Article

ARCs can convert Debt to Equity

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In a market where loans are getting sticky, banks are desperate to offload their stressed assets and are under constant pressure to improve their balance sheets it seems the only business that is to flourish is that of ARCs. Revival of a bad loan market[1] means lot of business of ARCs.

While the regulators seem to be constantly battering the banks and financial institutions to pull up their socks and salvage the sunk money, ARCs and banks have been at loggerheads on cut-off prices.

To facilitate banks to jettison the bad loans, RBI vide its recent notification[2] dated 23rd January, 2014 has permitted ARCs to convert debt of crisis driven companies into equity as a part of restructuring process and came pursuant to the amendments in SARFAESI Act, 2002 and recommendations of Key Advisory Group constituted by Government of India on ARCs.

As per the notification, RBI has advised that a *portion of the debt can be converted into equity* provided that their shareholding does not exceed 26% of the post converted equity of the company under construction.

Other amendments mentioned in the notification related to reduction in the threshold of consent from secured creditors for enforcing security interest reducing from 75% to 60% and the conditions for acquisition of debt from other SC/RCs.

While RBI does not specify what portion of the debt can be converted into equity, the cap is on acquisition of not more than 26% of the post conversion equity capital. On a bit of reflection ARCs still can hold 25.9% of equity in the borrower company and surely this can cause hindrance on passing of any special resolution in the company.

The amendment[3] in the SARFAESI Act, 2002 which inserted clause 9 (g) into the Act, whereby a portion of the debt could be converted into '*shares*,' the RBI directions indicate that the post conversion holding should not exceed 26% of equity holding. Reading the amendment in the Act and the insertions in the directions one may conclude that the entire debt may be converted into equity or preference shares provided the post conversion equity holding does not exceed 26%.

The notification does empower the ARCs to have certain power in the company, but what would be the motivation to convert the debt into equity?

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[1] The NPA level for 40 listed banks was at Rs. 2.22 lac crores almost 10.2% of their advances and higher by 36.9% from the last year.

[2] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8707&Mode=0

[3] http://www.prsindia.org/uploads/media/Enforcement/Enforcement%20of%20Security%20Interest%20and%20Recovery%20of%20Debts%20Laws%20Amendment)%20Bill%202011.pdf

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ARCs issue security receipts who would expect returns on recovery of the loans. If these receivables were to be converted into equity it may not be acceptable to the security receipt holders to expect dividends from the company or wait till the company regains its value, atleast not at the same rate of return offered to the security receipt holders. In such cases the ARCs may also be required to buy back the security receipts which would lead to crunch in the funds availability of the ARCs.

The notification may not dampen the borrowers spirits in terms of the damage caused but surely does not excite the ARCs either. The borrower's account was classified NPA owing to its inability to service the debt and now the ARCs would hold stake in such ship which is already showing signs of sinking!

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