ARC Models will always be work in progress

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Asset reconstruction is a concept that keeps coming up periodically whenever there is a NPA crisis. NPA cycles are unavoidable as they are linked with economic downturns which tend to be periodic. There have been several attempts made to address issues of asset quality with different levels of success at various points of time. The concept of asset reconstruction is hence is not new but such experiments have to be conducted regularly before the right note is struck as the issue is fairly complex. Also the mode of implementation needs constant fine tuning so that the desired results are obtained. The more recent concept of a bad bank has its relevance in this context, and though similar in scope to the existing ARCs that have been operating for decades, is different.

NPA resolution is an old story and several approaches have been taken to address the issue with the latest being the IBC. Debt Recovery Tribunals, ARCs under the umbrella of SARFAESI, IBC, bad bank etc. are all attempts made to address the issue. The problem in India is that the market is tilted towards the borrower and it becomes hard to enforce discipline in debt servicing when the going gets tough. This is so because on both the sides there are constraints when the environment turns adverse.

From the lenders point of view restructuring the loan makes sense as it remains a non-NPA and there is less pressure on the balance sheet at a time when profits are under pressure. Any resolution would mean that there would be a haircut that leads to eventual write-offs. Therefore there is an incentive to keep the asset as a standard one. In short, kicking the can makes economic sense within the scope of the regulatory structure.

The borrower is evidently better off when there is restructuring as the terms tend to be better as often the interest rate is reduced and tenure extended. While willful default is an exception rather than a rule, normally business cycles tend to affect businesses adversely which makes debt servicing difficult. At this stage seizing the asset and selling them may not sound fair for the borrower and hence there are attempts made to restructure the loan. Besides, if every potential default results in punitive action being taken enterprise will be thwarted.

To this structure of incentives must be added the role of litigation as it was a habit for companies to go to courts (which happens even in case of the IBC) when the issue of seizure of assets comes up.

Asset reconstruction companies come into the picture when the asset is non-performing and collection is difficult. The reasons for having such companies is that they take on the onus of collection or recovery by paying an upfront price for the failed asset to the bank. The bank takes a haircut but gets rid of the asset and need not expend time and manpower to collect the dues. The premise here is that the job of a bank is to do banking and not collections. The borrower's position does not change but instead of dealing with the bank has to work with the ARC for servicing and settlement. But the problem for the bank is at what price to sell the asset.

George Akerlof's theory of asymmetric information is relevant here. In his theory of lemons, it was argued that the seller of the car has knowledge of the quality of the vehicle which the buyer does not. Hence price determination is a challenge. How does one value a second hand car which looks good from the outside but is uncertain once it starts running? Here Akerlof had come up with the theory of signaling where an independent valuation or background of the owner could come into play to signal to the buyer the quality of the seller.

When it comes to a NPA it becomes tougher because neither the buyer nor seller knows about the true worth of the company which cannot service its loan. The company however may know the true value of the enterprise and its ability to come back on track and service the loan at a future date. But still it cannot be certain. Therefore both the parties have a different view on the quality of the company and its ability to perform in future. The company would like to present the best possible picture which will be fine for the buyer (ARC) but not for the bank which has not been able to recover its dues. This makes a solution interesting and puzzling.

Now, the bank would like to get a higher price for the asset being sold while the buyer (ARC) will want a lower price because in case a higher price is paid and the realization is lower, it would be a loss. This is why not too many deals would be struck between the ARC and the bank when the amounts involved are large. Normally such transactions also involve a clause which states that in case the ARC realizes a higher amount from the borrower, a part of it would go back to the bank. But a market solution is always going to be a challenge.

The solution is to get a valuation done by the third party which should be acceptable to the buyer and seller and which is recognized by the government. Banks do not hence risk selling cheap with any negative motive, while the buyer can be confident that the price is right. This can be an appropriate signaling mechanism which can be institutionalized. The credit rating agencies can play a role here in valuation of such assets/enterprises. In fact all NPAs above a certain threshold should be rated by rating agencies like CARE, CRISIL, ICRA etc. as a routine because it would then be easier for the bank and the ARCs to ascertain the true value of the loan over time.

The table below gives an idea about the success of various schemes under NPA resolution

	Total involved: FY20	Amount recovered	Ratio	Total involved: FY21	Amount recovered	Ratio
Lok Adalats	67,801	4,211	6.2	28,084	1,119	4.0
DRTs	2,05,032	9,986	4.9	2,25,361	8,113	3.6
SARFAESI Act	1,96,582	34,283	17.4	67,510	27,686	41.0
IBC	2,24,935	1,04,117	46.3	1,35,139	27,311	20.2
Total	6,94,350	1,52,597	22.0	4,56,094	64,228	14.1

Source: RBI

As can be seen in the table above the average recovery rate is around 22% which is quite low. It has varied across modalities in the past and while the IBC started off with big successes with the recovery rate touching 70%, once the low hanging fruits were plucked, it was back to the average value.

The idea of a bad bank or NARCL (National Asset Reconstruction Company Limited) is hence similar to the ARCs which have been functioning in the country. The main purpose is to offload bad assets of banks to the company which can then get into the mode of selling the assets. The major difference is that NARCL is owned by the government and when an asset which is fully provided for is sold, the bank gets 15% in cash and the balance in securities which are then guaranteed by the government to the extent of Rs 30,600 crore. In case the asset finally sells lower than face value, the bank can invoke guarantee from the government. Hence both the issues of valuation and realization are tackled here.

The fundamental question to be asked is whether such operations should be continuous or be temporary. Keeping such a facility as an on-going venture runs the risk of moral hazard as this can lead to dilution in lending standards by banks when they are assured by such a backstop facility. Companies also may be tempted to play truant when it comes to servicing debt as they know that in the most extenuating circumstances, the asset can be sold to the ARC. There is hence compelling reason for such bad banks to be persevered with a definite time line so that it is target oriented and addresses the existing issue of NPAs. Hence in this context the mandate seeks to cover Rs 2 lakh crore of NPAs. This limit hence caps the amount that will be taken on with a condition that the size of the asset should be above Rs 500 crore.

Globally bad banks have been set up more like special purpose vehicles to solve the pending issue of bad assets. These institutions have been wound up once the purpose was achieved. The present system in India hence needs to be differentiated. The bad bank concept of NARCL must ideally be closed down once the objective of asset resolution is done for the existing pack of NPAs. Subsequently it should be left to the market to decide as to how such assets would be valued. As seen in the table above as well as earlier experiences, the recovery rate has varied between 20-40% across all the mechanisms with the IBC having the highest rate at times (in the beginning only) of above 70%. The realization is better when the decision to sell is taken earlier. The problem is that with the passage of time the quality of the asset physically deteriorates further thus leading to lower valuation. A steel company that defaults and is not operating on viable lines will witness deterioration in the quality of the plant and machinery being used. This will lower interest of any potential buyer.

Therefore for efficient asset reconstruction it is necessary to recognize the quality of the asset immediately and not delay the resolution process. This will always be challenge especially for a promoter driven company where there is more reluctance to give up control. For the system to work well there have to be well defined rules which leads to an asset sale. This is a challenge but has to be done objectively. The moment subjectivity come in, there will a chance to delay things which as has been seen turns out to be a sub-optimal outcome for the system.

Views are personal