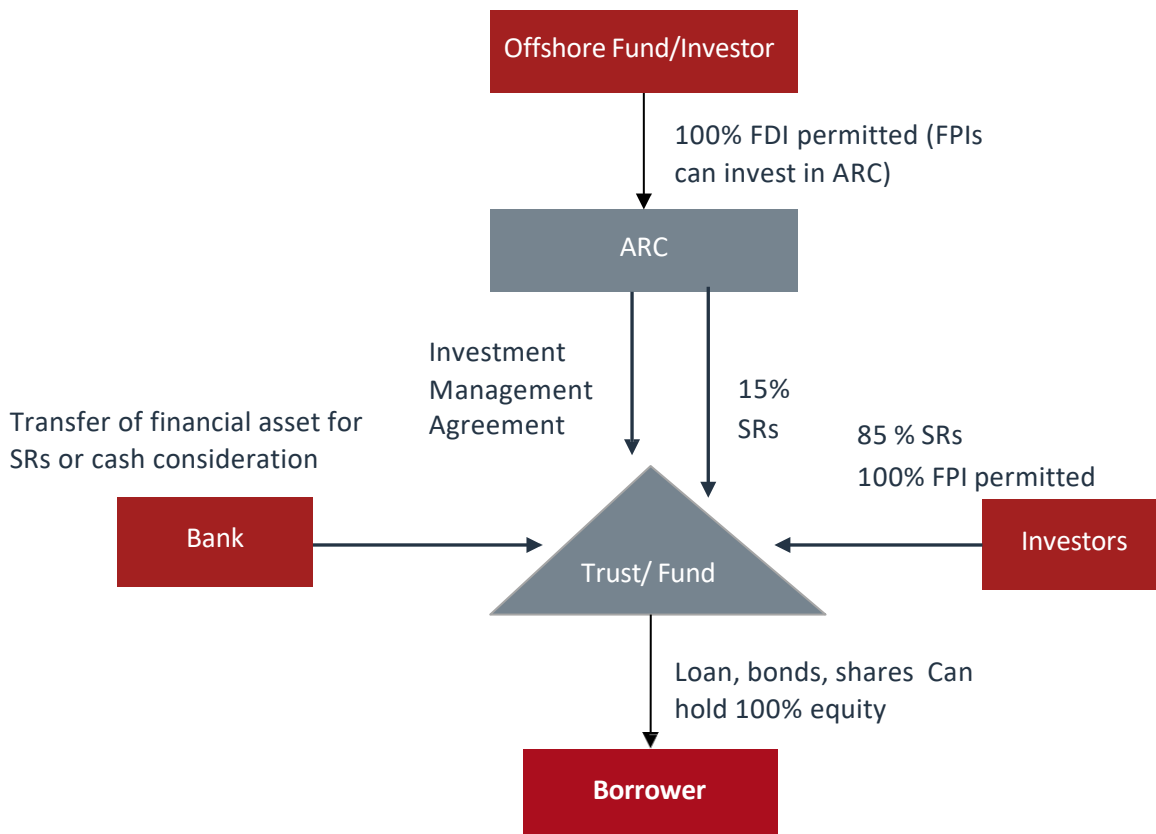
## Business Model of ARC

- Step 1: Bank provides financial assistance in return for security provided by debtors and borrowers
- Step 2: ARC purchase such bad debts/non-performing financial assets to realise the same
- Step 3: ARC issues SRs that would represent an undivided interest in the financial assets to the investors
- Step 4: ARC recovers debt in the span of 5 years (extended upto 8 years) and redeems the SR issued to Investors





### Typical ARC Structure



ARC can form multiple schemes for different type of assets and different classes of investors

The major source of earnings for ARCs are management/trusteeship fees, upside income arising out of the difference between recovery and acquisition cost of debt, and additional performance incentives given by banks for early recovery. The overall trends in profitability of ARCs suggests a largely stable return on assets close to 3%. While the return on equity showed a significant dip after 2014, it has revived from 2016 onwards to be close to 7%.



## Regulatory Framework of ARC

ARCs are registered and regulated under the SARFAESI Act, 2002. They acquire financial assets from banks/ FIs either on their own books or in the books of a trust set up for the purpose of securitisation and/ or reconstruction. RBI has issued the "Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003" covering the whole gamut of functioning of ARCs.

Important regulations pertaining to various prudential norms applicable to ARCs are tabulated below in brief

Net Owned Fund	Minimum INR 1billion on an ongoing basis
Acquisition of financial assets	Not allowed on a bilateral basis from sponsor banks/ FIs or an entity in the Group. Allowed to participate in public auctions
Investment in SRs	Minimum 15% of SRs in each class, under each scheme
Realisation of Assets	5 years, extendable up to 3 more years with Board approval
Capital to Risk-weighted Assets Ratio	15%
Asset Classification (Assets that are held in books of ARC)	Standard: If not an NPA; Sub-standard Asset: for a period not exceeding 12 months from the date it was classified as NPA; Doubtful Asset: if the asset remains a sub-standard asset for a period exceeding 12 months; Loss Asset: if the asset is non-performing for a period exceeding 36 months; the financial asset including SRs is not realized within the total time frame specified
Income Recognition	<ol style="list-style-type: none"> <li>a. Yield on SRs as well as Upside Income should be recognised only after full redemption of SRs</li> <li>b. Management Fee should be calculated as a % of net asset value at the lower end of the range specified by Credit Rating Agency.</li> </ol>

## Tax framework of ARC

As mentioned earlier, the income of ARCs, like that of asset managers of other classes, is the fee from the 'pool/ fund' for managing the fund/ assets. Income from other streams of income from recoveries from borrowers and management fees is to be accounted as per the accounting guidelines issued by the RBI. Such income received by an ARC is taxable as business income. Hence as such, barring certain complications around accounting as per RBI guidelines, the taxation of ARCs is relatively straightforward.

### *Taxation of ARC Trust and Investors*

The pool of funds wherein investors including the ARC pool their investments for acquiring loans from original lenders is formed as a trust as mentioned above. The IT Act grants a pass-through status to the Trust, hence there is no tax at the trust level. Thus, income is taxable in the hands of the investors in the same manner as if investments were directly made by the investor, and it is taxable in same nature and proportion as received by the Trust. The undistributed income is deemed to be credited to investors at the end of the financial year, hence investors are taxed in the year of collection or receipt by the Trust, and not in the year of distribution by the trust. The ARC trust is required to withhold tax @10% on the income distributed or accrued.

With this broad overview, one can consider some of the nuances and complexities relating to different streams of income. The income could arise or accrue to the trust from surplus from recovery or sale of loans, redemption of bonds/ preference shares, buy-back of shares (if the investment happens to be in the form of shares) or interest and dividends. As mentioned above, investors are taxed in the same manner as if the investments were directly made by the investors and as if the income were of the "same nature" as received by the trust.

Income from sale, repayment, and redemption of loans or securities could be either business income or capital gains, while income from revenue streams like interest or dividends is treated as business income or as income from other sources, depending on various factors discussed in subsequent paragraphs. FPIs, which are governed by a special provision on income from securities, would stand on a slightly different footing.

The characterization of income could be considered based on whether the investors are Indian investors or foreign investors.

### *Domestic investors*

In case of domestic investors, the factors in support of business income characterization would be (a) requirement of the "same nature" denoting same character/ head of income as received by the trust; (b) trust is engaged in the business of acquisition and recovery of loans, hence surplus on recovery, gains on disposal of securities, etc. are all part of business income; and (c) the trust would treat all assets as stock-in-trade and not as capital assets. Incidentally, the CBDT circular on characterization linked to the period of holding does not extend to loans and hence does not help in this matter. Characterization done based on the above factors at the trust level would flow through to the investors.

On the other hand, there are certain factors that support the capital gains characterization. One could take the position that the "same nature" as envisaged in provisions denotes types of income streams from various types of investment such as repayment of loan, interest, dividend, sale proceeds, redemption, etc. Hence each of these types of income, considering the investor categories and their individual fact pattern, will determine characterization or head of income.

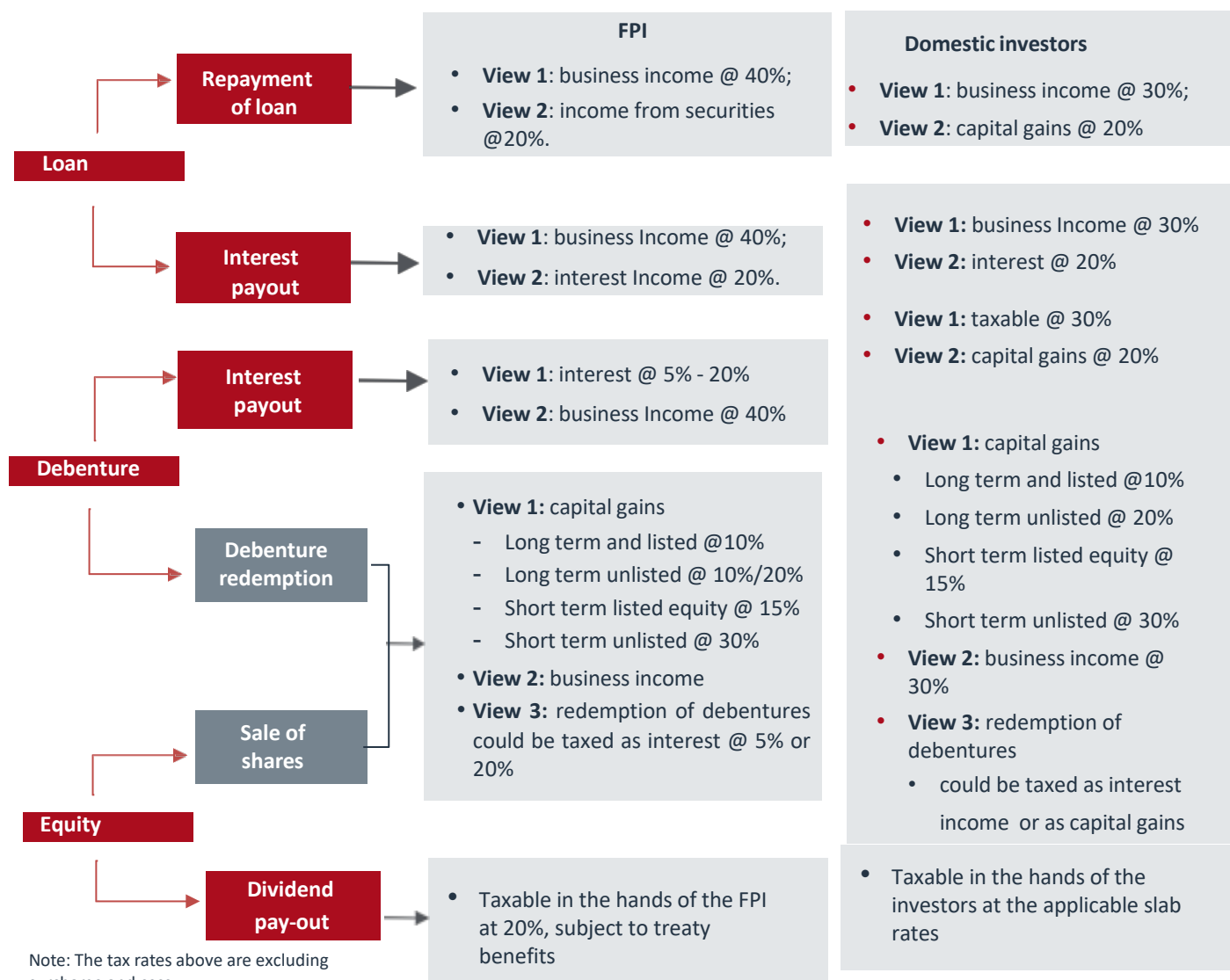
Appropriate characterization is important because, while the business income would get taxed at the higher rate (generally 30%, and depends on the status of the investor), capital gains are generally taxed at 10/15/20/30 % depending on the nature of asset class and holding period.

### Foreign investors

The only category of foreign investors that can invest in the trust are FPIs, who are allowed by the concerned regulations to invest in the SRs issued by the trust. Though there are special provisions contained in the Income-tax Act governing this category of investors, these provisions cover business profits but do not provide for any special rate. In other words, the special provisions do not bar any income from being taxed as business income. There is no mandatory characterization of every source of income, including that from ARC trust, as capital gains. Hence there is a view that even such investors can be taxed on income from the trust as business income attracting normal non-resident rate (subject to treaty provisions and an argument that there is no taxation in absence of a permanent establishment).

However, the other view is that the special provisions governing FPIs cover income in respect of securities, which could cover any income paid through the holding of such securities and not just interest or dividends. SRs issued by the trust are treated as securities and hence would cover income even in the nature of business profits and not just interest or dividends. Hence, the SRs would be taxable at 20% subject to lower treaty rates if applicable. In the case of a transfer of an SR itself by the investor, the gains should be taxed as capital gains.

### Tax rates in the hands of investors





## Current challenges and recommendations of the expert committee

Indian ARCs have been private sector entities registered with the RBI. Public sector AMC in other countries have often enjoyed easy access to government funding or government backing. Capital constraints have often been highlighted as an area of concern for ARCs in India. Data shows that the performance of ARCs has not been good in terms of both recovery and revival of business. Key factors behind the sub-optimal performance of the ARC sector are the age-old NPAs passed on to ARCs, difficulties faced by ARCs in raising funds, non-availability of additional funding for stressed borrowers, etc.

Considering the challenges impacting the ARC sector, a Committee was constituted by RBI, which submitted its report on September 14, 2021, providing recommendations covering all significant areas of functioning of ARCs. Some of the key recommendations of the Committee are as follows:

- ARCs to be allowed to participate in IBC proceedings as Resolution Applicants, either through their SR Trust or through AIFs sponsored by them.
- Minimum investment in SRs by an ARC, per SR class/ scheme, should be 15% of the lenders' investment in SRs or 2.5% of the total SRs issued, per SR class/ scheme, whichever is higher.
- Minimum requirement of net worth to be increased to INR 2 billion from the existing INR 1 billion.
- In cases where ARCs have acquired at least 66% of debt of a borrower, a two-year moratorium should be granted on proceedings against the borrower by other authorities, along with deferment of payment of government dues.
- When 66% of lenders decide to accept an offer by an ARC, the same should be made binding on the remaining lenders, and it must be implemented within 60 days of approval by majority lenders (66%). 100% provisioning on the loan outstanding should be mandated if a lender fails to comply with this requirement.
- All categories of SMAs to be considered for sale to ARC, and not only NPAs.
- In the interest of debt aggregation, ARCs should be allowed to also acquire stressed loans availed by domestic borrowers from regulated overseas banks and financial institutions.
- To widen the avenues for capital infusion in ARCs, categories of eligible qualified buyers should be further expanded to include HNIs with minimum investment of INR 10 million, corporates (Net-worth INR 100 million & above), all NBFCs/ HFCs, trusts, family offices, pension funds and distressed asset funds, with no related party connection.
- The ambit of 'financial assets' should be widened to allow ARCs to acquire financial assets for the purpose of reconstruction from regulated entities notified by RBI - AIFs, FPIs, AMCs making investment on behalf of MFs and all NBFCs (including HFCs) irrespective of asset size, as also from retail investors.



## Comparison of the current framework and the recommendations of the Committee

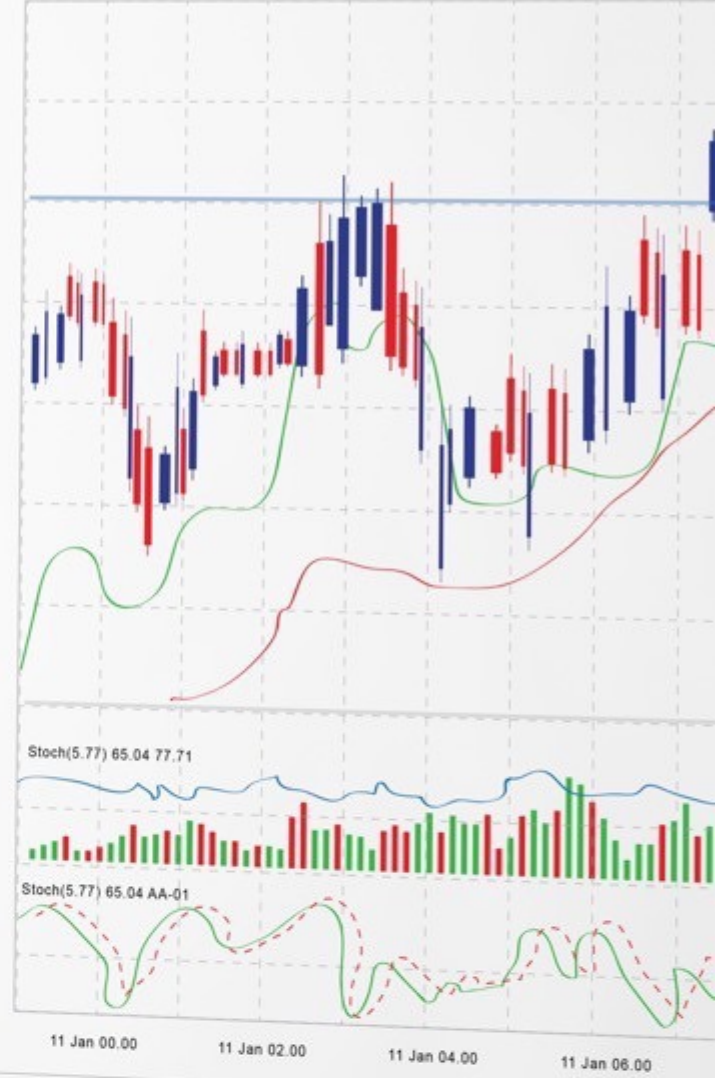
Framework	Current	Recommendations
Participate in IBC as a Resolution Applicant	Not allowed	ARC to become Resolution Applicant under IBC
Minimum investment in SRs by an ARC	15%	Higher of 15% of the lenders' investment in SRs or 2.5% of total SR issued
Minimum Net worth of ARC	INR 1 billion	INR 2 billion
Debt aggregation	75% (by value) of lenders decide to accept an offer by an ARC	ARC acquires 66% of aggregate debt pertaining to a borrower, with a two-year moratorium on proceedings against the borrower by other authorities
Assets sold to ARC	Only NPAs	All categories of SMAs as well as NPAs
Eligible Qualified Buyers	Financial institution, insurance company, bank, state financial corporation, state industrial development corporation, ARC or any AMC investing on behalf of mutual fund or a SEBI-registered FPI, any category of non-institutional investors as specified by RBI or any other body corporate as specified by SEBI	Expand to include HNIs with minimum investment of INR 10 million, corporates (Net Worth INR 0.1billion & above), NBFCs/ HFCs not notified as FIs, trusts, family offices, pension funds, distressed asset funds, with no related party connection
Entities from which ARC can acquire financial assets	Banks & Financial Institutions	All regulated entities, including AIFs, FPIs, AMCs making investment on behalf of MFs and all NBFCs (including HFCs), irrespective of asset size, as also from retail investors



**FOREX** ▾

Instant Execution

-0.01	-0.1	0.27	+0.01	+0.1
Stop Loss	-	not set	+	
Take P		not set	+	
Devia		not set	+	
1.27		1.2765 <sup>7</sup>		
		<b>Buy</b>		



About

Size	Symbol	Price	S/L	T/P	Pr
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# Insolvency and Bankruptcy Code

# Insolvency and Bankruptcy Code

## Introduction of IBC

The Insolvency and Bankruptcy Code, 2016 is the umbrella legislation for insolvency resolution of all entities in India - both corporate and individuals. The provisions relating to insolvency and liquidation of corporate persons came into force on December 1, 2016, while those of insolvency resolution and bankruptcy of personal guarantors to CDs came into effect on December 1, 2019. Its foundational objectives of IBC are as follows:

*“An Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximization of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith and incidental thereto.”*

IBC brings about a paradigm shift in the recovery and resolution process by introducing the concept of ‘creditor in control’ instead of ‘debtor in possession’, where creditors, any financial or operational shall exercise a control through Insolvency professionals in the event of default in payments of loans or interest start managing the company. Creditors now have guidelines that clarify details till the last mile, including distribution of recovery proceeds.

Within a year of implementing the Code, new networks of the NCLT - adjudicating authorities where corporate insolvency matters shall be heard, the new regulator having oversight over insolvency professionals and insolvency professional agencies ‘Insolvency and Bankruptcy Board of India’, new stream of professionals ‘Insolvency Professionals’ who play a key role in the efficient working of the insolvency and bankruptcy process under the IBC and new stream of Information ‘Information Utilities’ which electronically store facts about lenders and terms of lending and evidence of default. The IBBI charted the course of its implementation under the guidance of the Ministry of Corporate Affairs, GoI.

So far, recoveries in IBC have been better than in the erstwhile regime. As per RBI’s report on Trend and Progress of Banking in India 2019-2020, scheduled commercial banks observed 45% recovery in IBC. Although substituting multiple laws has proven to be impressive, delays in resolving cases have been unsatisfactory. The Parliamentary Committee too has raised its concerns regarding the delay in resolution process and low recovery rates.

## IBC journey over 5 years

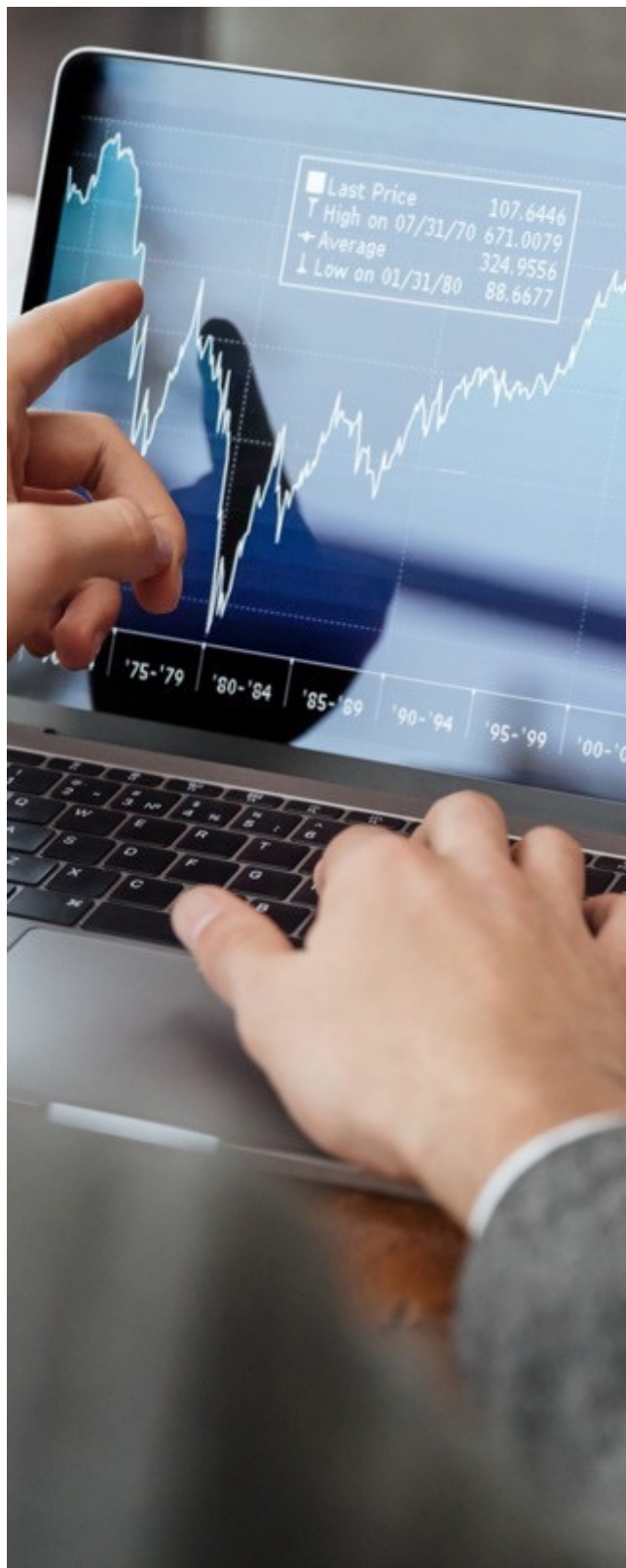
IBC has seen several successes as it has progressed well during last five years, though in certain respects it has fallen short of expectations. Hits and misses of IBC during last five years are summarized below:



- Successful resolution marked by several landmark judgments in the cases of Essar Steel, Jaypee Infratech, IL&FS amongst others
- Pre-pack framework for MSMEs
- Proposal for setting up National Asset Reconstruction Company Limited, popularly termed as a “bad bank”
- Introduction of Section 29A and Section 32A of IBC
- IBC recovery rate better than in other routes



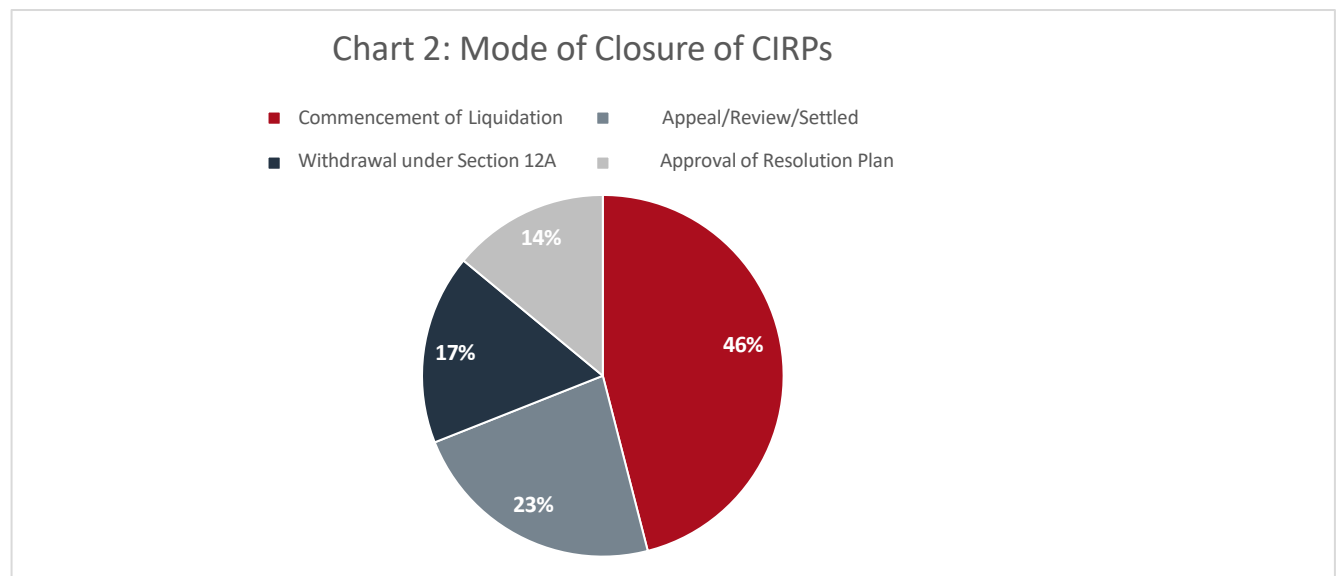
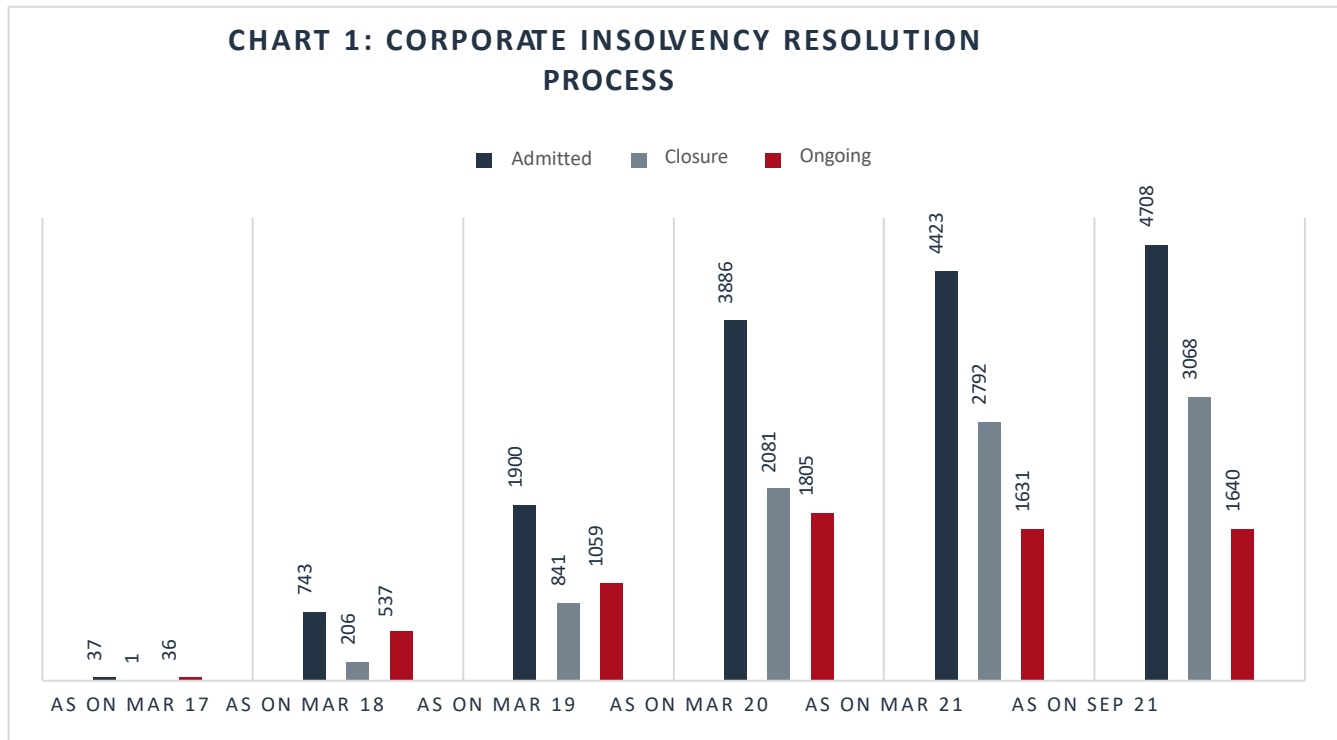
- Haircuts for lenders (Videocon Industries group reportedly took a haircut of over 95%)
- Recovery rate in 348 cases where the resolution plan was approved till March 2021 is 37%
- Prolonged cases (as of March 2021, 79% of on going cases have been continuing beyond 270 days)
- Out of 2,653 closed cases, 48% went into liquidation





## IBC Resolution

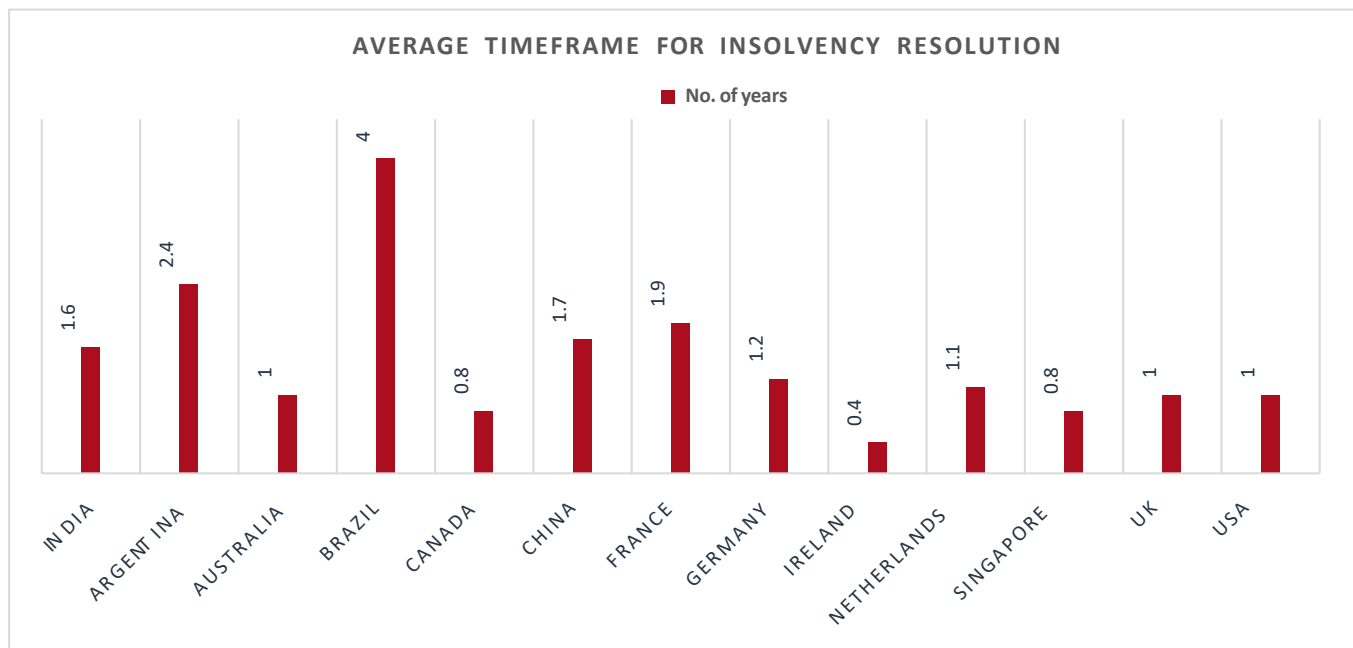
The provisions relating to CIRP are effective from December 1, 2016. A total of 4,708 cases have commenced by the end of September 2021 under the CIRP (Refer Chart 1 below). Of these, 3068 have been closed. Of the CIRPs closed, 701 have been closed on appeal or review or settled; 527 have been withdrawn and 421 have ended in approval of resolution plans (Refer Chart 2 below). Thus, CIRPs being closed as withdrawn or resolved constitute 1,649 cases as against 1,419 cases, which have ended in orders for liquidation.



The data provided in this section regarding corporate processes is provisional and as per quarterly rereport issued by IBBI.



One of the areas that has definitely helped India its ranking on the World Bank’s Ease of Doing Business survey is the improvement in the regulatory framework for resolution of NPAs. Given its relatively nascent stage in India, IBC has fared well in terms of the time it takes to resolve an insolvency. A comparative time frame for insolvency resolution in different countries as per World Bank data in 2019 is as follows:



To speed up the rescue of distressed companies which are ending up in bankruptcy tribunals, on December 23, 2021, the ministry of corporate affairs proposed the following amendments to IBC

- Ways for faster admission of cases in tribunals to initiate the bankruptcy process as well as for faster adoption of revival plans stitched together by stakeholders.
- To provide ‘a fixed time period for rejection or approval’ of a corporate turnaround plan by the tribunal and quicker admission of cases by tribunals.

The Chairman of the IBBI, Dr. Navrang Saini, in the July-Sept 2021 quarterly newsletter ‘IBC – Developing a Market for Stressed Assets’ states that 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 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 IBC 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 turnaround, at reasonable valuations.

The IBC 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 that enable extant businesses to be acquired through mergers, amalgamations, and demergers, free of stigma of the past misdeeds of the erstwhile promoters. Capital-intensive companies from infrastructure and power sectors that have come into CIRP can now be bought by investors at competitive prices.

Electronic platforms for distressed assets have recently been launched by NeSL and Mjunction, with the following four elements:

- market for interim financing
- virtual data room
- invitation and evaluation of resolution plans
- auctions during liquidation, which have advanced the development of market for distressed assets in India

### IBC Regulatory Framework

The IBC is a comprehensive and systemic economic reform by India that consolidates all existing laws dealing with insolvency and bankruptcy.

#### Applicability of IBC

The Code applies to the following categories of entities against whom proceedings can be initiated:

- i. any company incorporated under the Companies Act
- ii. Any other company governed by any special Act
- iii. Any Limited Liability Partnership incorporated under the Limited Liability Partnership Act, 2008
- iv. Such other body corporate (incorporated under any law) notified by Govt
- v. Personal guarantors to corporate debtor
- vi. Partnership firms and proprietorship firms
- vii. individual – other than persons covered in point v

IBC is not applicable to financial service providing entities i.e., Banks, FIs, Insurance Company, ARCs, MFs, AIFs or Pension Funds

Persons who can initiate corporate insolvency resolution process

IBC process can be initiated by the following entities:

Financial Creditor

Operational Creditor

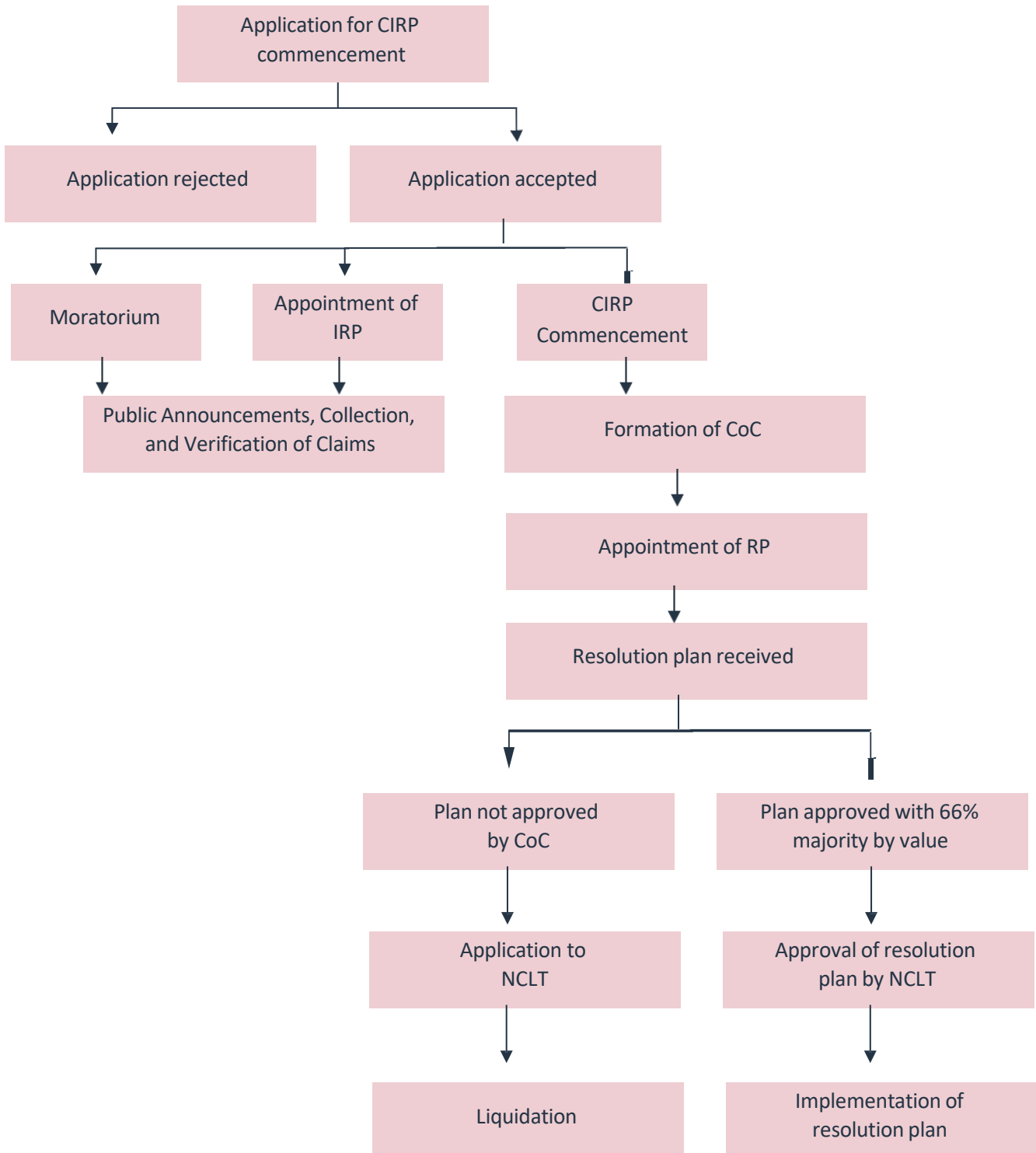
Corporate Debtor itself

#### Applicable limits

For Corporates – INR 0.1 million (CG can notify higher value not exceeding INR 10 million) For Individuals – INR 0.001 million (CG can notify higher value not exceeding INR 0.1 million)

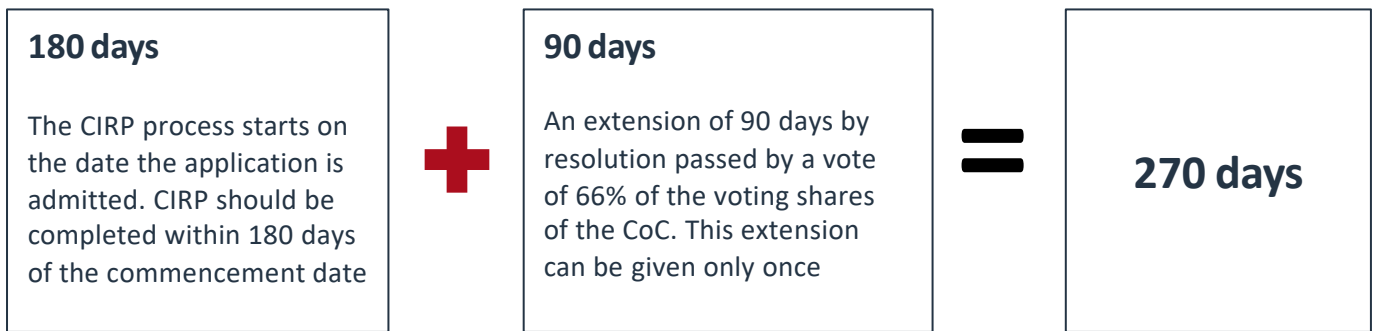
## Flowchart of CIRP process

The IBC contains the processes for starting and running the CIRP. Below is a flowchart of the CIRP process, which starts with applying to the AA to initiate the CIRP and ends with the order of the AA either approving the resolution plan or liquidating the CD





## Overall Timelines



The overall timeline for completing a CIRP now stands at **330 days**, hence a further extension of 60 days is available.

## IBC Tax Framework

Major tax implications and issues under Indian domestic tax laws (IT Act) are highlighted below

### Write back of loans

During a CIRP usually there will be a haircut on the loans given to the CDs and the lenders will have to bear a part of the losses. Waiver of loans in the hands of the borrower would be treated either as a capital receipt or as a business income depending on the underlying purpose or nature of the transaction. In the case of Mahindra and Mahindra<sup>4</sup>, the Supreme Court has held that if a loan is taken and utilised for capital purposes, the waiver of such loans will be construed as capital receipt and not liable to tax, whereas if a loan is taken for working capital purposes, the same to be treated as business income and be liable to tax in the hands of the borrower.

Further, in respect of operational creditors, the waiver of liability will be subject to tax under both normal and MAT provisions. The MAT liability could be mitigated by electing to the newly introduced concessional 25% corporate tax regime, or by a set-off of brought-forward losses. However otherwise, since there is no blanket exemption from MAT provisions for companies under IBC, the Company will be liable to pay MAT on the waiver of loan routed through the profit-and-loss account.

### Carry forward and set-off of losses

In case of a closely held company, carry-forward and set-off of losses is allowed only if there is a continuity in the beneficial owner of the shares carrying at least 51% voting power. In case of a company seeking insolvency resolution, it is expected that ownership of shares carrying more than 51% of voting power would change, thus leading to a lapse of the existing brought-forward losses. Most of the companies going under the resolution process under the IBC have huge losses. This was considered as an obstacle as the buyers were keen to continue with tax losses. Taking cognizance of the issue, the GoI amended the tax laws to allow such tax losses to continue to the CDs, in spite of a change in the shareholding, where company's resolution plan is approved under the IBC.

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<sup>4</sup> [2018] 302 CTR 213 (SC)



### **Transfer of shareholding**

The IT Act provides for fair value taxation in case of transfer of shares of a company at less than the FMV of such shares computed as per tax rules. Similarly, for the transferee, the shortfall between the FMV and the actual consideration is deemed as income and taxed at the applicable tax rate.

The FMV of the shares of the company going through insolvency proceedings is likely to be below the FMV and will result in tax implications in the hands of the transferor and transferee. Any additional tax on the account of the resolution will directly impact the resolution process. The Finance Act, 2020 and the Rules notified thereafter, provided for relaxation from aforesaid taxability on unquoted shares in the hands of the transferor and transferee under the IBC. A similar exemption should be provided for listed companies and their shareholders/ investors under these provisions.



## Special Stressed Fund - Alternative Investment Fund



## Special Stressed Fund - Alternative Investment Fund

SEBI vide press release<sup>5</sup> dated 28 December 2021 had decided to introduce Special Situation Funds, a sub-category under Category I AIF, which shall invest only in 'stressed assets' such as:

- Stressed loans available for acquisition in terms of RBI (Transfer of Loan Exposures) Directions, 2021 or as part of a resolution plan approved under IBC
- SRs issued by ARC
- Securities of companies in distress.
- Any other asset/security as may be prescribed by the Board from time to time

The framework for SSF will require the SSF to have a minimum corpus of INR 1 billion, accept investments of not less than INR 100 million from regular investors and INR 50 million from accredited investors, and have checks and balances to stop promoters of defaulting companies from making a backdoor entry. SSF will also be exempted from investment concentration norms in a single investee company and no restriction on investing their investible funds in unlisted or listed securities of the investee company. Initial and continuous due diligence requirements mandated by RBI for ARCs' investors shall also be applicable to SSFs while acquiring stressed loans in terms of RBI (Transfer of Loan Exposures) Directions, 2021.

Pursuant to the above, on January 24, 2022, SEBI has notified amendments to the AIF Regulations to include SSFs as a sub-category of Category - I AIFs (as further supplemented by circular dated January 27, 2022). The amendments are primarily included as a new Chapter (i.e. Chapter III-B) within the AIF Regulations and define SSFs as Category - I AIFs.

SEBI chairperson, Ajay Tyagi mentioned that 'With the potential to attract a lot of capital, AIFs can be a suitable vehicle to channel funds from sophisticated investors, individual and institutional, to purchase distressed loans from banks and NBFCs'.

Presently, there are few Special Situation funds, registered with SEBI at Cat II AIF. We have provided below a comparative of the current SSF - Cat II AIF and new SSF – Cat I AIF.

Particulars	Current SSF - Cat II AIF	New SSF - Cat I AIF
Investments into	Mainly unlisted companies	i. Stressed loans available for acquisition in terms of RBI (Transfer of Loan Exposures) Directions, 2021 or as part of a resolution plan approved under IBC 2016; ii. SRs issued by ARC iii. Securities of companies in distress; iv. Any other asset/security as may be prescribed by SEBI from time to time
Minimum corpus	INR 20 crore	INR 100 crore
Minimum Investment by investors	INR 1 crore and no limit in case of an accredited investor	INR 10 crore and INR 5 crore in case of an accredited investor
Investment concentration norms	Not more than 25% of the investible funds in an Investee Company	No criteria
Listed Securities	Yes – 49% or less	Yes - No limit restriction

<sup>5</sup> PR No.38/2021





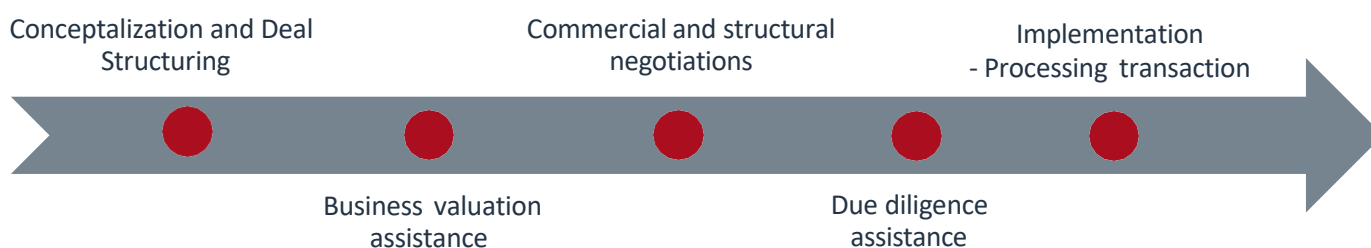
## Stressed Asset Opportunities - How we can help

# Stressed Asset Opportunities - How we can help

Nangia Andersen team is equipped to provide support in the following areas:

Entry Strategy
Advisory on Indian market and regulatory requirements, Structuring etc.
Investment Banking
<ul style="list-style-type: none"> <li>Deal sourcing - Potential target identification and discussion with identified targets</li> <li>Deal Support &amp; executive assistance</li> <li>Fund Raising - Venture funding; private equity placement; structured finance and acquisition finance</li> </ul>
Merger & Acquisition
Corporate and business restructuring involving business consolidation and/or disinvestment, Advice of demerger vs slump sale, Tax implications for buyer seller and shareholders, Assistance in Purchase Price allocation, Implementation of the scheme and obtaining court & ROC approval
Valuation
Enterprise valuation, Intangibles, Land & Building, Plant & Machinery, Financial assets i.e. Shares, NPAs, Security Receipts as per IBC code by Registered Valuer
Due Diligence
Business, Financial, Tax and Regulatory diligence
IBC
Structuring of the resolution plan, Preparation of resolution plan and bids, IBC documentation, Co-ordination, Negotiation & Transaction Closure and Transaction management
Forensic Services
Forensic Audits, Asset Tracing, Fraud Risk Assessment, Investigative Due Diligence, Cash Flow Monitoring, End use monitoring, ABAC reviews etc.
Tax and Regulatory Services
<ul style="list-style-type: none"> <li>Tax and regulatory aspects of investments into Stressed Assets</li> <li>Registration with RBI &amp; SEBI for ARC, NBFC &amp; AIF respectively</li> <li>Tax efficient structure for acquisition and repatriation of profits/ capital to home country</li> <li>GST related matters</li> </ul>

## Our comprehensive end-to-end approach





## Meet our Experts



**Rakesh Nangia**  
Chairman



**Sunil Gidwani**  
Partner - Financial services  
and Transaction Advisory



**Vishwas Panjiar**  
Partner - Insolvency and  
Transaction Structuring



**Srinivasa Rao**  
Partner - Risk Advisory



**Chirag Nangia**  
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