Here's why NAMC may fail to deal with large NPAs

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Will the experiment of handling large NPAs through a new entity, National Asset Management Company -NAMC, succeed? The slow legal process and low accountability at all levels are big hurdles

The proposed National Asset Management Company (NAMC) is expected to take over large non-performing assets (NPAs) from lenders and revive them. If these assets are to be transferred to NAMC, it follows that these have failed the benevolent corporate debt restructuring (CDR) test, and are unviable. How will the NAMC restore viability of these projects, except by way of significant write-offs? Who will fund such write-offs? What will happen to the factors that have led to such large NPAs? These issues will have to be boldly resolved if an NAMC has to succeed.

There are assignable causes of large infrastructure (and other) NPAs of public sector banks (PSB) or state-run banks. The NPAs have resulted from the banks' inadequate project evaluation, disbursements before mitigation of project development risks, and lax monitoring.

For example, in case of coal-based power projects, the banks disbursed loans before the letter of assurances from the coalfields for coal supply could be translated into bankable take-or-pay contracts; in the case of an ultra-mega power project, the banks had left the country risk for coal supply/ cost unmitigated, which eventually affected the project company adversely.

In the case of many toll road projects, the lenders did not mitigate the land acquisition and traffic risks aside from the sponsor risks. Issues in project cost evaluation of toll road projects by the banks were evident from a study by the Ministry of Road Transport and highways in 2011, that showed that on an average, banks had lent 39% more than the project cost arrived at by National Highway Authority of India (NHAI).

Banks add soft costs such as preliminary and pre-operative expenses and interest during construction, to the project cost. Besides, the accurate construction cost emerges after design finalisation.

Yet, the debt being 39% more than the project cost estimate of the NHAI, reflects asset overstatement which benefited the sponsor firms that were awarded project construction contracts on nomination basis.

Engaging lenders' engineers (LEs) for cost evaluation has obviously not helped the banks, as these LEs have business relations with the sponsors.

Although there is no study to evaluate quality of the assets for which the debts were raised by the institutional arrangers, it is likely that the institutional arrangers have also contributed to the current NPA scenario. No wonder foreign banks are completely absent in Indian project finance.

For the NAMC to succeed, it will have to ensure that the responsibility for causing financial distress is allocated to major participants, i.e. the sponsors, lenders, and the government, and the sacrifice is shared equitably by these participants.

The NAMC will need to infuse value in the projects by completely mitigating the project development, construction and operating risks, and harvest the value later. Experiences from all over the world show that an efficient legal system is sine-qua-non for the success of ARCs.

Hence, for the NAMC to be successful, there is no option but to speed up the legal process through amendments in Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) and The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) acts, and adding large number of Debts Recovery Tribunals (DRTs) supported by e-governance, so that matters are adjudicated within a stipulated time frame. Continuance of a half-hearted approach will render the NAMC useless, and eventually lead to a systemic crisis.

Over the last three decades, India has seen several pro-creditor legislations for resolving bad loans or NPAs, starting from Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) that was meant to expedite the revival of potentially viable sick units and closure of unviable ones through the quasi-judicial body Board of Industrial & Financial Reconstruction (BIFR). The BIFR has not met the intended objective.

The RDDBFI Act, 1993 was enacted to provide for expeditious adjudication and recovery of dues of banks and financial institutions from defaulting companies, through the DRT set up under the Act.

Owing to the legislative loopholes, judicial pronouncements, and poor administration, DRTs have not achieved the intended objective, and the 33 DRTs across the country have backlog of over 42,000 cases with defaults exceeding Rs1.40 lakh crore as on 31 March 2013.

Failure of DRTs to adjudicate the matters within the stipulated 180 days had been evident since the beginning. To remedy the situation, the government promulgated SARFAESI Act, 2002 under which lenders can seize secured assets except agricultural land, from defaulters directly.

Section 17 of the SARFAESI Act allows borrowers or any aggrieved party to appeal against acquisition of assets by the lenders. Such appeal, in terms of the Act has to be disposed of within a maximum period of four months.

This adjudication (of appeals) is also handled by the same over-burdened DRTs with the result that such appeals take years to resolve. In addition, collusive suits by defaulters with their cohorts in other courts induce years of delays. As a result, NPAs accumulate and the underlying assets are stripped, to the detriment of lenders.

Then the ARC experiment started which, as explained in yesterday's article, hasn't worked. We need a thorough redesign of the way we handle bad loans, starting with the origin to resolution, with accountability fixed at each stage.

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