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Why it may be time for Indian banks to take a hair cut to shelve bad loans

By [Sangita Mehta & Anuradha Himatsingka](#), ET Bureau | Updated: Jan 13, 2016, 04.41 AM IST

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Bad loan reduction has been the dominant topic in the [Indian banking](#) industry for more than two years, but hardly anything has happened. In fact, it could only worsen as the [RBI](#) tightens the screws on recognition of more [assets](#) as bad.

The difference between the desire and reality reflects in a senior banker's views on how a bad loan needs to be valued, and what a chairman of a strong textile maker had to say on these stressed assets.

"Just because we are a financially strong company does not mean we will pay more than the market value of the enterprise," says SP Oswal, chairman and MD at Vardhman Textiles, which has a market value of more than Rs 5,000 crore. "We are in business and we will negotiate the right price because ultimately we have to make profit in the future."

Turn to a banker and he has a different story to tell.

"I know the value of the underlying assets," says Arun Tiwari, chairman and MD of Union Bank of India who put on block Rs 1,000 crore of [bad loans](#) but did not sell any. "Why should I be shortchanged."



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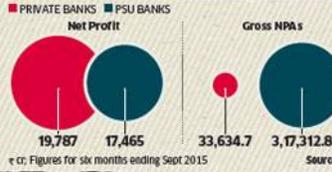
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Cut the Loss and be Smart About It

EARNINGS & PROBLEM LOANS OF LISTED BANKS



The acquisition cost for ARCs has gone up to around **60%** from earlier 40%. ARCs are good for solving mid-sized stressed loans valuing ₹1,000 to ₹2,000 cr, but can't handle the big problems of banks.

Banks in the West are willing to take a big hair-cut to the value of their asset and sell it to specialists at a loss.



We need more efficient conduct of Sarfaed & DRTs for resolution of stressed (assets). Also quick passage and implementation of the Bankruptcy Law and commercial courts. More M&A activity would also help. These have to be pursued. ARCs are not only suffering from paucity of capital but also the slow speed of resolution that we all complain about.

ARUNDHATI BHATTACHARYA
Chairman, SBI

The fundamental lesson of every situation of banking stress in recent years across the world is to recognise and flag the problem loans quickly and deal with them...

Forbearance is ostrich-like behaviour, hoping the problem will go away. It is not realism but naïveté.

RAGHURAM RAJAN Governor, RBI



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The Big Gulf

The gulf between the bankers and potential buyers on valuations has been the foremost stumbling block in the banking system trying to reduce its bad loans and revive those assets whose values are fast deteriorating. Indian bankers are still not accustomed to the way banking in the West is done where they are willing to take a big hair-cut to the value of their asset and sell it to specialists at a loss. The buyer then reorganises the company and makes it profitable in a few years.

"Banks worldwide try to get rid of bad loans from their books as early as possible," says Siby Antony, CEO, Edelweiss Asset Reconstruction. "But Indian banks tend to carry on their bad loans which made the assets unrecoverable. ARCs do not want to buy assets which cannot be revived because asset stripping and liquidation is not our business model." Bankers are reluctant to sell assets at half or one-third of the value of the book value unlike US banks which often sell for 50 cents, or even 25 cents on the dollar to recover and move on. But Indian bankers wait for the value to rise with the economic tide and for fear of someone accusing them of selling assets cheap.

ARCs Not Helpful

More than a decade and three years after asset reconstruction companies (ARCs) came into vogue in India, they have not been of much help in realising the objective of reducing bad loans of banks and reviving them.

It is estimated that ARCs, since their inception in 2003, have acquired just Rs 75,000 crore of loans by paying Rs 8,000 crore as cash. The situation is not improving, but only deteriorating despite the RBI's attempts.

In the first six months of this fiscal year, ARCs acquired just about Rs 7,000 crore of problem loans which is just 15 per cent of the total Rs 48,000 crore put on the block by banks. This is lower than Rs 28,000 crore last year same time.

Although asset reconstruction companies were seen as a novel way of getting rid of bad assets. They were also hobbled by poor capital structure and expertise and the absence of a legal system that is conducive to conduct their business.

"Asset reconstruction companies do not have the capacity and capital to purchase even

half of the non-performing assets from banks, given the magnitude of NPAs in the banking sector," says Ananda Bhoumik, MD, India Ratings.

"Public sector banks, too, do not have the capacity to clean their books on their own given the scarcity of their capital."

'Big Problems'

India Ratings estimates that all ARCs put together have a capital base of a mere Rs 4,000 crore which gives them ability to buy bad debts worth around Rs 1.2 lakh crore which is a mere 17 per cent of the total stressed assets in the system. It also pointed out that the acquisition cost for an ARC has also been rising because they are aiming to buy new NPAs where chances of recovery are higher than the seasoned NPAs. The acquisition cost has now gone up to around 60 per cent from earlier around 40 per cent, it says.

Bad loan buyers are quick to shift the blame on the Reserve Bank of India which mandated that these firms have at least 15 per cent of their own funds in the purchase of any asset as it suspected some are colluding with banks just to show lower bad loans, but not keen to recover them.

"One should not expect ARCs to solve banks' big problems," says Sanjay Jain, president and chief operating officer of Arcil. "ARCs are good for solving mid-sized stressed loans valuing Rs 1,000 to Rs 2,000 crore, but can't handle the big problems of banks."

Blame Game

While the blame game between the banks and stressed asset buyers are continuing as to who is responsible for the slow uptick in the sale of bad loans, the system is deteriorating quite fast.

The gross bad loans —where the borrower has not paid dues in time — of listed banks was at Rs 3.5 lakh crore as on September 2015 while an equivalent amount of restructured loans are expected to be in the banks' books. In other words, banks are dealing with close Rs 7 lakh crore of stressed assets, which do not include write-offs of thousands of crore of bad debt. The government may be moving swiftly to introduce the Bankruptcy Law but for it to bear fruits it could be three to four years as the infrastructure needed are put in place. In fact, despite that law, changes may be hard to come by if bankers' view of asset value do not change.

Given the magnitude of the problems that is holding the banking system many believe that there is no option other than the government stepping in as in the West where government backing is needed for the so-called 'bad banks' where government backs an asset reconstruction firm.

Finding an Alternative

"A disproportionate amount of attention is focused on recovery and [resolution](#) of stressed assets," says CVR Rajendran, former chairman of Andhra Bank. "As a result, banks are not able to focus on credit growth despite that fact that we are a credit-starved society. The alternative to this is to have a 'good bank-bad bank' model, where banks transfer their bad loans to a bad bank after taking a hair-cut."

But even this could possibly work only when it is funded by the government, said Rajendran.

Although evidence from other countries shows that it works well there are little signs of such an institution emerging in India.

"There is no illusion about the fact that the sovereign will have to play a role, as in many developed nations," says Ashvin Parekh, a consultant. "The government will have to find a way to fund the capital of banks. The better way out is to create a national ARC, owned by the government with a huge capital base so that it can acquire big-ticket stressed loans."

(With inputs from Atmadip Ray)

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