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EVOLUTION OF THE RESOLUTION FRAMEWORK FOR NPAs IN INDIA: A STUDY OF ASSETS RECONSTRUCTION COMPANIES AND BAD BANK PROPOSAL

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ABSTRACT

The idea behind a bad bank is to clean the balance sheets of the banks and financial institutions of an economy. Currently, the Indian economy is under a lot of pressure because of increasing NPAs in the banking sector particularly from the time when RBI started conducting asset quality review of the banks to get a clearer picture of the situation and this problem is going to escalate further because of the surge in COVID 19 cases and lockdowns due to the pandemic. This pandemic hits the Indian economy very hard, leading to a fall in growth rate, increasing unemployment, and providing uncertainty to all the sectors of the economy. Amidst this pandemic, the government proposed to setup a 'Bad Bank' in Union Budget 2021-22 to handle the stress in the banking sector of our economy. This study explores the idea of a bad bank in the Indian economy and analyse the positive and negative implications of it and this paper also attempts to understand the evolution of the regulations related to ARCs and see the performance of the present ARCs in India by looking into its shareholding pattern, size of non performing assets (NPAs) acquisition, recoveries in comparison with other resolution options, etc. the study revealed that the acquisition and the rate of recoveries of ARCs are growing but it is not sufficient to handle the entire NPAs crisis.

Keywords: ARCs, NPAs, Asset Quality, Bad Bank, Security Receipts, NARCL

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INTRODUCTION

As Stiglitz (2018) mentioned, "Crises seem to be a part of modern capitalism and capitalist system is neither efficient nor stable". Every crisis that originates, reflects the inherent risk present in an economy and creates large disruption that results in the collapse of economic activities. The onset of the COVID-19 crisis is not similar to the conventional type of economic crisis that arises due to the forces in a financial system. The shock due to COVID-19 severely impacted the lives and the livelihoods of people all around the world. Amidst the COVID-19 crisis, the government of India presented the union budget for the financial year 2021-2022 to bring India back on the road to growth and development. The union budget highlighted various schemes in the thrust areas of the economy and among them is a proposal of setting up of a bad bank 'National Asset Reconstruction Company Ltd' (NARCL), to handle the non performing assets (NPAs) of the Indian banking sector. As explained by Oncu (2017) "Bad bank is a corporation established to isolate stressed assets held by a bank or financial institution, or a group of banks or financial institutions. It might be established privately by the bank or financial institution, or the group of banks or financial institutions, or by the government or some other official institution."

Indian economy is a bank led economy and the financial sector in India is dominated by the scheduled commercial banks. Under the banking sector, public sector banks have played a crucial role in providing credit to the various priority and non-priority sectors but banks in India have been under constant stress due to deterioration in assets quality and shrinkage in the capital stock, these factors had deeply plunged the profits of these banks for quite a long period time and these weaknesses have drawn urgent attention towards the need of structural reform in the banking sector. In India, recapitalisation is been done by the government constantly through budget allocation, and recapitalisation bonds are used to enhance the credit flow process in the economy and to bring capital up to regulatory requirements but urgent attention is still required towards the constantly increasing pile of non performing assets (NPAs). As defined in the Master Circular of RBI (2015), banks can classify an asset as a non performing asset when it ceases to generate income for the bank. "Non performing asset (NPA) is a loan or an advance where interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan".

As mentioned in Economic Survey 2016-17, the significant rise in NPAs is faced majorly by an economy during the crisis time. This is what happened in the Asian financial crisis, most Asian countries like, Indonesia, Korea, Japan, Thailand saw a serious rise in non performing assets during that time, the same situation happened with US and European countries during the global financial crisis but Indian economy was not exposed to Asian financial crisis or Global financial crisis 2008 but despite we saw a rise in NPAs. During 2016, we saw a spike in the non performing assets (NPAs), At that time GDP growth was good, no major failure in our economy, everything was quite stable but despite this, there is been a rise in the non performing assets (NPAs). One possible reason identified was that during this time Asset Quality Review (AQR) was taking place and because of this, we saw a spike in stressed assets.

In India, for the purpose of resolution of non performing assets (NPAs) asset reconstruction companies (ARCs) commonly called bad banks, are allowed to set up as per SARFAESI Act 2002 requirement. Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, (2002) defined "asset reconstruction means acquisition by any asset reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance" and "asset reconstruction company means a company registered with Reserve Bank under section 3 for the purposes of carrying the business of asset reconstruction or securitisation, or both". The Bank for International Settlements (2002) defined the ARCs as follows: "A special purpose company set up by a government, a bank, or by private investors to acquire loans and other assets, a majority of which are usually impaired, for subsequent management (including restructuring) and in many cases, sale to investors." There is a slight difference between the ARCs and Bad bank as ARCs buys the stressed assets from banks and financial institution at a high discount but in the case of the bad bank mentioned in Union Budget 2021-2022, banks are going to transfer their stressed assets and this new entity will manage these stressed assets.

The idea of a bad bank is been used many a time during the crisis by various economies. During the time of the saving & loan institutions crisis in the US financial sector in 1980s, the Resolution Trust Company in the US handled all the bad loans given by Saving & Loan institutions. In the wake of the 'Global Financial Crisis of 2008', economists urged for internationally coordinated steps to resolve the crisis for the financial sector around the world and many economists stressed the idea of creating bad banks to remove the toxic assets from the balance sheets of the financial institutions. Suntum and Ilgmann (2013) studied the global financial crisis time, German banks took an early step in setting up the bad bank to find the resolution for the toxic securities generated during the global financial crisis of 2008. Bhagwati et al. (2017) explained the various bad banks setup during the crisis time, In Sweden, during 1990s banking sector was in crisis because of the credit squeeze and a large proportion of non-performing loans, to overcome this situation Riksbank (central bank of Sweden) setup a bad bank fully sponsored by the government as a measure to handle the situation of banks in the Swedish economy. Fung et al. (2004) explained, during the Asian financial crisis, many southeast countries were in serious trouble and the financial sector in these countries was on the verge of collapse, In Indonesia, during this time the non performing assets were around 50 percent of the gross loan provided, and to handle this catastrophic situation, the Indonesian government took serious measures and established the Indonesian Bank Restructuring Agency (IBRA). In the context of the Indian economy, the idea of a bad bank is been put forward by many economists, The Economic Survey 2016- 2017 has proposed the setting up of a 'Public Sector Assets Rehabilitation Agency' (PARA) or Bad bank to clear all the impediments currently plaguing loan resolution in the banking sector, but no such steps were taken in this direction in the past.

The following table shows the non performing loans to total loans (percentage) of different countries from the 2008 to 2019 period.

Table 1: Bank Non-performing Loans to Total Loans (percentage)

Country Name	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Australia	1.35	2.01	2.14	1.96	1.7	1.36	1.01	0.89	0.94	0.86	0.91	0.96
Bangladesh	-	-	-	5.85	9.73	8.64	9.36	8.39	8.86	8.89	9.88	8.9
Brazil	3.11	4.21	3.1	3.47	3.44	2.86	2.85	3.31	3.92	3.58	3.05	3.11
China	2.4	1.6	1.13	0.96	0.95	1.00	1.25	1.67	1.74	1.74	1.83	1.86
Greece	4.67	6.95	9.12	14.43	23.27	31.90	33.78	36.65	36.30	45.57	41.99	36.45
Pakistan	9.13	12.15	14.74	16.2	14.47	12.99	12.26	11.36	10.05	8.43	7.97	8.58
India	2.45	2.2	2.4	2.67	3.37	4.03	4.35	5.88	9.19	9.98	9.46	9.23
Russia	3.8	9.53	8.23	6.59	6.02	6	6.73	8.35	9.44	10	10.12	9.29
South Africa	3.92	5.93	5.79	4.68	4.04	3.64	3.24	3.12	2.86	2.84	3.73	3.89
US	3	4.96	4.39	3.78	3.31	2.45	1.85	1.47	1.32	1.12	0.91	0.85
UK	1.56	3.51	3.95	3.96	3.59	3.11	1.65	1.01	0.94	0.73	1.07	-

Note: Non performing loan is a term used globally instead of non performing asset and period for classification of loan as non performing is same in all of the countries mentioned above.

Source: World Bank Database

Table 1 is extracted from World Bank database; it shows the percentage of non performing loans to gross total loans for some economies since 2008. The problem of non performing loans is not unique to the Indian economy only but it's been faced by many other countries also. Greece, a country in the eurozone has a huge load of non performing loans due to its debt crisis. When you compare India's performance with other BRICS countries, India's rate is far more than China, Brazil, and South Africa (except for Russia, whose percentage rate is almost equal to India.) In neighbouring countries, Bangladesh and Pakistan's economies are also facing non performing loans problems. However, in the case of the US and China, the rate of non performing loans to total loans is low.

The following table shows the Non performing assets (NPAs) in India for the period ended March 2019 and March 2020.

Table 2: Asset Quality of Indian Banking Sector

(Amount in ₹ crore)

	Amount Outstanding (As at end March 2019)	Amount Outstanding (As at end March 2020)
Gross NPAs	9,36,474	8,99,803
Net NPAs	3,55,068	2,89,531
Gross NPA ratio (Gross NPAs as percentage of gross advances)	9.1	8.2
Net NPA ratio (Net NPAs as percentage of net advances)	3.7	2.8

Source: Extract from Appendix Table IV.1: Indian Banking Sector at a Glance, RBI

Table 2 above shows the data of all the scheduled commercial banks in India, the Gross NPAs amount has decreased by ₹ 36,671 crores from the year ended 2019 to the year ended 2020. There has been a fall in NPA ratio also from 9.1% to 8.2%. these fall in the non performing assets is because of improvement in the resolution process. When we see the current scenario, with the onset of the COVID 19 pandemic, all the countries around the world have opted for nation-wide lockdowns to curb the virus, this has seriously hampered the economic wheel and due to this pandemic, every sector of the economy is at risk, we may see a significant jump in non performing assets (NPAs) around the world. As per Financial Stability Report (Jan, 2021) there will be spike in NPAs and Gross NPA ratio of all Scheduled commercial Banks may increase from 7.5 per cent in September 2020 to 13.5 per cent by September 2021.

Resolution of the stressed asset is important but it comes with a lot of hurdles in the path as most of the banks find it difficult to coordinate with creditors, coordination with various stakeholders is required, the time required to solve the whole resolution process may vary from case to case and it depends upon the peculiarity of each specific case, capital erosion can be other hindrance in the process as NPAs may erode huge chunk of the capital cushion which may induce banks to avoid the process, and as Economic Survey 2016-17 pointed out that there is no as such incentive provided to banks for resolving these stressed assets but resolving these may attract some investigation from the government agencies. So, in conclusion, the path to resolve these assets is littered with so many obstacles.

As per the 'Doing Business 2020' report, India is ranked 63rd among 190 countries in the 'Ease of doing business' index. As per the report, India's economy is among the top ten economies which are witnessing a significant change across three or more factors in the calculation of the index. one of the important dimensions in the calculation of the index is how the country manages the resolution process.

Table 3: Ranking of countries on the basis of 'Resolution of insolvency'

Rank	Country
1	Finland
2	US
3	Japan
4	Germany
5	Norway
52	India

Source: Doing Business 2020 Report, World Bank

Table 3 shows the top 5 countries in the resolution of insolvency of companies, resolution of insolvency is one of the parameters in the 'Ease of doing business' index calculation. Under this factor, Finland, US, Japan, Germany, Norway are the top five countries in efficient resolution. The whole procedure from filing the insolvency to the completion of resolution is highly effective in these countries. India is at 52nd position out of 190 countries, this rank is been achieved because of the constant effort of the government in improving the business environment especially by incorporating the 'Insolvency and Bankruptcy code 2016', this legislation has influenced the ranking of the Indian economy in this index.

This paper studies resolution framework in India and is organised into five sections, section 2 states the objective of the study, section 3 deals with the evolution of asset reconstruction business in India and working of ARCs, section 4 with the critical analysis of the new bad bank set up in India and the last, section 5 is the conclusion of the paper and limitations in the study.

OBJECTIVE OF THE STUDY

The following objectives have been identified after studying the literature and understanding the rationale behind the concept of a 'Bad Bank'

i. To study the evolution of resolution framework related to non performing assets (NPAs) in India.

ii. To study the working and performance of ARCs (Asset reconstruction companies) in India.

iii. To analyse the issues related to setting up a new 'bad bank' as mentioned in the Union Budget of 2021-2022.

ASSET RECONSTRUCTION COMPANIES IN INDIA

Evolution of Resolution framework in India

The resolution process for the non performing assets (NPAs) was initiated with the passing of the Sick Industrial Companies (Special Provisions) Act (SICA), 1985 on the recommendation of the T. T. Tiwari Committee. Under this act, BIFR (Board of Industrial and Financial Reconstruction) was set up to examine the viability of the sick companies (both public and private sector companies) and forward them to the liquidation process, if it is necessary. After years of the implementation, SICA Act 1985 was found to be ineffective in handling the situation because it was an extremely lengthy process and with the intervention of the courts it became never ending. The Sick Industrial Companies (Special Provisions) Act (SICA), 1985 was able to complete only a few resolutions in comparison to the growing stock of non performing assets (NPAs). After this, in 1993 the government passed 'The Recovery of Debts Due to Banks and Financial Institutions Act, 1993' to expedite the process of recovery of the assets. Under this act, Debt Recovery Tribunals (DRTs) and Debts Recovery Appellate Tribunals (DRATs) were set up, but with the growing size of the NPAs this legislation was also found to be insufficient and with the intervention of the civil courts and Board of Industrial and Financial Reconstruction the resolution process became difficult to operate.

So, in to push the resolution process forward, the government passed the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, (2002) on the recommendation of the Narasimham Committee I and II, and the Andhyarujina Committee, which empowered the banks and financial institutions to start the resolution process on their own and auction off the non performing assets. SARFAESI Act 2002 gave a way to set up asset reconstruction companies in India by Individuals, banks (both public and private sector), and financial institutions. Every asset reconstruction company has to register itself under the SARFAESI Act 2002 (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act). RBI has prescribed the minimum 'Net Owned funds' should be ₹100 crores and the Capital Adequacy Ratio should be 15% of the Risk Weighted Assets (RWA). (Regulations related to ARCs are shown in figure 1)

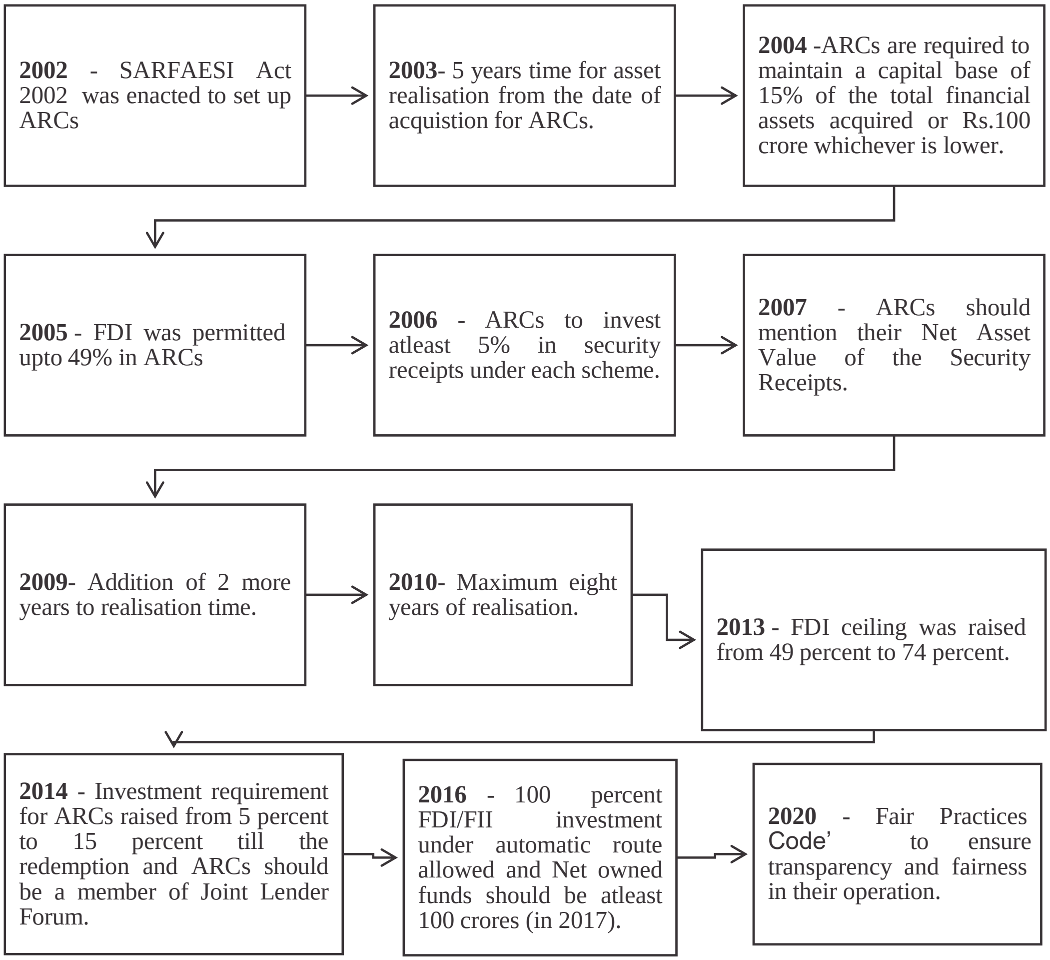
In August 2001, RBI initiated the Corporate Debt Restructuring (CDR) mechanism similar to the resolution scheme present in countries like the U.K., Thailand, South Korea, Malaysia, etc. at that time. The objective of CDR was to initiate the speedy resolution of the viable corporations having debt in multiple banking accounts/syndicates/consortium accounts with total outstanding exposure of Rs.20 crore and above with the banks and financial institutions. Under this mechanism, CDR Standing Forum, CDR Empowered Group, CDR Cell were setup, this three-tier structure was developed for the timely and transparent resolution mechanism.

In 2016, Scheme for Sustainable Structuring of Stressed Assets (S4A) was initiated for the non performing assets restructuring and to increase the credit flow in the economy. this scheme provided for the classification of a debt of a company in to sustainable debt and unsustainable debt based on the cash flow. As per RBI "A debt level will be deemed sustainable if the Joint Lenders Forum (JLF)/Consortium of lenders/bank conclude through independent techno-economic viability (TEV) that debt of that principal value amongst the current funded/non-funded liabilities owed to institutional lenders can be serviced over the same tenor as that of the existing facilities". Under this scheme, sustainable debt should at least be 50 percent of current funded liabilities.

Despite all these initiatives for the resolution of non performing assets (NPAs), the progress in resolution was not showing much significant result. So, to push forward this whole process the Insolvency and Bankruptcy Code was enacted in 2016. IBC, 2016 is a comprehensive act in solving the conflict between the creditors and debtors and this act has provided the stipulated period of time for the resolution to finish. IBC 2016 is based on four pillars; Insolvency and Bankruptcy Board of India, insolvency professionals, adjudicating authorities (Debt Recovery Tribunal (DRT) and National Company Law Tribunal) and information utilities for the speedy and transparent resolution.

This paper focuses on ARCs particularly and Figure 1 shows the timeline for all the major amendments in the regulation related to ARCs from 2002 till 2020.

Figure 1 - Important regulations related to ARCs



Source: RBI Website

ARCs in India

The first asset reconstruction company setup in India was ARCIL (Asset Reconstruction Company (India) Limited) in 2002 it was sponsored by the State Bank of India, IDBI Bank, ICICI Bank, and Punjab National Bank (PNB) (SARFAESI Act 2002 defines "sponsor as any person or an institution holding more than 10 percent of paid-up equity capital of ARC"). So far, twenty-eight asset reconstruction companies have been registered with RBI under section 3 of SARFAESI Act 2002 to handle the resolution process. the nature of ARCs in India is mostly private sector owned but some of them have been sponsored by public sector banks.

The following table shows the presence of commercial banks in the shareholding of these Asset reconstruction companies in India and it shows the sponsor commercial banks.

Table 4: Banks as shareholders in Indian Asset Reconstruction Companies (ARCs)

S No	Name of the company	
1	Pridhvi Asset Reconstruction and Securitisation Company Ltd.	Punjab National Bank (10%), UCO Bank (5%), Andhra Bank (1%)
2	ASREC (India) Limited	Allahabad Bank (27.04%), Andhra Bank (26.02%), Bank of India (26.02%), Indian Bank (11.22%), LIC (9.18%), Deutsche Bank (0.51%)
3	Asset Reconstruction Company (India) Limited	State Bank of India (19.95%), IDBI Bank ltd (19.18%), ICICI Bank ltd (13.26%), Punjab National Bank (10.01%), Karnataka Bank Ltd (2.64%), The South Indian Bank Ltd. (1.27%), Federal Bank Ltd. (1.27%)
4	India SME Asset Reconstruction Company Limited	Punjab National Bank, Bank of Baroda
5	JM Financial Asset Reconstruction Company Limited (Erstwhile JM Financial Asset Reconstruction Company Private Limited)	Indian Overseas Bank (6.09%)
6	Reliance Asset Reconstruction Company Limited	Union Bank of India (Erstwhile Corporation Bank) (11.5%), Indian Bank (11.5%),
7	International Asset Reconstruction Company Pvt. Ltd.	HDFC Bank
8	Assets Care & Reconstruction Enterprise Ltd. (Erstwhile Assets Care Enterprise Ltd.)	Axis Bank (13.67%), Punjab National Bank (7.64%), Bank of Baroda (2.66%)
9	UV Asset Reconstruction Company Limited	Central Bank of India

Source: Latest Annual Reports of all the ARCs

Table 4 shows the Indian commercial banks as a shareholder in these ARCs. Out of twenty-eight companies registered with RBI under section III of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 as of 31st Jan, 2020, only 9 ARCs have a presence of banks (Mostly public sector banks are present in shareholding) in shareholding and also the percentage of shareholding is small in many of the ARCs. If we look at commercial banks as a sponsor in the above many of the ARCs sponsor are commercial banks out of these nine ARCs. So, the conclusion from the above table would be that the ARCs in India are mostly private sector owned.

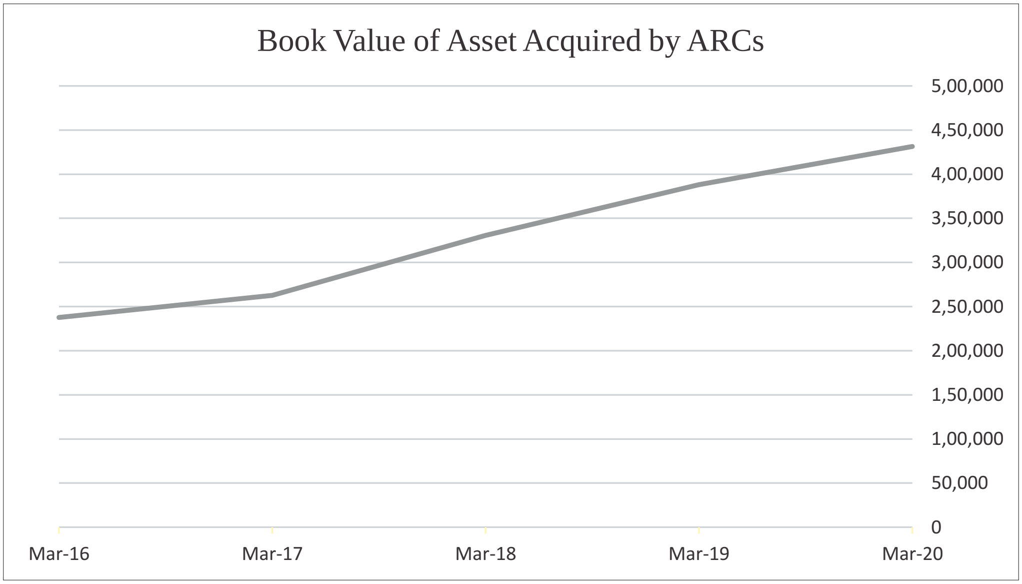
Working of ARCs

As per SARFAESI Act 2002, banks can sell their Non performing assets (NPAs) to asset reconstruction companies (ARCs) on Net book Value. With the selling of NPAs, the rights of the lender (banks) are transferred to ARCs. Asset reconstruction companies can make payments in cash or by issuing debenture or bonds or any other securities. So, whenever any bank sells their assets to ARCs, 15% of the asset sold would be given in cash to banks and the remaining 85% of the value is issued as Security Receipt (SR). (Earlier instead of 15% of cash payment, banks were paid only 5 %, but with this increment, there will be more cash flow to the banks on the selling off their NPAs). Bhagwati et al. (2017) studied the flow of stressed assets to the ARCs and found that since 2014 there is a fall in the acquisition of the assets by ARCs because of the change in the percentage payment to banks in cash. As per RBI requirement, ARCs are required to subscribe at least 15% of the Security Receipts (SRs) issued for the assets till the time all the SRs are redeemed fully and these SRs can also be purchased by Foreign Institutional Investors (FII) and by other QIB. Initially, the time frame decided by the RBI for asset realisation was five years from the date of acquisition but this time limit was changed in 2009 and increased to seven years and again revised to eight years in 2010. The framework of taking a company to the National Company Law Tribunal (NCLT) is also available to the ARCs.

The following figure shows the book value of asset acquired by ARCs from the period ended March 2016 to period ended March 2020

Figure 2

₹ in Crores



Source: RBI Database

Figure 2 shows the book value of the asset acquired by ARCs, there has been a constant increase in the value of the assets acquired by ARCs. As of 31st march 2020, the amount of asset acquired is ₹ 4,31,339 crores with an increase of 13.6% in the amount of the asset acquired but the acquisition does not solve the entire purpose, the information of acquisition must be seen and compare with the information of realisation of assets by these ARCs and when see the amount of NPAs in the economy, the transfer of these stressed assets is very less in comparison to the increasing amount of NPAs in our economy and also Bhagwati et al. (2017) studied the flow of stressed assets to the ARCs and we can conclude that the growth of the asset acquisition could have been more than the present rate but government regulation of increasing the cash payment to banks from 5 percent to 15 percent has demotivated the participation of ARCs.

The following table shows NPAs recovered by banks through ARCs and IBC resolution option.

Table – 5: NPAs recovered by banks through ARCs and IBC

(Amounts in Crores)

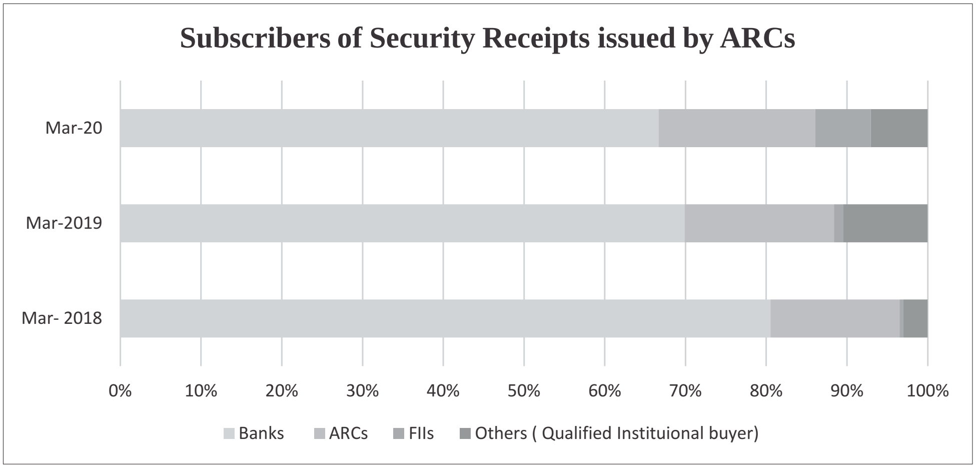
Year	Total		ARCs (SARFAESI Act)			IBC		
	Total Amount involved	Total amount recovered	Percentage of total amount	Percentage of total amount recovered	Amt recovered as per cent of amt involved	Percentage of total amount	Percentage of total amount recovered	Amt recovered as per cent of amt involved
2019-20	7,42,431	1,72,565	26.5	30.5	26.7	31.3	61.3	45.5
2018-19	7,25,996	1,18,647	35.6	32.8	15.0	20.4	56.2	45.7
2017-18	2,70,631	40,352	30.3	65.4	32.2	3.7	12.2	49.6
2016-17	2,78,300	38,500	50.8	67.3	18.3	-	-	-
2015-16	2,21,400	22,800	36.2	57.9	16.5	-	-	-

Source: Report on Trend and Progress of Banking in India 2019-20, 2018-19, 2017-2018, 2016-17, RBI

As per the information available in RBI's report on 'Trend and Progress of Banking in India'. there are four options for the asset recovery; Lok Adalats, Debt Recovery Tribunals, SARFAESI Act 2002 (ARCs) and IBC (Insolvency and Bankruptcy Code, 2016). As we can see in the table 5 given above, out of these four options, details of two resolution options are given. Insolvency and Bankruptcy code 2016 has major percentage in recovery, out of the total amount involved, 31.3% is handled by IBC and recovery rate is 61.3%, which is higher than Asset Reconstruction Companies recovery. Before the promulgation of IBC 2016, the ARCs were the major participator in recovery of the stressed assets but after the IBC 2016, resolution process got a major start, the total amount involved in entire recovery process got three times the amount recovered before the IBC 2016. The focus of the IBC 2016 is on resolution of corporate insolvency. With the incorporation of National Asset Reconstruction Company (Bad Bank) there will definitely be increase in the total amount involved in resolution process and the share of ARCs in recovery amount will also increase.

The following table shows the subscribers of security receipts issued by ARCs for three years from period ended March 2018 to period ended March 2020

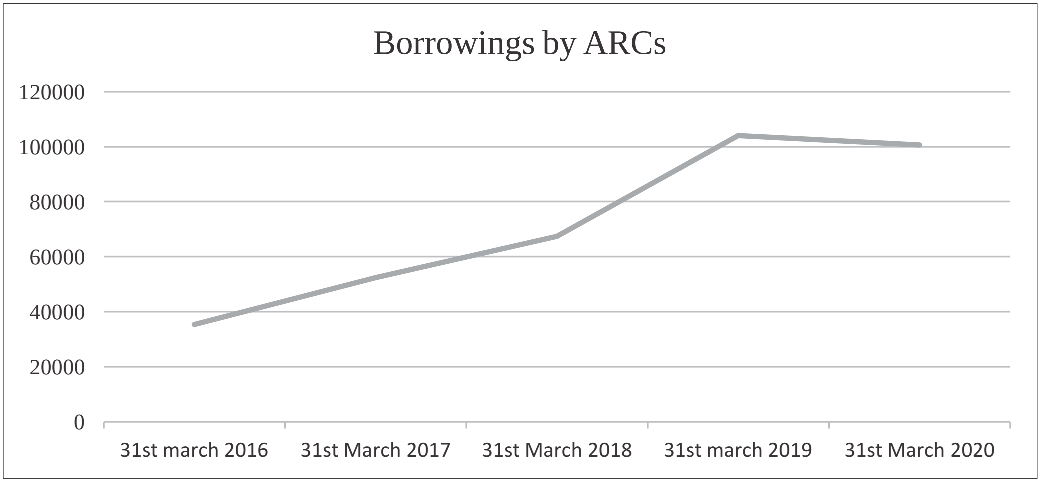
Figure 3



Source: Report on Trend and Progress of Banking in India 2019-20, RBI

Whenever any ARCs acquired NPAs from the bank they issue Security Receipts (SRs) against that asset and as per RBI regulations, every ARCs have to invest atleast 15% of the SRs issued. Figure 3 shows the subscribers to the Security Receipts (SRs) issued by the ARCs for the three financial years, As of March 2020 out of the total Security Receipt (SR) issued by ARCs, banks are the major subscribers with a share of 66.7% after that ARCs are the subscribers of 19.4% receipt and the shares of FIIs and other QIB in Security Receipt (SRs) is around 7%. the subscribing percentage of banks to Security Receipts (SRs) is been decreasing and the percentage subscription of Foreign institutional investors (FIIs) is increasing. the subscription of FIIs in the year ended 2019 is more than three times from the previous year's amount and the amount for the year ended 2020 increases by more than 6 times from the previous year's amount. This change in composition is due to the changes in the regulations related to investment in SRs and also ARCs are incentivised to diversify the subscribers to the Srs.

Figure 4 (₹ Million)

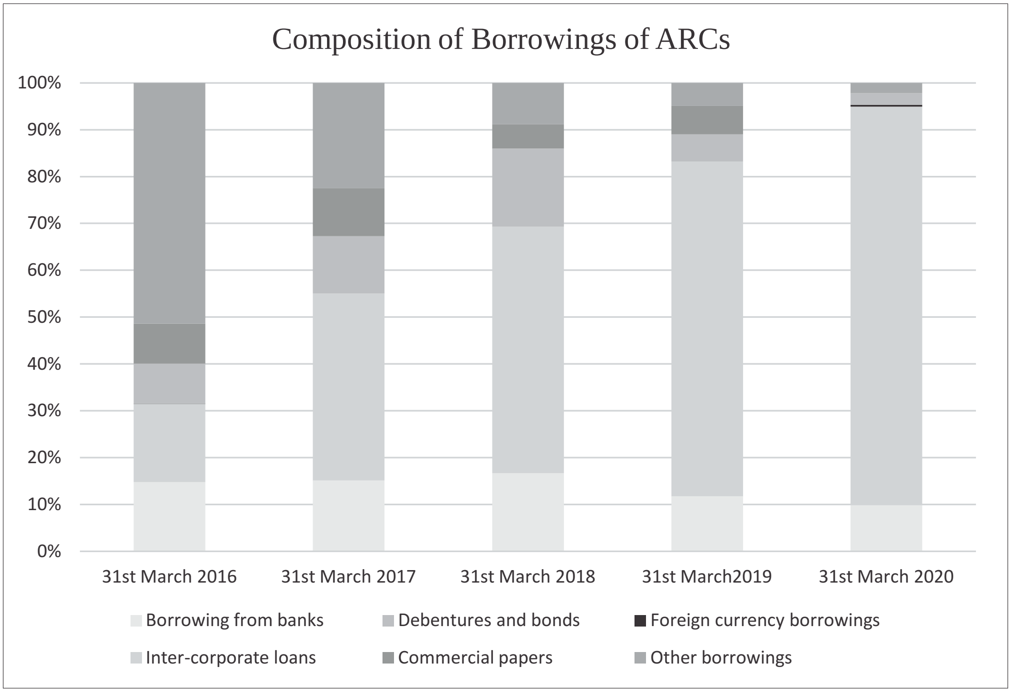


Note: Above information is of 13 major ARCs in India

Source: CMIE Prowess Database

Most of the ARCs in India are setup as private company with capital accumulated from domestic individuals and organisations, to do their normal operations these ARCs have been borrowing funds from different sources and also the size of the borrowing is constantly increasing every year. As we can in Figure 4 there has been a rise in the borrowings of ARCs with each year passing but a significant jump can be seen in the year ended in March 2019 when there is more than 50% increase in the borrowings. Figure 5 shows the sources of the borrowings by ARC for five years. The size of debentures and bonds in total borrowings is constantly increasing and the size of other sources of the borrowings is decreasing. In the year ended in March 2016 the borrowing through Debentures and bonds was 16.7% of the total borrowings but this increased to 85.1% in the year ended in March 2020 this means that ARCs in India are issuing more bonds and debentures to raise funds. The share of commercial papers in total borrowing has also been reduced significantly because of the increase in uncertainty in the money market in India after IL&FS Crisis. borrowings from the banks increased but the percentage of it in total borrowing is somehow stable.

Figure 5



Note: Above information is of 13 major ARCs in India

Source: CMIE Prowess Database

A NEW BAD BANK

National Asset Reconstruction Company Ltd (Bad Bank) as proposed by the Union Budget of 2021-2022 is going to be setup as public in nature as this idea is been initiated by the central government itself and as per the information available in the union budget, the shareholding will be held majorly by the public sector banks and remaining by private sector banks. The whole process of selling these stressed assets will follow the 'Swiss Challenge Method' in which NPAs will be open to other asset reconstruction companies also and based on the highest bidding the decision will be taken by the lender. The National Asset Reconstruction Company will have an edge over the other institutions as the entire shareholding of this institution will be held by the banks (both public and private) which will provide more confidence for the resolution and the participation.

Since there is no change in the regulations from the RBI in the working of ARCs, as of now NARCL is likely to follow the existing practice of paying 15 percent in cash for acquired loans and the remaining 85 percent in security receipts. As per the 'Times of India' news article, the process of resolution of the stressed asset will start from June with the transferring of 80 large NPAs account of size more than 500 crores or more. The loans which are 100 percent provided by the lender will be transferred to NARCL. the size of the transfer is expected to be over 2 Lakh Crores. Whether the government will provide a 100 percent loan loss guarantee against the security receipt issued by the bad bank is not clear now. Sovereign guarantee proposal has its own positive and negative side, as 100 percent Loan loss guarantee will provide confidence of the banks to participate in this whole process and will give more thrust to the implementation of the idea and it may also attract a large diversified investor base to invest in SRs but on the negative side it may lead banks from the realistic valuation of these Non performing assets (NPAs) and may increase the risk of 'Moral Hazard' for the future. The risk of moral hazard should not be there.

As Akerlof (1970) explained in his paper “The Market for Lemons”, how information asymmetry can degrade the mechanism of the market. The same principle can be applied here, the valuation of these Non performing assets (NPAs) with the degree of accuracy will be the most challenging task for the experts involved in the process. Gros (2009) explained the 'lemon problem' may arise in the case of NPAs transfer also and value determination is going to be difficult here for the newly bad bank.

As pointed out by Economic Survey 2016-17, banks in India didn't take significant steps towards the resolution of stressed assets as debt reduction by banks could attract investigation by some government agencies, and taking over of stressed organisations for their loan recovery will be politically difficult. Transparency in the process and full disclosure of all the material information is a major expectation from the bad bank to avoid future litigations.

Schäfer and Zimmermann (2009) explained the two main drawbacks to the bad bank idea. first, the need for huge capital, and other is future losses in the balance sheet. Private ARCs have not been much successful in resolution because of the shortage of capital but National Asset Reconstruction Company Ltd is going to be setup by the contribution of the banks. how much contribution will be made by each bank is still not clear. Banks in India are facing constant erosion in their capital because of NPAs and provision for NPAs. Yadav & Chavan (2021), have examined the bad banks in many countries and found that most of the bad banks that were setup in other countries were provided capital support from the government itself. In India's case, there is no contribution from government and the size of NPAs is very huge, and to deal with this huge capital is required. So NARCL has to explore the other options for raising capital. One other source which could be explored is the contribution from RBI, Central bank (RBI) in India has huge capital accumulated with reserve growing each year, the contribution from RBI could be helpful for the new bad bank.

CONCLUSION

The study analyses the idea of a 'bad bank' and concluded that the road to resolution is full of obstacles, various asset resolution legislation has been passed in India but the expected result has not been achieved yet. This paper studied the working of ARCs and found that the size of assets acquired by ARCs is increasing every year. In recoveries, the share of ARCs is next to Insolvency and Bankruptcy code 2016, so with the creation of the National Asset Reconstruction Company Ltd the share of ARCs in total recoveries is definitely going to increase in the future. This paper explored the sources of the borrowings and found that in the last five years borrowing through debentures and bonds is increasing at a significant rate and the long-term solvency of the selected ARCs is also analysed. In the end, the challenges related to capital deficiency, risk of moral hazard, transparency, and valuation process were discussed in relation to NARCL.

This research topic provides a further scope of study in the future, in few years the working of NARCL can be analysed and compared with the other resolution options to get a clear picture of the effectiveness of this institution.

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