

Bad loans and choke points

Poor ecosystem and legal delays frustrate many of the initiatives to create an efficient framework for resolving bad debts of banks. These need to be addressed



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OVER THE LAST five years, considerable progress has been made in resolving and recovering bad debts of banks. Despite this, there are still around Rs 10 lakh crore worth of stressed assets hanging around in the system. The newly-created National Asset Reconstruction Company (NARCL) in the public sector offers hopes for the faster clean up of lenders' balance sheets. This would be the 30th Asset Reconstruction Company (ARC) in the business of resolving distressed assets, but the first in the public sector.

Its greatest virtue lies in the faster aggregation of distressed assets that lie scattered across several lenders. Secondly, its securitised receipts (SRs) carry sovereign assurance. This is of particular comfort to PSU banks as price discovery would not be subject to later investigations. It would initially focus on large accounts with debts over Rs 500 crore. This is also expected to free the banks from the tortuous recovery process and afford them more space to focus on much-needed credit expansion. The newly-minted ARC, NARCL, is not a bank, but a specialised financial institution to help resolve the distressed assets of banks.

While the aggregation of debt is no doubt a distinct advantage, will it deliver better and faster results to lenders in terms of realisation? The proof of the pudding lies in execution and all eyes will be focused on IDRCL (Indian Debt Resolution Company), the operating arm, which would be in the private sector. Can this public/private partnership make a difference?

Over the last three decades, there have been several institutional and policy measures to resolve the bad debts. Institutional measures include BIFR (Board for Industrial and Financial Reconstruction, 1987), Lokadalat, DRT (Debt Recovery Tribunal, 1993), CDR (Corporate Debt Restructure, 2001), SARFAESI (Securitisation and Reconstruction of Financial Assets and Enforcement, 2002), ARC (Asset Recovery Company, 2002). But the resolution for these is a measly 6.2 per cent, 4.1 per cent and 26.7 per cent for Lokadalat, DRT and SARFAESI respectively. The RBI has also launched a slew of measures during 2013-14 to resolve, reconstruct and restructure stressed assets. These too did not deliver and they were all abandoned subsequently. The RBI has again come out with a prudential framework for resolution. A poor ecosystem and legal delays frustrate many of these initiatives. These need to be addressed.

Of the 28 ARCs (private sector) in operation, many are bit players. The top five ARCs account for over 70 per cent of the asset under management (AUM) and nearly 65 per cent of the capital. Either they should consolidate or strategise as niche or regional players. Even private sector ARCs have not done well in the sale of zombie assets. Hardly 13.9 per cent of the assets acquired are actually sold. Financial and business restructuring appears to be more an exception than the norm. Nearly one-third of debts are rescheduled. This is not much value addition to what lenders would have otherwise done at no additional cost. (See table 1)

The IBC, introduced in 2016, was landmark

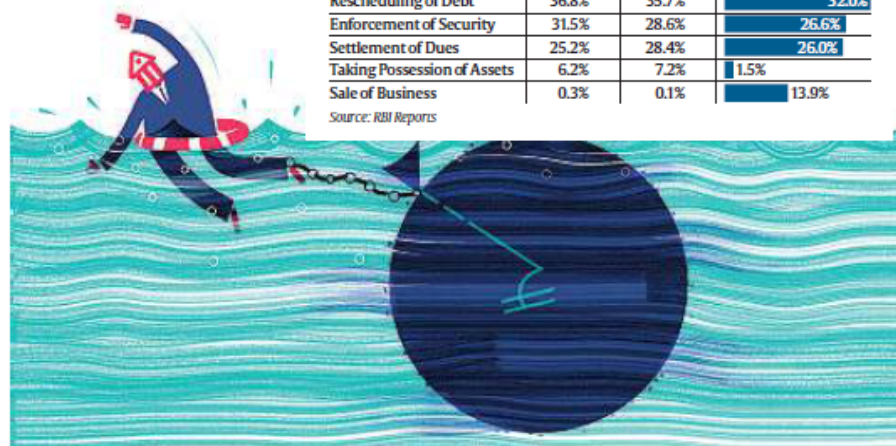


TABLE 1: DISTRIBUTION OF TOTAL ASSETS - RESOLVED BY METHOD OF RESOLUTION IN %

RESOLUTION METHOD	MAR 2018	MAR 2019	MAR 2020
Rescheduling of Debt	36.8%	35.7%	32.0%
Enforcement of Security	31.5%	28.6%	26.6%
Settlement of Dues	25.2%	28.4%	26.0%
Taking Possession of Assets	6.2%	7.2%	1.5%
Sale of Business	0.3%	0.1%	13.9%

Source: RBI Reports

legislation and marked a welcome departure from the earlier measures, with a legally time-bound resolution. The focus is on resolution rather than recovery. Qualitatively, it has instilled a sense of fear in mischievous corporate borrowers who have siphoned off funds, and dethroned them. It nearly put an end to evergreening. Even though there are delays under this newfound promise, they are counted in terms of days and not years and decades. It has succeeded in resolving a few large corporate borrowers with an average recovery of 45 per cent. But there is concern about the elevated haircuts -- in some cases going up to 95 per cent.

The NCLT (National Company Law Tribunal) proves to be the choke point. It is the backbone of the IBC, but lamentably is starved of infrastructure and over 50 per cent (34 out of 63) of NCLT benches were bereft of regular judges. Over 13,170 cases involving distressed debt of Rs 9.2 lakh crore are languishing with the NCLT. Even the parliamentary committee has rightly expressed indignation on a large number of positions left vacant. This lack of adequate infrastructure, coupled with the poor quality of its decisions, has proved to be the IBC's Achilles' heel. We need judicial reforms for early and final resolutions.

Forty-seven per cent of the cases referred to the IBC, representing over 1,349 cases, have been ordered for liquidation. Over 70 per cent of these cases were languishing at the now-defunct BIFR for years and decades. Against the aggregate claims of the creditors of about Rs 6.9 lakh crore, the liquidation value was estimated at a paltry Rs 0.49 lakh crore. Lenders and regulators need to address this issue of delayed recognition and resolution. Perhaps, incentives to lenders for more flexible provisioning requirements would encourage them to recognise early. Business stress and/or financial stress needs to be recognised even prior to regulatory norms on NPA classification.

The tendency to make decisions on the basis of first available information is called "anchoring bias". The first available information in bidding for distressed assets is the cost of acquisition to ARCs. In the case of the IBC process, it is the liquidation value by IBBI valuers. As per reports, distressed assets that are fully provided

for may be taken over by NARCL at 20 per cent. This low cost of acquisition would suffer from the anchor effect and bias. Potential bidders would quote prices nearer to this anchor. This was observed in the IBC bidding process where, in many cases, the quoted prices were close to the liquidation value.

Nobel Laureate Daniel Kahneman has argued that "the anchoring effect is not [a] laboratory curiosity. It can be just as strong in the real world" "When people face a difficult situation they clutch at straw[s] and that straw is [the] anchor straw". This may be mitigated by "opposite thinking". He suggests a three-step process to mitigate anchor bias: One, acknowledge the bias; two, seek more and new sources of information, and three, drop your anchor on the basis of new information. Valuation is a highly contested issue.

The RBI has made considerable progress in bringing about behavioural change in errant and willful defaulters by forbidding them to take back distressed assets. The NARCL should uphold this principle, not dilute it. Otherwise, the credit culture suffers. Second, it should have a sunset clause of three to five years. This will avoid the perpetuation of moral hazard and also encourage expeditious resolution. Third, anchor bias needs to be mitigated by better extrinsic value discovery. Fourth, it should avoid selling to other ARCs.

The NARCL is a welcome initiative. But no number of resolution and recovery tools and frameworks can address the fundamental problem of accumulation of elevated and recurring NPA generation. Prevention of the accumulation of NPAs (below 2 per cent) is critical.

The RBI has recently released (November 2) a report on the working of ARCs. The report vindicates our argument that the performance of ARCs is "lacklustre". The draft report, inviting comments from the public, makes 42 recommendations to improve the performance of ARCs. This article incidentally makes an effort to identify some constraints and offers solutions to improve the performance of ARCs.

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