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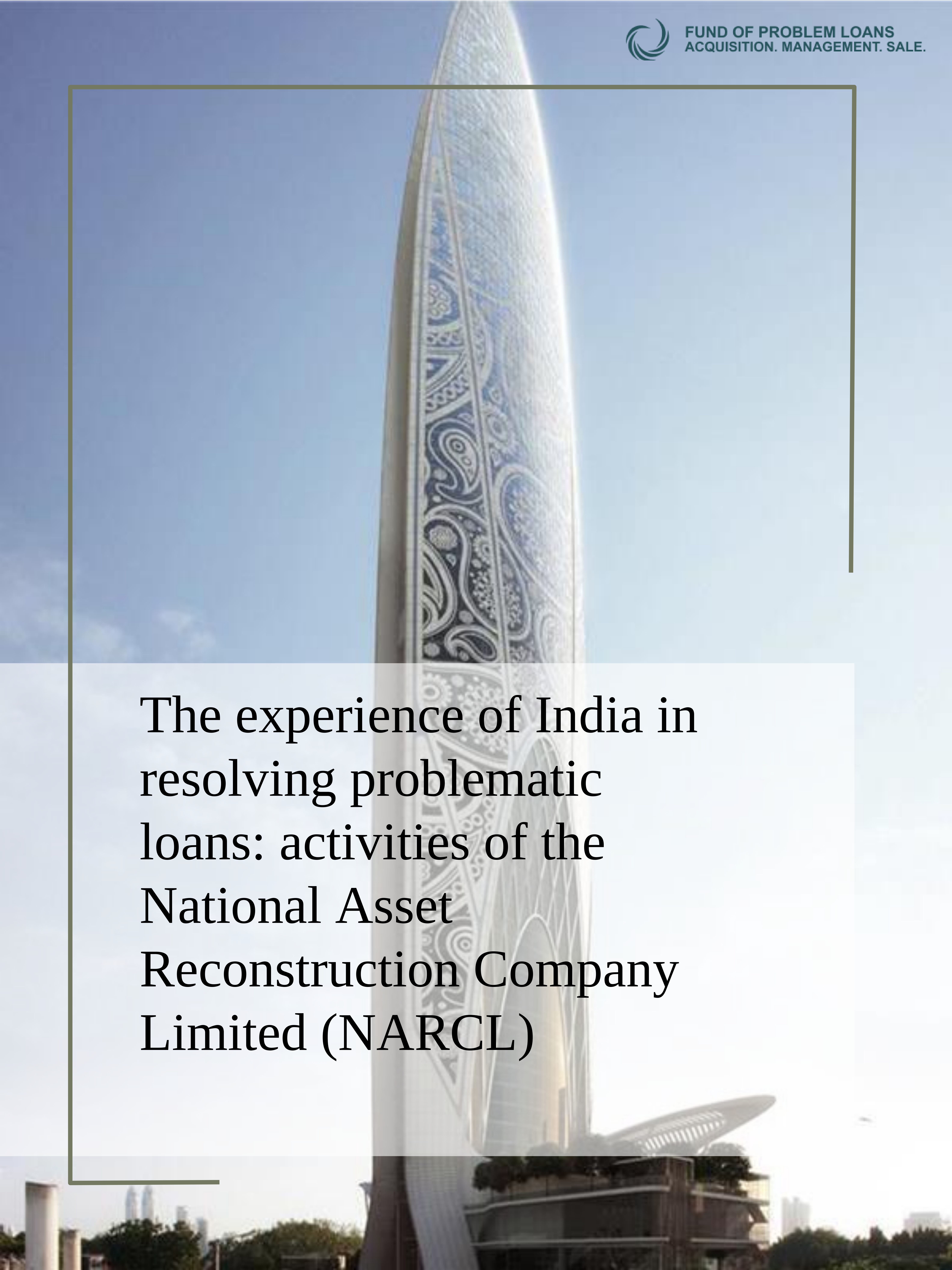


# The experience of India in resolving problematic loans: activities of the National Asset Reconstruction Company Limited (NARCL)

# I. Non-Performing Assets (NPA) – The Main Problem of the Banking Sector in India

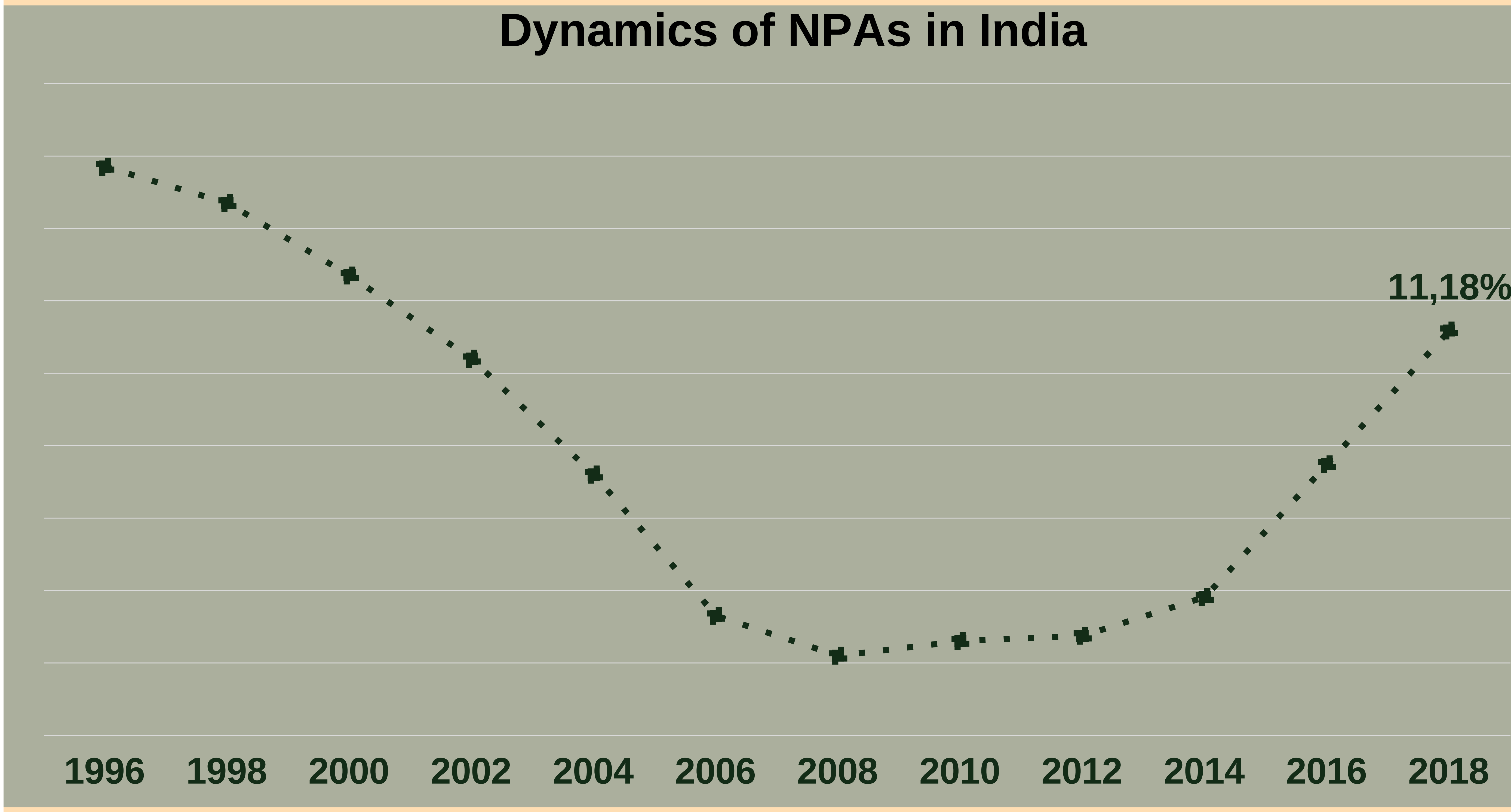
The banking sector in India has experienced significant fluctuations in the level of **Non-Performing Assets** (NPA) over the past decades, which has had a considerable impact on the economy, affecting credit availability, investor confidence, and overall financial stability.

The terms "Non-Performing Assets" (NPA) and "Non-Performing Loans" (NPL) are interchangeable and refer to loans that do not meet the scheduled principal and interest repayments. In other words, these are assets that do not generate income. Non-performing loans create an issue for asset quality. According to RBI regulations, a Non-Performing Asset (NPA) is a loan or advance where interest and/or principal repayment remains overdue for more than 90 days in the case of a term loan.

In the 1990s, the NPA level reached 15-20% due to weak risk management and inadequate regulatory standards, especially in public sector banks. In response, the government and the Reserve Bank of India (RBI) strengthened regulatory requirements, improved credit management and corporate governance, and established Asset Reconstruction Companies (ARCs), which led to the stabilization and reduction of the NPA level.

## I. Non-Performing Assets (NPA) – The Main Problem of the Banking Sector in India

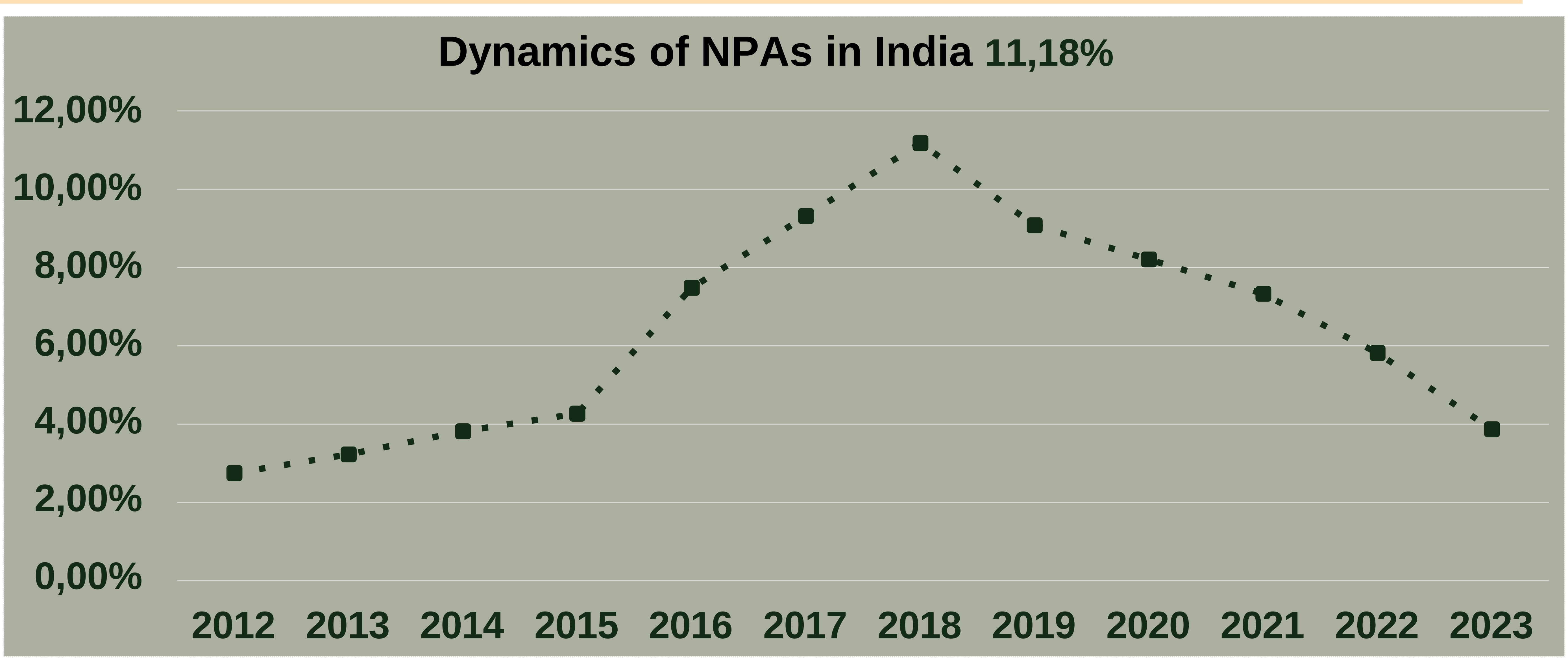
In the early 2010s, the NPA level was relatively low, but it then began to rise rapidly, reaching **11.18% in 2018.**




**Factors that contributed to the growth of NPAs:** From the early 2000s to 2008, the Indian economy was on an upward trajectory, and banks actively extended credit to corporate clients. However, the profitability of many corporations declined due to the slowdown in the global economy, sharp drops in commodity prices, bans on mining activities, and delays in issuing environmental clearances. This negatively impacted the infrastructure sector, particularly the power and steel industries, leading to price instability in raw materials and supply shortages.

# I.Non-Performing Assets (NPA) – The Main Problem of the Banking Sector in India

- After the global financial crisis of 2008, when the growth of lending slowed down, the asset quality of public sector banks began to deteriorate. Banks hid serious problems by creating a false sense of security and underestimating the NPA assessment.
- The growth of NPAs in the early 2010s was also driven by the easing of lending norms for large corporations without proper analysis of their financial performance.
- The asset quality review conducted by the RBI (2015-2016) led to a sharp increase in NPAs, reaching 10% in 2017-2018. This resulted in a slowdown in credit growth and a decline in profitability and capital.
- The banking sector in India has faced issues with non-performing loans since 2016, following the RBI's ban on any advance restructuring. This ratio peaked in 2018, reaching 11.18%.



## II. Measures for Resolving NPAs

From 2018 to 2020, significant improvements in NPAs were observed in Indian banks. In the RBI's Financial Stability Report for December 2018, it was stated that after a prolonged period of stress, the Indian banking sector was on the path to recovery. "Despite the significant costs associated with the expanded recognition of asset impairments in banks, this led to greater discipline in assessing creditworthiness, increased sensitivity to market risk, and better evaluation of operational risks."

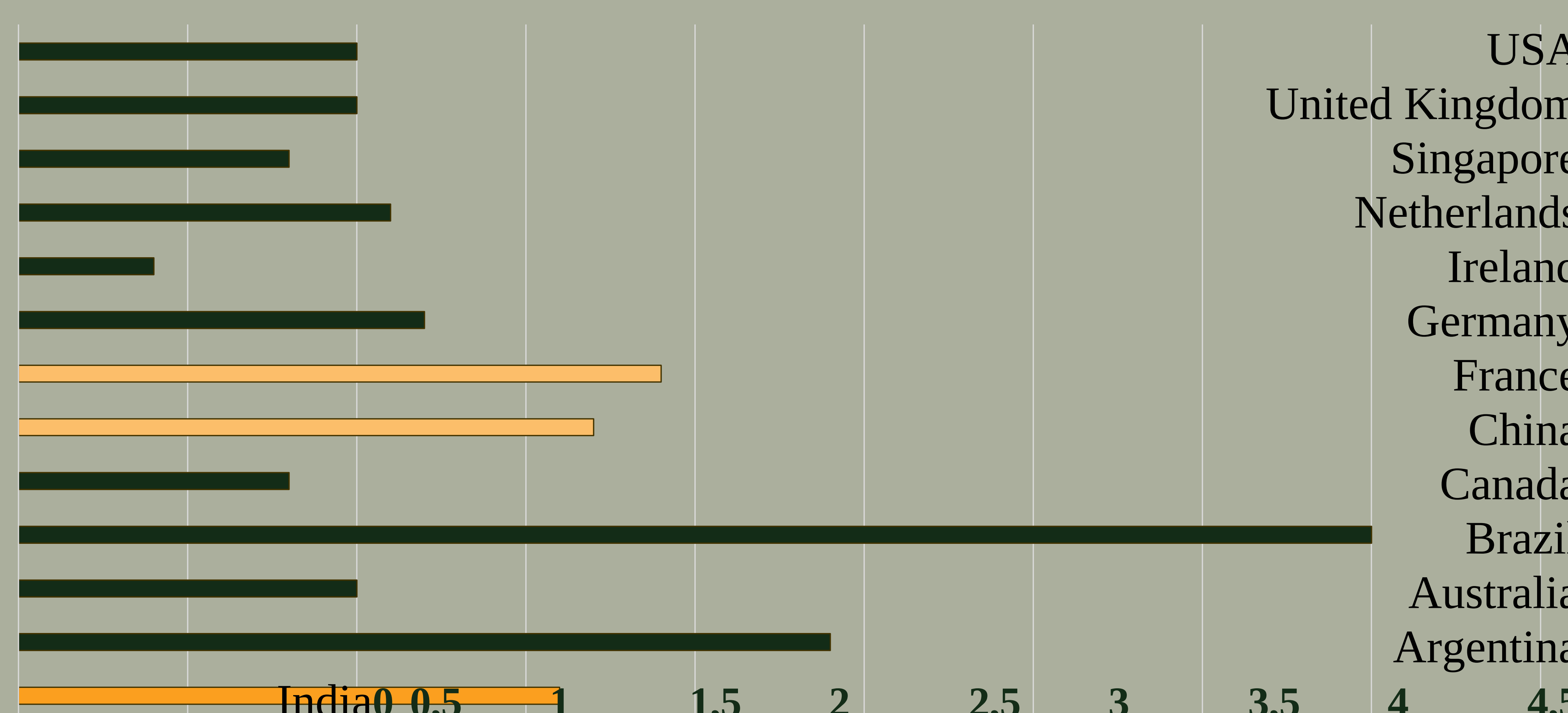
The reduction in NPA levels was the result of three key policy initiatives:

Firstly, improvement in credit discipline through the removal of various regulatory relaxations after the introduction of the RBI's Asset Quality Review (AQR) in 2015, as well as a revision of the prudential standards for resolving problematic assets. The new rules included the following principles: early identification and reporting of defaults by large borrowers by banks and financial institutions; full freedom for creditors to develop and implement resolution plans; fines in the form of additional reserves for delays in implementing the plan or initiating insolvency proceedings; removal of asset classification benefits during restructuring; and mandatory signing of inter-creditor agreements by all creditors to make decisions by majority vote.

## II. Measures for Resolving NPAs

Secondly, the effective bankruptcy process: In December 2016, the Insolvency and Bankruptcy Code (IBC) came into force. This is perhaps one of the most significant structural reforms in India's corporate sector. Notably, in 2013, compared to 0.8 years in Singapore and 1.7 years in China, the resolution of bankruptcy in India took 4.3 years. By 2019, this figure improved to an impressive 1.6 years, which was better than in China or France.

**Average insolvency resolution period**.




Thirdly, in the banking and financial services sector, 32 mergers and acquisitions were made in 2019, totaling $1.72 billion. As a result, the number of public sector banks in India decreased from 27 to 12. The key factors for the mergers were similarities in core banking decisions and regional coverage. This led to improved reserves and a reduction in net NPA ratios.

## III. CREATION OF ARC, NARCL, IDRCL

**ARC** is a specialized asset management company that buys debts from original creditors, securitizes them, and helps recover the debts. The term ARC is widely used in India, although its analogs in the world are Asset Reconstruction Companies (ARCs), which specialize in bank rehabilitation and managing Non-Performing Assets (NPAs).

Although ARCs were established in 2002, their evolution has been nonlinear. Three phases of this evolution can be identified:

**Phase 1**: Between 2002 and 2003, the concept of ARC emerged within the framework of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act (SARFAESI Act). 14 ARCs were created, but only some of them started operations. They operated under a 5:95 model, where the ARC contributed 5% of the funds to purchase the debt, and the remaining 95% came from partner banks. The risk remained on the balance sheets of the banks.

**Phase 2**: From 2014 to 2017, the 5:95 formula was changed to 15:85, which facilitated the successful reconstruction of distressed loans. During this period, another 10 ARCs were created.

**Phase 3**: The RBI increased the reserve requirements for banks working with ARCs to improve their market position. This allowed ARCs to have more opportunities in their operations. The RBI also raised the minimum net worth requirements for ARCs.

## III. CREATION ARC, NARCL, IDRCL

Many of the existing ARCs lack sufficient capital to help banks remove stressed assets from their balance sheets.

In 2021, a decision was made to establish the National Assets Reconstruction Company Limited (NARCL) to address the recovery of government sector assets.

NARCL, registered with the RBI as an asset reconstruction company under the SARFAESI Act of 2002, is funded by the equity capital of banks and non-bank financial companies. NARCL was created to address the problem of stressed assets with a risk of 500 crore rupees and above in the Indian banking system. Its investment strategy focuses on gathering stressed assets under one roof for efficient resolution.

Along with NARCL, the government established the Indian Debt Resolution Company Ltd (IDRCL). IDRCL is the operational entity that manages assets and attracts market professionals and resolution experts. IDRCL is owned by 14 major private and public banks in India, with state-owned financial banks holding a maximum of 49% of the shares, and the remaining portion owned by private sector creditors.

## IV. ASSESSMENT OF NARCL'S PERFORMANCE

According to experts, after two years of operation, the performance of the "bad bank" (NARCL) in the Indian banking sector has not met the initial expectations.

NARCL faced organizational, structural, and bureaucratic problems that delayed the acquisition of bad loans. The use of a dual structure, where NARCL acquires assets by making an offer to the leading bank, and IDRCL is involved in managing and creating value, led to complications in the process. This was contrary to the initial expectations that private sector participation would accelerate decision-making on resolution.

One of the problems faced by NARCL is the difference between the purchase price and the sale price, which is a common issue in the industry. ARCs, such as NARCL, typically discount the cost of capital by about 25% due to its high cost, while banks transferring their troubled assets to the ARC discount cash flows by a maximum of 12-13%. This significant difference in price expectations discourages banks from selling their troubled assets, even if NARCL offers relatively higher prices compared to competitors.

Another problem contributing to the low efficiency of the "bad bank" is the payment scheme—15% is paid upfront in cash, and the remaining 85% is paid through the issuance of Security Receipts (SR), backed by a government guarantee.

# IV. ASSESSMENT OF NARCL'S PERFORMANCE

Some market experts have suggested merging NARCL and IDRCL. This merger could optimize business opportunities, streamline operations, and potentially reduce costs. IDRCL assists NARCL in developing resolution strategies for acquired assets, including liquidation, asset sales, and attracting strategic investors in accordance with the Insolvency and Bankruptcy Code of 2016.

However, considering the reduction in the overall volume of gross NPAs, the tightening of insurance standards and risk management, and the long recovery time for SR value, banks do not find this option attractive. In March 2024, NARCL completed transactions related to banking debt worth 24,000 crore, acquiring assets such as Metenere and Simplex Infrastructure.

NARCL's total debt has doubled to 48,652 crore, but it still has not reached the target of 82,845 crore set in 2022.

Nevertheless, the long-term prospect of creating a dynamic secondary market for selling troubled loans in India is certainly possible, given the vast potential and volume of NPAs. The RBI's policy is clearly focused on resolving these troubled assets.

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# V. CURRENT SITUATION

In recent years, Indian banks have significantly improved their performance. Growth in lending, asset quality improvement, and digitization have led to increased profits and enhanced capital. The shift to digital payments has changed the lending process.

High demand for loans and the recovery of the investment cycle have contributed to the improvement of assets, a return to profitability, and the creation of capital and liquidity reserves.

According to the latest RBI report, the capital adequacy ratio of commercial banks stands at 16.8% as of September 2023. Asset quality continues to improve: net non-performing assets (NNPA) have decreased to 0.8%, and gross non-performing assets (GNPA) have decreased to 3.2%.

Standard & Poor's attributes this to a "healthy corporate balance sheet, stringent underwriting standards, and improved risk management practices," rather than the effectiveness of the "bad bank." Macro stress tests conducted by the RBI have demonstrated the resilience of banks to various economic conditions. It is forecasted that the CRAR at the system level will remain above the regulatory minimum in September 2024, reaching 14.8%, 13.5%, and 12.2% under the baseline, medium, and severe stress scenarios, respectively.

The material was prepared by the Chief Specialist of the Analytics and International Cooperation Department of the Corporate Development Department of the Joint-Stock Company "Problem Loan Fund" Turgulova A.D.

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