Do ARCs help resolve NPAs or just bail out banks?

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With gross NPA levels of Rs2.17 lakh crore in March 2014 and a restructured portfolio of Rs3.30 lakh crore, of which a lot will become NPAs, banks will continue to sell NPAs to the ARCs.

Internationally, the bankruptcy codes and effective legal mechanisms ensure speedy disposal of NPAs in the normal course. Hence, asset reconstruction companies (ARCs) are mainly set up as special purpose vehicles to resolve stressed assets during systemic crises.
The Indian ARC experiment is unique. ARCs are set up as perpetual entities to fix festering NPAs, which result from reckless lending and the inability of the judicial system to adjudicate the matter speedily. But ARCs are no longer serving their purpose.

According to the RBI, ARCs constitute a supportive system for stressed asset resolution, rather than the last resort to dispose of NPAs by banks. It may be recalled that an NPA suffers from a time mismatch between cash flow with debt servicing and/or inadequacy of cash flow for debt servicing.

If the most likely estimate of cash flow of a distressed account shows moderate shortfall in debt-servicing capability, such NPAs can be restructured with a modest sacrifice by the lenders and sponsors. High cash flow inadequacy and consequent unviability leads to a liquidation of the NPA. Definition of the time mismatch has evolved over years, and currently, Reserve Bank of India (RBI) prescribes the limit at 90 days, beyond which, a default renders the account an NPA.

Banks are expected to sell the assets to ARCs at a stage when the assets have a good chance of revival and a fair amount of realisable value for rehabilitation and reconstruction. The reconstruction is generally not feasible within the 8-year limit imposed by RBI. Hence ARCs largely focus on liquidating the assets.

Set up by independent sponsors including some banks, ARCs have limited capital. Hence, ARCs' major funding for NPA acquisition has been by issuing

Security Receipts (SRs) to the seller banks for up to 95% of NPA acquisition cost with a minimum of 5% of the SRs being funded in cash by the ARCs under the popular 5:95 structure.

These SRs are serviced in terms of agreed cash flow waterfall, upon liquidation of the underlying assets by the ARC. Distribution from the cash flow first goes to meet expenses (including taxes), next for payment of management fee to the ARC, and thereafter for servicing of the SRs - redemption and payment of yield on SRs.

Servicing of senior SRs if any, has priority over servicing of junior/pari-passu SRs. The remaining surplus, i.e. upside, is shared between the ARC and the seller bank according to an agreed ratio. There is no penalty for shortfall in servicing SRs.

Acquisitions of NPAs by ARCs during 2003-07 also had senior SRs subscribed by ARCs. Senior SRs ensured that the ARCs could earn significant returns even if the recovery from NPAs was a small fraction of the acquisition cost of the NPA, with the losses being absorbed by banks. Hence, from FY-2008, banks shunned SR based deals in favour of 100% cash deals, resulting in limited acquisition by ARCs characterised by resource constraints. As a result, the fourteen ARCs in the country clocked modest returns in FY-2012 and FY-2013 (see the table below).

	Return on Capital Employed			Return on Net worth		
Financial year	Highest	Lowest	Weighted average	Highest	Lowest	Weighted average
2012	17.40%	0.09%	8.86%	13.00%	0.21%	5.96%
2013*	14.70%	0.24%	10.10%	14.10%	0.03%	7.80%

** One outlier not considered for weighted average returns*

There has been a substantial increase in public sector unit (PSU) banks' gross NPAs, reaching Rs2.17 lakh crore in FY-2014, from Rs74,600 crore in FY-2011. Under duress to minimise provisioning amidst low profits and high NPAs, these banks returned with a 5:95 structure in the later part of FY-2014. However, this time all the SRs were pari passu (where creditors are paid as a ratio of their claim in total debt and without preference).

Zero sum game

Banks' sale of NPAs to ARCs has so far been mostly with a view to postpone the provisioning. The 5:95 structure meets this purpose as it enables ARCs to bid aggressively for the assets due to ARCs' 5% investment risk that is fully mitigated by the management fee of 1.5% to 2% per annum, of the acquisition cost.

For example, an NPA portfolio acquired for Rs100 crore that gets resolved at the end of 5th year and incurs a resolution cost of 4%, equally spread over the 5-year resolution period, and the management fee of 1.5% per annum on outstanding SRs, results in pre-tax Internal Rate of Return (IRR) of 19.3% to the ARC with an estimated 100% recovery despite a 15.4% write off, of the SRs.

For a 100% cash deal, for the same return of 19.3%, the acquisition cost to the ARC works out to Rs40 crore (40% of the acquisition cost in 5:95 structure). Such a low all-cash bid often entails immediate provisioning in the bank's books for the deficit between net outstanding debt and the asset sale price.

To obviate such provisioning, the banks prefer a 5:95 structure. To induce more aggressive bidding, banks sometimes allow a 2% management fee. An ARC's earnings comprise of the management fee, redemption of SRs, the yield (coupon) if applicable, and the potential upside. Since the management fee has a priority over other cash flows, the ARC's portfolio-life-time return is significantly affected by phasing of the recovery.

With high gross NPA levels of Rs2.17 lakh crore in March 2014 and a CDR portfolio of Rs3.30 lakh crore, of which a significant part is likely to slip into NPAs, banks will continue to sell large numbers of NPAs to the ARCs under the 5:95 structure over the next several years to minimise provisioning.

Banks' other major consideration for sale to ARCs is extremely tardy legal administration and enforcement. The government has recognised the need to remedy this, and the legal enforcement will have to be revamped urgently lest the country's banking faces crisis.

The current management fee driven model of ARCs also needs to evolve into an equitable risk-reward sharing model. Such models can be put in place only if the banks shed their tendency to avoid provisioning.

A new organisation, called the NAMC has recently been proposed. It is supposed to work on taking over big ticket NPAs from banks and revive them. The second part of this two-part look at NPAs and asset re-construction will take a closer look at how these ideas will pan out in the future.

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