

TECHNICAL ASSISTANCE COMPLETION REPORT

Division: SARD/INRM

TA No. and Name: TA3943-IND: Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India			Amount Approved: \$800,000	
			Revised Amount:	
Executing Agency: Ministry of Finance, Department of Economic Affairs (Banking Division)		Source of Funding: OCR	TA Amount Undisbursed: \$236,771.49	Amount Utilized: \$563,228.51
Date			TA Completion Date	
Approval 22 Oct 2002	Signing 27 Nov 2002	Fielding of Consultants 15 July 2003	Original 30 June 2003	Actual 31 May 2004
			TA Account Closing Date	
			Original 30 June 2003	Actual 31 May 2005

Description

1. By the end of the decade of the nineties, nonperforming loans (NPLs) in the banking system had impaired the financial position of a number of public sector banks, weakened the financial capacity of other financial institutions and emerged as a major concern of the Government of India (the Government). After exploring several options for resolution of nonperforming assets (NPAs), the Government decided on creating the enabling conditions for establishing an asset reconstruction company (ARC) as a part of the ongoing reform of the financial sector. To assist the Government in this initiative, the Asian Development Bank (ADB) approved the technical assistance (TA).

Objectives and Scope

2. The objective of the TA, as stated in the TA paper, was to assist the Government in developing an effective ARC for the early resolution of the high level of NPAs of public sector banks and other financial institutions. The TA scope included the following: (i) review the existing environment (legal, tax, regulatory) to identify gaps and deficiencies and recommend an appropriate framework for ARCs; (ii) review the nature and extent of NPAs in the financial sector; (iii) review the best international practices for successful ARC operations; (iv) assess the potential for recovery through security enforcement; (v) determine options for resolution of NPAs; (vi) recommend proven practical valuation techniques for NPAs; and (vii) prepare a feasibility study and operating plan for a model ARC.

Evaluation of Inputs

3. The terms of reference (TOR) were sufficient to cover the scope of the TA and meet the TA objective. The design for implementation and the executing arrangements were appropriate. A steering committee, consisting of representatives from Banking Division of Ministry of Finance, India, the executing agency (EA), Reserve Bank of India (RBI), ADB and the consultant team leader, was constituted as envisaged, to lend the needed direction to the consultants and for mid-course corrections during implementation. A Project Working Group consisting of representatives from EA, RBI and the consultant was also constituted to focus on efficient data gathering, brainstorming and facilitating interaction with the stakeholders. The consultants' inputs comprised (i) 31 person-months (pm), [within TA allocation of 32 pm (18 pm, international and 14 pm domestic consultants)]; (ii) conduct of and/ or inputs to five workshops viz., (a) two stakeholders' workshops - one mid term and one at the final stage - for consultations and feedback on findings and proposed recommendations; (b) lenders workshop for sharing international practices and lessons on work-out strategies, early warning systems, loan grading, and NPL resolutions; (c) a consultative meeting of representatives of relevant government ministries for dissemination of and feedback on draft final report (DFR); (d) an experience-sharing workshop (ESW) at ADB headquarters to share the TA findings and recommendations among senior government and ARC officials from a cross section of Asian countries. The EA involved itself actively in TA administration and provided timely feedback on consultants' findings. It addressed and participated in the midterm stakeholders workshop and the ESW; it chaired four steering committee meetings; it suggested and facilitated the consultative meeting of the relevant government ministries to obtain their feedback; and placed the final report on its official website for wider dissemination to the public. ADB's inputs were timely and adequate. ADB participated in the steering committee meetings and the stakeholders' workshop involving 10 mission days; monitored TA administration for quality, timeliness, adequacy of stakeholders' consultations, and conformity to TOR; responded timely to contract

variation requests; coordinated with EA and the consultants effectively. Overall the inputs were of good quality and facilitated quality outputs. The Government appreciated the inputs from the consultants and ADB. The EA's inputs were adequate and productive.

Evaluation of Outputs

4. The expected deliverables of the TA were submission of the reports (inception, midterm, draft final report, and the final reports), culminating in the final report providing the following: (i) the results of a review of the existing environment (legal, tax, regulatory) and the identified extant gaps and deficiencies; (ii) recommendation on the appropriate framework for ARCs; (iii) results of a survey of NPL portfolios in the financial sector including their characteristics, nature and extent of NPAs (iii) recommendations and options based on a review of the best international practices for successful ARC operations; (iv) assessment of the potential for recovery through security enforcement under optimal conditions; (v) suggested options for resolution of NPAs; (vi) recommended proven practical valuation techniques for NPAs; and (vii) a feasibility study and operating plan for a model ARC. These deliverables were provided efficiently and in a timely manner, addressing most of the TOR in adequate detail. The consultants could not quantify recapitalization needs in banks arising from transfer of NPAs to ARC due to lack of sufficiently objective assumptions on the market behavior in what is still a very early stage of market development. The final report was accepted by ADB and found to be satisfactory by the Government.

Overall Assessment and Rating

5. Set in the context of a financial sector that had achieved progress in sequenced reforms, the Project was relevant to the Government's focus on strengthening creditors' rights and legal reform, to set the enabling conditions for a market-based approach for the resolution of NPLs; it was also highly relevant to ADB's financial sector strategy aimed at efficiency in financial markets and reducing sector vulnerabilities through NPL resolution. Though India did not face compulsions of the kind experienced by some other Asian economies, where ARCs emerged as a response to crisis, the considerable NPL stock (banks - \$11.3 billion and financial institutions - \$5.3 billion) at the end of the Project indicates the Project's continued relevance. The Project was efficacious with (i) progress in the enabling legislations and regulations; (ii) licensing of three ARCs; (iii) transfer of NPLs worth Rs150 billion (\$3.4 billion equivalent) to an ARC; (iv) wide stakeholder consultations; (v) better response by recalcitrant debtors to threat under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002; (vi) relevant design; and (vii) experience sharing in resolutions strategies and asset valuation.

Though there were some delays in consultant recruitment and financial closure the Project objectives were fully met. Overall, the TA project is rated successful.

Major Lessons Learned

6. For sustainable impact of the project, a follow-on program was essential. ADB's proposal to invest in an independent investor-led ARC under the private sector window and the *Administration of Justice Project* are steps in the right direction. The Project and the enactment of SARFAESI Act tried to address the problem of NPL stock; and unlike in most other countries, the Government has chosen to rely on emergence of a market led ARC. However market dynamics can be effectively facilitated only by activating supply and demand factors. On the demand side, the reforms are indicated for - faster pace in adoption of global prudential regulations, greater autonomy and professionalism among the public sector banks, greater commercial orientation, and adoption of improved credit risk assessment tools. On the supply side, the reforms must incentivise establishment of independent investor-led ARCs, including foreign investors. Delays in administrative processes such as recruitment of consultants and assurance of counterparty support and processing of invoices pull down the project rating and indicate the need for improvements in these processes.

Recommendations and Follow-Up Actions

7. ADB should consider future programs with the Government towards reform of the banking sector, removal of exit barriers, capacity building for improved credit risk assessment and continued dialogue on infusing market dynamism through the right policies and regulations. ADB's parallel efforts under the TA on Secured Transactions Reform and the proposed project for the creation of a Central Registry are right steps in bringing about clarity on secured creditors' rights.

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