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Cherries, Lemons, and the Market for Non-performing Loans

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Citation guideline

Executive Summary

India has a well-established secondary market framework for NPLs. Over the last decade, it has also built a very robust insolvency resolution ecosystem. Despite these enablers, India's NPL market remains small. This paper argues that a market-design failure arising from adverse selection could be an impediment. Banks typically offer small, selective pools of NPLs for sale to investors; based on the bids received, they decide whether to accept the offers or decline them and retain the loans on their balance sheets. This cherry-picking of loans exacerbates information asymmetry, leading investors to discount NPLs at high rates and resulting in valuation mismatches and failed trades. When banks sell large fractions of NPLs, the scope for cherrypicking reduces, credibly signalling the asset quality of the portfolio offered for sale. This paper shows that selling large fractions of NPL portfolios can mitigate adverse selection and raise the equilibrium prices. Finally, this paper recommends regulatory measures to advance the NPL market.

Content

1. Introduction

Non-performing loans (NPLs) play a crucial role in determining banks' performance. While, on the one hand, NPLs prevent banks from recognising interest income on such loans, on the other hand, banks are required to make loan loss provisions (LLPs) to cover potential future losses (DeYoung et al., 2004). Consequently, NPLs impede banks' profitability and reduce their capital (Berger & DeYoung, 1997). High levels of NPLs can also lead to bank failures (Campbell, 2007), and systemic problems may even affect the economy's financial stability (Acharya, 2017).

However, the criticality of the NPL problem is exacerbated during crisis periods when many banks simultaneously face it. Therefore, managing NPLs becomes a critical function of a bank. Having an efficient and effective NPL resolution mechanism helps restore capital to the banking system.

In the last decade, banks in India have made substantial progress in recognising and resolving NPLs. During this period, India also developed a well-functioning insolvency resolution framework. Yet, India's distressed debt market remains underdeveloped relative to its size. The market has been plagued by low transaction volumes and high bid-ask spreads. Global distressed-debt investors have recently been moving away from the market[1]. It is important to attract foreign investors not only for their capital but also for their deep expertise in turning around distressed businesses. Therefore, these investors' avoidance of the Indian distressed debt market is a matter of serious concern.

In this paper, I study the strategic interaction during NPL sales between banks and investors. I show that low transaction volumes could stem from market failure arising from banks' strategies of selling small pools of NPLs relative to their NPL stock, which creates a severe 'lemons' (adverse selection) problem (Akerlof, 1970). I then present how this problem can be addressed through policy measures.

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[1] Several foreign distressed-debt investors and private equity funds have either relinquished their Asset Reconstruction Company (ARC) licenses or abandoned plans to establish ARCs. These include Lonestar Capital, KKR, Apollo Global, Bain Capital.

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 5

GREAT LAKES CHENNAI

2. Scale of the NPL problem and the resolution mechanism

Recent commentary on stressed assets in India's banking system (RBI, 2025) suggests that the NPL problem has been substantially addressed, evidenced by a softening of Gross NPL ratios to the lowest levels in two decades. However, a closer evaluation of the data reveals a different underlying story. Although Gross NPL levels have moderated to 2.2% of Gross Advances in 2025, down from the 2018 peak of 11.2%, the reduction does not fully reflect improved NPL resolution. While some of the reduction in Gross NPLs resulted from a decline in fresh slippages[2], a substantial share of NPL reduction came from write-offs of loans from the balance sheet, in accordance with the prudential income recognition norms set by the Reserve Bank of India, rather than from the actual recovery of dues on those non-performing loans.

Figure 1 shows the movement of Gross NPLs and Written-off loans over the last 10 years. The Gross NPLs of all Scheduled Commercial Banks in India as of March 31, 2025, were INR 4.32 Lakh Crore, representing 2.2% of Gross Advances. The banking system's written-off loan portfolio as of March 31, 2025, stands at INR 7.88 Lakh Crore, representing 183% of Gross NPL levels, implying an absolute NPL stock of INR 12.20 Lakh Crore.

Figure 1 also shows the difference in the NPLs of the Public Sector and Private banks. While addressed through policy measures a majority of the Gross NPLs and the Written-off loan

Figure 1: Gross NPLs and Written Off Loans of all Scheduled Commercial Banks
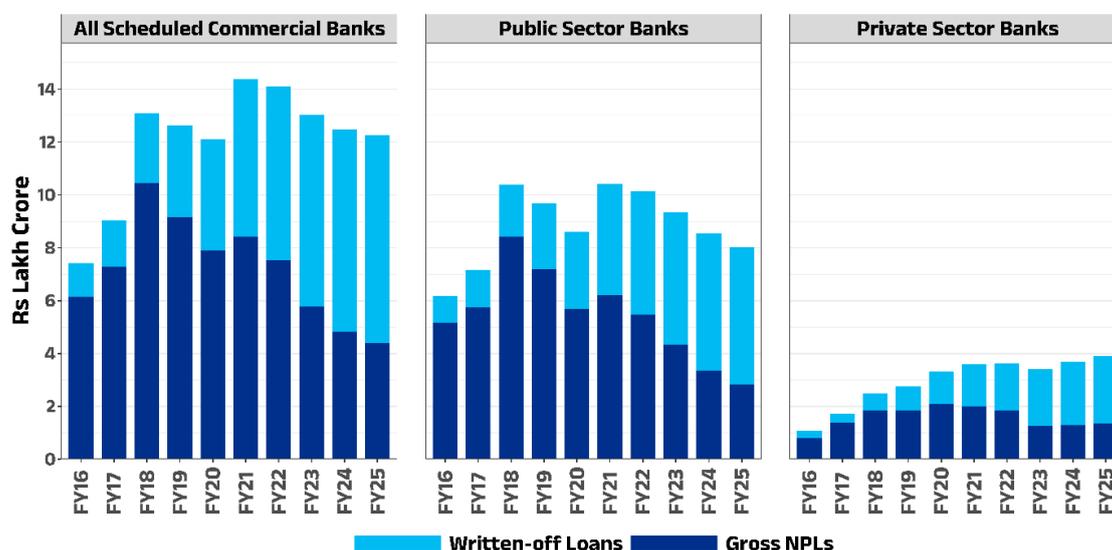
Source: CMIE Prowess Database (accessed on Feb 03, 2026).

[2]Fresh slippages refer to those loans that were classified as "standard" at the beginning of a period but have turned 'non-performing' during that period.

portfolio is contributed by the Public Sector Banks, both Public Sector and Private Banks have Written-off loan portfolios higher than Gross NPLs, indicating that timely resolution of NPLs is a problem for both Public Sector and Private Banks.

2.1 Need for a good distressed debt market

The scale of NPL stock in the banking system (the sum of Gross NPLs and Written-off Loans) is economically significant and raises questions about the timely and effective resolution of NPLs. If India had a well-functioning distressed-debt market, some NPLs would likely have been acquired by distressed-debt investors earlier in the default cycle, thereby providing banks with a timely exit and borrowers with specialised resolution capital and advice.

A good financial system is one that is not only determined by its capacity to deploy credit but also by its ability to recycle it. For recycling credit, a robust distressed-debt market is essential. There are three specific benefits to having a well-functioning distressed-debt market.

Unlocking capital

Banks operate in a highly regulated environment with aggressive capital requirements as per BASEL norms. When non-performing loans are sold, the high-risk illiquid assets are transformed into low-risk cash, which can be deployed for new credit allocation at a lower risk.

Price discovery and transparency

A well-functioning market offers a price discovery mechanism that provides better information about the banks' asset quality than book value-based ratios obtained from accounting principles.

Specialized Asset Resolution

NPL management requires different operational and managerial capabilities, often available with specialized entities. This can lead to the efficient resolution of NPLs from both the lender's and the borrower's perspectives. Capital-raising avenues through the banking system are effectively closed to borrowers classified as NPLs. When a distressed debt investor takes over the loan, a new path for borrower's fundraising may open.

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 7

GREAT LAKES
CHENNAI

3. NPL sales in India

Prior to 2002, there was no regulatory framework for the sale of NPLs by banks in India. The establishment of Asset Reconstruction Companies (ARCs) since 2003 paved the way for the development of a market for NPLs in India. While many countries adopted the state-owned asset management company model for NPLs resolution, India chose to set up 'private' ARCs to acquire and resolve NPLs (Pandey, 2022). In recent years, India facilitated the establishment of Alternative Investment Funds (Special Situation Funds). However, the majority of NPLs purchased to date have been through ARCs. The word 'through' is deliberate. ARCs acquire loans through the securitisation route by setting up special-purpose vehicles. These Special Purpose vehicles raise funds from investors by issuing 'Security Receipts'[3]. Notably, the share of selling banks' ownership of Security Receipts issued by ARCs remained above 80% until March 2018, and decreased to approximately 59% in March 2025. Although the participation of ARCs and other investors in recent years has increased, the selling banks' participation in newly issued Security Receipts remains prevalent.

While the initial 10 years of ARCs' establishment saw low transaction volumes, as banks' Gross NPL ratios continued to rise, transaction volumes have increased since 2014 (RBI, 2016). Figure 2 presents the Gross NPLs sold as a percentage of Opening Gross NPLs by different categories of
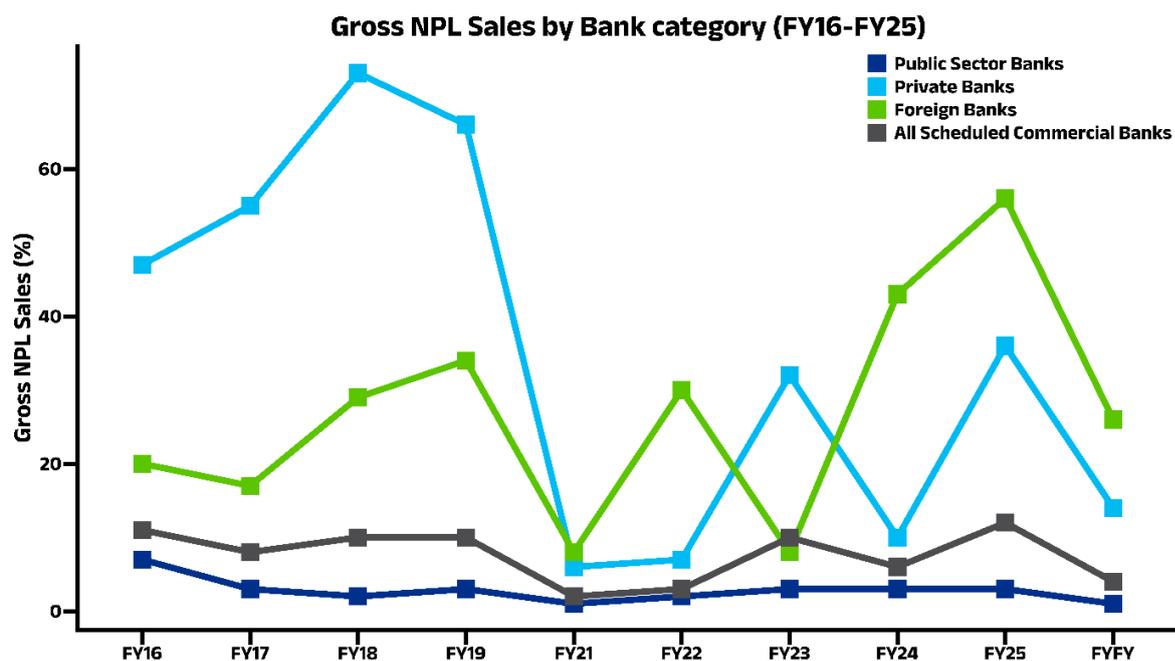

Figure 2: Gross NPLs sold as a percentage of Opening Gross NPLs by Scheduled Commercial Banks

Source: RBI Trend and Progress of Banking in India (various years)

[3]Security Receipts are pass-through securities issued by Special Purpose Vehicles set up by ARCs to raise capital to acquire NPLs. Qualified Institutional Buyers (QIBs) are eligible to invest in Security Receipts. QIBs include ARCs, banks and Financial Institutions, Alternative Investment Funds, etc.

GREAT LAKES CHENNAI

Cherries, Lemons, and the Market for Non-performing Loans
Page 8 | Great Lakes CFER White Paper Series | GLCFER WP No. 1

banks since 2016. The contrast between Public and Private sector banks is evident. Private-sector banks were more active in the secondary market than Public-Sector Banks, reaching a peak of 73% in 2018. Conversely, NPL sales by Public Sector Banks remained stagnant, confined to a narrow 1% to 7% range. Despite sovereign intervention through guarantees for Security Receipts backed by certain large NPLs, the sale of NPLs by Public Sector banks remained muted.

3.1 How Banks sell NPLs

The sale of NPLs by banks is regulated by the Reserve Bank of India. Banks typically offload NPLs through either Auctions, Bilateral negotiations, or the Swiss Challenge mechanism. When banks sell NPLs through auctions or bilateral negotiations, they initially select a pool of NPLs to offload. Prospective investors conduct due diligence and submit bids. Banks evaluate the bids and decide whether to sell the NPLs. Under the Swiss Challenge method, the bank receives an initial bid from an investor. The bank then invites other prospective investors to counter-bid. If the counterbid is higher, the initial bidder has a right of first refusal. If the initial bidder matches the counter-bid, then the loans are sold to the initial bidder. Otherwise, the loans are sold to the counter-bidder. The bank retains the right to withdraw the loan from sale even after the NPL auction. However, if a bank withdraws a loan from sale in a Swiss Auction, it is required to make provisions for such loans to reflect the price offered by the highest bidder. Some banks disclose Reserve Prices upfront; however, it is not mandatory.

NPL sales in India exhibit three stylized features:

1. **Strong information asymmetry**
   Banks possess superior loan-level information and borrower-specific insights that investors cannot fully verify ex ante. This problem persists despite several efforts taken by regulators to enhance information quality, such as CRILC, CERSAI, and the standardisation of Information-sharing templates, etc.

2. **High discretion in pool construction**
   Banks select a very small pool of NPLs for sale. In most cases, the sale decision is made on a loan-to-loan basis rather than on a portfolio basis. For example, during FY21-FY25, State Bank of India offered less than 10% of its NPL portfolio for sale each year, according to press releases on the bank's website.

3. **Wide variation in pool sizes**
   On most occasions, banks chose to offer small sizes of NPLs for sale, relative to their NPL stock. However, there are a few occasions when banks choose to sell a substantial fraction of their NPL stock. Yes Bank, which underwent a regulator-driven restructuring in 2020, sold a large share of its NPLs during FY23[4].

[4]Source: Yes Bank Annual Report FY23

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 9

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The outcome of the current NPL sale practices is low actual NPL sales. Table 1 shows the relative frequency distribution of NPL sale activity for a sample of 50 Scheduled Commercial Banks, including 28 Public Sector Banks and 22 Private Banks, from FY04 to FY25. The total number of observations is 919. Each observation corresponds to a specific bank in a specific financial year. The Sale Fraction denotes the percentage of Net NPLs that banks sell to ARCs each year[5]. While it is noteworthy that Public Sector and Private Banks didn't sell any NPLs in two-thirds of bank-years, there is a difference in the quantum of sales by Public Sector and Private Banks in bank-years when they eventually sell. Private Banks tended to sell a larger share of their NPLs than Public Sector Banks.

In this context, it is important to know how the practice of offering a small fraction of NPLs for sale to investors influences the outcomes of the sale process. In the next section, I present and analyse a model that emulates the NPL sale process.

Table 1: Relative frequency distribution of Sale Fraction in terms of Net NPLs based on actual sales by Public and Private Banks from FY04 to FY25

Sale Fraction Range	All Banks (%)	Public Banks (%)	Private Banks (%)
0.00	66.27	66.19	66.35
0.01–0.10	22.74	29.15	15.29
0.11–0.20	5.33	3.24	7.76
0.21–0.30	2.29	0.61	4.24
0.31–0.40	1.41	0.40	2.59
0.41–0.50	0.65	0.20	1.18
0.51–0.60	0.44	0.00	0.94
0.61–0.70	0.44	0.00	0.94
0.71–0.80	0.44	0.20	0.71
Total	**100.00**	**100.00**	**100.00**
Sample Size (Bank-years)	919	494	425
Sample Size (Banks)	50	28	22

Source: Data compiled from Annual Reports of respective banks

[5]This analysis relies on the Net NPL figures due to limitations in publicly available Gross NPL data pertaining to sales by each bank each year. As Net NPLs reflect provisioning adjustments, Sale Magnitude based on Net NPLs may not fully capture the extent of NPLs sold.

4. Sale of NPLs: The model

Consider a bank holding a portfolio of N non-performing loans (NPLs). The sale of NPLs by banks to investors may be viewed as a game of incomplete information, with banks holding private information about the quality of the loans that investors cannot verify or that is costly to verify.

Let R_i denote the present value of expected recovery net of resolution cost, discounted at a market-consistent rate of loan i, and $R_i \sim U\,[0, 1]$ independently across loans[6]. Loan quality is continuously distributed. However, for expositional convenience, the loans in the lower tail of the recovery distribution are referred to as 'lemons', and those in the upper tail as 'cherries' [7]. The bank observes R_i, whereas outside investors observe only the distribution, not individual R_i. The expected recovery of the full portfolio is therefore $E[R] = 1/2$.

Banks' strategy is to maximise the value of the entire NPL portfolio, including those proposed for sale and those retained on the balance sheet. Under standard auction or bilateral negotiation processes, the bank typically selects a pool of loans for sale and invites potential investors to evaluate the portfolio and submit bids. The bank makes two decisions. First, the fraction of NPLs proposed for sale. Second, the loans that must be included in the Sale process. The bank could sell a few selected NPLs, a large pool of NPLs, or randomise the selection process. Invariably, this selection process involves evaluating the recovery potential of the loans, if retained, relative to the expected sale price of the NPL. The bank is incentivised to pick cherries for retention on the balance sheet while offloading lemons to investors. This is referred to as 'strategic selection'. Therefore, the very inclusion of a loan in the portfolio implies that the bank's recovery expectation is lower than the expected price.

Suppose the bank proposes to sell a fraction $\alpha \in (0, 1]$ of its NPL portfolio. The bank knows which loans are cherries or lemons. Investors observe only the distribution. The investors also observe the pool size relative to the overall NPL portfolio. If the bank could credibly commit to selling a random subset, the expected value of the sold pool would be $E[R] = 1$. However, without commitment, investors rationally expect strategic selection.

Suppose the bank sells only a small fraction α. With private information, the bank maximizes retained value by selling the worst loans first and keeping the better ones. Thus, if it sells fraction α, it will sell loans with $R_i \in [0, \alpha]$. The expected recovery of the sold pool becomes $E[R \mid R \le \alpha] = \alpha$. Investors anticipate this. Therefore, the maximum price per loan they are willing to pay is $P(\alpha) = \alpha$. Notice that as $\alpha \to 0$, $P(\alpha) \to 0$. When the bank attempts to sell a very small

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[6]Investors, such as Asset Reconstruction Companies, evaluate the NPLs offered for sale and gather information through due diligence. Based on their evaluation of expected cash flows, timing of those cash flows, and associated risks, investors place bids to acquire respective NPLs at prices sufficient to meet their internal rate of Return (IRR) targets. To focus on the influence of banks' strategic selection / asymmetric information on the equilibrium prices, I ignore the other factors that may influence the prices.

[7]Examples of cherries include those NPLs with expected recoveries from minor debt restructuring. Examples of lemons include those NPLs with expected recoveries from complex litigation with uncertain timelines.

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 11

GREAT
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fraction, investors expect extreme cherry-picking and offer nearly zero. This generates large bid-ask spreads, leading to market failure for small portfolio sales.

Now suppose the bank attempts to sell a large fraction of the portfolio. If it sells fraction α, it can only retain fraction $1 - \alpha$. As α rises, the bank's ability to retain only high-quality loans shrinks, the marginal loan sold becomes higher quality, and the average recovery of the sold pool increases. If the bank sells the entire portfolio ($\alpha = 1$), $E[R \mid \alpha = 1] = 1$. No adverse selection remains. More generally, since $P(\alpha) = \alpha$, the price is increasing in α. Small α implies a very low price. A large α implies that the price converges to 0.5.

The mechanism operates through retention incentives. When the bank sells a small fraction, it can retain all high-quality loans, investors expect extreme negative selection. When the bank sells a large fraction, selective retention becomes infeasible, the quality of the sold pool approaches the portfolio average, and adverse selection reduces. Thus, adverse selection is most severe when disposal is marginal and weakest when disposal is systemic.

This framework highlights a structural paradox: Partial deleveraging increases adverse selection, while systemic deleveraging reduces it. NPL markets may, therefore, be inherently discontinuous, either frozen at low volumes or functioning at scale.

If the portfolio on sale is small relative to its NPL stock, the investor may infer that the bank is selecting low-quality NPLs ('lemons') for sale while retaining high-quality NPLs ('cherries') on its balance sheet. The investor adjusts prices to reflect this concern, thereby reducing the quoted price. Under common knowledge, Bank sees that the investor weighs down the 'average' price, and has no incentive to offer cherries in the basket of NPLs for sale. This leads to a market failure, a stable equilibrium. The bank is better off resolving NPLs internally, and investors are better off refraining from investment. This explains why there were no transactions in 66% of bank-years, and in the remaining bank-years, the majority of NPL transactions involved sale fractions below 5%.

As the fraction of the portfolio earmarked for sale approaches unity, the bank's ability to 'cherry'-pick declines. By committing to sell a large, non-discretionary share of the book, the bank provides a credible signal of transparency. As the investor perceives the sale pool to be more representative of the bank's aggregate portfolio, the adverse selection discount narrows as it approaches the population mean. The price per loan is an increasing function of the fraction sold, effectively rewarding the bank for the loss of flexibility in picking cherries.

The analysis suggests that low prices offered by investors are a rational response to information asymmetry. When a bank decides to include a particular NPL, it implicitly assumes that the prices offered by investors reflect the particular NPL's idiosyncratic risk. However, investors update their beliefs about the bank's selection strategy and adjust prices. This pricing externality flows to the entire portfolio if banks follow a loan-wise selection strategy.

GREAT LAKES CHENNAI

Cherries, Lemons, and the Market for Non-performing Loans
Page 12 | Great Lakes CFER White Paper Series | GLCFER WP No. 1

Consequently, the sell-versus-hold decision should not be made at the level of a single borrower account or a small fraction of the portfolio. To break this deadlock, banks should sell a larger share of NPLs and randomise the portfolio-selection process.

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 13

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5. Implications to bank's Sell v/s Hold decision

The equilibrium characterised above alters how the bank's sell-versus-hold decision should be understood. In a frictionless environment, this decision could be treated as a standard cost–benefit comparison at the level of an individual loan: if the expected recovery from internal resolution exceeds the price offered by investors, the bank retains the loan; otherwise, it sells. However, the asymmetric information framework developed in this paper shows that such a loan-level comparison is incomplete and potentially misleading. Under information asymmetry, the investor rationally updates beliefs about the quality of the loans included in the sale pool. When the bank offers only a small and selectively constructed fraction of its NPL portfolio, the investor infers that higher-quality loans are being retained and lower-quality loans are being offered for sale. Anticipating this selection bias, investors discount the price of the entire pool. The discount is therefore not purely a reflection of borrower fundamentals, but of strategic inference about the bank's selection process.

The model implies the presence of a portfolio-level pricing externality. When a bank evaluates whether to sell a particular loan, it typically compares the expected internal recovery with the market price offered for that loan. Yet the market price itself is endogenously determined by investors' beliefs about the bank's broader strategy. If investors believe that only weaker loans are being offered, prices for all loans in the pool decline.

Thus, the decision to sell a single loan cannot be separated from the bank's overall portfolio strategy. Loan-wise optimisation leads to equilibrium price suppression, which in turn reinforces the bank's incentive to retain higher-quality loans. The result is a stable low-volume equilibrium characterised by small sale fractions, wide bid–ask spreads, and investor withdrawal or reduced participation. In this equilibrium, retaining NPLs is not necessarily evidence of managerial inefficiency; rather, it is a rational response to depressed equilibrium prices arising from adverse selection.

In principle, selling NPLs converts illiquid assets into cash and reduces risk-weighted assets, thereby improving regulatory capital ratios. However, when prices are discounted due to adverse selection, the liquidity benefit must be weighed against the equilibrium-induced loss. The bank may rationally prefer to retain loans if the price discount exceeds the liquidity premium.

Selling transfers recovery risk and timing uncertainty to specialised investors. Yet if investors price aggressively to protect against selection risk, the bank effectively bears the cost of this informational asymmetry upfront through lower sale proceeds.

Because the bank possesses superior information about borrower quality, it has an incentive to retain loans with relatively stronger recovery prospects. This endogenous cherry-picking behaviour, while individually rational, reinforces investors' skepticism and further depresses

prices. Immediate recognition of losses upon sale becomes particularly prominent in the low-price equilibrium. Even if long-term portfolio value would be maximised through large-scale sales, short-term accounting losses create additional disincentives to deviate from the status quo.

When the fraction of NPLs offered for sale increases and approaches a substantial share of the total portfolio, the bank's ability to cherry-pick diminishes. In this case, the sale pool more closely reflects the overall distribution of loan quality. As a result, the adverse selection discount narrows, the price per loan increases, and the bank's incentive to retain higher-quality loans weakens. The equilibrium price is increasing in the fraction of the portfolio committed for sale. A credible commitment to sell a large, non-discretionary share of NPLs can shift the system from a low-volume adverse selection equilibrium to a higher-volume, more efficient trading equilibrium.

Even when a higher-volume sales strategy is economically desirable at the portfolio level, managerial incentives may prevent the transition to this equilibrium. Short-term performance metrics, career concerns, fear of ex post scrutiny, and loss recognition upon sale can all reinforce a preference for the low-sale equilibrium.

Thus, what appears as "status quo bias" may in fact be equilibrium persistence driven by a combination of informational frictions and institutional incentives. Without mechanisms that allow banks to credibly commit to broader portfolio sales, the adverse selection trap remains reinforcing.

The analysis above suggests that the underdevelopment of India's distressed debt market may not merely be the result of legal frictions or insufficient investor capital, but of an equilibrium driven by asymmetric information and strategic pool construction. When banks offer small, selectively constructed pools of NPLs, investors rationally discount prices, reinforcing the bank's incentive to retain higher-quality loans. The market becomes trapped in a low-volume, high-discount equilibrium.

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 15

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6. Recommendations

When banks sell individual loan accounts or small fractions of their NPL portfolios, only the most distressed assets trade at deep discounts. To break this trend, policy frameworks and bank-level strategies must shift from loan-level to portfolio-level assessment. In light of this paper's findings and implications for the bank's Sell vs. Hold decision, policy interventions should aim to alter incentives for banks and their managers to credibly transition to a high-volume equilibrium. The following measures can be understood as mechanisms to facilitate this shift.

1. **Amortization of divestment losses**

    Banks fear that large NPL sales pose the risk of significant immediate losses, making the short-term accounting impact particularly severe. If banks sell large fractions, for example, say 50% of the portfolio, then the losses maybe allowed to be absorbed over a period of three years, reducing the short-term earnings shock associated with large portfolio sales. This will reduce banks' incentive to hold NPLs on their balance sheets. This policy does not eliminate economic losses; rather, it smooths their recognition, enabling banks to crystallise the loan losses early.

2. **Realignment of managerial incentives**

    Performance metrics often prioritise current period performance over long-term value creation. In the presence of adverse selection, this encourages retaining NPLs to avoid immediate loss recognition, even if the long- term portfolio value would be enhanced by their decisive disposal. Executive compensation structures should therefore incorporate metrics tied to long-term recovery outcomes, capital recycling efficiency, and portfolio-level value maximization rather than solely to current-period accounting performance. By aligning managerial incentives with long-term portfolio efficiency, banks are more likely to adopt sale strategies that internalize the pricing externality identified in the model. This alignment facilitates the transition away from the adverse selection trap.

3. **Safe harbor arrangements**

    A significant hindrance to NPL sales is the risk faced by bank managers regarding post-facto scrutiny over the sacrifices made during the sale. The difference in NPL sale activity between PSU Banks and Private banks is an indicator of PSU banks'managers' reluctance to make decisions due to fear of future investigation. The government, as the major shareholder of PSU banks, must establish safe harbor arrangements that allow bank officials and boards to discharge their duties when making genuine economic decisions based on commercial wisdom.

4. **Discourage loan level inclusion/exclusion criteria**

    The model highlights that cherry-picking is a driver of the adverse selection discount. When banks retain discretion to include or exclude individual loans based on internal recovery expectations, investors rationally infer negative selection in the offered pool.

Regulatory guidance that encourages—or in certain contexts mandates—portfolio-level sale thresholds, randomized inclusion criteria, or predefined eligibility rules can reduce endogenous selection bias. By reducing the bank's ability to manipulate the pool's composition, the endogenous selection bias can be reduced or eliminated. This improves the prices offered by investors, leading to more transactions at higher prices. As the sale pool becomes more representative of the overall NPL distribution, investor beliefs adjust, adverse selection discounts narrow, and the equilibrium price per loan increases. This creates a virtuous cycle in which higher sale fractions sustain higher prices.

Each of the measures above can act as instruments to shift the NPL market from a low-sale, high-discount equilibrium driven by endogenous adverse selection to a high-sale, representative-portfolio equilibrium characterised by narrower discounts, higher transaction volumes, and improved capital recycling. These measures, although not intended to reduce information asymmetry, can alter investors' beliefs about pool construction. Effective policy must, therefore, address the strategic interaction between banks and investors.

Cherries, Lemons, and the Market for Non-performing Loans
Great Lakes CFER White Paper Series | GLCFER WP No. 1 | Page 17

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7. Conclusion

Distressed-debt investors allocate capital based on expectations of recurring deal flow. In a market characterised by sporadic, small-scale transactions, fixed costs of due diligence and platform establishment become difficult to justify. This reinforces thin participation and further entrenches the low-volume equilibrium. Regular, predictable offerings of substantial NPL portfolios create expectations of continuity. Once investors believe that banks are committed to systematic portfolio sales rather than opportunistic disposal of lemons, capital allocation to the market increases. Greater participation enhances competition, improves price discovery, and stabilizes the high-volume equilibrium.

Although the current level of NPLs poses no major financial stability risk in the immediate future, this situation offers an opportunity to deepen the secondary market for NPLs. This will make the economy better prepared to absorb the next wave of abnormal NPL spikes. When banks regularly offer large portfolios for sale, investors perceive this as a credible signal of continuity in NPL investment opportunities. This will prompt them to re-enter the market. However, achieving this requires more than just market forces. As both the sellers and buyers of NPLs are regulated by the same regulator (in this case, the Reserve Bank of India), coherent measures are required to encourage banks and their managers to make portfolio value-maximizing decisions.

Lastly, the paper provides a theoretical explanation of the "low-volume, high-discount" equilibrium in India's NPL market. It remains to be empirically tested whether banks' strategic selection is the dominant driver of market failure and, if so, the magnitude of the adverse selection discount.

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