Money, Banking and International Trade and Public Finance – An Empirical View

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Abstract:

This paper attempts to explore about bad banks and its implications of financial health of Indian banking sector. The Indian Banks' Association (IBA) recently submitted a proposal to the Finance ministry and the Reserve Bank of India (RBI) to set up a 'Bad bank' to take charge of INR 75,000 crore worth of non-performing assets (NPAs) and had requested the government to provide INR 10,000 crore of initial capital. This paper is prepared purely using secondary data that has been collected from official websites of RBI, SEBI and Ministry of Finance etc. This paper comes up with effective policies for resolving the bad banking scenarios in financial institutions and build positive financial momentum in the banking sector.

Keywords: RBI, NPAs, IBA, Bad Banks, Financial Health.

I. INTRODUCTION

The Indian Banks' Association (IBA) recently submitted a proposal to the Finance ministry and the Reserve Bank of India (RBI) to set up a 'Bad bank' to take charge of INR 75,000 crore worth of non-performing assets (NPAs) and had requested the government to provide INR 10,000 crore of initial capital. As per media reports, IBA had proposed to set up an Asset Reconstruction Company (ARC), an Asset Management Company (AMC) and an Alternate Investment Fund (AIF). The ARC will be owned by the government, but the AMC and AIF will have participation from the public sector as well as the private sector, as per the proposal.

The proposed structure of a Bad bank is based on the earlier recommendations of a panel headed by former PNB chairman Sunil Mehta in July 2016, that had proposed formation of an AMC called 'Sashakt' for resolving large bad loans. An illustrative Bad bank structure could potentially work as outlined below. The illustration draws from Malaysia's experience with their institutions 'Danaharta' and 'Danamodal' after the Asian crisis. The government could set up a bad bank ('Bank X') with an agreed upon capital base. The equity infusion could be funded via Government of India re-capitalization bonds issued to subscribers

II. BAD BANKS SCENARIOS

A bad bank is an entity established for the purpose of separating the stressed assets held by a regular bank from its performing assets (Öncü, 2016). The said separation is achieved by transferring the stressed assets from the regular bank to the bad bank. When that is done, the stressed assets go out of the balance sheet of the regular bank and it gets recapitalised. Thereafter the regular bank can focus on its normal business activity without worrying about the stressed assets. The task of managing and/or liquidating the stressed

assets is left to the bad bank. Since the toxic/stressed assets get removed from the balance sheet of the regular bank, it is often called as the good bank.

TYPES OF BAD BANK SCHEMES

The fourth type of bad bank scheme is called as the bad bank spin off. In this type of scheme a separate legal entity called the bad bank is established and the stressed assets of the regular bank are off loaded to the bad bank. The bad bank is a separate legal entity and it usually has a banking license. This results in the stressed assets being taken out of the balance sheet of the regular bank. It is this fourth type of scheme that is normally referred to as the good bank-bad bank scheme.

It may be noted that when a separate bad bank is established, it could be used to service the toxic assets of one bank or several banks. Also the bad bank may be established by a single bank or a consortium of banks.

III. OBJECTIVES OF THE STUDY

a. To explore the overview of Bad Banks in India.

b. To exhibit the favourable and unfavourable impact of Bad Banks on financial health of financial Institutions.

IV. METHODOLOGY USED IN THE STUDY

The data used for the research has been extracted from annual reports generated from official website of RBI, SEBI and Ministry of Finance. For fulfillment of objectives, the researcher had a review of various published papers to assess and explore the favorable and unfavorable impact of bad banks on financial health of financial institutions.

V. KEY ARGUMENTS IN FAVOR OF ESTABLISHING A BAD BANK:

Bad banks are more complex and time consuming to set up but have benefits both in terms of the core franchise and in terms of the non-core assets which are being worked out.

Price Discovery: A Bad bank may be better suited to fix the appropriate price. The transferring bank could make additional provisions in case the discovered cost is less than the book value and the Bank wants to retain the asset on its books.

Capital relief: Based on the existing prudential norms as defined by the RBI, NPAs are still accounted for in the branch books, whereas the corresponding advances are also adjusted for provisions and write-offs to arrive the Net Advances figure as published in the audited books of accounts.

VI. KEY ARGUMENTS AGAINST ESTABLISHING A BAD BANK:

Ownership disputes: Various options could be explored for the ownership of Bad banks - entirely government-backed funding, private funding, or a public-private partnership (PPP). While global Bad bank models with favorable outcomes were largely Government owned, many see advantage in having a Bad bank owned by the banks collectively. This would ensure that when a bad loan is resolved, the profits would accrue to the owners, i.e. the banks themselves. This would make the loss they booked on selling the non- performing assets at a discount, more palatable.

VII. KEY LEARNINGS FROM GLOBAL EXPERIENCE

Based on global experience, key learning for a prospective Indian Bad bank entity are as follows:

- A common key success factor is substantial upfront government funding, with less reliance on other banks, borrowings or AMC bonds for capital. If the AMC/s are funded mainly through debt, they run the risk of accrued interest on bonds and loans exceeding the cash recovery from the resolution of NPAs.

- The Bad bank entity/ AMC could broaden its shareholder base by inviting participation from domestic and foreign institutional investors.
- The Bad bank could be established with a finite lifespan to ensure better resolution and to reduce logjams
- The bad bank could include professionals outside government staff, with secondment from the private sector, including reputable banks, investment banks and international and sectorial experts
- The NPAs should be transferred to AMCs at fair value considering a probable haircut and not at book value. If NPAs are transferred at book value, all losses would need to be taken at the AMC level. In a scenario of negligible demand and low realized sale value, this structure could lead to losses for the AMCs.

The good bank-bad bank schemes have been utilized by a number of countries for resolving the crisis in their banking sectors due its obvious advantages. Some of the advantages of using good bank - bad bank schemes are outlined below:

- The regular bank after transferring its toxic assets to the bad bank can focus on its long term core operations without worrying about those toxic assets (Pinedo, 2009).
- Cleaning up of the balance sheet of the regular bank by transferring the toxic assets to the bad bank will have a positive impact about the regular bank in the eyes of the credit rating agencies, investors, lenders, borrowers and depositors (Pinedo, 2009). Since toxic assets are held by bad banks, these bad banks are prone to political interferences by politicians supporting the chronic debtors (Gandrud & Mark, 2013).

Unless the legislations creating the bad banks enact provisions to prevent such interferences, the functioning of the bad banks will be seriously jeopardized.

- A strong legal system that facilitates the creation and functioning of bad banks is a pre-requisite. Hence a regular bank would be able adopt a viable and reliable good bank-bad bank scheme only if the legislature has enacted necessary laws.

- Huge costs are involved in the creation and running of bad banks, transfer of toxic assets from the regular bank to the bad bank, restructuring the toxic assets, eventual disposal of the toxic assets etc. Many of these costs can be avoided, if the toxic assets are left with the regular bank itself.

- Sufficient number of skilled and specialized staff that is necessary to actively manage these stressed assets may not readily available. Even if available, engaging them would be a very costly affair.

VIII. CONCLUSION

NPAs in India have reached an alarming level, given short term and long term issues, combined with the stringent provisioning policies and guidelines of the Regulators and the ruling Governments. Lack of appropriate credit risk processes, lack of transparency in the operations and lack of democratic atmosphere in the banking industry and certain indiscriminate lending has added to the pile of NPAs. Major write-off provisions including unhealthy prudential write-off & IBC haircut provisions made during the last four years have further accentuated the problem. In most cases, it is the PSU Banks that are the worst hit because of such provisions. Smaller banks have also suffered given their presence as smaller consortium participants as well as lower diversification in loans. To pivot towards sustainable lending going forward, the Government would need to act fast on resolving the NPA issue, bring in accountability with lenders and reforms to guard against a repeat of the bad loan cycle.

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