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# Prospects of Bad Bank in Indian Banking Industry: Experiences from Abroad


*With the mounting bad loans in the banking industry, aggravated by the effects of Covid 19, the Government of India announced the setting up of a public Asset Management Company ('AMC') / bad bank to address the resolution of stress in the banking system. The concept of bad bank has been around internationally for quite some time and the track record of the bad banks has been mixed. We have picked up six such institutions from developed and emerging economies and summarized their experiences and the lessons that they hold for running a successful bad bank. It has been observed that the successful bad banks have been implementing rapid disposal of assets, innovative technologies, sunset clause, strong governance and transparency with frequent reporting.* ***Read on to know more…***

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## Introduction

The discussion on the setting up of a bad bank or a public Asset Management Company (AMC) has been doing the rounds for a long time and received fillip with the recommendations by the Sunil Mehta led Committee, under Project Sashakt. While the Committee refrained from calling it a Bad Bank, it recommended the establishment of an Asset Reconstruction Company (ARC) to take over assets > ₹500 crore and turn them around before selling them off to strategic investors. The announcement in the FY 22 budget to set up an ARC and an AMC for stressed asset resolution, saw the idea of a 'Bad Bank' gain further traction.

Given the stockpile of stressed assets, aggravated by the impact of Covid-19, the setting up of the Bad Bank has been envisaged as a measure to resolve stress from the banking system, in conjunction with the existing mechanisms, including the Insolvency and Bankruptcy Code, 2016 (IBC) and Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI).

### 1. National Asset Reconstruction Company Limited (NARCL) and India Debt Resolution Company Limited (IDRCL)

In September 2021, the government announced the setting up of NARCL, with the avowed objective of consolidating stressed assets for their subsequent resolution. The NARCL will be majority owned by public sector banks in which the State Bank of India, Union Bank of India and Indian Bank have picked up 13.27 per cent stake each, while Punjab National Bank has acquired about 12% stake[1] in NARCL.

NARCL has an objective to acquire high value stressed assets (> ₹ 500 crore) from the banking institutions, aggregating ~ ₹ 2 lakh crore, in a phased manner. NARCL will pay the agreed value for the bad assets in the form of 15% upfront cash and the balance 85% through government guaranteed security receipts. The cabinet has cleared the proposal to provide a government guarantee worth ₹ 30,600 crore to the security receipts issued by NARCL. This guarantee will cover the shortfall between the face value of the security receipt and the actual realization value from the sale or liquidation of the asset. It will be valid for a period of five years.

Under the process, the lead bank, on receiving an offer from NARCL, will go for a 'Swiss Challenge', wherein other asset reconstruction players will be invited to better the offer, to discover a higher valuation for the non-performing asset on sale.

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In the first phase, 22 fully provisioned assets, aggregating ₹ 90,000 crores have been identified for transfer to the NARCL. Alongside NARCL, India Debt Resolution Company Limited (IDRCL) has been proposed as a service company/operational entity which will manage the assets and engage market professionals and turnaround experts. The public sector banks and public financial institutions will hold up to 49% stake in IDRCL and the


balance will be held by private sector institutions. The NARCL-IDRCL structure will work in tandem with NARCL acquiring the stressed assets and IDRCL being engaged in their management and value addition.

As per the report issued in November 2021 by the Committee set up by the Reserve Bank of India (RBI) for the review of the working of AMCs (RBI Committee), the sub-optimal performance of the AMCs currently in operation has been attributed, inter alia, to paucity of funds and lack of focus on acquiring necessary skill sets for holistic resolution of distressed borrowers. NARCL with a corpus of ₹ 6,000 crores, and a government guarantee of ₹ 30,600 crores for SRs issued by it, will be well-positioned to make attractive offers to the lenders. Further, given IDRCL's proposed mandate as a service entity which will engage with professionals and turnaround experts, it should be better equipped to deal with the resolution of stressed assets.

While it is early days and the full picture on the working of both the institutions is yet to emerge, we thought it would be worthwhile to look at the experiences of other countries who have taken this route.

### 2. Practices from Other Jurisdictions

Distressed public asset management companies have been established in various jurisdictions, particularly during financial crises or to deal with high level of non-performing loans. However, their performance has been mixed. We have summarized below the performance of six representative economies from amongst the developed and emerging nations[2], and the lessons that they hold for us.

[1] https://www.livemint.com/industry/banking/narcl-bad-bank-to-soon-bring-more-directors-on-board-11634461601346.html

[2] Public Asset Management Companies: A Toolkit (2016). World Bank Group (https://openknowledge.worldbank.org/handle/10986/24332)

### 2.1. South Korea

During the financial crisis of Korea during 1997-98, when the liquidity in the banking system was scarce, the Korea Asset Management Corporation (KAMCO) set up by the Government, played a vital role in facilitating the restructuring process by purchasing distressed assets from the banks, merchant banks, investment trusts, securities firms, insurance companies and other non-banking financial institutions, which allowed the banks to resume their normal lending. Disposal of such distressed assets was achieved by KAMCO through numerous methods including competitive auctions, establishment of joint ventures, restructuring, collection of rescheduled repayments, international bidding, bulk (pooled) sales and issuing asset-backed securities.

One of the most effective methods of disposal of stressed assets was through the introduction of an online national auction portal called OnBid. This portal integrates the information from KAMCO and disseminates it to the public, providing a one-stop online shop for the whole auction process from searching assets to executing the contracts. Over the years, OnBid has proved to be highly successful as an effective and efficient mode for auctioning stressed assets. KAMCO focused on rapid disposal of the assets and resorted to workout / restructuring only in the limited cases where there was clear potential to enhance the value. It largely adopted market-oriented pricing mechanism in purchasing the NPLs and recovered more than the purchase price it paid for the assets. By the end of December 2002, KAMCO had resolved ~ 60 percent of its US$92 billion in assets, at an average recovery rate of 46.8 % of the face value[3].

KAMCO has been a successful experience on account of various factors. It was quick to respond to the needs of investors and tailored products accordingly. It aggressively sought out foreign investors, who helped bring in fresh liquidity into the market along with technical expertise. It helped improve information flow on the assets which led to better risk assessment and improved pricing.

### 2.2. Indonesia

The Indonesian Bank Restructuring Agency (IBRA) was established by the Indonesian Government as one of the measures to tackle the banking and economic crisis that fell upon the country following the Asian Monetary Crisis in mid-1997. IBRA was established on 26 January 1998 with an initial lifespan of 5 (five) years, which was extended till its termination on 30 April 2004. With the establishment of IBRA, the Government was instituting a 'bad bank' to allow the removal of bad loans from the banks, with an aim to promote the recovery of Indonesia's financial system.

**“On Bid, an online national auction portal in South Korea, provides a one-stop online shop for the whole auction process from searching assets to executing the contracts.”**

IBRA had decided to function in two divisions – asset management of credits (AMC) and asset management of investment (AMI). As a part of the bank restructuring program, all the loss-making loans from state and other banks were transferred to IBRA. Obtaining clear title to the assets for the securities undertaken against the loan became a difficult task for IBRA. Further, it resorted to 'direct sale' of loans which did not require the publishing of a public tender. The potential buyer was to offer a minimum of 70% of the face value of the stressed asset and it was directly sold to him.

Over its lifetime, IBRA sold approx. 60% of its NPL portfolio with around 87% of the sales occurring just between 2002 and 2004. The average recovery rate of IBRA was only a meagre 22%, which reflected both the poor quality of loans and the lengthy time taken for sale of such NPL. The IBRA was largely a failed exercise on account of various factors including political interference, and also lack of transparency regarding the valuation of assets and recovery efforts[4].

### 2.3. Malaysia

Danaharta was established as a national AMC by the Malaysian Government on 20 June 1998, in response to

[3] https://www.imf.org/external/pubs/ft/wp/2004/wp04172.pdf

[4] https://www.imf.org/external/pubs/ft/wp/2001/wp0152.pdf

the financial crisis. The main motive behind the establishment of Danaharta was the removal of NPLs from the financial system. NPLs accounted for a whopping 11.4% of the banking system loans in August 1998. Danaharta acquired assets at a market price and in exchange issued zero coupon government guaranteed bonds with a maturity period of five years. The threshold above which a financial institution could transfer its NPLs to Danaharta stood at above RM 5 million.

As of September 2005, Danaharta had resolved almost all the NPLs and recovered ~ RM 30.35 billion vs. the aggregate transfer value of RM 52.42 billion of the loans acquired, resulting in recovery of ~ 58%. While the date of last transfer to Danaharta took place in March 2001, the last date for asset disposal was 31 December 2005 when Danaharta was eventually wound up[5].

> **Danaharta of Malaysia has been recognized as a successful national AMC by international agencies such as the World Bank.**

Overall, Danaharta has been recognized as a successful national AMC by international agencies such as the World Bank. Among its various attributes which contributed to its success including strong legal authority, adequate financial support, and clear mandate, a key contributing factor was strong corporate governance and transparency. Its board published quantitative key performance indicators (KPIs) to assess Danaharta's effectiveness. It adopted the Malaysian Code on Corporate Governance. Danaharta published quarterly reports on its activities on its website and also recruited experienced professional staff, who were rewarded on the basis of achievement of KPIs.

### 2.4. Ireland

The National Asset Management Agency (NAMA), established in 2009, was created to tackle the financial crisis in Ireland and function as a bad bank. NAMA has focused on non-performing property and real estate loans. NAMA acquired, in total, ~ €74 billion worth of loans from the institutions participating in the NAMA scheme and issued securities worth ~€31.8 billion to such institutions, based on a transparent independent expert evaluation.

NAMA's success has been quite apparent in the decrease in the loans and receivables of NAMA to ~ € 0.85 billion in 2020[6]. Though NAMA does not have an expiry date, it would be wound up when the Minister of Finance determines that its existence is no longer necessary.

Its success has been driven by a clear mandate with a commercial focus and its primary objective is to get the best possible returns for the state and to do so expeditiously. Further, NAMA benefits from transparency and independence. NAMA reports quarterly and its management reports to Parliament every six months. Although NAMA is under high scrutiny, it has also been granted operational independence which allows NAMA to resist pressure from purchasers to sell at fire sale prices and from debtors.

### 2.5. United States of America

Following the success of Grant Street National Bank (GSNB), a private bank created by Mellon Bank to transfer and resolve its own stressed assets, the government of the United States of America decided to establish a thrift management entity called Resolution Trust Corporation (RTC) in 1989. The stressed assets of the banks which were declared to be insolvent by the Office of Thrift Supervision, were eventually taken up by the Resolution Trust Corporation. RTC solicited bids from a wide variety of bidders and over time, developed standard procedures, documentation, forms which the potential investors could use to bid on various institutions. RTC was also responsible for selling more than $450 billion of their real estate and disposing of 95% of their overall assets with a recovery rate of more[7] than 85%. While RTC was not exactly an asset management company, its experiences hold good for an AMC. RTC derived it success from focusing on timely funding and

[5] https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=1182&context=journal-of-financial-crises

[6] https://www.nama.ie/uploads/documents/Final-NAMA-Annual-Report-2020.pdf

[7] Frederick Mishkin and Stanley Eakins, Financial Markets and Institutions, Addison Wesley Longman, 2000, p. 498.

early and speedy disposition of assets. Of course, presence of a liquid, capital market assisted in the quick asset disposition. Strong internal controls, use of private sector professionals and well-designed incentives also contributed to the success of the institution.

### 2.6. Sweden

Various countries throughout Europe have resorted to utilization of the good bank – bad bank approach in order to deal with the crises the banking sector in their countries. The initial bad banks in Europe were set up in Sweden when the Swedish government set up two bad banks i.e., Securum and Retriva around 1992. Securum was responsible for taking over 1/3rd of the balance sheet of the country's largest bank Nordbanken and was funded by the government. On similar lines, Retriva was set up for the purpose of taking over the toxic / stressed assets of another bank i.e.Gota Bank. In total, Securum and Retriva combined had acquired ~ $871 million worth of stressed assets. Retriva was later merged with Securum.

While Securum was owned by the government, the management consisted of private individuals who were experts in their relative fields. This expertise proved to be useful in managing the stressed assets.

By the time, Securum was wound up in 1997, it had disposed of 98% of its portfolio of assets highlighting its great success by being wound up 5 years earlier than expected[8]. Securum's strategy for disposal of assets was straightforward and effective. Companies with low profitability, a low interest coverage ratio, a high debt/equity ratio, or no track record were filed for bankruptcy. Companies deemed to have potential were reorganized through mergers, acquisitions, and sales of assets.

It had the operational flexibility to take whatever actions were necessary to maximize the value of its assets. Securum was staffed by professionals, who had experience in restructuring, operating, and selling companies.

[8] Journal of Financial Crises – Swedish AMCs: Securum and Retriva - Mallory Dreyer

## 3. Conclusion and Key Takeaways

Basis the experiences of the above international banks, we have summarized below certain key drivers for success of a public AMC.

### 3.1. Rapid disposal of assets

One of the lessons from the experiences of the international banks is the focus on quick disposition of the assets. The board / management of the NARCL / IDRCL combine has to frame a clear strategy to identify upfront the assets which are capable of further value enhancement so that the turnaround / restructuring efforts are restricted to only those few. The default approach should be to focus on immediate commencement of disposal activities. One of the other common factors in the successes of the global institutions has been the deployment of tailored processes for disposal rather than a 'one size fits all' approach. KAMCO for instance widely resorted to international bidding and pooled sales, apart from the traditional competitive auctions.

> **RTC of USA was also responsible for selling more than $450 billion of their real estate and disposing of 95% of their overall assets with a recovery rate of more than 85%.**

The 22 initial NPAs which have been identified for transfer to NARCL are fully provisioned, long vintage stressed assets, with most of the large ones having already been admitted into the NCLT for Corporate Insolvency Resolution Process (CIRP). Thus, NARCL may have a limited role to influence the resolution in these cases except perhaps to expedite the decision-making as a single point of contact. However, given that the proposal is to transfer bad assets aggregating ~ ₹ 200,000 crores, in a phased manner, NARCL, going forward, would preferably be entrusted with stressed assets of a much a shorter vintage. A flexible approach, aimed at targeting a wider investor pool and focused on rapid disposition of the asset should see NARCL preserving the value of the asset.

### 3.2. Strong commercial focus, with a sunset clause

A strong commercial focus, with a sunset clause, would drive efficiency and reduce the pressure on the exchequer. Further, a sunset clause would guard against 'mission creep' and diffusing the original mandate. Most successful public AMCs have had a sunset period ranging from 5 to 15 years, depending on the nature of the assets.

NAMA, Danaharta, were issued clear, narrow mandates. Further, they appointed board members and staff, with private sector / international experience in asset management and awarded them performance-based incentives. The operational independence certainly boosted the outcome of these entities. IBRA, on the other hand, had a mandate which was overly broad and not aligned with its operating environment. While it was originally envisioned to be a bank restructuring agency, it was assigned several other tasks (eg. pursuing bank owners for misuse of liquidity support), which were not necessarily compatible with its operating environment. It also created sequencing problems and led to delays in its original task of asset disposition.

While a clear mandate has been set out for NARCL / IDRCL, one needs to wait and watch if the sunset clause would be introduced and how it would engage with professionals to ensure commercial focus.

**3.3. Strong governance and transparency, with frequent reporting**

A key common thread running through the successful institutions cited above, is strong governance and transparency. The importance of transparency, strong internal controls and oversight, frequent reporting can hardly be overstated in a public AMC, especially, when combined with operational independence. NAMA, Danaharta, Securum, KAMCO, all excelled at this.

NARCL / IDRCL should imbibe these best practices in respect of establishing clear KPIs, building annual plans and publishing the actual achievements. It should adopt a strong code of conduct, with zero tolerance for non-compliance. Periodic third-party evaluation of progress of the institutions may also be carried out.

**3.4. Independent market driven valuation**

Transfer price based on market value established through a transparent, due diligence process conducted with the assistance of independent experts would enhance transparency. NAMA, Danaharta, for instance acquired the assets at market prices.

Currently, it is envisaged that NARCL will provide the anchor price and the banking institutions will run a Swiss Challenge process, inviting other ARCs to better the price. The anchor price should be determined based on expert evaluation and an independent due diligence process. One of the key arguments of those opposed to a 'bad bank' is that it merely transfers the asset from one pocket to another. A market driven price would encourage the bad bank to show recoveries and have a commercial focus.

**3.5. Transfer of Assets to NARCL**

In most jurisdictions, the transfer of assets to the bad bank was either compulsory or encouraged through a carrot and stick policy. For instance, in the case of Danaharta, one of the 'sticks' was the Central Bank would not provide recapitalization if the bank did not transfer its non-performing loans to Danaharta. Likewise, by way of a carrot, the Central Bank allowed banking institutions to amortize losses resulting from the sale to Danaharta up to a period of five years.

While the first tranche of 22 NPAs has been identified and agreed for transfer to NARCL, going forward, there is no clarity as to the measures proposed to facilitate debt aggregation and encourage transfer of early stage stressed assets to NARCL. A strong carrot and stick policy should be put in place, e.g., regulatory forbearance on early transfer to NARCL, compulsory transfer on approval by the requisite majority, additional provision for dissenting with the majority.

**3.6. Enabling regulatory environment for the AMC to perform**

Across the successful AMCs, an enabling legal framework was created for the AMCs to fulfill their tasks. While we have a robust regulatory framework governing AMCs, there should be a provision for a limited period moratorium on legal proceedings against the borrower which would enable the AMC to focus on the resolution plan. (A similar recommendation has also been made in the report issued by the RBI Committee).

There is no doubt that there has arisen a need to address the burgeoning non-performing loans. At 9.23%, the NPA percentage of India is second[9] only to that of Russia at 9.29%. While a public AMC may not be a permanent solution, it can be an effective intervention, with appropriate safeguards, as has been experienced internationally.

[9] https://www.financialexpress.com/industry/banking-finance/are-bad-banks-really-good/2338952/