Why a bad bank needs a sunset clause

Without this there will be a problem of moral hazard. The core problem of wilful defaulters remains to be tackled

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On October 4, the Reserve Bank of India gave license to National Asset Reconstruction Company Limited (NARCL), popularly known as a bad bank.

The role of the bad bank is to establish a liquid market for Non Performing Assets (NPAs) with a underlying belief that banks will be able to sell their NPAs at a reasonable price.

NARCL, through its service company/operational entity India Debt Resolution Company Ltd (IDRCL), will manage the resolutions of these NPAs.

The NARCL will acquire these stressed assets through 15 per cent cash and 85 per cent security receipts (SRs) in a phased manner, of which ₹90,000 crore of the asset will be managed in the first phase.

A government guarantee will back the SRs for a maximum amount of ₹30,600 crore, and the guarantee will be valid for a resolution period of five years.

Currently, the Indian banking system has one of the highest gross non-performing assets (GNPA) to total asset ratio globally. Post-covid stress scenarios estimated by the RBI pegs it at an aggregate GNPA ratio in the range of 12.5-14.7 per cent.

Role of bad banks

The role of the bad bank is to establish a liquid market for NPAs with a promise that banks will be able to sell their NPAs at a fair value.

As a part of its NPA recovery mechanism, India already has a slew of measures like the debt recovery tribunals under the Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act in 1993, asset reconstruction companies (ARCs) as a part of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) in 2002, and the Insolvency and Bankruptcy Code (IBC) in 2016.

The secondary market of the Security Receipts (SRs) issued by the existing ARCs is quite illiquid. There is a dominance of the selling-bank in holding SRs, resulting in a limited demand for SR by other qualified investors.

Bad bank The ifs and buts /ISTOCKPHOTO

The main reason for the limited demand is the average low debt recovery rate of only 27.8 per cent, with the most recent 2019-20 showing a debt recovery rate of 26.7 per cent.

The NARCL is essentially an ARC with only two distinguishing features — (i) NARCL is intended for dealing in big sized tickets, and (ii) NARCL has a partial government guarantee.

This raises an important question: will NARCL be effective?

The history of successful ARCs across the world like Resolution Trust Corporation in the US, Securum in Sweden, Danaharta of Malaysia shows that the effectiveness of ARCs hinges on: (i) a focused mandate for setting up the ARCs, (ii) limited lifespan of the ARC, (iii) market-based resolution of NPAs.

The pitfalls

NARCL seems to have a focused mandate as stated in its proposal to acquire ₹2 lakh crore worth of stressed assets, but the absence of a clause about the lifespan of NARCL may lead to a moral hazard problem. Public sector banks (PSBs), who own 51 per cent stake in NARCL, may continue buying their own stressed assets through NARCL leading to the propagation and evergreening of bad loans.

Additionally there are question marks over the government guarantee of ₹30,600 crore in providing liquidity and creating a market for the NPAs.

To increase the effectiveness of the NARCL, the government should address the lifespan issue of NARCL in the form of a sunset clause; a bad bank for perpetuity will pose long-term risks to the financial stability of a country, like Huarong in China.

Moreover, there should be a fair and transparent mechanism while setting the haircut on the stressed assets by the NARCL.

The pricing mechanism should ensure that the net asset value (NAV) of the SRs is fairly priced, which will boost the participation and liquidity in the SR market.

While setting up a bad bank in the form of NARCL is a step in the right direction towards financial sector reforms; NARCL is just a palliative; it is neither a cure nor does it prohibit bad loans.

Unless there is a strong political will to recognise bad loans and support legal infrastructure to address wilful defaulters, setting up a bad bank may become a moot point.

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