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BAD BANK

JULY 2021 | THEME 355

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Bad Bank

July 2021| Theme 355

"Beware of little expenses; a small leak will sink a great ship."

Benjamin Franklin

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is "Bad Bank".

Background

The Indian economy has been reeling under the stress of non-performing loans for quite some time now, and the government and the Reserve Bank of India (RBI) have, over time, introduced several measures to contain the rising growth of stressed assets. Even before the COVID-19 pandemic, the incumbent stress had slowly but steadily blown into a crisis. Unfortunately, with the COVID-19 pandemic affecting economic sectors across the board, this problem has become worse. Bad loans in the system are expected to balloon in the wake of contraction in the economy and the problems being faced by many sectors. The RBI noted in its recent Financial Stability Report that the gross NPAs of the banking sector are expected to shoot up (almost double) to 13.5% of advances by September 2021, from 7.5% in September 2020, under the baseline scenario, as "a multi-speed recovery is struggling to gain traction" amidst the pandemic. The report warned that if the macroeconomic environment worsens into a severe stress scenario, the ratio may escalate to 14.8%. The K V Kamath Committee, which helped the RBI with designing a one-time restructuring scheme, has said companies in sectors such as retail trade, wholesale trade, roads and textiles are facing stress. Sectors that have been under stress pre-Covid include NBFCs, power, steel, real estate and construction. Setting up a bad bank is seen as crucial against this backdrop. The panel also noted that corporate sector debt worth Rs 15.52 lakh crore has come under stress after Covid-19 hit India, while another Rs 22.20 lakh crore was already under stress before the pandemic. This effectively means **Rs 37.72 crore (72% of the banking sector debt to industry) remains under stress.**

What is a Bad Bank and how does it work?

Bad banks are typically set up in times of crisis when long-standing financial institutions are trying to recuperate their wallets. While shareholders and bondholders generally stand to lose money from this solution, depositors usually do not. Banks that become insolvent as a result of the process can be recapitalized, nationalized, or liquidated. A bad bank conveys the impression that it will function as a bank but has bad assets to start with. Technically, a bad bank is an asset reconstruction company (ARC) or an asset management company that takes over the bad loans of commercial banks, manages them and finally recovers the money over a period of time. The bad bank is not involved in lending and taking deposits, but helps commercial banks clean up their balance sheets and resolve bad loans. The takeover of bad loans is normally below the book value of the loan and the bad bank tries to recover as much as possible subsequently.

McKinsey has outlined four basic models for bad banks. These included:

- An on-balance-sheet guarantee (often a government guarantee), which the bank uses to protect part of its portfolio against losses
- A special-purpose entity (SPE), wherein the bank transfers its bad assets to another organization (typically backed by the government)
- A more transparent internal restructuring, in which the bank creates a separate unit to hold the bad assets (a solution not able to fully isolate the bank from risk)

- A bad bank spinoff, wherein the bank creates a new, independent bank to hold the bad assets, fully isolating the original entity from the specific risk

In the present pandemic-affected market, the RBI has provided various relaxations to borrowers (in the form of an option to avail a loan moratorium or loan restructuring). However, a similar relaxation has not been provided to banks, who are expected to continue to repay their obligations.

Therefore, transfer of stressed assets from a bank's books to a Bad Bank could

- be able to focus on lending instead of loan recovery
- have availability of free capital that can be used more efficiently, since additional provisioning in connection with the transferred bad loans would not be required to be made
- see an improvement in credit ratings
- potentially see an overall improvement in banking business as investors, depositors and borrowers are more likely to engage with profitable banks.

Proposed Model of Bad Bank

India's earlier experience with bad banks seems to have left a feeling of scepticism. In 2004, when IDBI Limited's bad loans were bought out by a government fund, neither did the fund realise sufficient value from it, nor did IDBI Limited's lending record improve substantially. Critics therefore consider the bad bank as eyewash over accountability. This time, however, it appears that the proposal for establishing a bad bank is designed differently, drawing from experiences globally. The bad bank is proposed to be set up by state-owned banks and private sector banks, without any equity infusion from the government. Such bad bank will be purchasing stressed loan accounts exceeding Rs 500 crore against issue of security receipts to a wide pool of investors, including Alternative Investment Funds (AIFs). There may potentially be a sovereign guarantee to back the security receipts but that would fundamentally be to help banks meet regulatory requirements.

The budget 2021 proposed an Asset Reconstruction Company (ARC)-Asset Management Company (AMC) structure, wherein the ARC will aggregate the debt, while the AMC will act as a resolution manager.

- The proposed structure envisages the setting up of a National Asset Reconstruction Company (NARC) to acquire stressed assets in an aggregated manner from lenders, which will be resolved by the National Asset Management Company (NAMC).
- A skilled and professional set-up dedicated to Stressed Asset Resolution will be ably supported by attracting institutional funding in stressed assets through strategic investors, AIFs, special situation funds, stressed asset funds, etc for participation in the resolution process.
- Further, transferring these stressed assets to bad banks will entail recovery of 15% in cash and 85% in security receipts. The security receipts will be backed by a government guarantee, which is likely to ensure the face value of the SRs. The government is expected to provide a guarantee of Rs 31,000 crore for a period of five years for the NARCL.
- The net effect of this approach would be to build an open architecture and a vibrant market for stressed assets.

Assuming that banks will in fact be relieved of significant stress upon hiving off only those bad loans that are over Rs 500 crore, there are many positives here:

- Part ownership of the bad bank by private banks is likely to improve price discovery and related transparency of the sale of stressed loans by banks.
- Only part ownership by Government banks translates to lesser burden on the exchequer.
- With the backing of a sovereign guarantee, private banks are likely to be incentivised to participate in the capitalisation of the bad bank.
- Permitting AIFs to invest in the bad bank would widen the capital pool and involve market participation.
- The various credit guarantee schemes introduced by the Government to

improve accessibility of cheaper credit to micro, small and medium enterprises (MSMEs) may see fruition, as banks will have increased availability of capital to lend to MSMEs

India's Bad Bank/ NARCL

The National Asset Reconstruction Company (NARCL) is a legal entity now and has been registered with the Registrar of Companies (RoC) Mumbai. According to data available with the Ministry of Corporate Affairs (MCA), NARCL was incorporated on July 7, 2021 with an authorised capital of Rs 100 crore and paid-up capital of Rs 74.6 crore. The bad bank will be headed by PadmakumarMadhavan Nair, a stressed assets expert from State Bank of India (SBI), as the managing director. The Indian Banks Association (IBA) is likely to approach the Reserve Bank of India (RBI) to seek an ARC (Asset Reconstruction Company) licence. IBA had filed an application with the MCA to incorporate NARCL and India Debt Management Company (IDMCL) for managing bad debt in the system. While NARCL is a registered company now, IDMCL is yet to become a legal entity. While public sector banks are expected to hold a majority stake in NARCL, India Debt Management Company Limited (IDMCL) will likely be majority held by private banks.

Lenders have identified 22 stressed accounts worth around Rs 89,000 crore that are expected to be transferred to the new entity in the first phase. Over time, a much larger exposure of an estimated Rs 2 lakh crore is expected to be transferred to the NARCL. While SBI is expected to transfer around Rs 20,000-crore bad assets to the bad bank, Punjab National Bank (PNB) may transfer around Rs 8,000-crore NPAs to it. Union Bank of India has identified Rs 7,800-crore bad loans for transferring to NARCL. The accounts which have been identified by the banks include Videocon's VOVL (Rs 22532 crores total exposure), Reliance Naval and Engineering Limited (Rs 8,934 crores), Amtek Auto (Rs 9,014 crores), JaypeeInfratech (Rs 7,950 crores), Castex Technologies (Rs 6,337 crores), GTL Limited (Rs 4,866 crores), Visa Steel (Rs 3,394 crores), Wind World India Limited (Rs 3,161 crores), Lavasa Corporation (Rs 1,424 crores), Consolidated Construction Consortium Limited (Rs 1,353 crores), and others.Canara Bank has announced it would be the sponsor of the NARCL and hold a 12% equity, other public sector banks and state-owned Rural Electrification Corporation (REC) are also expected to hold under 10 percent stake each.

The arguments for and against bad bank

Arguments for Bad Banks

- **Providing Lending Leverage to Banks:** The benefits of bad bank include the recovered value, and significant lending leverage because of three factors:
    - Capital being freed up from less than fully provisioned bad assets.
    - Capital freed up from security receipts because of a sovereign guarantee.
    - Cash receipts that come back to the banks and can be leveraged for lending, also freeing up provisions from the balance sheet.
- **International Precedent:** There are several international success stories of a bad bank accomplishing its mission and there is no reason to believe why India cannot accomplish its objective.
    - The US implemented the Troubled Asset Relief Program (TARP) after the 2008 financial crisis, which helped the US economy after the subprime crisis.
    - It was modelled around the idea of a bad bank.
- **Revival of Credit Flow Post-Covid:** Some experts believe that a bad bank can help free capital of over ₽5 lakh crore that is locked in by banks as provisions against the bad loans.

Arguments Against Bad Bank

- **Not a Panacea:** It is argued that creating a bad bank is just shifting the problem from one place to another.

- Without fundamental reforms to solve the NPA problem, the bad bank is likely to become a warehouse for bad loans without any recovery taking place.

- **Tight Fiscal Position:** Furthermore, an important concern is regarding mobilizing capital for the bad bank. In an economy hit by the pandemic, it is hard to find buyers for distressed assets and the Government is also in a tight fiscal position.
- **No Clear Procedure:** Also, there is no clear procedure to determine at what price and which loans should be transferred to the bad bank. This may create political challenges for the Government.
- **Moral Hazard:** Some experts believe that setting a bad bank may also create moral hazard problems among the banks that would enable them to continue with their reckless lending practices, further exacerbating the NPA problem.

Final Word

It may be pertinent to note that shifting of stress from one entity to another should not be considered a ticket to solving the problem of stressed assets. A Bad Bank, or even a network of bad banks, will not make the losses disappear. The losses, or non-performing loans, transferred to a bad bank will still exist. The process may allow better recovery of these loans in future. For instance, ensuring that banks do not compromise on their due diligence merely because a bad bank will stand behind it. It will be important for the banks to review their lending policies and put in place a robust risk management system. The price at which stressed assets are being transferred is also an important consideration, especially when the transferring bank is an investor in the proposed bad bank. Further, it would be crucial to see how NARCL will manage these bad assets.

However, the proposal to establish a bad bank may be a positive move to relieve banks of their stress temporarily, given the present market situation particularly exacerbated by the pandemic. We may be able to take inspiration from the success of bad banks in foreign markets, its impact on the Indian market depends on its implementation.In order for the proposal to work efficiently, the Government and the RBI must ensure that sufficient bells and whistles are put in place - with a potential eye on improving lending behaviour.

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