

For banks to be good, some have to be bad

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The concept of 'bad' banks is not new, and transferring bad loans will enable greater transparency

Thanks to new financial design principles, 2016-17 is going to witness a slew of banks — 11 payment banks, 10 small banks, and two recently opened universal banks.

But in the overall financial design, one category that is conspicuous by its absence is a 'bad' bank. Simply put, bad loans are transferred from existing banks to a newly created 'bad' bank so that existing banks are insulated from these bad loans and their consequences.

The Indian banking system has stressed assets of over 11.3 per cent, some ₹8-9 lakh crore in absolute terms. These have grown by over 26 per cent y-o-y. The real numbers would be much higher if regulatory forbearances such as 5:25/Corporate Debt Restructuring schemes (where banks can extend tenures up to 25 years by refinancing a loan every five years) are excluded. According to the RBI's financial stability report, 16 banks have stressed asset ratio of over 16 per cent. Nine banks have negative return on assets, and another six have 0-0.25 per cent. These ratios are likely to get worse as regulatory forbearance gets taken away.

Asset reconstruction companies (ARCs) are the lynchpins of the existing bad-debt resolution set-up. They acquired bad loans of about ₹16,000 crore (a paltry 2 per cent of bad loan stock) during the second half of 2015. Given capital and other regulatory requirements, there is no way the ARC model can meet the massive challenge. Besides, 85 per cent of the sale consideration is given to banks by way of Security Receipts, which can take anywhere up to eight years before turning to actual cash or balance sheet benefit for banks. Though rated, there is no secondary market for these security receipts.

Tricky path

The administration of the Strategic Debt Restructuring (SDR) scheme, though path-breaking, is quite tricky and double-edged. Debt conversion into equity could be a disadvantage if the ruling market price is less than face value, the mandated floor price. This is the case in many companies — they don't have the required institutional mechanism to steer operations and financials.

In a first of its kind, the government created the Stressed Asset Stabilisation Fund (SASF) during 2004-5 in order to transfer bad loans of about ₹9,000 crore of IDBI; they even funded it. The SASF is one avatar of a 'bad' bank. If ₹9,000 crore bad loans could evoke a kind of bad bank, why not over ₹8 lakh crore?

The transfer of bad loans would bring about greater transparency and revive investor confidence in the real book value of bank assets. This enhances access to capital markets at decent valuations and provides growth capital, moderating

the burden on the government. The insulation provided by a 'bad' bank would bring better management focus both on resolving bad loans as well as better servicing of performing portfolios, and cater to their growth needs and new projects. This has the potential to put banks on a growth trajectory.

An old idea

The concept and practice are not new. The Bank of New York Mellon (1988) is a classic case. UK Asset Resolution manages the bad debts of erstwhile mortgage lenders Bradford & Bingley and Northern Rock. Ireland has the National Asset Management Agency.

Research carried out by the European Investment Bank (EIB), looking into about 14 cases across Europe and covering bad loans of over €1 trillion, recommends a new financial design to deal with bad loans in a proactive way. It offers two models: the first, a decentralised approach, wherein every bank saddled with huge troubled loans will have its own internal 'bad' bank; the second is a centralised 'bad' bank at the national level, which may be sector-specific.

Government backing and funding for the centralised model is essential as otherwise they would be at the mercy of vulture funds. With government guarantee, it can attract FDI, PE or hedge funds. can also minimise losses and effect gains. The proposed bankruptcy code reinforces the case for a new financial design for bad loans.

Independent governance, dedicated and appropriately skilled staff different from loan originators, limited role of government and wide range of strategies are among the vital factors needed for the success of the new financial design.

Given the scale, complexity and rapid growth of problem loans, the present financial design is not adequate. 'Bad' banks can help address these issues.

The writer was formerly CMD of Corporation Bank

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