# Down the Rabbit Hole

## Asset Reconstruction Companies and the Bad Debt of Indian Banks

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The finance minister's Budget speech 2021 revealed the government's plans to establish an Asset Reconstruction Company to take over bad debt from the books of public sector banks for eventual disposal. That suggests that the ARC route rather than recapitalisation would in the coming months be the main means of refurbishing capital in the public banking system. Since there are as many as 28 ARCs already in existence, the reason why the creation of one more would resolve a problem that is expected to worsen over the coming year is unclear. In fact, past experience indicates that ARCs have not helped enhance the actual recovery of lock-up in stressed assets. This suggests that the move is a means to postpone the problem of bad debt resolution so as to avoid having to recapitalise the banks with budgetary resources, which would widen the central fiscal deficit.

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The union government's effort at resolving the problem of excess bad debt on the books of Indian banks has come full circle with the announcement of one more Asset Reconstruction Company (ARC) or "bad bank" as a final solution to the problem. In Budget speech 2021, the finance minister announced plans to create a "new structure" to clean up the books of banks. The speech declared,

> An Asset Reconstruction Company Limited and Asset Management Company would be set up to consolidate and take over the existing stressed debt and then manage and dispose of the assets to Alternate Investment Funds and other potential investors for eventual value realisation.

The matter-of-fact nature of the statement reflected confidence that this solution would work; and would do so for all of "existing stressed debt."

What was ignored was the long history of unsuccessful government intervention to wipe stressed debt off the books of banks. And what was left unexplained was the supposed novelty of the proposal advanced in Budget speech 2021. The establishment of ARCs was envisaged in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 and the first such company, the Asset Reconstruction Company (India) Limited (ARCIL), promoted by the State Bank of India (SBI) and ICICI, began operations in that year. Reflecting on recent foreign investor interest in ARCs, in 2018–19, long after foreign investment was permitted in these entities, Avenue Capital Group, an American investment firm, became the largest shareholder of ARCIL after acquiring a stake of around 25%. As of now, the other shareholders include SBI (20%), IDBI Bank (19%), ICICI Bank (13%) and Punjab National Bank (10%). Since 2002, many more ARCs have been established. The Reserve Bank of India's (RBI) website lists 28 ARCs registered with it as of 31 January 2021.[1]

The process of asset reconstruction through ARCs involves banks setting a reserve price and attempting to auction bad debts. Depending on the price (reflecting the mutually agreed discount or haircut) arrived at through the auction, the ARC concerned will issue "security receipts" equivalent to the total sum at which the non-performing assets (NPAs) were sold. The RBI guidelines require ARCs to have skin in the game, holding a minimum specified percentage of security receipts (set at 5% in 2006 and raised to 15% in 2014) paid for in cash to the selling bank.[2] Besides acquisition by the ARCs, some of the security receipts are sought to be sold to foreign institutional investors (FIIs) and qualified institutional buyers (QIBs), with the remaining held by the banks. The only cash the bank receives upfront is the value of receipts acquired by the ARC and sold to FIIs and QIBs. In practice, because of the absence of strong investor interest, banks till very recently did not receive significantly more cash than the payment from the ARC and held most of the security receipts themselves.

The security receipts are managed by the ARC and redeemed as and when it has disposed of the stressed or defaulted asset, for which service it charges an annual management fee of around 1.5% of the value of the security receipts it manages, with that value being assessed by an accredited credit rating agency. ARCs are given a period of five years, extendable by three to ensure realisation. At the end of that period, a meeting of at least 75% of qualified investors can decide what needs to be done with the security receipts.

The ARC process gives banks partial relief. Banks are required by the RBI to make full (100%) provision for secured loans that go bad in a period of four years. The security receipts being investments are excluded from provisioning requirements. For determining the loss suffered when transferring NPAs to the ARC, the net asset value of the security receipts is estimated by the rating agency, and the loss incurred computed as the difference between the book value of the loans (minus any prior provisioning for NPAs) and the certified net asset value. The value of security receipts would be determined at any point by the assessment of how much of the value of the underlying NPAs can be realised. Initially, these losses had to be recorded in the profit and loss account in the year when the NPAs have been transferred to the ARC, but subsequently (from February 2014) banks were allowed to stretch the loss over two accounting years. If and when the NPAs are sold to interested investors hoping to make a profit through final realisation from the debtors, the proceeds are used to first cover legal and other resolution expenses, then to pay the ARC its management fee, and the balance is distributed to the holders of the security receipts in proportion to their holdings.

It should be expected that the perceptions of the ARCs and the banks on what would be a reasonable valuation of the stressed assets that render resolution possible and meaningful will diverge. Banks would like to set a high reserve price, but ARCs would argue that resolution is possible only when the valuation is lower and made attractive for investors. Despite this divergence, it is likely that the disagreement over price would be settled in favour of the bankers, because of the incentives motivating the ARCs. The earnings of the ARC are a combination of the management fee and any payment in excess of acquisition costs it receives for its own holdings of security receipts at the time of realisation. But with annual fees for the ARC set at 1.5% of security receipt value as determined by a rating agency, this proved to be the principal source of revenue and returns. It was an incentive that overrode the potential loss that could result from the original value of the security receipts acquired by the ARC, exceeding the sum finally recovered from the loan assets that underlie them. The result was that, even after the mandatory exposure of the ARC to security receipts associated with any NPA acquisition was raised to 15%, ARCs continued to take on new NPA assets for resolution. But if the result is that the final price of the stressed assets is set too high or the discount at which they are offered too low to attract investors, the security receipts (in excess of mandatory ARC acquisition) would devolve on the banks which might only receive sums that accrue to them as lenders as and when the borrower is liquidated. Banks would be the final losers, and the ARCs, the beneficiaries in the resolution process.

This experience draws attention to the principal concern of this paper: Why has the government decided to make the establishment of one more ARC an important plank of its renewed effort at bad debt resolution? Is it because experience has taught the government that of the many means of resolution, the ARC route has proved to be the best? And, if so, why has it chosen to create one more ARC, rather than use the 28 already in existence? Is that decision influenced by a conviction that important changes have to be made to the structure and rules of functioning of ARCs for greater effectiveness in resolution? Would all or most NPAs of public sector banks (PSBs) marked for resolution be directed to one single ARC? If so, what is the expected capital requirement to support this "giant" bad bank that would take on much of the business now distributed across 28 institutions?

## Existing Initiatives

One factor driving the government's announcement of a new effort at resolution is of course the sheer magnitude of the NPA problem, which remains unsustainably large despite successive drives for NPA reduction. NPAs on the books of PSBs stood at ₹5.77 lakh crore at the end of December 2020. Moreover, even as the government works to reduce the volume of NPAs using alternative resolution frameworks, new NPAs remain high. Over the financial year (FY) 2019–20, for example, scheduled commercial banks (SCBs) recorded an addition of ₹3.78 lakh crore to their stock of NPAs. In that year, NPA reduction (including through write offs) amounted to ₹3.94 lakh crore, making the net reduction rather small. In fact, the current problem is because of the reversal of what appeared to be long-term decline in the NPA ratio. In the decade before the first ARC was established in India in 2002–03, gross NPAs or GNPAs on the books of PSBs had come down from 23% of gross advances to 9.4% of gross advances. Official records indicate that this was further reduced to just 2% in 2008–09. Subsequently, following a slow climb to 5% in 2014–15, the GNPA ratio jumped to 9.3% in 2015–16, 11.7% in 2016–17 and 14.6% in 2017–18.[3] It was this reversal that triggered an intensified drive to rein in and reverse the rise.

There is now a consensus on why the GNPA ratio suddenly spiked. India experienced a domestic credit boom, driven by the liquidity pumped into the system by large inflows of foreign capital, which in turn led to a sharp increase in the deposit base of the commercial banking system (Chandrasekhar and Ghosh 2018). The credit boom that the surge in liquidity triggered, it is now widely acknowledged, resulted in provision of loans to projects, especially in the infrastructural sectors that failed to garner the revenues that were expected to help service their large debts. Corporates burdened by these large loans were debt-stressed. This problem was ignored for long, since these effectively "non-performing assets" were not recognised to be such, as the post-liberalisation corporate debt restructuring mechanism was exploited to restructure these loans, treat them as restructured "standard" assets and postpone the day of reckoning. When, finally, in 2015, the RBI decided to force recognition of these debts as bad debts, the volume of NPAs soared. The RBI's asset quality review (AQR) resulted in the ratio of GNPAs to gross advances for PSBs rising from 5% in March 2015 to a peak of 14.6% in March 2018. What is noteworthy is that at the end of March 2020, large borrowers with aggregate fund-based and non-fund-based exposure of ₹5 crore and above, which accounted for 51.3% of the aggregate loan portfolio of the SCBs, contributed to 78.3% of their GNPAs (RBI 2020).[4]

Once recognised, loans had in time to be technically written off, pending recovery of some proportion of them through direct negotiation between debtors and creditors or through the use of mechanisms available, such as debt tribunals, Lok Adalats (People's Court), action under the SARFAESI Act and the Insolvency and Bankruptcy Code's (IBC) resolution/liquidation process. In response to the Lok Sabha's unstarred question No 2286, the finance ministry informed Parliament on 8 March 2021 that

> as per RBI guidelines and policy approved by bank Boards, non-performing loans, including, inter-alia, those in respect of which full provisioning has been made on completion of four years, are removed from the balance-sheet of the bank concerned by way of write-off.

Small value loans up to ₹20 lakh are often sought to be settled between the borrower and the lender using the forum of Lok Adalats which were given statutory status under the Legal Services Authorities Act, 1987. The authority to adjudge on debt recovery matters was given to Debts Recovery Tribunals and Debts Recovery Appellate Tribunals established under the Recovery of Debts and Bankruptcy Act, 1993 to facilitate quick resolution. Not satisfied with the pace of recovery through these means, which was bogged down by litigation, the government enacted the SARFAESI Act in 2002 that enabled banks and financial institutions to push for recovery of secured credits without the intervention of the courts. As Table 1 indicates, between 2012–13 and 2014–15, recovery under the SARFAESI Act accounted for between 79% and 83% of all recoveries through debt tribunals, Lok Adalats, and the SARFAESI Act. This figure fell to 28% in 2016–17, possibly pointing to a shift to the IBC as the preferred mode of recovery of large debts.

According to finance ministry figures, PSBs had written off a total of ₹2.46 lakh crore worth of loans over the five years 2012–13 to 2016–17. The process had clearly begun to affect declared profits. In 2012–13, PSBs wrote off ₹27,231 crore, while declaring combined net profit of ₹45,849 crore. The corresponding figures for 2016–17 were ₹81,683 crore and ₹474 crore (Verma 2017). The answer to the Lok Sabha question mentioned earlier, reported that SCBs had written off loans of ₹2,36,265 crore, ₹2,34,170 crore and ₹1,15,038 crore during FY 2018–19, FY 2019–20 and the first three quarters of FY 2020–21 respectively, or a total of ₹5,85,473 crore. These, however, are technical write-offs, and the recovery effort continues, and borrowers remain liable. But during the three years mentioned, recovery from written-off loan accounts was just ₹68,219 crore (Government of India 2021a). Clearly, the record of recovery from written off loans was poor. As the amount involved in cases referred to the three traditional windows for recovery rose from ₹1.06 lakh crore in 2012–13 to ₹2.86 lakh crore in 2016–17, the recovery percentage fell from 22% to just 10% (Table 1). This meant that provisioning and the attendant losses must have been rising sharply.

Provisioning hurts a bank's bottom line and introduces hesitancy in incremental lending. But more importantly, it could put a bank on a trajectory where it is unable to meet Basel-type capital adequacy norms, requiring measures to beef up capital, including Tier 1 (or best and least committed) capital. To ease the burden on the banks and help them sustain reasonable capital adequacy ratios, the government has been supporting PSBs with funds for capitalisation, through acquisition of additional equity. In August 2015, the government announced a four-year Indradhanush plan, under which the PSBs would be provided with new capital worth ₹70,000 crore, with ₹25,000 crore being disbursed that financial year and the next, and ₹10,000 crore in each of the two subsequent years. This was followed by another major recapitalisation plan in October 2017, which involved infusing ₹2.11 lakh crore of new equity into the PSBs, of which ₹1,35,000 crore would be money from the government, financed with recapitalisation bonds. Another ₹18,139 crore was the balance due under the ₹70,000 crore Indradhanush plan initiated in August 2015 and funded from

**Table 1: NPAs of Scheduled Commercial Banks Recovered through Various Channels**
(Amount in ₹ crore)

| Year | Recovery Channel | Lok Adalats | DRTs | SARFAESI Act | Total |
|---|---|---|---|---|---|
| 2012–13 | No of cases referred | 8,40,691 | 13,408 | 1,90,537 | 10,44,636 |
| | Amount involved | 6,600 | 31,000 | 68,100 | 1,05,700 |
| | Amount recovered* | 400 | 4,400 | 18,500 | 23,300 |
| | 3 as % of 2 | 6 | 14 | 27 | 22 |
| 2013–14 | No of cases referred | 16,36,957 | 28,258 | 1,94,707# | 18,59,922 |
| | Amount involved | 23,200 | 55,300 | 95,300 | 1,73,800 |
| | Amount recovered* | 1,400 | 5,300 | 25,300 | 32,000 |
| | 3 as % of 2 | 6 | 10 | 27 | 18 |
| 2014–15 | No of cases referred | 29,58,313 | 22,004 | 1,75,355 | 31,55,672 |
| | Amount involved | 31,000 | 60,400 | 1,56,800 | 2,48,200 |
| | Amount recovered* | 1,000 | 4,200 | 25,600 | 30,800 |
| | 3 as % of 2 | 3 | 7 | 16 | 12 |
| 2015–16 | No of cases referred | 44,56,634 | 24,537 | 1,73,582 | 46,54,753 |
| | Amount involved | 72,000 | 69,300 | 80,100 | 2,21,400 |
| | Amount recovered* | 3,200 | 6,400 | 13,200 | 22,800 |
| | 3 as % of 2 | 4 | 9 | 17 | 10 |
| 2016–17 | No of cases referred | 21,52,895 | 28,902 | 80,076 | 22,61,873 |
| | Amount involved | 1,05,787 | 67,089 | 1,13,100 | 2,85,976 |
| | Amount recovered* | 3,803 | 16,393 | 7,758 | 27,954 |
| | 3 as % of 2 | 4 | 24 | 7 | 10 |

* 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.
\#: Number of notices issued. DRTs = Debt Recovery Tribunals.
Source: Reserve Bank of India, "Statistical Tables Relating to Banks in India," https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications#!4.

the government's budget. The remaining ₹57,861 crore was to be mobilised by the banks from the market.

In fact, having decided to adhere to Basel norms, since the early 2000s, the government has been allocating budgetary resources to infuse capital into the public banking system to strengthen their balance sheets and bring them into conformity with globally recommended standards. As Figure 1 shows, the government has thus far infused ₹4,16,500 crore into the public banking system, with much of it having been provided since 2010, and a huge proportion over 2016–19. The allocation for recapitalisation rose sharply once the AQR resulted in a spike in NPAs, from ₹14,000 crore in 2013–14 to a peak of ₹1,06,000 crore in 2018–19, before coming down to ₹69,200 crore in 2019–20 and a projected ₹20,000 crore in 2020–21.[5] But even this is far short of estimates of what the banks would require if Basel III has to be complied with. This does create a problem for a government committed to reining in the fiscal deficit, even while opting for greater leniency on the taxation front. More so because of the spike in the fiscal deficit following the fall in revenues and increased expenditures resulting from the COVID-19 pandemic.

## Recent Developments

Technical write-offs, recovery, and provisioning by the banks supported with recapitalisation support from the budget for the PSBs had triggered a new round of reduction in the NPA ratio, with the figures falling to 12.2% in March 2019 and 8.5% in March 2020. The recognition of stressed assets as NPAs resulted in the GNPAs of the PSBs rising from ₹2,79,016 crore on 31 March 2015 to ₹5,39,968 crore on 31 March 2016, ₹6,84,732 crore on 31 March 2017 and a peak of ₹8,95,601 crore on 31 March 2018. According to the government, on account of its strategy of "recognition, resolution, recapitalisation and reforms," the figure came down to ₹7,39,541 on 31 March 2019, ₹6,78,317 on 31 March 2020 and ₹5,77,137 crore on 31 December 2020 (Government of India 2021b).

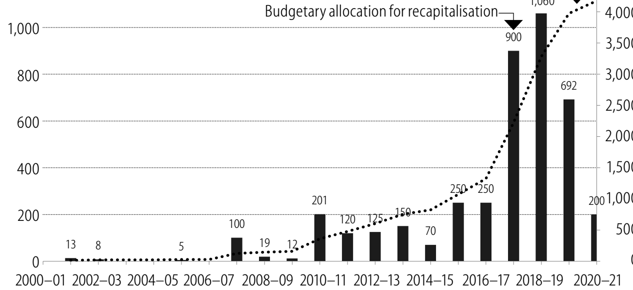
But banks are likely to be hit adversely by the pandemic in multiple ways. With the earnings of individuals and businesses (big and small) contracting or disappearing because of the COVID-19-induced crisis, defaults are bound to rise on past debt. This has not been reflected immediately to the full extent because of the moratorium on debt service by different sections that the banks have been forced to impose as part of the government's crisis alleviation package. In addition, with a fiscally conservative government not wanting to spend its way through the crisis, banks have been called upon to provide the support needed by a range of sections with new credit on reasonable terms when the probability of default has spiked. Not surprisingly, the July 2020 issue of the RBI's *Financial Stability Report* projected that the GNPA ratio could rise to 14.7% by March 2021 under a severe stress scenario, from its 8.5% level in March 2020 (RBI 2020). The losses as a percentage of the capital of the banks could amount to as much as 27.9%. A number of measures announced in the wake of the pandemic such as implementation of resolution plans to support stressed corporate or personal loan borrowers and to restructure micro, small and medium enterprise (MSME) loan accounts, while treating the assets as standard could result in bad loans not being immediately recorded as such. But they would have to be eventually recognised as NPAs, if they remain unserviced beyond the specified duration of the schemes.

This would require an intensification of the NPA reduction drive. Even before the pandemic, with the debt tribunals and Lok Adalats proving grossly inadequate to the task of managing the post-AQR spike in NPAs, the government's drive to address this problem had taken three forms. One was to organise funds for recapitalisation without letting it reflect in an enhanced fiscal deficit. The second was to provide means for banks to maximise recovery of technically written-off bad debts in the shortest possible time, for which it put in place the IBC. The third was to find ways of temporarily taking bad debt off the books of banks and transferring out the burden of resolving that debt, in which effort the ARCs had an important role to play.

The principal means to ensure the first of these objectives was to use an accountant's sleight of hand in the form of recapitalisation bonds. These bonds were issued by the government to banks which purchased them as investments. The funds received were invested by the government in equity issued by the banks. Since this involved both a credit (bank equity) and debit (borrowing against bonds) entry in the capital account of the government it made no difference to the fiscal deficit. The banks on their part were allowed to treat the purchase of bonds as a legitimate and safe investment, while the purchase of their equity by the government shored up their capital base. However, the government paid interest on the bonds held by the bank, which would show up in its revenue account in future years.

Besides the fact that this was a way of window dressing budgetary figures to hold down deficit numbers, this was a process that was using the government as a medium to convert the bank's own resources into its own Tier 1 capital, which is a peculiar way of addressing the issue of solvency stress. To do so, banks were being encouraged to divert their resources to safe and low-yielding investments, rather than push for enhanced credit provision which was the real intent of NPA reduction and recapitalisation. At one point, this became the dominant means of recapitalisation. Thus, in the significantly stepped-up recapitalisation plan announced in October 2017,

**Figure 1: Budgetary Allocation for Recapitalisation** (₹ billion)




Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

₹1.35 lakh crore of the announced ₹2.11 lakh crore of new equity to be issued by the PSBs was financed with recapitalisation bonds.

More recently, the government has decided to even do away with the fig leaf of accepting an interest payment commitment to establish that it did acquire capital at a cost to finance purchases of bank equity. The 2019–20 budget had provided for recapitalisation to the tune of ₹20,000 crore. At the fag end of the financial year, the Punjab and Sind Bank, Central Bank of India, Indian Overseas Bank, Bank of India and UCO Bank were recapitalised to the extent of the sum mentioned, releasing some of them from the RBI's Prompt Corrective Action framework, and enabling their return to normal functioning. This round of recapitalisation, however, was financed through the issue of "non-interest bearing, non-transferable special Government of India securities" valued at par. These bonds do not need to be marked to market by the banks and do not impose any interest burden on the government, allowing it to claim to have undertaken a cost-free, statistical resolution of part of the problem stemming from the writing down of debt.[6] But inasmuch as the banks concerned are investing their money in zero interest bonds issued by the government, as opposed to investing them in government bonds offering a 6% plus interest rate, say, they are incurring a loss. That loss, however, is not being recorded because of an administrative decision that the bonds will be valued at par till maturity, and not be marked to market. The only reason the government can even contemplate such a sham exercise is because these are PSBs which it controls.[7]

## Some Concerns

Meanwhile, the discomfort that recapitalisation that involved an actual allocation of budgetary resources caused a fiscally conservative government has led to calls for privatisation. Needless to say, given the volume of NPAs recorded after 2015, if the government's equity holding in public banks were to be kept at 51% or more, capitalisation funds from the official kitty would have had to be substantial. Financing that requirement largely through the issue of recapitalisation bonds would have been difficult to justify. So, increasingly, a case is being made for banks to mobilise capital from the equity market. But the problem is that selling equity in PSBs at a reasonable price would not be possible when their books are burdened with NPAs. Cleaning those books by writing off bad debt would result in losses that would also make equity sale at reasonable prices difficult, if not impossible.

In the circumstances, the options available were attempting debt write-offs with reasonable recovery either directly through the IBC process or via ARCs. Though the IBC process has ensured better recovery than earlier efforts through Lok Adalats, Debt Recovery Tribunals and action under the SARFAESI Act,[8] its success in terms of recovering an adequate share of corporate debt that turned bad has been limited. Between December 2016 and December 2020, 4,117 applications were admitted for resolution under the Corporate Insolvency Resolution Process. Of these, 897 cases were closed midway, and of the remaining 308 corporates were rescued through resolution, whereas 1,112 were closed for liquidation. Of the latter, as compared with the aggregate claims of the creditors of ₹6,04,574 crore, the liquidation value was set at ₹43,048 crore or at 7.1% of claims. It is unclear how much of even this can be recovered. As of 31 December 2020, 181 of these debtors had been fully liquidated. Outstanding claims against these debtors were ₹26,251 crore, and liquidation had recovered ₹607 crore (2.3%) as against a valuation of ₹598 crore.[9]

As was to be expected, in the case of the 308 debtors who have been rescued so far, the record of recovery was definitely better. As against aggregate claims of ₹4,99,928 crore, and an assessed liquidation value of ₹1,03,270 crore, the recovery through resolution was ₹1,99,511 crore or 40% of outstanding claims.[10] But in the aggregate, the expected recovery relative to outstanding claims in the case of the 1,420 cases that have been closed or are in the process of being closed through rescue or liquidation amounts to a meagre 13%. Much of the bad debt it appears will have to be fully written off and provisioned for, leading to losses and a need for recapitalisation, unless recovery mediated by ARCs dedicated to the task of bad debt resolution offers an alternative. A solution to the problem is urgent given the rapid pace at which write-offs are occurring.

## The Experience with ARCs

However, the almost two-decade long effort to use ARCs as a means of cleaning the books of banks has not yielded the expected results. How effective the ARC route to sustainable NPA reduction would be depends on: (i) the actual volume of NPAs that are absorbed in the process; (ii) the average discount at which NPAs are absorbed; and (iii) the success with disposal. Initially, the asset reconstruction was led by ARCIL, which, during 2005–06, acquired 559 cases of NPAs from 31 banks/FIs with total dues amounting to ₹21,126 crore (RBI 2006). However, the pace at which this figure rose remained low. A year later, by 30 June 2007, the total book value of assets acquired by ARCs stood at just ₹28,543.6 crore. One reason could have been the regulator's decision in 2006 requiring the ARCs to acquire at least 5% of the security receipts issued against assets taken over for management. Earlier, the ARCs only needed to negotiate the discount at which banks are willing to part with their NPAs and manage their disposal for a management fee. A situation where an ARC has no skin in the game and receives its management fee every year till the bank decides to completely write off the loan is in its best interest. If in the interim the loans are disposed off, well and good. If not, the loss is borne by the banks.

Even after the 5% mandatory purchase of security receipts by the ARCs was instituted, much of the security receipts tended to be held by banks. Thus, as of 30 June 2007, of the ₹7,436 crore worth of security receipts issued (against assets with a book value of ₹28,543.6 crore), ARCs held only worth ₹408 crore, other investors ₹134 crore and banks held the overwhelmingly large share worth ₹6,894 crore (RBI 2007).

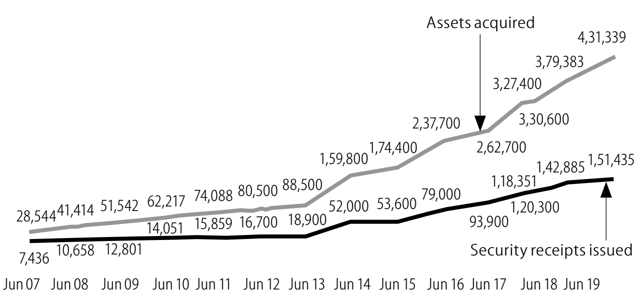
Another factor influencing the distribution of holdings of security receipts were changes in the guidelines on valuation of NPAs. Earlier, in July 2005, the RBI had required the boards of the banks concerned to arrive at a valuation procedure that would ensure attributing a reasonable value to assets based on an estimate of potential repayment and recovery. However, noticing that in many cases NPAs were being sold at discounts that undervalued them, in October 2007, the RBI issued guidelines on how banks, when selling NPAs, should work out the net present value (NPV) of the estimated cash flow associated with the realisable value of the available securities in order to price the NPAs (RBI 2008). This reduced the leeway ARCs had to acquire stressed assets at bargain prices. But with banks focusing on vintage bad assets that had been substantially provisioned for, during the early history of ARC operations in India, they were willing to accept much larger discounts relative to the book value of assets when transferring NPAs.

Moreover, as became clear from the AQR launched in 2015, over the period 2004 to 2012, while advances by the SCBs rose rapidly, leading to an increase in the volume of stressed assets, many of these loans were restructured and recorded as restructured standard assets. This reduced the pressure to technically write off debts and to recover as much as possible of the value of technically written-off assets. The net result is that between 2006–07 and 2012–13, the average annual value of NPAs sold by banks was just short of ₹10,000 crore, with the cumulative book value of assets acquired by ARCs rising from ₹28,544 crore to just ₹88,500 crore between June 2007 and June 2013 (Figure 2).

### NPAs and ARCs

However, as it became difficult to keep down the value of total NPAs, the pressure on banks to dispose NPAs rose. As a result, between June 2013 and March 2020, the volume of NPAs transferred to the ARCs rose from ₹88,500 crore to ₹4,31,339 crore, amounting to an average annual sale in excess of ₹50,000 crore or around five times the average in the six years preceding 2012–13. But the RBI's intervention seems to have prevented this pressure on the banks to offload NPAs from forcing them to offer larger haircuts. In the six years ending 2012–13, the value of security receipts issued averaged 23% of the book value of the NPAs transferred to the ARCs. This went up to 35% over the seven years ending 2019–20. This was also possibly partly explained by the government's decision to increase the investment in security receipts required of the ARCs to 15% of

**Figure 2: Book Value of Assets Acquired Relative to Security Receipts Issued**
(₹ crore)




Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

the total issued, encouraging the latter to raise the value of the ARCs. It could also be that the NPAs were of more recent vintage with lower provisions, raising the sale price relative to book value because of expectations of better recovery through sale of the discounted debt.[11]

But the improved ratio of the value of security receipts relative to the book value of NPAs they represented does not capture the actual benefits accruing to the banks, because of poor performance on the part of the ARCs in disposing of the security receipts. The cumulative value of security receipts fully redeemed fell from an average of 7% of the book value of the NPAs transferred to the ARCs during the six years ending 2012–13 to 3.6% over the seven years ending 2019–20.

A striking feature of intertemporal trends is that after having fallen from 92.7% in 2006–07 to 66.7% in 2012–13, the share of security receipts retained by banks in the total issued rose sharply to 82.5% in 2013–14. This close to 16 percentage point rise in the ratio in a single year was because the book value of assets transferred to ARCs in that year was at ₹71,300 crore equal to 1.2 times the ₹59,956 crore worth of NPAs that had been sold to ARCs between 2007–08 and 2012–13. This spike was explained by the fact that in order to encourage sales of NPAs "at a stage when the assets have good chance of revival and fair amount of realizable value," the RBI in 2014 permitted banks and financial institutions to sell SMA-2 accounts, where principal or interest payments were overdue by 61–90 days, and spread "any shortfall, if the sale value is lower than the NBV, over a period of two years" for assets sold up to 31 March 2015. Banks clearly saw in this an opportunity to write down a large volume of NPAs without taking too large a hit on single year profits.

The sharp rise in transfers to the ARCs raised concerns that banks were not substantially reducing their risks by selling to the ARCs. This possibly explained the decision to raise the investment in security receipts required of ARCs to 15% of total issued. Also the mode of calculation of management fees was tweaked, linking it to net asset value (calculated on the basis of likely rate of recovery) rather than the outstanding value of security receipts to incentivise realisation. Over time, the share of security receipts held by banks gradually declined from 82.5% to touch 66.7% in March 2020. Still high, but back to its June 2014 level. However, though the volume of NPAs transferred and security receipts issued has risen considerably after 2012–13, purchases of these security receipts by qualified institutional buyers and foreign institutional investors had been disappointingly low. After having risen from 1.8% in June 2007 of all security receipts issued, that ratio had risen to 9.5% by June 2013. But it fell sharply thereafter to 3.3% in June 2014 and 2.2% in June 2017. In what appears to have been a push to get banks to attract investors, regulations were changed in April 2017, requiring banks selling NPAs to set aside higher provisions against security receipts in excess of 50% of total issued against those NPAs. A year later, that breakeven point was brought down to just 10%.

The impact of these regulatory changes was dramatic. The ratio of the incremental value of security receipts issued to incremental NPAs acquired by the ARCs had at first fallen from 25% in 2007–08 to 13.1% in 2011–12. It then rose to 27.5% and 46.4%, respectively in 2012–13 and 2013–14. With ARCs required to hold 15% of the ARCs issued as of 2014, the value of both incremental NPAs acquired and security receipts issued fell sharply, resulting in a fall in the ratio to just 11%. But realising the benefits of the management fee they were getting, the scenario changed quickly with the ratio rising to 40% in 2015–16 and touching 60% in 2016–17. With the higher provisioning requirement for security receipts in excess of 50% imposed in April 2017, and that figure then brought down to just 10% in April 2018, banks were under pressure to attract investors in security receipts. ARC activity froze in 2017–18 and then the ratio of incremental security receipts issued to incremental NPAs acquired fell to 47% in 2018–19 and 17% in 2019–20. Banks were clearly offering much higher discounts to avoid having to make higher provisions against the "excess" security receipts they held, as defined by the new regulations. The benefits that consequently accrued to investors in discounted bad debt resulted in a sharp increase in the share of security receipts subscribed by ARCs and FIIs and QIBs, the combined share of which rose from 19.5% in March 2018 to 30% in March 2019 and 33% in March 2020. FIIs and QIBs (excluding ARCs) that had earlier not responded enthusiastically to the government's efforts to attract them into the market for security receipts increased their combined share of security receipts subscribed from 3.5% in March 2018 to 11.6% in March 2019 and 13.9% in March 2020.

### Speculating on the Way Ahead

Overall, the experience suggests that the ARCs did not yield the results expected in terms of disposal of bank NPAs. Either acquisition of NPAs by ARCs was sluggish, or disposal of security receipts was poor, or both. The banks selling NPAs hardly benefited, while the ARCs and subsequently the FIIs and QIBs seem to have done well. The generous management fee obtained by the ARCs in part explains the willingness of the ARCs to accept large volumes of NPAs, and the absence of aversion to the idea of acquiring 15% of the security receipts. The net returns they earn are quite significant even when the ARC process shows only limited success in disposing of NPAs. They rather than the banks were the principal beneficiaries of the process.

Thus, the effort to get the market to contribute to a resolution of the bad debt problem has clearly not worked. And as noted earlier, the volume of NPAs that banks have accumulated are so large that the other principal means of resolving them, which is recapitalisation by government funding, is proving to be an impediment to the government's effort to present itself as fiscally "prudent" by pursuing irrational fiscal deficit targets, the realisation of which is having to be repeatedly postponed. In addition, efforts to put in place a rapid resolution process under the IBC enacted in 2016 has also proved to be inadequate to the task, with the resolution process getting considerably delayed and proving effective only in a small number of cases.

It is in this background that the announcement in Budget 2021 to establish a "bad bank" to acquire NPAs and help the NPA resolution process, has to be assessed. Clearly, the government is not intending to take over the bad debt through means that impose a burden on its shrinking budgetary resources, as the sham recapitalisation effort establishes. On the other hand, having been announced in the budget, the proposed new ARC seems to be an initiative of the government. This raises the question as to what additional element the 2021 bad bank initiative would bring to the process to advance the NPA resolution effort.

As of now, this is not clear, since the details as to what new features would characterise the structure and functioning of the proposed ARC and AMC have not been revealed. It appears the government is itself still in the stage of formulating those details. This has given rise to much speculation, especially on the part of those who see in the proposed new "bad bank" the prospect of a final resolution to the intractable NPA problem. Since the establishment of the ARC was announced in the budget it is expected that the government would have a role. But given budget considerations, this is unlikely to involve funded intervention, excepting perhaps for a small sum by way of seed capital to support the effort of banks roped in to create the new institution. The other contribution the government may decide to make is provision of a guarantee on realisation of security receipts. This is a contingent liability that will not show in the books of the government in the year in which it is incurred. But given the past experience with disposal of security receipts, it is likely that security receipts are likely to remain largely unsold. And if and when the security receipts are discarded as worthless, instead of the loss being that of the banks, that loss would have to be borne by the government. Essentially, while the banks have to incur the loss resulting from the discount that the value of the security receipts issued against a given volume of NPAs reflects, they would at no time have to absorb any loss resulting from unsold security receipts. The security receipts being guaranteed, they are safe investments on the books of banks. And the smaller the discount that security receipts issued against any NPA reflect, the smaller the burden that the banks would have to bear. If and when the government decides that the unsold security receipt should be treated as a worthless asset, it would have to compensate for the losses of holders of the security receipts.

There remains the issue of from where the ARC/AMC would raise the capital required to acquire the loss-making assets from the banks. This might require another sleight of hand. Banks subscribe to the capital of the ARC/AMC, which is an investment and will remain so. The ARC uses the capital to acquire the NPAs at a smaller than "market-determined" discount that does not imply too much of a haircut that has to be covered by the bank with its capital. The NPAs acquired from the banks are paid for with security receipts, a large share of which are held by the banks, but which, being guaranteed by the government, show as safe investments in the books of banks. In sum, provisioning burdens for the bank are hugely reduced even as their books are cleared of NPAs. And, if and when any unsold security receipts are recognised as worthless assets, the loss would devolve on the government's budget. The holders of the security receipts, including the banks, are compensated by the government, which now records the loss in its budget. But only when it decides to recognise that a set of security receipts cannot ever be sold and their value realised.

Needless to say, all this is speculative. But some version of this method, which is an extension to the ARC route of the kind of sleight of hand that recapitalisation with bonds involves, seems to be the only way in which this new avatar of the asset reconstruction company can at least in a formal (but not real) sense help advance the long-drawn-out effort to clean the books of public banks the legacy of bad debt.

NOTES

1 See https://rbidocs.rbi.org.in/rdocs/content/DOCs/LSCRCRBI07092016.xlsx.

2 Initially, ARCs were not required to acquire security receipts themselves. In 2006, they were required to invest in 5% of the receipts. That figure was raised to 15% in 2014; see Bhagwati et al (2017) for details.

3 Figures from Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, various issues, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications.

4 *Financial Stability Report 2020*, "Chapter II: Financial Institutions: Soundness and Resilience," Mumbai: Reserve Bank of India, p 25.

5 During the financial year 2020–21, as on 31 January 2021, PSBs had raised ₹50,982 crore through issue of equity and bonds, and the government had infused ₹5,500 crore out of the budget provision of ₹20,000 crore. The budget provision for 2021–22 for recapitalisation has been kept at ₹20,000 crore. Government of India, Ministry of Finance, reply to unstarred Rajya Sabha Question No 852 provided on 9 February 2021.

6 See "Govt Set to Infuse ₹14,500 Capital in 4 State-run Banks," *Indian Express*, Thursday, 1 April 2021, p 15.

7 Rajendra Gill, "The Strange Case of Zero-Coupon Par Recapitalisation Bonds," *Moneylife*, at https://www.moneylife.in/article/the-strange-case-of-zero-coupon-par-re-capitalisation-bonds/63401.html.

8 According to the *Economic Survey 2020–21*, in 2019–20 the amount recovered by scheduled commercial banks under the IBC was at ₹1.73 lakh crore more than what was recovered through all other channels put together.

9 Government of India, Ministry of Finance, *Economic Survey 2020–21*, Vol 1, pp 155–56.

10 It could be argued that the fact that resolution value relative to liquidation value was 193% is a positive sign. But the figures raise doubts about the mode of arriving at the liquidation value, which is a kind of reserve price.

11 All figures in this and following sections obtained or computed from data in Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

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