



Working Paper Summary:
**Can Asset Reconstruction Companies
(ARCs) be Part Solution to the Indian Debt
Problem?**

Part 1 of 3
April 2017

Credits: Working Paper 338 'Can Asset Reconstruction Companies (ARCs) be Part Solution to the Indian Debt Problem?' by Jamini Bhagwati, M. Shuheb & Ramakrishna Reddy Boghati published in April 2017.

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INTRODUCTION

- India's financial sector is dominated by the banking sub-sector. It is the banks which provide the bulk of the funding not corporate-municipal bond markets or the pension and insurance sectors , where PSBs have been in the lead to provide funding for projects.
- Indian private sector banks have chosen to limit their exposure to shorter-term loans usually not longer than five years in maturity.
- PSBs could have been more circumspect in their medium to long maturity lending , PSBs were at the forefront of risky lending for public-private partnership (PPP) projects .
- Asset Reconstruction Companies (ARCs) were first set up after the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest legislation also known as the SARFAESI Act was approved by parliament in 2002.
- ARCIL was the first ARC set up by the State Bank of India (SBI) and ICICI as the principal share-holders. In the last fourteen years ARCs have grown in number and size but the capital at their disposal is dwarfed by the size of NPLs on bank balance sheets.

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PART I

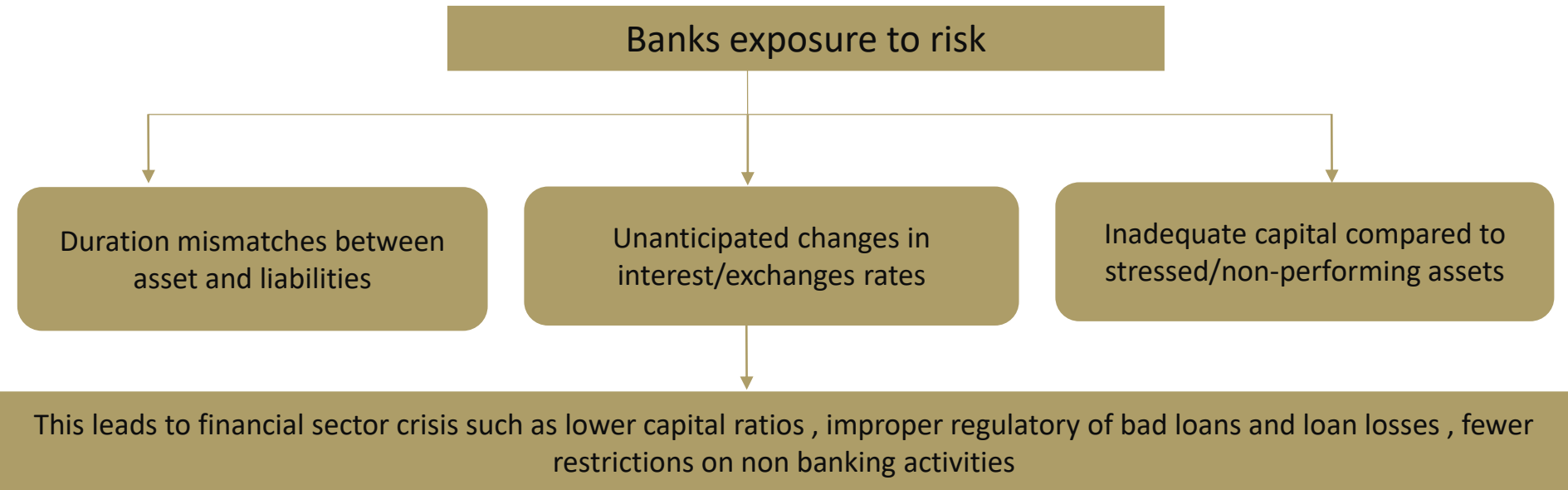
Part I provides an analysis of banking crises in select developed and emerging economies such as:

- Tackling of banking sector crises by government and regulators
- Setting up of Asset Management Companies (AMCs) , Resolution Corporation and Bad banks
- Information on Legislative changes and associated costs



BANKING SECTOR CRISES

Banks provide services of maturity transformation through deposits and long lending which expose them to credit risk over long period .





ASSET QUALITY INDICATION

Banks asset quality indications are a combination of

Non-performing loans
(NPLs) to total loans,

Non-performing loans
net of provisions to
capital

Sectorial distribution
of loans to total loans

Large exposures of
capital to single parties



Comparison of definitions of NPLs for comparing asset quality in different countries

Definition of NPLs in Select Countries

India	United states	Euro-area	Indonesia	China
<ul style="list-style-type: none">• RBI defines an asset as NPA if the asset did not provide any returns for 90 days.• NPAs are classified into sub-standard, doubtful and loss assets.	<ul style="list-style-type: none">• Loans past due for more than 90 days and nonaccrual loans	<ul style="list-style-type: none">• A loan is non-performing when payments of interest and principal are past due by 90 days or more,• Also, when there are good reasons to doubt that debt payments will be made in full.	<ul style="list-style-type: none">• Loans are deemed as NPLs when borrowers do not pay interest or principal for 90 days.	<ul style="list-style-type: none">• Loans for which repayment of principal or interest have been overdue for more than 3 months.



Securum (Sweden)

In 1990s, Sweden faced a banking crisis

↓
Severe credit shortage

↓
Leading to large proportion of non performing loans

↓
Setting up of bad banks to resolve crisis on an ad hoc basis

↓
Sweden's financial institutions faced credit loss of SEK 200 billion

↓
Of total loan Nordbanken had 8% where else Gota bank had 5% losses

↓
The total aggregate loss amounted to 12% of annual GDP

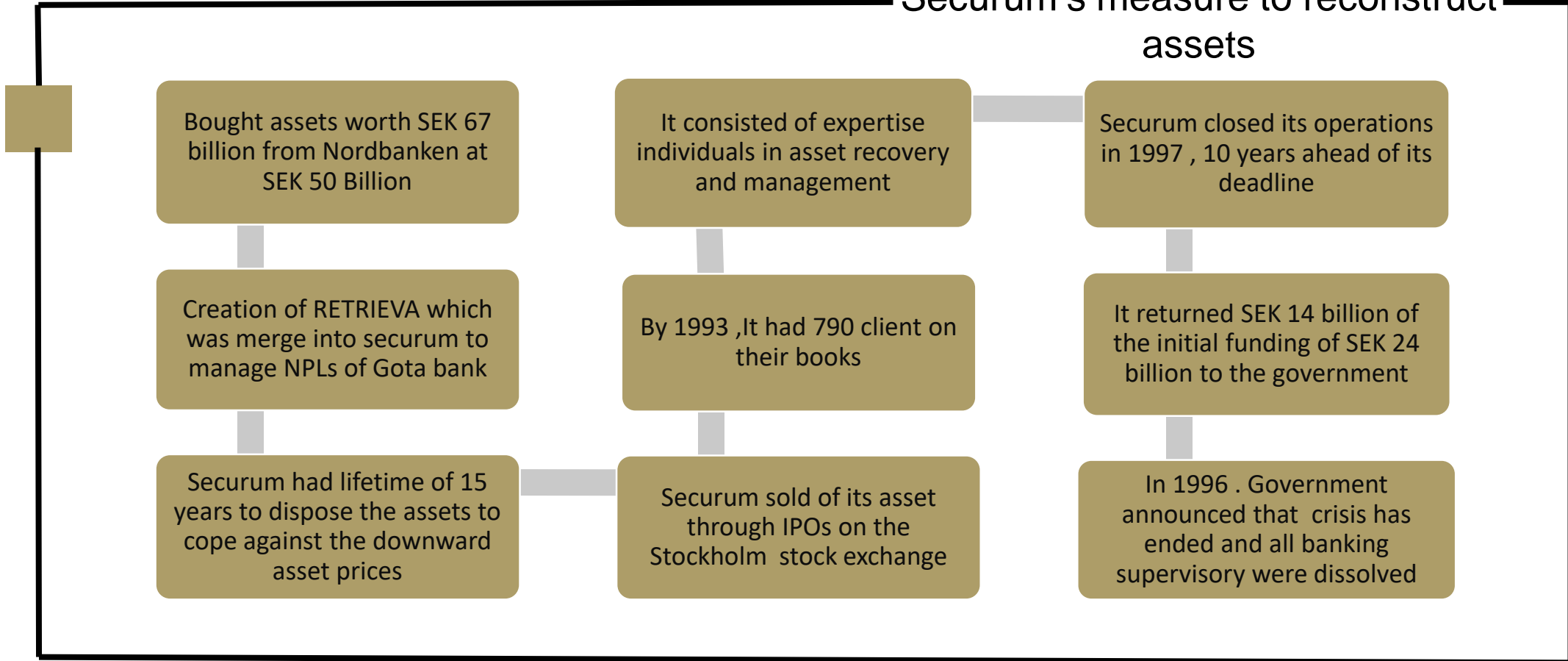
↓
Which resulted in creation of securum to manage bad assets

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Securum's measure to reconstruct assets



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Disposing of asset and criticism

The following factors helped Securum in disposing assets it acquired from Nordbanken and Gota:

- Government's backing and the legislative changes to speed up the recovery process
- Ability to act speedily to dispose assets beyond possibility of recovery
- Revival in property market as 80% of its asset were in real estate sector
- Support by opposition parties in measures taken by the government gained investor confidence

Criticism faced by Swedish government





Resolution trust corporation (RTC)[united states]

On early 1980s, Savings and loan institutions were faced with two problems

It could not offer higher interest rates for deposits

Long-term fixed interest rate mortgages loans

Interest rates were determined by government

When interest rates rose, the value of assets owned by institutions shrank

In an effort to support S&Ls the government deregulated these institutions

It cost around USD 124 billion to solve S&L crisis

United States Government during the S&L crisis was the establishment of a Resolution Trust Corporation (RTC)

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RTC's effort in resolving crisis

RTC was created in 1989 under FIRREA act

To maximize net present value of assets

To minimize the impact of assets of sales on financial markets

It made RTC work on disposing of asset that much more difficult

At the end of 1995 , it resolved 747 thrift institutions

It transferred assets worth US\$ 7.7 billion to FDIC which weren't resolved at the time of closure



Disposal of “troubled” asset post 2008 crisis in US

2008 crisis originated in US was in large scale

Suggestions to set up RTC alike institution

To dispose the troubled asset to bring institutions back to health

NPLs of banks declined after certain peak in 2009(5% of total loans)

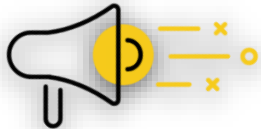
Substantial growth in primary and secondary markets for distressed assets

Regulatory requirements to write-off loans within stipulated time limits

In 2010, US passed DFA act to strengthen the financial system and plug gaps in their regulations

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NPL Crisis (Indonesia)

- In 1998 , Indonesian NPLs had risen to 48.6%
- Indonesian Banking Restructuring Agency (IBRA) was originated
- Its mandate was “to close, merge, takeover and recapitalize troubled banks”
- It took over 30% of banking system
- Acquired assets worth 20% of GDP .
- Legal power was granted to seize the asset of borrower
- Recovery rate was just 8%
- The net cost of the government was 51.9% of GDP.



Key Characteristics of Foreign RTCs, AMC and Bad Banks

Financing

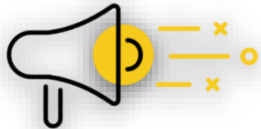
- Bad banks were finance from the issuance of government bonds
- In case of securum and RTC were fully funded by their respective banks

Administration

- Government involvement lead to sub-optimal out comes
- In case of IBRA the chairman was changed 7 times due to interference with lead to low recovery rate

Asset disposal/restructuring

- In case of securum the recovery of property rate were helpful
- In disposing of assets higher value were bundled with less attractive ones
- Wider range of instruments available to AMC was also an important factor



Non performing loans in Europe /Italy

EUROPE	ITALY
<ul style="list-style-type: none">NPLs has increased in Europe from 2.8 % in 2008 to 5.4 % of total gross loans	<ul style="list-style-type: none">The size of NPLs was EUR 356 billion at the end of June 2016 in Italy
<ul style="list-style-type: none">European Commission (EC) approved EUR 4.9 trillion as the total amount of state to restore financial system	<ul style="list-style-type: none">The prolonged slowdown of the Italian economy, particularly since 2008, is the chief contributor to the size of NPAs
<ul style="list-style-type: none">The Bank Recovery and Resolution Directive (BRRD) was introduced under which this 'bail-in' replaced 'bail-out in 2016	<ul style="list-style-type: none">The new NPLs in 2016 were lowest compare to 2008
<ul style="list-style-type: none">Under this directive ,banks which seek state help are put to resolution, and shareholders and junior bondholder shares the burden before taxpayers fund	<ul style="list-style-type: none">Net write down of NPL came down to EUR 191 Billion of which EUR 88 were taken as net bad loans was exposed to insolvent debtors



Role of AMC's in restructuring of NPLs

AMCs could be successful in resolving NPLs which consist of commercial real estate, land and related assets

NPLs are mostly corporate loans, resolution is doubtful given the lack of third party expertise, making AMC successful with condition



Summary

An analysis of cross-country experiences of bad bank/AMC/RTCs can provide important lessons for the current bad debt situation in India.

The following are a few of the reasons for the relative success of these models in foreign jurisdictions:

- Political consensus;
- Efficient legal processes;
- Effective legislative changes to give adequate powers to AMC/RTC;
- Developed financial markets;
- Use of private sector expertise in restructuring/recovering companies



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