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Resolving Non-performing Assets of the Indian Banking System

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VI. Resolving Non-Performing Assets of the Indian Banking System—The Role of Asset Reconstruction Companies[1]

A. Introduction

1. **Credit quality is low in the public sector banks (PSBs) and Development Finance Institutions (DFIs), the dominant sub-sectors of the Indian banking system.** The high incidence of non-performing assets (NPAs) was the result of many factors, including poor credit analysis skills and lending decisions, external shocks (e.g., unexpected slowdown in economic activities), and shortcomings in the legal and judicial system that prevent the timely exercise of creditor rights. Resolving the large stock of NPAs has been a policy priority since the start of economic reforms in the early 1990s. However, progress has been limited. Recently, the authorities have been actively pursuing the proposal of establishing an asset reconstruction company (ARC) as a major instrument for facilitating the resolution of NPAs.[2]

2. **International experience suggests that there are common factors that contribute to the success of asset management companies (AMCs).** These include supporting legal and regulatory environment; strong leadership; operational independence; appropriately structured incentives; and commercial orientation. There are, however, alternative strategies for managing and disposing of impaired assets, depending on factors such as the type of asset, size and distribution, the structure of the banking system, and available management capacity in the banks and in the public sector. There is no single optimal solution but rather a combination of solutions for each country that may vary over time and for each bank.

3. **This paper reviews the nature of NPAs in the Indian banking system and discusses the key design features that would be important for the ARCs to play an effective role in resolving NPAs.** The analysis draws upon recent regional and cross-country experiences in dealing with impaired assets during periods of financial crises. The main conclusions are:

- An ARC in India has the potential to contribute to the resolution of the NPAs because such a vehicle provides a mechanism of pooling together scarce skills in managing and disposing of impaired assets. It could also help to resolve the coordination problems of multiple creditors.

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[1] Prepared by Dong He (x34062), who is available to answer questions.

[2] In the international literature such companies are typically referred to as Asset Management Companies (AMCs). In this paper, ARCs and AMCs are used interchangeably.

- However, the potential can only be realized if it is accompanied by changes in the foreclosure laws to speed up the repossession of assets and by the removal of legislation that tends to protect defaulting companies.

- It is critically important to ensure that the ARC has operational independence, is commercially oriented, and has profit maximization as its operational objective. Thus transactions between the ARC and the major banks and financial institutions, which are also likely to be its major shareholders, should be on an arms-length basis and should not be used as an instrument to "window dress" the NPA problem.

- Moreover, since the market price of NPAs is likely to be much lower than the recorded book value (net of provisions) of such assets, the authorities would need to be prepared to let the banks recognize the losses and reduce their recorded capital levels. A recapitalization strategy would therefore have to be worked out.

4. **The remainder of the paper is organized as follows**: Section B describes the nature of the NPA problem in the public sector banks and financial institutions. Section C summarizes the efforts that have been taken by the authorities to resolve NPAs. Section D distills lessons from international experiences in AMCs, and Section E discusses key issues for an effective ARC in India.

B. The Nature of the NPA Problem

5. **PSBs and DFIs have been plagued by a large stock of NPAs.** NPAs before provisioning were 12½ percent of gross credit at end-2000/01 in PSBs. This ratio was brought down sharply from the peak of 25 percent in 1994, mainly on account of a rapid growth in the volume of credits (i.e., the denominator) rather than a decrease in the level of NPAs. Net of provisions, NPAs still account for a sizeable 6¾ percent of net credit (Table VI.1).[3] Credit quality has been even lower in the major DFIs, notwithstanding that

[3] Indian banks, particularly public sector banks, tend not to write off loans but keep fully provisioned loans on the books. One reason often cited is the possibility of being questioned in Parliament and the risk of investigation for favoritism, particularly in the case of large write-offs.

regulations on DFI's income recognition and classification tend to be more lax than those for banks. Moreover, DFIs provision less than banks – net NPAs as a share of net loans are about twice that of banks. (Table VI.2). A large part of the NPAs reflects the legacy of poor quality lending of the past—close to 60 percent of NPAs in the "doubtful" category comprise those credits that have been nonperforming for over two years. (Table VI.3).

6. **The reported NPA numbers are also believed to understate the true magnitude of impaired assets.** Banks are required to classify loan as substandard only once they have been in arrears for more than six months.[4] Exceptions to loan classification are also allowed in cases of agricultural credits.[5] Table VI.4 indicates that loan classification standards in India are less stringent than those that have been adopted by many of its Asian neighbors and other emerging market countries. Private sector analysts believe that NPA levels for public sector banks are significantly higher at 20 to 25 percent of total loans rather than the reported 12½ percent if more conservative classification standards are adopted and ever-greened loans are identified as impaired assets.

7. **Provisioning coverage for NPAs in PSBs, at less than 50 percent, is relatively low.** In contrast, foreign banks in India on average provision at a rate of about 75 percent.[6] The 10 percent provisioning requirement for "substandard" assets may not be sufficiently conservative, given that these assets could be nonperforming for up to one and half years. The current provisioning standard for doubtful loans (the majority of which have been non-performing for over two years) recognizes that the value of collateral may not be fully realized and imposes a haircut of 20 to 50 percent on the market value of collateral in this category. Given that enforcement of creditor claims is extremely difficult under the

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[4] The regulation has recently been changed and banks will be required to classify loans overdue 90 days as substandard, effective from March 2004.

[5] Agricultural credits are treated as NPAs only when they are past due after two agricultural seasons.

[6] This probably understates foreign banks' practices. Foreign banks write off NPAs more quickly. Had they kept these assets on the books as domestic banks do, the rate of cumulative provision relative to gross NPAs would be higher. An alternative method for examining this issue is to consider the present value of nonperforming assets, taking into account the fact that court judgments against defaulters take ten years or more. If only 50 percent of the face value of the NPAs is recovered in 10 years, and assuming a discount rate of 10 percent, the loss would be 80 percent on a present value basis.

Table VI.1. Loan Quality of Commercial Banks, 1997–2001[1]

(In percent)

	Gross NPAs/ Gross Loans		Net NPAs/ Net Loans		Net NPAs/ Equity[2]
	1997	2001	1997	2001	2001
Public sector banks	17.8	12.4	9.2	6.7	80.9
Old private banks	10.7	11.1	6.6	7.3	69.1
New private banks	2.6	5.1	2.0	3.1	21.7
Foreign banks	4.3	6.8	1.9	1.9	11.4
All banks	15.7	11.4	8.1	6.8	65.2

Source: *Report on Trend and Progress of Banking in India*, various years, and staff estimates.

[1] Data are as of end-March of the referenced year.
[2] Equity is defined as Tier I capital.

Table VI.2: NPAs of Development Finance Institutions

(As of end-March)

	Gross NPAs outstanding (In billions of rupees)			Net NPAs/Net Loans (In percent)		
	1999	2000	2001	1999	2000	2001
IDBI	64.9	76.8	83.7	12.0	13.4	14.8
ICICI	36.2	39.6	29.8	7.8	7.6	5.2
IFCI	42.3	41.0	39.0	20.8	20.7	20.8
Total[1]	143.4	157.4	152.5	12.0	12.3	11.7

Source: *Report on Trend and Progress of Banking in India*, various issues.

[1]The sum of IDBI, ICICI, and IFCI.

Table VI.3. Classification of NPAs of Public Sector Banks

(In percent of total NPAs, as of end-March)

	Sub-standard	Doubtful	Loss	Total
1997	28.5	59.8	11.7	100
1998	31.7	56.5	11.8	100
1999	30.8	56.6	12.6	100
2000	30.7	57.1	12.1	100
2001	26.6	61.3	12.1	100

Source: *Report on Trend and Progress of Banking in India*, various issues.

Table VI.4. Past-Due Criteria in Selected Loan Classification Systems, 2000[1/]

(In months)

Country	Special Mention	Substandard	Doubtful	Loss
Argentina	Up to 3	3–6	6–12	Over 12
Chile (Consumer)	Up to 2	2	4	5
Czech Republic	Up to 3	3	6	12
India	**n.a.**	**Over 6**	**Over 18**	**n.a.**
Indonesia	Up to 3	Up to 6	Up to 9	Over 9
Korea [2/]				
Secured portion	Up to 3	3	n.a.	n.a.
Unsecured portion	n.a.		3	3
Malaysia	n.a.	3–6	6–9	Over 9
Mexico (credit card)	1	2	3–6	Over 7
Philippines	Up to 3	Over 3	Over 6 [3/]	Over 6 [4/]
Poland	Up to 1	1 or qualitative	3	6; borrower in bankruptcy
Russia	Up to 5 days	Up to 1	1–6	Over 6
Thailand	n.a.	3–6	6–12	Over 12

Source: Adapted from Cortavarria et al. (2000).

Notes: n.a. means "not applicable."

1/ Other criteria, such as repayment capacity may also apply to loan classification (as shown, e.g., in the case of Poland). Several of the countries listed additionally use "pass" and "special mention" as categories above substandard.
2/ The secured portion can be classified as substandard. The unsecured portion may be classified either doubtful or loss depending the possibility of collection.
3/ A past due unsecured loan can be classified as "doubtful" if it was classified as "substandard" in the previous examination, and the principal has not been reduced at least 20 percent during the previous 12 months.
4/ Six months overdue for an unsecured loan, or six months for a secured loan not in the process of collection and interest unpaid for six months, and loans classified as "doubtful" on which no payment has been done for the last twelve months. Past due loans that are well secured may be classified as substandard-secured.

current legal system, these provisioning requirements may not adequately reflect the true likelihood of recovery. Table VI.5 compares the level of required provisions in India and in other emerging market economies.

Table VI.5. Levels of Required Provisions in Selected Countries, 2000[1/]

(In percent)

Country	Pass [2/]	Special Mention[3/]	Substandard	Doubtful	Loss
Argentina	1	5	25	50	100
Chile	0	1	20	60	90
Czech Republic	2	5	20	50	100
India	**0.25**	**n.a.**	**10**	**20–100**	**100**
Indonesia	1	5	15	50	100
Korea[4/]	0.5	2	20	50	100
Malaysia [5/ 6/]	1.5	n.a.	20	50	100
Mexico	0.5	10	45	65–85	100
Philippines [6/]	2	5	25	50	100
Poland	0	5	20	50	100
Russia	1	n.a.	20	50	100
Thailand	1	2	20	50	100

Source: Adapted from Cortavarria et al. (2000).

1/ For commercial loans, G-10 countries do not have such general guidelines. Banks are expected to develop suitable and appropriate levels of provisioning based on loss experience and accounting practices.
2/ Considered general provision in Czech Republic, India, Indonesia, Korea, Malaysia, Philippines, and Thailand.
3/ Considered general provision in Korea and Thailand.
4/ That portion of a loan classified doubtful or loss that is fully secured will normally be classified substandard to the extent of the market value of collateral.
5/ Computed against total outstanding loans, including interest, and net of interest in suspense and specific provisions.
6/ Provision computed against uncollateralized portion, in case of doubtful and loss.

8. **The distribution of NPAs among banks and DFIs is uneven**. The ratio of net NPAs to net advances ranged from highs of 20.8 percent in IFCI and 18.3 percent in Dena Bank to a low of 2 percent in the Corporation Bank, as of end-March 2001. Even though the ratio of net NPAs to net advances in the State Bank of India (SBI), the largest bank, was relatively low at 6 percent, the gross NPAs on the books of the SBI were 23 percent of the total NPAs of the public sector banks and DFIs,[7] owing to its large market share. Including its subsidiaries, the SBI group made up 30 percent of total NPAs. The other large holders of

[7] Including only IDBI, ICICI, and IFCI.

NPAs were IDBI (12 percent), Bank of Baroda (5.7 percent), IFCI (5.6 percent), and Punjab National Bank (5 percent). Thus the top five holders of the NPAs made up 51 percent of the total NPAs in the system. In comparison, the NPAs of the three "weak banks," namely the Indian Bank, UCO Bank, and the United Bank, were only 6.6 percent of the total.

9. **The size and sectoral distribution of NPAs in PSBs** is shown in Table VI.6. A closer examination of the data indicates that about half of the NPAs were of fairly small size.[8] About 45 percent of the NPAs in public sector banks were accounted for by priority sector lending, which tends to be of smaller size than non-priority sector loans.[9] The rest of the NPAs were mostly loans to the medium and large industrial sector rather than the service sector. Industrial sector loans are typically collateralized with fixed assets of the borrower, thus the value of such collateral is closely related to the overall performance of the borrower.

Table VI.6. Sectoral and Size Distribution of NPAs in PSBs

(As of March 31, 2001)

	Amount (In billions of rupees)	Percentage of Total
Large industries	115.0	21.0
Medium industries	86.6	15.8
Other non-priority sectors	95.2	17.4
Agriculture	73.1	13.3
Small scale industries	102.9	18.8
Other priority sectors	61.7	11.3
Public sector units	13.3	2.4
Total	547.7	100

Source: Muniappan (2002)

[8] The size distribution of lending by public sector banks was as follows: credits that were smaller than Rs. 200,000 (US$4200) in amount were about 25 percent, credits that were between Rs. 200,000 and Rs. 100 million (US$2.1 million) in amount were about 50 percent, and credits above Rs. 100 million in amount were about 25 percent, of all credits outstanding.

[9] Under the priority sector lending requirement, domestic banks are required to lend 40 percent of net credit (on a flow basis) to priority sectors that include agriculture, small scale industries, the export sector, and "weaker" sections of the community. As of end-March 2001, loans to small scale industries accounted for 43 percent of all priority loans by public sector banks and agricultural loans were 30 percent of the total.

10. **Another feature of the NPAs in India is that the large-sized loans have often been in the form of consortium lending**, i.e., such loans involve multiple creditors. Different creditors often have different motivations and strategies of dealing with a delinquent borrower, and the lack of coordination among creditors has been cited as an important reason for the failure to reach loan workout agreements.

11. **The high stock of NPAs has a number of negative consequences for the Indian economy and the banking system**. To the extent that NPAs were incurred by loss-making borrowers, they represent a misallocation of scarce capital resources, which imposes a high opportunity cost to the Indian economy. From the banking system's point of view, high loan loss provisions, which have averaged annually above 1 percent of assets, reduce net profits and tend to put pressure on the lending rates. High real lending rates discourage new and credit-worthy borrowers from seeking loans from banks, with negative consequences for real economic activity. From a macroeconomic policy point of view, rigidities in lending rates that result from the large stock of NPAs dampen the effectiveness of monetary policy. In addition, to the extent that the public sector banks have to be recapitalized by the government because of the credit losses, the NPAs represent a source of quasi-fiscal liabilities.

C. Current Avenues for Resolving NPAs

12. **Recovery of NPAs through either negotiated settlement or through filing suits with the court system has been hampered by the "public character" of PSBs**. Even though negotiated settlement of NPAs has been found less costly and faster than legal remedies and have been quite successful with small borrowers, it has not been used for the resolution of larger NPAs.[10] Settlement of such loans by PSBs has been hampered by fears of prosecution by the Central Bureau of Investigation (CBI) and Central Vigilance Commission (CVC), an anti-corruption watch dog set up by the government. The CBI and the CVC can question settlements that result in book losses to a public sector bank, since they involve a reduction in the capital share of the government. This threat naturally dampens the enthusiasm by the managers of the PSBs for settlement, especially since the management receives no clear benefit from resolving the situation by settlement.

13. **Judicial and legal weaknesses are also a major factor in India's high NPAs.** Court judgments against defaulters take ten years or more and even then may not be enforced. Roughly 1.4 million court cases are pending. In addition, suits for debt recovery are

[10] In July 2000, the RBI issued guidelines for a one-time compromise settlement scheme that allowed banks to provide concessions in accrued interest in order to facilitate repayment of NPAs of smaller sizes (up to Rs. 50 million). The scheme appeared to be successful, with the amount of recovery reaching Rs. 22 billion as of July 30, 2001. In August 2001, the RBI also issued guidelines for a non-statutory mechanism for Corporate Debt Restructuring (CDR), following the principles of the London Approach. However, this mechanism has not been actively used up to now.

barred once a company is designated as a sick unit, under the purview of the Board for Industrial and Financial Restructuring (BIFR, established under the Sick Industrial Companies Act of 1985). Though the BIFR procedure was designed with the idea of quick bankruptcy proceeding (modeled on the U.S. Chapter 11), in practice it usually takes four years or more even to decide whether a firm is viable. These delays and favorable treatment for "sick" firms, such as relief from debt service obligations and, in the past, access to low cost credits, have led even some non-sick firms to take advantage of "sick status."[11]

14. **Since 1993, the government has begun setting up special debt recovery tribunals (DRTs) to bypass the courts and provide speedier resolutions, but so far this has not had a major impact**. The tribunals were given authority over credit-related cases and the transfer of pending cases was mandatory. However, resources and skills were insufficient. Delaying tactics were not penalized and no penalties exist for violation of sanctions. There have been important efforts to improve the effectiveness of the tribunal system, including a March 2000 amendment to the Debt Recovery Tribunals Act that provided for the attachment of collateral, and the 2000/01 budget provided for a substantial increase in the number of tribunals and their staff. Nevertheless, now even with 29 tribunals and 5 appeals tribunals, they are clearly insufficient. As of September 2001, the DRTs had disposed of only 18,703 cases (less than 0.2 percent of the pending court cases) and had recovered only Rs. 35 billion.

D. Lessons from International Experiences

15. **AMCs have been used extensively as an instrument of bank restructuring in countries that have experienced banking problems in the past two decades**. Their roles have also become prominent in the resolution of the Asian financial crisis of the late 1990s. However, the performance of the AMCs in achieving their stated objectives has been

[11] As at the end of March 2000, the outstanding bank credit to the sick/weak industrial units amounted to Rs. 237 billion, close to 40 percent of total NPAs of the banking system (although outstanding loans to these units are not all NPAs).

Table VI.7. Key Features of AMCs in Asia: Korea, Malaysia, Indonesia, Thailand

	KAMCO (Korea)	Danaharta (Malaysia)	IBRA (Indonesia)	TAMC (Thailand)
Objectives	Freeing banks from NPLs and supporting corporate restructuring while maximizing recoveries	Freeing banks from NPL problem; maximizing recoveries	Assist banks in recapitalizing; aim at maximizing recoveries	Supporting recovery of the corporate sector
Structure—Policy Board	Professional Management Committee, with 5 out of 10 members from the private sector	Professional and independent Board of Directors, with 6 out of 9 members from the private sector	Professional Oversight Committee, with most of the 7 members from the private sector	Non-professional Board of Directors, with 3 out of 11 members from the private sector
Disclosure of financials (FS)	FS: independently audited, published semi-annually	FS: independently audited, published semi-annually	FS: independently audited, published annually	FS: audited by Auditor-General of Thailand, published semi-annually
Criteria for Asset Transfer	▪ Ordinary NPLs (overdue more than 3 months) ▪ Special NPLs (court approval obtained for restructuring)	▪ NPLs over RM 5 million ($1.3 million), in most cases ▪ NPLs from FIs seeking state recapitalization (at least 10% of their loan portfolio)	Classified loans (Cat. IV and V) from closed, state-owned, and jointly recapitalized banks	▪ Private banks: multi-creditor, secured NPLs over B 5 million ($110,000) ▪ State financial institutions: all NPLs eligible
Purchase/Transfer Price	▪ Ordinary NPLs: 45 percent of appraised value of collateral less senior liens ▪ Special NPLs: NPV of projected cash flows. ▪ Unsecured loans: 3 percent of face value	▪ At market value as appraised by Danaharta based on independent auditors ▪ Gain-sharing with 80 percent (after deducting costs) to financial institution	Purchased at zero value but bank losses from the sales were effectively shouldered by the state (see below)	▪ Private bank NPLs: collateral value—appraisal standards by TAMC ▪ State NPLs: collateral value ▪ Unsecured loans: to be decided ▪ Gain-loss sharing: cap bank losses at 30% of transfer price
Pays with	Interest bearing KAMCO bonds guaranteed by the government	Zero coupon Danaharta bonds guaranteed by the government	Bank losses from selling NPLs at full discount were made up with issuance of interest bearing government bonds	Interest bearing TAMC bonds guaranteed by the FIDF
Funding	▪ Contributions from FIs; ▪ Borrowing from Korea Development Bank; ▪ Issuance of government guaranteed bonds	▪ Government capital injection; ▪ Loans from Khazanah/EPF ▪ Issuance of zero coupon government guaranteed bonds	▪ Government capital injection ▪ Operational cash-flow from asset recoveries	▪ FIDF capital injection ▪ Issuance of FIDF guaranteed bonds ▪ Loan recoveries
Asset disposition and management	Auction; public sale; equity partnership; and securitization	Private auction; tenders; securitization; special administration (business restructuring)	Debt and business restructuring of larger loans; outsourcing of medium sized loans; auctions of smaller loans; foreclosure	Debt and business restructuring; foreclosure; outsourcing
Special powers	n.a.	▪ Appointment of special administrator for business restructuring ▪ Foreclose on collateral	Power to seize debtor assets (PP17)	▪ TAMC administered business restructuring largely bypassing court process ▪ Foreclosure on collateral

Source: IMF (2001).

mixed in many countries, suggesting that potentially serious pitfalls could exist in their operations. This section summarizes the key factors that contribute to the success of AMCs in achieving their objectives.[12]

16. **Policy makers need first to decide that an AMC is indeed a necessary instrument to have in order to resolve the non-performing loans of the banking system.** Establishment of an AMC may be useful when the size of the problem reaches systemic proportions so that special management skills are needed. An important purpose of having asset management companies is the managerial factor. The handling of bad loans and assets requires other skills than are normally available in a bank. Real estate specialists, liquidation experts, and people with insights into various industrial sectors may be needed. In addition, managing large amounts of bad assets would interfere with the daily running of the bank. If a separate AMC is established to handle the bad assets, both the good bank and the AMC could be given independent and transparent profit goals. That would provide clearer incentives for managers and staff. Moreover, to the extent that the workout of non-performing assets is hampered by a lack of coordination among different creditors, a AMC could facilitate the resolution of such loans with multiple creditors.

17. **Experience has shown that AMCs with clearly defined, focused, and consistent goals are more likely to be effective.** Different countries have taken different approaches to defining the goals for their AMCs. In some countries the AMCs functioned mainly as rapid disposal vehicles, where the goal was to dispose of the asset as quickly as possible so as to avoid further deterioration in value and to minimize the carrying cost of the government. In other countries the government set up vehicles whose focus was on restructuring. In some cases, the emphasis was on restructuring the nonperforming loans so as to make them marketable. In others, the goal was to achieve broader corporate restructuring of the borrowers and the government owned banks. Regardless of the focuses of different AMCs, their operations should be guided ultimately by the objective of profit maximization or loss minimization, taking into full account market conditions as well as the funding cost to the AMC.

18. **There are no clear-cut rules as to whether a single AMC monopoly (the centralized approach) is preferable to a number of competing AMCs (the decentralized approach).** There are advantages and disadvantages associated with each approach. A very large AMC may obtain economies of scale but could also become unwieldy, which might hamper the ability to react swiftly, such as in sales transactions. In general, the choice of a particular organizational structure for AMCs depend on a number of factors, including types of assets, magnitude of the problem, depth of markets, and characteristics of debtors. For instance, when the types of impaired assets in different banks differ substantially, there may be some rationale to group assets by types and to transfer them to AMCs specializing in the management of a particular type or types of assets. When there is lack of depth in markets for

[12] Table VI.7 summarizes key features of AMCs in Korea, Malaysia, Indonesia and Thailand.

certain assets, there may be stronger rationale for a centralized approach in the disposal of such assets.

19. **AMCs must have adequate legal powers.** The legal basis of the AMC should provide for clean transfers of titles (and the associated priority) in all asset transactions of the AMC. Similarly, legal obstacles for the transfer of assets, such as the requirement that the permission of the debtors be obtained before the transfer of loans can be effected, should be removed. The legal basis should ensure that the AMC "stands in the shoes" of the former bank at least in the eyes of the law. In addition, asset disposal by public AMCs could be retarded by perceived potential legal liabilities accruing to the AMC management. In this situation, legal protection for the employees of the AMCs in the execution of their responsibilities in good faith should be considered. Furthermore, when the existing legal system is not equipped to deal with the magnitude of the nonperforming assets, or when endeavors to reform the system are excessively time-consuming, there may be a case to grant special legal powers to AMCs, as was done, for example, in Malaysia, to facilitate asset recovery and restructuring.

20. **To be effective, an out-of-court process for financial and corporate restructuring needs to be backed up by credible court-supervised processes for seizure of assets, foreclosure, liquidation, receivership, and reorganization.**[13] Without the threat of court-imposed loss, there is not enough incentive for corporate debtors to cooperate with voluntary efforts and agree to asset sales, equity dilution, and diminution of management control that may be part of a fair restructuring deal. While some debtors might voluntarily cooperate, more often the success of out-of-court efforts ultimately depends on the ability of creditors to impose loss on debtors through the seizure of assets, foreclosure, or liquidation. During the Asian crisis, the threat by legal regimes of foreclosure and bankruptcy was relatively robust in Korea and Malaysia. In Thailand and Indonesia, however, the threat remains rather attenuated, even after efforts at reform. Repeated demonstration of an ability by Korea's courts and creditors to seize ownership and control of a debtor corporation encouraged others to cooperate with voluntary workout efforts.

21. **Stakeholders of the AMC must be able to evaluate its performance.** A realistic valuation/pricing of assets based on market pricing, sound accounting norms, strong loan classification and provisioning standards, and/or discounted present values, is crucial to the success of AMCs. Evaluating performance requires proper accounting for the assets at the time of transfer and for cash flows over time. Unfortunately, when AMCs have carried assets

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[13] Box VI.1 lists the key ingredients of an effective corporate restructuring framework that are considered international best practices.

Box VI.1. Suggested Best Practices for Corporate Restructuring

Bankruptcy Regime

- A prompt ability by unsecured creditors to appoint a receiver to liquidate a company for a general failure to service debts on time;
- A prompt ability by secured creditors to seize and sell collateral;
- A court-supervised reorganization framework that protects debtors from asset seizures; provides priority for new lending; gives a debtor and its creditors an opportunity to work out a mutually satisfactory restructuring plan; allows a majority of creditors to "cram down" a reorganization plan on a holdout minority of creditors; and converts the case into a court-supervised liquidation if interim milestones and reasonable deadlines are not met;
- A legal presumption, which can be altered in negotiation, that the equity interests of all shareholders—including minority shareholders—are wiped out in case of corporate insolvency; and
- Substantial institutional capacity, in terms of experienced judges, receivers, and insolvency professionals.

Out-of-Court Processes

- Agreed standards among financial institutions for out-of-court workouts, including appointment of a lead creditor and steering committee; development and sharing of information; priority for new lending; apportionment of losses among creditor classes; thresholds for creditor approval of proposed workouts; and means for the resolution of inter-creditor differences;
- Reliance on market participants to structure and negotiate out-of-court workouts based on available information and the participants' commercial interests; and
- A strong financial regulator able and willing to force banks to take immediate losses on corporate restructuring and to take over banks whose risk-weighted capital adequacy ratio falls below an acceptable level.

Market for Impaired Assets

- A well-developed secondary market for corporate debt, including distressed debt;
- Opportunities and encouragement for banks to set up professionally managed private asset management companies for distressed corporate debt and converted equity;
- If a public asset management company is needed, its operation should be based on best commercial and market principles;
- No legal barriers to the debt/equity conversions or the swift re-deployment of corporate shares, real estate, and productive assets—including through foreign investment, hostile takeover, or merger; and
- No immediate taxation of non-cash corporate reorganizations, e.g., mergers, share swaps.

Source: Adapted from Kawai et al. (2000).

at their old book value, they typically show low recoveries leading the public to believe that the AMC has been a failure. Performance should be measured against either a "mark-to-market" value or an estimated recovery value at the time of transfer. If assets transfer at book value then appropriate provisions should be established as soon as possible after transfer, so that the initial shortfall is clear to everyone and performance is measured against original book value net of provisions.

22. **To shield the AMC from undue political influence, steps should be taken to ensure its operational independence.** Because AMCs handle large volumes of assets, and in some countries may control a significant percentage of the wealth of the nation, it is important that they be insulated from political interference in the disposal and restructuring of assets. One approach is to establish the AMC as an independent entity not subject to the whims of the legislative process. It should be governed by an independent and professional board of directors. In addition, it should be given independence from the budget appropriations process in the same manner as that of central banks. Rather, the AMC should fund its operating expenses from its own cash flow.

23. **There is a need for a structure of incentives that are designed to ensure effective and efficient asset management and disposal.** A right incentive structure needs to address both the issues of the limited life of the entity and the performance of the staff. One option is to limit the life of the AMC at the time it is created. Another approach is to develop incentives for the board members so that they will counterbalance the motivations of the staff to prolong the life of the AMC unnecessarily. In addition, a large part of the compensation packages for staff should be performance based. Just as an AMC's performance should be judged based on its recoveries compared to the original estimated recovery value, a similar approach should be used for establishing performance goals for employees and managers.

24. **When public AMCs have discretion in the choice of assets to purchase or take over, they should apply strict criteria in the selection of the assets.** In principle, they should only take on those assets they are likely to manage more effectively. For example, small credits whose recovery can be undertaken more efficiently by the bank branches where the credit originated should also be left with the banks, but fixed assets such as foreclosed properties and loans that require foreclosure or settlement with debtors are good candidates for transfer to AMCs.

25. **Innovative vehicles may be needed to deal with the financing needs of a corporate borrower that is implementing a restructuring plan approved by its creditors.** When a NPA is purchased by the ARC, the banking relationship between the borrower and the bank typically ends. In principle, NPAs owed by borrowers that are potentially viable, perhaps after financial and operational restructuring, should stay with the bank, although the bank's existing claims against the borrower may need to be restructured through financial engineering techniques such as a debt/equity swap. Nevertheless, the ARC could still play an important role. The ARC could sponsor corporate restructuring or de-leveraging funds, which can be set up to manage the corporate restructuring tasks on the banks' behalf, since banks are not typically good at managing equity stakes in industrial companies. Therefore, the relationship between the ARC and the banks is likely to be more complicated than a straightforward one of buy and sell.

26. **The transfer of assets to the AMCs should be executed at fair market prices.** Several approaches to transfer pricing have been used, each with their own benefits and limitations. A uniform price can be established, based on a fixed portion of book value. This approach permits quick transfer without delays in negotiations with the bank but raises the

possibility that the AMC purchases the worse assets while the bank retains the better assets. An alterative is to set a price that can be adjusted in light of eventual proceeds. A drawback of this approach is that it may reduce the willingness of the sellers to part with the assets since they will still maintain their exposure to the final price of the assets. In this situation, some form of profit-loss sharing arrangement can help overcome this problem. In Thailand, for example, the originating bank and the Thai Asset Management Corporation (TAMC) would share equally the first 20 percent of the gains relative to the transfer price, with the remainder accruing to the banks. In the event of a loss, the banks' losses will be capped at 30 percent of the transfer price.

27. **Speed of disposal of impaired assets should be primarily a commercial decision.** It should be guided by the goal of maximizing the value of assets by taking into account of market conditions as well as the funding cost of the asset management companies. The AMC typically faces conflicting pressures when it comes to the disposal of its assets. The AMC may sell its assets immediately, reducing the concerns about warehousing of assets but accepting fire sale prices. Alternatively, the AMC may seek to manage the assets, waiting for a recovery of the economy and the opportunity to sell the assets gradually into the market. However, managing assets creates the significant risk that asset values will deteriorate, particularly if the skill mix of the AMC staff is in asset resolution rather than the long term management of assets. While a number of alternatives have been suggested (including competitive bidding, securitization of income streams from assets, and put-back clauses in the sales contract), there is little experience to date on the final resolution of assets. Sweden allowed a five-year period for the resolution of the asset and the United States allowed seven years. Other AMCs, however, continue to struggle with asset resolution.

E. Key Issues for An Effective ARC in India

28. **In the 2002/2003 budget, the government announced plans to establish a pilot ARC in India by June 2002.** In parallel, the government plans to submit to Parliament a Banking Sector Reforms Bill that will provide an enabling legal environment for the development of a market for impaired assets. It is envisaged that the pilot ARC will initially have a small capital base and will be incorporated as a private sector entity, to be owned jointly by public sector banks and financial institutions, multilateral institutions, and other private sector investors and to be run by professional managers. Other details of the proposal are still being worked out.

29. **To be effective, the ARC should be designed to reflect the nature of the NPA problem in India, as well as to follow international best practices.** There are a number of key considerations in the Indian context. First, the legal and judicial environment must be improved for timely exercise of creditor rights. The value of impaired assets will increase substantially if foreclosure rights are strengthened and the bankruptcy procedures are streamlined. Second, the ARC should be managed and run on commercial principles. Transactions between the ARC and the public sector banks and financial institutions, which will be its major shareholders, should be on an arms-length basis so that transfer prices will be market determined. The ARC should not be used as an instrument to "window dress" the

NPA problems of its major shareholders. Third, the authorities have to be prepared to allow the major banks to recognize hidden credit losses and a strategy for filling recapitalization needs to be put in place, otherwise few transactions will take place.

30. **An effective ARC in India must operate under a conducive legal framework.** The ARC must have sufficient legal powers to recover assets, such as the ability to attach assets and foreclose on collateral without going through the court system. Furthermore, in order that delinquent borrowers will have the right incentives to cooperate in good faith with the ARC, the Sick Industrial Companies Act must be repealed and the BIFR be abolished. In its place, an effective insolvency regime for the corporate sector should be put in place (see Box VI.1). This does not imply that the ARC should not be established before such legal reforms are implemented. It is nevertheless true that the ARC will not be effective in achieving its objectives without such legal reforms.

31. **Mixed ownership of the ARC has complex implications for a number of operational issues.** An important issue relates to whether the government should guarantee the liabilities issued by the ARC as a source of funding. Although a government guarantee could help the ARC have easier access to market funding and lower its funding cost, it has important implications for incentives. Without a government guarantee, bond holders must look to the value of the assets for payment and the ARC will be motivated to ensure that assets are properly valued when they are transferred to the ARC. Moreover, there will be an ongoing incentive for revaluation and proper financial reporting. With a government guarantee, these incentives will, to a large extent, be dulled and the resultant moral hazard could expose the government to higher fiscal costs. On the other hand, even without an explicit guarantee, investors may believe that there is at least an implicit government guarantee on the bonds issued by the ARC of mixed ownership. Thus the government will need to weigh the benefits and costs of guarantees and clarify its intention explicitly.

32. **Ownership of the ARC by the PSBs and DFIs also raises the potential of conflict of interest**, as the PSBs and DFIs will be both its major shareholders and customers. As shareholders, they have an interest in the financial performance of the ARC. As sellers of NPAs, they have an incentive of asking for the highest price on the assets to be sold, which would have a negative impact on the profitability of the ARC. Resolving such a conflict can be tricky. It is thus important that the ARC should have operational independence and be managed and staffed by professionals with properly designed incentive structures.

33. **The development of a market for impaired assets depends crucially on the willingness of banks to recognize the hidden losses.** As discussed earlier, the loan loss provisioning cover of the NPAs does not adequately reflect the likelihood of loss in the Indian context. Thus transferring the NPAs at market prices would imply that the selling banks will have to recognize the hidden losses and take a hit on their capital. In the absence of the willingness and/or the ability to take such losses, NPAs will likely not be transferred, and few transactions would take place. The regulatory authorities should encourage the recognition of such losses even if they negatively impact the capital adequacy levels. For the

government, a proper analysis of the likely magnitude of losses should be done and a strategy of recapitalization should be developed and implemented.

34. **An important operational issue concerns the choice of banks from which the ARC should buy NPAs.** Previous proposals have focused on the NPAs of the "weak banks" and the ARC was seen as an instrument to facilitate the restructuring of such banks. However, as discussed earlier, the NPAs held by the "weak banks" are only a small part of that of the banking system. Thus, any attempt to reduce the NPA level of the system should include the largest holders of NPAs, not just the "weak banks." In addition, it appears that, based on available data, at least half of the NPAs are of fairly small size and are probably not suitable for purchase by the ARC. The PSBs should be encouraged on a regular basis (rather than on a one-off basis) to reach debt restructuring and workout solutions with such small borrowers. Loan workouts should be seen as a commercial exercise without political connotations. In this regard, operational freedom that allows speedier loan workout and write-off should be part of the larger effort to increase the commercial orientation of PSBs.

35. **An effective strategy of NPA resolution has to involve the financial and operational restructuring of unviable industrial borrowers.** Because the representative NPAs of larger size are industrial loans collateralized by the fixed assets of the borrowers, they typically do not have much value if the viability of the borrower is in doubt. However, corporate restructuring has been a difficult process worldwide. Its success depends not only on an efficient and effective corporate insolvency regime, but also on labor laws, competition policies, trade policies, and other structural factors. From this perspective, the resolution of the NPAs in the banking system is only a part of the larger effort of industrial restructuring and structural reforms. It is inherently difficult and requires strong political leadership. While setting up the ARC provides a potentially useful instrument to facilitate bank and corporate restructuring, it would be naïve to expect that it alone will be the panacea for the resolution of the NPA problem of the Indian banking system.

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