

Bad banks-panacea for the stressed banking sector

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Abstract

Banks are facing severe problem of rising NPAs. Rising NPAs are affecting both the profitability and creditability of the banks. Banks are restraining from lending to priority sector and commercial users, as a result, there is a fall in real credit available in the economy. This in turn is affecting the overall growth of the economy. Economic Survey 2016-17 also pointed to twin balance sheet problem and proposed setting up of Public Sector Asset Rehabilitation Agency (PARA) or Bad Bank. Bank will be an entity entirely dedicated to the management and recovery of bad loans. However, setting up of bad bank in India is at very nascent stage. The paper highlights the severity of NPAs in the banking sector, elucidates the concept of bad bank and discusses the suitability of bad bank in Indian scenario.

Keywords: NPA, PARA, bad bank

1. Introduction

NPA as the name implies stands for a non-performing asset. It is an asset from which bank does not earn any income. Though shown as an asset in the balance sheet, it is actually a burden on the bank's financial structure. This is why it is also called bad loan. To solve the problem of bad loan, Economic Survey proposed the creation of Bad Bank. Bad Bank will be a government entity to manage bad loans. Bad portion of the loan will be managed and recovered by the bad bank. Thus, the bank can focus on its core business and enhance its productivity and profitability.

2. Objectives of the study

1. To delve into the significance and current position of NPAs in the banking sector;
2. To understand the concept of bad bank;
3. To explore the various organizational models of bad bank;
4. To analyse the suitability of bad bank in the Indian framework.

3. Non-Performing Asset

Investments made and the loans given by the banks are treated as assets of the banks and appear on the asset side of the balance sheet. The bank earns income in the form of interest from these lendings. When the customer defaults in making payment of interest/ installment of principal for over a certain period, the loan is categorized as NPA. As per the current norm, if a loan is overdue during the last 90 days, it will be categorized as a Non -Performing Asset (NPA). Loan continues to be shown as an asset but it becomes non performing and in a way burden for the bank. The health of the bank is judged by the percentage of NPA. Higher the percentage, the poorer the financial condition of the bank.

4. Current NPA Scenario in India

The Asset Quality Review (AQR) initiated by RBI under former Governor Mr. Raghuram Rajan and implemented from Q3 of FY16 resulted in a massive jump in gross NPAs. "Non-performing assets of banks have increased from Rs. 2.75 lakh crore in March 2015 to Rs. 7.33 lakh crore as on June 2017^[1]. "State Bank of India accounted for the largest share of about 22.7% in the total NPAs during the quarter. The NPAs stood at Rs 188,068 crore as of June 2017. Top 5 banks together – SBI, PNB, BOI, IDBI, and BOB account for a share of 47.4% totaling to Rs 393,154 crore. 11 of the top 12 banks in terms of NPAs are public sector banks (PSBs) with the exception being ICICI Bank. Top 12 banks together account for 75.7% share-Public sector banks appear to be definitely more stressed than private banks-ICICI Bank and Axis Bank are the only private sector banks in the top 15 with a combined share of 7.9% in the total NPAs^[2]".

5. Factors contributing to upswing in NPAs

1. In early 2000, when the economy was in boom phase, very huge lendings by the banks were made to the corporate sector. However, with the slowdown in economy profits of the corporates fell and they made default in payment even after loans were restructured.
2. Loans were given to corporates without proper check of their financial position and credit worthiness.
3. Five sectors namely textiles, aviation, mining, steel and infrastructure could not perform as expected and accounts for major portion of NPA. It was mainly the public sector banks that extended the loans to these sectors; hence these banks are bearing a greater burden of NPAs.

¹ <http://www.thehindubusinessline.com/money-and-banking/govt-to-infuse-rs-211-lakh-crore-into-psu-banks-over-2-years/article9921759.ece>

² <http://www.careratings.com/upload/NewsFiles/SplAnalysis/Bank%20NPAs%20June%202017.pdf>

4. Substantial increase in NPA's of public sector banks cannot be attributed solely to private sector lending. Studies show that major defaulters are big corporate houses rather than small farmers and businesses. Also it has come to light that education loans are also a major contributor to the NPAs of public sector banks.
5. The absence of Bankruptcy code in India and slow legal system make it difficult for banks to recover these loans from both corporate and non-corporate.

6. Bad Bank

The Economic Survey for 2016-17 pointed to a "twin balance sheet" (TBS) problem. The balance sheets of both public sector banks (PSBs) and some corporate houses are in terrible shape and it has been seen as a major obstacle to investment and reviving growth. The problem of NPA faced by the banks is the largely associated with that of corporate sector. During the boom years, some companies borrowed a lot of money from banks to invest in infrastructure and commodity-related businesses, such as steel, power, infrastructure etc. But due to slowdown in these sectors, corporate profits hit very low. With low profits, the corporates were not able to repay their loans and their debts rose to an alarming level. They had no other option other than to cut back investments. Also, banks have not been able to recover principal/interest on these loans, which has affected the bank's profitability. This has further resulted in banks sanctioning fewer loans for small businesses and other priority sectors. This problem of twin balance sheet is seen as a major deterrent to new investment and thus economic growth of the country.

To solve the problem of bad loans in India, the Reserve Bank of India (RBI) has introduced multiple schemes over the last few years: debt recovery tribunals (set up way back in 1993), Asset Restructuring Companies (ARCs), Corporate Debt Restructuring (CDR), Strategic Debt Restructuring (SDRs) and Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI). While each of these measures has been effective up to a point, they have not been able to deal with the problem comprehensively.

To overcome this problem, a new solution which is gaining popularity is the "bad bank". The concept is simple: Divide a bank's assets into two categories, good and bad. By separating the two, a bank can focus attention on managing good assets only and not chasing bad ones. It also alleviates the concerns of investors and helps the bank focus on future lending by improving health and transparency.

7. Journey of bad bank

The first bad bank was constituted at the Pittsburgh-headquartered Mellon Bank in 1988 in response to problems in the bank's commercial real-estate portfolio. The model of a "bad bank" has been previously used in countries like Sweden, France, and Germany. In India, the commercial banks have been finding it difficult to resolve the problem of bad banks on their own and have been insisting on government support in the form of creation of bad banks. The idea of starting a bad bank by the government was proposed in the Economic Survey 2016-17 under the name 'Centralized Public Sector Asset Rehabilitation Agency' (PARA) that could

take charge of the largest, most difficult cases, of non-performing assets (NPAs) in the banking system.

8. Bad bank modus operandi

The government is yet to give clearance to creation of bad bank. Nothing has been finalized as to structure and modus operandi of bad bank, however, such an institution would be largely based on the principles of an asset restructuring company (ARC). ARC buys bad loans from the entity at discounted rates and uses its expertise to recover loan from defaulters. ARC or Bad Bank will relieve the bank from bad loans, thus enabling the banks to focus on their core business and improving their performance.

9. Organisation model of bad banks

A report by McKinsey & Co., "Understanding The Bad Bank", proposes four organizational models for a bad bank based on two decision factors:

- a) First is to decide whether bad assets should be shown as assets in the balance sheet or not. Treating them as burden and discarding them from the balance sheet depicts the true financial position of the bank and brings greater transparency in the banking system. But this is very cumbersome and expensive process.
- b) Secondly, it is to be decided whether bad loans should be managed in a banking entity or special purpose vehicle.

Depending on the choices, the four basic bad-bank models are: on-balance-sheet guarantee, internal restructuring unit, special-purpose entity and bad-bank spin-off.

1. On-balance-sheet guarantee

In this model though bad loans continue to be shown on the assets side of the balance sheet, bank gets a loan guarantee from the government for a part of its portfolio. This way only a part of bank's risk is transferred. Under on-balance-sheet guarantee structure, bank cannot fully focus on its core business as it is still not fully relieved of bad loan.

2. Internal restructuring unit

In this model, a separate internal restructuring unit is created. This separate unit is created to handle and manage bad loans only. Banks transfers the bad assets to this unit; assigns separate staff and report the results separately for this unit. This increases the transparency in the bank as performance of the bank can be better analysed now. This model relies on the existing management team to restructure assets. However, if the existing management is not fully concerned about resolving bad loan problem then this is not an effective solution.

3. Special-Purpose Entity

In a special-purpose entity model, bad loans are transferred to a special purpose entity. This model is suitable where bad loans fall into homogeneous set of assets. The bad loan problem in India is concentrated in a few sectors like infrastructure and basic metals. An effective solution would be to transfer bad loans from distressed sectors into sector-specific SPVs, securitize them and sell them in an auction.

4. Bad-Bank Spin-Off

A bad-bank spin-off is the most effective and comprehensive method to counter the problem of bad loans. In a spin-off model, a separate bank is created and all the bad loans are transferred to this unit ensuring complete risk transfer. This model is very complex as asset pricing and valuation is not an easy task. Also a competent management team and skilled staff is required to manage a banking entity which starts with something that has already been termed as bad. The Public Sector Asset Rehabilitation Agency (PARA) proposed by the Economic Survey 2016-17 falls in this category.

10. Suitability of bad bank in Indian scenario

The NPA problem has reached alarming position. It is affecting the banks' capability and intention to extend real credit. A key to the problem is seen in the form of creation of bad bank. However, economists in the country are divided in their opinion whether a bad bank can help solve the bad loan problem. The problem of NPAs existed in the 1980s also but the structure of NPA today is different from that time. NPAs that exist today can be bifurcated into two parts- A part of that is due to slowdown in the economy, whereas the other and annoying part is due to willful default by the big corporate houses. Opening a bad bank as a government entity would mean utilizing tax payers' money to pay bad loans. This can be justified to some extent for that part of NPA which is due to recession in the economy. However, government may find it hard to justify the financing of wrong doings of bank or big business houses. Opening a bad bank is not the solution. First the government should segregate the justifiable and unjustifiable portion of NPA. Instead of accepting and waiving the wrongdoings, government should enforce strict policy measures.

Those in favour argue that creating a bad bank is the only solution for destressing the stressed banking sector. They argue that a single competent authority will be more effective in overcoming the problem of bad loan rather than each bank tackling on its own. The impact of stressed assets is being felt far beyond just the banking sector. It is slowing the entire economy. The banks, particularly public sector banks are facing difficulty in raising funds which in turn is affecting their lending to the commercial sector. Severely burdened by bad debts, banks are also not transmitting the monetary policy measures effectively fearing lower profits or further losses as the case may be. Between January 2015 and today, RBI has cut the bank rate by 175 basis points. The Banks have not passed on this reduction to their customers fully. They have done so, at best, for just little over 50 percent. This has meant that interest rates, much to the disappointment of the government, continue to remain high thwarting a faster pace of economic growth.

11. Conclusion

Though on the face it may appear that bad bank will effectively eradicate all the problems of stressed loans that Indian banking industry is facing over the years, setting up of bad bank is a very complicated process. Its implementation requires lot of organizational and financial restructuring while finalizing the nuances of the bank. Bad bank is not magic band which will destress the bank balance sheet, it is just one

of the measures. It has to be complimented by other stronger and stricter control measures. Also it will be difficult to design one structure for bad bank which will be applicable across all regions and all types of NPAs. In a country like India, the focus has to be on designing a customized solution for different sectors and different types of bad loan problem.

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