

# Why a Bad Bank for bad loans is a good idea, but it may be late

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Long-term bad bank backers say that it needs regulatory support to succeed.

On a gloomy Monday morning early in the fall of 2008, **Lehman Brothers** stunned the interconnected world of high finance, announcing the biggest bankruptcy in global history. Within three weeks of the Lehman announcement that put more than \$600 billion of assets under write-down risks, the US administration began the Troubled Asset Relief Program (TARP), creating perhaps the biggest **bad bank** to help recover money seemingly sunk into the subprime sinkhole. When the programme ended in December 2014, with the world's biggest economy returning to a stable growth trajectory, TARP had recovered about \$442 billion, earning a profit of about \$15 billion.

For North Block, therefore, TARP is a classic precedent – a state-run recovery programme that actually ran its intended course. For a nation with about Rs 10 lakh crore stuck in bad loans, interim finance minister **Piyush Goyal** recently sought to tackle the problem by

weighing in the idea of a bank, and free the government-run lenders now groaning under the crushing weight of nonperforming assets (NPAs).

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### **Let down by Indian allies, the Maharaja may need a foreign hand**

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Goyal's declaration comes even as New Delhi is struggling to capitalise government lenders, the private sector asset reconstruction companies (ARCs) largely failing to recover dud loans, and the two-year-old bankruptcy code deviating widely from the prescribed timelines.

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So, is a state-run bad bank a viable option? Yes, say bankers and analysts but with a caveat — only if it is structured in a way that is workable. “The problem of bad loans is a huge problem. For us to solve this, we have to take whatever solutions are available. This is an experiment worth exploring, but only if questions around capital, people, management and recovery are well thought out,” said former RBI deputy governor HR Khan.

At the RBI, Khan was opposed to the bad bank idea as the thinking then was to support the existing infrastructure to deal with the mess. However, the sheer magnitude of the problem prompted a re-think. “We didn't think the problem would become so gigantic. Since then, the total NPAs in the sector have doubled to Rs 10 lakh crore from Rs 5 lakh crore. Clearly, this problem requires an out-of-the-box solution,” Khan said.

### **SHOW ME THE MONEY**

But where will the money come from? NPAs in the books of PSU banks alone stand at Rs 8.9 lakh crore. Even if half (Rs 4.5 lakh crore) of the loan is sold to a government ARC at one-fourth the consideration (Rs 1.25 lakh crore), New Delhi will have to pump in Rs 1 lakh crore (90% of the consideration amount) to acquire the assets, show back-of-the-envelope calculations.

To be sure, details on the new bad bank, its structure and funding sources are not known yet. Also, the fact that Goyal is just an interim finance minister until the recovery of Arun Jaitley, also puts a question mark on the timelines.

Goyal announced the bad bank on his visit to his home city Mumbai, replying to questions on how the government plans to deal with rising bad loans. He has already said that a panel headed by Punjab National Bank chairman Sunil Mehta will give recommendations on the formation of the bank.

Analysts say details of the new entity are too sketchy to consider it with any seriousness. “There are so many questions about this proposal, starting from how it is going to be funded? How will they price these loans? How much haircut banks will take? And more than anything else, whether the decisions taken by these officials will be immune to scrutiny from the government’s vigilance arm and the CBI,” said Karthik Srinivasan, senior vice president at ICRA.

Initial enthusiasm about the bankruptcy code has meant that foreign investors such as KKR and Brookfield are ready to invest in distressed assets and make a killing in an economy growing at more than 7%. But there are doubts whether a residual government stake will be a deterrent for foreign investors.

“There are several foreign investors like KKR, Blackstone and AION that are keen to invest in a distressed market... Instead, the government should capitalise banks and improve the ease of doing business, which would encourage foreign investors to stay invested,” said a senior bank official.

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Some others question the need for something new when the existing infrastructure is not being utilised fully.

“There are enough ARCs doing the same kind of job. To put scarce capital in another entity, which will do a similar kind of job, does not look like such a good idea,” said Kalpesh Mehta, partner, financial services at [Deloitte](#) India. Instead, Mehta favoured giving banks the flexibility to enhance their capital through innovative financing.

“For example, public sector banks are sitting on thousands of crores of real estate. They can use this to enhance their capital by pooling in their assets in a Real Estate Investment Trust (REIT) which could easily yield them 8 to 9% per annum besides saving them a capital charge,” Mehta said.

Next is the question on talent: If all bad loans are transferred, it is about the size of SBI which has nearly 2.75 lakh staff. In a country where even resolution professionals are beaten up, how do the staff of the bad bank resolve or recover?

“Where are the people to manage?” asked Khan. “We cannot find managing directors for our banks for many months together. How can we expect to find people who can do this complex job within a strict timeline?”

## **STRUCTURE OF THE BAD BANK**

Long-term bad bank backers say that it needs regulatory support to succeed. This means the entity is an extraordinary institution with special benefits and a specific purpose, much like the TARP.

“This special status could be a provisioning holiday or a lower cash commitment while buying these assets from banks. But we must be careful that this new entity is not used as a parking lot for junk discarded by the banking sector,” said Saurabh Tripathi, senior partner at [Boston Consulting Group](#).

Unlike earlier days, any new ARC will need deep pockets since the RBI rules mandate that 90% of the consideration amount should be paid in cash and the remaining could be security receipt — a quasi-debt instrument maturing in 5-7 years.

“The idea of setting up a large ARC is not a worthwhile solution,” says KM Jayarao, executive vice chairman, Ambit JC Flowers ARC.

“The government, regulators and the banks shouldn’t be thinking of band-aid solutions. They only provide temporary relief and drain public fund.”

Then there is the question of valuations. “Whether banks agree on valuations will depend on how this new ARC structures its transactions. Will it be at a fixed price and banks will get rid of bad loans at one go or will it be at a discount?” asked ICRA’s Srinivasan.

Separately, a special status for the entity could alienate other stakeholders also involved in the clean-up. Calls for a level playing field are already being echoed by the Association of ARCs of India, the lobby group for bad banks. There are 25 ARCs registered with the RBI, but not all are active.

## **LINKED TO THE FUTURE**

Khan believes that a bad bank should be seen as a question of survival for lenders under RBI restrictions. "It should be seen as linked to the future of these PCA banks. The idea of a bad bank is workable now because most of them have provided for these loans and will not have to bear the provisioning once these are sold off," Khan said.

Both Tripathi and Khan, however, said that it is important the government does not hurry the implementation of this crucial project. "This is a big challenge. We have to get the structure right. Otherwise, it won't be worth the effort," Tripathi said.