Indian Model of Bad Bank: More of a Public Sector Flavour

***Bibekananda Panda**, Senior Economist (PhD)*

State Bank of India

Introduction

Bad bank, a corporate structure that isolates risky assets held by banks in a separate entity, was conceptualized in India almost 23 years back in 1998 by the Narasimham Committee - II that advised a single asset reconstruction company (ARC) as a bad bank, which only got materialized recently. Nonetheless, the importance of a bad bank was felt on many of the occasions when Indian banking amassed a good chunk of stressed assets in supporting economic growth while financing large corporates and infrastructure projects. Moreover, the asset quality review (AQR) exercise of RBI in 2015 exposed a significant chunk of legacy NPAs in the balance sheets of banks and emphasized the need for bad bank. To clean up the NPA mess, Economic Survey (2017) suggested a public sector asset rehabilitation agency (PARA). The Indian Banks' Association (2018) proposed for three entities, an ARC, an asset management company (AMC), and an alternate investment fund (AIF) together known as project 'Sashakt' for resolving large stressed assets.

The Union Budget 2021-22 proposal of setting up of an ARC and AMC to consolidate and take over the stressed debts over Rs 5 billion each from the banks and thereafter professionally manage and dispose them off to buyers for value realization was approved by the cabinet after 7-months in September 2021. National Asset Reconstruction Company Limited (NARCL), the official Bad Bank was incorporated under the Companies Act with an authorized capital of Rs 2 billion and paid-up capital of Rs 1.5 billion. It was licensed by the RBI under section-3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act 2002) to operate as an ARC. Alongside, India Debt Resolution Company Ltd. (IDRCL), an operational entity, was also set up to manage the bad debts and engage market professionals and turnaround experts for value realization. While public sector banks (PSBs) were to maintain ownership of 51% in NARCL, their exposure was limited to 49% in IDRCL.

Operational Mechanism

Initially, stressed assets above Rs 5 billion, each amounting to about Rs 2 trillion, were proposed to be taken over by the NARCL in two phases under a 15:85 structure, where 15% of the net asset was proposed to be paid in cash and issue security receipts (SRs) for the rest 85%. As the government equity contribution was absent in the new entity, government guarantees aggregating up to Rs 306 billion in the form of SRs were issued to NARCL with a guarantee fee of 0.25% which were to increase with passage of time. The guarantee was proposed to be valid only for five years and was to be invoked by the NARCL in meeting the shortfall between the face value of the SRs and the actual realization upon resolution or liquidation. As the government valued the legacy NPAs at 18% (i.e., 18% of Rs 2 trillion = Rs 360 billion), SRs of Rs 306 billion government guarantees were issued (85% of Rs 360 billion = Rs 306 billion). This reduced the need for upfront cash payments by banks to Rs 54 billion (15% of Rs 360 billion).

New Approved Structure: A Principal- Agent Arrangement

The complex dual structure and operational mechanism of the bad bank was questioned by the RBI and the regulatory approval took longer than expected to only happen in the last week of January 2022. The final bad bank structure approved by the RBI is very different from the original one placing a principal-agent relationship between the two, wherein NARCL will be the principal agency acquiring bad loans while outsourcing its resolution to IDRCL, its agent. As the NARCL will have the final authority to decide on resolutions proposed by IDRCL, the approved bad bank structure may compromise on requisite flexibility to deal with the resolution process, as the advantage of the IDRCL being an independent private entity lead by industry turnaround experts may lose its requisite flexibility in decision making. The resolution process as envisaged earlier remains unaltered, where the NARCL will provide a binding offer to lenders, following which the lead bank will hold a Swiss Challenge auction inviting counter offers from other ARCs, NARCL, being the anchor bidder, will have the right to match the counteroffer.

The delay in regulatory approval has signalled the teething trouble with the new entity; it has questioned the operational efficiency going forward as the NARCL, the public sector entity, has to approve the resolution proposal of IDRCL, a private entity. The opportunity cost to the stakeholders due to delayed approval of the bad bank has been substantial as the proposed pipeline of Rs 2 trillion legacy NPA is now cut short to Rs 828 billion with a basket of 15 stressed accounts worth Rs 503 billion getting transferred to the proposed bad bank by March 31, 2022, in phase-I. This is because many of the initially proposed stressed accounts have already been resolved or are in the final stage of resolution.

The creation of an additional ARC (NARCL) while 28 of those are in operation, was mainly due to the absence of a large ARC with government backing. Unlike other economies, ARCs in India are private institutions and suffer from concentration risk in asset under management (AUM) and SRs issued. Given the private character of these ARCs, they rely heavily on borrowings, particularly from banks, as a major source of their funds. Of the total AUM, 62% and 76% were held by the top-three and top-five ARCs. In terms of capital base, 62% was held by the top-three ARCs; the corresponding share was 67% for the top-five ARCs. Due to low capital base, the existing ARCs have been helpful in resolution of stressed assets, especially for smaller value loans. Banks not only are the major shareholders and lenders to ARCs but also are the sellers of bad assets to ARCs. As the interconnectedness led to the circuitous movement of funds between banks and ARCs, to increase skin in the game, RBI has allowed ARCs to accept 100% of foreign direct investment (FDI) through the automatic route in 2016.

Benefits to the Banking System

As the bad bank will lead to aggregation of debt at one entity, it may speed up the process for finding interested buyers, transfer of assets, formalizing write-downs etc. Compared to Insolvency and Bankruptcy Code (IBC) the NARCL has the additional provision of selling of the assets directly to the investors which may help in quicker value realization for the banks. Due to time-linked guarantee cost, it would incentivize quicker action on resolving stressed assets thereby helping in better value realization as guarantee is valid for 5 years and carries a rising cost. The bad loan transfer would improve the asset quality of banks and recovery may get booked as profit as these assets are fully provided for and the written-off assets are placed at zero book value on balance sheets of banks. The upfront cash payment would aid in providing incremental cash flows. It will enable banks to focus more on their core operations by freeing top management. With improved valuation, banks may raise growth capital from the market at competitive rates. Additionally, banks may monetise sovereign-backed SRs by selling it in the primary market and carrying a sovereign guarantee, SRs may get a liquid secondary market for price discovery. Most importantly, the new structure is done away with inter-creditor agreement concept; i.e., 75% of creditors by value and 60% of the creditors by number must agree to a restructuring package of an existing debt that is prevailed in IBC.

Conclusion and Key Learnings from Global Experiences

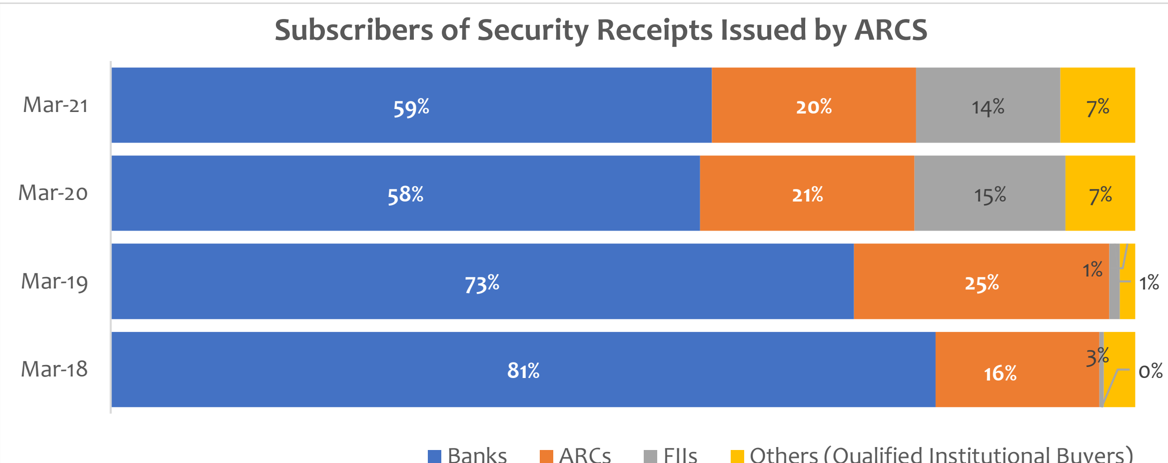
After the East Asian currency crisis of 1996-97, South Korea set up Korea Asset Management Corporation (KAMCO) with a government stake of 42.8%, focussing on the acquisition, management, and disposition of NPAs. KAMCO supported banks through purchase of NPAs, engaged in corporate restructuring by extending loans, debt-equity swaps, payment guarantees and recovered funds through the efficient management and disposal of assets. As the bonds were guaranteed by the government, they carried 0% risk weight for regulatory capital purposes by providing a strong incentive for banks to sell NPAs and improve their capital base. KAMCO's overall resolution strategy combined disposition and medium-term debt workout and restructuring. As of December 2002, KAMCO resolved USD 54 billion of assets, at an average recovery rate of 46.8% of face value. In the similar line, Malaysian bad bank (Danaharta) was also a success. The agency achieved consolidation by bringing down the number of commercial banks to 10 from 50. It dealt with nearly 3,000 NPA accounts and its lifetime loan recovery rate was 59%, the highest among its Asian peers, and got liquidated in 2005.

On the other hand, the bad bank experiment was a gross disaster in China. From opening 4 bad banks in 1999, today China has more than 59 bad banks. Deviating from its original mandate, Chinese bad banks have transformed themselves into investment banks with a multitude of subsidiaries, doing everything from real estate and securities broking to insurance and high-yield cross-border lending. Chinese bad banks today are effectively serving to conceal NPAs as over 90% of NPA transactions are financed by the banks through direct loans to bad banks or through some indirect financing vehicles. Where the bad bank resells over 70% of the NPAs at inflated prices to third parties, who happen to be borrowers of the same bank.

India, being a late entrant, has the natural advantage to learn from the experience of other nations in handling such legacy NPAs resolutions. The cross-country experience of bad banks in resulting in significant resolutions is mixed. While the bad bank was a gross disaster in China, it brought the desired results in South Korea, Malaysia, the USA, Sweden, and many other economies.

Hence, based on the experiences of various economies, India needs to immediately consider the following aspects.

- India needs to fix a sunset clause for the NARCL to ensure better resolution. KAMCO, Danaharta, Securum, Resolution Trust Corporation, IBRA all had this strategy. As the purpose of the bad bank is to resolve the legacy NPA, it should not exist in perpetuity as other resolution mechanisms headed by IBC are well equipped to handle the regular bad loans.
- An important cause for the failure of the Chinese bad bank was the gradual broadening of the original mandate. Unlike Chinese bad bank, NARCL must stick to its specific mandate.
- One more important aspect of a bad bank is the network effect. The interconnectedness of the banks and ARCs needs to be dealt with very carefully in the case of NARCL and other ARCs as well. In its Report on Trend and Progress of Banking in India 2019-20, the RBI has touched upon the interconnected issue. While the RBI has tightened the bank provisioning and has liberalised foreign portfolio investment norms in SRs of ARCs resulting in a fall in the share of banks in SRs issued by ARCs from 81% in March 2018 to 59% as on March 2021, post-implementation of the NARCL, the interconnectedness issue must be taken more seriously. The regulatory mechanisms should keep a close watch at the valuation of the assets to protect against a fire sale leading to poor recovery.



Source: Reserve Bank of India

- Additionally, inclusion of professionals outside government staff is one of the main criteria for the success of the bad bank. Hence, experts from the private sectors are best to guide the project.

****

References

1. Ben, C. et al (2021). *Hidden Non-Performing Loans in China (April 2021)*. Available at SSRN: http://dx.doi.org/10.2139/ssrn.3662344

2. IMF (2004). *The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea*. IMF Working Paper WP/04/172. https://www.imf.org/external/pubs/ft/wp/2004/wp04172.pdf

3. GoI (2021). *Frequently Asked Questions regarding Central Government guarantee to back Security Receipts issued by National Asset Reconstruction Company Limited for acquiring of stressed loan assets*. PIB. https://pib.gov.in/PressReleasePage.aspx?PRID=1755466

4. GoI (2021). Union Budget 2021-22. https://www.indiabudget.gov.in/

5. RBI (2021). *ARCs in India: A Study of their Business Operations and Role in NPA Resolution*, RBI Bulletin, April 2021. https://rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=20203

6. RBI (2021). *Report on Trend and Progress of Banking in India 2020-21*. https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020CF9C9E7D1DE44B1686906D7E3EF36F13.PDF