# FINANCIAL PERFORMANCE OF ASSET RECONSTRUCTION COMPANIES AND ITS IMPACT ON BANKING STABILITY

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## ABSTRACT

The rising level of Non-Performing Assets (NPAs) has posed a significant challenge to the stability and efficiency of the banking sector. Asset Reconstruction Companies (ARCs) were introduced in India as specialized financial institutions. Their primary objective is to reduce the burden of bad loans on banks and improve the overall health of the financial system. This study examines the financial performance of ARCs and evaluates their impact on banking stability.

The research analyzes key indicators of financial performance such as asset acquisition, recovery rates, profitability, and operational efficiency of ARCs. By purchasing distressed assets from banks, ARCs enable banks to remove NPAs from their balance sheets and redirect their resources towards productive lending activities. This process contributes to improved liquidity, enhanced credit flow, and greater financial stability within the banking sector. However, the effectiveness of ARCs largely depends on their recovery strategies, valuation mechanisms, and the regulatory environment governing their operations.

The study also considers the role of regulatory oversight by the Reserve Bank of India in strengthening the functioning of ARCs and ensuring transparency in the distressed asset resolution process. Despite their importance, ARCs face several challenges, including inadequate capital, slow recovery processes, and difficulties in resolving complex distressed assets.

Overall, the study highlights that strong financial performance of ARCs can significantly contribute to reducing NPAs and strengthening banking stability. Improving regulatory support, operational efficiency, and recovery mechanisms will further enhance the role of ARCs in maintaining a stable and resilient banking system.

## I. INTRODUCTION

A nation's ability to sustain financial stability depends on having a strong banking sector. The amount of NPAs in the banking sector is one measure of soundness. In this regard, it is widely known that the Indian banking system frequently suffers from high levels of non-performing assets, which have an impact on the profitability and ultimately the capital position of banks, particularly public sector banks (PSBs). This has contributed to a certain degree of risk aversion among the banks, which has slowed the nation's credit expansion in recent years.

In order to address the issue of rising NPAs and growing loan default, the Reserve Bank of India (RBI) launched the Asset Quality Review (AQR) in 2015[1]. Following this, the government implemented the 4Rs strategy, which includes Recapitalizing PSBs, Resolving and Recovering value from stressed accounts through clean and effective laws and processes, and Reforms in banks and the financial ecosystem. PSBs saw a significant decrease in gross NPAs owing to these measures. Pursuant to this, the gross NPA ratio i.e., gross NPAs as a percentage of gross loans and advances of Scheduled Commercial Banks (SCBs) has been steadily declining over the past eight fiscal years. As of the end of September 2025 (provisional data), it was at a historic low of 2.15%, which is lower than the level from 2010-11[2].

According to the most recent statistics available with RBI as of 30.09.2025, the gross NPAs ratio for domestic operations was 2.15% for SCBs, 2.50% for PSBs, 1.73% for PVBs (i.e., Private Banks), and 0.80% for foreign banks[3]. Additionally, starting March 2018, PSBs' gross NPA ratio has declined more than that of PVBs and foreign banks.

Due to the ongoing decrease in SCBs' gross NPAs, including PSBs, they have been able to lower their provisioning, which has enhanced their profitability and had a beneficial effect on business growth. Additionally, it shows that PSBs with a solid balance sheet and consistent profitability have better underwriting and asset quality.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security interest Act, 2002 (SARFAESI) and the Recovery of Debt and Bankruptcy Act, 1993 have been

[1] PIB Delhi, Gross NPAs of Scheduled Commercial Banks (SCBs) for domestic operations reach a historic low of 2.15% as of September, 2025, (Feb 09, 2026, 4:35PM), https://www.pib.gov.in/PressReleasePage.aspx?PRID=2225442&reg=3&lang=1.

[2] *Id.*

[3] *Id.*

amended to make them more effective, and the Government and RBI have taken extensive steps to prevent, reduce, and recover NPAs[4][5]. Important changes to SARFAESI included, among other things, giving the RBI the authority to audit and inspect ARCs and to penalize non-compliance; requiring all security interest to be registered with the Central Registry of Securitization Asset Reconstruction and Security Interest of India (CERSAI); creating more DRTs to expedite case resolution; and allowing non-institutional investors to invest in Security Receipts.

## II. EVOLUTION OF IMPORTANT LEGAL AND REGULATORY FRAMEWORKS FOR HANDLING STRESSED ASSETS

The management of NPAs has long been a top priority for the government and the RBI due to its importance for the stability and health of the banking system. In order to handle stressed assets in the banking industry, a number of legislative and regulatory frameworks have been implemented over time.

The Sick Industrial Companies (Special Provisions) Act, 1985 was the first major legislative framework designed to manage stress in the banking system[6]. This Act was passed in order to guarantee the prompt discovery of illness in industrial units and to expedite the resolution of such units through a specialized body of experts known as the Board for Industrial and Financial Reconstruction (BIFR). However, prolonged legal fights and stakeholder decision-making delays prevented the Act from accomplishing its intended goals. In order to help with loan recovery and lessen the burden of debt, the Narasimham Committee I had first suggested the creation of Debt Recovery Tribunals in 1993[7]. Even though these tribunals had some initial success, they were (i) constrained by a financial cap of Rs. 10 lakhs and (ii) lacked the infrastructure and legal capacity to handle an increasingly heavy caseload[8]. This could account for the legislature's decision to reduce the role of courts in asset recovery going ahead. For instance, the SARFAESI Act, 2002 permitted lenders to auction securities without the involvement of the courts. More significantly, it established an entirely different institutional alternative in accordance with the Narasimham Committee II's recommendation. In order to

4 Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002.
5 The Recovery of Debts and Bankruptcy Act, 1993.
6 The Sick Industrial Companies (Special Provisions) Act, 1985.
7 Report of the Committee on the Financial System, 100-112, 1991.
8 Natasha Singh, Profits with Purpose: Have ARCs Focused on Returns or Revival?, SCC ONLINE TIMES (Sept. 27, 2023), https://www.scconline.com/blog/post/2023/09/27/profit-with-purpose-have-arcs-focused-on-returns-or-revival/.

"clean" the banks' balance sheets by acquiring NPAs and trying to successfully securitize and/or restructure them, Section 3 of the SARFAESI Act, 2002[9] established the ARCs. As a result, Sick Industrial Companies (Special Provisions) Act, 1985 was eliminated in 2003. The Companies Act, 2013 later included some related laws, and the National Company Law Tribunal (NCLT) took over BIFR's duties[10].

The SARFAESI Act and Recovery of Debts Due to Banks and Financial Institutions Act, 1993 are two other significant pieces of legislation designed to make it easier to recover debts owed to banks and financial institutions. While the latter allows secured creditors to exercise their security rights without court intervention, the former offers a method for quicker recovery through specialized courts known as Debt Recovery Tribunals. Additionally, the SARFAESI Act made it easier for Asset Reconstruction Companies to be established as institutional tools for managing banks and other financial institutions stressed assets.

To assist banks in managing stressed assets more effectively, the RBI has implemented a number of regulatory frameworks in addition to legislative measures. The Corporate Debt Restructuring (CDR) framework, which offered a method for the prompt and transparent restructuring of debt of viable business entities outside the scope of BIFR, DRTs, and other legal actions, was one such endeavor[11]. Through a coordinated restructuring procedure, this structure aimed to minimize losses to creditors while maintaining viable corporate entities.

The Framework for Revitalising Distressed Assets in the Economy, 2014, was another important regulatory action[12]. The objectives of this framework were to improve the restructuring process generally, encourage lenders to agree on restructuring plans collectively., and centralize the reporting and distribution of information on large credit exposures. The RBI subsequently implemented a number of restructuring programs, including the Scheme for Sustainable Structuring of Stressed Assets (S4A), the Strategic Debt Restructuring Scheme (SDR), and the Flexible Structuring of Long-Term Project Loans[13]. However, on June 7, 2019, the RBI released new recommendations through the "Prudential Framework for Resolution of Stressed Assets" [14] in response to the scheme's uneven effectiveness. While eliminating the

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9 Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, §3.
10 The Companies Act, 2013.
11 Reserve Bank of India, Corporate Debt Restructuring (CDR), DBOD. No. BP.BC.68/21.04.132/2002-03 (Issued on Feb. 5, 2003).
12 Reserved Bank of India, Framework for Revitalising Distressed Assets in the Economy – Refinancing of Project Loans, Sale of NPA and Other Regulatory Measures, RBI/2013-14/502 (Issued on Feb. 26, 2014).
13 Reserve Bank of India, Scheme for Sustainable of Stressed Assets, RBI/2015-16/422 (Issued on June 13, 2016).
14 Reserve Bank of India, Prudential Framework for Resolution of Stressed Assets, RBI/2018-19/203 (Issued on June 7, 2019).

previous restructuring plans, this framework allows for the early identification, reporting, and time-bound resolution of stressed assets.

Banks often prefer transferring stressed assets to ARCs because they offer several advantages. First, ARCs allow banks and financial institutions to focus on their core lending activities by removing stressed assets from their balance sheets, thereby freeing capital and managerial resources. Second, ARCs handle the stressed assets and carry out recovery on behalf of lenders when they invest in security receipts (SRs). Third, ARCs can help borrowers revitalize their firms, protecting productive assets and increasing lender returns.

The Insolvency and Bankruptcy Code, 2016 (IBC) was finally passed as a result of efforts to provide a thorough insolvency resolution process[15]. Since it combined the bankruptcy and insolvency regimes into a single code, this legislation has become an important tool for recovering stressed assets. The IBC has become the favored method for resolving stressed assets in recent years. The IBC's guarantee of timely and optimal recovery for creditors and the ARC sector's comparatively poor record in terms of recovery and company revival are the two key causes of this change.

In the year 2024, RBI issued Directions to establish a comprehensive framework for ARCs under the SARFAESI Act, 2002 to ensure transparency, efficiency, and accountability in resolving stressed assets[16]. All ARCs must register with the RBI and maintain a minimum Net Owned Fund (NOF) of Rs. 300 crores (to be achieved by March 31, 2026), while those with Rs. 1000 crores NOF can act as Resolution Applicants under the IBC. The Directions emphasize strong governance through Board-approved policies, effective risk management, and strict regulatory oversight. ARCs are restricted from accepting public deposits and must follow prudent investment norms and disclosure standards.

A key feature is the structured process for asset acquisition and resolution requiring due diligence, fair valuation, and time-bound recovery. ARCs must prepare a resolution plan within 6 months and generally complete recovery within 5 years (extendable to 8 years), using methods such as restructuring, settlement, enforcement of security interests, or conversion of debt into equity. The framework also introduces safeguards like Independent Advisory Committee (IAC) review, creditor approvals, and borrower protection measures to ensure

[15] The Insolvency and Bankruptcy Code, 2016.
[16] Reserve Bank of India, Master Direction – Reserve Bank of India (Asset Reconstruction Companies) Directions, 2024, RBI/DOR/2024-25/116 (Issued on Apr. 2, 2024).

fairness and maximize recovery. Overall, the Directions strengthen ARC functioning, improve NPA resolution, and contribute to greater stability in the banking sector.

## III. WORKING MECHANISM OF ASSET RECONSTRUCTION COMPANIES

ARCs are specialized financial organizations which were created under SARFAESI Act to handle and settle banks and other financial institution's NPAs. By obtaining such assets and making an effort to collect the unpaid balances through organized recovery procedures, their main goal is to lessen the impact of bad loans on the banking system. Banks can enhance and clean up their balance sheets by moving stressed assets to ARCs. The SARFAESI Act provides the legal framework for ARCs in India. The RBI regulates ARCs and establishes rules regarding their registration, capital requirements, and operational procedures.

When banks or other financial institutions choose to move their NPAs to an ARC, the ARC's operational model starts. Usually, these assets are sold for less than their anticipated recoverable value. By using this procedure, banks are able to eliminate non-performing loans from their records and concentrate on their main function of lending money to the economy's productive sectors. Banks can lower their provisioning needs and strengthen their capital adequacy position by selling stressed assets to ARCs.

ARCs often use a combination of upfront cash and Security Receipts (SRs) to structure the purchase consideration after acquiring the stressed assets. The selling bank receives a portion of the asset value in cash, and the ARC issues SRs to represent the remaining value. The right to a portion of the recovery proceeds from the underlying asset is represented by SRs. In order to share the risk and gain of the recovery process, the selling bank frequently subscribes to a sizable amount of these SRs.

In order to maximize the value of the stressed assets when they are acquired, the ARC implements a number of reconstruction and recovery strategies. Restricting or rescheduling the borrower's repayment obligations, negotiating one-time settlements, turning debt into ownership in the borrower's firm, or even taking over or altering the borrower's business management are some examples of these actions. In order to revitalize the company, ARCs may occasionally sell the secured assets or attract new investors. Either restoring the borrower's financial viability or maximizing the lender's recovery are the goals of these actions.

Lastly, after subtracting management fees and other ARC operating costs, the funds are divided among the holders of Security Receipts when recovery is accomplished through restructuring, settlement, or asset sales. By helping banks manage stressed assets, increasing recovery rates, and encouraging the effective resolution of distressed loans, ARCs play a significant role in the financial system.

## IV. IMPACT OF ARCs ON BANKING STABILITY

The role played by ARCs is important for maintaining stability in the banking sector as they aid banks in getting rid of NPAs and improving their financial well-being. As a result, they get a strong balance sheet and increase their lending potential. The effectiveness of their operations, however, remains a question of much concern.

### Positive Impact

The ARCs have contributed immensely towards the consolidation of the Indian banking sector through the systematic and effective resolution of the issue of NPAs. By purchasing the stressed assets, the ARCs help in cleaning the bank books, making them more capable of making fresh loans due to increased capital adequacy.

The fact that ARCs provide expert support for the healing process is the second significant advantage of utilizing their services. Unlike banks, whose primary role is to provide loans, ARCs have experience with the restructuring, settlement, and revitalization of distressed assets. Better recovery results are frequently the consequences of this specialization, especially in complex business accounts.

Additionally, by using techniques that avoid out-of-court proceedings, ARCs contribute to expediting the resolution of stressed assets. ARCs reduce the risks of asset deterioration and save time by permitting out-of-court remedies. Furthermore, laws like the IBC and SARFAESI Act aid in the resolution of stressed assets.

Moreover, in recent times, ARCs have taken on an additional function of managing NPAs related to retail lending like housing and education. Banks are unable to take care of such assets owing to their sheer number. The adoption of advanced technologies like artificial intelligence has further enhanced their ability to analyze borrower behavior and improve recovery rates.

Additionally, ARCs allow banks to focus on their core function of lending rather than being burdened with recovery processes. This improves overall efficiency in the financial system and supports economic growth.

**Negative Impact**

ARCs have advantages, but they also have a number of drawbacks that reduce their efficacy. The low investment required, or "skin in the game", is one of the main issues. Only roughly 2.5% of ARCs must invest in SRs; the other funds are provided by outside investors. This lowers their financial risk and can make them less motivated to aggressively seek treatment.

The warehousing of assets, where ARCs obtain NPAs but fail to take adequate action for prompt resolution, is another problem. This undermines the goal of an effective recovery by causing delays and asset value loss.

Concerns about backdoor settlements and a lack of transparency are also present. Through ARCs, debtors occasionally negotiate settlements in an indirect manner that would not accurately reflect the assets true market value. In a similar vein, banks occasionally turn down borrower One-Time Settlement (OTS) proposals before selling the same assets to ARCs for less, which raises concerns about efficiency and justice.

Conflicts of interest can also occur when the assignor bank manages the asset even after it has been transferred to an ARC. This compromises the ARC framework's independence. Another drawback is that ARCs are part of a larger recovery ecosystem that still has to deal with issues like economic uncertainty, regulatory restrictions, and legal delays. Recovery rates have generally been uneven, even with mechanisms like DRTs and SARFAESI.

Lastly, NPAs might rise due to global economic conditions including financial instability and geopolitical conflicts, which puts more strain on ARCs and reduces their efficacy.

## V. COMPARATIVE ANALYSIS OF LEGAL AND REGULATORY FRAMEWORK OF DISTRESSED ASSET RESOLUTION ACROSS JURISDICTIONS

### 1. Brazil

The legal and regulatory framework in Brazil is relatively developed and has evolved alongside the growth of its distressed assets market. The World Bank DARP report highlights that Brazil has a large and active Non-Performing Loans (NPL) market supported by regulatory developments and accounting standards such as IFRS 9, which encourage banks to recognize losses and dispose of bad loans more efficiently[17].

Brazil's system permits banks to create service platforms and sell troubled assets; over time, state-owned banks and non-financial organizations have also taken part in these transactions. Recovery techniques are expanded by the regulatory environments support for a variety of asset types, such as real estate-owned assets and legal claims. However, enforcement is frequently negotiated, and legal action is only taken as a last choice, suggesting that judicial enforcement is generally flexible but occasionally takes longer.

**2. China**

China resolves distressed assets using a state-driven legal and regulatory framework. The legal framework governing China's corporate bankruptcy system is composed of two parts: the Enterprise Bankruptcy Law (EBL) of the People's Republic of China, and the judicial interpretations subsequently issued by the. Supreme People's Court[18]. According to the DARP research, authorized Asset Management Companies (AMCs), which are supported or sanctioned by the government and are crucial in obtaining and resolving NPLs, dominate the market[19].

Over time, China's legal and regulatory structure has been modernized, increasing the market's appeal to investors. Nonetheless, the system is still largely controlled by state policy, has little transparency, and depends more on administrative coordination than strictly on court enforcement. Even though the framework is getting better, it is still not entirely driven by the market, as evidenced by the continuous expansion of investor participation and servicing infrastructure.

Therefore, China's framework is characterized by strong institutional control, centralized resolution mechanisms, and gradual legal modernization.

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[17] Josep M. Julià et al., DARP – Creating Distressed Assets Markets, WORLD BANK, (June, 2019), https://ppp.worldbank.org/sites/default/files/2022-03/201910-Distressed-Assets-Recovery-Program.pdf.

[18] Yi Chen, Judicial review of corporate bankruptcy reorganization value in China: a critical analysis based on 590 judicial judgments, 13 Humanit Soc Sci Commun 396, 396-397 (2026).

[19] *Id.*

### 3. Greece

Greece has undergone significant legal and regulatory reforms in response to its financial crisis, making it a key example of a restructured European system, such as –

a. Amendments to the Code of Civil Procedure, to speed up enforcement and improve recovery of secured claims,

b. Introduction of a pre-bankruptcy rehabilitation framework,

c. Enactment of the NPL Law (2015), enabling loan transfers and establishing licensed Loan Management Companies (LMCs),

d. Liberalization of loan sales and servicing markets,

e. Introduction of electronic auctions and out-of-court workout mechanisms.

These changes established a controlled environment for NPL transactions and greatly increased the effectiveness of enforcement. The report does point out that institutional efficacy and servicing capacity are still growing, which means that actual implementation is still lagging behind law improvements.

Greece is therefore an example of a legal system that has undergone reform, transitioning from a weak system to one that is more organized and conducive to investment.

## VI. CONCLUSION

ARCs have become a vital institutional tool for tackling the ongoing problem of NPAs in the Indian banking sector. Their assistance in recovering stressed assets has greatly improved bank balance sheets, increased liquidity and allowed banks to concentrate on their primary lending operations. The combined effect of ARCs, regulatory changes, and frameworks like SARFAESI and the IBC has improved overall financial stability, as evidenced by the decreasing NPA levels in recent years.

ARCs financial success, however, has produced inconsistent outcomes. Even if they provide expertise in asset reconstruction and expedite settlement through out-of-court procedures, their utility is nevertheless constrained by issues like low capital investment, inconsistent recovery rates, resolution delays, and governance challenges. The efficiency of the recovery process is sometimes decreased by the propensity for asset storage and the absence of significant incentives.

By establishing more stringent governance guidelines, better valuation standards, time-bound resolution procedures, and increased transparency, the RBI Directions, 2025 represent a major step toward fortifying the ARC ecosystem. These steps are intended to improve ARCs financial performance by ensuring that they run more effectively and responsibly.

In conclusion, by lowering NPAs and fostering credit expansion, ARCs significantly contribute to banking stability. Stronger regulatory oversight, greater capitalization, enhanced recovery plans, and incentive alignment are necessary for their long-term efficacy. ARCs have the potential to become a more potent instrument for guaranteeing a robust and stable banking sector in India with further reforms and effective implementation.