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New norms will temper ARC growth to 30%: CRISIL

But they will improve price-discovery and recovery prospects

India's asset reconstruction companies (ARCs) have witnessed very high growth in recent times, riding on business opportunities emanating from higher non-performing assets (NPAs) in the banking sector. Their assets under management (AUM) have increased four-fold to Rs.42,000 crore in the year to June 30, 2014. However, this growth is expected to moderate to 30 per cent in the following 12 months because of the amendments to regulations announced by the Reserve Bank of India on Tuesday.

This is because, CRISIL believes that in the near term, ARCs will find it challenging to align their pricing with the expectations of the asset-selling banks, given that the minimum investment requirement has been increased significantly. In the long term, however, the new rules will bolster price-discovery.

Says Mr. Pawan Agrawal, Senior Director, CRISIL Ratings: *"The amendments to regulations will also improve the recovery prospects for ARCs. Membership of the joint lenders' forum, lower threshold for consent to enforce the SARFAESI Act, more time available to conduct due diligence, and greater disclosures will all enhance transparency and lead to better resolution of NPAs."*

Regulatory steps taken over the last one year have been structurally positive for ARCs. These measures will lead to lower vintage of NPAs being sold by banks, and quicker debt aggregation. The average age of NPAs being sold has fallen below 2 years as against around 5 years in the past – and will reduce further. CRISIL expects the average time taken to aggregate debt can also be reduced to around 12 months from nearly 24 months earlier. Progress on these fronts will enhance recoveries, which is critical for the long-term sustainability of the sector.

ARCs will also face two other challenges. First, their capital needs will increase because the minimum investment requirement in Security Receipts (SRs) has been tripled to 15 per cent from 5 per cent. **Says Mr. Rajat Bahl, Director – CRISIL Ratings:** *"The ability of ARCs to raise capital will now become a key differentiator. Further earnings will be under pressure because rules on management fees now stand revised. This will translate into slower growth and higher gearing in the medium term."* However, higher skin in the game will increase ARCs' focus on pricing and recovery.

The second challenge is to increase the value they bring to the resolution process. To be sure, ARCs have successfully reconstructed several large accounts, and have demonstrated ability to recover monies through asset sales. But recovery levels haven't been up to the potential -- the cumulative redemption ratio of SRs for the 10 years till June 2013 stands at 53 per cent. CRISIL believes this track record will improve with the strengthened regulations and positive steps being taken by the industry.

Next, policy makers need to step in and fortify legal and recovery frameworks, and work towards a stronger bankruptcy code to ensure that recoveries become structurally faster.

