THE ROLE OF ASSET RECONSTRUCTION COMPANIES (ARCs) IN NON-PERFORMING ASSETS (NPAS) MANAGEMENT IN INDIAN BANKING SECTOR: AN EMPIRICAL STUDY

Dr. Manas Chakrabarti
Associate Professor, University of Gour bangla, Malda, W.B., India
Email: manaschakrabarti38@gmail.com

ABSTRACT

The unabated rise in stressed assets of the Indian banking sector is a reason for concern for the economy. The problem is acute particularly among the state-owned Public Sector banks. With the economic growth rate slowing down to less than 5% now there is additional stress on bank loans. The Reserve Bank of India estimated that Non-performing Assets (NPAs) and stressed assets put together account for 10% of total bank loans at the end of September, 2014. With the slowdown of the Indian economy, a number of companies/projects are under stress. As a result, the Indian banking system has seen increase in NPAs and restructured accounts during the recent years. Asset reconstruction companies (ARCs) in India came about after the SARFAESI Act of 2002 to act as a bad bank by isolating NPAs from the balance sheet of bank/FII and facilitate the latter to focus on normal banking activities. ARCs in India have been set up as non-government vehicles with the support from the banking system rather than debt aggregation and funding support under a government owned/supported model. As on 31st March, 2015 there are fourteen ARCs operating in India out of which five are functioning as private company. Since 2003, selling loans through auction to ARCs in return for Security receipts became popular with banks. However, in recent years this option has not been exercised by the Indian banks in an encouraging manner. This paper is an in-depth analysis on the role of ARCs in the Indian Banking Sector in respect of Stressed Assets Management (including NPAs); this humble study also travel around on the various problems which hinder smooth functioning of ARCs and try to explore prospects of ARCs in the Indian economy. This is an exploratory study on the basis of secondary data.

Keywords: Asset Reconstruction Companies; Indian Banking Sector; Non-Performing Assets; Stressed Assets; Security Receipts

INTRODUCTION

In the banking system, high level of NPAs can be serious drag on overall performance of economy due to diversion of its management and financial resources towards recovery of NPAs. Greater the resources needed by banks to reserve for losses, lesser is the amount of capital they can leverage. Consequently it compel the banks to take conservative approach in providing new loans; which may lead to credit crunch in the financial market, amounting to economic and financial degradation. During the period from 2010 to 2014 gross NPAs of all banks in India increased from INR 85000 crores to INR 204250 crores and Restructured Advances from INR 136,426 crores to INR 332,000 crores.

Asset reconstruction companies (ARCs) in India came about after the SARFAESI Act of 2002 to empower banks and some financial institutions to seize collateral in secured loans, without the involvement of courts. Asset Reconstruction Companies are act as a bad bank by isolated Non
Performing Assets from the balance sheet of bank/FI and facilitate the latter to concentrate in normal banking activities. This is about the in-sourcing vs. out-sourcing choice of banks. Some banks could choose to build internal distressed assets teams. Others could choose to sell distressed assets to specialised firms that have skills in dealing with distressed assets. Since 2003, ARCs are playing a vital role in Stressed Assets management in India.

OBJECTIVES AND METHODOLOGY OF THE STUDY

The present study aspires to make an overall evaluation on the functioning of ARCs in India in respect of Non-performing Assets (NPAs) management. To be specific, the main objectives of the study are -

1. To explain the need for NPA management and identify the strategy need for the same.
2. To elucidate the conceptual aspect on ARCs.
3. To describe the functioning of ARCs including their transaction structure.
4. To explain the need for ARCs in NPAs management.
5. To analyse the performance of ARCs in India.
6. To elucidate the problems and prospects of ARCs in India.

Accordingly, the reminder of the paper is organised as under. Section three and four laid down the need for NPAs management and strategy adopted for the same respectively. Section five and six explain the conceptual aspects of ARCs and Security Receipts (SRs) respectively. Section seven narrates down the history of ARCs in India. Section eight and nine represents a brief sketch over various functions of ARCs and transaction structures to execute the same respectively. Section ten focuses on the various benefits of ARCs. The next chapter, i.e. chapter eleven evaluates the performance of ARCs in India. Problems and prospects of ARCs are discussed in chapter twelve and thirteen respectively and on the basis some recommendations for effective functioning of ARCs are made in chapter fourteen. The last section is devoted for concluding observations.

This study is basically exploratory in nature and the entire gamut of discussion has been made on the basis of secondary sources. Secondary data are collected from various reports on ARCs published by RBI, annual reports of various ARCs in India, reports of the various committees set up by the government on ARCs and the publications of Association of Asset Reconstruction Companies (AARCs). Parameters like ratios, percentage of growth and others are considered for some meaningful comparison and analysis to evaluate the role of ARCs in India in respect of stressed assets management and also to derive some concrete conclusion.

Non-performing Assets (NPAs): A Stress on the Banking System

The Introduction of Financial Sector reforms since 1991 have changed the visage of banking industry in India to a great extent. The banking industry has moved steadily from a regulated environment to a deregulated market based economy. With the beginning of liberalization and globalization, resulting in market development there has been fabulous change in the intermediation role of banks in India. The pace of transformation has been more noteworthy in recent times with technology acting as a catalyst. Consequently, we are observing the cut throat competition in the banking industry these days. Obviously, the problem of swelling non-performing asset (NPA) is catching attention and accumulation of huge NPA has assumed immense importance in the context of economic growth. The vitality of the Indian banking system, particularly Public Sector Banks which control 70% of the banking business, is threatened by rising non-performing assets (NPAs). The gross NPAs of the Indian Banks stood at INR 255400 crores and GNPA percentage is 5.10% as on 31.03.2014. Besides NPAs, the stress assets (restructured standard advances) constitute about 5.9 percentage of the gross advances as on 31.03.2014 (table 1). It is reported by some rating firms that NPAs in the banking system are set to increase in the range of Rs.60,000 crores to Rs. 1 lac crore in the coming days. Non-performing Assets are threatening the stability and demolishing bank’s profitability through a loss of interest
income, write-off of the principal loan amount itself. Therefore, the Indian banking system may not sustain this enormous NPA pile-up.

**Table 1. Stress in the Indian Banking System Rs. in crores**

<table>
<thead>
<tr>
<th>Items</th>
<th>2009-10</th>
<th>2010-11</th>
<th>2011-12</th>
<th>2012-13</th>
<th>2013-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross NPAs (All banks)</td>
<td>84747</td>
<td>97922</td>
<td>142300</td>
<td>194000</td>
<td>255400</td>
</tr>
<tr>
<td>Increase in NPAs (YOO)</td>
<td>15774</td>
<td>13175</td>
<td>44378</td>
<td>51700</td>
<td>61400</td>
</tr>
<tr>
<td>Restructured Advances (RA)</td>
<td>136326</td>
<td>137602</td>
<td>218608</td>
<td>301000</td>
<td>332000</td>
</tr>
<tr>
<td>Increase in Restructured Advances (YOY)</td>
<td>61122</td>
<td>1176</td>
<td>81006</td>
<td>82392</td>
<td>31000</td>
</tr>
<tr>
<td>Gross NPA as a % of Gross Advances (i)</td>
<td>2.5</td>
<td>2.3</td>
<td>2.9</td>
<td>3.6</td>
<td>5.1</td>
</tr>
<tr>
<td>RA as a % of Gross Advances (ii)</td>
<td>4.2</td>
<td>3.5</td>
<td>4.7</td>
<td>5.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Total stress as a % to Gross Advances (i + ii)</td>
<td>6.7</td>
<td>5.8</td>
<td>7.6</td>
<td>9.4</td>
<td>11.00</td>
</tr>
</tbody>
</table>

**Strategy for NPAs Management**

In India, Corporate Debt Restructuring (CDR) and Asset Reconstruction companies are two pronged strategy to address the NPA resolution. Co-existence of CDR and ARCs is a mutually beneficial association. CDR typically focuses on restructuring of viable businesses at early stages of distress while ARCs would focus on cases involving multi-pronged workouts involving sale of businesses and assets of the borrower company without any limit on size of the debt. In a multiple ARCs model, it would be necessary to stay away from fragmentation of debt, particularly in respect of large and medium sized NPAs. ARCs should focus on those cases where they are better positioned to aggregate debt. This will make easy resolution process a “win-win” approach for all.

To resolve NPAs, debt aggregation capability and necessary skill sets for resolution are decisive. ARCs with ability to aggregate debt of different classes are in a better position to tackle inter-creditor issues. The debt aggregation capability provides better leverage in implementing resolution strategy. Further, The Banking Regulation Act of India has provided wide-ranging powers to ARCs for resolution of NPAs. ARCs have access to all possible routes available to banks/FIs for resolution as also access to additional empowerments viz. step-in rights and change in management, sale or lease of business. Thus, ARCs with focus and domain expertise in resolution and the statutory / regulatory empowerments for resolution are in a better position to implement timely resolution strategy thereby enhancing the value from recoveries.

**What is Asset Reconstruction Companies (ARCs)?**

Asset Reconstructions companies were created to administer and recover Non Performing Assets acquired from the banking system. They are acting as a bad bank by isolating NPAs from the balance sheet of bank/FII and facilitate the latter to focus on normal banking activities. Banks and financial institutions with a large proportion of their bad loans or Non Performing Assets can sell to a separate entity i.e. Asset Reconstruction Company. Then Asset Reconstruction Companies recover a sum through attachment, liquidation etc. The objective is to help banks in making clean books by reducing NPAs. Asset Reconstruction Companies are also making profit by buying NPAs at a lower price. The process is all about in-sourcing vs. out-sourcing choice of banks in respect of recovery of overdue. Some banks prefer to build internal distressed assets teams. Others could choose to sell distressed assets to specialised firms (i.e. ARCs) that have specialised skills in dealing with distressed assets.
What is Security Receipts (SRs)?

SARFAESI Act 2002 (Section 2(1)ZG) define Security Receipt as “Security Receipt” means a receipt or other security, issued by a securitization company (SCs) or reconstruction company (RCs) to any Qualified Institutional Buyers (QIBs) pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization. Latter on RBI Circular dated May 28, 2007 further elaborates the concept of SRs as SRs issued by SCs/RCs are predominantly backed by impaired assets. SRs have the following inimitable features as compared to other types of securities issued on securitization of normal assets:

- SRs are not a debt instruments since they combine the features of both equity and debt. However, these are recognized as securities under Securities Contracts (Regulation) Act, 1956.
- The cash flows from the underlying assets cannot be assessed in terms of value and intervals.
- The sale of SRs is restricted to QIBs only.
- These instruments when rated would generally be lower than investment grade. These instruments are generally privately placed and presently not listed.

History of ARCs

A cross country experience suggests that ARCs have been successfully deployed to implement a comprehensive NPA management strategy in the aftermath of systemic banking crisis. In East Asian countries, Korea, Taiwan, Mexico, Thailand etc., the Governments have encouraged transfer of assets to ARCs by making a supportive environment. In 1980s, United States used government sponsored ARC - Resolution Trust Corporation (RTC) to trounce thrift crisis. Governments may also provide special powers to ARCs that are not otherwise available to banking system.

In India the problem of recovery from NPAs was first time recognized in 1997 by the Government of India. The Narasimhan Committee observe that an important aspect of the continuing reform process was to soften the high level of NPAs as a means of banking sector reform. The committee believe that with a mixture of policy and institutional development, rising concern for NPA could be arrested. However, the enormous backlog of existing NPAs continued to chase the banking sector and this impinged severely on the banks’ performance and ultimately their profitability. The Report envisaged formation of an “Asset Recovery Fund” to take the NPAs off the lender’s books at a discount. Accordingly, Asset Reconstruction Company (Securitization Company / Reconstruction Company) is registered under Section 3 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act, 2002. It is regulated by Reserve Bank of India as a Non Banking Financial Company (u/s 45-I (f) (iii) of RBI Act, 1934). RBI has exempted ARCs from the compliances under section 45-IA, 45-IB and 45-IC of the Reserve Bank Act, 1934. They will perform like an AMC (Asset management Company) within the ambit of the RBI guidelines.

Transaction structure adopted by ARCs

Stage 1:

At first, an ARC acquires NPA by floating an SPV which acts as a trust whereby the ARC is a trustee and manager. NPA are acquired from banks/FIs at fair value based on assessment of realisable amount and time to decree. The banks/FIs may receive cash/bonds/debentures as consideration or may invest in SRs issued by the ARCs.

The trust acquires NPAs from banks/FIs and raises resources by devising fund/schemes for the financial assets taken over. Accordingly, it issues securities to the investors which are usually QIBs. Security Receipts represent undivided right, title and interest in the trust fund. Subsequently, the ARC redeems the investment to the bank/FIs out of the funds received from the issued securities. After acquiring the NPA, the trust becomes the legal owner and the security holders its immediate beneficiaries. The NPAs acquired are usually held in an asset specific or portfolio trust scheme. In the
portfolio approach, due to the small size of the aggregate debt the ARC constitutes a portfolio of the loan assets from different banks and FIs. Whereas when the size of the aggregate debt of a bank/FI is large, the trust takes asset specific approach.

Stage 2: Thereafter, different fund schemes are pooled together in a master trust scheme and sold to other investors on an agreed term basis. The ARC periodically declares the NAV of respective schemes.

Function of ARCs

In accordance with the Act and RBI guidelines, ARCs can acquire the financial assets of NPA companies on their own balance sheet or through the trust structure by floatation of schemes for raising resources through selling of Security Receipts (SRs) from QIBs. The “trust” structure for acquisition and resolution of NPAs is most preferred structure by the investors and in generally in line with the international practices.

As per RBI Notification no. DNBS.2/CGM (CSM)-2003, dated April 23, 2003, ARCs can perform the following functions:-

1. Acquisition of financial assets (as defined u/s 2(L) of SRFAESI Act, 2002).
2. Change or takeover of Management / Sale or Lease of Business of the Borrower.
3. Rescheduling of Debts.
4. Enforcement of Security Interest (as per section 13(4) of SRFAESI Act, 2002).
5. Settlement of dues payable by the borrower.
Benefits of ARCs

Following are the benefits of ARCs

- Relieving banks from the burden of NPAs which could allow banks to focus better on managing the core business and also tapping new business opportunities.
- By maximising recovery value through minimisation of cost, ARCs can bring back depositor and investor confidence by ensuring the lender’s financial health.
- ARCs help in building industry expertise in loan resolution, besides serving as a catalyst for important legal reforms in bankruptcy procedures and loan collection.
- ARCs play an important role in developing capital markets through secondary asset instruments.

Performance of ARCs in India

Unlike in other countries where ARCs are government sponsored or government has direct participation (including the funding support) in operations of ARCs, in India, the Government has minimal participation in the Non-Performing Loan (NPL) resolution process. The Indian ARC model envisages market forces to consolidate and attractively package lender interests, arrange funding for providing clean exit to seller banks and lend focused attention for NPL resolution. In line with the above objective, ARCs in India have been set up as non-government vehicles with the support from the banking system rather than debt aggregation and funding support under a government owned/supported model. Further, the Indian model envisages setting up of multiple ARCs and funding to be arranged by ARCs on their own. As on 31st March, 2015 there are fourteen ARCs operating in India out of which five are functioning as private company (table 2).

Table 2. List of Asset Reconstruction Companies (ARCs) in India as on 31st March, 2015.

<table>
<thead>
<tr>
<th>Sl no.</th>
<th>Name</th>
<th>Public / Private</th>
<th>Sponsored by</th>
</tr>
</thead>
<tbody>
<tr>
<td>01</td>
<td>Asset Reconstruction Company India Limited (ARCIL)</td>
<td>Public</td>
<td>ICICI, SBI, IDBI and PNB</td>
</tr>
<tr>
<td>02</td>
<td>ASREC (India) Limited</td>
<td>Public</td>
<td>Unit Trust of India</td>
</tr>
<tr>
<td>03</td>
<td>Edelweiss Asset Reconstruction</td>
<td>Public</td>
<td>Edelweiss Financial Services India Ltd.</td>
</tr>
<tr>
<td>04</td>
<td>Alchemist Asset Reconstruction Company Limited</td>
<td>Public</td>
<td>Alchemist Ltd.</td>
</tr>
<tr>
<td>05</td>
<td>Assets Care and Reconstruction Enterprise Ltd.</td>
<td>Public</td>
<td>IFCI</td>
</tr>
<tr>
<td>06</td>
<td>India SME Asset Reconstruction Company Limited</td>
<td>Public</td>
<td>SIDBI, Bank of Baroda, United bank of India and SIDBI Venture</td>
</tr>
<tr>
<td>07</td>
<td>Pridhivi Asset Reconstruction and Securitisation Company Limited</td>
<td>Public</td>
<td>Punjab National Bank, UCO bank and Andhra bank.</td>
</tr>
<tr>
<td>08</td>
<td>Reliance Asset Reconstruction Company Limited</td>
<td>Public</td>
<td>Reliance Capital, Corporation Bank, Indian Bank, GIC of India, Dacecroft and Blue Ridge</td>
</tr>
<tr>
<td>09</td>
<td>UV Asset Reconstruction Company Limited</td>
<td>Public</td>
<td>N.A.</td>
</tr>
<tr>
<td>10</td>
<td>International Asset Reconstruction Company Private Limited</td>
<td>Private</td>
<td>HDFC Bank, Tata Capital Financial Services Ltd., City Union bank, FMO – Netherlands, ICICI bank Ltd, Standard bank plc UK</td>
</tr>
</tbody>
</table>
Invent Asset Securitisation & Reconstruction Private Limited
Private
Group of Professional from diversified field of banking, law, Accountancy.

JM Financial Asset Reconstruction Company Private Limited
Private
JM Financial Services India Ltd.

Pegasus Asset Reconstruction Private Limited
Private
Group of Professional from diversified field of banking, law, Accountancy.

Phoenix ARC Private Limited
Private
Group of Professional from diversified field of banking, law, Accountancy.

Source: www.arcindia.co.in.

Since 2003, selling loans through auction to ARCs in return for SRs became popular with banks. Certain banks started to offload a big chunk of NPAs from their books via this route. However, in the past few years, this option has not been exercised by the banks in an encouraging manner. The primary reason for low consummation of NPA auctions is due to price expectation mismatch between banks and ARCs, contributed largely by the discount factor and pricing of risks associated with recovery which comprise of estimate of realizable amount and period of realization. Although ARCs were created as a systemic response to address growing NPAs but the recent experience suggests that while NPAs are accelerating, flow of Assets to ARCs has rather been dreary (Figure 1). Again, Poor performance of Security Receipts has affected the industry in two ways – firstly, the overall deals between ARCs and banks have reduced considerably; secondly, more banks prefer cash sale to SRs.

Problems with ARCs
During the period from 2003 to 2014 Stressed assets at banks (NPAs + restructured loans) have increased from INR 0.7 trillion to INR 6.1 trillion in 2014. In this period, the annual sale of assets by banks to ARCs has stagnated at INR 0.05 to INR 0.123 billion a year. Now let us discuss what went wrong with ARCs in India –

1. Excessive Banking regulatory interference. ARC is simply a buyer of distressed debt and ARC might be an individual, or a private equity fund, or any other structure. The sale should be a clean transaction where distressed debt is sold and cash is paid to the lender. There are no problems with the working of the ARC on the counts of consumer protection, micro-prudential regulation or systemic risk, therefore the working of ARCs should be completely unregulated. So far, this clarity of thought has been absent, and the working of ARCs has been riddled with poorly thought out RBI regulations.
2. How banks should sell distressed assets is not clarified. Micro-prudential regulators of banks are often keen to hide the problems of bank fragility. This problem has hampered sound thinking about regulations governing provisioning and the sale of assets by banks to ARCs. Actually Provisioning norms by Indian banks, are driven by regulatory prescriptions rather than risk assessment. Even though an asset becomes non-performing after being overdue for 90 days, provisions for the loss associated with this are spread over a period of four years. This generates a perverse incentive to not sell NPAs: provisioning for an NPA has a gradual impact on the balance sheet of the bank while sale of the NPA has to be booked as an upfront loss. As a result banks either hold on to these assets for longer than it is economically sensible, or sell assets to ARCs only when the transaction is at or above book value. In addition, there are a variety of procedural problems with the process of banks selling NPAs including auctions that do not give adequate time for due diligence by ARCs, and auctions that are cancelled after bids are received.

3. Feeble bankruptcy process. The ability of ARCs to realise value is defined by the bankruptcy process. The legal framework for recovery are the debt recovery tribunals (DRTs), set up under the RDDBFI Act, 1993, and the enforcement of security interest under the SARFAESI Act. But unfortunately both these mechanisms have performed poorly in resolving NPAs. Recovery as a percentage of the outstanding amount for cases filed was at 19 percent and 16 percent for DRTs, in 2013 and 2014 respectively. The recovery percentages were 24 percent and 22 percent under SARFAESI, in the same period. While RBI has allowed ARCs to take over the management of the defaulting firm, restructuring under the provisions of the Companies Act is a time taking process. It requires specialised management skills and long term financing, both of which ARCs may not currently possess. Given the time and cost involved in this type of restructuring, only NPAs with very high recovery potential will be selected for this type of resolution.

4. In sourcing vs. outsourcing of distressed asset management: Ideally, the banking rules about distressed assets resolution should be neutral to the identity of the debt holder. However, in India, at numerous points, the powers in processing distressed debt favour banks and do not give non-bank actors comparable powers. This creates incentives for in-sourcing of the distressed debt function. Recovery process by ARCs usually involves taking possession of the collateral security, settlement or rescheduling of payments, sale or lease or takeover of the borrower's business and conversion of debt into equity. But the operational guidelines for many of these were issued by RBI much after 2002. For example, the guidelines for management takeover of the defaulting firm were issued in 2010, eight years after the Act was passed, with subsequent amendments in 2011, 2012, 2013 and 2014. The guideline allowing ARCs to sell assets to each other, which enables them to aggregate assets of a borrower for a management takeover, came in 2013. As a consequence, from 2002 to 2013, ARCs were just handicapped. Banks have been given additional power for dealing with stressed assets, that are not available to ARCs. These include loan restructuring for individual assets, and the corporate debt restructuring (CDR) mechanism for dealing with stressed consortium loans. Banks are enjoying greater restructuring flexibility, under the CDR process, than do ARCs. For example, both the CDR lenders and ARCs have been allowed to convert debt of the borrower firm to equity. SEBI guidelines on lock-in period for share issuance have been relaxed for issuance under the CDR mechanism. Unlike the requirement in the Indian Takeover Code, the acquirer of shares in the CDR process is exempted from making an open offer. However, no such exemptions have been provided for the conversion of debt to equity by ARCs.

5. Lack of adequate foreign skills and capital. A natural pool of expertise is global firms with a specialisation in distressed debt management. Perhaps the only pool of capital that can pay cash for distressed assets is overseas buyers. However, autarkic policies by RBI have restricted
the entry of foreign players, and capital controls have been used to block the inflow of foreign capital. This choked ARCs of both capital and knowledge.

Therefore a question may arise, how ARCs survived in India in an environment riddled with mistakes in regulation? There are two things that are helping ARCs to remain viable even in such a market. The first is the low levels of capital that ARCs need to acquire NPAs. When ARCs issue SRs to finance the NPA acquisition, it is done through trusts in which ARCs, as per RBI guidelines, need to have at least 5 percent of own investment. These SRs have a maturity of 5 years, which can be extended to 8 years in special cases. This is the time-frame that ARCs have, in order to recover value from the acquired assets. Any loss at the end of this period has to be borne by SR holders proportionately. Since the ARC share in the loss from the asset is limited to 5 percent, it allows ARCs to acquire assets even at uneconomic valuations. In most cases, the seller bank, who can sell assets at close to book value, itself subscribes to the balance 95 percent of SRs. The second is the annual management fee (usually 1.5-2 percent of the acquisition value of the asset) that ARCs receive from the seller bank. The fee has no link with the recovery from the asset. Hence, the ARC has little incentive to recover or resolve assets. They just need to hold the assets till maturity of the SRs, during which they continue to earn the management fee income. In this form of the sale transaction, the NPA risk remains in the bank balance sheets and it is merely being reclassified as investment in SRs. Therefore ARC industry in India remains ineffective so far NPA management is concerned.

Prospects of ARCs

On 30th January, 2014 RBI released a Framework for Revitalising Distressed Assets in the Economy, with a number of changes in the operational framework for ARCs. The guidelines proposes the following changes in the ARC framework –

- Assets in the 61 to 90 days category can also be sold to ARCs. This would encourage early sale of distressed assets and better recovery.
- Banks allowed in spreading loss on sale over a two year period, for assets sold till March, 2015. They can also enjoy reverse provisions made for NPA, if there is gain on sale. This would address banks’ concerns on loss on sale of assets.
- It is obligatory for banks to accept bids in an auction that are above reserve price and fulfil conditions specified.
- Steps have to be taken to improve price lucidity in price on bilateral sale of assets.
- Sale of assets between ARCs and their sponsor banks is permitted only through a see-through and arms length auction. These would improve transparency in the sale process.
- Promoters of companies allowed buy-back assets from the ARCs, with ARCs demonstrating no prior complicity between the ARC and the defaulting borrower, to the RBI.

All the above measures create a positive impact over ARCs functioning in India. On one hand, these remove procedural snags faced by ARCs; on the other, there is pressure on Public Sector Banks (PSBs) to offload their growing NPAs or face erosion in profits in the medium term. Both factors contributed to a rapid gush in sale of NPAs from banks to ARCs in the last quarter of FY 2014. PSBs take a leading role in this regard. For example, State Bank of India (SBI) in its Annual Report for FY 2014, has accounted a sale of INR 36 billion of NPAs to ARCs. The book value and the sale value of these assets are INR 15 billion and INR 16 billion respectively, with SBI making a profit of INR 1 billion from these transactions.

The surge in NPA sale transactions in 2014 has led to the following further changes through the 5th August, 2014 notification by the RBI in respect of ARCs-

- Increase ARCs capital commitment in the acquired asset from 5 to 15 percent.
• ARCs fees now linked to the net asset value (NAV) of the acquired assets rather than the outstanding value of the security receipts. This means, shortfalls in recovery now affect ARC fees.
• Amplified reporting and disclosure requirements for ARCs, especially when asset are sold by banks above book value and for asset sale by ARCs at a significant discount.
• Increased time that ARCs get for due diligence at asset auctions, at least two weeks.
• Reduced planning period for acquired assets from one year to six months. This is also the time frame within which the acquired asset needs to be re-rated or re-valued.
• Inclusion of ARCs in the Joint Lenders Forum (JLF) and a mandate for them to put up a list of wilful defaulters on their website.

The changes initiated by RBI in 2014 are helping ARC to execute their transactions in the following manner -
• Banks are now selling assets to ARCs without actual risk transfer, since 95 percent of the value of the sale got back into banks' balance sheets as investment in SRs.
• ARCs earning fee income linked to the book value of the asset and not to its recovery value. Low levels of ARCs capital commitments meant no real incentive for them to resolve NPAs.
• Promoters, even the wilful defaulters, getting relief from repaying their dues under the ARC model, which was focused on warehousing instead of resolution of NPAs.

Recommendation for effective functioning of ARCs in India

The latest amendments in the Framework for Revitalising Distressed Assets in the Economy in 2014 have raised the ARCs risk in acquiring assets. ARCs will now need to make recoveries to earn fees and to get returns on invested capital. However, the larger problems of these arrangements remain unresolved. In order to make easier in distressed debt processing and ARCs work, the work plan for policy makers should consists of the following elements:

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

The best indicator for the health of the banking industry in a country is its level of NPAs. It reflects the performance of banks. However, in recent years NPAs have become a major concern for the Indian economy. ARCs with statutory/ regulatory powers can function in an effective manner as a nodal resolution agencies co-existing with CDR mechanism in respect of NPA and stressed assets management. But their business is not growing up due to number of reasons. Bank officials are hesitant to sell bad loans because they fear this might be perceived as an admittance of failure to recover the loan. They also fear vigilance inquiries. The growth of ARCs is important for the Indian Economy. ARCs can add value by cutting short the time to resolution as well as maximizing the recoveries. These practices will enable banks/ FIs to move to internationally accepted norms. There should be mechanism to review to working of ARC which should work upon increasing the transparency in the sector. The banks/ FIs that cannot sell the assets immediately to ARCs due to possible balance sheet concerns should support the resolution efforts of ARCs. As more and more private players enter into this sector, this space is really worth watching for.

REFERENCES

9. RBI Report on Trend and Progress of Banks in India (2010-15)
11. http://www.arcindia.co.in