Asset Reconstruction Companies: Addressing Nepal's NPL Crisis

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The Government of Nepal's 2025/26 budget (FY2082/83) proposed creating a specialized Asset Reconstruction Company (ARC) to clean up banks' balance sheets by buying non-performing loans (NPLs) and illiquid collateral (non-banking assets). This initiative marks a part of a broader financial sector reform, motivated by persistent stress in Nepal's banking system. Recent reports suggest that Nepalese banks are facing stagnating loan growth, deteriorating profitability, and rising NPLs. For instance, the average NPL ratio among commercial banks reached roughly 4.8% by late FY2081/82 (Q3 2024/25), up from 3.65% a year earlier. Nine of 20 banks even exceeded NRB's prescribed 5% NPL limit, with Himalayan Bank highest at 7.68%[3]. These trends, along with large volumes of unsold collateral, could have played a huge role to convince policymakers that banks require an ARC to absorb bad loans and foreclosed properties, thereby recapturing capital for fresh lending.

ARCs: Functions and Mandate

Asset Reconstruction Companies (ARCs) are specialized financial firms established to purchase and resolve distressed bank assets. The core mandate of ARCs is to acquire NPL portfolios and other stresses assets from banks, usually at a discount, and then manage or liquidate them to maximize recovery[2]. In doing so, ARCs effectively "clean up" bank balance sheets, freeing capital and restoring lending capacity. ARCs usually earn asset management fees and share any upside from recoveries. In India, for instance, ARCs issue security receipts to banks to fund purchases[8]. They then use four main methods to resolve loans: restructuring terms, outright sale (often via auctions), liquidation of collateral, or one-time settlements (special compromises)[8]. Moreover, ARCs take legal control over collateral (land, real estate, equipment, etc.) so that banks can stop provisioning for bad loans and avoid lengthening ever-greening relief to troubled borrowers[2]. All in all, ARCs act as a quasi- "bad bank", that separates toxic assets from the financial sector and drives their orderly resolution.

NPL and NBA Trends in Nepal

Nepal's NPL situation has gradually worsened. According to NRB, the industry wide NPL ratio rose from about 3.0% in mid-2023 to roughly 3.86% by mid-July 2024[6]. Recent bank reports for Q3 2081/82 showed an average NPL ratio of 4.83%, reflecting the slowdown in loan recoveries. Key sectors such as construction have seen large stress, and banks fear underreporting of bad loans as a hidden risk. Concordantly, banks also have accumulated significant non-banking assets (NBAs) in form of collateral seized on defaulted loans (land and real estate). An analysis by NRB indicated that about 64.9% of loans are backed by property, yet market conditions have left much collateral unsold[9]. By Poush 2081 (December 2024), roughly 4.9% of loans (approximately NPR 26 billion) were effectively inactive, generating idle profits of NPR 28 billion on bank books[9]. In sum, stagnant auctions and falling property values have swollen banks' NBA holdings and eroded liquidity.

The economic consequences of rising NPLs and NBAs can be serious. High volume of bad loans force banks to keep large provisions, squeezing profitability and capital ratios[3]. Similarly, banks' return on assets and equity have dipped as interest income has fallen and administrative costs have risen. This has resulted in slow credit flows to the private sector which is impeding investment opportunities. Consumers and businesses are struggling to access finance as banks are trying to de-risk their portfolios. In this context, policymakers are worried if the mounting NPL burden is left unchecked, this could trigger a credit crunch and higher fiscal exposure.

Resolving Bad Assets and Recapitalizing Banks

ARCs address bad assets by acquiring them from banks and conducting specialized recovery efforts. Usually, a bank sells a pool of NPLs (and sometimes related collateral) to an ARC at a negotiated price. Payment may be in cash, bonds or security receipts that are backed by the acquired loans. Once the ARC holds the assets, it uses restructuring techniques which includes: renegotiating terms with borrowers, rescheduling payments, or even converting debt into equity. If borrowers cannot be revived, the ARC exercises foreclosure rights or liquidates collateral through auction or sales. ARCs also often have more flexibility (e.g. extended timelines, asset management expertise) to outwork loans, since they are dedicated to maximizing recovery rather than lending.

ARCs help recapitalize the banking sector indirectly by removing NPAs from banks' books. This is because banks no longer need to provision indefinitely against those loans, which immediately frees up capital. If the ARC pays at least a portion of the book value, banks can shore up their capital or meet regulatory ratios. For example, successful ARC operations can boost a bank's return-on-equity by reducing loan-loss reserves. Over time, as ARCs sell collaterals or recover funds, banks may receive further payouts from liquidation proceeds (depending on the sale price and structure). While often this recovery flow is below the face value but is better than outright write-offs. All in all, ARCs clean up bad debts, restores banks' ability to lends and stabilizes the financial system without requiring direct capital injections.

ARC Structure and Profitability: An Indian Example

Indian economy's experience provides a mature example of ARC operations. India introduced ARC in 2002, and today there are multiple licensed ARCs (Non-Banking Financial Corporations; NBFCs) serving the banking sector. These include large entities like the Asset Reconstruction

Company (India) Ltd. (ARCIL), which is a joint venture of SBI, ICICI Bank and global funds and others (India Infoline ARC, Edelweiss ARC, etc.). ARCs typically have modest paid-up capital (regulatory minimum of INR 300 crore) and generate funds by issuing security receipts to banks.

Operational Structure

ARCs in India are regulated by the Reserve Bank of India (RBI) under the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI Act, 2002). They raise capital from banks and investors to purchase NPLs. For example, ARCIL has about INR 16,926 crores in Assets Under Management (gross NPL acquisitions) as of December 2024[4]. ARCIL's ownership is mainly held by Avenue India Resurgence Pt. Ltd. (70%) followed by State Bank of India (SBI; 20%)[4]. Other ARCs may be sponsored by groups or financial institutions. ARCs operate with strong oversight and they are required to have experienced management, maintain adequate capital ratios and adhere to fair recovery practices.

Profitability

ARC profits tend to be volatile and usually hinges on recover outcomes. Analysis by credit rating agencies in India show that return on assets for ARCs swung frequently from FY2020 to FY2024. Indian ARCs earn revenue mainly through: a) managements fees (typically a percentage of the acquired book value), b) a share of any upside (above a guaranteed floor) when disposing assets, and c) gains from selling collaterals. However, if recoveries are slow or collaterals sell at deep discounts, profitability can be low. The recent regulatory scrutiny (May 2024) has highlighted challenges of ARC in India[2].

Regulatory View

Fitch Ratings (through its affiliate India Ratings) highlights that ARCs' cash flows are intrinsically unpredictable, since their revenue depends on eventual recovery rates, which are hard to forecast[4]. Nonetheless, a sound recovery track record and strong capital base (low leverage) can make ARCs relatively low-risk investment vehicles. Generally, ARCs in India maintain high provision coverage and low gearing. Overall, the sector has shown modest profitability when the macroeconomic environment is stable. In FY2023/24, Indian ARCs collectively issued security receipts worth over INR 10 lakh crore and generated recovery that lifted many of them into profitability[8].

South Asian Case Studies

Sri Lanka

Sri Lanka's banking crisis prompted a similar "bad bank" plan. In August 2023, government sources confirmed plans to set up an ARC to ring-fence toxic assets[1]. This state-backed entity would be empowered to acquire distressed loan portfolio at discounts and use legal recovery powers on behalf of banks. Sri Lank's high NPL ratio (about 13.3% in mid-2023) has strained commercial banks' capital[1]. The ARC proposal, approved in principle in the prior budget, aims to free banks from these loans so they can resume normal lending[1]. However, like in Nepal, Sri Lankan officials recognize this is a complex undertaking that required new legislation and funding.

Bangladesh

Bangladesh has faced a rapid NPL buildup (over 30% of loans by mid-2025) and is under pressure to form an ARC. The IMF and World Bank have repeatedly urged Dhaka to create a legal framework for an ARC to resolve bad debts[5]. So far, Bangladesh has relied on regulator measures (loan rescheduling, banking court) but these have not stemmed defaults. Donor agencies including the ADB are ready to support an ARC's establishment[5]. A local analysis noted that without an ARC, banks will continue provisioning massive amounts and taxpayers may eventually bear the cost (as in other countries)[5]. Key lessons that Nepal can learn from Bangladesh is that implementing an ARC requires clear objectives, adequate capital, and coordination in insolvency regimes.

Pakistan

Pakistan has not adopted an ARC model but has taken regulatory steps to curb NPLs. The State Bank of Pakistan (SBP; Central Bank) in July 2024 issued guidelines requiring banks to submit detailed plans to reduce their existing NPL stock and prevent further growth[10]. This mandate is being enforces as a condition under the IMF program. Pakistan's NPL ratio remains moderate (around 6-7% in 2024) but is monitored closely given the macroeconomic stress[10]. Unlike Nepal's proposal, Pakistan's approach so far has been to use oversight and restructuring mechanisms rather than a dedicated ARC. The IMF report notes that almost all banks in Pakistan have submitted NPL cleanup plans, with SBP monitoring implementation[10]. This shows an alternative model: central bank-directed resolution without a separate ARC. However, for Nepal, the consensus is leaning towards a bespoke ARC because market-based liquidation has largely stalled.

These case studies highlight that legal authority and capital support are critical. Sri Lanka's draft ARC law and Bangladesh's pending ARC legislation underscore the need for strong statutory backing. Pakistan's experience illustrates that a solely regulatory approach can be a stopgap but may not fully unlock stalled assets. For Nepal, a statutory ARC (like India's ARCs or Sri Lanka's bad bank) could be more effective than piecemeal loan-by-loan restructuring, provided it is well-designed.

Table 1: Comparative Approaches to NPL Resolution in South Asia (2024–2025)

Country	**Mechanism / Entity**	**Notes**
Nepal	Planned ARC	ARC announced in FY 2082/83 budget; NRB drafting law to buy banks' NPLs/NBAs.
India	Licensed ARCs (e.g. ARCIL)	ARCs acquire NPLs via security receipts; largest ARC (ARCIL) AUM ~INR 16,926 cr (Dec 2024), profit INR 304 cr in FY2024.
Sri Lanka	Proposed "Bad Loans Bank"	Govt approved state-owned ARC for toxic assets; NPL ratio ~13.3% in mid-2023.
Bangladesh	Proposed ARC (pending)	IMF/ADB urge ARC creation; NPLs projected >30% by mid-2025.
Pakistan	SBP NPL-resolution plans	No ARC; SBP mandated banks to submit NPL-reduction plans (July 2024).

Nepalese Case Study

Nepal's *Asset Reconstruction Company Bill* could follow in line with India's **SARFAESI Act, 2002**, which lets a secured creditor or an ARC **take over the management of the borrower's entire business and redirect monies owed by that firm's customers**, powers embedded in section 13(4)(b) and reinforced by section 15's "manner and effect of take-over of management".

Since many Nepalese bad-loan cases involve *operating* trading houses (gypsum, coal, steel inputs, etc.) whose value lies in live contracts and supply-chain goodwill rather than bricks-and-mortar collateral, an ARC that lacks those SARFAESI-style powers would recover only the scrap value of stock and receivables.

Case A illustrates why an ARC's mandate must extend beyond seizing land and warehouses to legally running distressed operating companies and capturing their cash-flows.

Case A – Beyond Real-Estate Collateral: Why Operational Control Powers Matter

Borrower	Mid-sized gypsum trading company financing raw-material imports for cement/steel plants
Security Mix	Working capital claim on receivables and inventory; plus, secondary mortgage on aging warehouse
Outcome	- Auction of stocks/receivables realised - Warehouse sale fetched - Remaining part of the loan turned irrecoverable until a rival distributor offered to buy the operating business outright

What an ARC with SARFAESI-style powers could have done

1. **Step in as de-facto management** (s. 13(4)(b) SARFAESI) to keep supply flowing, preserving the firm's unique supplier rebates and B2B goodwill.

2. **Serve notice on buyers** to redirect payments to the ARC under s. 13(4)(d), effectively converting trade receivables into a cash waterfall for lenders.

3. **Run the business as a going concern** or sell it lock-stock-and-barrel under s. 9(a) "sale or lease of the whole business" typically realizing 45-60 % of face value in similar Indian cases.

Why Nepal's ARCs would need these power

- Without clear takeover and receivables-redirection clauses, any Nepali ARC would be stuck with the same low-value collateral banks now hold.
- Creditor-driven management change is already mainstream across the border: the first full takeover under section 13(4)(b) was upheld in Indian courts in 2024, setting a practical precedent.
- Budget 2082/83 likewise flagged the need for "operational-restructuring powers" when announcing the ARC initiative, while IMF Article IV staff noted that "asset-quality measures hinge on effective ARC enforcement tools".

Granting Nepalese ARCs the power to take over a borrower's entire business exactly as Indian ARCs can under SARFAESI Act and the RBI's 2010 "Change-or-Take-Over" guidelines, which allow a takeover when holders of 75 % of security receipts consent lets the creditor keep contracts alive, redirect customer payments and run or sell the firm as a going concern instead of dumping inventory for scrap. In India this mandate has repeatedly turned write-offs into real money: when Edelweiss ARC seized 70 % of debt at Bharati Shipyard in 2015 it installed a professional CEO, raised about INR 500 crore of fresh working capital and rebranded the yard as Bharati Defense, salvaging war-ship orders and preserving asset value and at Karaikal Port the same ARC's operational control pushed EBITDA from INR 70 crore to INR 180 crore in just 18 months, paving the way for an over INR 1,400 crore sale to Adani Ports in 2023 which nearly was double the asset's INR 822 crore liquidation worth. Courts have blessed the model too: Rural Electrification Corporation's 2017 takeover of Facor Power was the first judicially endorsed use of SARFAESI Act, confirming that lenders may lawfully replace management until dues are cleared. These precedents show that operational control powers routinely lift recoveries to 45–60 % of face value, safeguard jobs and supply chains, and attract strategic buyers benefits which Nepal would forfeit if its ARC could seize only land and warehouses.

Conclusion and Policy Recommendations

Looking back at the international experience and Nepal's context, key recommendations for an effective ARC framework in Nepal include:

- **Enaction of a clear legal framework:** Legislation of a dedicated Asset Management Company Act to formally define the ARC's mandate, powers, and governance is crucial. This law should be able to authorize the ARC to acquire NPLs and NBAs at a prescribed procedure, bypass certain bureaucratic delays (e.g. property transfer approvals)[9], and enforce recovery (e.g. fast-track auctions, debt-restructuring authority).

- **Capitalization and ownership structure:** Ensuring that the ARC is adequately funded in also imperative. Possible models might include: a) a public-private partnerships, where banks and the government jointly subscribe to ARC equity or b) a fully-government-owned ARC with commercial management. Regardless, the ARC should have enough capital to purchase sizable NPL pools. One innovative approach can be to allow the ARC to issue bonds to banks in exchange for NPL assets, with these bonds counting towards banks' statutory liquidity (SLR) requirements. Such government-backed bonds would lower ARC funding costs and mitigate banks' risk.

- **Pricing and funding mechanisms:** The valuation methods for NPL portfolios should be defined transparently. Banks should sell NPLs at a formulaic discount reflecting independent asset appraisals, to prevent collusion. Upfront payment to banks could be in government securities, cash, or bonds from the ARC. It is important to consider a framework like India's security receipts or bonds, where banks bear some of the haircuts but also share any upside from future recoveries. The finance ministry might guarantee initial ARC issues (similar to India's recent NARCL guarantee), thus making the ARC creditworthy without immediate budgetary outlay.

- **Governance and oversight:** The ARC should be structured with strong and independent governance, preferably a board comprising public and private sector experts (e.g. bankers, legal professionals, NRB representatives) should oversee operations. Broad powers must be granted: for example, the ARC should be allowed to directly evaluate and purchase collateral from banks without local authority bottlenecks. Likewise, special authority (possibly through NRB) may be needed to facilitate sales of large properties and to waive certain procedural hurdles.

- Integration with banking regulation: It is also imperative to coordinate ARC operations with existing regulatory frameworks. For instance, NRB should adjust provisioning rules to ensure banks fully provision for any NPLs transferred to the ARC. The central bank can set phased targets (similar to Pakistan's plans) for reducing system-wide NPLs via the ARC. Also, ARC needs to strengthen credit monitoring and foreclosure norms so that future loans are not allowed to sour unchecked. The ARC should report progress to NRB/FIU to maintain transparency.

In summary, a successful ARC in Nepal will require strong political commitment and well-calibrated design. It must balance swift disposal of distressed assets with fairness to banks and debtors. If executed properly, it can arrest the rise of bad loans, restore confidence in the financial sector, and set the stage for healthier credit growth. The challenges are significant, but the potential payoff is, revitalized banking intermediation and economic dynamism which makes the effort worthwhile. With clear legislation, prudent capitalization, and robust governance (drawing on regional precedents), Nepal's ARC can become a cornerstone of banking-sector reform and financial stability.

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