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ASSET RECONSTRUCTION COMPANIES IN INDIAN BANKING INDUSTRY

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Growing non-performing assets is a recurrent problem in today's Indian banking sector. Asset quality was not prime concern in Indian banking sector till 1991 as banks were mainly focused on performance objectives such as opening wide branches, development of rural banking services by inculcating financial inclusion habits, priority sector lending etc. While the primary function of banks is to lend funds as loans to various sectors of the economy such as agriculture and industry through various types of schemes and projects personal loans but in recent year's banks have become very cautious in extending loans. The reason being mounting nonperforming assets (NPAs) piling on the balance sheets of the Indian banks as such the asset quality of the banks has deteriorated.

At the macro level, rising NPAs have checked off the supply line of credit of the potential lender and thereby having a deleterious effect on capital formulation and arresting the economic activities in the country. At the micro level, unsuitable level of NPA has eroded current profits of banks and financial institutions. The problem of NPA is not a matter of concern for banks and financial institutions alone but it is a matter of concern for the entire public. The factors like unfavorable business cycle, unanticipated shocks such as natural calamities, the RBI lending policy, bad management by banks etc. influence the NPAs in banking sector. *(Shastri, F.C. (2007))*

Bad loans are essentially of two types — those that are a consequence of routine banking operations and those that are a reflection of a greater systematic rot, as in the Indian context where the bulk of non-performing assets (NPAs) are due to government interference/loan waivers/difficulties in recovering dues etc. There are essentially two approaches to tackling NPAs —

- ✓ Leave the banks to manage their own bad debts.
- ✓ Do the same thing on a strenuous, central level through a centralized agency or agencies.

The gross non-performing advances (GNPAs) ratio of Scheduled Commercial Banks (SCBs) increased to 9.1 per cent from 7.8 percent between March and September 2016, pushing the overall stressed advances 4 ratio to 12.3 percent from 11.5 percent. GNPAs of the NBFC sector as a percentage of total advances increased to 4.9 per cent from 4.6 per cent between March and September 2016. NNPAs as a percentage of total advances also increased to 2.7per cent from 2.5 per cent during the same period.

Bad loan crisis of state-owned banks surged 56.4 per cent in the 12-month period ending December 2016. It is set to rise further in the next two quarters with the small and medium sectors struggling to repay the loans after the NDA government's demonetization move in November 8. Despite the Reserve Bank of India (RBI) announcing numerous restructuring schemes, the bad loans have risen up from Rs 261,843cr by 135 per cent in last two years. They now constitute 11 per cent of the gross advances of Public Sector Unit (PSU) banks. In all, the total NPAs including both the public and private sector banks were Rs 697,409cr in December 2016. The figures were compiled by Care Ratings. Five banks have reported gross NPA ratios of over 15 per cent. Indian Overseas Bank's (IOB) gross NPA ratio 22.42 per cent, which means Rs 22.42 out of Rs 100 lent by the bank, will be classified as bad loan. Similarly, UCO bank posted NPA ratio of 17.18 per cent, United Bank of India (UBI) 15.98 per cent, IDBI bank 15.16 per cent and Bank of Maharashtra 15.08 per cent. (*http://www.financialexpress.com).* To rescue the banks from bad loans Asset Reconstruction Companies in India are playing pivotal role by isolating NPAs from the balance sheet of bank and facilitating the latter to focus on normal banking activities. Since 2003, selling loans through auction to ARCs in return for Security receipts became popular with banks.

Asset Reconstruction Company (ARC)/ Securitization Company (SC)/ Reconstruction Company (RC) are centralized agencies for resolving bad loans created out of a systematic crisis. ARC buys up distressed assets from banks and other financial institutions re-package them and then sell them in the market. Non-performing Assets (NPAs) can be assigned to ARCs by banks at a discounted price, enabling a one-time clearing of the balance sheet of banks of sticky loans. At the same time, the ARC can float bonds and recover dues from the borrowers directly. ARCs can have several alternate structures. They can either be publicly or privately owned or a combination of both, and can be either separately capitalized units or wholly-owned subsidiaries. Centralization of bad loans in one or a few hands obviously gives banks more influence and they are left with cleaner balance sheets and do not have to deal with problem clients. ARCs deal with a larger portfolio; they can mix up good assets with bad ones and make a sale which is appetizing to buyers. It is easier to do a capital-market based funding for an ARC than for the banks themselves.

Several countries have tried variants of the ARC. In the Czech Republic (1995), Sweden (1992) and Thailand (1998) the troubled bank was split into a 'good' bank and a 'bad' bank. This approach was probably best when only one or a few banks are in serious difficulty. The alternate approach was used in the United States (1989) during the savings and loan crisis and more recently in Korea (1997) and Malaysia (1998). In India the problem of recovery from NPAs was first time recognized in 1997 by the Government of India the Narasimhan Committee observed that an important aspect of the continuing reform process was to soften the high level of NPAs as a means of banking sector reform. The committee believed that with a mixture of policy and institutional development, rising concern for NPA could be arrested. However, the enormous backlog of existing NPAs continued to chase the banking sector and this interrupted severely on the banks' performance and ultimately their profitability.

Asset Reconstruction Company (Securitization Company / Reconstruction Company) is registered under Section 3 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. It is regulated by Reserve Bank of India as a Non-Banking Financial Company (u/s 45I (f) (iii) of RBI Act, 1934). RBI has exempted ARCs from the compliances under section 45-IA, 45-IB and 45-IC of the Reserve Bank Act, 1934. They will perform like an AMC (Asset Management Company) within the territory of the RBI guidelines.

Performance of ARCs in India:

Unlike in other countries where ARCs are government sponsored or government has direct participation (including the funding support) in operations of ARCs, in India, the Government has minimal participation in the Non-Performing Loan (NPL) resolution process. The Indian ARC model envisages market forces to consolidate and attractively package lender interests, arrange funding for providing clean exit to seller banks and lend focused attention for NPL resolution. ARCs in India have been set up as non-government vehicles with the support from the banking system rather than debt aggregation and funding support under a government owned/supported model. Further, the Indian model envisages setting up of multiple ARCs and funding to be arranged by ARCs on their own. As on 31st March, 2015 there are fifteen ARCs operating in India. (Table 1)

Table 1: List of Asset Reconstruction Companies (ARCs) in India as on 31stMarch, 2015

S.No	Company Name	Logo of the Company
1	Alchemist Asset Reconstruction Company Limited	
2	ASREC (India) Limited	
3	Edelweiss Asset Reconstruction	
4	Asset Reconstruction Company (India) Limited (ARCIL)	
5	Assets Care and Reconstruction Enterprise Ltd	
6	India SME Asset Reconstruction Company Limited	
7	International Asset Reconstruction Company Private Limited	
8	Invent Assets Securitization & Reconstruction Private Limited	
9	JM Financial Asset Reconstruction Company Private Limited	
10	Meliora Asset Reconstruction Company	
11	Pegasus Asset Reconstruction Private Limited	
12	Phoenix ARC Private Limited	
13	Pridhivi Asset Reconstruction and Securitization Company Limited	
14	Reliance Asset Reconstruction Company Limited	
15	UV Asset Reconstruction Co. Ltd	

Source: www.arcindia.co.in.

"The improvement in NPAs during Q4 of 2013-14 needs to be cautiously examined in the face of the increased offload of loans to asset restructuring companies (ARCs) by banks," the RBI said in its Annual Report. Out of Rs 16,960 crore asset sales in 2013-14, Rs 15,470 crore was accounted by public sector banks.

Mega asset sales involving Bharati Shipyard (total debt Rs 8,500 crore sold to ARC for 4570 crores) and Hotel Leela (total debt Rs 4,200 crore sold to ARC for 4,100 crores) were reported in the first quarter of the year. Massive corporate debt restructuring and asset sales to ARCs have aided banks to reduce the NPA level marginally. Gross NPAs increased from 2.4 per cent of gross advances in March 2011 to 4.4 per cent in December 2013, before declining somewhat to 4.1 per cent in March 2014. *(August 25, 2014, Indian Express)*

The movement of NPAs of commercial banks and transfer of assets to ARCs for the last five years is given below. (Table-2)

Table 2: Movement of NPAs of commercial banks and transfer of assets to ARCs for the last seven years

	Amount Rs. In crores						
	2007-Mar	**2008-Mar**	**2009-Mar**	**2010-Mar**	**2011-Mar**	**2012-Mar**	**2013-Mar**
Gross NPAs	50,487	56,435	68,973	84,747	97,922	142,300	1,94,000
Incremental Gross NPAs		5949	12,538	15,774	13,175	44,378	51,700
	2007-Jun	**2008-Jun**	**2009-Jun**	**2010-Jun**	**2011-Jun**	**2012-Jun**	**2013-Jun**
Book Value Transferred to ARCs	28,544	41,414	51,542	62,217	74,088	80,500	88,500
Incremental flow (during the year)	-	12,870	10,128	10,675	11,871	6,412	8,000
SRs issued	7436	10,658	12,801	14,051	15,859	16,700	18,900
Incremental SRs issued (during the year)		3222	2,143	1,250	1,808	841	2,200

Source: Reserve Bank of India Publication 'Report on Trend and Progress of Banking'

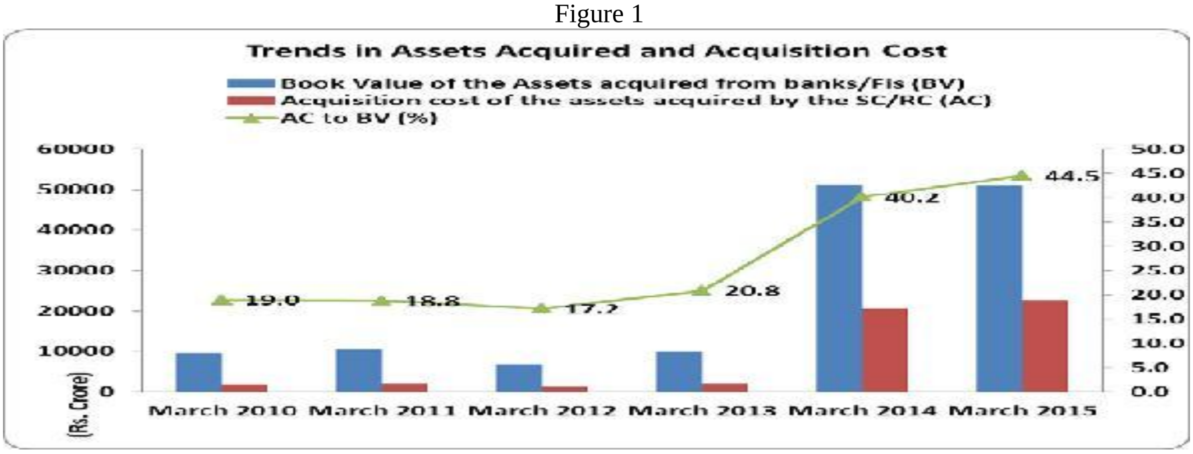
From the past seven years (2007-2013), the Gross NPAs of the banking system have been on a rise and the incremental growth shows acceleration. However, growth in book value of NPAs sold by banks/ financial institutions to ARCs, which were created as a systemic response to tackle the menace of growing NPAs, has not been able to keep pace. An area of concern that needs critical introspection-the incremental SRs issued since 2008 has been declining, even while NPAs are growing, as shown in the (Table-2). It can be seen from that the flow of NPA to ARCs showed a sharp dip during the two years ended June 2013, compared to the previous three years. This trend saw its reversal in the remaining three quarters of 2013-2014, when the banks under increased pressure from the regulator and Government to bring down their NPA levels and after realizing the growing need for substantial provisioning, started auctioning their non-performing loans with aggression which not witnessed earlier.

Asset Reconstruction Companies also took advantage of this unprecedented opportunity to acquire assets and bid aggressively as dictated by their assessment and business considerations. (http://www.iarc.co.in)

Since 2003, selling loans through auction to ARCs in return for SRs became popular with banks. Certain banks started to offload a big chunk of NPAs from their books via this route. However, in the past few years, this option has not been exercised by the banks in an encouraging manner.

The primary reason for low consummation of NPA auctions is due to price expectation mismatch between banks and ARCs, contributed largely by the discount factor and pricing of risks associated with recovery which comprise of estimate of realizable amount and period of realization. Although ARCs were created as a systemic response to address growing NPAs but the recent experience suggests that while NPAs are accelerating, flow of Assets to ARCs has rather been dreary (Figure- 1). Again, Poor performance of Security Receipts has affected the industry in two ways – firstly, the overall deals between ARCs and banks have reduced considerably; secondly, more banks prefer cash sale to SRs.

Figure 1



https://rbi.org.in/scripts/

However, only a few of them appear to be successful in acquiring assets from banks. Of fifteen registered SCs / RCs, asset size in respect of top three SCs / RCs (viz., ARCIL, 'JM Financial' and 'Edelweiss') account for more than two thirds of total assets of all SCs / RCs. An analysis of purchase of NPAs by SCs / RCs indicate that acquisition cost as a percentage to book value of assets increased sharply from 20.8 per cent as on March 2013 to 44.5 per cent as on March 2015. In other words, the discount rate at which SCs / RCs are acquiring NPAs from the banks / FIs decreased considerably, possibly on account of (i) developing of improved NPA recovery methods by banks (ii) selling of relatively fresh NPAs (iii) outsourcing the valuation of NPAs (iv) presence of competition among SCs / RCs while auctioning NPAs. On the recovery side, the performance is not very encouraging.

As on March 31, 2015, the average recovery rate (assets resolved as a % to assets acquired) of SCs / RCs was at 31.0 per cent. One of the reasons for a dip in the average recovery rate is due to the fact that substantial part of the assets under management of SCs / RCs is acquired recently. Further, a wide variation in recovery rates among SCs / RCs is also observed for the same reason. An analysis of investor class in security receipts (SRs) does not depict any divergence. It is observed that seller banks / FIs have been subscribing majority of SRs. On an average seller banks / FIs have been subscribing 74 per cent of total SRs issued during the period March 2010 to March 2015 from past two years, seller banks have subscribed around 80 per cent of total SRs.

Table 2: Subscription of Security Receipts – By Institution

Item	**March 2010**	**March 2011**	**March 2012**	**March 2013**	**March 2014**	**March 2015**
SRs held by SCs / RCs in its own account	21.2	21.0	21.4	24.0	15.0	14.4
SRs issued to other QIBs	5.5	7.3	8.8	8.6	4.7	3.5
SRs held by Seller banks / FIs	73.3	71.4	69.4	66.8	80.0	82.0
SRs held by FIIs	0.0	0.2	0.4	0.5	0.3	0.2
Total	100	100	100	100	100	100

https://rbi.org.in/scripts/

The aggregate asset size of SCs / RCs witnessed sharp growth of 64.8 per cent during 2014-15 on top of 21.3 per cent growth witnessed in the previous year. In numerical terms, aggregate asset size of SCs / RCs stood at 6920 crore as on March 31, 2015. The reported average Return on Assets of SCs / RCs was at 3.48 per cent while the average Return on Equity stood at 4.48 per cent during the period March 2010 to March 2014.

Figure 3

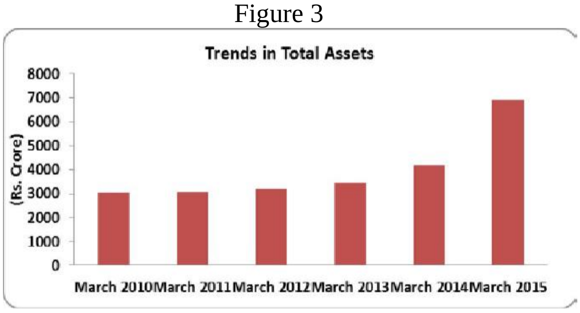
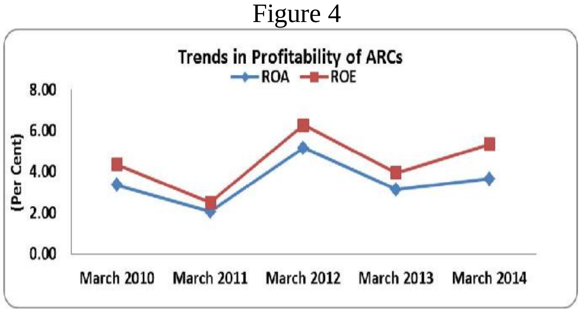


Figure 4



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In FY14, NPL (non-performing loans) sales to ARCs have jumped to Rs270 billion from Rs80 billion in FY13. However, these are being done primarily without the transfer of risk as banks continue to hold over 90% of the security receipts (SRs). ARCs have also raised acquisition price to 60%+ of book value, compared with 25% of book historically for cash-based transactions. With ARCs earnings 1.5-2% fee on the AUM, they have been willing to incur the 5-10% initial cash outflow on the inflated asset value. The share of cash as transaction value has also come down to 8-9% vs25% a few years back. Regulatory changes have also helped ARCs become more meaningful. RBI has allowed the sale of sub-standard accounts to ARCs vs earlier NPAs for more than two years. Further, one time dispensation allows amortization of losses on the sale of NPL to ARCs by banks over a period of two years for sale done before FY15. As newer NPAs are being sold with lower provisions, banks have been keen to sell at a higher nominal value.

Banks have showcased around Rs 90,000 crore worth of distressed assets on sale to the asset reconstruction companies (ARCs) during April-December, 2015. However, the size of bad loans that have been showcased by banks is significantly small when one compares it with the huge pile-up of bad debts that's strangulating the banking sector at present. Bad debts have piled up on the bank books with stressed assets at the end of the third quarter pegged at over Rs 7 trillion (one trillion is one lakh crore), out of which Rs 4.6 trillion is already classified as non-performing assets by banks. The asset quality review by Reserve Bank of India (RBI) spiked up the non-performing loans for all banks – both private and public sector banks with 28.6% sequential jump in gross NPAs and 33.4% rise in net NPAs. About 6% of all bank loans are now NPAs and for the public sector banks, it is 7.2%. This results in provision expenses of public sector banks jumping 93.8% and for private sector banks 67% incrementally during the third quarter ended December 31, 2015.
(http://www.dnaindia.com/money/report-arcs)

During FY 2015, SBI sold 5904 accounts having aggregate value of Rs 6981 crore to Asset Reconstruction Companies for Security Receipts (SRs) of Rs 4406 crore. During FY 2014, SBI sold 255 accounts having aggregate value of Rs 1488 crore to Asset Reconstruction Companies for Security Receipts (SRs) of Rs 1605 crore. (Feb 12, 2016 http://stressedassets.co.in/arc/)

According to a report by Credit Suisse, bad loans are likely to move up further to 6.6% of loans by Mar 2016 as most banks have deferred the impact over two quarters. State Bank of India, the country's largest state-owned bank said bad loans are expected to surge in the coming quarter and this will likely hit profitability. The provision coverage–having enough capital in the bank to provide for any bad loans–has also slipped to 43%. Meaning, only 43% of the loans are provided for. At state-owned banks the un provided non-performing assets (NPAs) are now 30–75% of their capital and un-provided problem loans (loans which are in trouble and could turn into NPAs) even higher at 65–200%, the report said. (Feb 16,2016http://www.forbes.com).

State-owned Punjab National Bank planned to sell up to Rs 3,000-crore bad loans to asset reconstruction companies (ARCs) in the fourth quarter. PNB's asset quality deteriorated and gross non-performing assets (NPAs) rose to 8.47 per cent of the gross advances as against 5.97 per cent same quarter a year ago the net NPAs rose to 5.86 per cent of the net advances as of December quarter of 2015-16, from 3.82 per cent in the previous year's third quarter. In absolute terms, the gross NPAs have increased to Rs 34,338.22 crore as of December 2015, from Rs 22,211.43 crore. Net NPAs were at Rs 22,983.40 crore during the quarter, up from Rs 13,787.76 crore (Feb 17, 2016, http://timesofindia.indiatimes.com).

Public sector lender Indian Bank has sold non-performing assets (NPAs) worth Rs 600 crore to asset reconstruction companies (ARCs) in the March quarter of FY16 Punjab National Bank, United Bank, Central Bank of India, Allahabad Bank and Oriental Bank of Commerce had put up their loans for sale to ARCs. Of the banks which wanted to sell loans, United Bank has the largest share at R250 crore, followed by PNB at Rs 240 crore (April 14, 2016http://www.financialexpress.com).

Conclusion:

ARCs has added value by cutting short the time to resolution as well as maximizing the recoveries as the cash realization activity from defaulters which is a lengthy and cumbersome procedure thus by relieving the banks to allow them to focus better on managing the core business activities including new business opportunities. They are serving as a catalyst for important legal reforms in bankruptcy procedures and loan collection. Though the asset reconstruction companies have been present in India for close to fifteen years, their activity was relatively limited. The banks had also not actively used this route as the recovery track record from the previous cycle for the larger ARCs were not encouraging and popular. Present scenario and factors (internal and external)especially the push by the finance ministry to PSU banks to reduce their reported NPA levels and RBI favoring banks to transfer bad debt to ARCs to facilitate earlier resolution gave a face to ARCs in the Indian banking industry even though at present ARCs are playing a magnificent role in reviving and relieving the bank from its distressed assets but so far to the present context their roles to some extent are not recognized although government of India and RBI has brought lot of changes in regulations especially the upcoming new bankruptcy code and 100 percent foreign direct investments will boost capital flows and make them an increasingly important intermediary between lenders and borrowers but still a long way to go how much these initiatives will benefits the number of participants in the market and for the survival these saviors need to be checked. For efficient resolution of bad assets, there is a need for banks to work with assert construction companies more closely and to make these ARCs more active. Despite RBI's continued efforts India remains far from being a vibrant asset sale market. Banks are not following a consortium approach is a major issue which led to the delay of 12-18 months for debt aggregation. Even though an asset becomes non-performing after being overdue for 90 days, provisions for the loss associated with this are spread over a period of four years. This generates a perverse incentive to not sell NPAs provisioning for an NPA has a gradual impact on the balance sheet of the bank while sale of the NPA has to be booked as an upfront loss. As a result banks either hold on to these assets for longer than it is economically sensible, or sell assets to ARCs only when the transaction is at or above book value. In addition, there are a variety of procedural problems with the process of banks selling NPAs including auctions that do not give adequate time for due diligence by ARCs, and auctions that are cancelled after bids are received at times ARCS have to resort to a time-consuming process of dealing with each bank separately often at differing commercial terms.

Abbreviations Used in Article:

- ✓ AMC (Asset Management Company)
- ✓ Asset Reconstruction Company (ARC)
- ✓ Non-Performing Loan (NPL)
- ✓ Quarter (Q)
- ✓ Financial Institutions (FIs)
- ✓ Foreign Institutional Investors (FIIs)
- ✓ Financial Year (FY)
- ✓ Non-Performing Assets (NPAs)

- ✓ Non-Performing Asset (NPA)
- ✓ Reconstruction Company (RC)
- ✓ Reserve Bank of India (RBI)
- ✓ Securitization Company (SC)
- ✓ Scheduled Commercial Banks (SCBs)
- ✓ Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI)
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- ✓ 45-IA. Requirement of registration and net owned fund
- ✓ 45-IB. Maintenance of percentage of assets.
- ✓ 45-IC. Reserve fund.

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