Role of ARCs in NPA Resolution
Progress So Far and Future Strategy

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ARCs in India
The foremost cause for emergence of ARCs in India was the implementation of prudential norms which exposed the seriousness of Non Performing Assets (NPAs) in the banking system to the external world. Further, the Narasimham Committee Report also reiterated the need to pay focused attention on NPAs and suggested creation of an ‘Asset Recovery Fund’ with the objective of isolating NPAs from the financial system, freeing the banks / FIs to concentrate more on their core activities and facilitating development of market for distressed assets. The concept of ARC has gained further importance in the light of enactment of SARFAESI Act, 2002.

Internationally, the bankruptcy codes and effective legal mechanisms ensure speedy disposal of stressed assets in the normal course and thus ARCs came into existence as special purpose vehicles to resolve systemic crises. However, the ARC experiment in India is distinctive as ARCs were set up as perpetual entities to fix NPAs resulting mainly from corporate lending coupled with inability of the judicial system to adjudicate the matter speedily.

The broad functions of ARCs in India are acquisition of financial assets, change or takeover of management, sale or lease the business of the borrower, rescheduling of debts, enforcement of security interest and settlement of dues payable by the borrower. It is a market-driven model that allows banks to take their own decisions to sell bad loans to ARCs, based on bilateral negotiations and / or auctions. The present model does not envisage any fiscal support or tax forbearance from the government. When a bank sells stressed assets to an ARC, the bad loan moves out of the bank’s book and becomes a standard investment against Security Receipt (SR) under Available for Sale (AFS) category, thus freeing the bank from making a provision against the loan resulting in improved profit. ARCs form trusts to acquire assets from banks and financial institutions and the maximum life of these trusts can be five years, which is extendable up to eight years, with the board’s approval. Trust becomes the legal owner of the asset and SR holders become its beneficiaries. The trust redeems money to the investors in proportion to the recovery from underlying assets. The SRs are rated by external agencies and quarterly NAVs are published.

The main source of ARC revenue is from the surplus generated from recovery over the acquisition cost. Out of the above, ARCs keep around 20 percent as management incentive and the rest is distributed to holders of SRs. ARCs charge a fee of 0.5 to 2 percent of the asset’s value as management fee.

Performance of ARCs
As on 31st March 2015 there are 15 ARCs operating in India out of which five are functioning as private companies. It is reported that so far all the ARCs put together have acquired assets worth INR 1.90 lac crore for INR 63000 crore at 67 percent discount. As per the Financial Stability Report 2015, the discount rate has been coming down in the recent years and stood at 58 percent in 2015. The business handled by the ARCs in the recent years is furnished in Table 1. Though, there is a reasonable good growth in operations of ARCs, the revival process is taking inordinate delay, say, beyond five years, coupled with tardy recovery rate (12% of acquisition cost) which is a cause of serious concern. Further, the cumulative redemption ratio of SRs since inception stood at 53 percent only which is far below the expected level.
ARCs – Opportunities

- With the slowdown of the global economy, a number of companies / projects are under stress and as a result, the lenders are saddled with stressed assets (NPAs and Restructured loans). The estimated stressed assets are about 15 percent of total credit portfolio of the banking industry at the end of March 2016.

- RBI has announced a host of measures since 2013 that have fuelled distressed asset sale business: tightening the Corporate Debt Restructuring (CDR) mechanism, setting up a Joint Lenders’ Forum (JLF), pushing banks to disclose the real picture of bad loans, advising them to increase provisioning for stressed assets, introducing 5:25 scheme where loans are to be amortised over 25 years with refinancing option after every five years, empowering them to take majority control in defaulting companies under the Strategic Debt Restructuring (SDR) scheme and allowing the banks to sell even the loans where the principal or interest was overdue by 60 days compared to 90 days earlier.

- However, the biggest trigger is the recent RBI guidelines to the banks to clean up their balance sheets by March 2017 which forced the banks to approach ARCs to sell part of their stressed asset portfolio.

- Of late, global investors are showing interest in ARCs which is a positive sign for the industry as they provide transfer of technical knowledge, information and capabilities, which definitely paves the way to handle complex cases with ease and confidence.

ARCs – Challenges

Typically ARCs undertake two important activities viz, Resolution and Recovery. Resolution is more of aggregating debt, infusion of capital, identification of non-core assets and bringing in a strategic partner. Of late, the units coming under resolution process are coming down and found not feasible for reconstruction within short or medium term. Thus, ARCs largely focus on recovery process by liquidating the assets. In this context, ARCs are confronting the following challenges which need to be addressed on priority.

- The recent guidelines require the ARCs to pay 15 percent upfront (earlier 5%) which has direct bearing on the operations of the ARCs as they are operating with low capital funds. At present, the options available to ARCs are limited as the fragmented ownership is coming in the way to attract foreign capital and unable to raise money from public as legal issues remain the biggest hurdle for the recovery of NPAs. The ability of the ARCs to raise capital will now become a key differentiator.

-ARC industry opines that banks should lower the reserve price as they are paying 15 percent upfront while acquiring the asset. Banks, however, are not ready to buy this logic as the value of the asset does not come down irrespective of upfront fee. Pricing always remains a bone of contention for the sale of bad assets and the best way to address this could be a recovery rating of such assets before they are sold, instead of rating them later.

- ARCs have successfully reconstructed several large accounts, and have demonstrated their ability to recover dues through asset sales. But recovery levels and the cumulative redemption ratio of SRs is not encouraging.

- Currently, ARC officials are not allowed to visit the factories of a company offered as a security of the loans that are being sold. Unless they get a sense of the value of the securities, how would they make a fair offer to buy them? Thus, there is need to have a fair practice code both for the banks as well as ARCs to make the business a success.

- PSBs are scared to sell their assets to private ARCs for fear that the quantum of hair cut can always be questioned by the Government, Regulator and investigation agencies (CBI/CVC) at a later date.

Despite challenges, the ARCs remain enthusiastic to be in the business due to increased pile of stressed assets around INR8 trillion as on 31st December 2015 and the major chunk of these assets are likely to be made available to ARCs for sale in the ensuing years. While the banks are being pushed by the regulator to clean up their books, ARCs see it as a business opportunity.

Critics are of the view that today banks found ARCs as a safe route to suppress their NPAs by shifting from ‘Loan Book to Investment Book’ since SRs are treated as security under AFS. There are instances where defaulters are buying back from the ARCs the underlying securities of the loans at cheaper rate through back-to-back arrangements.

Table 1: Sale of Stressed Assets by Banks to ARCs

<table>
<thead>
<tr>
<th>Year</th>
<th>Acquisition price in crore</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009-10</td>
<td>1800</td>
</tr>
<tr>
<td>2010-11</td>
<td>2000</td>
</tr>
<tr>
<td>2011-12</td>
<td>1200</td>
</tr>
<tr>
<td>2012-13</td>
<td>2100</td>
</tr>
<tr>
<td>2013-14</td>
<td>20585</td>
</tr>
<tr>
<td>2014-15</td>
<td>22658</td>
</tr>
</tbody>
</table>

Source: Business Today – August 2015 issue
**Table 2: Percent of total advances vis-à-vis stressed assets – Sector-wise**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total Advances (%)</th>
<th>Stressed Assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>15.00</td>
<td>29.80</td>
</tr>
<tr>
<td>Iron &amp; Steel</td>
<td>4.50</td>
<td>10.20</td>
</tr>
<tr>
<td>Textiles</td>
<td>3.40</td>
<td>7.30</td>
</tr>
<tr>
<td>Mining</td>
<td>1.30</td>
<td>1.40</td>
</tr>
<tr>
<td>Aviation</td>
<td>0.50</td>
<td>2.40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>24.70</strong></td>
<td><strong>51.10</strong></td>
</tr>
</tbody>
</table>

*Source: RBI Reports*

**ARC Bank (Bad Bank)**

RBI reports on sectoral data (June 2015) indicate that among the broad sectors, industry continued to record the highest stressed advances ratio of about 19.50 percent, followed by services and retail with 7 percent and 2 percent respectively. In terms of size, medium and large industries each had this ratio at 21 percent, whereas it is 8 percent in the case of micro industries. Out of total INR 11 lac crore stressed assets of the banking system, around INR 5.50 lac crore pertains to the sectors shown in Table 2.

Infrastructure sector has been in the lime light over the years on account of its importance from the point of its share in total credit portfolio of the banking industry as well as its present share in stressed assets too. This sector is confronting structural issues such as legal and procedural hurdles in land acquisition, delays in permissions and uncertainties in planning and execution of the projects. These issues coupled with long gestation period have direct bearing on the timely repayment of loans due to mismatch in cash flows.

Going forward, further credit flow to infrastructure sector, which is vital for economic development, is likely to be constrained due to the growing trend in stressed assets. Thus, it should be of utmost priority for all the stakeholders to resolve this issue at the earliest both in terms of kick-starting viable stalled projects and finding alternate funding sources.

The recent SDR provisions issued by RBI (June 2015) allows the banks to convert debt into equity in defaulting companies. Post conversion, banks have 18 months time to find new buyers for their stakes. Since in many SDR cases, the deadline is coming closer, the pressure on banks to find buyers is increasing. Banks are primarily interested in containing their losses and not on making money and this is what is attracting Private Equity (PE) investors. Hope there will not be any regulatory hurdles as the government and RBI are also interested in cleaning up the banking system.

There are some comments on the rise of bad loans especially in PSBs attributing for their reckless lending without looking into viability of the projects. However, the fact remains that all these bad loans are not because of bad banking but also due to contagious effect of global meltdown and steady slowdown of the Chinese economy coupled with increased incidence of stalled projects, delayed policy decisions, economic slowdown, macro factors related to supply and demand and mismanagement.

Stressed assets affect profitability of the banks in two ways viz, loss of interest income and increased provisioning on these assets. Data over the last few quarters indicate that severity is more in PSBs than Private Sector counterparts. This lowers the ability of banks to lend to borrowers that genuinely require capital to expand their businesses, which would create economic activity and jobs. In addition, this may translate into a higher burden for taxpayers in the broader economy. Further, the systemic risk of a contagion due to large scale defaults would be disastrous for the economy.

Globally, entities tackling bad assets are formed as a response to a systemic crisis to protect commercial banks by creating one ‘Bad Bank’ that takes over the stressed loans of the entire system. Typically, governments provide legal, regulatory, fiscal and administrative support to such institutions. The aim of creating such an entity is to protect the capital of the banking system as banks need to set aside money for bad assets and this erodes their capital.

Presently, the existing operations of majority ARCs are confined to small or medium ticket advances on account of resource constraints. The stressed assets scenario of Indian banking system is posing a unique challenge as the presence of big ticket advances is expected to rise in the ensuing years. Given the scale, complexity and rapid increase of stressed assets, the present model is not adequate and there is an urgent need to look for alternatives.

Currently, the capacity of ARCs to expand operations is limited because of their low capital base. It is reported that the current capitalisation of all ARCs put together is around INR3000 crore only. With the cash component increased to 15 percent of acquisition, the net worth of ARCs would be sufficient to acquire only INR 20000 crore of stressed assets. Assuming that ARCs acquire the NPAs at 60 percent discount of the book value, the capacity of the ARCs to handle is just INR 33000 crore stressed asset portfolio where as the requirement is huge.

Banks can explore the possibility to setup ARC as subsidiary or acquire a joint venture with other ARCs or through a project with other ARCs. While the RBI has barred ARCs from acquiring bad loans from sponsor banks...
on a bilateral basis, it has allowed such transactions if the asset is auctioned in a transparent manner on an arm's-length basis and if prices are determined by market factors.

Against the above backdrop, the government is deliberating on a proposal to set up a 'Bad Bank' with equity contribution from the Government / RBI as consolidation of bad loans can simplify resolutions and allow the banks to focus on lending rather than recovery of stressed assets.

The transfer of NPA s from PSBs to 'Bad Bank' would bring about greater transparency and revive investor confidence in the real book value of bank assets and it enhances access to capital markets at reasonable valuations and addresses the capital related constraints. It would also bring better management in resolving stressed assets and improve the quality of credit portfolio of PSBs to the desired level. Further, it enables the banks to cater the growing credit requirements of the economy, present and future projects, and put the banks on a growth trajectory.

On the flip side - the critics are not comfortable with the idea of government equity in 'Bad Bank' and feared a 'moral hazard'. With a national ARC (Bad Bank), bankers especially PSBs could again be short on due diligence while granting loans as they have the comfort of transferring dud loans to 'Bad Bank' tantamount to 'Old Wine in New Bottle'. This could also make them complacent at initiating needed reforms in credit appraisal and recovery process. Thus, the defaulters are likely to get long rope to circumvent payment of dues on frivolous grounds and finally settle the account with paltry amounts, which is detrimental to the interest of all stakeholders.

It appears that RBI is also averse to the idea of contributing equity to the 'Bad Bank' by the Government / RBI. In this context, the views expressed by Sri Raghuram Rajan, Governor, RBI is worth noting 'there is no need to set up separate Bad Bank to deal with stressed assets of PSBs, as these banks themselves have the backing of the Government. The issue is now clean it up'.

Way forward

ARCs or Bad Banks - be in Private Sector or Joint Venture with banks or owned by Government or RBI, they have no magic wand to revive stressed business units instantly. Mostly they use the bilateral route by working alongside the promoter to de-leverage the business.

It is the fact that ARCs are not business restructuring experts but they are only financial restructuring specialists. Often, bankers hold a grudge against ARCs as they are unable to turn around the units due to limited financial muscle, which leaves little scope for revival.

The performance of ARCs or Bad Banks has direct bearing on the banks as banks will get their money back through redemption of SRs only when ARCs recover the dues or liquidate the assets by auction. If ARCs fail to recover loans, it is merely a book entry of transfer of a junk asset from a bank to an ARC. In order to protect the interests of all the stakeholders, the Government, Regulator and legal system should ensure to make the system to work effectively.

While ensuring better and speedier recovery of loans is undoubtedly important, deeper structural reforms and systemic changes are needed to ensure that the cleaned balance sheets remain clean.

Securitisation, which involves pooling various types of contractual debt and selling their related cash flows to third party investors as securities, is an important tool to improve infrastructure financing. Banks can particularly take advantage of securitisation route for freeing up capital, rebalancing risks and more efficiently to manage their Application Lifecycle Management (ALM).

As per the press reports, it is believed that Government of India proposed to allow 100 percent foreign ownership in ARCs; and offering them tax sops besides allowing single ownership in the trustee firms are the positive moves to built a vibrant corporate bond market. Further, it would also bring in much needed technical expertise, which is critical in enhancing the viability and competitiveness of infrastructure projects.

'Distressed Debt and Securitisation' is the asset instrument of the future. Investors with their detailed knowledge of

Continued on page 46.........................

About the Author

N S N Reddy is currently working as assistant general manager at Andhra Bank. A commerce graduate, he has professional qualifications in CAIIB and PGDBM (NIBM).

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