

**ROLE OF ARCS IN CREDIT RISK MANAGEMENT OF THE INDIAN BANKING INDUSTRY**

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**Abstract**

*The considerable rise in Nonperforming Assets of the banking Industry in India is a significant matter with regard to its survival. The trend in distressed assets shows a high rate of Nonperforming Assets which create serious problems to our banking sector. Several solution mechanism and legal frameworks have been setup by Reserve Bank of India to reduce the quantum of the stressed assets. Internationally, the implementation of legal mechanism is considered as effective tool for speedy recovery of the debt. In India Asset Reconstruction Company is constituted to buy the debtors in the hands of the bank and release the debt. The emergence of Asset Reconstruction Company in India was due to the implementation of prudential norms of credit risk management for reducing the burden of nonperforming Assets. Asset Reconstruction Company helps the banks to maximize the recovery of debt and allow them to concentrate on better management of new business opportunities. This paper examines the role of Asset Reconstruction Company in Indian banking Industry.*

**Key words:** Asset Reconstruction Company, Nonperforming Assets, stressed Assets, Credit risk

**1. INTRODUCTION**

The Banking institutions play a vital role in the economic development of every country. The survival of banking Industry mainly depends on the effective utilization of financial resources. Traditionally banks collect deposits from the public and make loan and advances out of deposits collected. The reforms in banking sector paved way for a vibrant, stable, healthy and efficient banking system. The efficiency of the banks can be measured in terms of the profits earned. The main source of revenue for this type of organization is the interest collected on loans and advances. Better utilization of fund and ensuring asset quality are the main concern to survive in a regulated banking environment. The main income generating activity involves more risk to the banker in the form of Nonperforming assets. The non-performing Assets will lead to adverse effect on the asset management and stagnation of the financial resources. The corporate sector started make huge investment in the expansion and diversification of their

activities. They started in infrastructure and mega projects like power generation, telecom & steel to reap the advantage of growing industrial environment. Global crisis and collapse of the infrastructural projects were not in anticipation of the investors who expected bright future and growing business opportunities. Corporate sector borrowed funds domestically failed to repay their dues as a result of low revenue and high operating cost. Increasing cost and low cash inflow affected the debt servicing capacity and bank facing high level of credit risk. Various measures have been taken by the RBI and Government of India to reduce the volume of NPA by ensuring effective credit risk management process.

The recovery of debt from corporate sector is a difficult task due to the inability of judicial system to adjudicate the problem with immediate effect. Several measures adopted by RBI and the banking authorities to avoid the increasing trend in NPA among Corporate world. Asset reconstruction companies in the legal mechanism for collecting the amount of debt still outstanding in the hands of banks. ARCs undertake the debt of the bank in a mutual agreement to collect it from the borrower.

## **2. REVIEW OF LITERATURE**

Joel Bessis (1998) emphasis in his research paper, "Risk Management in Banking" the impact of credit risk. The three division of credit risk such as default risk, exposure risk and recovery risk properly analyzed in credit risk management process. Credit risk management include the decision making process before the credit decision , the follow up, all monitoring and reporting activities.

Reserve Bank of India (1999) reported the external and internal factors which contribute towards NPA. The study recognized the contributories to NPA such as business collapse, variation in input price, outdated technology of the industrial sector, delay in completing the projects, inefficient management etc. The various debt recovery processes with its efficiency and problem have also been mentioned in the report.

Mukherjee (2003) revealed the international experience of policy conclusion for NPA resolution. The different countries considered different strategies like formation of Asset management Companies and decentralized restructuring. The asset management companies help the financial institution to remove the NPA from the balance sheet. But the AMC approach is

not much effective in developing Countries to resolve the NPA problem.

Sinha (2000) explained the banker's opinion about the NPA resolution strategies through the formation of Asset Reconstruction Company or Asset Reconstruction fund. The analysis was made when there was some area in implementing the initiative of ARC or ARF to solve the problem of debt recovery. He opined that setup of ARCs by a group of banks would not be a correct practice because the constituted ARCs would be a subsidiary of holding bank.

FICCI Report (2005) reported the remarkable progress of banks in eliminating the Nonperforming assets from the balance sheet. It is mainly due to the enactment of Securitization and Reconstruction of Financial Assets and Enforcement of security interest Act and constitution of Asset Reconstruction Companies in this regard. The report reveals the necessity of framing separate NPA norms for the Agriculture and SME sector.

### **3. SIGNIFICANCE OF THE STUDY**

A powerful banking sector is inevitable requisite for flourishing economy. The setback in this sector may have negative impact on the other sectors of the economy. Stressed assets will affect the profitability of

banks, slow economy and reflect in the state of industrial health. The growth and survival of this sector is possible through comprehensive strategies for lending and recovery of bank loan. The goal of credit risk management should be maximizing risk adjusted rate of return of banks by maintaining credit risk exposure within acceptable parameters. Basel committee Principles of credit risk management specifically addresses the area of establishing an appropriate credit administration and monitoring process. ARCs play vital role in Indian banking sector by supporting the banks for collecting the due amount of bank on account of their lending. They render the facility to concentrate in new business opportunities. Through the analysis of the performance of ARCs, the present study enquires the role of this type of institutions in credit risk management of Indian banking sector.

### **4. STATEMENT OF PROBLEM**

The Indian banking sector face serious setback from different quarters, especially in the area of credit risk management .The financial stability and growth of financial institutions mainly arise out of good assets which they hold. A high quantum NPA in asset portfolio will lead to long term survival crisis; fail to maintain proper return on investment. A strong banking

sector is essential for the economy by channelizing the savings for core area development. In Credit risk management, the role of ARCs considered as a significant one. It acts as an agency to offload the stressed assets from the balance sheet. Taking in to account the role of ARCs in credit risk management of the Indian banking industry, it is considered appropriate to evaluate the Challenges and performance of these agencies.

## 5. OBJECTIVES

1. To observe the legal mechanism to resolve the bank stressed assets
2. To study the performance of ARCs in NPA resolution.
3. To examine the challenges and opportunities of ARCs in banking Industry.

## 6. RESEARCH METHODOLOGY

Based on the objective of the study the research design applied is of descriptive type. Available Secondary data was analyzed and used for the present study. The researcher procure the data from documents like financial reports of different ARCs and banks, RBI bulletins, recommendations and reports of various committees. Secondary data also make available from magazines, newspapers and financial journals.

## ARCS AS MECHANISM FOR NPA MANAGEMENT

The level of distressed assets reached in significant manner in Indian banking system. The service of ARCs successfully used in solving the severe problem of credit risk management and recognized as a globally accepted strategy. Countries like Thailand, Mexico, Korea and Taiwan have implemented the ARCs model to solve the issues of NPA. ARCs function is almost similar to that of Asset Management Company. It helps the bank to concentrate in their core area of business as they undertake the responsibility of debt recovery. ARCs are also beneficial to the entire economy by restoring the operational efficiency of the financial institutions. When the bank sells the NPA to an ARC, it will convert as a standard investment against Security Receipt. This investment is shown under the category Available for Sale (AFS)

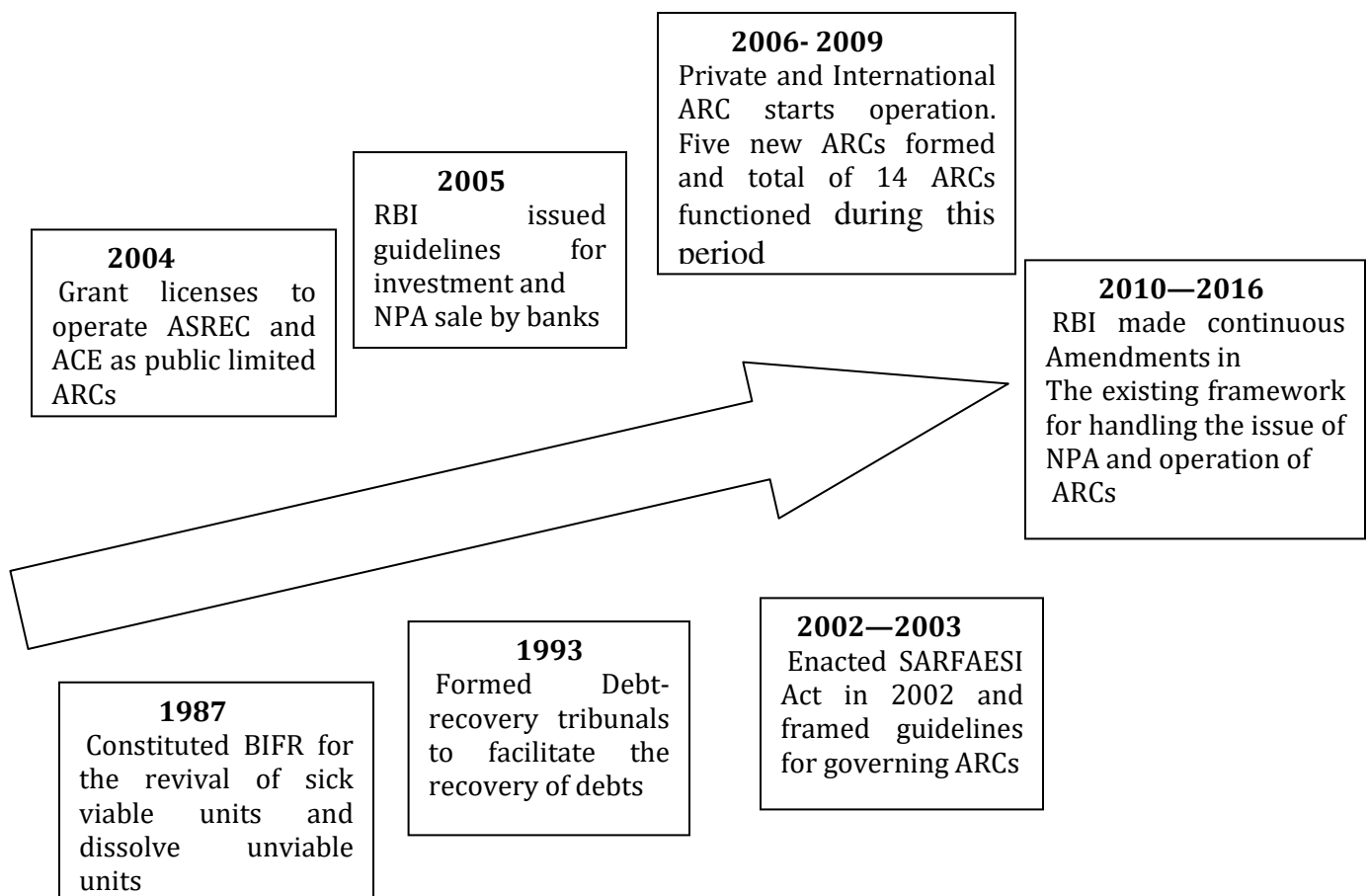
## EMERGENCE OF ARCS IN INDIA

In India the experiment of ARCs is distinctive as the major amount of NPA resulting from corporate lending and the inability of the judicial system to adjudicate the issues of NPA speedily. As a result of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), many asset reconstruction companies (ARCs) were

constituted in India. This type of institutions was setup in India as private vehicles with the support of banks and recognition of RBI. The extensive function of ARCs include acquisition of financial assets, rescheduling of debts ,takeover of management, enforcement of security interest , sale or lease the business of the borrower and settlement of dues

payable by the borrower. ARCs form trusts to acquire the assets from banks and financial institutions. The constituted trust becomes the owner of the asset as per agreement and the beneficiaries are the SR holders. The main source of revenue is the surplus earned from the debt recovery over the acquisition cost.

### EVOLUTION OF ARCS IN INDIA



### PERFORMANCE OF ARCS

There was 15 ARCs functioning in India as on 31st march 2015. As per the financial stability report 2015 the discount rate has been coming down to 58% which was 67% in earlier years. There was reasonable good growth in the operation of ARCs in the recent years. As per data source of RBI loan purchased by the 27 ARCs as of March 2018 was Rs 3.32 lakh crore. The Gross bad loan still held by the banks stood at over Rs.10lakh crore as of March 2018. The transfer of NPA to ARCs bring greater confidence among the investors and it enhance the market value of capital. Effective intervention of ARCs in debt recovery process helps the banks to resolve the problem of stressed assets.

### ARCS CHALLENGES

Generally ARCs undertake two important functions such as resolution and Recovery. Resolution is concerned with aggregating of debt, infusion of capital, identification of non-core assets and bringing in a strategic partner. ARCs mainly focus in the recovery process by realizing the assets. Presently the ARCs face some challenges which are addressed on priority basis.

- Legal issues stand as a hurdle for the recovery of NPAs. Most of the ARCs are facing the problem of shortage of capital fund.

- Valuation and rating the bad assets of the banks is not in proper way and it create issues while making negotiation with bank for undertaking the NPA
- The ARC officials are not allowed to visit the premises of the business which offered as security of the main loan. There should be fair code of conduct between bank ARCs the dealings in good manner
- Government, investigating agencies and Regulators laid some restriction on public sector to sell their assets to private ARCs
- ARCs have demonstrated good track record in recovering the dues through realization of assets. But recovery position and cumulative redemption ratio of security receipt is not encouraging.

### ARCS OPPORTUNITIES

- 1) The estimated stressed assets of the banking Industry are about 15% of the total credit portfolio. It is an opportunity for the ARCs for future development and number companies started to undertake this type of ventures
- 2) Recently RBI announced some measures to in liberalized way to sell the assets of banks to ARCs. Corporate Debt Restructuring, Joint lenders forum are the schemes pushing banks to disclose the current position of bad assets.

- 3) The guidelines to the banks to clean up the balance sheet induce them to approach the ARCs to sell their bad asset portfolio
- 4) The Global investors are interested to make investment in ARCs .It is a positive sign for the industry for further development by adopting the technical knowledge, information and capabilities of overseas investors.

### CONCLUSION

The involvement of ARCs has direct influence on the banks activities related to the debt recovery. RBI should encourage the activities of ARCs to ensure more control over increasing trend of NPA in Banking Sector. The government, Regulator and legal system should ensure effectively to protect the interest of all the stakeholders. The policy makers should step in and build up legal and debt recovery frame work more effectively. It will create strong foundation for the development of ARCs in India

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