

# Asset Reconstruction Company

Prudential framework for resolution of stressed asset

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21<sup>st</sup> march 2025

*A core set of financial stability indicators for banks are:*

*Capital adequacy*

*Under Pressure*

*Asset quality*

*Deteriorating*

*Earnings and profitability*

*Net Interest Merging narrowing*

*Liquidity*

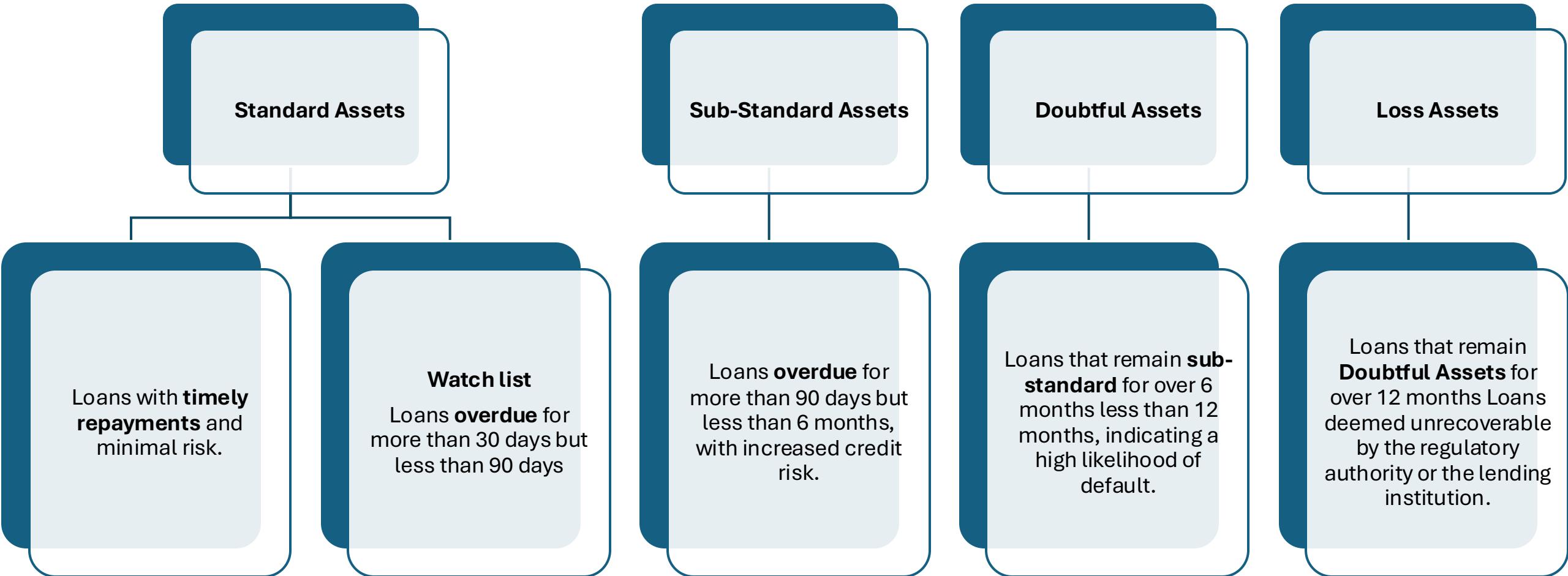
*Excessive increasing negative carrying cost*

*Sensitivity to market, credit and operational risks*

*Increasing*

# Non-Performing Assets (NPAs)

Banks and financial institutions classify their outstanding debts into four categories:



The classification criteria vary based on the type of financial institution and the regulatory framework governing it. Among these categories, non-performing assets (NPAs) specifically include sub-standard, doubtful, and loss assets.

## Classification of Loan Defaults by Nature

### 1. Payment Defaults

- *Interest and/or principal installments remain overdue for more than 90 days.*
- *Discounted or purchased bills remain unpaid for 90 days beyond their due date.*
- *Credit card dues remain unpaid for 90 days from the due date.*
- *Non-fund-based facilities converted into fund-based loans remain unrecovered for 90 days from the date of conversion.*

### 2. Borrower-Related Defaults

- *The debtor has been declared bankrupt or is undergoing bankruptcy proceedings.*
- *The debtor is untraceable or has been out of contact for 90 days.*
- *The borrower submits different financial statements for the same period.*

### 3. Misuse or Mismanagement of Funds

- *The loan has been misused for purposes other than originally intended.*
- *A new loan is sanctioned for settling trust receipts (TR) without prior disclosure at the time of opening the letter of credit (LC).*

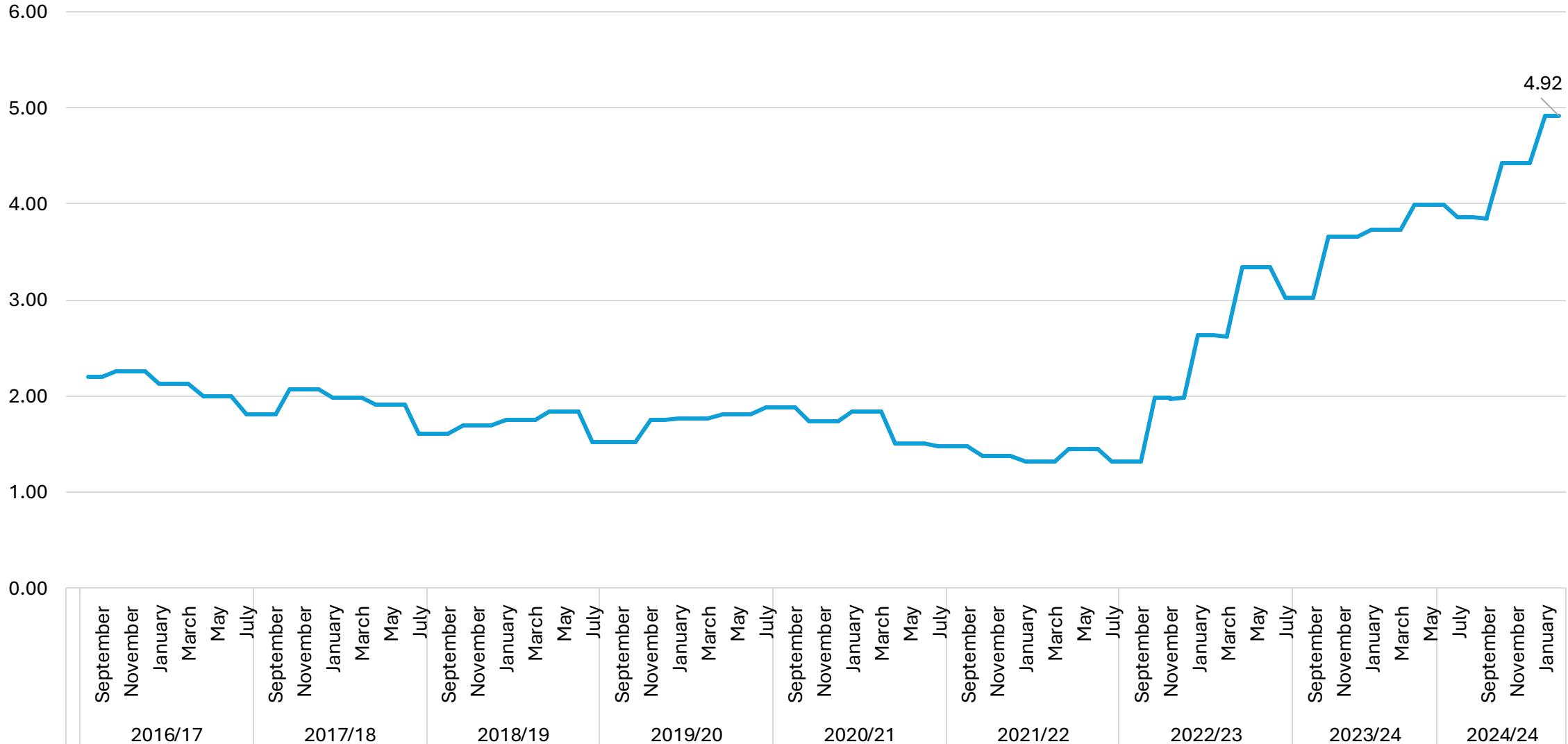
### 4. Business or Project Failure

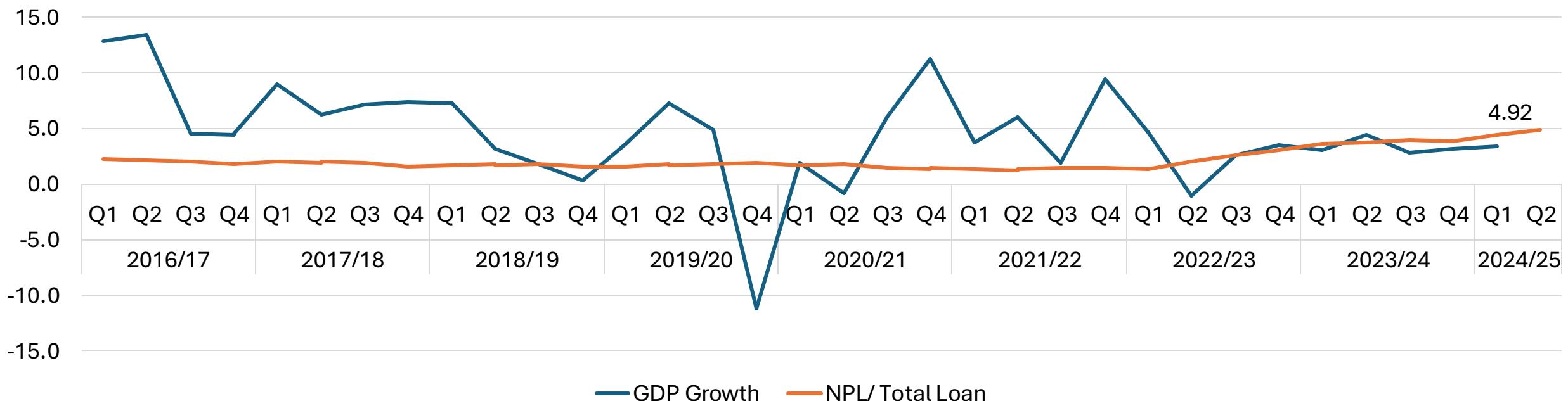
- *The project or business is non-operational, except in cases of valid circumstances.*

### 5. Legal and Recovery Actions

- *Recovery proceedings, including auctions or legal actions, have been initiated.*
- *A new loan or additional credit is extended to a blacklisted borrower.*

### NPL/ Total Loan





The chart presents data on GDP growth and the ratio of Non-Performing Loans (NPL) to total loans for various quarters from 2016/17 to 2024/25. Over this period, GDP growth fluctuated significantly, with the highest growth recorded in Q1 2016/17 at 12.9%, and the lowest contraction in Q4 2019/20 at -11.2%, largely due to the impact of the COVID-19 pandemic. After the sharp decline in 2019/20, the economy began to recover, although growth remained moderate and volatile. Some quarters showed slower growth or even negative growth, particularly in 2022/23. Despite this, there were signs of gradual recovery, with Q4 2020/21 marking a strong rebound at 11.2%.

The NPL ratio, on the other hand, exhibited an overall decline in the earlier years, from 2.25% in Q1 2016/17 to 1.48% in Q4 2020/21, signaling improved loan quality and a lower default risk in the banking sector. However, starting in 2021, the NPL ratio began to rise, peaking at 3.98% in Q3 2023/24. This increase suggests growing challenges for the banking sector in managing defaults, possibly related to post-pandemic economic stresses and inflationary pressures. In QII 2024/25, the NPL ratio reached a high of 4.92%, signaling persistent concerns about loan repayment.

The data suggests a correlation between economic performance and banking sector stability. Periods of high GDP growth generally align with lower NPL ratios, reflecting a healthier economic and banking environment, while times of economic contraction tend to correspond with higher NPL ratios, indicating stress within the banking sector.

## Risk Assets Classification

Rs in billion

Pass Loan	4,570.44		79.89%	
Watch List	675.76	5,246.20	11.81%	91.70%
Special Mention Loan	405.29		7.08%	
Other specified Loan	69.36	474.65	1.21%	8.30%
Gross Loan	5,720.86		100.00%	100.00%

## Current Loan Portfolio

Rs in billion	Mid-July			Mid-Feb
Provision for Risk	2022	2023	2024	2025
<b>Opening</b>		<b>110.30</b>	<b>168.12</b>	<b>230.01</b>
<b>Addition</b>		<b>85.63</b>	<b>105.41</b>	<b>77.61</b>
<b>Less Write Back</b>		<b>27.56</b>	<b>43.24</b>	<b>27.34</b>
<b>Less Recovery from Written off Loan</b>		<b>0.25</b>	<b>0.29</b>	<b>0.12</b>
<b>Closing</b>	<b>110.30</b>	<b>168.12</b>	<b>230.01</b>	<b>280.16</b>
<b>Gross Loan Loans Provision</b>	<b>2.27%</b>	<b>3.33%</b>	<b>4.26%</b>	<b>4.90%</b>

## Current Loan Portfolio

Amount in Billion	Mid-Feb 2025	%age
<b>Gross Loan</b>	<b>5,720.86</b>	<b>100.00%</b>
<b>Good loan</b>	<b>5,246.20</b>	<b>91.70%</b>
<b>Problem Loan</b>	<b>474.66</b>	<b>8.30%</b>
<b>Provision made</b>	<b>280.16</b>	<b>4.90%</b>
<b>Additional provision required if all become Bad</b>	<b>194.50</b>	<b>3.40%</b>
<b>Paid up Capital and Statutory Reserves</b>	<b>567.16</b>	<b>9.91%</b>
<b>Total capital</b>	<b>764.85</b>	<b>13.37%</b>
<b>Net capital If all problem loan become bad</b>	<b>372.66</b>	<b>6.51%</b>
<b>Total capital If all problem loan become bad</b>	<b>570.35</b>	<b>9.97%</b>

*As of mid-January 2025, Nepal's gross loan portfolio totals NPR 5,720.86 billion, with 91.70% classified as good loans (NPR 5,246.20 billion) and 8.30% as problem loans (NPR 474.66 billion).*

*While this indicates relatively healthy loan quality, it underscores the importance of careful handling of the banking sector's risk profile.*

*Provisions currently amount to NPR 280.16 billion (4.90% of gross loans), serving as a buffer against defaults. However, if all problem loans were to turn bad, an additional NPR 194.50 billion (3.40%) in provisions would be required, raising the total provisioning requirement to 8.30%.*

*The banking system is supported by NPR 567.16 billion in paid-up capital and statutory reserves, equivalent to 9.90% of gross loans. With additional reserves, total capital reaches NPR 764.85 billion, or 13.37% of the loan portfolio.*

*In a stressed scenario where all problem loans turn bad, net capital would drop to NPR 372.66 billion (6.51% of gross loans), falling below the minimum capital threshold.*

*When Tier 1 capital breaches this threshold, banks lose their lending capacity, reducing investment and slowing economic activity. However, total capital would remain at NPR 570.35 billion (9.97%), demonstrating resilience while emphasizing the need for vigilance.*

*This challenging scenario also presents opportunities for reform.*

*With timely action, the regulator can review and update policies to fortify the financial system.*

# **Key Considerations: Can Asset Reconstruction Companies (ARCs) Help Solve Nepal's Debt Problem?**

## **1. Valuation & Market Readiness**

- Should banks accept reasonable valuations for only a fraction of their non-performing assets (NPAs)?
- Banks must mark down asset values to levels acceptable to the market and ARCs.

## **2. Transparency & Governance**

- Establish a clear and transparent methodology to prevent collusion and allegations of wrongdoing.
- Engage private sector participants through an open and competitive bidding process.

## **3. Regulatory Oversight & Financial Stability**

- Nepal Rastra Bank (NRB) should conduct periodic Asset Quality Reviews to assess financial institutions' health.
- NRB must introduce measures to improve price discovery and facilitate efficient credit risk transfer.

## **4. Legal & Structural Reforms**

- Reduce legal barriers and roadblocks that hinder asset resolution and recovery.
- Develop policies to enable ARCs to issue security receipts (SRs) or "hope notes" as part of debt resolution mechanisms.

## **5. Government & Institutional Support**

- Define the extent and form of government financial backing for ARCs.

*Is Nepal Rastra Bank (NRB) adequately positioned to take proactive measures by reassessing asset classification and provisioning methods?*

*Introducing robust insolvency laws to expedite loan resolution*

*Encouraging the development of asset reconstruction companies (ARCs) could create a more efficient recovery framework.*

*Transitioning to a loss-given-default model, rather than time-based provisioning norms, could better reflect actual risks.*

*Implementing stricter asset classification guidelines and accurately assess provisioning needs to enhance preparedness.*

*Aligning Nepal's provisioning framework with regional best practices and fostering collaboration among stakeholders, the country can address financial challenges effectively and strengthen its banking sector.*

## ***Process of Asset Reconstruction Company***

***The primary objective of acquiring debts or non-performing assets (NPAs) is to recover the outstanding dues. However, the recovery process is complex and involves multiple strategies. Asset Reconstruction Companies (ARCs) can adopt the following approaches:***



***Management Restructuring:***

*Changing or taking over the borrower's business management.*

***Business Sale or Lease:***

*Selling or leasing the borrower's business to facilitate debt recovery.*

***Debt Rescheduling:***

*Offering alternative repayment schemes or restructuring payment arrangements.*

***Security Enforcement:***

*Exercising legal rights over collateral in accordance with applicable laws.*

***Asset Possession:***

*Taking control of secured assets pledged by the borrower.*

***Debt-to-Equity Conversion:***

*Converting a portion of the outstanding debt into equity shares.*

***This streamlined process allows ARCs to effectively recover dues while ensuring business viability and legal compliance.***

*The working of the ARC can be summarized by the following diagram:*

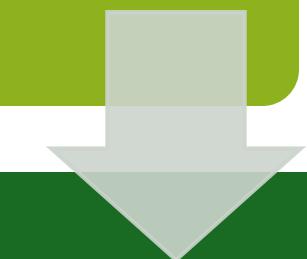
### *Debtors / Borrowers / Obligors*

- *Banks offer financial assistance*
- *The borrowers provide security for such financial assistance*



### *Banks / Financial Institutions*

- *Transfer the bad debts / NPAs to ARCs*
- *ARCs purchase such assets to realize the same*



### *Qualified Buyer*

- *Purchase security receipts*
- *ARC issue security receipts representation undivided interest in the financial assets*
- *ARCs can acquire secured assets from banks by paying in cash or by issuing debentures, bonds or any other security*



## Options for Assets Management

<b><i>Institutional Arrangement</i></b>		
<b>Mandate</b>	<b>Decentralized</b>	<b>Centralized</b>
Narrow	<i>Private asset management companies.</i> <i>Private resolution trusts</i>	<i>Rapid resolution vehicles (U.S. Resolution Trust Corporation; Financial Sector Restructuring Authority, Thailand)</i>
Broad	<i>Bank workout units.</i> <i>Private resolution trusts</i>	<i>Broad mandate centralized asset management companies (Danaharta, Malaysia; Korean Asset Management Corporation)</i>

## ***Decentralized Arrangements***

*Decentralized arrangements refer to asset management structures where private sector institutions retain management responsibility.*

### ***For Open Institutions:***

*Institutions can choose to manage assets within their existing framework or establish a specialized subsidiary or private asset management company to handle distressed assets more effectively.*

### ***For Closed Institutions:***

*Authorities may transfer assets to a resolution trust, managed by a private financial institution for a fee.*

*Nonperforming loans can be transferred to asset management companies for more efficient handling and resolution.*

*To support this process, authorities should facilitate the establishment of asset management companies by removing legal barriers. This includes*

*Enabling the smooth transfer of ownership and transaction priorities without requiring debtor consent.*

*An asset management company should be legally empowered to act on behalf of the bank in asset transfers.*

## Independence

- A centralized asset management company must operate autonomously to withstand political pressures from borrowers. To ensure efficiency and effectiveness, it should be established as an independent entity—preferably under a special law. This structure would grant the company flexibility in hiring top professionals and advisory firms, both domestically and internationally, while enabling independent decision-making on asset purchases, restructuring, and disposals.

## Funding

- Financial independence is crucial to prevent political interference, particularly in staffing and resource allocation. The company must have adequate funding to fulfill its mandate, with an operational budget distinct from funds allocated for asset acquisition. Funding can be sourced from government bond proceeds or the company's own bond issuances backed by the government. However, any losses incurred should be absorbed directly by the national budget.

## Legal Framework

- A robust legal foundation is essential for the company's success, particularly regarding asset transfers. The legal framework should ensure the seamless transfer of ownership and establish clear transaction priorities. Any legal barriers, such as requiring debtor consent before loan transfers, should be eliminated to streamline operations.

## Accountability, Transparency, and Governance

- The company must maintain high standards of accountability and transparency. It should regularly report its performance to parliament and the public while undergoing rigorous external audits conducted by professional auditors on behalf of its stakeholders.



*These measures would contribute to a more stable and resilient financial system capable of withstanding future shocks*

<p><i>Accounting Farmwork</i></p>	<p><i>Accounting within the Farmwork of ICAN</i>  <i>Specific accounting guideline for ARC by NRB</i></p>
<p><i>Revenue Recognition</i></p>	<p><i>Main items of Revenue: Management fees, Interest and Other gain</i>  <i>The reorganization of revenue as per the contract of specific trust</i></p>
<p><i>Valuations of Investment</i></p>	<p><i>Assets should be valued as available sale as per NRB Guideline</i>  <b><i>Arms-length, expert valuation of assets is required</i></b>  <i>NAV must be declared every six months</i></p>
<p><i>Provision write off</i></p>	<p><i>Unrealized management fees outstanding for 6 months</i></p>

# Thank You!