CARE Ratings
Professional Risk Opinion

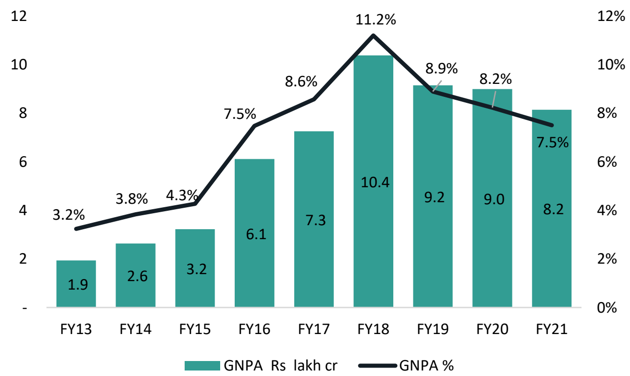
Moving to NPA resolution in India?

July 16, 2021 I BFSI Research

Introduction

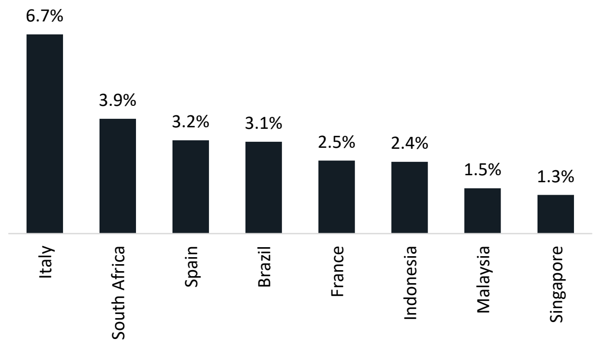
The NPA problem in India has been severe both in absolute as well as in comparative terms. Despite a recent dip, systemic NPAs are at a higher level compared to earlier levels as well as international levels. The following figures bring out the depth of the issue faced by the banking system by tracing the evolution of the GNPAs over the last eight years and by comparing the country's GNPA ratio against other countries.

Figure 1: Movement in GNPA



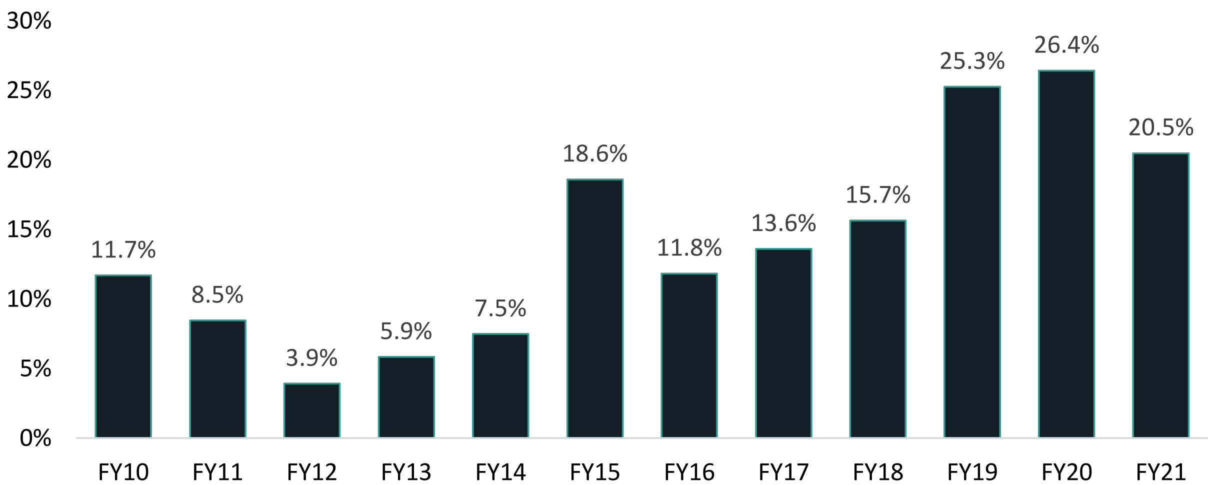
Source: RBI, CMIE

Figure 2: GNPA Ratio of Select Countries



Note: Reporting period for national accounts data, FY; Indonesia: Fiscal year end: March 31, reporting period for national accounts data: CY; Data for Indonesia include Timor-Leste through 1999 unless otherwise noted; Singapore: Fiscal year end: March 31; reporting period for national accounts data: CY; Source: World Bank

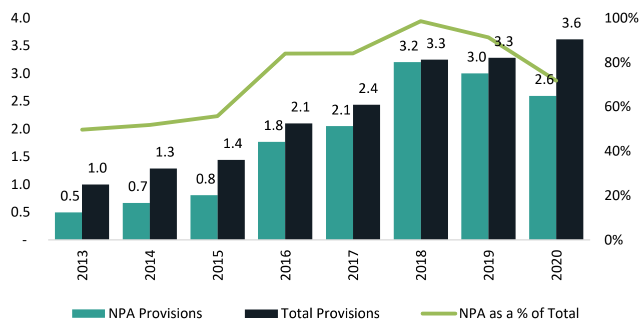
Figure 3: Increased share of Write-offs (Write-off as a % of Closing GNPA)



Source: RBI, CARE Ratings

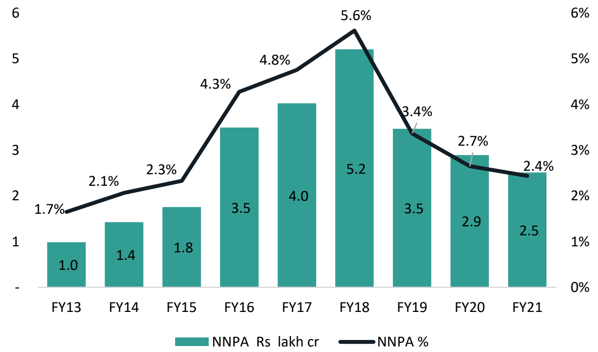
The earlier figures showcase that GNPA had reduced significantly from the earlier peaks (Rs.10.2 lakh crore and 11.5% in FY18), however, it should be noted that write-offs have accounted for quite a large share of the same. Figure 3 indicates that, in the earlier years, write-offs had a smaller share, however, post FY18, the share has markedly increased indicating that SCBs have cleaned their books taking a hit and recoveries have had a smaller share of the same.

Figure 4: Movement in Annual NPA Provisions



Source: RBI, CMIE

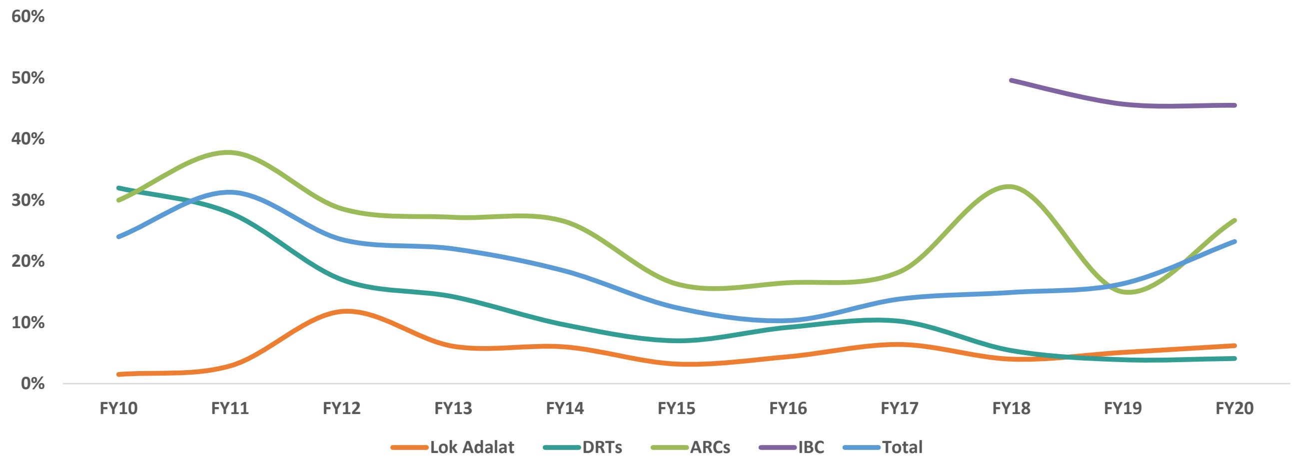
Figure 5: Movement in Net NPA



Source: RBI, CMIE

The overall bank credit growth in March 2021 slowed to 5.6% (on y-o-y basis) vs. a growth of 6.1% in March 2020. The credit growth has been slower on account of pandemic-caused slowdown in the economy and the continued risk aversion by banks. However, as per RBI's macro stress test, the GNPA ratio of all SCBs may increase to 9.80% under the baseline scenario by March 2022 and may further increase to 10.36% and 11.22% under medium stress, and severe stress scenarios (as given in 'Financial Stability Report'). Under the baseline scenario, PSBs' GNPA ratio may increase to 12.52% by March 2022, which is an improvement as compared with the earlier estimate given by RBI in January 2021 (previously RBI had estimated the GNPA ratio would increase to 16.2% by September 2021), and is a reflective of various regulatory support by government/RBI, while the GNPA ratio of PVBs may increase to 5.82% under the baseline scenario by March 2022 and may further increase to 6.04% and 6.46% under medium stress and severe stress scenarios. The stress test assessment has been done considering the upliftment of ban on asset classification and using the reported asset quality position as of March 2021. While the underlying assumptions for such assessments are an estimation based on the current scenario, it indicates that the need for SCBs is to be mindful of the asset quality and take appropriate steps such as to shore up capital in an anticipation of provisioning led by increasing stress in the wake of the second wave of the covid-19 pandemic.

Figure 6: Amount Recovered as a % of amount involved

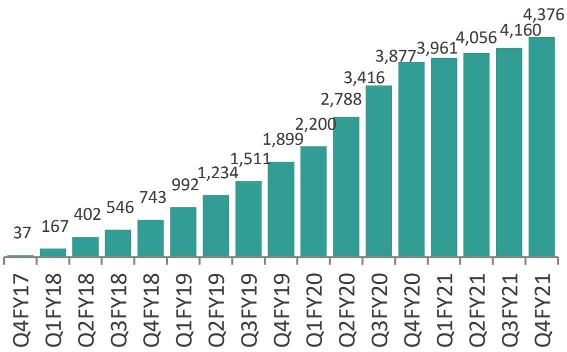


Source: RBI

An effective asset resolution mechanism is an integral part of a well-functioning financial system. Consequently, RBI has provided several options for resolution and collection such as Lok Adalat and Debt Recovery Tribunals (DRTs), and ARCs. The earlier options were created for a speedy settlement of debt-related matters. However, despite their initial promise, these options faced considerable delays which can partly be attributed to their over-stretched capacity and inadequate infrastructure. Consequently, over four years ago, the IBC was introduced to speed up the resolution process. The IBC has been the most significant reform concerning NPA resolution. According to RBI, in FY20, the amount recovered as a share of the amount involved under IBC was 45.5%, followed by 26.7% by ARCs, while Lok Adalat and DRTs had significantly lower shares.

The following sections track the growth in IBC and provide details on the cases in the same.

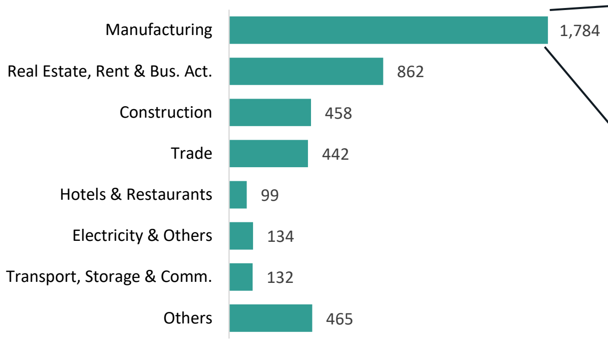
Figure 7: Cumulative # of CIRPs admitted



Source: IBBI

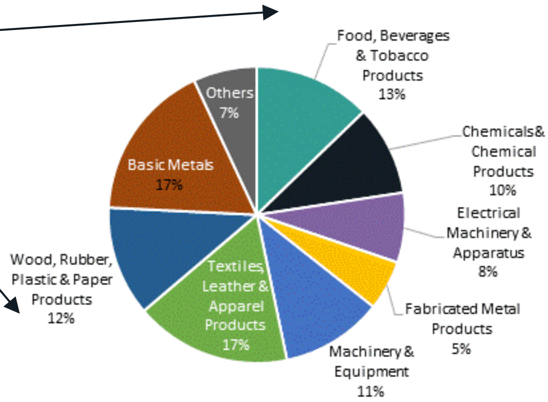
The number of cases admitted for Corporate Insolvency Resolution Processes (CIRPs) over the last 16 quarters has increased significantly, and has been generally increasing every quarter, with a major portion of these cases being admitted over the last ten quarters, thereby highlighting the rising acceptance of IBC as an effective debt resolution mechanism. However, the cases admitted slowed down in FY21 (499 cases) compared with 1,978 cases admitted in FY20. The March-end quarter witnessed a drop of around 47% compared with the previous year. This can be attributed to the suspension of fresh bankruptcy proceeding for Covid-19 defaults which ended on March 24, 2021.

Figure 8: Cumulative # of CIRPs by sector



Source: IBBI

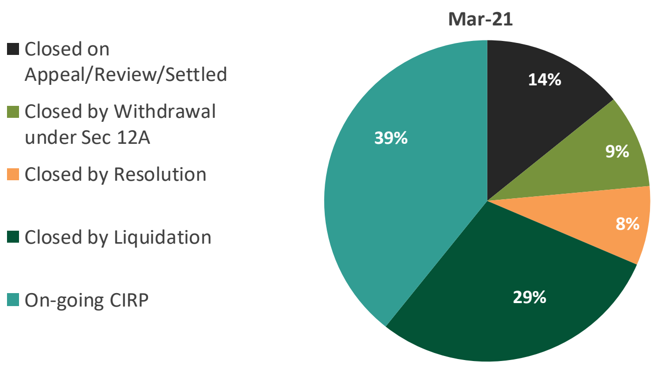
Figure 9: Distribution of manufacturing sector under CIRP



Source: IBBI

The figure shows the dispersion of the admitted cases by sector. As can be observed, the manufacturing sector accounts for the highest share at 41% of the overall cases, followed by the real estate (20%), construction (10%) and trading sectors (10%). The sectors have largely remained constant compared with last year. Within the manufacturing domain, 'textile, leather & apparel products' and 'basic metals', both accounting for 7% each (similar in quarter ended March 2020), continue to have the largest cumulative number of cases admitted under the IBC in quarter ended March 2021.

Figure 10: Status of CIRPs



Of the total 4,376 cases admitted into CIRP at the end of March 2021, 39% of the cases continue to remain in the resolution process against 57% as at the end of March 2020, with manufacturing sector accounting for 15% (23% in March 2020) followed by real estate (8% in March 2021 vs. 12% in March 2020) and construction segment (4% in March 2021 vs. 7% in March 2020). 1,277 cases have ended into liquidation (i.e., 29% of the total cases admitted, higher compared with last year). Over two-third of these cases (around 946 CIRPs) were BIFR / non-operational companies or those in which the resolution value was less than or equal to the liquidation value.

Around 14% (901 CIRPs) of the cases have been closed on appeal or review or settled compared with 9% in March 2020. 8% of the cases have been withdrawn under Section 12A: A significant number of such cases (48%) were less than Rs.1 crore. The primary reason has been either the full settlement with the applicant which has increased to 37% against 24% as at end of March 2020 or other settlement with creditors (22%). Only 8% of the total cases have ended in approval of resolution plans (an increase by 2% compared with March 2020).

Figure 11: Summary of CIRPs Yielding Resolution

	Amt/%	
Particulars	**Up to March 2020**	**Up to March 2021**
Total admitted claims of Financial Creditors (Rs cr)	384,436.7	516,047.0
Liquidation value (Rs cr)	96,349.5	112,643.7
Realisable by FCs (Rs cr)	176,673.7	202,617.8
Realizable by FCs as a % of their claims admitted	45.9	39.3
Realisable by FCs as a % of their liquidation value	183.4	179.9

Source: IBBI

In the past, recovery rate in India was as low as 26 cents to a 1 USD (i.e., 26% recovery). Post implementation of the IBC, as can be seen in the above table, the overall recovery rate till date in India has improved to 39.3%. However, the recovery for Q4FY21 has dipped to 26.4%, which is significantly lower than 64.1% reported in quarter ended March 2020. Of the total claims which were settled via liquidation with an admitted claim amount of Rs.5,211.9 crore in Q4FY21, the realisable value was only Rs.350.0 crore (around 7% of the admitted claim amount).

Of the 1,723 on-going CIRPs, there has been a delay by more than 270 days for the completion of process of 79% of on-going CIRPs in March 2021 compared with 34% in March 2020. As per the IBBI data collation, this can be attributed to the lockdown imposed in 2020, resulting from the onset of COVID-19 pandemic in the country.

As can be seen in earlier figures, although IBC has improved the recoveries in few large assets, the resolution time has been significantly high, while the other avenues have not recovered significantly high numbers. Consequently, to deal with this stress and free up the balance sheet for fresh lending, bank balance sheets need to be cleared of the legacy NPAs. Hence, an idea which had been mooted earlier has been revived, i.e., house a significant portion of the legacy bad debts in a single agency (a bad bank) and clean up the bank's balance sheets.

What is a Bad Bank?

A bad bank is an asset reconstruction company / asset management company (ARC/AMC) established for the purpose of acquiring the stressed/bad assets held by a regular bank. The stressed assets go out of the balance sheet of the regular bank and the regular bank can focus on its normal business activity without worrying about the stressed assets. The task of managing and/or liquidating the stressed assets is left to the bad bank. The bad bank does not undertake lending or deposit activities but helps banks to resolve bad loans and clean up their balance sheets.

International experience has been mostly encouraging: The concept of a bad bank evolved primarily in the US. The most popular example is that of the Mellon Bank. Mellon Bank set up an entity called the Grant Street National Bank (GSNB). GSNB was created to acquire Mellon Bank's NPAs and then sell off these bad debts. GSNB acquired the bad debts at a substantial discount and subsequently sold off all the toxic assets transferred to it and was then closed. After the successful experience in the US, bad bank as a concept has been implemented in varying degrees of success in other countries including Malaysia, Spain, Cyprus, China, France, and Germany.
As per RBI study on ARCs, Securum of Sweden which was set up in 1992 and wound up in 1997, succeeded in recovering close to 86% of the amount involved, while Danaharta of Malaysia, which was operational between 1998 and 2005, managed to recover about 58% of the amount involved. As per the World Bank and the Financial Stability Institute, the key success factors of the AMCs include (1) a narrow mandate with clearly defined goals, (2) a definite lifespan, (3) supportive legal infrastructure involving bankruptcy and private property laws, (4) strong political will to resolve NPAs, and (5) strong governance, transparency, and disclosure requirements.

Prior Indian experience has not been optimal: In 2004, Stressed Assets Stabilization Fund (SASF) was set up as a Special Purpose Vehicle (SPV) Trust by the government to acquire the stressed and non-performing assets of erstwhile Industrial Development Bank of India (IDBI) aggregating to around Rs.9,000 crore in over 600 accounts. According to a 2014 audit report by the Comptroller and Auditor General (CAG), SASF was able to recover approximately Rs.4,000 crore as of end-March 2013 implying a recovery rate of around 44%. However, this recovery rate has been achieved over a decade with major recoveries occurring at the inception of the Trust.

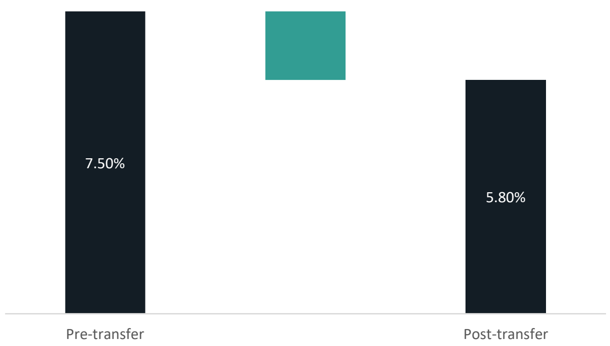
National Asset Reconstruction Company Limited (NARCL): In the Union Budget FY21-22, the Finance Minister, Mrs Nirmala Sitharaman announced that an Asset Reconstruction Company (ARC) and Asset Management Company (AMC) would be set up to consolidate and take over the existing stressed debt. It would then manage and dispose of the assets to Alternate Investment Funds (AIFs) and other investors for eventual value realisation. The union government will neither have any direct shareholding or management control in the NARCL. Canara Bank is anticipated to be the lead sponsor and largest shareholder of NARCL. NARCL would be majority owned by the PSBs, while private sector banks are anticipated to be active participants in the Asset Management Company which would work on resolving the accounts. NARCL would function as an aggregator and would warehouse all these accounts, while an Asset Management Company would be incorporated and would work to resolve the accounts. As per media reports, the sale process of theses NPAs is likely to work as follows:

- Lenders to shortlist accounts which would be made available for sale to the NARCL. These accounts would be shortlisted as per the criteria mentioned below.
    - Approximately NPAs totalling to around Rs.2 lakh crore would be sold to NARCL. As per initial discussions, around Rs.80,000 - Rs.90,000 crore of loans would be offered to the NARCL in the first tranche.
    - The amount outstanding in each loan account would over Rs.500 crore across lenders.
    - These companies would be spread across industries including auto, power, steel, cement, and roads.
    - These entities would have been likely admitted under the insolvency process and would almost be fully provided in the banks' books.
    - Loan accounts under liquidation or where fraud has been identified would be excluded.
    - Furthermore, stressed assets close to being resolved and for which a one-time settlement is under process may not be transferred to NARCL.
- After NARCL announces plans to acquire the account, lenders would conduct a "Swiss challenge" method-based auction. The Swiss Challenge will enable the public sector banks to comply with RBI's norms that require banks to sell loans through a price-discovery process rather than doing a one-to-one deal.
- Other ARCs would also be able to participate in the auction and would be able to acquire the asset by either offering a higher price or similar price but with full payment to be made in cash.
- NARCL would acquire the account from the lenders. NARCL to provide 15% of the sale price in cash and 85% in security receipts (SRs).
- Government to potentially guarantee the SRs. As per media reports, IBA has estimated that the cost to the government would not exceed Rs.31,000 crore and would be available for five years thereby incentivising faster resolution. However, the structure and nature of any guarantee is yet to be finalised.
- Each corporate NPA will be converted into a special purpose vehicle, which will be sold/ managed by the NARCL.

Implications

The key implications of the proposed structure and loan transfer process have been detailed below.

Reduction in Headline numbers, however, stress would remain in the system.
Figure 12: Movement in GNPA ratio due to transfer to the NARCL



Source: Company filings, CARE Ratings

If the proposed transfers of NPAs from Banks to NARCL are considered on the likely book at the end of FY21, the GNPA figure would come down below 6%. This is assuming that the entire amount is transferred and the SCBs do not balk at transferring the NPA accounts to an ARC and booking a larger haircut than if they had simply kept these accounts on their own books and worked on a recovery mechanism. The revised GNPA ratio post transfer could be around the same levels prior to the AQR exercise. Once the transfer is carried out, the revised estimated GNPA number (for the sample under consideration) would be approximately Rs.6 lakh crore and the revised estimated GNPA ratio would be around 5.8%. Consequently, it is estimated that the GNPA ratio would go down by 1.6%-1.8%. Until these troubled assets are resolved, this would simply be headline management as the stress would continue to exist in the system. Additionally, this number does not consider the reductions due to resolution and recovery, and additions due to the stress prevalent in the system and the wider economic disruptions due to the multiple waves of the pandemic.

Shortlisting criteria ensures that only those loans would be transferred which have been fully provided for and where resolution is not likely to be achieved soon. Furthermore, this would also mean that older loans would be transferred. As was evident in the IDBI SASF experience, recovery is higher in earlier years and hence older loans would have a lower probability of collection or would realize a smaller than expected recovery rates and hence could generate a lower level of interests from the banking community.

Provisioning norms: As per RBI guidelines, on completion of four years, NPAs which have been fully provided, are removed from the bank's balance-sheet via a write-off. Further, banks write-off NPAs as part of their regular exercise to clean up their balance sheet, avail of tax benefit and optimise capital, in accordance with RBI guidelines. The overall provision would depend on the government's guarantee of the SRs (provision would rise on SR valuation) but the transfer of NPAs from bank books would free up the provisions.

Concluding remarks

A bad bank is an expensive proposition to set up and needs a well-defined structure, and a defined exit strategy for it to operate as a onetime entity. A bad bank is generally expected to be more efficient in recovery as it will step into the shoes of multiple lenders who currently have different compulsions when it comes to resolving a bad loan. A successful bad bank needs buy-in from all lenders of the NPAs, expertise in resolving bad loans or operate the running companies whose debt has been acquired, pricing of assets, robust legal framework for debt resolution, along with a strong commitment to reforms.

NARCL, by enabling banks to reduce a portion of their accumulated NPAs, would be a potent tool towards NPA resolution. The RBI as well as the government have undertaken several steps such as improved corporate governance norms, bank mergers, PSB recapitalisation, AQRs to address some of the structural issues. However, additional structural reforms would be required to address the accumulated NPAs. These structural reforms include bank capital infusion, better governance, and loan underwriting, monitoring for early warning signs of distress, creating a secondary market for bad loans for better price discovery, and faster implementation of IBC.

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