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Addressing NPAs of Banks: PARA-the last frontier?

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Growth in Indian banking sector has been quite rapid over the years with significant progress being made in terms of number of banks, branches, financial inclusion and financial performance. However, there has been a tendency for the quality of assets of the system to come under pressure in the last few years due to slowdown in economic growth as well as serious issues on the infrastructure side. The NPA ratio was as high as 9.1% in September 2016 and had gone up from 7.8% in March. Stressed assets had increased from 11.5% to 12.3% during this period. Quite clearly the problem is acute and tackling NPAs has become a primary objective of the government and RBI.

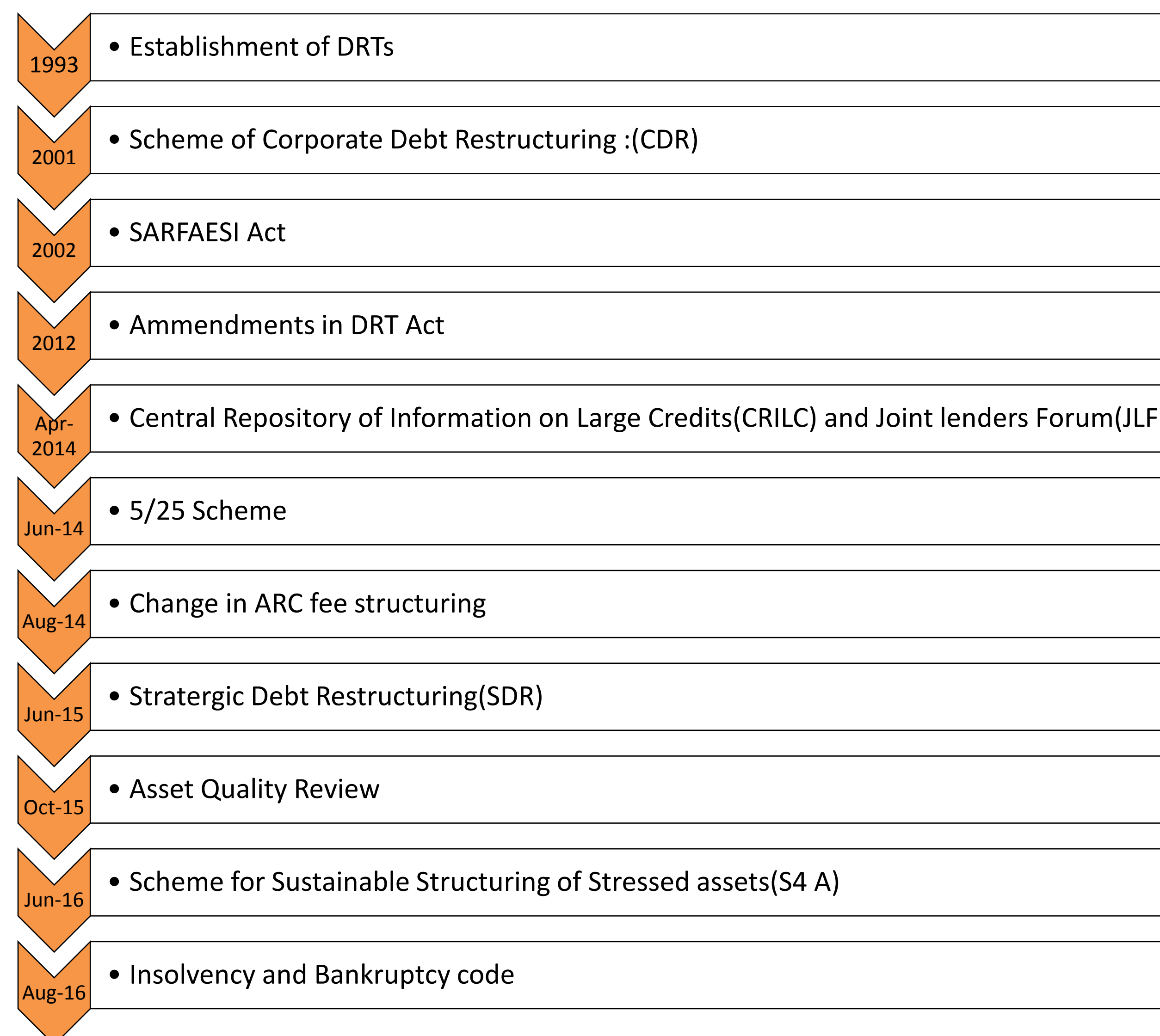
The history of addressing the issue of weak assets is fairly deep in our context, though the success level has been less than satisfactory. It is against this background that the Economic Survey has spoken of the constitution of the Public Asset Rehabilitation Agency (PARA) as the concept of a bad bank has also gained prominence. The foregoing discussion looks at various measures that have been taken to address the issue of NPAs over the years.

Various measures have been taken to solve the problem of Bad loans even before 1990. For example,

- Sick Industrial Companies Act, 1985 was enacted for timely detection of sick companies,
- Board for Industrial and Financial Reconstruction (BIFR) was set up in January 1987,
- The Appellate Authority for Industrial and Financial Reconstruction (AAIRFR) was setup in April 1987.
- Lok Adalat mechanism was constituted under the Legal services Authorities act, 1987 to resolve NPAs of Rs 10 lakhs and above through mutual compromise.

It took years for banks to recover their loans as a lot of time was spent in judicial process prior to 1990. In order to avoid shortcomings in the measures taken before 1990, the RBI along with the Government, have initiated various institutional measures to speed up the recovery of bank loans.

The chart below chronicles the various steps taken in this regard in the last two decades or so.



The Framework

- **Debt Recovery Tribunals**

The idea of having Debt Recovery Tribunals (DRTs) came up from Narasimham Committee 1, 1991. DRTs were established consequent to the passing of Recovery of Debts due to Banks and Financial Institutions Act (RDBBFI), 1993 and appeals against orders passed by DRTs lie before Debts Recovery Appellate Tribunal (DRAT). Banks can approach DRTs for disputed loans above Rs 10 Lakhs. At present, there are 33 DRTs and 5 DRATs functioning at various parts of the country. 6 new DRTs are also being established at Bengaluru, Chandigarh, Dehra Dun, Ernakulum, Hyderabad and Siliguri. Though the aim was to recover the loans timely, implementation of DRTs resulted in following problems:

- There were small numbers of DRTs managing the increasing number of cases.
- They were unable to solve the cases on time.
- It also failed to handle the loans of large borrowers.
- In many DRTs, the posts of various presiding officers have remained vacant for years resulting in lesser no. of people solving the ever increasing cases.

- Lastly, often, the borrowers and guarantors raised superficial issues leading to prolonged hearing and, consequently, delays.

Due to various loopholes in DRTs, various changes were made in DRT Act in 2012 to improve the functioning, to prescribe a time frame for filing of pleadings and to give recognition and clarity to the settlements entered into between borrowers and banks.

- **Corporate Debt Restructuring Mechanism**

It was introduced with the aim of ensuring timely and transparent mechanism for restructuring of debts of viable entities and to minimize the losses to the creditor. This route can be taken only when:

- The total exposure (fund-based and non-fund based) exposure is Rs. 10 cr and above.
- The accounts are classified as 'standard' and 'sub-standard' by 90% of the creditors.

The CDR mechanism in India has a three tier structure:

- CDR standing forum
- CDR Empowered group
- CDR cell

Why did it have limited success?

- Despite having Inter creditor agreement (ICA) between various lenders, restructuring became unenforceable as CDR mechanism is non-statutory in nature.
- Promoters' equity was financed by borrowed amount that added the burden of debt servicing on banks.
- CDR cell faced problems on account of delay in sale of unproductive assets due to various legalities involved.

Table 1: Performance of CDR cell since inception (Rs crores)

Date	Total References Received by CDR Cell		Cases Withdrawn on account of package failure		Cases exited successfully		Live cases in CDR	
	No. of cases	Aggregate debt	No. of Cases	Aggregate debt	No. of cases	Aggregate debt	No. of cases	Aggregate debt
As on Dec 2013	605	4,07,656	115	29,038	69	52,625	259	2,07,635
As on Dec 2014	647	4,52,940	155	50,104	77	58,682	288	2,72,099
As on Dec 2015	655	4,74,002	202	83,552	86	62,217	242	2,57,235
As on Dec 2016	655	4,74,002	264	1,25,093	98	70,851	168	2,07,060

Source: CDR cell

Since CDR's inception, about 605 cases were referred till Dec'13, of which only 69 cases were able to exit successfully. This means only 11% of the total cases were successfully resolved. Also, around 42 new cases were added from Dec'13 to Dec'14 out of which only 8 cases were resolved successfully (which could have belonged to earlier years as well).

Further, banks have not added any fresh cases of restructuring since 31 March'15 after the RBI withdrew a crucial forbearance allowed to banks in CDR cases. Banks will now have to provide 15% for bad loans as against 5%.

- **Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act**

The idea of SARFAESI Act was proposed by Andhyarujina Committee, 1999 that stressed on empowering banks and financial institutions to take possession of the NPAs. Thus, via SARFAESI, creditors were empowered to recover their loans without the intervention of the court.

Under the RDDBFI Act, 1993 banks approach the Debts Recovery Tribunal (DRT) whereas, under SARFAESI Act, 2002 borrowers, guarantors, and any other person aggrieved by any action of the bank can approach the Debts Recovery Tribunal (DRT). The Act had stipulated four conditions for enforcing the rights by a creditor:

- The debt is secured.
- The debt has been classified as an NPA by the banks
- The outstanding dues have to be Rs 1 lkh and above and more than 20% of the principal loan amount and interest there on.
- The security to be enforced should not be an agricultural land.

SARFAESI Act had resulted in establishment of ARCs where banks could sell their stressed assets by selling them to these ARCs. This was done so that banks could resume focusing on their traditional deposit and loan operations while ARCs could use their skills to restructure the corporate debts. ARCs were setup as private vehicles mainly with the support of banks.

Table 2: Number of ARCs and assets acquired from Banks

Values	Dec-13	Mar-14	Mar-15	Mar-16
Company count	5	13	14	16
Total acquired from banks (in bn)	163.56	351.64	584.79	726.26

Source: RBI

There has been 23% increase in the no. of ARCs from Mar’14 to Mar’16 and Rs 726.26 billion has been acquired from banks by ARCs. The growth in resolving the cases through ARCs has sharply declined from 56% in Mar’15 to 32% in March’16 and this can be attributed to following reasons:

Drawbacks of SARFAESI Act:

- The major problem with ARCs was that they were finding it difficult to resolve the assets that they had purchased from the banks. Therefore, they wanted to purchase the loans only on low prices. Consequently, banks were reluctant to sell them loans on a large scale. In order to solve this issue, the fee structure was reformed in 2014 where ARCs had to pay a higher amount to these banks in cash. Since the rate of return earned by ARCs had started declining due to a change from 5/95 scheme to 15/95 scheme, these companies saw no incentive in continuing buying bad loans from banks. The sales have declined since then and only 5% of total NPAs were sold in FY15 and FY16 through this route.
- Banks are not allowed to book profit if the bad assets are sold to ARCs; in fact they have to keep that money as a cushion against future provisions. This is not the case if such a settlement has been done with the borrower. Thus, this discourages banks to sell NPAs to ARCs.
- Security receipts are subject to declaration of Net asset value(NAV) every six months; therefore the SR investors are required to book losses in case of a drop in NAV. Few ARCs have also made investments in SRs.
- Capital remains the major problem for Securitization companies (SCs) and Restructuring companies (RCs). The net worth of 15 ARCs is only about Rs 4,000 crore compared with the level of stressed assets in the banking system. Affluent investors are interested in this business but are wary of judicial and administrative environment.

- Also, investors want to earn higher returns on investing in high stressed assets, but unfortunately, pricing has been the major issue. In order to help ARCs bring much needed capital, Union Budget FY16 changed the norms by allowing 100% FDI in ARC space.

Success rates of various channels/measures:

Banks have tried using various measures in order to reduce their NPAs. Success story of three channels employed by banks are as follows:

Table 3: SCBs' NPAs recovered through various channels (Amt in Rs bn)

Channel of Recovery	2014-15(Revised)			2015-16		
	No. of cases Referred	Amount involved	Amount Recovered	No. of cases Referred	Amount involved	Amount Recovered
Lok Adalats	29,58,313	309.79	9.84	44,56,634	720.33	32.24
DRTs	22,004	603.71	42.08	24,537	693.41	63.65
SARFAESI	1,75,355	1,567.78	256.00	1,73,582	801.00	131.79
Total	**31,55,672**	**2,481.28**	**307.92**	**46,54,753**	**2,214.74**	**227.68**

Source: RBI

Amount recovered by all SCBs reduced by 26% from Rs 307.92 bn in 2014-15 to Rs 227.68 bn. This reduction is attributed to a decline in number of cases resolved through SARFAESI. The recovered amount was reduced by 52% from Rs 256 bn in 2014-15 to Rs 131.79 from 2015-16.However, recovery through DRTs and Lok Adalats had shown an improvement.

Recovery rates, defined as Amount recovered/Amount involved, increased from 3% in 2014-15 to 4% for Lok Adalats and 7% in 2014-15 to 9% in 2015-16 for DRTs.

It is to be noted that around 96% of the cases were referred through Lok Adalats in 2015-16.

Table 4: PSBs NPAs recovered through various channels (Amt in Rs bn)

Channel of Recovery	2014-15(Revised)			2015-16		
	No. of cases Referred	Amount involved	Amount Recovered	No. of cases Referred	Amount involved	Amount Recovered
Lok Adalats	25,96,351	270.2	9.31	42,44,800	690.17	31.34
DRTs	18,397	532.03	34.84	19,133	574.39	55.9
SARFAESI	1,66,804	1,463.06	234.34	1,59,147	650.08	110.33
Total	27,81,552	2,265.29	278.49	44,23,080	1914.64	197.57

Source: RBI

As proportion of NPAs is higher in PSBs, it is of utmost importance to look at the success rates of various channels used by them. They could only recover Rs 197.57 billion in FY16 as compared to Rs 278.49 bn in FY15.

- **Central Repository of Information on Large credits (CRILC)**

Banks realized that information asymmetry can prove to be a major bottleneck in strong credit monitoring and hence, they came up with an idea of maintaining large loan databases of all the borrowers having aggregate fund based and non-fund based exposures of Rs 50 million and above. The aim of creating this database was to enable banks to take informed decision and early recognition of asset quality problems by reducing information asymmetry. Under this, the RBI's regulation requires banks to classify loans into Special mention categories of SMA-0, SMA-1, and SMA-2.The dues can be recovered by forming a

Joint lenders forum (JLF) once an account becomes SMA-2. The decisions in JLF can be taken by 75% of creditors by value and 60% by number agree, but reaching an agreement in these Forums was the major bottleneck.

Decision making capabilities of JLF were adversely affected as group of lenders never reached a consensus that resulted in delays in the way this scheme was supposed to work.

It was also observed that banks were not forming JLF as and when required. Therefore, RBI came up with a notification mentioning that the bank with the largest exposure in the consortium will be supposed to pay the penalty, in case the JLF is not formed within the 15 days an account has been categorized as SMA-2.

Since the introduction of JLF in April'14 to February'15, commercial banks had formed 355 JLFs for stressed cases with public sector banks accounting for 254 such cases of which only 33 cases were referred to CDR forum in 2014-15.

Due to lower success rates of ARCs, DRTs and other measures. Banks tried focusing on the measures discussed as below:

- **5/25 Scheme**

This scheme was established for revival of stressed assets in the infrastructure sectors and eight core industry sectors that comprises of major chunk of NPAs in the banking system. This scheme focused on rescheduling amortizations to give firms more time to repay. Interest rates were adjusted every 5 years in the 25 years period in order to match the funding period with the long gestation and productive life of these projects. The banks were supposed to treat these loans as standard that helped them reduce their provisioning costs.

In order to cover more no. of NPAs and further strengthened the scheme, RBI has lowered the threshold to Rs 250 crore as compared to earlier mandate of Rs 500 crore.

Drawbacks of this scheme:

- The objective of the scheme was derailed because the refinancing was done at a higher rate of interest so that banks could preserve the NPV of the loan amount.
- There were few disclosures of the accounts getting refinanced under the scheme.
- It was felt that this was one of the tools deployed to cover NPAs by banks.
- Theoretically it was argued that the scheme could benefit infrastructure projects with stable cash flows but may not prove good for sectors like steel and cement as companies in these sectors go through cycles. Therefore, they will be able to service the debt in profit making cycle but not when they will be incurring losses.

- **Strategic Debt Restructuring (SDR)**

Under this scheme, banks were given an opportunity to convert the loan amount into 51% of equity and were supposed to be sold to the highest bidders, once the firm becomes viable. This measure was unable to help banks resolve their bad loan problem as only 2 sales have taken place through this measure due to viability issues. It was observed that difficulties in finding buyers and disagreement over valuations were challenges in implementation.

- **Asset Quality Review (AQR)**

In order to solve the problem of Bad debts, the first and foremost step is to recognize those assets. Therefore, RBI had ensured that banks evaluate loans in lines with RBI classification rules till March 2016. But the problem with this scheme is that banks are still not showing the true state of their balance sheets by continuing to evergreen loans.

- **Sustainable Structuring of Stressed Assets (S4A)**

Under this scheme, banks were given the opportunity of segregating the loan amount into sustainable and unsustainable portions where the sustainable loans were those that could be repaid through current cash flows. The unsustainable portion recognized can then be converted into equity and preference shares. This was done by an independent agency for big ticket loans. The only difference between SDR and this scheme is that this scheme results in no change of ownership of the company. This scheme recognized that large debt reductions will be required to restore the viability but public sector banks were unwilling to grant write-downs as there were no incentives to do so and write-downs of large debtors could quickly exhaust banks' capital cushions.

- **Insolvency and Bankruptcy code**

Due to limited success of the schemes mentioned above, the Insolvency and Bankruptcy code was formed in FY16 that seeks to combine the existing framework by creating a single law for insolvency and bankruptcy. At present it takes more than 4 years to resolve a case of bankruptcy in India and this code strives to reduce this time to less than a year. Key features of this code entails following:

- The code recommends two separate tribunals to supervise the process of insolvency resolution for corporates and individuals: The National Company Law Tribunal for Companies and Limited Liability Partnership firms; and the Debt Recovery Tribunal for individuals and partnerships.
- Maximum time limit of 180 days has been set for corporates for the process to get completed that can be further extended by 90 days.
- The process can be initiated either by a debtor or a creditor.

But, the newly established Bankruptcy code has to be tested first on the smaller cases and has to be given some time for handling large and complex cases until it is fully operational.

Public Sector Asset Rehabilitation Agency (PARA)

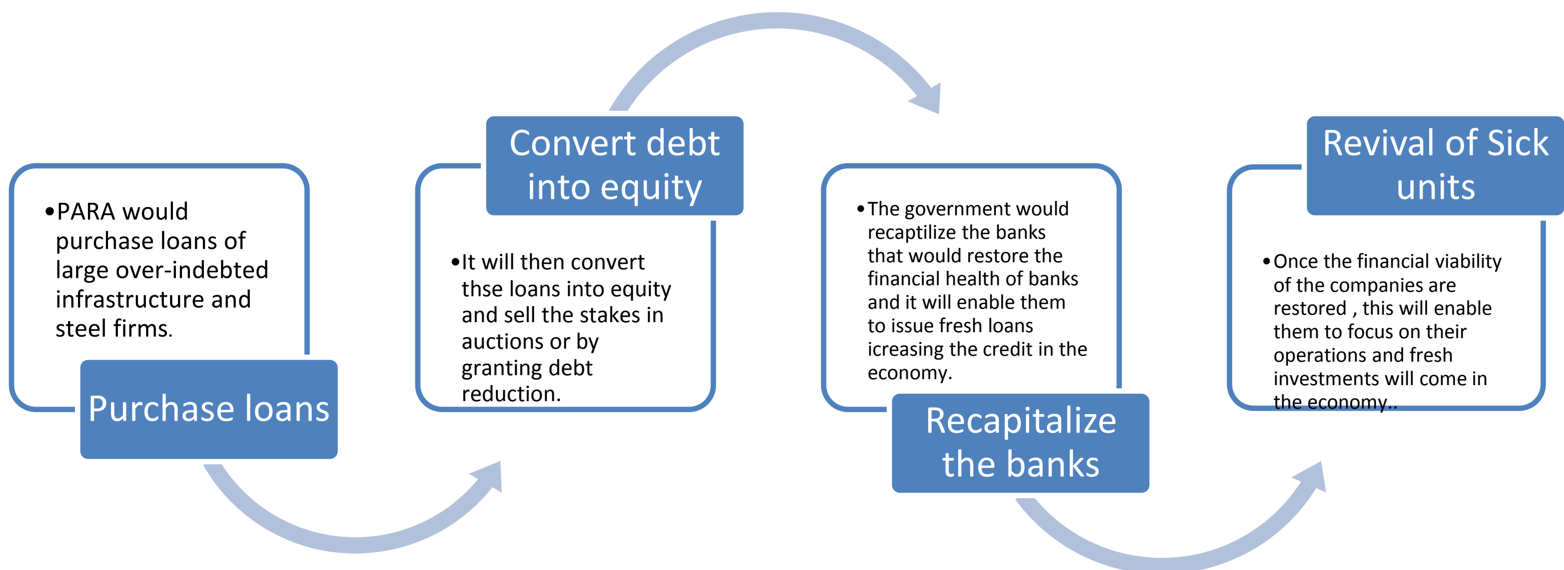
An initiative that has been mooted of late is the formation of a public sector asset rehabilitation agency with the acronym of PARA. The concept is similar to the idea of a bad bank which is being spoken of.

The Economic Survey 2016-17 has proposed a new centralized agency named "Public Sector Asset Rehabilitation Agency" (PARA) to solve the problem of overleveraged companies and bad loan encumbered banks, generally known as Twin Balance sheet (TBS) problem. This agency is expected to solve the coordination problem since debts would be centralized in one agency and is expected to be set up with proper incentives by mandating to maximize recoveries within a time frame.

Economic Survey FY17 also suggests various measures to bring in the required capital for funding PARA so that it can further fund Banks and stressed companies.

- First source will be through issue of government securities.
- Capital can also be raised from capital markets provided government is ready to sell down its holdings.
- Another source of capital could be RBI. As RBI is exceptionally highly capitalized, it is suggested that it probably can transfer its government securities holdings to public sector banks.

Working Framework for PARA:



What will drive its success?

In order for the smooth functioning of PARA, following are the things that have to be taken care of:

- Banks have to come to a consensus. This is critical because history shows that banks have been really slow in selling assets to the restructuring companies as they were not ready to take the kind of haircuts that these companies expect them to do. Earlier the discount rates ranged between 25%-30% but a change in regulation of upfront 15% proceedings to be done in cash has led the discount rates used for acquiring the NPAs to increase and range between 50-60% of the book value. Therefore, if PARA has to function smoothly, it has to ensure that the same pricing issue doesn't remain as neither the restructuring companies nor the banks want to bear the loss. A solution could be to fix the discount on loan value (probably use the adjusted book value) and the upfront cash payment as a rule which will then ensure there is less debate on the issue.
- The other important issue is the availability of capital with these restructuring companies. For every Rs 100 NPA of a bank which is sold at say 50% value which is Rs 50, PARA will have to pay Rs 7.50 in cash to the bank and the balance through securities, (assuming 15% cash has to be paid upfront while acquiring these assets). Hence if the aggregate of Rs 6 lkh crore of NPAs is to be taken over theoretically by PARA, the amount that has to be paid upfront assuming 50% discounted price would be Rs 45,000 cr. PARA will have to look at resources to this extent or proportional to the purchase price of the NPAs. Funding will have to be through capital or debt.
- The critical part will be the valuation of the NPA by PARA. There should be an independent evaluation of the NPA by recognized agencies so that there is uniformity in pricing. A credit rating of these assets would be useful in such price discovery.

PARA is a useful concept and scores over ARCs in so far as that it will be owned by the government. Addressing this issue directly would free resources of the government in capitalizing banks in future, which would also be better placed to raise the same from the market.