Banking

'Bad bank' aims to break India's NPA curse

Implementation challenges such as ensuring fair value and timely disposal of assets will need to be overcome for the strategy to be successful

By **Karry Lai**

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India's 'bad bank' is slated to launch at the end of March to handle non-performing assets (NPAs) from banks. Market participants have told IFLR that the strategy will help to aggregate distressed assets and expedite the process of selling them to potential investors, however, it will be difficult to ensure that the assets are properly valued and sold in a timely manner.

At least 50,000 crore ($7.7 billion) of toxic assets are expected to be transferred to the National Asset Reconstruction Company (NARCL) in the first phase by the end of March. Under the latest 'bad bank' structure licensed by the Reserve Bank of India, the public sector bank majority-owned NARCL will acquire and aggregate bad loans from banks while the private sector bank majority-owned India Debt Resolution Company (IDRCL) will handle the resolution process and manage the selling of distressed assets to potential investors.

"The 'bad bank' will take over loans and aim to resolve these - it may either sell down the loans or restructure individual companies with participation from private funds, strategic investors and asset reconstruction companies," said Anuj Kumar, managing director and CEO at financial services group Pepper India Advisors.

"The 'bad bank' will be able to aggregate loans from several banks and also purchase them at fair value, which will make it easier to make decisions on an eventual restructuring."

The structure of the 'bad bank' allows the public and private sector banks to work together to deal with stressed loans so that the distressed assets can be liquidated and sold to foreign investment funds. "Before this strategy, it was hard to maximise the amount of distressed assets that could be sold to potential investors," said Yogesh Vishnoi, legal counsel at hotel chain Oyo.

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NARCL will acquire assets and issue security receipts in a 15:85 ratio so that selling lenders and banks will hold 85% of the security receipts and NARCL will subscribe to the remaining 15%. The security receipts issued by NARCL through its trusts will be backed by a government of India guarantee for an amount up to 30,600 crores.

"The guarantee is expected to provide comfort to potential investors in situations where there is a shortfall between the face value of the security receipts and the realised sum at the time of redemption," said Nikunj Maheshwari, partner at AZB & Partners, who is advising NARCL. "The guarantee comfort is also likely to boost liquidity around the security receipts which are tradeable."

Traditionally, the government has tried to tackle the issue of NPAs through strategies such as the securitisation and reconstruction of financial assets while banks have turned to corporate debt restructuring, but these have not been successful.

"The existing asset reconstruction companies have not been as successful in resolution of NPAs due to limited to capitalisation," said Maheshwari. "This is where NARCL differs from other asset reconstruction companies as the 'bad bank' will be capitalised by both equity and debt and aims to acquire high value loans in multiple phases. The government guarantee provides further support to NARCL and its potential investors."

The success of the 'bad bank' will depend on speedy disposal of bad debt at a fair price. "It certainly opens up a potentially quicker avenue for lenders for resolution of stressed assets given that the Insolvency and Bankruptcy Code process has become slower and there is a huge backlog of cases at the various National Company Law Tribunals," said Rukmini Roychowdhury, partner at Krishnamurthy & Co.

As the 'bad bank' will be the sole entity engaged in the process of recovery or liquidation, Roychowdhury believed that the problem of coordination with different stakeholders will be resolved.

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Challenges ahead

One of the implementation challenges is gaining the trust of potential investors outside of India and this process will take time.

Another is ensuring the fair valuation of loans when the 'bad bank' takes over them, as well as the will to resolve these loans at realistic valuations without waiting too long, which would erode value.

"The valuation of stressed assets is a key challenge if such bad loans are transferred at a higher percentage of book value, the loss will have to be absorbed by NARC and thus, the government," said Maheshwari. "The subdued growth of the secondary market is also a key concern. There may not be enough response from the secondary market if the banks holding the security receipts try to sell them."

If a resolution is not completed in the proposed term of five years, Maheshwari added, the guarantee will fall away and it is likely that security receipt holders will seek to redeem their securities within the five year term.

One of the arguments against the 'bad bank' is that instead of tackling the underlying structural problems in the banking system to improve public sector banks, it shifts the problem from one place to another. "The public sector banks will now be both shareholders and customers which leads to the possibility of circulation of the same bad debt from one book to another," said Roychowdhury. "It may be argued that these banks can find buyers for the security receipts, but that is dependent on the development of a deep secondary market."

As of now, 38 stressed accounts totalling more than INR 825 billion have been identified to transfer to the 'bad bank' and 15 accounts will be transferred in the first phase.

"The immediate challenge that I foresee is how the 'bad bank' will increase its coverage to also include banks with smaller books of toxic assets," said Avijit Banerjee, CEO and managing director at Argon Capital Advisors. "As of now, the 'bad bank' will initially acquire NPAs of INR 5 billion and above. This may not bring in banks with a smaller book size into the net of reconstruction and resolution of the 'bad bank'."

While a number of challenges lie ahead, the transfer of bad debt to a specific entity solely focused on asset reconstruction will help with the recovery process and ease India's NPA crisis. "The transfer of bad debt would help banks clean up their balance sheets and allow them to focus on their main business of lending with more focus on diligence and credit evaluation, thereby reducing the possibility of loans turning sour in the future," said Maheshwari.

Ultimately, Vishnoi believes that bad loans will continue to grow unless the root causes are being targeted. "Bad loans will worsen until the government takes care of SMEs, such as through tax cuts," he said. "The Reserve Bank of India should also be stricter in getting banks to disclose non-performing loans."

Kumar's view is that the restructurings are aimed at improving underwriting standards at the banks, however he said that restructurings that result in company owners losing their companies' or their shareholdings diluted will serve to improve the credit culture and indirectly result in lower bad debts.

In the long run, what needs to be in place are more stringent measures to make banks think twice before lending and to put in penalties. "I think the transfer pricing mechanism of the toxic assets needs to be re-looked, since it seems lucrative enough to make the Indian banks become complacent and take more risky exposures in their books, which eventually they would dump it on the 'bad bank'," said Banerjee.

The current pricing mechanism of 15% of toxic assets being acquired in upfront cash and the balance 85% in government-backed security receipts is a "full carrot approach" for the banks carrying the legacy NPAs, he suggested. "There is no value penalty being applied whatsoever," he said. "Unless the value of the toxic assets paid to the banks, in whatever form, is a lot less than the book value of the assets, there will be an increasing chance of banks being complacent and taking riskier loan exposure in the future."

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