Thinking out of the box for bank NPAs

The ever-growing bad loans of public sector banks (PSBs) have kept them perennially in need of funds from their principal owner. The government has committed to infusing Rs70,000 crore of taxpayer money under Mission Indradhanush. Reserve Bank of India (RBI) deputy governor Viral Acharya has conceded that the programme will be grossly inadequate to address the problem—and that what is needed is something like the *sudarshan chakra*. The deputy chairman of the erstwhile Planning Commission, Montek Singh Ahluwalia, has suggested in this newspaper recognition, resolution, recapitalization and reform (by reducing government equity to 33%) should be the four "Rs" of the *sudarshan chakra*.

Non-performing assets (NPAs) are inherent in banking. The discussion these days tends to concentrate on very large NPA accounts, numbering less than 50. In the process, a large chunk of agricultural, small and medium enterprises (SMEs) and mid-corporate NPAs get ignored. As almost all PSBs require recapitalization and the government cannot provide all the money, sustainable solutions are needed.

PSBs wrote off a record Rs81,683 crore worth of bad loans in the financial year ended March 2017, a jump of 42% over the previous year's write-off amount. Loans written off during the last five years amounted to a whopping Rs2.46 trillion, comprising mainly agricultural, SME and mid-corporate loans. Though written off and valued at zero, these loans are covered by primary security and collaterals—mostly real estate—worth several thousand crores. As per regulatory prescription, these securities are valued at zero irrespective of their realizable value, sometimes much higher than the loan outstanding. In developed markets, the resolution process is quick; in India, it can take many years, and then more for actual cash recovery.

Apart from the lengthy legal process, recovery of bad loans is hampered by several other factors. First, in the case of consortium and multiple banking arrangements, the loans and underlying securities are fragmented among several banks. This creates a major impediment as a bank with a relatively insignificant share can delay or scuttle the whole resolution process. Second, unlike in developed economies, in India there is no active secondary market for NPAs that would enable an exit from problem loans when considered appropriate. Despite being experienced in NPA resolution and important actors in the financial sector, banks themselves stay away from participating in NPA auctions. Most of the time, after several failed attempts, the selling bank has no option but to sell the loan to an asset reconstruction company (ARC), which is the only bidder. The combined capability and geographic reach of ARCs is minuscule compared to the size and geographic spread of NPAs. Third, there is a lingering fear in the minds of some bank executives of their decisions being questioned by government bodies.

Putting PSBs' bad loans for auction "exclusively for the PSBs" can address most of these issues and create an active secondary market for NPAs. In order to attract larger participation, the auction can be carried out with no reserve price or security deposit. As sellers and buyers are owned by the government, there wouldn't be much scope for underhand dealing. Agricultural and SME loans can be auctioned in a calibrated manner.

Different PSBs could approach the proposed auction from different perspectives. In the case of written-off or fully provided for NPAs, any amount realized would get added to capital. This would be a saving proposition for a PSB which is starved for capital. It could be for the consolidation of bad loans scattered across banks for better resolution. It could also be for creating a distinct portfolio of loans acquired at distress prices. This could make good business sense, as even a small recovery out of this portfolio, acquired at rock bottom prices, could provide an attractive return.

The suggested process is not evergreening, for the sale would be on outright cash basis through an auction. It would be in line with RBI guidelines which permit buyers of such loans to treat them as “standard assets” for three years subject to certain conditions. No external approval would be needed as the RBI has already permitted banks to carry out such trades on the basis of a policy approved by the board of the bank concerned. Looking into the inherent advantages, some banks may transform themselves organically into “bad banks”, the creation of which is considered by many experts to be the need of the hour.

As for funds for buying these assets, they are already there with the banks; loans are “technically” written off against provisions created out of actual profits generated by banks. There is no cash outflow. For example, the State Bank of India made an operating profit of Rs50,848 crore during FY 2016-17. Out of this, Rs32,247 crore was transferred towards a loan loss provision; technical loan write-offs amounted to Rs20,570 crore, with no cash outflow.

Ideally, this process could be implemented by PSBs whose capital has been badly eroded as a prompt corrective action, prior to approaching the government for recapitalization. A similar process may be carried out before the merger of PSBs, in order to bring out the hidden value of the PSB being acquired. Selling written-off or fully provided for NPAs in an exclusive auction among PSBs for raising capital may be a better proposition than selling the bank itself for a song.

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