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WILL A BAD BANK FIX INDIA'S BROKEN BANKING SYSTEM?

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

Last month, the Union government set up the National Asset Reconstruction Company Limited (NARCL) under the Companies Act. It thus delivered on its promise to set up a 'bad bank' to clean up the balance sheets of commercial banks. Under the new set up, the NARCL will take over loans worth almost 2 lakh crore from the books of commercial banks at a mutually agreed price. The NARCL will pay 15% of the price of these loans upfront in cash to banks and then issue security receipts in lieu of the remaining amount. The NARCL will then try to resolve these bad loans in a time-bound manner with help from the India Debt Resolution Company Limited (IDRCL). In case the IDRCL is unable to sell these bad loans at a satisfactory price to make good on the security receipts, the Centre will step in and fund the gap, but within a budget limit of 30,600 crore. In a conversation moderated by **Prashanth Perumal J.**, Ajit Ranade and C.P. Chandrasekhar discusss the bad bank proposal. Edited excerpts:

Ajit Ranade: First of all, this is a one-time, time-bound effort. The bad bank has been set up to remove bad assets from the balance sheets of banks and free up capital which will allow bank lending to grow. Credit growth is important for economic growth, and bank balance sheets are constrained by the presence of bad assets. So, one of the main objectives of the bad bank is to remove these assets from the balance sheets of existing banks and consolidate them within a bad bank. Meanwhile, the resolution and recovery process can continue. The proposed design of the bad bank separates the trustee part of the NARCL, where the assets will sit, from the the IDRCL, which will engage in the recovery and turnaround of bad assets. So, it's a twin structure working to free existing banking capital to enable higher credit growth.

Will a bad bank fix India's broken banking system? | The Hindu Parley podcast

C.P. Chandrasekhar: There are many reasons to bail out banks but two in particular are crucial. One is the fact that there are depositors involved here. If you allow banks to fail, depositors who operated under the presumption that the regulatory framework would protect their money would be undermined. Historically, we've found that central banks try to actually save banks, either by bailing them out or by amalgamating them with stronger banks, in order to be able to protect depositors. Two, there is a systemic problem. If a bank fails, and there is a sort of contagion effect, you could actually have systemic problems. Banks are the core of the settlements system and the credit pipe and allowing them to go down would be a problem. And finally, there is also the option of getting banks to write off these bad assets and then the government can recapitalise them. But that would deal a significant blow to the government's finances.

C.P. Chandrasekhar: You need to compare the risk to the system itself — the impact that bank failures would have on depositors and the social and political implications of it — with the moral hazard of bailing out banks. The more important problem is the systemic risk. But second, here we have a system in which banks are predominantly publicly owned. So, the problem is, in some sense, the result of the state allowing the use of banks for certain purposes.

Ajit Ranade: These so-called bad loans have been completely 100% provisioned. However, the manpower of these banks is still spent on recovery and supervision. Now, it's important that these loans be moved to a separate entity which is exclusively focused on recovery, so that the bank can then focus on its core business, which is business development, giving new loans, credit growth, etc. And it is not an exclusive 'either... or' for banks. For their growth, banks will

need to be infused with additional capital to achieve the credit growth needed to get to 7-8% GDP growth. So, the government will continue to pour more capital into banks, while bad loans will be moved to a separate entity.

A Bad Bank for bad loans: Is it a good idea? | The Hindu In Focus Podcast

C.P. Chandrasekhar: I think we have to see this in the context of accumulated bad debt of banks being addressed over a period of time through various mechanisms. First, we had the Lok Adalats, then the debt recovery tribunal, and then the SARFAESI (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest*)* Act, which is supposed to give creditors much more power to be able to recover debt. Then we had the IBC (Insolvency and Bankruptcy Code). The understanding till recently was that the IBC would allow quick resolution, and the haircut that the banks would have to take would be relatively small. If you have a government that is committed to a conservative fiscal stance, then to think of going through a process in which these large amounts of accumulated debt will be cleared, which is essentially a process of partial write-off and recapitalisation, cannot be sustained if the haircuts are large. When IBC started, it appeared as if you're going to get a pretty high rate of recovery. As we moved along, the rate of recovery began to decline quite sharply. So, the point is, by adopting a bad bank mechanism, the government seems to think it will be in a position to paper over this contradiction — the need to resolve the bad loan problem and its unwillingness to allocate significant amounts from its Budget.

Ajit Ranade: What the NARCL is doing is providing an asset resolution platform, which is for the banks and by the banks. There have been some 28-odd private ARCs, which have perhaps not performed. Under the bad bank, asset acquisition and trusteeship has been segregated from asset resolution. The primary purpose of the IDRCL is resolution through specialists who can salvage some value. Even if they can recover only 25%, that's more than what the current record shows. The IDRCL will actually have incentive to resolve debts efficiently because of the profit-sharing arrangement. So, the incentives are aligned.

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C.P. Chandrasekhar: The government has said that of the 2 lakh crore, it will be in a position to cover only as much as 30,600 crore. So, you're going to be in a situation where the banks are still going to carry the burden and take a hit to their profitability. On the other hand, if you look at those who defaulted, a large number of them being big corporates, they are going to walk away with their debts resolved at steep discounts. Banks might be left with perhaps not new losses, but with losses nevertheless, which have already been provided for, whereas those who defaulted would be let off in terms of their assets not being seized in significant measure.

Ajit Ranade: These are two different things. One is to go after the defaulters and the other is to recover the asset and salvage value from it. Corporates are not going to go scot-free. If there is an established criminal negligence or criminal activity, there is a separate process for that. Moreover, the bad bank is focusing the energies of banking personnel. The bad bank is not to be seen as a recurring thing wherein balances will keep moving from the existing banking balance sheets into this structure. If that happens, you are inviting the tendency of what we call moral hazard, as then there is no effort from the bank per se to try and recover.

Ajit Ranade: The staffing, the pay scale, etc. in the IDRCL will be different. For example, when the State Bank of India (SBI) runs an asset management company, the AMC employees are not on the same pay scale as the SBI. So, we have to recognise that the incentives, pay structure, staffing, talent, and ultimately governance... that's what's going to matter.

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C.P. Chandrasekhar: There is a lack of clarity about certain things. One is the discount which is going to be negotiated between the NARCL and the banks. Once the bad debt is moved on to the books of NARCL, it will be handed over to the IDRCL. Now, as in the case of private ARCs in the past, both these entities would also be charging a managerial fee. So, they’re going to cover a large part of their costs through the managerial fee charged to manage and dispose of these assets. What is going to be the incentive to try and get the maximum price possible from these bad loans is not really clear.

Ajit Ranade: The difference is that in the case of the existing ARCs, there is no guarantee for the value that will be recovered from the security receipt. So, typically, the average purchase price of bad loans by existing ARCs is something like 36%, but there is no backing for the security receipts; these receipts may end up being of zero value. The actual recovery could be just one-fourth of the 36%, which is 9%. In the new structure, the average purchase price will be lower, but the security receipts for the remainder of the value will be covered by the government up to 30,600 crore. That in itself changes the incentives.

Ajit Ranade: The fact is that over the last few years, the NPA ratio has been mounting and we’ve tried many things. We now need to bring the problem to manageable proportions. In that sense, the bad bank is taking a small chunk out of the overall NPAs. But NPAs will continue to grow. Bad loans are a function of business cycles — during down cycles, the bad loan ratio increases, but in up cycles, the bad loan ratio comes down. The idea is to keep it within manageable proportions.

Explained | Will the money recovered from Vijay Mallya, Nirav Modi and Mehul Choksi help banks?

C.P. Chandrasekhar: There is a structural issue involved here. As opposed to the 1980s and 1990s, an overwhelming share of defaulted debt in this round has been corporate debt. Why did this come about? Earlier, financing capital-intensive projects was seen as something which had to happen through the government’s budget or through development finance institutions specialised in development finance. There was also the idea that you could finance these investments through long-term capital available through an active bond market, which India does not have to a significant extent. The government decided that it cannot mobilise the resources to finance investments and decided to get financial institutions to set up commercial banks. Therefore, the burden of financing these investments was transferred by the state to the public banks. And banks are not supposed to do too much of this because there are significant liquidity and maturity mismatches. So, we got this problem because we have put the burden of finance of a certain kind on banks, which should not have been put on banks, which sometimes gets concealed by focusing on some frauds here and there.

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