Analysis

SEBI Introduces Special Situation Funds: Opens doors for acquisition of stressed loans without ARC intermediation

Key Takeaways

- Special Situation Funds (SSF) have been launched Category – 1 AIF for sophisticated investors.
- Offshore investors no longer have to rely on an Asset Reconstruction Company / Asset Reconstruction Trust framework to invest in stressed assets.
- 25% diversification requirement not applicable to SSF.
- Ability to buy loans directly, not restricted to 'securities'.
- Edge over ARTs - allowed to act as resolution applicants in IBC, acquire uncapped equity of stressed borrowers, and no FPI registration required to invest.

Background

One of the biggest challenges faced by offshore funds wanting to invest in bad loans in India was necessary intermediation by a third party Asset Reconstruction Company (***ARC***). In most cases, the structure involved the ARC sponsoring and managing an asset reconstruction trust (***ART***), which acquired such bad loans from the funds received by the issue of security receipts. Setting up an in-house ARC wasn't feasible in most cases due to high regulatory requirements such as capital adequacy norms – most likely driven by the regulatory intent that ARCs should rather act as asset managers for ARTs than manage assets on their own books. ARCs and SR holders were also not always aligned on the governance and enforcement mechanics of the loans acquired. Offshore investors therefore pressed for a regime that allowed them to invest without the need for intermediation by an ARC.

A committee was formed to review the working of asset reconstruction companies (***Committee***), which recommended the creation of special situation funds (***SSF***) in the nature of AIFs as an alternative to ARTs. Premised on the recommendations of this Committee, the SEBI (Alternative Investment Funds) Regulations, 2012 have been amended and notified on January 24, 2022[1] (***Amendment Regulations***) to introduce special situation funds as a new sub-category under Category I AIF.

In September 2021, the Committee recommended as follows:

> "*Given the limitation of traditional sources of financing for ARCs, the Committee recommends that, going forward, ARCs should be allowed to sponsor an AIF. All categories of AIFs have already been specified as QBs. Allowing an ARC to*

[1] No. SEBI/LAD-NRO/GN/2022/68, dated January 24, 2022.

sponsor and set up an AIF, duly registered with SEBI with the objective of investing in stressed assets could address the above constraints and provide an additional investor base including HNIs and improve the ability of the ARC to effectively reconstruct the debt and also turn around the borrower. This would be in the interests of the SR investors and the economy. Further, there would be increased flexibility in restructuring options, given that investments to debt/ equity may be funded directly from the AIF. Using the AIF as a source can help ARCs in raising funds in a risk mitigated manner (in line with other AIFs) based on their performance track record and help in turning around many stuck cases. The objective is to use the AIF as an additional vehicle to advance the purpose of the ARCs to facilitate restructuring/ recovery of the acquired debt. For revival of stressed companies, the ARCs may need flexibility to arrange the financial assistance from banks and FIs and additional capital for revival. Accordingly, an ARC should be allowed to set up an AIF which can subscribe to SRs issued by the trust set up by it and also invest in such companies for which debt has been acquired by the ARC for securitisation. As per Section 10(2) of Act, ARCs may undertake activities other than the permitted businesses, only with the prior approval of RBI. The Committee recommends that RBI should exercise the powers granted under Section 10(2) to allow ARCs to set up AIFs which should be registered with SEBI."

Interestingly, SEBI has gone a step further and enabled a regime for SSFs which does not require an ARC to be a sponsor. In this article we analyse the SSF regime, its likely implications, and potential structures going-forward.

The Change – Introduction of the SSF Regime

The SSF regime has sought to create a less cumbersome avenue for investors looking towards the stressed assets market in India. An SSF can conceptually do 2 main things: (a) invest in 'special situation assets', and / or (b) act as a 'resolution applicant' under the IBC.

Special situation assets have been defined vide the Amendment Regulations to include the following:

(i) stressed loans[2] available for acquisition[3];
(ii) SRs issued by an ARC;

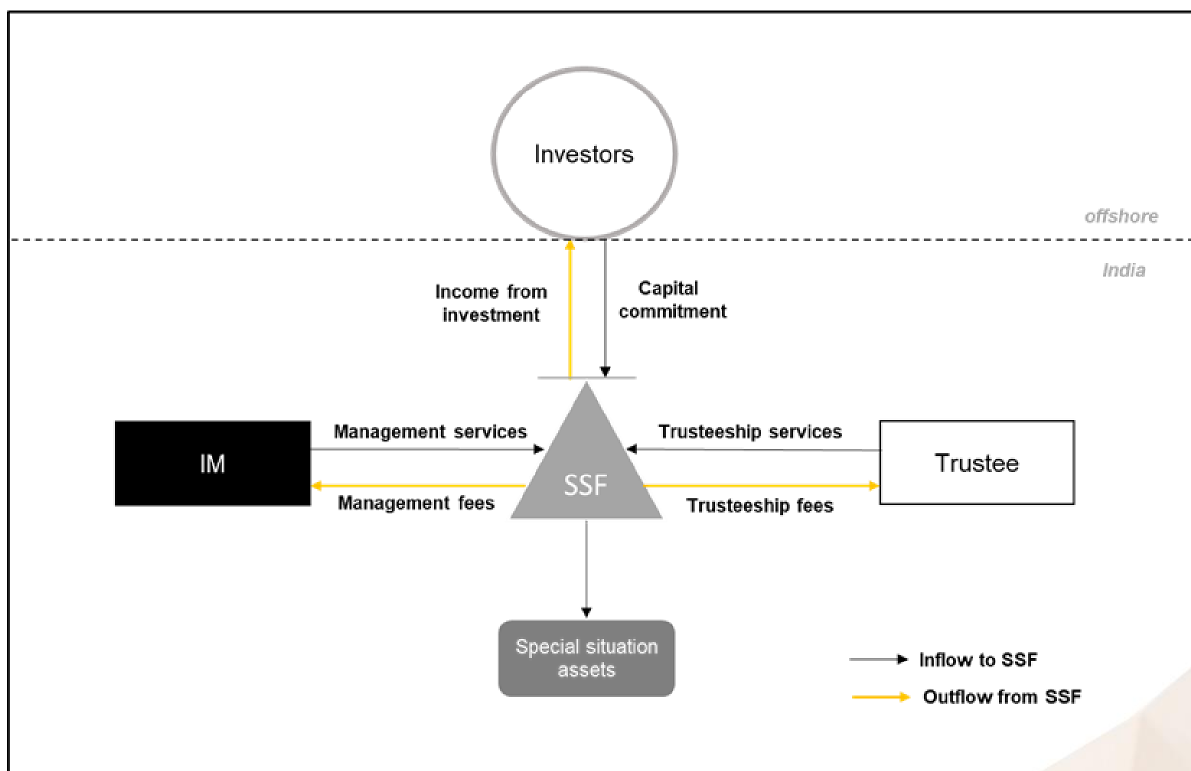
[2] Loan exposures classified as Non-Performing Assets (***NPAs***) i.e., an asset which has ceased to generate income for the bank, or as Special Mention Accounts (***SMAs***) i.e., an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of her debt obligations (though the account has not yet been classified as NPA).

[3] As per (a) the terms of Clause 58 of the Master Direction – RBI (Transfer of Loan Exposure) Directions, 2021, or (b) as part of a resolution plan approved under the IBC, or (c) in terms of any policy issued by the RBI or the Government of India.

(iii) Securities of investee companies - either whose stressed loans are available for acquisition in accordance with (i), or against whose borrowings SRs have been issued by an ARC, or whose borrowings are subject to corporate insolvency resolution process under Chapter II of the IBC and the credit rating of the financial / credit instruments / borrowings have been downgraded to "D" or an equivalent ranking, or whose who have disclosed a default which is continuing for a period of at least 90 days after the event of default and credit rating of the financial / credit instruments / borrowings have been downgraded to "D" or an equivalent ranking.

(iv) Any other assets as the Board may specify.

Structurally, the mechanism for investing in special situation assets via an SSF could be as follows:



The AIF Regime Thus Far

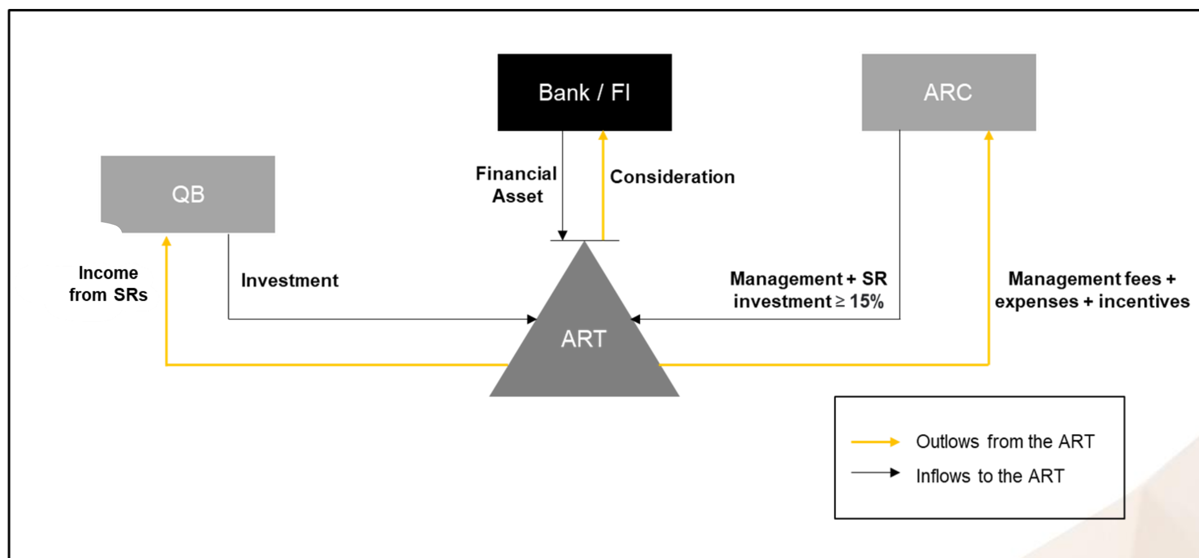
Earlier, AIFs could only invest in commodities and 'securities', as defined under the Securities Contracts (Regulation) Act, 1956, and not loans[4]. While a debt fund, which is a Category–II AIF, could invest in debt securities of listed or unlisted investee companies or in securitized debt instruments, this was as close as an AIF could get to acquiring debt. To that extent, the new regime wherein SSFs are allowed to directly acquire loans could be a gamechanger.

[4] SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021.

The ARC Framework

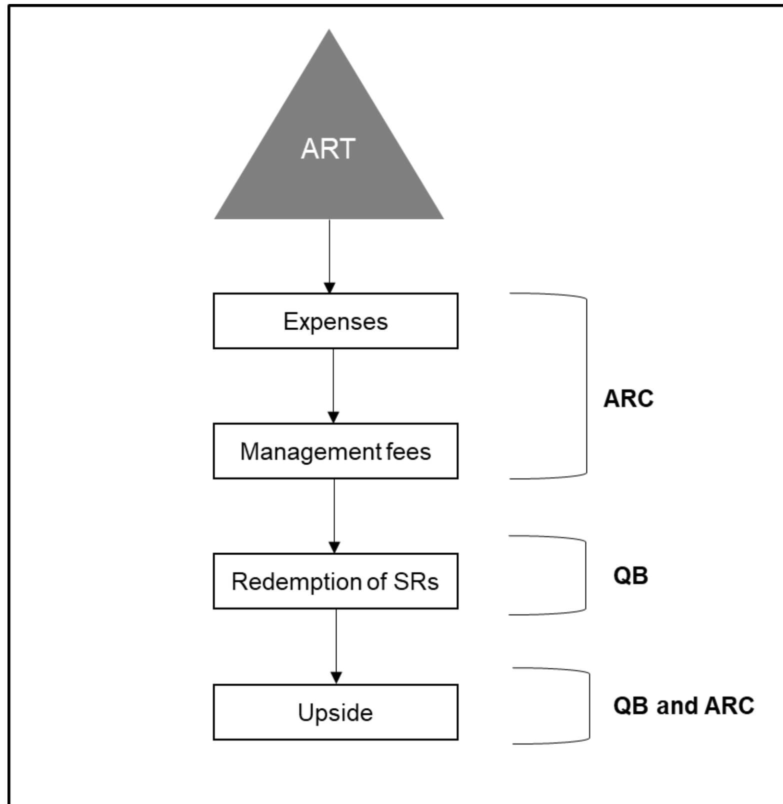
Prior to the introduction of the SSF regime, only 'permitted transferees' were allowed to acquire stressed loans. As per the RBI (Transfer of Loan Exposures) Directions, 2021 – this category included scheduled commercial banks, all India financial institutions (NABARD, NHB, EXIM Bank, and SIDBI), small finance banks, all non-banking finance companies (including housing finance companies) and ARCs. Out of these, ARCs have historically occupied centre stage in the private market for loan acquisitions.

ARCs were introduced with the objective of helping banks and financial institutions manage their stressed assets by reducing the non-performing assets on their books. They did this either by acquiring financial assets on their own company books, or in the books of an ART set up for the purpose of securitisation / reconstruction. However, the SRs issued by these ARTs, which were backed by such loans, could only be acquired by financial institutions, insurance companies, banks, state financial corporations, state industrial development corporations, ARCs, and asset management companies investing on behalf of mutual funds or registered foreign institutional investors (***Qualified Buyers*** or ***QB***). In the context of offshore funds, the investing entities had to be registered as FPIs to invest in SRs. The structure was usually as follows:

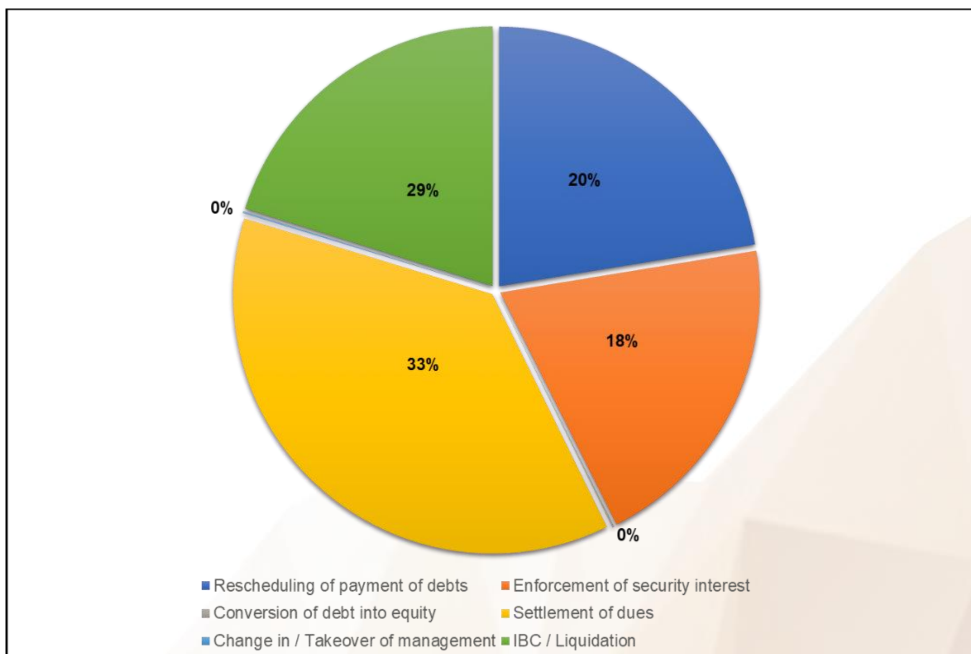


The amount of outflow from the ART is a function of the ARC's restructuring efforts. The first level of payments made by an ART is towards expenses, managements fees and incentives to the ARC itself, this is followed by redemption of the SRs held by the QBs (ARCs also qualify as QBs, since they are required to hold a minimum of 15% of SRs). The remaining funds are then allotted to the QBs and ARCs as per agreement between them.

The diagrammatic waterfall of the outflow is as follows:



However, data indicates that the performance of ARCs in revival of businesses has been unsatisfactory. The following chart indicates the methods of reconstruction deployed by ARCs during the financial years 2004-2021[5]:



[5] Data as per Report of the Committee to Review the Working of Asset Reconstruction Companies, Reserve Bank of India, dated September 2021.

While ARCs have managed to maintain some relevance by virtue of their unique position as private sector led institutional framework for handling / resolution of stressed assets, the commercial disincentives are underpinned by some foundational complications.

1. *No revivals.* ARCs seem to have lost the plot of ensuring revival of businesses. The effectiveness of asset reconstruction efforts is a function of the amount of SRs redeemed and upside earned. During a period of 9 years[6], the total redemption of SRs weighed against the total SRs issued, setting the overall recovery made by the sector at roughly 68.6%. However, if redemption is measured as a factor of the book value of the assets acquired, the figure drops to 14.29%. Data indicates that roughly 80% of recovery efforts in the sector have not resulted in revival of businesses.

2. *Limited funding flexibility.* Turnaround of stressed borrowers requires liquidity but raising and maintaining a steady flow of funds becomes difficult due to adverse asset classification of the defaulter accounts. Banks and institutional lenders are unlikely to lend funds given the stressed nature of the borrower, which unwillingness is only exacerbated by the unlikely assurance of return. Additionally, ARCs have restrictions on the amount of restructuring support finance they can provide (capped at 25% of funds raised under a scheme). An SSF will not be subject to any such restrictions – and as such, have a relatively higher potential to infuse the volume of funds required, at the frequency required.

3. *Inability to acquire equity.* A restructuring exercise involving a debt-to-equity conversion would result in the lenders acquiring equity in the borrower company, in addition to the debt. However, under the current regulatory and legal framework, the effectiveness of ARCs is sub-optimized due to their inability to acquire equity of the borrower company. Conversely, SSFs have been permitted to acquire both debt and equity of a stressed company without any restrictions.

4. *Can't participate in IBC.* The current regulatory and legal framework does not specifically permit ARCs to act as Resolution Applicants (***RA***) under IBC, leaving a grey area in their participation (since courts have allowed them in the past). The rationale being that the legal and regulatory design of ARCs is focused on recovery of debt from the borrower and not on resolution of the borrower's insolvency. In contrast, SSFs have been specifically permitted to act as RAs, which can be instrumental in investors' efforts to take the asset private, rather than be subject to the discretion of the committee of creditors (***CoC***) under the IBC.

5. *Restrictions on sale / lease of businesses.* While the SARFAESI Act provides for the sale or lease of a part or whole of the business of the borrower as a measure for asset reconstruction, RBI guidelines indicate that no ARC shall take this measure until the RBI issues necessary

[6] Financial Year 2004 to Financial Year 2013.

guidelines in this behalf (which have not yet been issued). No such restriction on sale or lease of business will apply to an SSF, thus opening up additional fund streams and giving the SSF an edge to reconstruct the asset in the most appropriate way it deems fit.

6. *Sub-optimal enforcement regime under SARFAESI.* SARFAESI Act allows 'secured creditors' to enforce security interest only in respect of assets classified by them as NPAs. While RBI has issued guidelines on asset classification of stressed assets on the ARCs' own balance sheets, it has not issued any such guidelines on asset (specifically NPA) classification of assets held in trust structures managed by the ARC, such as the ARTs. There is a regulatory lacuna here which could significantly hamper the way ARCs enforce security interest, specifically for assets held by the ARTs. While SSF's may not be entitled to benefits under SARFAESI, and this can act as a deterrent; on a comparative, the efficacy of enforcement benefits available to an ARC have not been very effective either. At best, there is a marginal opportunity cost in this respect.

7. *Value leakage.* ARCs are mandatorily required to hold a minimum of 15% of security receipts; while this was done to ensure the ARC has 'skin in the game' and hence acts in the best interest of investors and investing lenders, this results in value leakage for investors, which inhibits sophisticated investors who have the risk appetite and willingness to access 100% of security receipts, from investing in ARTs.

8. *Dependence on ARC.* Enforcement and ability to control the assets is hinged on support from the ARC, which historically has not always been the most forthcoming. Only in the event of non-realisation of the assets for a period of 8 years, do the qualified buyers (holding at least 75% of the total value of security receipts) get to call a meeting of all the qualified buyers and pass a resolution binding on the ARC.

9. *Debt aggregation.* There are often situations where multiple ARCs acquire different parts of sub-standard assets of a single borrower – leading to multiple ARCs, and multiple ARTs, holding dispersed portions of the same borrower's assets for different QBs. It would be significantly more efficient to bring all the assets of a common borrower under the control of a single ARC/ART. However, if an attempt is made to consolidate the debt in one ARC, the ARC is required to mandatorily redeem the SRs from the sale proceeds. The ARC is not permitted to transfer the assets without redemption of the SRs. Such redemption requirement prevents the ARCs from having the flexibility to transfer the assets and achieve the benefits of aggregation. There is no corresponding requirement for an SSF aggregating debt, which allows SSFs the flexibility to transfer stressed assets if it is expedient to do so. SSFs, however, and importantly so are locked-in from transferring the stressed assets for a period of 6 months.

Comparative analysis

At a practical level, a comparative analysis of both routes is as follows:

Factor	ART	SSF	Implication
Incorporation and registration	Must be sponsored by an ARC. Hence, investors must find an ARC to collaborate with.	An offshore fund can itself be the sponsor. No need for an ARC or any other regulated entity.	Setting up an SSF is much easier than incorporating an ARC. There are no capital adequacy norms, and the regime has limited regulatory supervision and reporting requirements.
Type of assets	Financial assets[7], though enforcement entitlements are limited to NPAs	Special Situation Assets	
Investor	Qualified Buyers	No restriction	Foreign investors had to take an FPI registration to invest in SRs, which won't be required to invest in an SSF. However, SSFs require a minimum investment of INR 10 cr or INR 5 cr if the investor is an accredited investor (as per AIF regulations)
Corpus	≥ INR 100 crores (~USD 1,32,28,390)	≥ INR 100 crores (~USD 1,32,28,390)	
Manager / sponsor's investment in the scheme	≥ 15% of SRs	not less than 2.5% of the corpus or five crore rupees, whichever is lesser (~USD 661,695).	Minimal value leakage

[7] "*financial asset*" means debt or receivables and includes— (i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or (ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or (iii) a mortgage, charge, hypothecation or pledge of movable property; or (iv) any right or interest in the security, whether full or part underlying such debt or receivables; or (v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or [(va) any beneficial right, title or interest in any tangible asset given on hire or financial lease or conditional sale or under any other contract which secures the obligation to pay any unpaid portion of the purchase price of such asset or an obligation incurred or credit otherwise provided to enable the borrower to acquire such tangible asset; or (vb) any right, title or interest on any intangible asset or licence or assignment of such intangible asset, which secures the obligation to pay any unpaid portion of the purchase price of such intangible asset or an obligation incurred or credit otherwise extended to enable the borrower to acquire such intangible asset or obtain licence of the intangible asset; or] (vi) any financial assistance;

SARFAESI Enforcement benefit	Available	No benefit available to an SSF	SARFAESI regime for ARCs is not very efficient, as explained above. Besides, in most cases, SARFAESI is superseded by IBC, and SSFs may have an edge in the IBC process as they qualify as RAs.
Ability to convert debt into equity	ARCs have the ability to convert debt into equity. However, the shareholding of the ARC / ART shall usually be ≤ 26% of the sectoral FDI limit.	No restriction on conversion of debt into equity, this allows the SSF a significant upside as they have the ability to take complete control of the company. This can translate into efficient restructuring, such as through IBC.	SSFs can act as alternate capital vehicles with the ability to own the entire asset (entire equity + debt), giving them greater flexibility to finance and turn around the stressed borrower.
Resolution applicant	While there is no provision that allows an ARC to be an RA – courts have accepted resolution plans submitted by ARCs in the past.[8] There appears to be a statutory grey area when it comes to ARCs acting as RAs under IBC.	Specifically permitted to be RA	SSFs have a significant edge to credit bid or otherwise acquire assets as an RA in IBC.
ROFR	Right of first refusal (***ROFR***) is available for an ARC - essentially, a bank offering stressed assets for sale shall offer the first right of refusal to the ARC which has	No right of first refusal is available for an SSF. Therefore, ARCs have a relative advantage in undertaking debt aggregation.	SSF may lag in its ability to aggregate debt. Debt aggregation helps in having a greater say in the CoC at the resolution stage.

[8] R. Velu v. Palm Lagoon Backwater Resorts Private Limited (MA/113/KOB/2020 in TIBA/9/KOB/2020) (CP.1312 of 2018 of Chennai Bench); Bank of India v. Aparant Iron and Steel Private Limited (MA 2960 of 2019 in CP No.2859/I&BC/MB/MAH/2018).

	already acquired the highest and significant share (~25-30%) of the asset.		

Way forward

Covid-19 saw a slew of companies with good promoters fall into a cash trap and come under stress. There is significant interest in offshore funds to participate in the credit secondaries of such companies so as to provide them with high yield rescue financing. Strategies such as these have the ability to turn around stressed borrowers and bring them back to profitability. However, there is a need to allow for flexibility to structure tailor made solutions involving different avenues of capital infusion across debt, equity and mezzanine funding. The current ARC / ART framework did not offer such flexibility, and hence, despite interest from global sponsors of special situation funds / credit funds, the credit secondary market for bad debts could never take off.

The introduction of an SSF framework opens possibilities for companies which have good promoters, and revival potential, but are stuck in debt traps. The regime significantly deregulates a rather stringently regulated space and might appear inviting for a much larger pool of offshore investors. There may be a few tax concerns, which we will discuss separately in a follow up to this Analysis. However, the SSF regime seems to check most of the boxes that the investors wanted. Hopefully, a similar disintermediated regime could also be initiated to allow FPIs to directly buy stressed assets, and probably a similar regime to also allow for AIFs and FPIs to acquire standard assets.

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