

## Attacking NPAs: Is the Asset Reconstruction Company the Solution?

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One of the important measures announced in the recent union budget is the establishment of an Asset Reconstruction Company (ARC). This company is expected to buy non performing loans from banks and off load them to interested buyers. Multilateral institutions like IFC and ADB have apparently shown interest in participating in this scheme.

Attacking NPAs (Non Performing Assets) is one of the biggest challenges our economy faces. After all, only by releasing blocked capital, will the banks be motivated to cut interest rates. (Administrative diktats cannot be used to reduce interest rates on a sustained basis.) So any step in this direction should be welcomed. In many Asian countries, since the currency crisis of 1997-98, the governments have made various efforts to deal with NPAs. It is useful to draw insights from their experiences and understand the challenges which the ARC will face. Otherwise, the ARC might end up as one of those moribund institutions like BIFR.

In Thailand, the government has set up the Thai Asset Management Corporation (TAMC). The TAMC buys state banks' bad loans at about 33% of their face value. There are plans for a similar arrangement with private sector banks as well. TAMC has been empowered to compel debtors to restructure and to foreclose on assets. It also enjoys immunity from prosecution for losses incurred.

On paper, the TAMC scheme looks fine. But there have been problems in implementation. The value of loans purchased from banks has fallen short of expectations. There are fears that TAMC may not be harsh on influential and well-connected debtors. Besides, there is a general feeling that state owned banks are being preferred to private sector ones. There is also a lurking suspicion that the balance sheets of the private sector banks are being cleaned up just to persuade them to start lending again.

In China, loans amounting to an estimated \$1.2 trillion had turned sour by 1995. The government took off bad loans worth \$150 billion from the four big state banks and placed them in asset management companies (AMC) by late 2000. The AMCs are expected to liquidate these loans in the next few years. But doubts still remain whether the AMCs can deliver. Markets do not exist for the repackaged assets. It is also not clear why the AMCs should be more successful than the banks in dealing with the bad loans. Analysts feel that in the absence of restructuring of inefficient industries, freeing up of interest rates and removal of government interference, fresh bad loans may pile up even if the older loans are attacked. Meanwhile, foreign investors who can play an important role in buying the NPAs are worried about the ambiguous legal status of the AMCs and inadequate protection of creditors' rights.

Recently, the Bank of China, the best managed of the four big banks in China admitted that nearly 30% of its loan book was non-performing. The reason for this sad state of affairs is that 60% of loans still go to struggling State Owned Enterprises. So, new bad loans continue to pile up.

China's AMCs are also not in a position to enforce liquidation. The country's inadequate bankruptcy laws prevent any rapid disposal of assets. So, AMCs have resigned themselves to swapping debt for equity in the SOEs. In many cases, the AMCs have issued bonds to buy out the bad loans. Interest has to be paid on these bonds. Any shortfall in realisation by the AMCs at the time of disposal will have to be borne by the state. This would lead to bigger budget deficits and the crowding out effect, defeating the very purpose for which the AMCs have been set up.

But the Chinese are realising that procrastination is dangerous. Huarong Asset Management Corporation President Yang Kaisheng recently admitted the need to move fast to avoid what he calls the ice cream effect. As time goes by, the value of the loans melts. On October 29, 2001, the government made a bold announcement that

it would allow AMCs to sell non-performing assets at steep discounts to the face value. A Morgan Stanley led consortium paid Huarong \$100 million to acquire paper worth \$1.2 billion.

In Indonesia, IBRA (Indonesia Bank Reconstruction Agency) has not made as much progress on the NPA front as expected. Among the challenges which IBRA has faced are lack of cooperation by some bank owners and pledged assets being subject to legal encumbrances. In Malaysia, a government agency called the Corporate Debt Restructuring Committee and the state run AMC, Danaharta Nasional are stepping up their efforts to deal with non performing loans. But few companies are being closed or restructured. They are mostly being sold to the government.

In short, the ARC by itself may not be adequate to solve India's burgeoning NPA problem. Along with the ARC, a deeper market for disposing of the NPAs needs to be created. Faster bankruptcy procedures are also needed. In the absence of these structural measures, the ARC may well remain a lame duck.

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