Modernised Banking System in India Issues and Challenges

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Abstract

This paper tries to explore about bad banks and its implications of financial health of Indian banking sector. A Bad bank is a corporate structure that isolates risky assets held by banks in a separate entity. It is established to buy toxic assets from a good bank at a price that is determined by the Bad bank, most likely with a haircut to the book value of the stressed loans being transferred. It may be controlled by the government, and apart from the government, other private players invest in its equity. It may raise loans from other participants. These transactions happen at arm's length and a Bad bank is managed by professionals with domain knowledge of managing stressed assets. 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 c. 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. 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 come 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

With banking sector GNPAs in India perhaps already above INR 10 lakh crore, and expected to increase to upwards of INR 15 lakh crore in the near future, there is an increasing ask to unburden the banking system of NPAs and expedite the recovery process. A Bad bank is a corporate structure that isolates risky assets held by banks in a separate entity. It is established to buy toxic assets from a good bank at a price that is determined by the Bad bank, most likely with a haircut to the book value of the stressed loans being transferred. It may be controlled by the government, and apart from the government, other private players invest in its equity. It may raise loans from other participants. These transactions happen at arm's length and a Bad bank is managed by professionals with domain knowledge of managing stressed assets.

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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 2018, 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

Bank X could acquire tranches of bad loans from across Banks/ NBFCs. Assuming average fair value of 40 per cent of book value of loans transferred, Bank X could acquire up to 2.5x worth of gross NPA from troubled lenders By transferring such assets to the Bad bank, the original institution could clear its balance sheet, although it would still be forced to take write-downs. To protect the interests of taxpayers and to restore trust, this transfer would have to be done at fair market valuations i.e. at a discount to book value, as certified by Government appointed independent values. Steep haircuts in certain cases might lead to capital adequacy challenges in a few PSU and private Banks, necessitating recapitalization on a need-basis for these banks. The core purpose of the Bad bank would be to buy bad loans from banks at a discount, in order to attempt recover of money from various defaulters. The Bank would need to be a centralized agency in a position to take tough decisions. This section attempts to describe various points of view as to whether there is an actual need to set up a Bad bank in India and if yes, the design of such an institution.

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, 2017). 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.

HISTORICAL EXAMPLES OF BAD BANKS

More than in theory, bad banks evolved in the late 1980's out of the crisis in the banking sector of the United States of America. At that time due to the steep fall in real estate and oil prices, a number of banks were on the verge of collapse and bankruptcy (Bleier, 2008). The most badly hit was Mellon Bank based at Pittsburg, Pennysilvania. That bank was steadily making loss and had to be recapitalized. For this purpose, Mellon Bank created another bank called the Grant Street National Bank (GSNB). GSNB was not a normal bank which would collect deposits and lend the same. The purpose of creating GSNB was to transfer Mellon Bank's toxic assets to it

(McKinsey& Company, 2003). The GSNB would then liquidate those toxic assets and thereafter liquidate itself. The toxic assets of Mellon Bank having an original worth of $ 1.4 billion was transferred to GSNB at a discounted book value of $ 640 million. This purchase was primarily funded by a public issue of extendable pay-through notes and Mellon Bank's shareholder's dividends. (The shareholders of Mellon Bank received GSNB's shares for their dividend value). GSNB which was created in 1988, liquidated all the toxic assets transferred to it and went out of existence in July, 1995 (Bleier, 2008). Mellon Bank on its part began to make profits within about one year of the creation of GSNB (McKinsey& Company, 2003).

The success of the Mellon Bank's case has resulted in the good bank-bad bank approach being adopted both in the USA as well as other countries. The success of GSNB promoted the US government to establish an asset management company called the Resolution Trust Corporation. This corporation took over the task of liquidating those stressed assets of banks declared as insolvent by the Office of Thrift Supervision. The early 1990's saw this corporation liquidating stressed assets worth $394 billion which arose as a result of the saving and loan crisis of the 1980's (Schäfer & Zimmermann, 2009). However this bad bank resolution process cost the US tax payer a total of $ 124 billion (Curry & Shibut, 2000).

Japanese banks have employed the good bank-bad bank technique to restructure their bad debts. In 1992, the Banker's Association of Japan created a bad bank by the name Credit Co-operative Purchasing Company (CCPC). This company purchased the stressed assets of Japanese banks and serviced them (Bleier, 2008). The banks which sold the stressed assets at a discounted valued to CCPC itself financed the said sale by extending a loan for the sale value. The CCPC then sold the real estate property and other assets given as security for the stressed assets and used that money to repay the loan extended to it by the bank which had sold the stressed assets to it (Taniuchi, 1997).

Many countries in Europe have successfully used varying shades of the good bank – bad bank solution to deal with the bad loan crisis in their respective banking sectors. The earliest bad banks in Europe were set up in Sweden. The Swedish government set up two bad banks by the name Securum and Retriva (Schäfer & Zimmermann, 2009). Securum was established in 1992 to take over the stressed assets of Nordbanken, a commercial bank. Securum financed this purchase partly with a loan from Nordbanken and partly with a government equity infusion (Repousis, 2017). At about the same time, Retriva was established for taking over the stressed assets of Gota Bank (Ingves & Lind, 1996). The remaining good assets of Gota Bank were auctioned off and purchased by Nordbanken (Repousis, 2017). Even though that bailout package cost the tax payer a considerable amount, the same was offset by the end of 2007 due to revenues from dividends, selling of stock etc. (Schäfer & Zimmermann, 2009). The two bad banks on their part successfully liquidated the stressed assets taken over by them (Repousis, 2017).

In Germany a bad bank called Berliner Immobilien Holding (BIH) was created in 2006 to separate the stressed assets of a bank called Berliner Bankgesellschaft (Schäfer & Zimmermann, 2009). However, when a bigger financial crisis hit Germany in 2008-09, the German Federal Legislature enacted a law in July 2009 for providing a good bank-bad bank solution which put very little burden on the tax payer. The said law created two separate

bad bank models for the private and public banks. For the private banks the German law created a special purpose entity model. Under the said model, private banks transferred their stressed assets at the book value to these special purpose entities. As consideration for such transfer, these special purpose entities issued bonds at 90% of the book value of the stressed assets to the transferring bank. These bonds were guaranteed by a government funded institution called Special Fund Financial Market Stabilisation (SoFFin). The

said guarantee is only for redemption at par value. For such guarantee SoFFin charged the bank a one-time fee as well as a fixed annual sum. For the public banks, the German law created a 'Consolidation Model'. Under the said model the public banks could transfer not just stressed assets but also other type of assets including business divisions which had lost their profit making ability. The fundamental feature of the consolidation model was that certain types of liabilities that were incurred prior to the coming into force of the legislation would be borne by the German Federal and State Governments (Ulrich & Ilgmann, 2013).

In Ireland, a bad bank by the name National Asset Management Agency (NAMA) was established through legislation in 2009 to deal with the crisis in its banking sector arising from the global meltdown in the real estate sector (Honohan, 2009). Under this scheme all toxic assets of a participating bank were transferred to NAMA at a discounted value. Payment to the transferring bank was in the form of Irish government bonds. Once this transfer took place, NAMA was statutorily mandated to liquidate those assets within a time frame of seven to ten years in such a manner as to obtain the optimum financial return. Banks transferred a total of € 74 billion at a discounted value of 57% to NAMA. By mid-2015, NAMA had liquidated more than 70% of its major obligations and is eventually expected to bring profit to the Irish Government by the time it would be wound up (Schoenmaker, 2015).

Spain in the year 2012 created a bad bank by the name SAREB (an acronym short form for a Spanish name which when translated to English reads as 'Company for the Management of Assets proceeding from Restructuring of the Banking System'). The toxic assets of many Spanish banks were transferred to SAREB. As of mid-2016, SAREB held assets worth more than € 50 billion and is expected to profitably liquidate those assets within 15 years of its creation (Blazsek, 2016).

The above brief analysis of important historical examples of bad banks very clearly shows that there is no standard or uniform structure of bad banks. Different countries have created different bad bank schemes to suit their national requirements. However, the basic purpose of the bad banks is same, i.e. to separate (and eventually liquidate) the toxic assets from the balance sheets of the regular banks so as to save the latter from collapse.

TYPES OF BAD BANK SCHEMES

As discussed above, the fundamental principle of good bank-bad bank technique is in the separation of the stressed assets of a regular bank from its performing assets (Mínguez, 2016). The purpose of this separation is for enabling a specialized management team to liquidate the stressed assets. For achieving the said separation of assets it is not always necessary that the bad bank and the good bank be separate legal entities. Bad banks can also be created as a separate business entity within the regular bank. Keeping this in mind, it is possible to identify four

basic types of bad bank schemes (Martini, et al., 2009). The first type of bad bank scheme is called the on-balance sheet guarantee. Under this scheme certain stressed assets of a bank are protected from further loss under a guarantee agreement whereby the government or some public institution guarantees that the book value of those stressed assets will not go below a certain value. Those stressed assets however, remain in the balance sheet of the regular bank. The second type of scheme is the internal restructuring unit scheme. Here, instead of creating a bad bank as a separate legal entity, an internal bad bank or restructuring unit is created. All the stressed assets of the bank are transferred to the internal restructuring unit which manages the same. In this case also the stressed assets remain in the balance sheet of the regular bank. The third type of bad bank scheme is referred to as the off-balance sheet special purpose entity. In this type of scheme the regular bank transfers the stressed assets to a special purpose entity which is usually public funded. It results in the stressed assets being taken off the balance sheet of the regular bank. 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

This study has the following objectives:

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.

Frees management bandwidth and specifically allows the management to:

- Focus on driving the performance of the core business
- Right-size the infrastructure for the organization
- Reduce the balance sheet and realise value from non-core assets through tailored solutions

- Release capital into or lower the capital requirements at the core business

Quicker resolution: Pooling of bad assets under a single entity can help in terms of resolutions (quicker decisions) as and when growth improves and demands for these assets increase.

Plugs in loopholes in ARC model: Private-run ARCs have not seen much success in resolving bad debts. International experience shows that a professionally run central agency with government backing could overcome the coordination and political issues that have impeded progress over the past years.

Domain expertise: A dedicated Bad bank may be better than a number of PSU banks replicating similar departments in their respective organizations Under a competent management and Board, the value of these stressed assets could be better preserved Domain focus could potentially help tap long-term pools of foreign and domestic capital via equity/debt issuance versus

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:

Potential steep haircuts: A prominent issue with Bad banks is not the need for it, but how to set it up, particularly when debt and equity capital is scarce and costly and fair value of the assets under consideration is estimated to be low. Transfer at computed fair value with steep haircuts may cause a severe blow to bottom line of the transferring bank, preventing a full transfer of risk to the Bad bank as contemplated

Lack of buyer demand: The price at which toxic assets are to be transferred may not be market- determined and price discovery may not happen. A key challenge includes the need for rapid, reliable data collection and analysis:

- Development of a detailed recovery/deleveraging plan
- Design of a structure that meets capital objectives
- Project based set up with cost base carefully aligned with asset recovery/deleveraging activity
- Developing and managing appropriate resources in areas such as restructuring and recovery, commercial real estate, IT and portfolio sales/M&A
- The need to utilize restructuring techniques for non-core assets when the workout unit itself has an intensive workload
- The need for management to focus primarily on developing the core franchise (good bank) whilst appropriately managing the non-core assets

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. TABLE: TREND IN INDIAN BANKING NPA

Country	FY15	FY16	FY17	FY18	FY19	FY20
Public sector Banks	5.0%	9.3%	11.7%	14.6%	11.6%	11.3%
Private Sector Banks	2.1%	2.9%	4.1%	4.7%	5.3%	4.2%
Foreign Banks	3.2%	4.2%	4.0%	3.8%	3.0%	2.3%
Small Finance banks	0.0%	0.0%	1.2%	2.5%	2.0%	NA
GNPA (%) – All SCBs	4.3%	7.5%	9.3%	11.2%	9.1%	8.5%
GNPA – SCBs (INR TN)	3.2	6.1	7.9	10.4	9.4	NA
Gross Advances - SCBs	75.6	81.7	85.0	92.7	102.3	NA

Source: RBI Financial Stability Reports

VIII. 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.

IX. PROS AND CONS OF BAD BANKS

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).
- The transfer of toxic assets to the bad bank will relieve pressure over the capital of the regular bank. This would enable it to involve itself in profitable/growth oriented business activities (Pinedo, 2009).
- The bad bank, which is created as a specialised agency to deal with toxic assets, can hire specialised personnel to manage those assets. This will help the speedy disposal of those assets with minimum loss in the most efficient manner.
- The bad bank can be given special powers to expedite loan recovery and toxic asset disposal (Klingebiel, 2000).
- The ownership of the toxic assets and its collaterals are centralized in the bad bank thereby facilitating better management of those assets (Klingebiel, 2000).
- The good bank-good bank scheme minimizes contagion risks. Since the toxic assets of the regular bank are removed from its balance sheet and transferred to a new entity, the performing assets of the regular bank are less exposed to risks of failure (Bolzico,Mascaro, & Granata, 2007).

The good bank-bad bank schemes are not without disadvantages. Some of them are enlisted below.

- Prior to the creation of a bad bank, certain key operational decisions are taken regarding many issues including how the associated risks will be managed. If these decisions go wrong, the bad bank and its owners will suffer huge losses (Elliott, 2009).
- The regular bank usually transfers the toxic assets to the bad bank at a discounted value. This lowers the market value of similar assets held by other banks. This forces the other banks to liquidate similar assets at lower

prices thereby starting a vicious cycle which pushes prices below their fundamentals. This is known as fire sale externality (Ulrich & Ilgmann, 2013).

- If banks become aware that there will always be a bad bank to takeover and manage their toxic assets, then banks will tend to be less careful while granting loans.

- 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.

X. CONCLUSION

While there's no official communication from the RBI about the creation of a 'bad bank' or a one-time loan restructuring proposal so far, a loan recast scheme for certain categories of borrowers has been announced.

As per a Government official, "We have studied the banks' proposal (bad loan). The fact is there are already market-led options available for asset reconstruction and it looks better that way,"

“The government is not keen to infuse equity capital into a bad bank, which has been recently proposed by the Indian Banks' Association. The government's view is that bad loan resolution should happen in a market-led way.”

The above analysis will clearly show that the basic task of the bad bank is to mop up the mess created by the regular banks in relation to the management of their toxic assets. The toxic assets of a regular bank are transferred to the bad bank not just for the purpose of better management of the transferred assets but also for the purpose of cleaning up the balance sheet of the regular bank. This process however involves some costs. As long as these costs are borne by the concerned banks or private players, the impact on the economy will be limited and the government need to have only a regulatory control over the entire process. However, if these costs are financed with tax payer’s money, a mere regulatory control by the government agencies will not be sufficient and a more strict and watchful control of the bad banks by the government will be necessary.

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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