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INTRODUCTION
REVIEW OF LITERATURE
NEED/IMPORTANCE OF THE STUDY
STATEMENT OF THE PROBLEM
OBJECTIVES
HYPOTHESIS (ES)
RESEARCH METHODOLOGY
RESULTS & DISCUSSION
FINDINGS
RECOMMENDATIONS/SUGGESTIONS
CONCLUSIONS
LIMITATIONS
SCOPE FOR FURTHER RESEARCH
REFERENCES
APPENDIX/ANNEXURE

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- Bowersox, Donald J., Closs, David J., (1996), "Logistical Management." Tata McGraw, Hill, New Delhi.
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A STUDY OF ARCS: TOOL TO CLEAN NPAs OF THE INDIAN BANKING SECTOR

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ABSTRACT

A stable financial economy depends on sound banking system. A high level of NPAs in the banking system can affect the economy in many ways. ARCs have been used worldwide, particularly in Asia, to resolve NPAs problems. However, these had a varying degree of success in different countries. This research article attempts to give focus on stress & asset quality of the banking sector, performance of ARCs in resolving NPAs problems, Regulatory norms of RBI for ARCs & various reforms adopted in this aspect. Between 2002 and 2005, sale to Asset Reconstruction Companies (ARCs) was a popular route among banks to address NPAs, but the poor returns from realization-linked Security Receipts (SRs) has dis-incentivized banks to use this route. On 30th January 2014, RBI released a regulatory framework for early recognition and revitalization of distressed assets, which details steps for early recognition and quick action upon the first signs of stress in any account. The framework also proposes a structure to incentivize banks for faster action by way of restructuring or sale of assets. We believe that the guidelines will aid in arresting the deterioration of economic value; increase deal flow to ARCs, special situation funds and stressed asset investors. In addition, the guidelines ease the process for lenders to change the management and rehabilitate stressed borrowers, which in turn will allow these companies to survive and preserve jobs.

KEYWORDS

Reserve Bank of India, Asset Reconstruction Companies, Non-Performing Assets, Regulatory Norms, Security Receipts.

INTRODUCTION

A healthy financial system can help achieve efficient allocation of resources across time and space by reducing inefficiencies arising out of the market frictions and other socio economic factors. In modern economies, Banking plays a crucial role in the financial stability and security of financial system of a country. Failure of a bank brings some serious repercussion as we see in the recent episodes of financial turmoil. Most of the meltdown globally like Argentina, Gulf Country, Mexican crisis, US sub prime crisis etc. are more inclined towards banking sector. So, NPAs beyond a certain level are indeed cause for concern for everyone involved because credit is essential for economic growth and NPAs affect the smooth flow of credit.

Some major reforms like dilution of government equity holding in Public sector banks, liberalization of FDI norms, liquidity adjustment facility, interest rate swaps, cross country forward contract, introduction of real time gross settlement, SARFAESI Act, BASAL III, base rate system etc. has been adopted which imply new challenges for Indian Banks.

OBJECTIVES OF THE STUDY

1. To analyze the trend of NPAs & asset quality of the banking system
2. To check whether ARCs focus on NPAs and act as a broom of " clean bank"
3. To explain the regulatory norms of RBI & its various reforms in this sector.

RESEARCH METHODOLOGY

Descriptive Research Methodology is adopted to conduct this research. Secondary source of data is used in this context such as RBI annual report, RBI bulletins, various research articles, IARC website etc.

ANALYSIS

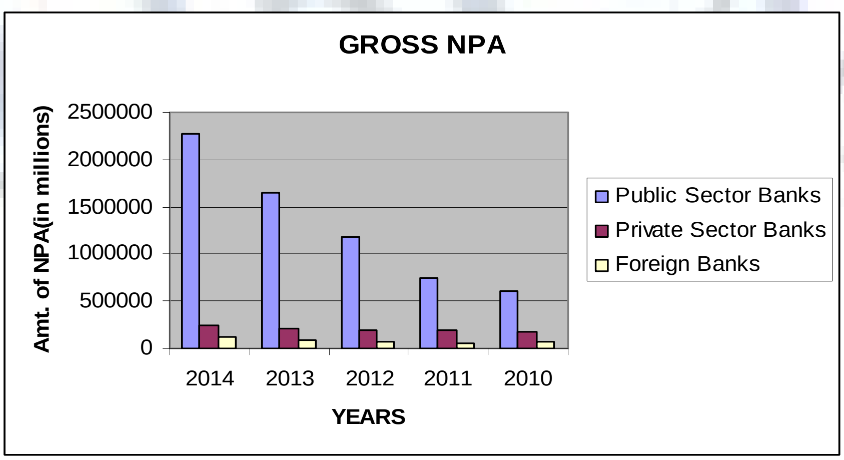
STRESS IN BANKING SECTOR

TABLE 1: GROSS NPA (Amt in millons)

	2014	2013	2012	2011	2010
Public Sector Banks	2280741	1650057	1178389	746638.9	599272.6
Increase NPA yoy	630684	471667.8	431750.3	147366.3	149702.6
Private Sector Banks	245424	210705.2	187678.1	182405.815	176399.7
Increase NPA yoy	34719.05	23027.04	5272.303	6006.089	7133.726
Foreign Banks	115790.1	79770.9	62965.87	50686.793	71335.93
Increase NPA yoy	36019.24	16805.03	12279.07	-20649.132	6890.925

Source : RBI (Movement of NPAs)

FIG. 1

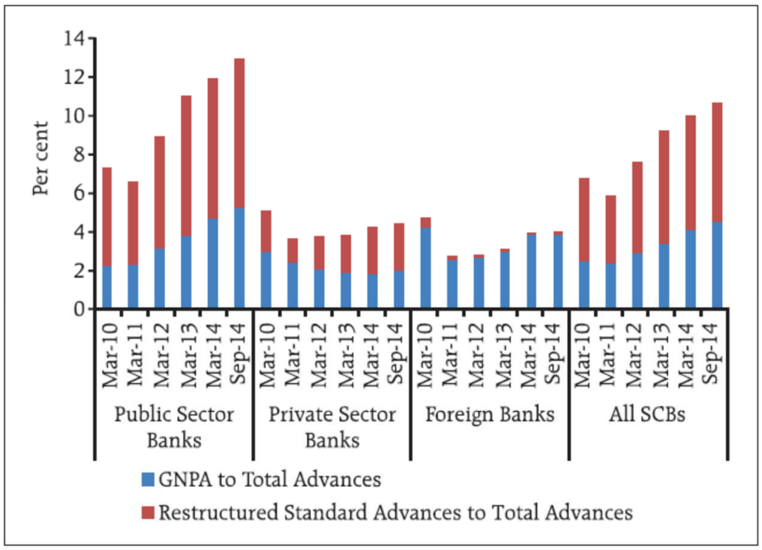


OBSERVATION

- The gross NPA ratio at the aggregate level stood at 3.6% at the march 2013 up from 3.1 % at end march 2012
- Increase in NPA on account of lower asset quality, lower Provisioning coverage ratio and higher lending to priority sectors
- Gross NPAs of banking system have gone up approx by 2 times in 2 years from march 2012 to march 2014
- Asset quality for the banks has been deteriorated due to the inadequate credit appraisal, disbursal and recovery mechanism of the banks, so as to credit cost elevated.
- In sync with the increment in growth of gross NPAs as well as a lower provisioning coverage, net NPAs registered growth.
- The deterioration in asset quality was most perceptible for the SBI group with its NPA ratio reaching a high of 5% at end march 2013 which included in Public Sector banks here.
- NPA increases have been more pronounced in case of the public sector banks. There are various factors affecting the asset quality of SCBs adversely, such as the current slowdown- global and domestic, persistent policy logjams, delayed clearances of various projects, aggressive expansion by corporate during the high growth phase etc.
- As the sectoral classification of NPAs , it is revealed that share of agriculture in total NPAs has increased marginally where as share of micro & small enterprises came down as compare to previous year.
- Restructured Assets have gone up by more than 2 times in 2 years from march 2011 to march 2013.

ASSET QUALITY OF ALL SCBs

FIG. 2



Source: RBI supervisory returns.

The gross non-performing advances (GNPAs) of SCBs as a percentage of the total gross advances increased to 4.5 per cent in September 2014 from 4.1 per cent in March 2014. The net non- performing advances (NNPAs) as a percentage of total net advances also increased to 2.5 per cent in September 2014 from 2.2 per cent in March 2014. Stressed advances increased to 10.7 per cent of the total advances from 10.0 per cent between March and September 2014. PSBs continued to record the highest level of stressed advances at 12.9 per cent of their total advances in September 2014 followed by private sector banks at 4.4 per cent as the above chart shows.

IMPLICATIONS

- Increase in Gross NPAs will require additional Provisioning
- Additional provisioning means huge capital locked which hamper credit creation & overall investment climate of the economy.
- During 2013-14, the growth in net profits of SCBs, which had been on a declining trend since 2011-12, turned negative. SCBs as a whole reported net profits of about ₹809 billion**,** indicating decline by 11.3 per cent compared to previous year.
- For restructured assets, provisioning norms have changed effective current financial year – 5% on fresh restructuring in 2013-14 and 3.5% as on march 2014 for existing stock up from 2.75% as on march 2013 ,4.25% from 31st March,2015 & 5% from 31st March 2016 spread quarter wise.

STRUCTURAL OPTIONS

A. Legal – Enhance effectiveness of enforcement rights

- SARFAESI 2002 – comprehensive act which provide law for setting up of ARCs
- Debt recovery Tribunal – Recovery courts
- Appeal to SICA/BIFR

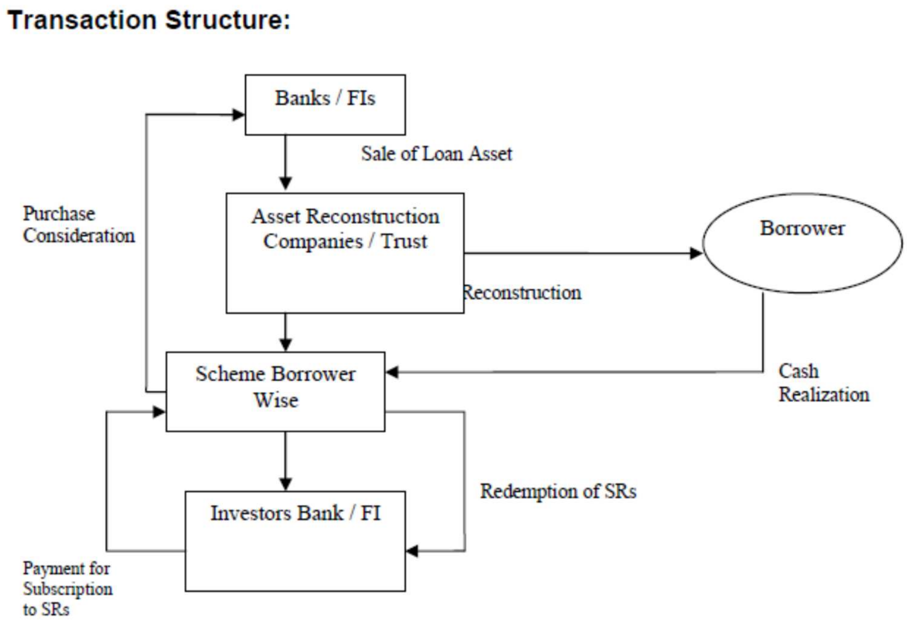
B. Voluntary – Encourage lender driven restructuring

- Corporate Debt restructuring – Forum of lenders under the control of RBI
- Bank's own workout.

SARFAESI Act 2002 – The securitization and reconstruction of Financial Assets and Enforcement of security interest Act which was enacted by the Parliament in December 2002. It provides

- The norms for setting up of Asset Reconstruction companies (ARCs).
- Enforcement of Security Interests by secured creditors
- A legal framework for securitization of assets.
- Grants powers to lenders to reconstruct/ resolve NPAs through selling or leasing a part or whole of the business of the borrower or settling dues payable by the borrower or taking possession and disposing the underlying security or effecting change or takeover of management of the business of the borrower.
- Grants powers to lenders to foreclose security interest with a 60 days Notice on receipt of consent of 75% (now changed to 60%) of the concerned Lenders by Value.

FIG.: 3



So far, this approach has not worked. Stressed assets at banks (NPAs + restructured loans) have increased from Rs. 0.7 trillion in 2003 to Rs. 5.3 trillion in 2013. In this period, the annual sale of assets by banks to ARCs has stagnated at Rs.0.05 to Rs.0.1 billion a year.

WHAT WENT WRONG?

a) ***Excessive regulatory interference.*** ARC is a buyer of distressed debt. It might be an individual, or a private equity fund, or any other structure. The sale should be a clean transaction where distressed debt is sold and cash is paid to the lender. Therefore the working of ARCs should be completely unregulated. This clarity of thought has been absent.

b) ***Mistakes in regulations about how banks sell distressed assets***. In India, provisioning norms are driven by regulatory perspective not by risk assessment. An asset which become 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. 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.

The sale of bad assets is not a true sale for hard cash. Banks would think in a sensible and commercial way when and only when: (a) Tough provisioning rules kick in the moment an asset is NPA and (b) The sale of distressed debt is a simple sale in return for cash. Neither of these conditions holds today, reflecting poor thinking in banking regulation.

c) ***Weak bankruptcy process.*** The ability of ARCs to realise value is defined by the bankruptcy process. The legal frameworks for recovery are the debt recovery tribunals (DRTs), the SARFAESI Act but both of them performed poorly in resolving cases of NPAs. Recovery as a percentage of total outstanding cases was 14% for DRTs & 22% for SARFAESI in 2013. While takeover of management procedure is time taking process under the companies act specify by RBI.

d) ***Is insourcing vs. outsourcing of distressed asset management a level playing field?*** In India, at numerous points, the powers in processing distressed debt favour banks and do not give non-bank actors comparable powers. This creates incentives for insourcing of the distressed debt function. SARFAESI provides for several mechanisms to enable ARCs to carry out recovery. But the operational guidelines for many of these were issued by RBI much after 2002. For example, the guidelines for management takeover of the defaulting firm were issued in 2010, eight years after the Act was passed. As a consequence, from 2002 to 2013, ARCs were handicapped. Banks have greater restructuring flexibility, under the CDR process, than do ARCs. For example the requirement in the Indian Takeover Code, the acquirer of shares in the CDR process is exempted from making an open offer. No such exemptions have been provided for the conversion of debt to equity by ARCs.

e) ***Barriers to foreign skills and capital***. RBI has hampered the entry of foreign players, and capital controls have been used to block the inflow of foreign capital. This choked ARCs of both capital and knowledge.

TABLE 2: NPAs OF SCBS RECOVERED THROUGH VARIOUS CHANNELS (Amount in ₹ Billion)

Year	No.	Recovery Channel	Lok Adalats	DRTs	SARFAESI Act	Total
2011-12	1	No. of cases referred	4,76,079	13,365	1,40,991	6,30,429
	2	Amount involved	17	241	353	611
	3	Amount recovered*	2	41	101	144
	4	3 as per cent of 2	**11.8**	**17**	**28.6**	23.6
2012-13	1	No. of cases referred	840,691	13,408	190,537	1,044,636
	2	Amount involved	66	310	681	1,058
	3	Amount recovered*	4	44	185	232
	4	3 as per cent of 2	**6.1**	**14.1**	**27.1**	21.9
2013-14	1	No. of cases referred	1,636,957	28,258	194,707	1,859,922
	2	Amount involved	232	553	946	1,731
	3	Amount recovered*	14	53	244	311
	4	3 as per cent of 2	**6.2**	**9.5**	**25.8**	18

Notes

1. * : Refers to amount recovered during the given year, which could be with reference to cases referred during the given year as well as during the earlier years.
2. DRTs : Debt Recovery Tribunals.

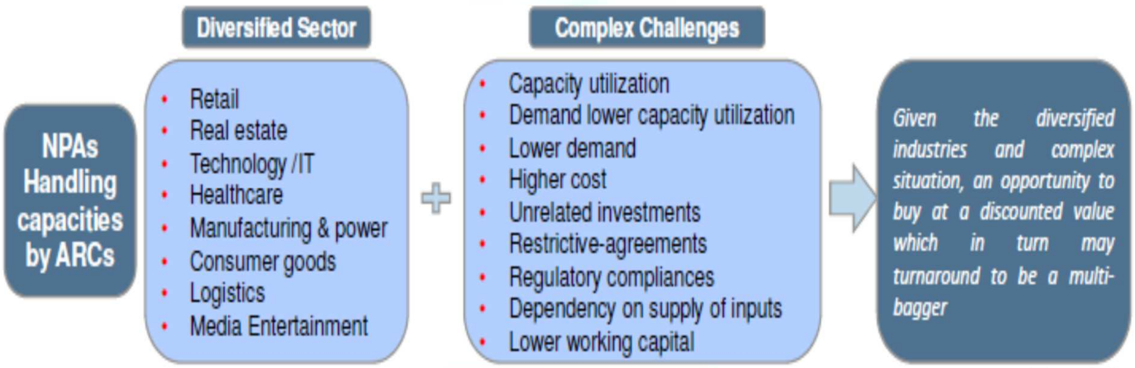
Among the three channels for NPA recovery, i.e. Lok Adalat, DRTs, SARFAESI Act, the largest amount was recovered through the SAEFAESI Act. As ARCs were created as a dynamic response to cover the growth of NPAs, However recent experience as we can look at the above table, suggest that NPAs are accelerating as compare to flow of asset recovery through ARCs. The percentage of recovery cases to outstanding has been decline.

TABLE 3: HANDLING CAPACITY OF ARCS WITH RISING NPAs (Rs. in Crore)

	Mar -09	**Mar-10**	**Mar -11**	**Mar-12**	**Mar- 13**
Gross NPAs	68,973	84,747	97,922	142,300	1,94,000
Incremental Gross NPAs	12,538	15,774	13,175	44,378	51,700
	Jun -09	**Jun-10**	**Jun -11**	**Jun-12**	**Jun- 13**
Book Value Transferred to ARCs	51,542	62,217	74,088	80,500	88,500
Incremental flow	10,128	10,675	11,871	6,412	8,000
SRs issued	12,801	14,051	15,859	16,700	18,900
Incremental SRs issued	2,143	1,250	1,808	841	2,200

Source :IARC website

FIG. 4

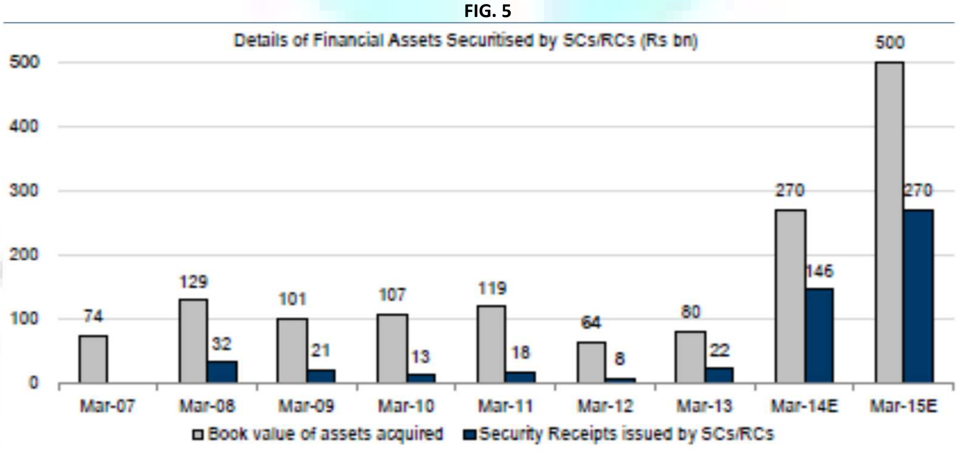


RECENT DEVELOPMENT

- On 30th Jan 2014, RBI has proposed the following changes in the regulatory framework of ARC
- Assets in the category of 61-90 days, can sold to ARCs. This encourages the early sale of bad loans and better recovery process.
- For the assets sold till March 2015, Banks are allowed to spread loss on the sale over two years period. If there is gain in the sale transaction, it is allowed to banks to reverse provisions made for NPA. This would address the bank's concern on the loss on sale of assets.
- It is compulsory for banks to accept the bid price in the auction if it is above the reserve price and they have to fulfill the conditions specified.
- Various steps are taken to improve the price transparency. For example sales between two ARCs and their sponsors are permitted only through transparent and length arm auction.
- If ARCs ensure to RBI that there is no prior collusion between ARC and the defaulting borrower, then promoters of the companies are allowed to buy-back assets from ARCs

These measures removed procedural hurdles faced by ARCs and on the other hand, there is pressure on PSBs to offload their growing NPAs. As a result of these factors in FY14, NPL sales to ARCs have jumped to Rs270 bn from Rs80 bn in FY13, and will likely double further in FY15. Most of this sale was by public sector banks (PSBs). For example, State Bank of India (SBI) in its Annual Report for FY 2014, has reported a sale of Rs. 36 billion of NPAs to ARCs. The book value and the sale value of these assets are Rs.15 billion and Rs.16 billion respectively, with SBI making a profit of Rs.1 billion on these transactions.
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. 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.

FIG. 5



Source: RBI, Credit Suisse estimates

The spurt in NPA sale transactions in 2014 led to further changes through the 5th August, 2014 notification:

- The ARCs will now have to mandatory invest and hold 15 % of the SR in place of a limit of 5 % earlier.
- The SC/RCs will now have to conduct a due diligence within a period of two weeks to verify the existence of the underlying assets.
- Reduced planning period for acquired assets from one year to six months. This is also the time frame within which the acquired assets need to be rated and re-valued.
- The calculation of the management fees is more scientific and linked to the percentage of the NAV at the lower end of the range of NAV specified by the credit rating agency rather than on the outstanding value of SRs at present and the same should not be more than the acquisition value of the underlying asset. . Shortfalls in recovery now affect ARC fees.

- Increased reporting and disclosure requirements for ARCs, specially for asset sale by banks above book value and for asset sale by ARCs at a significant discount.
- The SCs/RCs should also form part of the Joint lending forums in terms of the circular issued by RBI and a mandate for them to put up a list of willful defaulters on their website.

These changes will help reduce three aspects of bank-ARC transactions as they have been proceeding:

- Banks selling assets to ARCs without actual risk transfer, since 95 percent of the value of the sale got back into banks' balance sheets as investment in SRs.
- ARCs earning fee income linked to the book value of the asset and not to its *recovery value*. Low levels of ARCs capital commitments meant no real incentive for them to resolve NPAs.
- Promoters, even the willful defaulters, getting relief from repaying their dues under the ARC model, which was focused on warehousing instead of resolution of NPAs.

These latest amendments have increased the ARCs risk in acquiring assets. ARCs will now need to make recoveries to earn fees and to get returns on invested capital. However, the larger problems of these arrangements remain unresolved.

CONCLUSION

In order to make distressed debt processing and ARCs work, the work plan for policy makers consists of the following elements:

- The role of RBI in regulations should stop at the point of sale of distressed assets to the ARC. The working of the ARCs should be unregulated as there is no market failure there.
- Mistakes in micro-prudential regulations of banks, in recognition and provisioning by banks, need to be addressed.
- Banks should be required to do true sales in exchange for cash of distressed debt. This will yield closure on the books of the bank. After the transaction, the ARC would work to obtain recovery with no relationship to the original lender.
- The bankruptcy process should be improved.
- ARCs should be first class participants in the bankruptcy process. There should be no bias in the bankruptcy process in favour of any one kind of financial firm such as bank.
- Establishment of operations by foreign ARCs should be feasible with 100% equity ownership. Foreign capital into ARCs (whether private or foreign) should be welcome through private equity structures. All institutional investors in India -- but not banks -- should be able to invest capital into these private equity structures. Banks should only face the choice of selling (in exchange for cash) or not selling.

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