NPAs and their assignment to Assets Reconstruction Companies (ARCs)

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Introduction

NPA is a classification used by financial institutions that refer to loans that are in jeopardy of default. The moment the borrower fails to pay interest or principal for a period 90 days the loan is classified as a non-performing asset. Non-performing assets are proving to be a nuisance for financial institutions as interest on loans happens to be their main source of income.

With a view to moving towards international best practices and to ensure greater transparency, it had been decided to adopt the '90 days' overdue' norm for identification of NPAs, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) is a loan or an advance where;

- Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- The account remains 'out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC),
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes,
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.
- Non submission of Stock Statements for 3 Continuous Quarters in case of Cash Credit Facility.
- No active transactions in the account (Cash Credit/Over Draft/EPC/PCFC) for more than 90 days.

Classification of NPAs

Non-Performing Assets can be classified in three categories based on the period for which the asset has remained non-performing:

1. Sub-standard assets: a sub-standard asset is one which has been classified as NPA for a period not exceeding 12 months.
2. Doubtful Assets: a doubtful asset is one which has remained NPA for a period exceeding 12 months.
3. Loss assets: where loss has been identified by the bank, internal or external auditor or central bank inspectors. But the amount has not been written off yet, wholly or partly.

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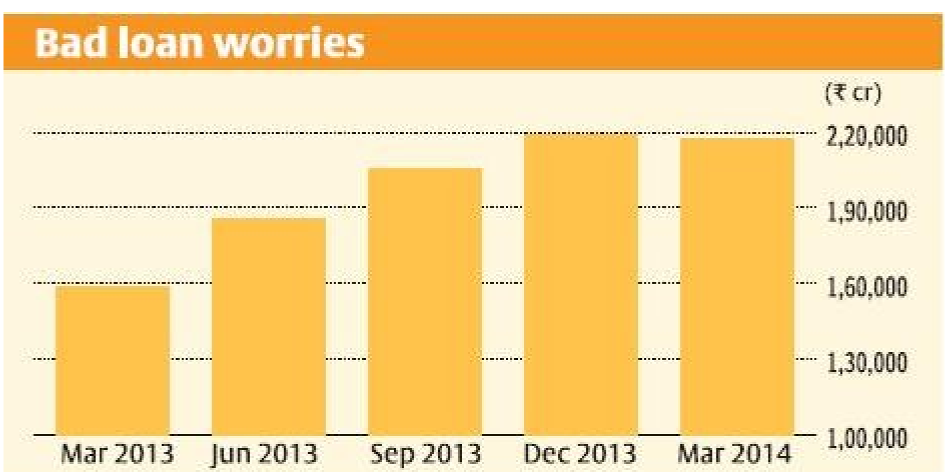
The problem of NPAs

The problem of non-performing loan/assets is a global one and has been receiving attention of banks, economist, regulators and public, alike.Inspite of the fact that Indian banks are said to be conservative, increase in NPAs at such a startling rate is unimaginable. In India NPAs are increasing at an alarming rate as between 2009 and 2014, gross NPAs of Indian banks have soared from Rs. 69,000 crores to a whopping estimate of Rs. 2.8 lakh crores. The major problem in this regard is being faced by Public Sector Banks, though private sector banks are no exception to it.

It looks as if due diligence has not been exercised while sanctioning/ advancing loans though the possibility of some extraneous reasons also cannot be ruled out, particularly in case of bigger loans, as it has been observed recently when in some of the public sector banks some top functionaries have been found involved and either been suspended or even terminated. If we have to give a loan of say Rs.10000 from our own pocket, we think hundred times regarding the credentials of the person or we can lend to forget about the same. Being public money at stake banks cannot think of the latter alternative and have to be more sincere and serious while considering any application for financial assistance.

Asset quality for public sector banks will remain a cause of concern with gross non-performing assets (NPAs) expected to remain at elevated level of about 4.4to 4.7 per cent in the current fiscal as against 4.4 per cent as on March 31, 2014 and 4.6 per cent as on June 30, 2014, said the ICRA report, despite the revival in the economy as during Q1, 2014-15, GDP grew by 5.7 per cent in year-on- year, as against 4.6 per cent in the previous two quarters, mainly, because of considerable pickup in industrial growth. However, bad debts (non-performing assets or NPAs) of public sector banks (PSBs) rose sharply to 5.32 per cent as on September 30, 2014, against 4.82 per cent on September 30, 2013.

"Overall, the Gross NPAs of the banking sector (PSBs and private banks) could be at 4 to 4.2 per cent as in March 2015, as against 3.9 per cent as in March 2014 and 4 per cent as in June 2014," as per the report.



*Gross non-performing assets of listed PSU banks

Tackling NPAs and the increasing reliance on Asset Reconstruction Companies

There is no dearth of laws to tackle non-performing assets (NPAs) of banks — such as the Sarfaesi Act, 2002 (The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act), the Debt Recovery Tribunal (DRT) Act 1993, the Companies Act and Bankruptcy Laws for assets recovery and winding up processes. Each time the issue of NPAs takes centre stage, banks and regulators, particularly RBI, are seen firming up policies to "effectively" deal with NPAs and tackle wilful defaulters. In the process, several circulars have been issued since 1991-92. In his budget speech the Finance Minister has also shown his deep concern and told the banks categorically to pull up their socks in dealing sternly with bad loans and particularly wiful defaulters.

Despite several such measures by the regulator and banks, there is no respite in the surge in NPA and restructured accounts, particularly in the Micro Small and Medium Enterprises (MSME) and corporate sector, raising fears of a lurking loan contagion. Instead of calling the borrower for an early resolution and looking into the possibility of restructuring in an appropriate manner, banks try to assign the debt to asset reconstruction companies (ARCs). ARCs are specialized agencies which help the banks in resolution of their bad loans,they work for multiple banks,and are regulated by RBI.

It looks to be strange that the lender himself putting himself in back seat fetches the ARC in forefront, inspite of the fact that banks know better about the financial status and practical difficulties of the borrower and, thereby, should be in a better position to recover the amount.
When debt is assigned along with the underlying security, the ARCs call upon the borrowers to settle the accounts. After that, ARCs are supposed to pay about 5 per cent of the value of debt and the remaining has to bedischarged in form of security receipts only. In the process, the bank gets the benefit of assignment of debt in the form of reduction in its NPAs. Despite no real recovery for the bank, this transaction reduces the gross and net NPAs of the respective bank and helps in so-called NPA management process.

Now-a-days, this is a preferred route for banks because it skips accountability of the bank officials in settling the account. As already indicated, the bank should be in a better position to take a decision on settlement of a loan with the borrower, having dealt with the borrower company for a considerably long period of time. Asset Reconstruction Company of India (ARCIL), the first entity set up to buy distressed assets/bad loans from banks, reports that, of late many public sector banks have come forth to sell/loans assets of defaulters.

Indian Bank assigned assets worth about Rs. 670 crore to ARCs in 2013-14. UCO Bank assigned 133 NPA accounts worth Rs.1,869 crore. Bank of India has sold Rs.1,071 crore, while Canara Bank sold close to Rs.700 crore of bad loans during the year. India's largest bank, SBI, has been selling assets aggressively, reports suggest, concluding nearly Rs. 5,000 crore of asset sales. "In this fiscal year (2013-14), we acquired Rs.4,400 crore worth of bad loans from banks. Last year, this figure was just Rs.780 crore," says P Rudran, Managing Director and CEO, ARCIL. And this may just be the tip of the iceberg. There are 14 other asset reconstruction companies in India, of which JM Financial, International Asset Reconstruction Company, Edelweiss, and Alchemist are quite active.

In 2013-14, for the first time, assets worth close toRs.50,000 crores were offered by banks to these ARCs. In 2012-13, this figure was just Rs. 12,000 crores.But why are banks in a sudden rush to sell assets? One reason is the new reporting requirement that RBI has put in place from April.

A few months ago, the RBI had asked banks to identify and take early action on loans likely to turn bad, even if the borrower delayed servicing the loan by a month or two (the cut-off for recognition of a bad loan is 90 days). This has put pressure on banks with sizeable bad loans to take quick action to clean up their books. In 2013-14, the gross non-performing assets of all PSU banks went up by 37 per cent. Banks are also taking advantage of the accounting leeway given by the RBI on such distressed-asset sales. The RBI had in January 2014 said that if banks sold assets to ARCs below their net book value, losses incurred could be spread over two years while reporting numbers. This helps banks show a higher profit. The offer is valid until March 2015.

“Usually banks come forward in the second half of the year to sell assets. This year we are seeing a lot of action in the first quarter itself,” says Rudran. Asset sales are also picking up because banks are now able to obtain better prices for these sales.

Better pricing of NPAs

“Earlier the price was less than 30 per cent of the value of loans, now it has improved to about 55-60 per cent,” says Rudran. ARCs are able to offer a better price because banks are now willing to accept delayed payment, in the form of ‘security receipts’ or SRs. So, the ARC makes a down payment and when the amount is finally recovered, the balance is paid to the bank against the SRs. While two-thirds of the assets were sold for cash in 2012-13, most of the transactions used SRs in 2013-14, says Rudran. However, some banks prefer hard cash.

If banks sell assets to ARCs, they, of course, prefer to receive up-front cash payment, rather than go for the SR route, which would require them to do a mark-to-market on the investment every year. If the value comes down, banks need to provide depreciation on such investments. Experts warn that banks’ recent willingness to sell distressed assets isn’t the end of the bad-loan saga.

The Rs.50,000 crores worth of asset sales have to be viewed against total bad loans of about Rs.2 lakh crores for listed public sector banks. And to induce banks to sell assets, ARCs need to demonstrate that they are indeed able to recover the amounts from the borrower. Only then will banks finally be able to recover at least part of their earlier loans.

In the changed scenario of new prudential norms and emphasis on quality lending and profitability, functionaries in banking system, should make it amply clear to potential borrowers that banks resources are scarce and these are meant to finance viable ventures so that these are repaid on time and relevant to other needy borrowers for improving the economic lot of maximum number of households. Hence, selection of right borrowers, viable economic activity, adequate finance and timely disbursement, correct end use of funds and timely recovery of loans is absolutely necessary to minimize the incidence of NPAs.

The Way Ahead

It is high time for the banks, particularly PSUs, to look in to the concern of NPAs/bad loans more cautiously, seriously and sincerely. They should understand that salvation does not lie in assigning the bad loans to the ARCs, rather they should be careful and cautious while sanctioning/ advancing loans. Stakeholders' money should better be considered as something kept with them in trust and confidence and should only be used/ advanced after due diligence. At the same time the functionaries in banks should not embrace an attitude of negativity so far as making advances to genuine and upright borrowers is concerned.

FM Flags NPAs

FM asks banks to bring down NPAs | Urges banks to lend more

Gross NPAs Rise (In %)

	SEP-13	MAR-14	SEP-14
Nationalised banks	4.34	4.40	5.15
Public sector banks	4.82	4.72	5.32
Private sector banks	2.06	1.88	2.04
Foreign Banks	3.64	3.86	3.9
All banks	4.22	4.11	4.56

On November 20, 2014, the Finance Minister has asked state-run banks to take proactive steps to support credit growth and discussed ways to bring down their bad loans or non-performing assets (NPAs). The minister was addressing the heads of state-run banks. The finance ministry in a statement said a clear message was conveyed that banks should carry out lending on the basis of objective due diligence without being unduly conservative, in a completely transparent manner without fear or favour. The banks have been advised to work objectively and professionally.