Source : www.livemint.com Date : 2020-11-03

LET A BAD BANK LIGHTEN OUR SISYPHEAN LOAD OF BAD LOANS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

A well-designed ‘bad bank’ could reduce perverse incentives and keep PSBs from rolling back to their bad ways

One of the features of Indian banking has been the perpetual struggle against the Sisyphean task of cleaning up public sector banks (PSBs). Just as their health was recovering, with capital infusions, slowing slippages and higher provision coverage ratios, covid has threatened to roll them back into the depths of Hades. If the deteriorating asset quality of SBI Cards is a sign of things to come, PSBs are unlikely to emerge from the crisis unscathed. Given that a healthy banking system will be vital to a post-covid economic recovery, a business-as-usual approach does not seem optimal.

While their stressed assets are worrying, the key concern is that the Insolvency and Bankruptcy Code (IBC) process takes an average of 340 days for resolution. This market-driven process is arguably the best way to resolve stressed assets. But a long resolution period amplifies the second-order effects of stressed assets. This is because bank capital and managerial bandwidth get tied up, and resolution uncertainty tends to turn them risk averse. Banks, therefore, could be constrained from executing their core function of advancing credit to fuel a recovery. The need of the hour is neither to suspend the IBC, nor to seek resolution outside its ambit, but to create a mechanism that allows PSBs to offload stressed assets in an equitable manner so that they can hit the reset button and focus on credit creation.

In this context, the idea of a “bad bank" has been resurrected in several quarters. It would unburden PSBs swiftly. It will enjoy scale efficiencies and bargaining power, even as coordination frictions are minimized and decision-making gets both centralized and faster. These factors will add significantly to the quality of resolution and the quantity of recovery. Theoretically, a bad bank looks like a very elegant solution, but there are several nuances of funding, valuation, incentives and management that will determine whether it will cleanse balance sheets or worsen the malaise.

The government is justified in being reluctant to fund such an entity. This is because the transfer of stressed assets to a bad bank will inevitably lead to capital write downs in some banks. The government will then find itself in the fiscally unenviable position of having to recapitalize banks even after funding the purchase of stressed assets from those banks. Also, another government-funded and owned bank is unlikely to do a better job of managing the mismanaged assets of other government-owned banks. IBRA, Indonesia’s bad Bank, failed precisely for this reason.

For a bad bank to be successful, it will have to be funded by private capital and managed by specialists who focus on maximizing recovery, unconstrained by political concerns, legacy relationships with promoters, and prospects of post-retirement opportunities, all of which are often seen to cloud the judgement of PSB bankers. The government can provide seed equity capital and mobilize private capital for the bulk of the funding. In fact, the first bad bank to be carved out of Mellon Bank in 1988 was funded entirely by private capital. Kamco, the South Korean bad bank, also raised debt from markets to fund its purchases of stressed assets. Given that in the current low-yield environment global asset managers are sitting on approximately $2.6 trillion of capital (FT and Prequin data) in search of higher-yielding distressed debt opportunities, mobilizing capital for an Indian bad bank should not be difficult. If need be, the government can provide partial credit guarantees and/or low-cost currency hedging options on the debt issued by such a bank.

Other issues involve the valuation of distressed loans and incentivizing banks to sell these loans to such a bad bank. These issues are closely intertwined. Due to uncertainty over valuations and the public-sector nature of banks, bank managers suffer from perverse incentives. They are reluctant to sell these loans, since they risk being investigated for wrongdoing if the price at which they sell is much lower than what is ultimately recovered, while there is no career risk associated with holding on to an underperforming loan even if it reduces the ultimate recovery. The situation with Dewan Housing Finance Ltd, where bankers want rebidding despite receiving four public bids, is a testament to these perverse incentives.

Valuation uncertainty is not unique to India. Even in developed markets, the pricing of distressed loans is relatively opaque and their trading illiquid. A bad bank will have to reduce the impact of valuation uncertainty to incentivize bankers to sell distressed loans. An elegant solution is to issue participation rights, which confer upon selling banks the right to participate in recoveries over and above the price at which they sell loans. This will minimize the risk of under-pricing for selling banks and limit the impact of bankers' incentives. Malaysian bad bank Danaharta used this model effectively by letting banks claim up to 80% of the recoveries beyond their sale prices. These rights could also be made tradable.

A well-capitalized, professionally-managed and time-bound bad bank could alleviate asset quality-related risk aversion among Indian PSBs. However, it will by no means cure the inefficiency that afflicts them. That will require deep and painful structural reforms in their ownership, management and incentive structures. In their absence, like Sisyphus, a new bad bank would again have to haul the burden of non-performing assets uphill in a few years.

Diva Jain is director at Arrjavv and a 'probabilist' who researches and writes on behavioural finance and economics.

END