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Why IBA's proposal to have govt-backed bad bank could hit a wall

BY SALONI SHUKLA, ET BUREAU | UPDATED: MAY 16, 2020, 10.03 AM IST

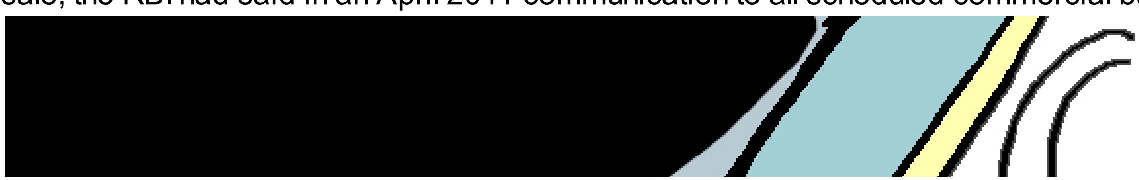
Mumbai: The initiatives to create a bad bank may hit a wall, as the banking regulator and the government, which is expected to sponsor it, are unlikely to accept two key proposals that the bankers' lobby group has made.

The Indian Banks' Association wants to transfer accounts where fraudulent activities have been detected to the new entity that will hold their risky assets. It is also proposing to sell bad loans at book value to the asset reconstruction company (ARC).

A government official involved in assessing the IBA's proposal asked how the government could pay for loans where a fraud had been declared. "There is a moral hazard issue here," he said.

As per the proposal submitted to the government and the Reserve Bank of India, fraud-hit accounts could be considered on a case-to-case basis, with approval from the regulator, to sell to the band bank. However, lenders who sell these loans will have to deal with all inquiries relating to fraud investigation.

Current rules don't allow the sale of such loans. Banks cannot sell bad loans that have originated fraudulently or have been classified as fraud as on the date of a planned sale, the RBI had said in an April 2011 communication to all scheduled commercial banks.



Banks have a plan to transfer ₹70,000 crore of bad assets to the proposed ARC.

As per data with the finance ministry, between April and December 2019, banks and financial institutions had reported frauds worth ₹1.43 lakh crore.

Another bone of contention is the transfer of assets to the bad bank on the book value net of minimum regulatory provisions. This, banks say, would avoid time-consuming valuation process and due diligence. But, even ARCs don't buy bad assets from banks at book value.

"In almost every bad loan sale, banks have taken haircuts ranging from 20% to 90%, then how can this sale happen at book value without determining the true valuation of the underlying asset and its recovery potential," questioned the CEO of an ARC, while speaking on the condition of anonymity.
Data with the RBI show that asset values have been inflated in bank books. When an ARC bought a loan from a bank, the recovery rate was more than 40% in 10 years of the 15-year period till 2019. In some years, such as 2009 and 2010, it was more than 90%.

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