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Professional Risk Opinion

NARCL –NPA Resolution Gaining Momentum

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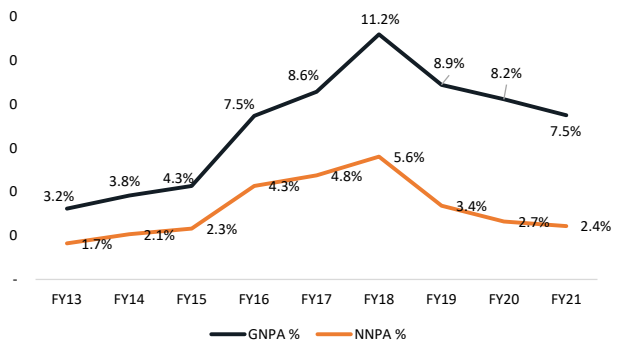
Introduction

The banking system has been under severe stress due to several factors, however even as they remain at elevated levels, the NPAs have been witnessing a general trend downward. During FY21, while there was a decline in wholesale NPAs with resolution of legacy accounts under IBA and lower slippages in the corporate segment, there was a relative increase in retail NPAs and services. Even the proportion of retail seems smaller, there was a definite rise in the slippages in FY21. Within retail, there was rise in NPAs across segments during FY21 impacted due to Covid. Unsecured segments such as personal loans and credit cards witnessed higher NPAs.

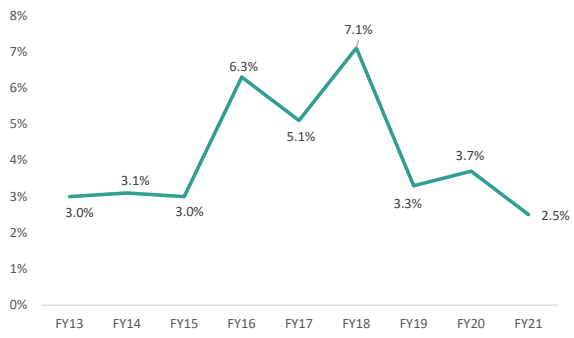
Additionally, the banking system's pandemic caused asset quality challenge though reducing continues, especially in the retail and the MSME segments, as the second covid wave has increased the stress on comparatively weaker borrowers that had availed of restructuring/ECLGS and may see higher slippages than what was earlier expected, while recovery continues to be contingent on the broader economic growth and on any upcoming covid waves.

Figure 1: Movement in NPAs



Source: RBI, CMIE

Figure 2: Movement in Slippage Ratio



Source: RBI, CMIE

In an earlier note, we had laid out the scale of the NPA issue in India, an update on the IBC, and an initial perspective towards what has been termed as a bad bank (Moving to NPA resolution in India?). In the current note, we discuss the government guarantee and a discussion on the pricing of these NPAs. As envisaged earlier, the Government of India has decided to provide a guarantee/ backstop of up to Rs. 30,600 crores to the SRs proposed to be issued by the NARCL. With a proposed asset transfer of about Rs 2 lakh crore (as per the PIB release), cash: SR ratio implies a floor of 18% to the recovery process. The figure below provides a few scenarios around the first tranche, which, it is believed, would mainly consist of accounts which have been fully provided/ written off, proposed to be transferred to the NARCL.

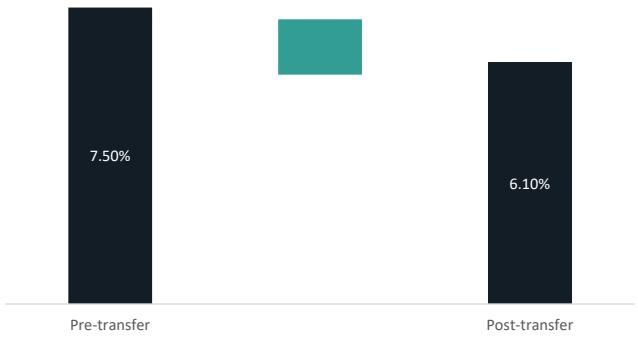
Figure 3: Key Highlights and Recovery Scenarios

Particulars	Amount (Rs cr)			
Total assets to be transferred	2,00,000			
Central Govt Guarantee valid for 5 years	30,600			
Guarantee % of loans transferred	*15%*			
Phase I				
Assets to be transferred-written off loans	90,000			
	Option I	**Option II**	**Option III**	**Option IV**
Expected realisable value (%)	*15%*	*20%*	*25%*	*30%*
Expected realisable value (Rs cr)	13,500	18,000	22,500	27,000
Cash @ 15%	2,025	2,700	3,375	4,050
% of original loan value	*2.3%*	*3.0%*	*3.8%*	*4.5%*
SRs @ 85%	11,475	15,300	19,125	22,950
% of original loan value	*12.8%*	*17.0%*	*21.3%*	*25.5%*
Phase II				
Assets to be transferred	1,10,000			

Source: PIB, CARE Ratings

The NARCL would pay 15% of the valuation in cash. As these loans have been fully provided for / written off, the cash equivalent of the provisions would be reversed, and which are not expected to be material as the same would be dispersed amongst several banks. From accounting perspective on an aggregate level, on the liability side, the cash received would be profit from recoveries resulting in an increase in shareholders' funds, while on the asset side, investments (equity/ debt in NARCL) would rise. This might change from an individual bank perspective depending on its share in the NARCL's equity and share of the loans transferred to NARCL.

Figure 4: Movement in GNPA ratio due to transfer to 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, with an additional assumption that around 50% of the first tranche (approximately Rs 45,000 crores) would consist of accounts that have been written off and are not part of the GNPAs, the portion of GNPAs that would be transferred would be around Rs 1.55 lakh crore. Hence the GNPA ratio would reduce by 1.3%-1.4% and hence, the GNPA figure would come at slightly above the 6% level. 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. 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.

The following figure tracks select banks which have indicated the quantum of NPAs that would be transferred to the NARCL.

Figure 5: Banks Assets for NARCL

Bank	Approx. Allo. to NARCL (Rs cr)	As a % share of Phase I	Adv Mar 21
State Bank of India	22,000	24.4%	0.9%
Punjab National Bank	8,000	8.9%	1.1%
Union Bank of India	7,800	8.7%	1.2%
Bank of India	3,530	3.9%	0.9%
Central Bank of India	2,700	3.0%	1.5%

Source: Bank filings, CARE Ratings

Concluding remarks

NARCL given its mandate, pedigree and consequent access to capital would be focusing on the larger corporate cases, which the other ARCs would find difficult to match. This is likely to result in these ARCs choosing to focus on the small corporate group as well as the retail/ MSME segment.

NARCL, by enabling banks to reduce a portion of their accumulated NPAs, would be a potent tool towards the resolution of accumulated NPAs. Further, the value realisation would have to be more than the capital put in by the banks as otherwise it would just be shifting of the problem without resolution.

Single point debt aggregation is anticipated to cut through the red tape of multiple approvals and speed the resolution process. Another key benefit of this aggregation would be that the bandwidth of senior management of multiple banks would be freed up to focus on growing the business and not just focusing on these legacy issues. Further, the government too has incentivised early resolution with an increasing level of guarantee fees to be paid over the five year period.

The IBC has witnessed resolutions in a few sectors such as cement with minimal haircuts, while large cases in sectors such as auto are yet to be resolved. Additionally, in a few cases the resolution has been close to the liquidation value implying a haircut of over 90% of the debt. Hence, the value realisation by this development will be closely monitored.

However, these measures address a portion albeit a significant chunk of the accumulated NPAs but does not address the whole. 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 creating a secondary market for bad loans for better price discovery, and faster implementation of IBC.

Annexure - NARCL: Key Details

FAQ	Details
What is National Asset Reconstruction Company Limited (NARCL)? Who has set it up?	NARCL has been incorporated under the Companies Act and has applied to Reserve Bank of India for license as an Asset Reconstruction Company (ARC). NARCL has been set up by banks to aggregate and consolidate stressed assets for their subsequent resolution. PSBs will maintain 51% ownership in NARCL.
What is India Debt Resolution Company Ltd. (IDRCL)? Who has set it up?	IDRCL is a service company/operational entity which will manage the asset and engage market professionals and turnaround experts. Public Sector Banks (PSBs) and Public FIs will hold a maximum of 49% stake and the rest will be with private sector lenders.
Why is NARCL-IDRCL type structure needed when there are 28 existing ARCs?	Existing ARCs have been helpful in resolution of stressed assets especially for smaller value loans. Various available resolution mechanisms, including IBC have proved to be useful. However, considering the large stock of legacy NPAs, additional options/alternatives are needed and the NARCL-IRDCL structure announced in the Union Budget is this initiative.
Why is a Government Guarantee needed?	The Govt support to kickstart the whole process and provide for initial hiccup. Further, resolution mechanisms of this nature which deal with a backlog of NPAs typically require a backstop from Government which imparts credibility and provides for contingency buffers. Hence, GoI Guarantee of up to Rs 30,600 crore will back Security Receipts (SRs) issued by NARCL. The guarantee will be valid for 5 years. The condition precedent for invocation of guarantee would be resolution or liquidation. The guarantee shall cover the shortfall between the face value of the SR and the actual realisation. GoI's guarantee will also enhance liquidity of SRs as such SRs are tradable. –
How will NARCL and IDRCL work?	The NARCL will acquire assets by making an offer to the lead bank. Once NARCL's offer is accepted, then, IDRCL will be engaged for management and value addition.
What benefit do banks get from this new structure?	It will incentivize quicker action on resolving stressed assets thereby helping in better value realization. This approach will also free up management bandwidth enabling them to focus on increasing business and credit growth. As the holders of these stressed assets and SRs, banks will receive the gains. Further, it will bring about improvement in bank's valuation and enhance their ability to raise market capital.
Why is it being set up now?	Insolvency and Bankruptcy Code (IBC), strengthening of Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI Act) and Debt Recovery Tribunals, as well as setting up of dedicated Stressed Asset Management Verticals (SAMVs) in banks for large-value NPA accounts have brought sharper focus on recovery. Despite these efforts, substantial amount of NPAs continue on balance sheets of banks primarily because the stock of bad loans as revealed by the Asset Quality Review is not only large but fragmented across various lenders. High levels of provisioning by banks against legacy NPAs has presented a unique opportunity for faster resolution.
Is the guarantee likely to be invoked?	Government guarantee will be invoked to cover the shortfall between the amount realised from the underlying assets and the face value of SRs issued for that asset, subject to overall ceiling of Rs.30,600 crore, valid for 5 years. Since there shall be a pool of assets, it is reasonable to expect that realisation in many of them will be more than the acquisition cost.
How will Government ensure faster and timely resolution?	The GoI guarantee will be valid for five years and condition precedent for invocation of guarantee will be resolution or liquidation. Further, to disincentivize delay in resolution, NARCL has to pay a Guarantee fee which increase with passage of time.
What will be the capital structure of NARCL and how much will Government contribute?	Capitalization of NARCL would be through equity from banks and Non-Banking Financial Companies (NBFCs). it could also raise debt as required. The GoI guarantee will reduce upfront capitalization requirements.
What will be NARCL's strategy for resolution of stressed assets?	NARCL is intended to resolve stressed loan assets above Rs.500 crore each amounting to about Rs. 2 lakh crore. In phase I, fully provisioned assets of about Rs. 90,000 crores are expected to be transferred to NARCL, while the remaining assets with lower provisions would be transferred in phase II.

Source: PIB

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