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Can asset reconstruction companies (ARCs) be part solution to the Indian debt problem?

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Working Paper 338

Can Asset Reconstruction Companies (ARCs) be Part Solution to the Indian Debt Problem?

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April 2017



INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS

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Abstract

The Indian debt overhang issue is one of the major reasons that fresh investments are currently not being made in the scale required to promote higher growth and boost employment. Among banks the public sector banks (PSBs) are burdened with the bulk of net non-performing loans (NNPAs). These NNPAAs are concentrated in long gestation projects, for example, in the steel, power and infrastructure sectors and most of the lending was to about 50 major borrowers. This paper details the approaches of other countries when their banking sectors were burdened with unsustainable levels of impaired assets. The paper examines the bad debt situation in India, the circumstances under which Asset Reconstruction Companies were registered and the changing regulatory requirements under which they have been operating in India. Till now, the extent to which ARCs have helped towards resolving the debt problem has been limited. Given that fixed costs in setting up ARCs have already been incurred this paper suggests how ARCs could play a catalytic and more significant role in addressing the debt overhang. The paper does not discuss the causal origins of Indian bad debt in any detail and is not intended to suggest comprehensive remedies to this debt problem.

Keywords: *Banking crisis, bankruptcy, asset reconstruction companies, bailout, corporate restructuring, security receipts, debt recovery tribunals, bad bank*

JEL Classification: *G010, G21, G230, G280, G330, G340*

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Can Asset Reconstruction Companies (ARCs) be Part Solution to the Indian Debt Problem?¹

Jaimini Bhagwati, M. Shuheb Khan, Ramakrishna Reddy Bogathi

Introduction

India's financial sector is dominated by the banking sub-sector. That is, for the financing needs of longer gestation projects it is banks which provide the bulk of the funding not corporate-municipal bond markets or the pension and insurance sectors. Among banks it is the public sector banks (PSBs) which have been in the lead to provide funding for infrastructure, power and steel production projects. Indian private sector banks have chosen to limit their exposure to shorter-term loans usually not longer than five years in maturity except for housing in urban areas with the property itself as collateral.

PSBs could have been more circumspect in their medium to long maturity lending between 2002 and 2012 when credit expansion was high and the volumes of funds allocated to infrastructure projects and large capital expenditure projects boomed². However, given the encouragement from its majority shareholder, namely the central government, PSBs were at the forefront of risky lending for public-private partnership (PPP) projects. It has been amply apparent for some time that inflated project costs coupled with asset stripping made borrowers less vulnerable to remedial debt-recovery steps that are available to banks to take-over assets of defaulters. The proportions of stressed assets/non-performing loans (NPLs) on balance sheets of PSBs and private banks as of end September 2016 were 15.8 percent/4.6 percent³ and 11.8 percent/3.2 percent respectively. These high volumes of impaired assets on PSBs' balance sheets have sharply reduced their ability to provide fresh lending.

Asset Reconstruction Companies (ARCs) were first set up after the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest legislation also known as the SARFAESI Act was approved by parliament in 2002. ARCIL was the first ARC set up by the State Bank of India (SBI) and ICICI as the principal share-holders. In the last fourteen years ARCs have grown in number and size but the capital at their disposal is dwarfed by the size of NPLs on bank balance sheets.

As the debt overhang issue has grown in size over the last five years it is time to review the extent to which ARCs have been part of the solution. Namely, what are the prospects of ARCs being able to address a limited yet significant proportion of the increasing volumes of

¹ This paper has been written as part of Research Studies conducted under the 'ICRIER-RBI Chair' headed by Professor Jaimini Bhagwati. We are thankful to Dr Subir Gokarn (Executive Director, IMF and former Deputy Governor RBI) and Mr Pratip Chaudhuri (former Chairman of State Bank of India) for their valuable comments

² During 2004-05 to 2007-08, the investment-GDP ratio increased by 11 percentage points to reach 38 percent by 2007-08 (Chapter 4, The Festering Twin Balance Sheet Problem, Economic Survey 2016-17, Page 87)

³ Stressed assets include gross nonperforming assets and restructured assets. Assets which were written off are not included.

impaired assets? This paper examines the extent to which ARCs have succeeded in addressing the stocks of NPLs on the balance sheets of PSBs and under what circumstances they could play a more significant yet at best complementary role to address this cloud over the Indian banking sector.

Section I of this paper provides an analysis of banking crises in select developed and emerging economies. Specifically, how governments and regulators have tackled banking sector crises in the US, Sweden and Indonesia. Section I also describes the setting up of so called “Bad” Banks, Resolution Corporations and Asset Management Companies (AMCs) to provide the required capital and provide time for banks to be nursed back to health. The legislative changes which were brought about in these three jurisdictions and associated costs are also covered in this section.

Section II includes past examples of when Indian banks had to be financially supported by government and RBI exercised regulatory forbearance. However, this Section does not detail the causal reasons for the rising proportions of non-performing assets. Section II covers the extent to which Indian scheduled commercial banks (SCBs) are hurting. This Section discusses the working of Indian ARCs and how their functioning has evolved as RBI has repeatedly revised its regulatory norms for them. Section II also examines the regulations authorised by RBI for banks to recognise impaired assets. Further, the sequential manner in which banks can convert loans to equity in case borrowers are unable to service debt despite every opportunity to recover, is also analysed. As the chopping and changing of RBI rules has been complex and hence difficult to follow, the time line of regulatory changes effected are provided in Annex 1.

Section III assesses the capital adequacy of Indian ARCs and corresponding regulatory norms and hence ability to be a significant factor in relieving stress in the Indian banking sector. This Section also examines under what circumstances ARCs, or AMCs as these known elsewhere, could have a greater relevance in India. More importantly, rather than as a source of capital for banks the question is whether ARCs could play a significant role in the price discovery of distressed assets.

This concluding Section also refers to the latest Economic Survey’s proposal for a top down central government driven approach to address this festering problem of high proportions non-performing assets on bank balance sheets. The ground reality in India is that any directly observable attempt to fully resolve this debt overhang problem would be quickly mired in political economy and legal considerations. The extent to which large defaulter corporates can be pressured to honour contractual commitments would determine the magnitude of funds that government would have to provide to nurse PSBs back to health. Consequently, this paper does not suggest overall remedies to the debt problem. That is, the paper’s focus is to highlight the current limited role of ARCs which can and should be enhanced given that the fixed costs have already been incurred in setting them up.

Section I

1.1 Banking Sector Crises

The history of financial sector crises in several countries shows that the majority of such situations have their origins in imprudent bank lending. Some of these episodes were systemic to the financial sector as a whole while others were limited to the banking sector⁴. At an elementary level of understanding banks provide the service of maturity transformation that is, borrowing short through current or savings deposits and lending long. This is to take advantage of the yield curve, which is usually upward sloping, reflecting the premium for taking credit risk over long periods. Consequently, banks are exposed to risks stemming from: (a) duration mismatches between assets and liabilities; (b) unanticipated changes in interest/exchange rates; and, (c) inadequate capital compared to stressed/non-performing assets. The World Bank's analysis of financial sector crises shows that crisis-hit countries had "less stringent and complex definitions of minimum capital, lower actual capital ratios, were not strict enough in the regulatory treatment of bad loans and loan losses and faced fewer restrictions on non-bank activities"⁵.

A core set of financial stability indicators for banks are: (a) capital adequacy; (b) asset quality; (c) earnings and profitability; (d) liquidity; and (e) sensitivity to market, credit and operational risks. Asset quality indications are a combination of non-performing loans (NPLs) to total loans, non-performing loans net of provisions to capital, sectoral distribution of loans to total loans and large exposures of capital to single parties⁶. The quality of bank assets across countries is not readily comparable as the definitions in separate jurisdiction are not quite the same.

NPLs are usually defined as assets which have not provided any returns for 90 days. Before the South East Asian crisis, banks had a time period of 180 days past due to classify assets as NPLs⁷. A comparison of the definitions of NPLs for comparing asset quality in different countries is presented in the table below.

⁴ The 2008 crisis which had its origins in the US housing-financial sector turned into a widespread systemic economic downturn.

⁵ Banking crisis, World Bank <http://www.worldbank.org/en/publication/gfdr/background/banking-crisis>

⁶ Sundararajan et al. (2002), "Financial Soundness Indicators: Analytical Aspects and Country Practices", International Monetary Fund

⁷ Walter Yao (December 2015), Not All NPLs Are Created Equal, FEDERAL RESERVE BANK OF SAN FRANCISCO <http://www.frbsf.org/banking/asia-program/pacific-exchange-blog/nonperforming-loan-ratio-asset-quality-measures-in-asia/>

Table 1: Definition of NPLs in Select Countries⁸

Country	Definitions of NPLs
India ⁹	RBI defines an asset as NPA if the asset did not provide any returns for 90 days. NPAs are classified into sub-standard, doubtful and loss assets. Source: Master Circular on Income Recognition, Asset Classification, Provisioning & Other Related Matters – UCBs, RBI, July 1, 2015, (https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=9850&Mode=0)
United States	Loans past due for more than 90 days and nonaccrual loans. Source: Federal Reserve
Euro-area	A loan is non-performing when payments of interest and principal are past due by 90 days or more, in accordance with the Basel II definition of default, or when there are good reasons to doubt that debt payments will be made in full. Source: https://www.ecb.europa.eu/paym/coll/html/questions.en.html
Indonesia	Loans are deemed as NPLs when borrowers do not pay interest or principal for 90 days. Source: Bank Indonesia
China	Loans for which repayment of principal or interest have been overdue for more than 3 months. Source: Central Bank of China

During the South East Asia crisis in the late 1990s financial sectors in several countries were burdened with non-performing assets along with liquidity issues. Governments established AMCs such as the Korean Asset Management Company (KAMCO) in South Korea, Danaharta in Malaysia, and the Indonesian Bank Restructuring Agency (IBRA) in Indonesia. Examples of government-led efforts to resolve or reduce stress in the financial sector in advanced economies include the Resolution Trust Corporation (RTC) in the United States and Securum in Sweden.

The recovery of loans and/or disposal of NPLs depends on the regulatory framework in the country, bankruptcy laws and operational independence of financial institutions. There are drawbacks to the setting up of separate AMCs instead of creating a bad bank to takeover impaired assets. For example, there could be information asymmetries regarding borrower details.¹⁰

⁸ For detailed discussion on definition of NPLs see “Non-performing loans: regulatory and accounting treatments of assets”, Bank of England <http://www.bankofengland.co.uk/research/Pages/workingpapers/2016/swp594.aspx>

⁹ In India, Definition of nonperforming assets (NPAs) include nonperforming loans and assets which stop generating income for banks. For details please see Master Circular - Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, https://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7357

¹⁰ Stefan Ingves et al., “Issues in the Establishment of Asset Management Companies”, IMF Policy Discussion Paper, May 2004

Table 2: Bank Non-performing Loans to Total Loans (percentage)

Country Name	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
China			28.5	22.4	29.8	26.0	20.4	13.2	8.6	7.1	6.2	2.4	1.6	1.1	1.0	1.0	1.0	1.1	1.5
Euro area	8.0	4.5	4.6	3.7	2.9	3.0	2.5	2.3	1.8	1.3	1.8	2.8	4.8	5.4	6.0	7.5	7.9	6.8	5.7
India	15.7	14.4	14.7	12.8	11.4	10.4	8.8	7.2	5.2	3.5	2.7	2.4	2.2	2.4	2.7	3.4	4.0	4.3	5.9
Italy	9.2	11.8	9.8	7.8	6.7	6.5	6.7	6.6	7.0	6.6	5.8	6.3	9.4	10.0	11.7	13.7	16.5	18.0	18.0
Indonesia		48.6	32.9	34.4	31.9	24	6.8	4.5	7.3	5.9	4.0	3.2	3.3	2.5	2.1	1.8	1.7	2.1	2.4
United Kingdom	2.9	3.2	3.0	2.5	2.6	2.6	2.5	1.9	1.0	0.9	0.9	1.6	3.5	4.0	4.0	3.6	3.1	1.8	1.4
United States	1.0	1.0	1.0	1.1	1.3	1.4	1.1	0.8	0.7	0.8	1.4	3.0	5.0	4.4	3.8	3.3	2.5	1.9	1.5
World			9.0	9.7	9.6	8.3	6.7	5.2	3.9	3.1	2.7	3.0	4.2	4.0	3.9	3.7	4.1	4.1	4.3

Source: World Bank

Table 2 lists non-performing loans as a percentage of total gross loans for a few emerging and developed economies since 1997. Currently, non-performing loans are a major banking issue not just in India but also in the Euro-zone particularly in Italy where NPLs have currently reached 18 percent of total loans¹¹. In this context, instances of bad banks/AMCs set-up by governments such as Securum in Sweden, Resolution Trust Corporation (RTC) in United States, Indonesia Bank Restructuring Agency (IBRA) and the current banking crisis in Italy are examined in this Section.

1.2 Sweden

1.2.1 Securum

During the early 1990s Sweden faced a banking crisis resulting in a severe credit shortage and banks were left with large proportions of non-performing loans, concentrated in the real estate sector. This crisis showed up the shortcomings of the Riksbank's (the central bank) regulatory overview mechanisms¹².

According to the Riksbank's quarterly review¹³, "the methods for resolving the crisis were chosen initially on an ad hoc basis" because the crisis unfolded too quickly and did not allow for the consideration of alternatives to support banks. A bad bank was set up keeping in mind the health and size of the banks affected by the crisis. The steps taken by the Swedish government clearly helped stabilise the banking sector as it posted operating profits a little

¹¹ Bank non-performing loans to total gross loans (%), World Bank data, <http://data.worldbank.org/indicator/FB.AST.NPER.ZS>

¹² Johan Molin (September 2009), "How has the Riksbank managed the financial crisis?", Page no: 128, Economic Review, 2010

¹³ Stefan Ingves and Goran Lind (1996), "The management of the bank crisis – in retrospect", Quarterly Review I 1996, Riksbank

over SEK 10 billion in 1994, after posting operating losses totalling around SEK 90 billion during 1991-1993¹⁴.

During the 1990-94 crisis, Sweden's financial institutions had credit losses of SEK 200 billion¹⁵. Of the six large bank groups in Sweden, four had losses in the range of 3-5 percent of total loans while Nordbanken had 8 percent, and the Gota Bank had 15 percent losses¹⁶. The total aggregate losses amounted to 12 percent of annual GDP¹⁷. In October 1992, Nordbanken created its own bad bank¹⁸ Securum, to manage the bad assets. In January 1993, the government took over full ownership of this institution. The government insisted on the writing down of losses by the failing banks as determined by the Banking Supervision Authority before they turned to the government for recapitalisation. The Swedish government acquired equity in the banks which were recapitalised with tax-payer funds.

Securum bought assets worth SEK 67 billion (a little over 4 percent of GDP) from Nordbanken at SEK 50 billion. An AMC called Retrieva was also created to manage the NPLs of Gota Bank and later, it was merged into Securum¹⁹. Retrieva bought assets worth SEK 45 billion, amounting to 3 per cent of the banking sector's assets. The transferred assets amounted to 80 per cent of the real estate sector and the assets were transferred mainly on the basis of the size and complexity of the loans involved²⁰.

The purpose of creating a bad bank was to manage non-performing assets and Securum initially had a defined lifetime of 15 years to gradually dispose of assets because selling them during the crisis would have escalated the downward trend in asset prices. Although Securum was owned fully by government, the management consisted of private experts which led to owner-management i.e. Principal-Agent issues. Private individuals who had expertise in asset recovery and management were required to manage the assets of Securum²¹. Securum had 790 clients on their books and by early 1993, 70 per cent of the assets/debtor companies were either liquidated or declared bankrupt. Securum sold off its assets through IPOs on the Stockholm Stock Exchange, to businesses and individuals. In specific cases, healthy assets were bundled with bad assets before sale²². When the bad bank was created, Stefan Ingves, the director general of Sweden's Bank Support Authority said, "Securum is designed to last 10 to 15 years". However, Securum closed its operations in 1997, 10 years ahead of its deadline and it returned SEK 14 billion of the initial funding of SEK 24 billion to the

¹⁴ Ending the Bank support, Ministry of Finance, DS 1995:67, Sweden, Operating losses include Securum as well.

¹⁵ History of financial supervision authority, <http://www.fi.se/Folder-EN/Startpage/About-FI/Who-we-are/History/>

¹⁶ Ending the Bank support, Ministry of Finance, DS 1995:67, Sweden

¹⁷ Swedish central bank chief Bäckström speech, Federal Reserve Symposium, August 29, 1997

¹⁸ Securum also acted as an Asset Management Company (AMC)

¹⁹ Peter Englund (June 2015), "The Swedish 1990s banking crisis – A revisit in the light of recent experience", Riksbank, <http://www.riksbank.se/Documents/Avdelningar/AFS/2015/Session%201%20-%20Englund.pdf>

²⁰ Refer to "The Use of Asset Management Companies in the Resolution of Banking Crises Cross-Country Experiences", Daniela Klingebiel, World Bank, 2000

²¹ Securum and the Way out of the Swedish Banking Crisis, Clas Bergstrom et al. (May 2003). SNS - Centre for Business and Policy Studies, Sweden

²² Economist (June 1997), "Cleaning Up," <http://www.economist.com/node/92241>

government. In July 1996, the Swedish government announced that the banking crisis had ended and the Banking Supervisory Authority was dissolved²³.

The following factors helped Securum in disposing assets it acquired from Nordbanken and Gota.

- It had government backing and the legislative changes (Table 3) to speed up the recovery process²⁴ and clearly-defined goals.
- Securum was able to act speedily and that helped dispose of assets which were beyond any possibility of recovery²⁵.
- The revival in property markets helped Securum as 80 percent of its assets were in the real estate sector and also the broader economic recovery was helpful (Figure 1).
- Opposition parties supported the measures taken by the government which helped restore investor confidence²⁶.

Table 3: Examples of Financial Sector Crisis-related Legislative Changes in Sweden, United States and Indonesia

	Legislative Changes
Sweden	Act to enable state aid to banks and other credit institutions was passed by Parliament in 1993 and repealed in 1996. This Act stated that: <ul style="list-style-type: none"> • State aid must be conditional • Government can own equity in banks which had approached government for recapitalisation • If bank capital adequacy ratio fell below 2 per cent the Bank Support Authority was entitled to transfer ownership of bank to government by share transfer • Government could retain part of the rise in value if profitability is restored Source: 1993 Act on state aid to banks and other credit institutions
United States	United States Government passed The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989 to stabilise its thrift industry <p>Under FIRREA</p> <ul style="list-style-type: none"> • Resolution Trust Corporation (RTC) was established to conduct asset disposal and act as a conservator/receiver of thrift institutions • Resolution Funding Corporation (REFCORP) was created to provide funds to RTC • RTC was given powers to authorize the emergency acquisition of failed institutions by overriding state laws • RTC and FDIC were directed to make use of private entities such as real estate and loan portfolio asset-property management, marketing, and brokerage services and expertise in asset recovery in carrying out its activities Source: FIRREA Act 1989
Indonesia	Banking law was amended to give special powers to the Indonesian Bank Restructuring Agency (IBRA) IBRA was allowed to take control of failing institutions without the approval of owners or borrowers and “it was able to threaten owners of failed banks with seizure of their assets for violation of obligations” <p>Source: Mari Pangestu and Manggi Habir, The Boom, Bust and Restructuring of Indonesian Banks, IMF WP/02/66, Page no:77-78</p>

The entire Securum exercise cost tax-payers SEK 35 billion, about SEK 15 billion less than initial estimates which amounted to 2.1 percent of GDP at 1997 prices²⁷.

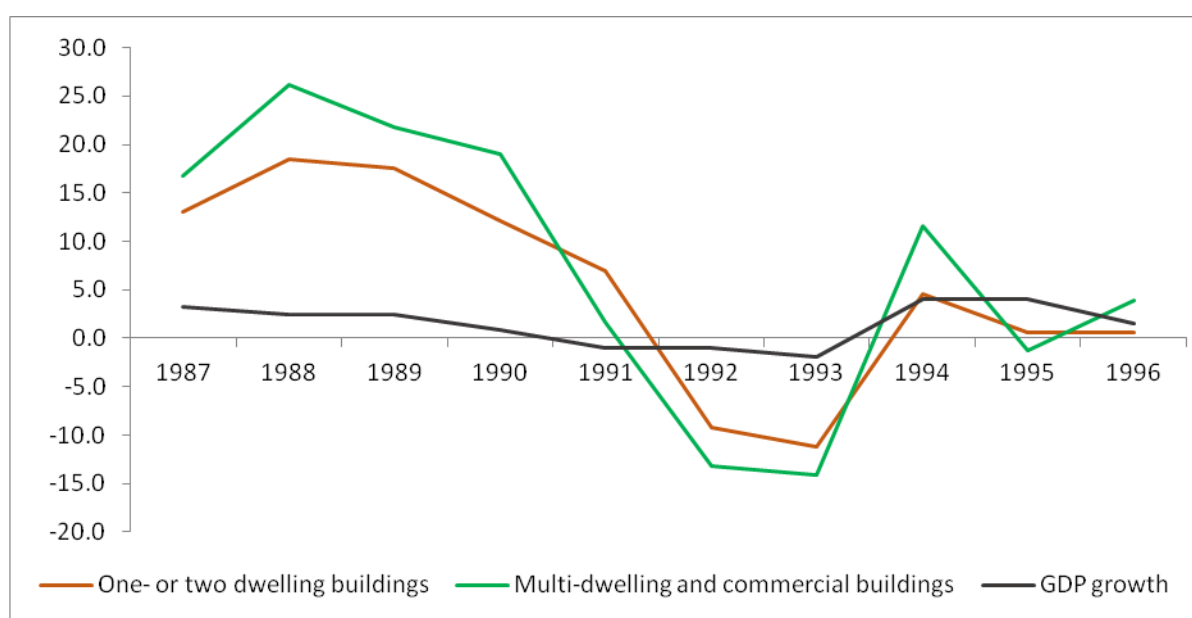
²³ Sweden: 2009 Article IV Consultation - Staff Report, IMF

²⁴ Ending the Bank support, Ministry of Finance, DS 1995:67, Sweden

²⁵ Lars Jonung (February 2009), The Swedish model for resolving the banking crisis 1991-93: Seven reasons why it was successful, Economic Papers 360, European Commission

²⁶ Lars Jonung (February 2009), The Swedish model for resolving the banking crisis 1991-93: Seven reasons why it was successful, Economic Papers 360, European Commission

Figure 1: Real Estate Prices and GDP growth: Sweden (1987-1996)



Source: Statistics Sweden and IMF WEO October 2016

Subsequently, the Swedish government was criticised for providing open-ended funding to Securum and concerns were raised about market distortions. Due to principal-agent issues, there were problems in incentivising management. In 1994, the chairman of the company resigned after publicly-aired differences between management and the government²⁸. For all its drawbacks, Securum was deemed by *The Economist* to be a reasonable model in cleaning bank books²⁹.

1.3 United States

1.3.1 Resolution Trust Corporation (RTC)

The Savings and Loan crisis in the United States had its origins in thrift institutions. In the early 1980s, savings and loan institutions (S&Ls) were faced with two major problems. First, S&Ls could not offer higher interest rates for deposits even when other financial institutions were offering attractive rates because S&L's interest rates were determined by government which made it difficult for them to attract deposits. Second, most of the loans provided by these institutions were long-term fixed interest rate mortgages and predictably when interest rates rose, the mark-to-market value of assets owned by these institutions shrank. Of a total USD 960 billion of outstanding mortgage loans, S&Ls had provided around USD 480 billion³⁰. To put matters in perspective, long-term fixed interest rate mortgages amounted to

²⁷ The Swedish Banking Crisis, Roots and Consequences, Peter Englund (1999), Oxford University Press

²⁸ Securum and the Way out of the Swedish Banking Crisis, Clas Bergstrom et al (May 2003). SNS - Centre for Business and Policy Studies, Sweden

²⁹ Economist (June 1997), "Cleaning Up", <http://www.economist.com/node/92241>

³⁰ Kenneth J. Robinson, Savings and Loan Crisis 1980-89, Federal Reserve Bank of Dallas, <http://www.federalreservehistory.org/Events/DetailView/42>

80 percent of the assets of S&Ls. In an effort to support S&Ls the government deregulated these institutions which had adopted risky practices, accentuating the problem³¹. It cost around USD 124 billion (1.5 percent of GDP at 1997 prices) to resolve the S&L crisis³².

Among the steps taken by the United States Government during the S&L crisis was the establishment of a Resolution Trust Corporation (RTC). The RTC was created in 1989 under the title V³³ of the Financial Institutions Reform, Recovery, and Enforcement (FIRREA) Act. It was mandated to maximize the net present value of assets, minimise the impact of asset sales on financial markets and was also tasked with continuing to provide affordable housing to low-income households³⁴. These contradictory objectives made the RTC's work in disposing assets that much more difficult. At the time the RTC was created in 1989, it inherited 262 failed thrift institutions from the Federal Deposit Insurance Corporation (FDIC).

In 1989, FIRREA also created the Resolution Funding Corporation (REFCORP) for the sole purpose of providing funds to the RTC³⁵. Funds were required to repay depositors at failed thrift institutions and to purchase assets from insolvent institutions. RTC issued capital certificates to REFCORP for it to borrow. FIRREA also allowed the RTC to borrow from the US Treasury by issuing promissory notes. However, there was a ceiling on such borrowings³⁶.

In 1990, Treasury Secretary Nicholas Brady, also the Chairman of the oversight board of the RTC, reported to the House Banking, Finance & Urban Affairs Committee that it was difficult to estimate the total cost incurred by the RTC. Responding to the Committee's comment that the RTC's resolution process was slow, Brady said that rapid sale of assets would have accentuated the crisis and caution was needed in disposing of assets³⁷.

At the end of 1995, RTC had "resolved" 747 thrift institutions and its costs amounted to US\$ 447 billion. RTC sold assets in ways such as direct sale to individuals and corporations and securitization. RTC was wound down by December 31, 1995 a year ahead of its scheduled closure. RTC transferred assets worth US\$ 7.7 billion to the Federal Deposit Insurance Corporation (FDIC) which were not resolved at the time of its closure³⁸.

³¹ For full history of Savings and Loan Crisis, see "An Examination of the Banking Crises of the 1980s and Early 1990s", https://www.fdic.gov/bank/historical/history/167_188.pdf

³² Timothy Curry and Lynn Shibut, The Cost of the Savings and Loan Crisis: Truth and Consequences, FDIC Banking Review

³³ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Title V, <https://www.gpo.gov/fdsys/pkg/STATUTE-103/pdf/STATUTE-103-Pg183.pdf>, Page nos: 181-226

³⁴ Resolution Trust Corporation, "Annual Report", 1994

³⁵ Resolution Funding Corporation, <https://www.frbsservices.org/files/operations/pdf/ResolutionFundingCorporation.pdf>

³⁶ Politics and Policy: The Creation of the Resolution Trust Corporation, <https://www.fdic.gov/bank/analytical/banking/2005jul/article2.pdf>

³⁷ Resolution Trust Corporation Oversight Report, <https://www.c-span.org/video/?12706-1/resolution-trust-corporation-oversight-report>

³⁸ RTC, Annual Report 1995

1.3.2 RTC and Courts

During its lifetime RTC was involved in about 110,000 lawsuits and the government's legal costs exceeded US\$ 540 million. According to the fact sheet published in 1993 by General Accounting Office (GAO), RTC was involved in 77,523 legal cases during the period October 1991 to November 1992, with 3,138 additions per month. Most of these cases (69 percent) were initiated by the RTC and it was the defendant in 12 percent of the cases. RTC's Legal Information Systems (RLIS) data showed that it had spent close to a billion dollars on legal fees and close to US\$ 350 million was spent on 2806 professional liability matters which included suits brought against the former owners and shareholders of the institutions³⁹. The amount spent by the FDIC and RTC on outside legal counsel peaked in 1991, at US\$ 701 million⁴⁰. RTC mostly used outside counsel until 1993. The RTC Completion Act which was passed in 1993, directed RTC to use in-house expertise before turning to outside legal counsel. The Act also authorized RTC to allow the acquisition and administration of failed thrift institutions by other institutions including banks. This was invariably not allowed under state laws but RTC had the legal powers to override state laws and the reason was that delays in acquisition of failed thrifts by banks could substantially increase the cost of resolution of such thrifts⁴¹.

1.3.3 Disposal of "Troubled" Assets post-2008 crisis in the US

The 2008 global financial crisis which originated in the United States was unlike previous recent crises, both in size and scale. There were suggestions from various quarters to set up an RTC-like institution to dispose of troubled assets which would help bring financial institutions back to health⁴². Unlike what happened in the 1990s, after the 2008 crisis, impaired assets were bought directly by the Federal Reserve and the US Treasury under its Troubled Asset Relief Program (TARP)⁴³.

Although this was the worst financial crisis since the Great Depression of the 1930s, the non-performing loans of banks peaked in 2009 (5 percent of total loans) and have been declining since then because of the following factors⁴⁴:

- Over the last three decades the primary and secondary markets for distressed assets have grown substantially, averaging around USD 400-450 billion worth of transactions per annum;
- Regulatory requirements to write-off loans within stipulated time limits⁴⁵.

³⁹ Mark Cassell (August 2003), How Governments Privatize: The Politics of Divestment in the United States and Germany, Page no:219

⁴⁰ FDIC, Chapter 18: The FDIC's Use of Outside Counsel, Managing the Crisis: The FDIC and RTC Experience

⁴¹ Wayne M. Josel, "Resolution Trust Corporation: Waste Management and the S&L crisis", Fordham Law Review, 1991

⁴² Nicholas F. Brady, Eugene A. Ludwig, and Paul A. Volcker, Resurrect the Resolution Trust Corp., September 2008, <https://www.wsj.com/articles/SB122161086005145779>

⁴³ Please see Annex IV for the list of Programs under TARP

⁴⁴ Nadège Jassaud and Kenneth Kang, A Strategy for Developing a Market for Non-performing Loans in Italy, IMF Working Paper WP/15/24

According to several estimates, to date, the global financial crisis cost the US economy from a few trillion US dollars (USD) to more than USD 10 trillion⁴⁶. In order to strengthen the financial system and to plug gaps in financial sector regulation, US passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) in July 2010. An executive order issued by the United States President Donald Trump in February 2017, has directed the Secretary of Treasury to report on the efficiency of US financial regulations.

1.4 Indonesia

By 1998, during the South East Asian crisis, Indonesian NPLs as a percentage of total gross loans had risen to 48.6 percent⁴⁷. The Indonesian Government established the Indonesian Bank Restructuring Agency (IBRA) in January 1998, as part of the International Monetary Fund's (IMF) US\$ 14.1 billion bailout programme to support/resolve failing banks, and its mandate was, "to close, merge, takeover and recapitalise troubled banks". The IBRA was also tasked with managing the Government's banking and related assets. Under an agreement with IMF, the Government stood guarantee for all bank liabilities.

IBRA took over 30 percent of the banking system and acquired assets worth 20 percent of the GDP⁴⁸. IBRA initially had 500 staff and most employees were from the Central Government and public financial institutions⁴⁹. IBRA was granted legal powers to seize the assets of borrowers. Despite the powers bestowed on IBRA the recovery rate⁵⁰ was just 8 percent and the net cost to the government was 51.9 percent of GDP⁵¹. The reasons for this were excessive involvement of the government in the operations, political instability in the country and numerous changes in leadership: there were seven heads of the agency during its life of 6 years⁵².

1.5 Key Characteristics of Foreign RTCs, AMCs and Bad Banks

1.5.1 Financing

The financing of a so-called bad bank, AMC or RTC, can come from issuance of government-backed bonds. In Korea and Taiwan, more than 90 percent of the financing of

⁴⁵ "U.S. regulatory guidance has introduced time-limits on writing off NPLs that are independent from the time needed to foreclose. For example, after 180 days past due, a mortgage loan is valued exclusively based on the underlying collateral (at market price with no adjustment for possible increase in value over time). Any loan balance that exceeds the value of the collateral, less the cost to sell, should be written off. This requirement is regardless of how long it takes to foreclose." (IMF 2015)

⁴⁶ US Government Accountability Office, Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act, GAO-13-180, January 2013

⁴⁷ Bank Non-performing Loans to Total Gross Loans (%), World Bank data

⁴⁸ Mari Pangestu and Manggi Habir, The Boom, Bust and Restructuring of Indonesian Banks, IMF WP/02/66

⁴⁹ Bank Restructuring in Practice, Bank for International Settlements, Policy Papers, No. 6, August 1999, Page no 197, <http://www.bis.org/publ/plcy06.pdf>

⁵⁰ Amount recovered out of total book value

⁵¹ Dong He, The Role of KAMCO in Resolving Non-performing Loans in the Republic of Korea, IMF WP/04/172

⁵² For more on the corruption and scandals in the Indonesia's financial sector please see "Combating Corruption in Indonesia Enhancing Accountability for Development", World Bank, East Asia Poverty Reduction and Economic Management Unit October 20, 2003

AMCs was through government-backed bonds⁵³. In the case of Sweden and United States, Securum and RTC were funded fully by the respective governments.

1.5.2 Administration

At times, the involvement of government leads to sub-optimal outcomes. In the case of Indonesia's IBRA the recovery rate was low at 8 percent. Political interference in the operations of IBRA is apparent since the Chairman of IBRA was changed seven times in just 5 years⁵⁴.

1.5.3 Asset Disposal/Restructuring

The relative "success" of the bad bank, Securum, in Sweden, and the RTC in the US was due to several factors. In Sweden, the recovery of property prices was helpful (Figure 1). The replaced management consisted of experts who played a vital role in analyzing asset values, which is crucial in the less liquid conditions in asset markets during a crisis. In disposing of assets, higher value assets were bundled with the less attractive ones⁵⁵. Deeper financial markets (Table 4) and availability of a wider range of instruments to these AMCs were also important factors. By contrast, markets for stressed assets, corporate bonds and other debt securities are far less wide and liquid in developing economies.

Table 4: Measure of Financial Depth in 2012 (per cent of GDP)

	Equity	Financial bonds	Corporate bonds	Securitised loan	Non-securitised loans
United States	116	99	36	66	60
Western Europe	59	113	14	12	108
China	47	18	9	-	132
India	60	5	3	-	54

Source: McKinsey Global Institute⁵⁶

1.6 Nonperforming Loans (NPLs) in Europe/Italy

Non-performing loans in the Euro area have increased from 2.8 per cent of total gross loans in 2008 to 5.4 per cent in 2016. Such loans peaked in 2013 at 7.9 per cent and declined thereafter owing to the fall in NPLs in Spain. After the Global Financial Crisis (GFC) of 2008, the European Commission (EC) approved EUR 4.9 trillion as the total amount of state

⁵³ Ben Fung, Jason George, Stefan Hohl and Guonan Ma (February 2004), Public asset management companies in East Asia: A Comparative Study, Financial Stability Institute, Bank for International Settlements, Occasional Paper No 3, <http://www.bis.org/fsi/fsipapers03.pdf>

⁵⁴ For complete analysis of IBRA please see Ben Fung, Jason George, Stefan Hohl and Guonan Ma (February 2004), Public asset management companies in East Asia: A Comparative Study, Financial Stability Institute, Bank for International Settlements, Occasional Paper No 3, <http://www.bis.org/fsi/fsipapers03.pdf>

⁵⁵ For example in Sweden, Securum combined bad loans with working loans and sold of

⁵⁶ Jaimini Bhagwati et al. (June 2016), Financial Sector Legislative Reforms Commission (FSLRC) & Financial Sector Regulation in India, ICRIER Working Paper 324, Page no 40

aid permitted to restore confidence in the financial system. Of this EUR 4.9 trillion of sanctioned state aid, EUR 1.9 trillion was provided directly by member states⁵⁷. However, in 2014, the Bank Recovery and Resolution Directive (BRRD) was introduced under which this ‘bail-in’ replaced ‘bail-out’, which came into force in 2016. Under this directive, banks which seek state help should be put into resolution, and shareholders and junior bondholders have to share the burden before taxpayer funds are used. There is another way for banks to get state help and that is by requesting ‘precautionary recapitalisation’. This is discussed later in this Section in the context of setting up a state fund of EUR 20 billion in Italy to support troubled banks.

Table 5: Bank nonperforming loans to total gross loans (percentage)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Euro area	2.8	4.8	5.4	6.0	7.5	7.9	6.8	5.8	5.4
Spain	2.8	4.1	4.7	6.0	7.5	9.4	8.5	6.2	6.1
European Union	2.8	4.7	5.4	5.8	6.7	6.4	5.6	5.6	5.2
Greece	4.7	7.0	9.1	14.4	23.3	31.9	33.8	36.6	37.0
Italy	6.3	9.4	10.0	11.7	13.7	16.5	18.0	18.0	

Source: Bank non-performing loans to total gross loans (per cent), World Bank data

The prolonged slowdown of the Italian economy, particularly since 2008, is the chief contributor to the size of NPAs. Growth forecasts for the Italian economy are not encouraging and Italy is expected to reach its pre-2008 GDP level by 2025⁵⁸ (Figure 2). Other reasons for the rise in NPA levels are⁵⁹:

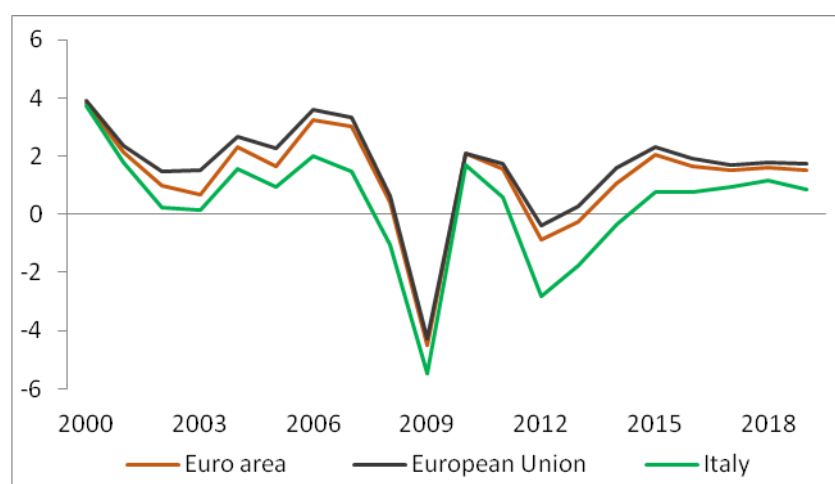
- The slow pace of NPL write-offs and inadequate provisioning for NPLs
- Bank reliance on collateral
- Inefficient and lengthy legal processes
- Relatively small Italian distressed debt markets

⁵⁷ State Aid Scoreboard 2015 > Aid in the context of the financial and economic crisis, European Commission

⁵⁸ IMF, 2016 Article IV Consultation—Press Release; Staff Report; and Statement By The Executive Director For Italy, IMF Country Report No. 16/222, July 2016

⁵⁹ Nadège Jassaud and Kenneth Kang, A Strategy for Developing a Market for Nonperforming Loans in Italy, IMF Working Paper WP/15/24

Figure 2: GDP growth



Source: IMF World Economic Outlook database October 2016

Inefficient Legal Processes

The Italian Central Bank governor, Ignazio Visco, highlighted the long and deep recession and lengthy recovery procedures as the chief reasons for the rise in NPA levels. He also commented that if the time taken for recovery had been in line with the Euro area average, then Italian NPA levels would have been half of the current levels⁶⁰. In Italy, on average, it takes more than seven years to complete a bankruptcy procedure and three years to foreclose the real estate collateral.

According to the World Bank's 2017 Doing Business Report, Italy ranks 20 out of 31 OECD countries in resolving insolvency. In enforcing contracts, Italy is in the 30th position out of 31^{61,62}. Despite the recent legal reforms in the country such as measures to encourage out-of-court settlements and amendments to the insolvency law, the number of enterprise insolvencies, which is close to 15,000 is nearly double that in the pre-crisis years⁶³.

The size of NPLs in the Euro area stood at EUR 1014 billion in April 2016, which is less than EUR 1114 billion in April 2015⁶⁴. In Italy, the size of NPLs was EUR 356 billion at the end of June 2016, which is 18 percent of total outstanding loans. Net of write downs NPLs came down to EUR 191 billion (10.6 percent of total loans), and of this, only EUR 88 billion (4.8 percent of total loans) considered as net bad loans was exposed to insolvent debtors. Even though NPAs in the Italian banking system continued to increase after the global financial crisis, the addition of new non-performing loans in 2016 was the lowest since 2008.

⁶⁰ Speech by the Governor of the Bank of Italy, Ignazio Visco, 23rd ASSIOM FOREX Congress, 28 January, 2017

⁶¹ Nadège Jassaud and Kenneth Kang, A Strategy for Developing a Market for Non-performing Loans in Italy, IMF Working Paper WP/15/24

⁶² Resolving Insolvency, Doing Business Report, The World Bank

⁶³ Nadège Jassaud and Kenneth Kang, A Strategy for Developing a Market for Non-performing Loans in Italy, IMF Working Paper WP/15/24

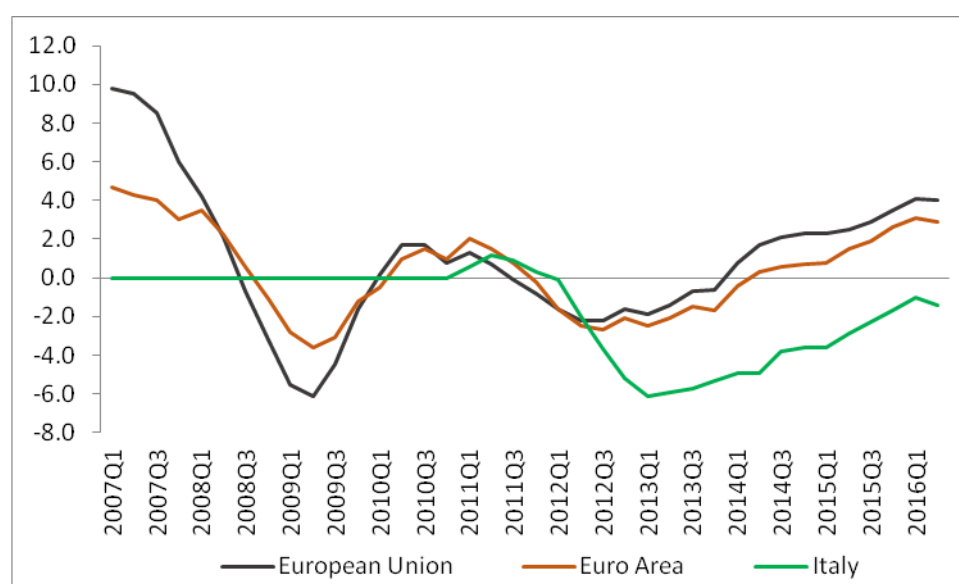
⁶⁴ Statistical Data Warehouse, European Central Bank

Table 6: Non-performing loans in Italy as of June 2016

	In Euro billions	As % of total loans
Total NPLs	356	18
NPLs net of write-downs	191	10.6
Exposure to insolvent debtors (net bad loans)	88	4.8

Source: Bank of Italy⁶⁵

It is estimated that about EUR 100 billion of loans is backed by real estate assets⁶⁶ and it is worth noting that the house prices in Italy have dropped over 14 percent during 2010-16 (Figure 3). A July 2016 IMF staff report states that if the risks in the Italian banking system are not contained, this could pose a significant risk to Europe, and to even the global financial system⁶⁷.

Figure 3: House Price Index – Annual rate of change

Source: Eurostat

In its Financial Stability Review of November 2016, the European Central Bank (ECB) examined the role of Asset Management Companies (AMCs) funded by governments in resolving NPLs in the banking sector. This review has noted that AMCs could be successful in resolving NPLs which consist of commercial real estate, land and related assets. However,

⁶⁵ Speech by the Governor of the Bank of Italy, Ignazio Visco, 23rd ASSIOM FOREX Congress, 28 January, 2017

⁶⁶ “The Italian NPL market The NPL volcano is ready to erupt”, PwC, June 2016

⁶⁷ IMF, 2016 Article IV Consultation—Press Release; Staff Report; And Statement By The Executive Director For Italy, IMF Country Report No. 16/222, July 2016

when NPLs are mostly corporate loans, resolution is doubtful given the lack of third party expertise. That is, AMCs can be successful but under specific conditions⁶⁸.

In Italy, loans to enterprises consist of around EUR 250 billion, and of this, EUR 154 billion represents the lowest category, given their legal status⁶⁹. Private-investor interest in bad loans has been increasing over the last two years as evident from transactions between banks and investors. In the first half of 2016, deals worth EUR 11.4 billion were closed and another EUR 40.6 billion were in the pipeline. This is a significant increase from 2015, when EUR 17.3 billion worth of transactions were concluded⁷⁰.

Despite this increase in distressed debt sales, there are concerns over the health of the European banking sector. In the stress tests conducted by the European Banking Authority (EBA), capital shortfall of Italy's third largest bank, Monte dei Paschi di Siena (MPS), under an adverse scenario analysis, increased to EUR 8.8 billion in December 2016, from earlier estimates of EUR 5 billion, in July 2016⁷¹. In December 2016, MPS failed to raise EUR 5 billion from private investors. The Italian Parliament has approved a state fund of EUR 20 billion to support troubled banks. MPS is seeking state help under 'Precautionary Recapitalisation'.

According to the Bank Recovery and Resolution Directive (BRRD), under Precautionary Recapitalisation⁷²:

- This is meant for institutions which are solvent⁷³ but pose a serious threat to the economy;
- Banks that fall short of capital in stress test results of the European Banking Authority (EBA);
- Does not necessarily result in initiation of resolution procedures but could result in state aid;
- A minimum 8 per cent of liabilities must be absorbed by shareholders and junior creditors.

These measures are conditional on approval of the European Commission. In case of MPS, even though the Italian Government has signaled that it will provide state funding assistance

⁶⁸ Addressing market failures in the resolution of non-performing loans in the euro area, Financial Stability Review, November 2016

⁶⁹ José Garrido, Insolvency and Enforcement Reforms in Italy, IMF Working Paper WP/16/134, July 2016

⁷⁰ Deleveraging Europe 2016, H1 Market Update, Deloitte

⁷¹ 2016 EU-wide stress test results, European Banking Authority, http://www.eba.europa.eu/documents/10180/1519983/EBA_TR_IT_J4CP7MHCXR8DAQMKIL78.pdf

⁷² At A Glance: Recapitalisations - BRRD provisions and State Aid rules, European Parliament, [http://www.europarl.europa.eu/RegData/etudes/ATAG/2014/528739/IPOL-ECON_DV\(2014\)528739_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/ATAG/2014/528739/IPOL-ECON_DV(2014)528739_EN.pdf)

⁷³ A bank is considered as solvent, "if it fulfils the minimum capital requirements (i.e. Basel III Pillar 1 requirements). In addition, the bank should not have a shortfall under the baseline scenario of the relevant stress test." And this is determined by European Central Bank (ECB)

to the bank it is not certain whether the EU will approve precautionary recapitalisation of the bank⁷⁴.

From the Italian experience, it appears that an insolvency law, alone, does not make the required difference in recovering impaired assets, and it is equally the legal infrastructure and efficiency of the regulatory framework which determines the time taken for recovery of assets.

Summary

An analysis of cross-country experiences of bad bank/AMC/RTCs can provide important lessons for the current bad debt situation in India. The following are a few of the reasons for the relative success of these models in foreign jurisdictions:

- Political consensus;
- Efficient legal processes;
- Effective legislative changes to give adequate powers to AMC/RTC;
- Developed financial markets;
- Use of private sector expertise in restructuring/recovering companies.

Section II

2.1 Overview of Bankruptcy and Restructuring Framework and Genesis of ARCs in India

The sharp rise in NPAs since 2013-14 has brought the focus back on Indian banks under stress, RBI as regulator and government as majority share-holder of public sector banks (PSBs). India's legal framework to address bankruptcies and/or restructuring has not been sufficiently efficient or effective in addressing non-performing assets. According the World Bank's Doing Business Report of 2016, India was ranked 135 among 189 countries on resolving insolvency^[1]. This Report estimates that, "resolving insolvency takes 4.30 years on average and costs 9 per cent of the debtor's estate. The average recovery rate is 25.70 cents on the dollar"^[2]. India's weak institutional structure to recover non-performing loans has affected the health of the banking system and also seriously hampered credit growth in the economy⁷⁵. The principal issue right now for the banking sector is how best to reduce the debt overhang to enable banks to renew longer-term lending prudently.

⁷⁴ Italy Clears Hurdle in Monte Paschi Rescue Without Even Trying, Bloomberg, January 9, 2017

^[1] Doing Business 2016

^[2] Doing Business 2016

⁷⁵ Credit growth averaged 21.9 per cent between 2004-05 and 2013-14. With rising NPAs, risk aversion and concern over capital adequacy has increased, resulting in lower credit growth (RBI, Financial Stability Report June 2016). Credit growth has averaged 10 per cent in last two years (RBI database, 2016).

2.1.1 SICA and RDDBFI Act

Indian bankruptcy/insolvency law has evolved over the last three decades. The government constituted the T. T. Tiwari Committee in 1981, to deal with sick industrial units. Based on the recommendations of this Committee, the Sick Industrial Companies (Special Provisions) Act (SICA), 1985⁷⁶ was approved by Parliament⁷⁷. SICA dealt with both, private and public companies, with the objective of, “determining sickness and expediting the revival of potentially viable units or closure of unviable units”⁷⁸. Under SICA, the Board of Industrial and Financial Reconstruction (BIFR) was set up to assess the viability of industrial companies and refer unviable companies to high courts for liquidation^{79,80}.

SICA was mostly ineffective in the revival or liquidation of sick industrial units. The lengthy, sometimes even never-ending legal proceedings in BIFR and the high courts rendered the law ineffective. Courts often slowed the liquidation of companies recommended by BIFR and acted outside the remit of SICA to protect the interests of workers. BIFR, and in several cases the high courts, did not take a broader view of the implications of their judgments, which proved counter-productive in protecting workers’ interest⁸¹ or the financial sector and overall business sentiment. Under the SICA Act, owners/directors remained at the helm of companies during BIFR proceedings. The BIFR Tribunal acquired the reputation of a ‘haven’ for debtor companies to seek shelter from their creditors for decades, with corporate owners-managers siphoning off assets in the interim”⁸². This made debt recovery difficult, if not impossible, even if BIFR eventually ordered liquidation of the company concerned⁸³. In summary, SICA proved to be a major hurdle in effective implementation of subsequent legislative reforms to address insolvency cases.

A sharp rise in the number of NPA cases being heard in civil courts⁸⁴ prompted the government to set up separate tribunals to deal with debt recovery cases. In 1993, the Indian Parliament approved the Recovery of Debts due to Bank and Financial Institutions Bill

⁷⁶ <http://bifr.nic.in/introduction.htm>

⁷⁷ <http://bifr.nic.in/introduction.htm>

⁷⁸ <http://bifr.nic.in/introduction.htm>

⁷⁹ MoF (2015) The report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design

⁸⁰ Orders of the BIFR can be challenged in the Authority for Industrial and Financial Reconstruction (AAIFR).

⁸¹ In 1993, The Committee on Industrial Sickness and Corporate Restructuring recognised that, “the various barriers to industrial and corporate restructuring serve no economic goal. By preventing reorganization at the appropriate time, these barriers choke off future growth opportunities, and so foster an uncompetitive environment which rapidly leads to gross and pervasive industrial sickness. For exactly the same reasons, these barriers are anti-labour although the restraints seek to protect labour in the short run, these actually harm long and medium-term employment by eliminating growth possibilities. Equally, these barriers go against the economic interests of any non-myopic government. They result in a systematic drain of scarce public funds, foster a climate of budgetary support, and eventually justify high tariffs, quotas, sectoral and product reservations to sustain inefficient firms. Indeed, barriers to restructuring have only one over-riding purpose: they maintain an army of inefficient promoters and managers in the public and the private sector, who justify their incompetent existence on the ground that their firms “protect” employment”.

⁸² ZWIETEN (2015)

⁸³ ZWIETEN (2015)

⁸⁴ At the end of September 1990, more than 15 lakh cases of public sector banks, involving Rs 5622 crores were pending in various courts (The Recovery of Debts Due to Banks and Financial Institutions Act, 1993)

(RDDBFI), to expedite adjudication and recovery of debts due to banks and financial institutions⁸⁵. The RDDBFI Act established debt recovery tribunals⁸⁶ (DRTs) to deal with NPAs of both secured and unsecured borrowers, with loan amounts exceeding Rs 10 lakh⁸⁷. However, the recovery process under this Act has been delayed by the intervention of civil courts and references to BIFR.

BIFR was systematically misused by loan defaulting companies to stall loan recovery proceedings by banks and financial institutions under the RDDBFI Act⁸⁸. By claiming that accumulated losses were equal to or more than their net worth⁸⁹, companies took cover under the BIFR (under SICA⁹⁰) to frustrate and delay debt-recovery proceedings. Under the RDDBFI Act, banks and financial institutions can file debt recovery cases with Debt Recovery Tribunals (DRTs), which are expected to dispose of the case within 180 days⁹¹. However, in practice, proceedings in tribunals are indefinitely delayed. Roy and Sane (2016) found that delays are on account of lawyers asking for more time to file documents, absence of lawyers and adjournment of hearings⁹². Inadequate infrastructure in tribunals and a limited understanding of corporate business among DRT judges has prolonged the delays. Due to the large number of pending cases in DRTs, hearings sometimes take place after gaps of six months to a year⁹³.

2.1.2 SARFAESI Act and Genesis of ARCs in India

In the late 1990s and early 2000s the banking industry was saddled with non-performing assets (NPAs). The gross non-performing assets (GNPAs) as a percentage of advances for scheduled commercial banks (SCBs) stood at 15.7 in March 1997⁹⁴. The Narasimham Committee I and II, and the Andhyarujina Committee suggested enactment of legislation which empowers banks and financial institutions to take possession of securities and sell them without intervention of courts⁹⁵. Based on these recommendations, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI)

⁸⁵ DRT, The Recovery Of Debts Due To Banks And Financial Institutions Act, 1993

⁸⁶ DRT judgments can be challenged in Appellate Tribunals. There are 33 DRTs and 5 DARTs across India, which are presided over by district and high court judges (or persons with equivalent qualification) respectively.

⁸⁷ <http://www.drtat.tn.nic.in/Docu/RDDBFI-Act.pdf>

⁸⁸ Nair (2015), “Sick firms take BIFR route to delay legal action by banks”

⁸⁹ BIFR, criteria to determine sickness in an industrial company

⁹⁰ Section 22 of SICA states that, “no suit for the recovery of money or for the enforcement of any security against the industrial company or of any guarantee in respect of any loans or advance granted to the industrial company shall lie or be proceeded with further, except with the consent of the Board or, as the case may be, the Appellate Authority” MoF (1986), The Sick Industrial Companies (Special Provisions) Act, 1985

⁹¹ DRT, The Recovery Of Debts Due To Banks And Financial Institutions Act, 1993

⁹² Roy and Sane (2016), “Understanding judicial delays in India: Evidence from Debt Recovery Tribunals”

⁹³ Gandhi (2014), “Banks, Debt Recovery and Regulations: A synergy” talk delivered by Shri R. Gandhi, Deputy Governor, RBI, on Dec 29, 2014 at the “Workshop for Judges of DRATs and Presiding Officers of DRTs”

⁹⁴ RBI (2009), Gross and Net NPAs of Scheduled Commercial Banks – Bank Group-wise

⁹⁵ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

Act, 2002, was approved by Parliament⁹⁶. This Act only covers secured borrowers. After the notice period (60 days) given to non-performing secured borrowers expires, banks can themselves adjudicate the course of action. The Act empowers financial institutions to take possession of collateralised assets, manage assets, sell, or lease a part, or all of the business of the borrower⁹⁷.

The Committee on Banking Sector Reforms (Narasimham Committee II), recommended setting up of Asset Reconstruction Companies (ARCs) to transfer NPAs from the banks⁹⁸. Acting on the recommendations of this Committee, the Union Budget of 2002-2003 proposed the establishment of ARCs by public and private sector banks, financial institutions and multilateral agencies to take over NPAs and develop markets for securitized loans⁹⁹.

The SARFAESI Act provided for the establishment of ARCs. Accordingly, on April 23, 2003, the RBI issued guidelines under the SARFAESI Act, for setting up Securitisation Companies, or Reconstruction Companies (SCs/RCs)¹⁰⁰. The Asset Reconstruction Company (India) Limited (ARCIL) was the first ARC to be established in 2002, with the State Bank of India (SBI), IDBI Bank Limited (IDBI), ICICI Bank Limited (ICICI) and Punjab National Bank (PNB) as sponsors¹⁰¹. Currently, 19 ARCs have been permitted to do business in India (list at Annex 2). The performance of Indian ARCs is discussed in the following sub-section.

To facilitate the implementation of the SARFAESI Act without impediments stemming from the BIFR, SICA was amended in 2002. The amendments meant that after the commencement of SARFAESI Act, “no reference shall be made to BIFR”¹⁰². Pending “reference shall abate if the secured creditors, representing not less than three-fourth in value of the amount outstanding” take measures allowed under the SARFAESI Act¹⁰³. However, the elements of overlap between SARFAESI Act and SICA meant that there was continuing confusion about jurisdiction. In some cases, defaulting companies successfully argued that the expression, “reference is pending” does not apply to companies declared sick by BIFR. Therefore, creditor banks were not entitled, under law, to enforce the SARFAESI Act¹⁰⁴¹⁰⁵.

⁹⁶ Section 34 of the SARFAESI Act states that, “no civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which a Debts Recovery Tribunal or the Appellate Tribunal is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act or under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993)”

⁹⁷ RBI (2015), Notification as amended up to June 30, 2015 - The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003

⁹⁸ RBI 2001 (2001), Committee on Banking Sector Reforms (Narasimham Committee II) - Action taken on the recommendations

⁹⁹ MoF (2002), Speech of Shri Yashwant Sinha Minister of Finance, 28th February, 2002

¹⁰⁰ Securitisation Companies, or Reconstruction Companies (SCs/RCs) are to referred as Asset Reconstruction Companies (ARCs)

¹⁰¹ Arcil Website, About Arcil

¹⁰² THE SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985

¹⁰³ THE SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985

¹⁰⁴ AZB and Partners (2008), Noble Aqua Pvt. Ltd. v State Bank of India, “Laws for sick industrial companies still need to be harmonized” AZB and Partners, The Mint, Oct 26 2008

¹⁰⁵ M/S. Kanakadhara Spinning Mills vs the Registrar on 23 July, 2009

The Supreme Court ruling on January 29, 2016, in *Madras Petrochemicals vs BIFR* has brought clarity and finality with precedence being given to SARFAESI Act over SICA. The Court said that the phrase, “reference is pending”, “covers all references pending before the BIFR, no matter whether such reference is at the inquiry stage, scheme stage, or winding up stage”¹⁰⁶.

Indradhanush Scheme

The Indian central Government announced the so-called Indradhanush Scheme in 2015, to recapitalise and revamp the functioning of public sector banks. Government has estimated that the additional capital needed over the next few years up to FY 2019 would be about Rupees 1,80,000 crores, and has proposed a budgetary allocation of Rupees 70,000 crores to recapitalise banks. Government expected that, “improved valuations coupled with value unlocking from non-core assets as well as improvements in capital productivity, will enable PSBs to raise the remaining Rupees 1,10,000 crores from the market”. Given the magnitude of the NPA problem, capital infusion seems inadequate. Raising of Rupees 1,10,000 crores from capital markets after stock market valuations rise due to improved productivity also seems unrealistic.

Banks Board Bureau

To improve the governance of public sector banks, the government established the Banks Board Bureau (BBB) in 2016. The BBB is expected to advise the government on the selection and appointment of Board members in PSBs and FIs¹⁰⁷. BBB is also to advise the government on the, “formulation and enforcement of a code of conduct and ethics for managerial personal in PSBs/FIs”¹⁰⁸.

2.1.3 Recent Government Measures to Support Creditor Banks and Debt Recovery Channels

NPAs in Indian public sector banks (PSBs) have increased sharply over the last few years from 2.4 per cent in March 2011 to 11.8 per cent in September 2016. The substantive factors for this sharp increase in NPAs are the slowing down of economic growth, stoppage of large infrastructure projects (because of Supreme Court judgments banning iron ore and coal mining, for example), slower than projected acquisition of land and environmental clearances¹⁰⁹. These delays have lowered the capacity of borrowers to service their debt. Private banks lend for shorter maturities and have mostly abstained from longer-maturity infrastructure lending. Despite this it is noteworthy that NPAs in private sector banks have remained less than 3 percent over the same period which raises serious questions about the

¹⁰⁶ <http://judis.nic.in/supremecourt/imgs1.aspx?filename=43306>

¹⁰⁷ MoF (2016), “Functions of the Banks Board Bureau”, Department of Financial services, Ministry of Finance, October 20, 2016

¹⁰⁸ MoF (2016), “Functions of the Banks Board Bureau”, Department of Financial services, Ministry of Finance, October 20, 2016

¹⁰⁹ Jaimini Bhagwati et al. (June 2016), Financial Sector Legislative Reforms Commission (FSLRC) & Financial Sector Regulation in India, ICRIER Working Paper 324

quality of credit appraisal in PSBs and RBI's regulatory oversight. The shortcomings of debt recovery channels have compounded the problems of PSBs.

Table 7: Asset Quality of India Banks¹¹⁰

	Mar-11	Mar-13	Mar-14	Mar-15	Sep-15	Mar-16	Sep-16
Public Sector Banks							
Gross NPAs (%)	2.4	3.8	4.7	5.4	6.2	9.6	11.8
Net NPAs (%)	1.2	2	2.7	3.2	3.6	6.1	7.4
Restructured Assets (%)	-	7.2	7.2	8.1	7.9	4.9	4.0
Gross NPAs + Restructured Assets (%)	-	11	11.9	13.5	14	14.5	15.8
Gross+ Restructured + Written off (%)	-	13.4	14.1	16.1	17	-	-
Private Sector Banks							
Gross NPAs (%)	2.5	1.9	1.9	2.2	2.2	2.7	3.2
Net NPAs (%)	0.6	0.5	0.7	0.9	0.9	1.3	1.6
Restructured Assets (%)	-	1.9	2.3	2.4	2.4	1.8	1.4
Gross NPAs+ Restructured Assets (%)	-	3.8	4.2	4.6	4.6	4.5	4.6
Gross NPAs+ Restructured+ Written off (%)	-	5.4	6.4	6.7	6.7	-	-

Source: RBI database, presentation of S. S. Mundra (Deputy Governor, RBI), RBI Financial Stability Report, June 2016, and RBI Financial Stability Report, December 2016

RBI data shows a significant increase in the number of cases and amounts outstanding in different recovery channels in recent years. The total number of cases has increased from 6.3 lakhs in 2011-12, to 46.5 lakhs in 2015-16. The corresponding amounts involved has increased from Rs 61,100 crores to Rs 2,21,400 crores in the same period. The Lok Adalat, a forum to address small delinquent loans, accounts for more than 95 per cent of cases, but less than 35 per cent of the total amount. DRTs and the SARFAESI route for loan recovery account for Rs 69,300 crores and Rs 80,100 crores, respectively (Annex 3).

The Government has taken measures to strengthen the debt recovery process, for instance, by enacting the Insolvency and Bankruptcy Code, 2016, to, “consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of asset values of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto”¹¹¹. Under this Act and the Companies Act, 2013, the government has set up the National Company Law Tribunal (NCLT), and National Company Law Appellate Tribunal (NCLAT)¹¹². All proceedings under the Companies Act, 1956, have

¹¹⁰ Annex IV provides numbers on Returns on Assets (RoA) and Returns on Equity (RoE) data for Scheduled Commercial Banks

¹¹¹ The Insolvency and Bankruptcy Code, 2016

¹¹² Ministry Of Corporate Affairs Notification, New Delhi, the 1st June, 2016

been transferred to the NCLT¹¹³. Similarly the proceedings pending before the Appellate Authority for Industrial and Financial Reconstruction (AAIFR) and the Board for Industrial and Financial Reconstruction (BIFR) have been transferred to this tribunal¹¹⁴.

Under the new Bankruptcy Code, the NCLT is the adjudicating authority for corporate persons including corporate debtors and personal guarantors, while the DRT deals with individuals and partnership firms¹¹⁵. The objective is to speed up insolvency mechanisms since the lack thereof is one of the major impediments for doing business in India. Under the Bankruptcy Code, if an insolvency is not resolved within 180 days, the company will go into liquidation and creditors will be paid from the proceeds¹¹⁶. To facilitate the implementation of the Insolvency and Bankruptcy Code, the government has a delay of over 10 years finally notified the repeal of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA)¹¹⁷.

2.1.4 Recent RBI Measures

In February 2014, the RBI made it mandatory for banks to form a committee called the Joint Lenders' Forum (JLF) as soon as borrowers with aggregate exposure of Rs 100 crores show signs of stress¹¹⁸. The RBI provided this JLF option for lenders to restructure distressed accounts and to explore the possibility of convincing alternate equity/strategic investors¹¹⁹. These measures did produce the desired results.

In 2015, the RBI observed, "in many cases of restructuring of accounts, borrower companies are not able to come out of stress due to operational/managerial inefficiencies despite substantial sacrifices made by the lending banks. In such cases, change of ownership will be a preferred option". RBI introduced the Strategic Debt Restructuring Scheme (SDR) in June 2015 which gave an option to the JLF to convert part, or all debt into equity shares in the borrower company. Important conditions of conversion under SDR were that JLF must collectively hold more than 51 per cent of equity and lenders should divest the holdings to new promoters as soon as possible. If they are unable to find new buyers for 18 months, the asset would be treated as an NPA and standard provisioning norms would apply.

Subsequent RBI reports show that SDR too has not been substantively successful in addressing the NPA problem. Banks invoked SDR provisions in 21 cases but only 2 have been closed out¹²⁰. Finding new buyers for stressed assets has proved to be difficult in practice. To address these concerns, the RBI introduced the Scheme for Sustainable

¹¹³ [THE COMPANIES ACT, 2013](#)

¹¹⁴ [THE COMPANIES ACT, 2013](#)

¹¹⁵ [Bankruptcy Code, 2016](#)

¹¹⁶ Khullar, Vatsal (2015), "[The rise of Non Performing Assets in India](#)", The PRS Blog, 11th, 2016

¹¹⁷ MoF(2016), Sick Industrial Companies (Special Provisions) Repeal Act, 2003 (1 of 2004)

¹¹⁸ Principal or interest payment overdue between 61-90 days

¹¹⁹ [Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum \(JLF\) and Corrective Action Plan \(CAP\)](#)

¹²⁰ Vishwanath Nair (2016), "[Has the strategic debt restructuring experiment run aground?](#)", Livemint, Aug 20 2016

Structuring of Stressed Assets (S4A) in June 2016¹²¹. Banks can now use S4A for accounts with an aggregate exposure of more than Rs 500 crores. In this scheme, lenders estimate the fraction of debt which can be serviced by borrowers under the original repayment schedule. The residual debt is called unsustainable and lenders can convert this into equity. Unlike the SDR scheme, there is no requirement to find new buyers under S4A.

In July 2015, the RBI also introduced a scheme called, “Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries”, also known as the 5/25 scheme. In this scheme, banks have the option to revise the terms of repayment of loans in infrastructure and core industries. They can extend the repayment period to up to 25 years with refinancing every five years¹²². SDR, 5/25 and S4A have been designed to stabilise businesses but have not yielded the desired results. The RBI holds banks responsible for the scheme’s limited success and in its 2016 Annual Report stated that “some of the current difficulties come from an unrealistic application by banks of a scheme so as to postpone recognition of a loan as a NPA”.

2.2 Asset Reconstruction Companies (ARCs) in India

2.2.1 ARC Business Model

Under the SARFAESI Act, banks can sell non-performing loans to ARCs. ARCs can acquire secured assets from banks by paying in cash or by issuing debentures, bonds or any other security¹²³. Banks put up NPAs for auction with reserve prices and sell to the highest bidders. The acquisition cost of stressed assets for ARCs hovered around 20 per cent of book value till 2013. However, instead of paying full acquisition costs upfront, ARCs issue security receipts (SRs), or “hope notes”. At first, because there were no investment requirements for ARCs, the SRs were almost entirely subscribed to by the NPA-selling bank. In 2006, the RBI made it mandatory for ARCs to invest a minimum of 5 per cent in each tranche of SRs. In 2014, this ARC investment requirement was increased to 15 percent. In addition to banks, a few other qualified investors are eligible to invest in SRs¹²⁴. The 2016-2017 Union Budget documents mention that non-institutional investors would be allowed to invest in SRs. However, the guidelines to this effect have not yet been issued.

If a creditor bank sells an NPA with a book value of Rs 100 at Rs 20, the ARC would issue security receipts (SRs) worth Rs 20. Under the current guidelines, ARCs must invest at least 15 percent¹²⁵ of the worth of SRs issued, or, in this example, Rs 3. Given the lack of enthusiasm among other investors, seller banks end up holding around 80 per cent of the SRs. SRs are backed by impaired assets, without predicable cash flows and have characteristics of

¹²¹ Scheme for Sustainable Structuring of Stressed Assets

¹²² Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries

¹²³ Law Ministry (2002), The Securitisation And Reconstruction Of Financial Assets And Enforcement Of Security Interest Act, 2002

¹²⁴ The Union Budget of 2016-17 has relaxed the norms allowing non-institutional investors to invest in SRs

¹²⁵ “Cs/RCs shall, by transferring funds, invest a minimum of 15% of the SRs of each class issued by them under each scheme on an ongoing basis till the redemption of all the SRs issued under such scheme”
Regulatory framework for SCs/RCs – Certain amendments, RBI August 2014

both debt and equity¹²⁶. Recovery proceeds are distributed according to the shareholding of SRs. As an intermediary recovering dues on behalf of SR holders, ARCs charge a management fee equal to around 1.5 percent of the total outstanding SRs. Currently, management fees are calculated and charged as a percentage of the net asset value (NAV) at the lower end of the net value specified by the rating agency¹²⁷.

The distribution of recovery proceeds follows a so called “waterfall structure”. That is, legal and resolution expenses are met first. Thereafter, management fees are deducted from proceeds before balance recoveries are distributed among SR holders. The upside in recoveries, if any, is usually shared by ARCs and banks in the proportions of 20:80. ARCs specify a time frame of five years from the date of acquisition, for reconstruction or realisation of the assets. However, on expiry of five years, the Board of Directors of the ARC may increase the period for realisation of financial assets up to three more years¹²⁸. If reconstruction/realisation fails in this time, 75 per cent of the Qualified Institutional Investors (QIBs) are entitled to call a meeting and any resolution passed by them is binding¹²⁹.

2.2.2 Bank Motivation for selling loans to ARCs

Under RBI’s guidelines, banks are required to make 100 percent provision within four years for NPAs consisting of secured loans. SRs are classified as investments and their Net Asset Value (NAV) is based on assessments of a credit rating agency “if the sale to SC/ RC is at a price below the net book value (NBV) (book value less provisions held), the shortfall should be debited to the profit and loss account”¹³⁰. Till February 2014, banks were required to debit the loss from the sale of NPAs from their profit and loss account for that accounting year. To incentivise sale of NPAs, the RBI relaxed this norm after February 26, 2014, and up to March 31, 2016¹³¹. Under the new guidelines, banks can spread the loss on account of sale to ARCs over two years. The logic is that over longer time horizons bank balance sheets would recover. In any case, if banks hold on to stressed assets this will get reflected in their numbers on headline gross non-performing loans. Another incentive for banks to adopt this strategy could be interaction with specialised ARC officers to help expedite the recovery process. ARCs are required to get their SRs rated by SEBI-registered rating agencies at regular intervals and inform the banks/financial institutions so that they can adjust the valuation of

¹²⁶ RBI , Guidelines on declaration of Net Asset Value of Security Receipts issued by Securitisation Company/ Reconstruction Company

¹²⁷ RBI (2014), Regulatory framework for SCs/RCs – Certain amendments

¹²⁸ RBI (2010), The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003 – Amendments

¹²⁹ RBI , Guidelines on declaration of Net Asset Value of Security Receipts issued by Securitisation Company/ Reconstruction Company

¹³⁰ RBI (2012), Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances

¹³¹ RBI (2012), Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances

their investments¹³². A few banks have used the ARC route, on a limited scale, to reduce GNPA's on their balance sheets.

2.2.3 Track Record of Indian ARCs

ARC operations can be divided into four phases, beginning from 2002 and until 2016 (Table 8). In the first phase, 2002-03 to 2005-06, NPAs in the banking sector amounted to around 6 per cent. In these three years, few asset sales materialised as ARCs were just created. However, in 2005-06, NPA transactions got a major boost as ARCIL acquired 559 cases of NPAs from 31 banks/FIs with a total book value Rupees 21,126 crores¹³³.

As macro-economic growth accelerated in Phase 2, 2006 to 2013, banks' balance sheets improved and NPA numbers came down, averaging around 2.6 per cent. The improvement in bank balance sheets reduced the pressure on them to sell loans to ARCs. In 2006, RBI introduced the 5 per cent investment requirement for ARCs in each scheme. Another important factor for the subdued sales was insistence of banks for all cash deals because of their disappointment with the SR model. Banks found that ARCs made investments in senior classes of SRs and redeemed their investment in SRs on a priority basis even though SRs subscribed to by other QIBs were yet to be redeemed¹³⁴. Even with low recoveries, priority redemption along with management fees ensured reasonable returns on investments for ARCs, with minimal risk.

In 2010, RBI asked ARCs to "continue to hold a minimum 5 per cent stake of the outstanding amount of SRs issued by the SC/RC under each scheme and each class till the redemption of all SRs issued under a particular scheme"¹³⁵. Due to the lower levels of NPAs and the demand for all cash deals, transaction volumes remained subdued throughout this period. The book value of NPAs sold between 2006-07 and 2012-13 averaged around Rupees 9500 crore annually. At the end of March 2013, the cumulative book value of assets acquired by ARCs amounted to Rupees 88,500 crores. Vintage loans, which were difficult to recover, were sold during this phase. With significant provisioning already in place, banks were able to sell these assets at around 20 per cent of book value¹³⁶.

¹³² RBI, Guidelines on declaration of Net Asset Value of Security Receipts issued by Securitisation Company/ Reconstruction Company

¹³³ RBI (2006), "Operations and Performance of Commercial Banks (Part 2 of 3)", Trend and Progress of Banking in India, RBI 2006

¹³⁴ RBI (2010), The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003 – Amendments

¹³⁵ RBI (2010), The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003 – Amendments

¹³⁶ Gandhi(2015), "Asset Reconstruction and NPA Management in India"

Table 8: Phases in ARC business

Phase 1	Phase 2	Phase 3	Phase 4
2002-03 to 2005-06	2006-07 to June 2013	July 2013 to August 2014	Since August 2014
High NPA (6.1 per cent)	Low NPA (2.6 per cent)	High NPA (4.1 per cent) ¹³⁷	High NPA (6.2 per cent) ¹³⁸
No investment requirement for ARCs	5 per cent investment requirement for ARCs under each scheme ¹³⁹	5 per cent requirement for ARCs under each scheme	15 per cent requirement for ARCs under each scheme
ARCs just introduced: low transaction volumes in first three years. However, in 2005-06 significant portions of banking NPAs were sold to ARCs	Due to low NPAs and bank demand for all cash deals instead of SRs	Regulatory changes to encourage sale of fresh stressed assets, low investment requirements for ARCs and high NPAs resulted in higher volumes of transactions	Despite high NPAs low volumes of transactions due to higher investment requirements for ARCs and management fee calculations

Source: Authors' estimates

The third phase is a significant one for ARCs: the quality of assets held by the Indian banking sector particularly those held by PSBs has deteriorated sharply. The relative slowdown of the economy and stoppages in large infrastructure, steel and power projects has reduced borrowers' ability to service their loans¹⁴⁰. In some instances, banks struggling to recover their dues directly from borrowers did take the ARC route. The RBI relaxed the guidelines of banks' asset sale to ARCs in February 2014, to encourage sale of fresh stressed assets¹⁴¹. It stated in its notification that ARCs "should be construed as a supportive system for stressed asset management with greater emphasis on asset reconstruction rather than asset stripping. Towards this end, sale of assets to SCs/RCs (ARCs) is encouraged at a stage when the assets have good chance of revival and fair amount of realizable value"¹⁴². Large volumes of stressed assets on the balance sheets of the banks combined with relaxed guidelines¹⁴³ resulted in a significant increase in the sale to ARCs. Around 40 per cent of the total volume of ARC transactions (in terms of book value) since their inception took place in this short phase of 13 months. Figure (4) shows the significant surge in assets sold by banks to ARCs. Although, this Figure seems to overstate¹⁴⁴ sales, it does highlight the sudden increase in the asset sale to ARCs during this short period of time.

¹³⁷ In March 2014

¹³⁸ Between September 2014 and September 2016

¹³⁹ RBI (2006), The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003, RBI September 20, 2006

¹⁴⁰ Standing Committee on Finance (2015-16), "Non-Performing Assets of Financial Institutions"

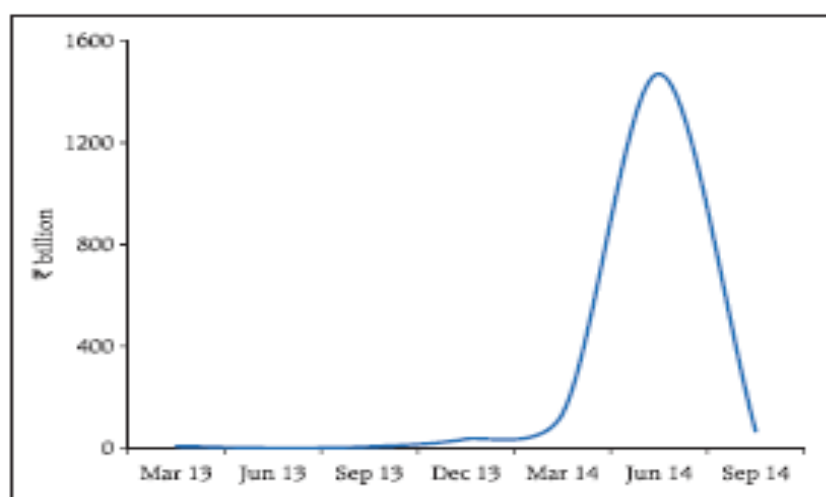
¹⁴¹ RBI (2014), "Framework for Revitalising Distressed Assets in the Economy - Refinancing of Project Loans, Sale of NPA and Other Regulatory Measures", February 26, 2014

¹⁴² RBI (2014), Framework for Revitalising Distressed Assets in the Economy - Refinancing of Project Loans, Sale of NPA and Other Regulatory Measures

¹⁴³ Banks/FIs were allowed to sell assets where principal or interest payments were overdue by 61-90 days (classified as SMA-2 accounts). Banks were also allowed to, "spread over any shortfall, if the sale value is lower than the NBV, over a period of two years" for assets sold up to March 31, 2015 (RBI, February 26, 2014)

¹⁴⁴ Data used in this chart is not consistent with numbers from other RBI sources

Figure 4: Amount of assets sold by banks to ARCs



Source: Financial Stability Report (Including Trend and Progress of Banking in India, 2013-14) December 2014

Concurrently, concerns surfaced in regulatory and government circles whether genuine risk transfers were taking place. The most noticeable part of the exercise was that NPA seller banks continued to hold large percentages of SRs. For example, in 2013-14, banks subscribed to SRs worth Rs 18,760 crores out of a total of Rs 20,410 crores, issued by ARCs.

In the first three phases, the management fees earned by ARCs played a major role in their purchase considerations: a onetime investment requirement of 5 per cent, compared to annual management fees of around 1.5 per cent, ensured that ARCs received a return of around 20-30 per cent on their investments, even with the low and slow recovery highlighted by the World Bank¹⁴⁵.

In the third phase, as banks started selling fresh NPAs with lower provisions, the sale prices increased sharply. The cost acquisition of stressed assets by ARCs hovered around 20 per cent of book value till 2013. It increased to above 40 per cent of the book value after 2013 (Figure 6) but the management-fee driven model ensured that ARCs were not deterred by the higher pricing.

¹⁴⁵ Doing Business Report (2016) estimates show that “resolving insolvency takes 4.30 years on average and costs 9 per cent of the debtor’s estate. The average recovery rate is 25.70 cents on the dollar” (World Bank)

Table 9: Cumulative ARC Business in India (Rupees Crores)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Book Value of assets acquired	28544	41414	51542	62217	74088	80500	88500	139700	190600	210600
Security Receipts issued	7436	10658	12801	14051	15859	16700	18900	39310	61740	75830
Security Receipts subscribed by:										
(a) Banks/FIs	6894	8319	9570	10314	11233	11600	12600	31360	50530	62300
(b) ARCs (SCs/RCs)	408	1647	2544	2940	3384	3600	4500	5880	8860	10910
(c) FIIs	-	-	-	-	39	100	100	120	120	330
(d) Others (Qualified Institutional Buyers)	134	692	687	797	1203	1500	1700	1940	2220	2280
Amount of Security Receipts completely redeemed	660	1299	2792	4556	6704	8200	10100	11290	12940	14850

Source: RBI Trend and Progress, 2015-16 NPA transfer data is from a July 9, 2016, *The Indian Express newspaper report*¹⁴⁶

Note: Data for the book value of assets acquired in 2013-14 and 2014-15 has been estimated by authors using data from RBI Trend and Progress Reports and Deputy Governor R. Gandhi speech (September 15, 2015)

Cumulatively, ARCs acquired Rs 88,500 crores worth of assets and issued Rs 18,900 crores of SRs till FY 2013, but managed to redeem only Rs 10,100 crores worth of SRs. The high return for ARCs and low recovery of loans highlighted the difficulty of scaling up the ARC model. The sharp upward spike in transactions in the third phase invited greater RBI scrutiny and it raised the ARC investment requirement from 5 per cent to 15 per cent in August 2014¹⁴⁷. It also changed the method of calculation of the management fee: ARCs fees are now a percentage of the net asset value (NAV) at the lower end of the net value specified by the rating agency while earlier they were estimated as a percent of the outstanding value of SRs¹⁴⁸. New investments norms have been enforced by the RBI to “ensure that distressed asset sales to ARCs genuinely transfer risks out of banks”¹⁴⁹. According to the RBI’s December 2014 Financial Stability Report the “rationale behind these regulatory changes was to incentivise realisation and thereby expedite the process of recoveries/restructuring as the net asset value (NAV) of SRs is calculated on the basis of the likely rate of recovery of stressed assets”.

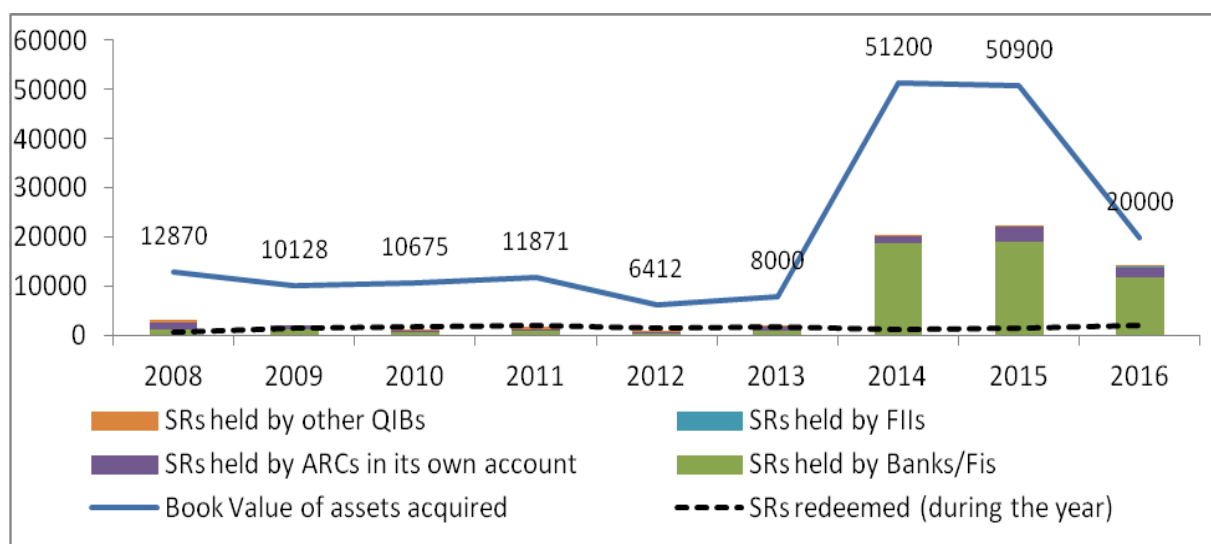
¹⁴⁶ Indian Express(2016), “ARCs buy just 15% of Rupees 1.3 lakh crores of NPAs put up for sale by banks”, July 9, 2016

¹⁴⁷ RBI (2014), Regulatory framework for SCs/RCs – Certain amendments

¹⁴⁸ RBI (2014), Regulatory framework for SCs/RCs – Certain amendments

¹⁴⁹ RBI (2014), RBI Annual Report 2013-14

Figure 5: Annual ARC Business in India (Rupees Crores)

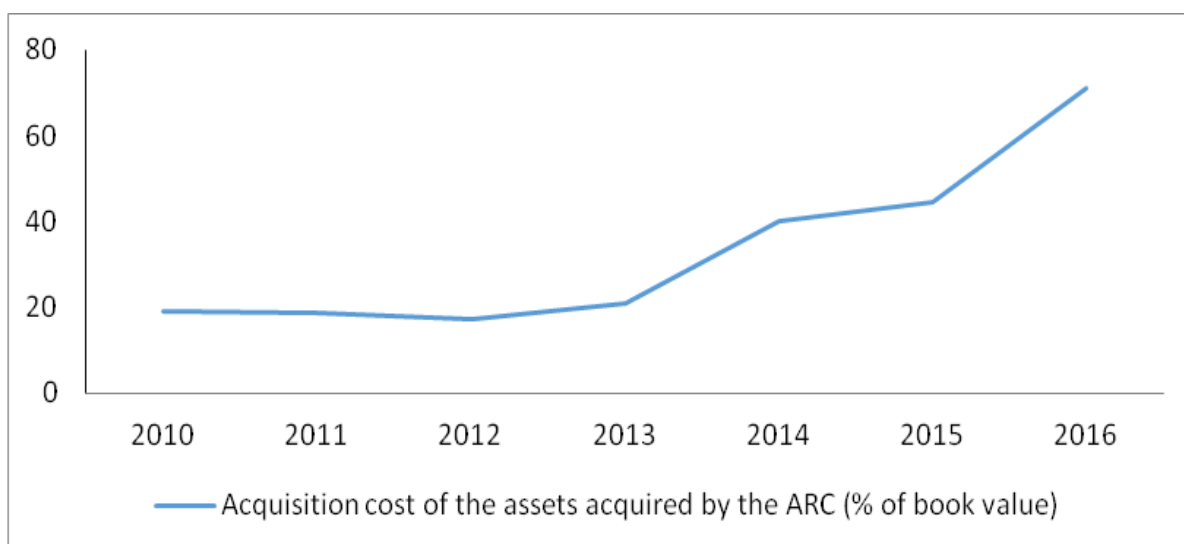


Source: Estimated from Table 9

The fourth phase for ARCs started after these regulatory changes after August 2014 which were implemented by RBI. NPAs increased sharply during this phase but the changes introduced by RBI inhibited asset acquisition by ARCs. The increased investment requirement has significantly lowered the return on investment from management fees. Further, the higher investment requirement has exposed the capital constraints of ARCs. ARCs seeking registration are required to have a minimum capital base of Rs 2 crores. According to the RBI, “owned funds shall be an amount not less than 15 per cent of the total financial assets acquired or to be acquired by the Securitisation Company or Reconstruction Company on an aggregate basis or Rs100 crores whichever is lower”¹⁵⁰. In March 2016, the total own fund base of ARCs was Rs 3680 crores. With this higher investment requirement the pricing of assets has become a major issue for the ARCs as they now have to pay 15 percent of the agreed sale price upfront. These factors have resulted in a sharp decline in sales to ARCs despite the higher NPAs in Phase 4.

¹⁵⁰ RBI The Securitisation Companies and Reconstruction Companies (Reserve Bank), Guidelines and Directions 2003

Figure 6: ARC Acquisition Cost (as per cent of book value of assets acquired)



Source: R. Gandhi speech (September 15, 2015). Cost data for 2016 is from the RBI Annual Report and the book value of assets acquired is from a July 9, 2016, newspaper report in *The Indian Express*¹⁵¹

Higher transactions in recent years have brought about greater scrutiny from regulators. Regulatory changes directed towards better risk transfer and improved functioning has significantly reduced NPA sales which highlights the limitations of the ARC model and suggests that measures to enhance ARC accountability have impacted ARC business negatively in a major way. With the regulatory changes effected in August 2014, ARCs will need to focus on actual redeeming of security receipts as it is no longer possible for them to base their profit model on management fees¹⁵².

ARCs have largely been in liquidation rather than turn-around/restructuring of entities, to recover outstanding dues. One of the major reasons has been the delay in implementation of enabling laws. In 2010, ARCs were given the option to change or take over management of borrower businesses to recover dues. However, on realization of their dues ARCs were required to restore management to borrowers¹⁵³. From 2014 onwards ARCs were permitted to convert a portion of debt into shares of borrower companies as a measure of asset reconstruction provided ARC shareholding does not exceed 26 per cent of the post converted equity¹⁵⁴. Despite these changes, as yet there has been no discernible shift towards turn-around/restructuring of entities by ARCs.

¹⁵¹ Indian Express (2016), "ARCs buy just 15% of Rupees 1.3 lakh crores NPAs put on block by banks", July 9, 2016

¹⁵² RBI (2014), Financial Stability Report (Including Trend and Progress of Banking in India 2013-14) December 2014, page 48

¹⁵³ RBI (2010), Guidelines on Change in or Take Over of the Management of the Business of the Borrower by Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines, 2010

¹⁵⁴ RBI (2014), Conversion of debt into shares, consent level of security enforcement actions and permission to acquire debt from other SC/RCs

2.2.4 Recent Measures to Improve Price Discovery and Transfer of Credit Risk

RBI has announced two more measures to strengthen the framework governing sale of non-performing assets: “in order to make sure that sale of stressed assets by banks actually result in true sale of assets and to create a vibrant stressed assets market, it has been decided to progressively restrict banks’ investment in SRs backed by their own stressed assets”¹⁵⁵. From April 2017, if banks purchase SRs on assets it has offloaded to an ARC beyond 50 percent of the marked-down value of the asset, then it will have to set aside capital as if it were an NPA. From April 1, 2018, this threshold of 50 percent will be reduced to 10 percent. Even though these measures could limit the sale of NNPA to ARCs, it is important to transfer credit risk from the bank concerned to the ARC.

To improve price discovery, RBI has also opened up the sector to other entities and its September 1, 2016, circular states that “prospective buyers need not be restricted to SCs/RCS (ARCs). Banks may also offer their assets to other banks/NBFCs/FIs etc. who have the required capital and expertise in resolving stressed assets. Participation of more buyers will result in better price discovery”¹⁵⁶.

Banks/NBFCs/FIs were allowed to purchase and sell NPAs even earlier. The 2005 circular said, “Banks shall sell non-performing financial assets to other banks only on cash basis. The entire sale consideration should be received up-front and the asset can be taken off the books of the selling bank only on receipt of the entire sale consideration”¹⁵⁷. A major difference between banks/NBFCs/FIs and ARCs is that ARCs are allowed to issue SRs in lieu of NPAs, but it appears that banks/NBFCs/FIs can buy only ‘without recourse’ basis, that is, the entire credit risk associated with the non-performing financial assets should be transferred to the purchasing bank¹⁵⁸. The lack of clarity/information on banks/NBFCs/FIs buying NPAs indicates that this market has not grown. Although RBI’s September 1, 2016 circular seems to have brought banks/NBFCs/FIs on par with ARCs in terms of asset purchase it is not clear from this circular, whether banks/NBFCs/FIs can issue SRs. If there is such a relaxation for banks/NBFCs/FIs, ARCs would face greater competition.

2.2.5 Foreign Investment in Indian ARCs

The Government has liberalized foreign investment in Indian ARCs and SRs. Such investment was opened up in 2005 with government allowing foreign direct investment (FDI) of up to 49 percent. FDI/FII investment ceiling in Indian ARCs was increased to 100 percent in May 2016 (Table 10). Foreign investors have episodically shown interest in non-performing loans. However, lengthy legal proceedings in India are a major hurdle. In this context, effective implementation of the Bankruptcy Code may improve foreign investors’ interest in acquiring and/or restructuring stressed assets.

¹⁵⁵ RBI (2016), Guidelines on Sale of Stressed Assets by Banks

¹⁵⁶ RBI (2016), Guidelines on Sale of Stressed Assets by Banks

¹⁵⁷ RBI(2005), Guidelines on purchase/sale of Non -performing Assets, July 13, 2005

¹⁵⁸ RBI (2015), Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, July 1, 2015

Table 10: Policy Evolution of Foreign Investment in Indian ARCs

Nov 2005	FDI up to 49 per cent was permitted from 2005 (MoF, November 11, 2005)
Nov 2005	FII's were permitted to invest up to 49 per cent in each tranche of Security Receipts, subject to the condition that a single FII in each tranche shall not exceed 10 per cent of the issue (RBI Nov 11, 2005)
Aug 2013	FII's were permitted to invest in ARCs and the FDI ceiling was raised from 49 per cent to 74 per cent. This was subject to condition that no sponsor could hold more than 50 per cent in an ARC either by way of FDI or by routing through an FII. Individual FII shareholding in ARC was restricted to 10 per cent (RBI Aug 19, 2013)
Aug , 2013	FII investment in each tranche of Security Receipts was enhanced to 74 per cent and individual limit of 10 per cent was removed (RBI Aug 19, 2013)
May , 2016	100 per cent FDI/FII investment under automatic route allowed. Individual FII limit remains at 10 per cent (DIPP press release May 6, 2016)

Summary

Looking back Indian bankruptcy/insolvency law and subordinate legislation has gradually evolved over the years. The implementation of the SARFAESI Act gave authority to financial institutions to adjudicate the course of action and this resulted in some improvement in the recovery rate. However, SARFAESI and the Indian legal practices have just not been adequate to deal with the recent surge in NPAs.

The Insolvency and Bankruptcy Code, 2016, is expected to improve the insolvency resolution process. Such improvement would depend on availability of quality Insolvency Professionals, appointment of adequate numbers of tribunal officers who understand the interaction between law and business. Indian's slow judicial processes could continue be a major hurdle in the recovery process for the banks and ARCs. Corporates find grounds to drag debt recovery cases to civil courts and stall the proceedings of tribunals. International experience shows that speedy judicial systems are imperative for effective asset resolution.

Regulatory changes directed towards greater risk transfer and improved functioning has significantly reduced NPA sales. Apart from favourable market conditions, successful turn-around/restructuring requires experienced professionals with domain knowledge, flexible labour laws and credit lines. In this on-going period of higher NPAs, market conditions are not that favourable. Further, in the light of RBI's revised norms, most ARCs are currently inadequately capitalised to fund high-value acquisitions. That is, ARCs need to access higher volumes of funding and improve their capabilities to turn businesses around.

Section III

3.1 International Experience in Addressing Unsustainable Bank Debt

The substantive cores of the options-remedies that the Indian government could adopt to address the debt overhang which is constraining fresh lending by Indian PSBs are stated in the summaries at the end of Sections I and II. Section I details the Securum bad bank set up in Sweden and the Resolution Trust Corporation (RTC) in the US respectively. In these two cases and the Indonesian Bank Restructuring Agency (IBRA), the governments concerned provided the capital to resolve illiquidity-insolvency among large domestic banks/financial institutions from spreading and becoming systemic. The supporting logic for government funding was that an economy wide crisis would impose long lasting economic costs including lower growth and higher unemployment. Repeatedly, the reasoning has been that large systemically important financial institutions (SIFIs) have to be rescued at government cost to avoid widespread shutting down of banks/firms. Currently, Italian banks are the most seriously in trouble in the Euro zone and the Italian government/central bank are consulting with the European Commission and the European Central Bank how best to avert a financial sector crisis which could spread to Europe and beyond.

Post the 2008 financial sector crisis, the US, European and other central banks and governments provided support to banks and large financial institutions on similar grounds. Namely, that not doing so would cause even more distress at a nation-wide level. The C.M. Reinhart and K. M. Rogoff book titled “This Time is Different: Eight Centuries of Financial Folly” details the innumerable times that governments have stepped in to bailout private banks. As the insolvent banks are not allowed to shut down it is not evident that if governments provide limited and more sharply conditional funding to allow orderly winding down of SIFIs, market based solutions including the setting up of new banks would not have evolved. The counter-factual cannot be proved. However, repeated government funded bailouts creates the obvious moral hazard of banks enjoying this too big to be allowed to fail status and hence bank management senses that the downside to continuing with imprudent lending practices is limited.

The Basle Committee on Banking Supervision (BCBS) and the Bank for International Settlements (BIS) have issued several studies on the too big to fail issue. Across the Atlantic, the US Federal Reserve Bank is subjecting banks to stress tests and insisting that SIFIs must have plans on how these will wind down in a situation of near insolvency without creating a systemic crisis. The bottom line, however, continues to be in the US that tax-payers may have to again provide capital in future banking crises. For tax-payers the compensatory story has repeatedly been that a systemic breakdown of the financial sector was avoided. The Resolution Trust Corporation in the US spent US\$1.54 billion in 1995 dollars on legal costs alone. This level of expenditure on legal fees was questioned by the Senate Banking

Committee during the RTC's report to the committee on the progress of dissolving the RTC¹⁵⁹.

On balance, in fairness to governments and regulators, it appears that the changes in laws in Sweden, the US and Indonesia does reduce the probability of suicidal future risk taking by banks. The past experience of foreign resolution trusts and asset management companies provide insights for India on how best to resolve the high volumes of stressed assets owned by Indian PSBs without government having to inevitably provide full funding support.

3.2 Size, Nature and Consequences of Indian Debt Overhang

RBI's Financial Stability Report of December 2016 suggests that despite the growing proportions of stressed assets and net non-performing advances of banks the risks to the financial sector as a whole and banks in particular are manageable. However, the opportunity costs of growth foregone because bank credit growth has slowed down are not adequately discussed in this report.

The following Figure 7 (page 93 in the latest Economic Survey 2016-17) shows that loans to industry, adjusted for inflation, have been coming down steadily since 2005-2006. It can also be seen that real loan growth rate has decreased from around plus 5 percent in 2012-2013 to about minus 7 percent in 2015-2016.

Figure 7: Real Loan Growth to Industry¹⁶⁰ (Deflated by average of CPI-IW & WPI)



Source: Economic Survey 2016-2017

One of the principal reasons for the current reduced bank lending is that large debtor corporates which have stressed balance sheets have either defaulted or been tardy in debt

¹⁵⁹ Termination of the Resolution Trust Corp, C-SPAN, <https://www.c-span.org/video/?65792-1/termination-resolution-trust-corp>

¹⁶⁰ Data up to end-November 2016 for FY17

service payments. Earlier, corporate borrowing volumes were high during the period 2004-05 to 2008-09 based on robust domestic/international growth and demand projections. International growth and demand were sharply down post the 2008 international financial sector crisis¹⁶¹. In India too overall demand came down and projects were greatly delayed in the power, steel and road-building sub-sectors.

In 1997 the total volume of non-performing loans (NPLs) as a percentage of total volume of loans provided by Indian banks was 15.7 per cent. This same number was 5.9 per cent in 2015 and 11.8 per cent at the end of September 2016. It was as high as 10.4 per cent in 2004 and reached the lowest level, in the last twenty years, of 2.2 per cent in 2009. However, the norms for recognising NPLs were not uniformly the same over this period and the numbers on capital set aside by Indian banks on account of NPLs are not readily available in the public domain. That is, going by the numbers that are available, the Indian banking sector has dealt with even higher levels of NPLs in 1997 than at the end of 2016. The difference with the past is that the absolute volumes of stressed assets and NPLs are much higher now. Of course, the size of the Indian economy and consequently the ability of debtors and creditors to address this large debt overhang is also correspondingly higher.

According to the Economic Survey 2016-2017 (paragraph 4.18 page 86) “firms that had borrowed abroad when the rupee was trading around Rupees 40/dollar were hit hard when the rupee depreciated, forcing them to repay their debts at exchange rates closer to Rupees 60-70/dollar”. The Rupee has depreciated in nominal terms but as of end 2016 was about 15 per cent over-valued, as compared to its level in 2004, in trade adjusted terms against a basket of 36 currencies and even more so against the more relevant basket of 6 currencies. Business school students learn about hedging against movements in foreign exchange rates. It is surprising that the Economic Survey does not mention that Indian companies which borrowed in hard currencies needed to hedge against foreign exchange risk. If such risk cover is too expensive or not available for the required maturities it should have been obvious to Indian firms that they had to limit their foreign currency borrowings.

This year’s Survey suggests that as government and RBI look for ways out of the debt overhang problem this should not be a “morality play”. It can be readily agreed that using morality as a benchmark could be counterproductive or sub-optimal. However, engendering “moral hazard” by encouraging the belief that government will always bail out private firms at tax-payer cost does not make sound economic sense either. To a substantial extent private sector firms have to be held responsible since their demand projections were excessively optimistic and corresponding borrowings were too huge. Incomprehensively, large and well established private firms did not take into account the risks of shortfalls/lags in revenue flows compared to debt obligations. Clearly, corporates were complacently/irresponsibly sanguine about their ability to complete high cost projects on time.

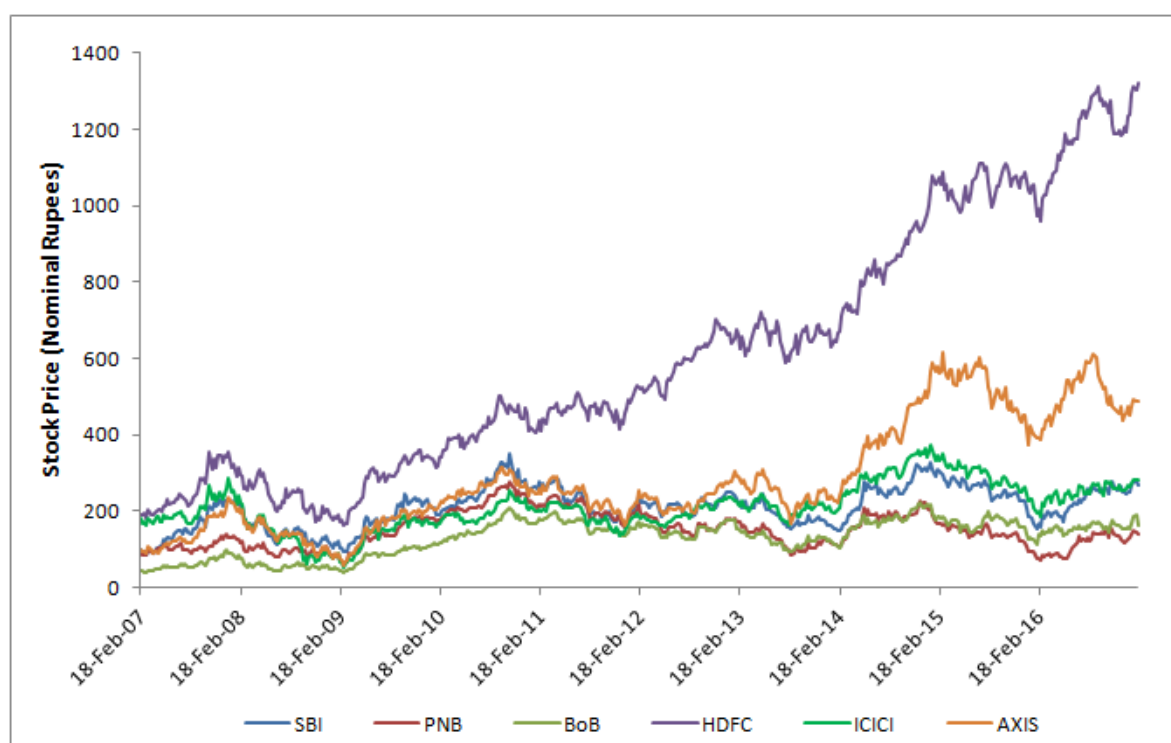
At the same time, the 2008 international financial sector crisis, delays in land acquisition, Indian government environmental clearances and Supreme Court judgements banning mining

¹⁶¹ Economic Survey 2016-17, The Festering Twin Balance Sheet Problem, Page 86

of iron ore and cancelling of coal mine allocations were difficult to anticipate. The fact is that for several large debtors their interest coverage ratio (earnings divided by interest expenses) has decreased to below one. Specifically, private power producers have been adversely impacted by the downturn in demand coupled with a fall in per unit prices. As the Supreme Court has set aside its ban on coal mining and the central government is trying to speed up clearances corporate bottom lines could improve. However, banks would struggle to raise lending since their risk capital is inadequate to cover losses stemming from their existing stressed loan portfolios. Additionally, if lending rates come down further given the Rupee liquidity glut post demonetisation that would again hurt the term lending banks as their borrowings usually have longer durations compared to loans.

The following Figure 8 shows the extent to which the stock market prices of public sector banks have stagnated and lagged private banks over the last ten years. It would be difficult for PSBs to raise adequate volumes of financing from capital markets even if they were to divest some of government's share-holding within the majority shareholding floors mandated by their respective pieces of legislation (e.g. the SBI Act which requires the central government to hold a majority equity stake in State Bank of India).

Figure 8: Stock Prices of Select Public Sector and Private Sector Banks



Source: NSE

3.3 Interminable Legal Obstacles and Roadblocks

Section II details the manner and long periods over which corporate debtors have used the SICA legislation and BIFR, set up under SICA, and the complex requirements-processes of

Indian courts to delay-avoid meeting their debt obligations. The 2002 Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act and the Debt Recovery Tribunal (DRT) Act were meant to reduce delays in disputes between creditors and debtors. SARFAESI represented progress compared to SICA-BIFR because creditor banks could dispose mortgaged assets with less hindrance from courts. The setting up of DRTs too was a step forward since cases can be processed faster by these specialised tribunals as compared to regular courts which are overburdened.

Taking stock, even with SARFAESI and DRTs, the situation has not improved measurably for creditors. For instance, as of end-2015 about 70,000 appeals were pending with DRTs. Currently, there are 33 DRTs and 5 DRT Appellate Tribunals and in the usual course it would take decades to clear the backlog. Further, DRT Appellate Tribunal judgements can be appealed in High Courts through Writ Petitions.

Harking back to 1990 and the US experience of resolving bad debts, the US Treasury Secretary had reported blandly to a House Committee that it was not possible to estimate the costs incurred till then by the Resolution Trust Corporation. By 1995 the RTC was estimated to have used up US\$447 billion in 1995 dollars. Significantly, RTC was involved in 110,000 lawsuits. This is a high number of lawsuits even compared to India. However, the US judiciary is better staffed and legal outcomes are much faster in that country.

The Insolvency and Bankruptcy Code (IBC) of 2016, National Company Law Tribunal (NCLT) and the Insolvency and Board of India (IBBI) have been enacted/set up by government to enable banks to recover dues faster and more fully. In the past, Indian corporate debtors have found ways to delay resolution of cases when PSBs have sought the assistance of courts. Court processes have been tediously long and at times have been caught up with issues of social justice. The logic has been that if debtor businesses are foreclosed and sold by creditors this could engender unemployment and/or be unfair to shop-floor workers. It is not clear, at this early stage of the setting up of NCLT and IBBI, that Indian courts would act more decisively than in the past and not allow extraneous considerations to delay relief to creditors.

On a positive note, detailed amendments to the SARFAESI Act were approved by parliament in September 2016. The changes in this law should help ARCs raise funds and restructure defaulting companies. Plus, empower DRTs vis-à-vis civil courts and help them to settle disputes more expeditiously. For example, the categories of potential investors in SRs have been increased. And, the management of borrower companies does not necessarily have to revert to original owners once debt is finally repaid. Overall, the expectation among ARC professionals is that the September 2016 amendments of the SARFAESI Act should facilitate the functioning of DRTs and DRATs and reduce the time taken for adjudication processes.

3.4 “Bad” Bank for India

The Economic Survey 2016-2017 released on 31 January 2017 has suggested the setting up of a Public Sector Assets Rehabilitation Agency (PARA) or Bad bank. Although this was not

referred to in the Finance Minister's budget speech, separately on 3 February 2017 the Finance Minister has mentioned to the media that a bad bank could be considered. The Economic Survey suggests that PARA could be funded by assigning a fraction of RBI's equity to government¹⁶².

As detailed in Section I, Sweden adopted the bad bank route in 1993 and called it Securum. This initiative was deemed to be successful although ex-post the government was criticised for having bailed out private banks at the cost of tax-payers. The assignment of blame was somewhat muted as the real-estate sector which provided the underlying assets recovered substantially. In the US in the Savings and Loans crisis and subsequently in 2008 government provided capital as did the Federal Reserve by buying toxic assets. Although the support provided has been deemed to be a success the moral hazard of recurrent episodes of irresponsible borrowing-lending has also been reinforced. Now, with the Trump presidency in the US there is talk of rolling back the Dodd-Frank Act which, despite its complexity and cumbersome procedures, does reduce the probability of future financial sector crisis¹⁶³.

The risks, due for example to an unexpected sharp rise in FX outflows, involved in the Economic Survey's suggestion of RBI diluting its equity base by funding a bad bank are considerable. Further, a bad bank fully owned by government with management handed over to professionals from the private sector could lead to principal-agent issues as was the case of the Securum bad bank in Sweden. Even abstracting from capital adequacy risks for RBI or implementation pitfalls involved in this option, debt forgiveness yet again for defaulting Indian corporates would convince private Indian firms and PSBs that this would be the standard solution in the future.

Government Funding Support

The Union Budget and documents tabled by the Finance Minister in parliament on 1 February 2017 indicated the following steps to address PSB debts that are past due: (a) central government's "Indradhanush" initiative which currently provides for Rupees 70,000 crores of risk capital support for PSBs to be complemented by an additional allocation of Rupees 10,000 crores in 2017-2018. The Indradhanush initiative of government is discussed in detail in Section II. In summary, as of end September 2016, the total volume of non-performing assets on the books of PSBs was Rupees 5,89,502 crores. The current total Indradhanush allocation of Rupees 80,000 crores if made fully available would address 13.6 per cent of the debt overhang of PSBs. Consequently, Indradhanush, as it stands now, would address a small fraction of the problem unless it catalyses funding from non-government sources. It has been reported in the media that government is considering Indradhanush II but the amount that

¹⁶² "The RBI would (in effect) transfer some of the government securities it is currently holding to public sector banks via a PARA. As a result, the RBI's capital would decrease, while that of PARA would increase. There would be no implications for monetary policy, since no new money would be created" (Chapter 4: The Festering Twin Balance Sheet Problem, Economic Survey 2016-17, Page 98)

¹⁶³ Jaimini Bhagwati et al. (June 2016), Financial Sector Legislative Reforms Commission (FSLRC) & Financial Sector Regulation in India, ICRIER Working Paper 324

may be provided would be deliberated upon after RBI completes its inspection of bank books post March 2017.

3.5 Asset Reconstruction Companies (ARCs)

The Union Budget of 1 February 2017 referred briefly to support for Indian ARCs. Namely, that stock exchanges would be allowed to list Security Receipts (SRs) issued by ARCs to provide liquidity through secondary market trading and thus attract additional capital. RBI's circular of September 2016 brings banks/NBFCs/FIs on par with ARCs in terms of purchase of distressed assets. For the remaining part of this paper any reference to ARCs includes other institutions engaged in the purchase, turnaround and/or sale of distressed assets.

Section II includes analysis of the Indian experience with the setting up of ARCs. Till August 2014 ARCs needed to put up just 5 per cent of the marked down value of the asset which was to be acquired. The balance was accounted for by the issuance of SRs. SRs do not carry interest and were almost entirely purchased by the bank "selling" the NPA to an ARC. This 5 per cent amount was inadequate as a token of an ARC's seriousness of intent to turn the asset around or to repackage and then sell. ARCs received up to 1.5 per cent annually of the marked down value of the NPA as management fees. Consequently, there was little urgency for an ARC to dispose of the stressed assets that were acquired. Since August 2014 RBI has stipulated that 15 per cent of the value of the acquisition has to be paid by ARCs and this has resulted in a sharp drop in asset acquisition by ARCs.

ARCs are not endowed with adequate risk capital to make a sizeable impact towards addressing/restructuring net non-performing assets of the Indian banking sector. As of now, RBI as the regulator has not allowed ARCs to access capital markets for equity or debt capital. It could be argued that ARCs should not be allowed to raise equity/debt capital in capital markets since it could transfer market/credit risk from banks to public sector institutional providers of capital such as LIC. However, it could be stipulated by RBI that funds can only be raised by ARCs from private capital market sources. And, private entities could be defined as institutions with at least 76 per cent equity capital from non-government/public-sector sources.

Government as the majority owner and RBI as the regulator are concerned about deliberate undervaluation of impaired assets. That is, there could be collusion between PSBs, the agency/agencies which purchase non-performing assets and the sponsors/current owners of the assets. The SARFAESI Act and RBI prescribe valuation methodologies for impaired assets. SARFAESI's "procedure for sale of banks'/FIs' financial assets to Securitisation and Reconstruction Companies" stipulate that sales of financial assets should be structured in such a manner that all credit risk is transferred to the purchaser i.e. sale "without recourse basis". RBI has laid down procedures for the "purchase/sale of non-performing financial assets, including valuation and pricing aspects"¹⁶⁴. Even though these RBI guidelines are detailed PSB management is apprehensive that it could face vigilance action if on an ex-post

¹⁶⁴ RBI Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015

facto basis it is alleged that there was collusion between PSBs and the purchaser of stressed assets with or without the involvement of the original corporate owners.

In this context, although ARCs remain thinly capitalised they can bring arms-length and professional valuation of non-performing assets in PSB portfolios. It was highlighted in a Business Standard article¹⁶⁵ by Subir Gokarn, former Deputy Governor of RBI, that accurate valuation of stressed assets is not a trivial question but “fundamental in our (Indian) regulatory and governance context”. Additionally, the scanning and digitization of legacy data relating to the huge stock of pending cases needs to be expedited and Debt Recovery Tribunals need financial resources to outsource detailed analytical work to private firms. This is an important task that Indian ARCs could facilitate-support to get done.

Auctioning of Impaired Assets

A transparent methodology to prevent collusion and allegations of wrong-doing is to auction assets through confidential bidding processes. In this context, the Parliamentary Consultative Committee of the Ministry of Finance met in mid-March 2017 and considered the possibility of public auction of stressed assets. It has been reported in the print media that the Ministry of Finance is in favour of the participation of public sector undertakings (PSUs) in the steel and power sectors in such auctions. It is possible that cash-rich PSUs could be persuaded by government to make excessively generous bids for impaired assets. It is crucial, therefore, to involve private sector parties in a bidding process which would be open to a variety of bidders i.e. ARCs, NBFCs, banks and PSUs.

Specifically, arms-length, expert valuation of assets is required and ARCs are particularly well placed to help provide this valuable service. And, it is highly likely that the entire volume of net non-performing assets (NNPAs) does not need to be fully written off. A mark-down of assets to what are in the market’s view reasonable levels should attract professional expertise in turning assets around or splitting/merging these to enhance value and then resell. That is, ARCs could, for now, be a supplementary and qualitative part of the solution. Effectively, ARCs can provide “honest” market feedback on the value of NNPAs.

As discussed in detail in Section II, the single most significant factor which impedes the resolution of non-performing assets is the inability of banks to mark-down the value of such assets to levels which would be acceptable to the market/ARCs. More than any other factor, even indefinite legal delays it is the nervousness of PSBs to accept sharp marking down of non-performing assets which is standing in the way of addressing the problem explicitly. The Banks Board Bureau could assist PSBs in arriving at asset valuations that are transparently fair by prescribing norms for the bidding process for impaired assets.

Even if PSBs were to accept reasonable valuations for a fraction of their NNPAs, ARCs given their current limited capitalisation, cannot currently provide substantive solutions. As of March 2016, the total capitalisation of ARCs was Rupees 3680 crores compared to the

¹⁶⁵ “Matters of Valuation” by Subir Gokarn in Business Standard dated 4 October 2015

Rupees 3.5 lakh crore volumes of NNPA's. Government has recently allowed 100 per cent foreign ownership of ARCs. To the extent the ARC business in India can provide a rate of return that is considered by foreign investors to be consistent with country (India) and industry-project, market, credit and operational risks it is conceivable that higher levels of foreign investment would be forthcoming for India based ARCs.

4. Conclusions

Effectively, large Indian corporates have free American put options¹⁶⁶ on the debt owed to PSBs. Large corporate borrowers have been able to default/delay debt repayments with little by way of material consequences. Select corporate free-riders have allowed assets to wither or be stripped and are consequently indifferent if banks or ARCs take-over their equity holdings which have little residual value.

RBI puts out Asset Quality Reviews at periodic intervals. RBI's bank supervisory warnings need to be sharper and the warning signals it places in the public domain need to be more insistent. For instance, as the latest Economic Survey has indicated the average size of non-performing loans for the 50 largest borrowers is Rupees 20,000 crores¹⁶⁷. Even if such information were it to be put out by RBI in a timely manner it may not get adequate attention of the majority share-holder, namely government. However, such RBI reports would get wide circulation through the media and make it that much more difficult for government to ignore.

To sum up, even without injection of additional foreign capital, ARCs could be a qualitative and to an extent a quantitative part of the solution. Specifically, ARCs can provide "market" feedback on valuations of NNPA's and provide restructuring solutions for the debt overhang problem which is exacerbated by excessively lengthy Indian legal processes. The importance of accurate valuations, turnaround options plus speedier legal remedies cannot be overstated. Consequently, this paper analyses the conditions under which Indian ARCs have functioned and how these could be tweaked for them to be a larger part of the solution than till now.

¹⁶⁶ An American put option gives the holder of the option the right to sell the underlying asset at any time during the duration of the contract at a pre-determined price.

¹⁶⁷ "Stressed assets are concentrated in a remarkably few borrowers, with a mere 50 companies accounting for 71 percent of the debt owed by IC1 (interest coverage ratio below one) debtors. On average, these 50 companies owe Rs 20,000 crores in debt, with 10 companies owing more than Rs 40,000 crores apiece".

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Annex I

Evolution of important regulations related to Asset Reconstruction Companies in India

Capital base of ARCs	Minimum Owned Fund of Rupees 2 crore (<u>RBI guidelines for SCs/RCs (ARCs) April 23, 2003</u>)
	RBI asked ARCs to maintain capital base of 15% of the total financial assets acquired or to be acquired on an aggregate basis or Rs.100 crore whichever is lower ¹⁶⁸ (<u>RBI March 29 , 2004</u>)
	RBI permitted ARCs to deploy their funds for undertaking restructuring of acquired loan accounts with the sole purpose of realizing their dues (<u>RBI , April 22, 2009</u>)
Investment Requirements for ARCs	No investment requirement in the Security Receipts <u>2003 RBI guidelines</u>
	RBI asked ARCs to invest in security receipts an amount not less than 5% issued under each scheme (<u>RBI, Sep 20, 2006</u>)
	RBI asked to hold their 5 percent investments till the time all the Security Receipts issued under that class are redeemed completely (<u>RBI Apr 21, 2010</u>)
	RBI raised the investment requirement 5 per cent to 15 per cent on ongoing basis till the redemption of all the Security Receipts issued under such scheme (<u>RBI , Aug 05 , 2014</u>)
Asset valuation and Management fee	ARCs should declare Net Asset Value of the Security Receipts issued by it at periodical intervals ¹⁶⁹ (<u>RBI May 28, 2007</u>)
	RBI changed the management fee estimate from as a percent of outstanding value of Security Receipts to as percentage of net asset value (NAV) at lower range of the net value specified by the rating agency (<u>RBI Aug 05 , 2014</u>)
Realisation	Maximum five year timeframe for the asset realisation from the date of acquisition(<u>RBI guidelines for ARCs (April 23, 2003)</u>)
	Extension of two more years for realisation of the assets after the completion of five years (<u>RBI, April 24, 2009</u>)
	RBI allowed ARCs to increase the period for realisation of financial assets so that the total period for realisation shall not exceed eight years after the expiry of five years (<u>RBI April 21, 2010</u>)

¹⁶⁸ the Securitisation Company or Reconstruction Company should continue to hold this owned fund level until the realization of the assets and redemption of security receipts issued against such assets

¹⁶⁹ to enable the Qualified Institutional Buyers to know the value of their investment in the Security Receipts issued by the Securitisation Company/Reconstruction Company

	For the purpose of the restructuring proposals approved / to be approved by BIFR/CDR/JLF, ARCs permitted to accept a resolution period co-terminus with other secured lenders (<u>RBI notification , May 07, 2015</u>)
Investment in ARCs	FDI up to 49 % was permitted in 2005 (<u>MoF, November 11, 2005</u>)
	FII's were permitted to invest in ARCs and FDI ceiling was raised from 49 per cent to 74 per cent. It was subject to condition that no sponsor can hold more than 50 per cent in an ARC either by way of FDI or by routing through an FII. Individual FII's shareholding in ARC was restricted 10 per cent (<u>RBI Aug 19, 2013</u>)
	100 per cent FDI/FII investment under automatic route allowed. Individual FII limit remains at 10 per cent (<u>DIPP press release May 6, 2016</u>)
	FII's were permitted to invest up to 49 per cent in each tranche of Security Receipts subject to condition that single FII in each tranche shall not exceed 10 per cent of the issue (<u>RBI Nov 11, 2005</u>)
	FII investment in each tranche of Security Receipts was enhanced to 74 per cent and individual limit of 10 per cent was removed (<u>RBI Aug 19, 2013</u>)
	FII's were permitted to invest 100 per cent in each tranche of Security Receipts (<u>DIPP press release, May 6, 2016</u>)
Takeover of the management of the business of the borrower	ARCs were given option to change or take over management of the business of the borrower to recover the dues. On realization of its dues ARCs shall restore the management to the borrower (<u>RBI Apr 21, 2010</u>)
Conversion of debt into shares	ARCs were permitted to convert a portion of debt into shares of the borrower company as a measure of asset reconstruction provided their shareholding does not exceed 26% of the post converted equity <u>RBI January 23, 2014</u> .
Membership in Joint Lenders' Forum	ARCs should be members of JLF and should be a part of the process involving the JLF <u>RBI Notification August 05, 2014</u>).
Planning period	Time period given to ARCs to formulate a plan for realization of non-performing assets was reduced to 6 months from 12 months <u>RBI Aug 05 , 2014</u>
Debt aggregation	For the purpose of debt aggregation ARCs were permitted to acquire debt from other ARCs on with the condition that transaction will be settled in cash (<u>RBI Notification January 23, 2014</u>)

Annex II

Indian Asset Reconstruction Companies

ARC	Sponsors¹⁷⁰ (holding more than 10 per cent share)¹⁷¹
Alchemist Asset Reconstruction Company Ltd.	
ASREC (India) Ltd.	<u>Allahabad Bank, Bank of India, Andhra Bank, Indian Bank</u>
Edelweiss Asset Reconstruction	<u>Edelweiss</u>
Asset Reconstruction Company (India) Ltd.	<u>SBI, IDBI, ICICI and PNB</u>
Assets Care and Reconstruction Enterprise Ltd	<u>SSG Capital Management, IFCI and PNB</u>
India SME Asset Reconstruction Company Ltd.	<u>SIDBI, SIDBI Venture Capital Ltd., UBI and Bank of Baroda</u>
International Asset Reconstruction Company Pvt. Ltd.	<u>HDFC Bank and Tata Capital</u>
Invent Assets Securitisation & Reconstruction Pvt. Ltd.	
JM Financial Asset Reconstruction Company Pvt Ltd.	<u>JM Financial Ltd, N. S. Sekhsaria, R. Bimalkumar Pvt. Ltd.</u>
Meliora Arc	
Pegasus Asset Reconstruction Pvt. Ltd.	
Phoenix ARC Pvt. Ltd.	<u>Kotak Mahindra Prime Ltd. and Kotak Mahindra Investments Ltd.</u>
Pridhivi ARC Ltd.	<u>PNB, Motaparti Siva Rama Vara Prasad, M. Rajya Lakshmi</u>
Reliance Asset Reconstruction Company Ltd.	<u>Reliance Capital, Corporation Bank and Indian Bank</u>
Omkara ARC	
UV Asset Reconstruction Company Ltd.	<u>Central Bank of India</u>
Prudent ARC Ltd	
MAXIMUS ARC Limited	
CFM Asset Reconstruction Private Limited	

Source: ARC websites

¹⁷¹ SARFAESI Act defines "sponsor" as any person holding more than 10 percent of paid-up equity capital of ARC

Annex III

NPA's of SCBs Recovered through Various Channels

(Amount in ` Billion)

Year	Sr No.	Recovery Channel	Lok Adalats	DRTs	SARFAESI Act	Total
2012-13	1	No. of cases referred	840,691	13,408	190,537	1,044,636
	2	Amount involved	66	310	681	1,057
	3	Amount recovered*	4	44	185	233
	4	3 as per cent of 2	6.1	14.2	27.2	22
2013-14	1	No. of cases referred	1,636,957	28,258	194,707#	1,859,922
	2	Amount involved	232	553	953	1,738
	3	Amount recovered*	14	53	253	320
	4	3 as per cent of 2	6	9.6	26.6	18.4
2014-15	1	No. of cases referred	2,958,313	22,004	175,355	3,155,672
	2	Amount involved	310	604	1,568	2,482
	3	Amount recovered*	10	42	256	308
	4	3 as per cent of 2	3.2	7	16.3	12.4
2015-16	1	No. of cases referred	4,456,634	24,537	173,582	4,654,753
	2	Amount involved	720	693	801	2,214
	3	Amount recovered*	32	64	132	228
	4	3 as per cent of 2	4.4	9.2	16.5	10.3

- 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. #: Number of Notices issued
 3. DRTs- Debt Recovery Tribunals.

Source: RBI

Annex IV

Scheduled Commercial Banks' Return on Assets and Return on Equity (percent)

Bank Group	Return on Assets			Return on Equity		
	2013-14	2014-15	2015-16	2013-14	2014-15	2015-16
1. Public Sector Banks	0.5	0.46	0.2	8.47	7.76	-3.47
1.1 Nationalised Banks*	0.45	0.37	0.49	7.76	6.44	-8.52
1.2 The State Bank Group	0.63	0.66	0.42	10.03	10.56	6.78
2. Private Sector Banks	1.65	1.68	1.5	16.22	15.74	13.81
3. Foreign Banks	1.54	1.84	1.45	9.03	10.24	8
All SCBs	0.81	0.81	0.31	10.68	10.42	3.59

Notes

Return on assets = net profit/average total assets.

Return on equity = net profit/average total equity.

* Nationalised banks include IDBI Bank Ltd and Bharatiya Mahila Bank Ltd.

Source: RBI

Annex V

TARP Programs¹⁷²: under TARP, government committed initially US\$ 700 billion for various programs but the Dodd-Frank Act reduced this amount to US\$ 475 billion. This was spent for the following five programs:

- Stabilising banking institutions
- Restarting credit markets
- Stabilising auto industry
- Stabilising American International Group (AIG)
- Housing to prevent avoidable foreclosures

¹⁷² TARP Programs, United States Department of the Treasury, <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx>

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