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Market Watch

# View: Why a new 'Bad Bank' when there are 28!

BY MC GOVARDHANA RANGAN, ET BUREAU | UPDATED: MAY 09, 2020, 06.19 PM IST

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After years of lull bankers are turning proactive. This time it is not a new found aggression to lend but to palm off their bad loans to taxpayers.

A 'Bad Bank' is being touted as the panacea for industry's ills, yet again. This time in anticipation of defaults after the lifting of moratorium granted to overcome the Covid-19 stress instead of post the bad loans pile up. Once banks' bad loans are transferred to the newly created entity banks would turn agile again and fuel economic growth with new credit.

Many countries have followed such models including Sweden, Indonesia and Ireland. In its simplest form it is selling the Non-Performing Loans of a bank to the bad bank so that bank's financials are sound and attractive. India too discussed it soon after the Asset Quality Review in 2015 exposed how banks were papering over rotten assets.

If it is a question of selling bad loans to another entity why not sell to Asset Reconstruction Companies which almost perform a similar function. The counter is that the past experience has not been encouraging and they are inefficient.

What has been the experience with the 28 ARCs. The recovery rate looks insignificant compared to their values when they were on banks' books.

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Average recovery for 15-years between 2004 and 2019 has varied between 2.4 percent and 21.5 percent of the book value as assessed by the banks, data from the [Reserve Bank of India](#) shows. Only in one year - 2010 - it was above 20 percent.

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But the data on the recovery rate based on the value assigned by the ARCs when they bought a bad loan from a bank tells a different story.

The recovery rate compared to the rate at which ARCs bought loans from banks was more than 40 percent in 10 of the 15 years. In some years like 2009 and 2010 it was more than 90 percent.

In essence, the asset values in banks' books were inflated way too high. Even a bad bank cannot solve the asset value mismatch problem.

“The recovery performance when measured with regard to the Securities Receipts issued (that is, after factoring in the discount to the total bank claims) is generally better,” the RBI’s Financial Stability Report for June 2019 says. “While the performance of ARCs given the recovery rates is fairly impressive, the recovery performance in some recent years appears to be on a decline.”

While the ARC model predates the advent of the Insolvency and Bankruptcy Code making the data less relevant, what is the reality under the transparent bankruptcy process.

Total claims since the insolvency law became effective shows that just about 43.15 percent of the of the financial creditors’s claims are realizable, data from the Insolvency and Bankruptcy Board of India shows. It has since deteriorated in the December quarter with Rs. 23,668 crores claims likely realizing Rs. 2,878 crores or 12.16 percent.

Experience at both the ARC level and bankruptcy law resolutions show that the ‘asset value’ at banks books are impediment to resolutions rather than the absence of a tool.

How does a bad bank help in the given scenario? First it needs capital. Anyone who invests in it would look for returns.

Would the banks sell an asset at the likely market or realizable value which the past data reflects? If so why not sell them to ARCs with a similar mechanism? The discussion also involves government owning a stake in the bad bank after it already threw Rs. 2 lakh crores into state run banks between 2018 and 2019 fiscal years. Private lenders such as [Axis Bank](#), [IndusInd Bank](#), and [Yes Bank](#) have also raised

billions of dollars in equity in the past few years.

Experience on bad loans shows the case for a new bad bank is very weak. But if the industry still believes it could dawn a new era it should go for a market oriented solution with private capital funding the bad bank rather than dragging the government in.

The case for using the taxpayer money for feeding the poor is stronger than funneling it into a bad bank.

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