Asset Re-construction and NPAs – are we on the right track?

by *Sundar Sankaran*[*]
[Published December 30, 2001]

The nationalized banks in India are saddled with non-performing assets (NPAs) in excess of Rs50,000 crore (US$10.4bn). Add the NPAs of other banks, financial institutions. The country has a problem of mammoth proportions.

Do we know another country with similar problems? Yes. China. The problem loans in China are believed to be in excess of US$200bn – more than 60 per cent of these are dues from state-owned factories.

How has China dealt with the problem? Way back in 1999, it constituted four asset management companies - Orient, Cinda, Great Wall and Huarong – to recover NPAs of China's banks. The four have flexibility in determining their approach to recovery. Huarong recently sold $1.3bn worth of NPAs to a foreign consortium led by Morgan Stanley that includes Lehman Brothers, Salomon Smith Barney and KTH Capital Management. It recovered a mere 9 per cent of book value – albeit with an arrangement to share the upside, if the consortium earns more than their "preferred return" of around 20 per cent within 24 months.

How is India dealing with the problem? As can be expected, a committee is in place! The committee recently suggested the constitution of an Asset Reconstruction Company (ARC) with share capital of Rs200 crore (US$41.5mn) contributed by 31 lending organizations including 27 public sector banks. Industrial Development Bank of India (IDBI) is to work out the finer details. Transfer of assets to the ARC would be on the basis of consultation between the bank/FI, the ARC and an outside professional body.

The ARC route has a number of benefits – one, the sour grapes get identified and segregated, so that the rot does not spread to the good assets; two, the recovery process would entail either helping the borrower get back into the black or initiating strong-arm recovery processes, both of which are activities that require specialized skills.

I see three problems with the Indian approach. Firstly, the urgency levels demonstrated are inconsistent with the gravity of the problem. Secondly, transferring NPAs to an ARC addresses the symptoms, not the source of the problem. Thirdly, the single ARC approach would be disastrous.

No doubt a single ARC approach ensures that no effort is wasted with more than one ARC chasing the same defaulter. But are we not creating a monopoly with no benchmark to compare it against? Would it not be better to have multiple ARCs – each pursuing its own recovery strategy? What would happen if a bank / FI is not happy with the proposed valuation for transfer of its NPAs? Does it have any other alternative?

A strategic approach to the issue throws up the need for three distinct initiatives–

Deterrent measures – *How to prevent problems*

A significant portion of defaults in the country is caused on account of "unwillingness to pay" rather than "inability to pay". There is therefore a need for deterrent regulation, making it easier and faster to re-possess assets, determine liabilities etc. This would deter "voluntary defaults".

...2

[*] Sundar Sankaran is Director, Advantage-India Consulting Private Limited

Value Protective measures – *How to prevent problems becoming bigger*
The tendency to support unviable units leads to a double whammy. Good money follows bad money into the unit. Further, the assets – whether tangible machines or intangible brands - lose value if not properly exploited. A process of compulsory management change followed by a viability call and operating in an environment of quick exit would avoid escalation of problem cases.

India does not need a Sick Industrial Companies Act. The need is for a Protection of Business Value Act. This could provide for an institutional mechanism of Certified Value Protectors (CVP) having the requisite business and organization skills to provide alternative management for units where viability is not certain. Upside for the CVPs could be generous and linked to turnaround.

Based on measurable yardsticks such as interest of CVPs in taking up the case, performance against agreed time-bound targets etc, if the view is that a unit is not viable, then a stop-loss call of quick exit has to be taken.

Recovery measures – *How to extract whatever is encashable*
Once the stop-loss call has been taken, the focus should be to encash whatever value is possible through the legal route and give the NPA a quiet burial. Such encashment could be through auctions, where the bidders would be from the ranks of ARCs.

A regulatory environment that is not as stringent as the normal NBFC framework and which ensures smoother recovery processes could lead to several ARCs in both the private and public sectors. A process of market-led churning would ensure that over a period of time, India has 4 or 5 solid ARCs, with a reputation for different strategies, sectors etc.

The above approach would ensure that resources in the economy are put to the best possible use. But a consequence would be earlier employee separations. How will these employees survive? Social security mechanisms, backed by the government are inevitable. How to fund this in the current context of government finances? That deserves a separate spotlight!

The nationalized banks in India are saddled with non-performing assets (NPAs) in excess of Rs50,000 crore (US$10.4bn). The problem loans in China are believed to be in excess of US$200bn.

How is India dealing with the problem? As can be expected, a committee is in place! A strategic approach to the issue throws up the need for three distinct initiatives –

Deterrent measures – A significant portion of defaults in the country is caused on account of "unwillingness to pay" rather than "inability to pay".

Value Protective measures – India does not need a Sick Industrial Companies Act. The need is for a Protection of Business Value Act.

Recovery measures – The focus should be to encash whatever value is possible.

The above approach would ensure that resources in the economy are put to the best possible use. But a consequence would be earlier employee separations. How will these people survive? That deserves a separate spotlight!