The Meaning And Structure Of Bad Bank

ABSTRACT

With the success of the Bad bank concept in European and western countries it grabs the attention of global economies and becomes the most preferable solution for the Non-performing loans. Now Due to COVID 19 Pandemic Indian government also thinking of implementing Bad bank concept but is not easy as it seems in paper because there is no standard and uniform structure for bad bank. Different countries followed variety of methods which are suitable to their environment. This paper attempted to describe the concept of bad bank and the main aim of this study is to study the mechanism followed by various countries to implement the bad bank concept and offer few suggestions to India concerning the implementation of bad bank. For this researcher used secondary data and the result is that there is high success rate when there is private participation and independence from the government as it saves taxpayers money, gives freedom to perform well, and achieve its objective.

INTRODUCTION

The bad bank is in the headlines again. Now, with the COVID-19 pandemic threatening to create a bad loan tsunami. When all measures fail, there's always the "Bad Bank" comes on. The idea is not new one and has been suggested by various people at different points of time. First in the year 2015 Asset Quality Review conducted by Reserve Bank under Governor Raghuram Rajan, which forced banks to recognise problem accounts as non-performing assets had sparked a debate on bad bank as a possible solution. The 2017 Economic Survey examined this idea and suggested the creation of a Public Sector Asset Rehabilitation Agency (PARA). The then interim Finance Minister Piyush Goyal also revived this idea in 2018, he set up a committee under PNB Chairman Sunil Mehta to study the feasibility of national Asset Reconstruction Company, or in other words, a bad bank. And recently in 2020 the IBA submitted its proposal to both RBI and central government to set up Bad Bank in two tier system.

REVIEW OF LITERATURE

Spyridon Repousis- "Bad Bank" Strategy in Greek Banking Sector and Receivables from Banks under Liquidation (2017)

Spyridon Repousis from University of Nicosia, Cyprus, published a research paper titled "Bad Bank" Strategy in Greek Banking Sector and Receivables from Banks under Liquidation in July 2017. In this research paper the researcher presents the "bad bank" strategy followed in Greek banking system to safeguard the stability during the current financial crisis.

Michael Brei, Leonardo Gambacorta, Marcella Lucchetta and Bruno Maria Parigi - Bad bank resolutions and bank lending (2020)

BIS Working Papers No 837 Bad bank resolutions and bank lending by Michael Brei, Leonardo

Gambacorta, Marcella Lucchetta, and Bruno Maria Parigi published in January 2020. This paper investigates whether impaired asset segregation tools, otherwise known as bad banks, and recapitalisation lead to a recovery in the originating banks' lending and a reduction in non-performing loans (NPLs). The major conclusion is that bad bank segregations are effective in cleaning up balance sheets and promoting bank lending as long as they combine recapitalisation with asset segregation.

STATEMENT OF THE PROBLEM

On paper the idea is simple, but its implementation is more complicated, perhaps the reason why this idea has only been toyed with and not implement by policymakers in India. A Bad bank is not a novel one and already so many countries implemented this concept but there is no standard and uniform structure of bad bank. So before implementing the concept it is important to know the best feasible structure to implement it. This paper helps to understand the different structures followed by different countries to implement the Bad bank concept; this helps to decide the best structure.

MEANING OF BAD BANK

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A bad bank is a corporate structure which separates illiquid and high risk assets (Non-performing assets/loans) held by a bank or a financial institution, a group of banks or financial institutions. In addition to segregating the bad assets from the parent banks financial statements, a bad bank structure allows specialized management to deal with the problem of bad debts. The measure allows good banks to focus on their core business of lending while the bad bank can specialize in maximizing value from the high-risk assets. A bad bank is termed so simply because it holds bad loans, or non-performing assets (NPAs).

We can understand the concept with an example. Let's say Bank X lends advances to several individuals and corporates in its regular course of business but later those borrowers defaulted for repaying, so Bank X accumulates more due amount of instalments and interest as time goes. It needs to keep some money as reserves against these accumulated dues (Non-performing loans) according to central bank rules. Now, this hurts a bank because large size of NPLs shows the ill-health or financial weakness of that bank and it weakens the bank X borrowing and lending ability and makes it difficult to conduct business.

In these circumstances, the bank X want to segregate its 'good' assets (loans which are being repaid as per schedule) from its 'bad' assets (which are in default, and it realises it will not be easy to recover) through the establishment of a bad bank. The segregation aims to allow investors to assess the bank's financial health with greater certainty. As a result, Bank X will clean up its balance sheet and reduce its exposure to risky assets.

Therefore, a bad bank is expected to help the banks by purchasing all their bad assets, usually at a price below the book value of these loans, and manage those assets, to recover the money over some time and liquidate itself once its purpose fulfils.

Let see some bad bank structures followed by various countries

GRANT STREET NATIONAL BANK-US

To solve the NPLs problem, the bad bank concept was first introduced in back 1988 by US-based Mellon Bank by creating Grant Street National Bank by spinning off its capital, and five of its board members into it to hold its toxic assets.

Grant Street National Bank is not created as a normal bank to accept deposits from public, but to served the purpose of resolving or liquidating bad debt to recover as much money as it could, and was eventually liquidated itself a few years down the line after it had served its purpose.

Subsequently, countries like Finland, France, Sweden, Indonesia, Germany and several other countries implemented the idea.

THE HELLENIC FINANCIAL STABILITY FUND (HFSF) AND THE HELLENIC

DEPOSIT AND INVESTMENT GUARANTEE FUND (HDIGF)-GREEK

The Hellenic Financial Stability Fund (HFSF) was founded in July 2010 as a private legal entity and not belong to the public sector. It entrusted with administrative and financial autonomy, operates under the rules of the private economy, and is governed by the provisions of the founding law as applicable. Contribute to the maintenance of the stability of the Greek banking system for the sake of public interest, is the main objective of the HFSF.

The Fund shall operate under a comprehensive strategy for the banking sector and the Non-Performing Loans (NPLs) management, which is agreed between the Ministry of Finance, the Bank of Greece and the Fund, as revised from time to time.

The HFSF has its registered office in Athens and its duration by the decisions of the Minister of Finance, shall be up to 31 December 2022 and the duration may be extended, if deemed necessary for the fulfilment of its scope.

And it’s one of the objectives is to provide loans to the HDIGF for resolution purposes.

THE HELLENIC DEPOSIT AND INVESTMENT GUARANTEE FUND (TEKE/ HDIGF)

The Hellenic Deposit and Investment Guarantee Fund (TEKE) is the operator of the deposit guarantee and investment compensation schemes. It is a legal person governed by private law and is supervised by the Ministry of Finance. HDIGF is not a public entity or a government agency and is outside the narrow or broader public sector.

HDIGF is composed of three separate Schemes:

The HDIGF schemes are distinct from each other and are the available funds of each Scheme of HDIGF shall constitute separate property groups distinct from each other and shall be used exclusively for the fulfilment of the purposes of each Scheme.

TROUBLED ASSET RELIEF PROGRAM (TARP)-US

The TARP was established and run by the United States Treasury to stabilize the country’s

financial system, restore economic growth, and reduce the effect of the wake of the 2008 financial crisis. TARP seeks to achieve these targets by purchasing troubled companies' assets and stock.

The US government declared in December 2013 that its investments had earned more than $11 billion for its taxpayers. Actually out of $426.4 billion investment it recovered funds around $441.7 billion. The US government also declared that TARP saved more than one million jobs by preventing the American auto industry from failing, helped stabilize banks, and restored credit availability for both individuals and businesses.

THE NATIONAL ASSET MANAGEMENT AGENCY NAMA-IRISH

NAMA was established in 2009 by the Irish Government to solve the serious financial crisis in Irish banking. NAMA had been assigned with a very large balance sheet and has been given the task of managing that balance sheet right down to zero as soon as it is commercially practicable. It must recover at a minimum all of the expenditure incurred by it on acquiring loans, on advancing working capital and on its costs. In doing so, it will pursue all debts owed by its debtors to the greatest extent feasible.

NAMA's strategy is not only concentrated with the disposal of property but also on investment in assets to make them more attractive to buyers and thereby increase their ultimate disposal value.

SAREB-SPAIN

SAREB (Spanish: Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria - English: Company for the Management of Assets proceeding from Restructuring of the Banking System) Spanish government bad bank, owned by government , it is established on 31/08/2012 for managing assets transferred by the 4 nationalized Spanish financial institutions (BFA-Bank, Catalunya Bank, NGC Banco-Banco Gallego and Bank de Valencia).

The law empowered the FROB (The Fund for Orderly Bank Restructuring) to transfer the impaired assets and assets which could be considered a threat to the viability of an institution to an asset management company (SAREB) .The main objective is to remove the assets from the balance sheets of the institutions to allow them to be independently managed. The AMC may issues bonds and securities recognising or giving rise to the debt. The law establishes that the assets are to be transferred to the asset management company without any need for consent from third parties. Before transfer, the Bank of Spain (central bank) will determine the value of the assets based on appraisal reports.

FROB held 45% shareholding of the financial institutions and Private shareholders own 55% of SAREB. SAREB performs as a bad bank, it acquires property development loans from Spanish banks in return for government bonds, primarily with an object to improving the availability of credit in the economy. Over the fifteen years years, SAREB has to dispose of all of its assets, its main aim will be to maximise its profitability. However, it does not have a banking license. SAREB equipped with legal benefits that don't applicable to other Spanish limited liability companies, such as a preferential creditor for subordinated debt over other creditors.

SECURUM AND RETRIVA-SWEDEN

The financial crisis in Sweden evolved with huge losses reported by the country's largest saving bank, Forsta Sparbanken, in 1991. Later, Nordbanken commercial bank also reported huge losses in which 71% of common stocks owned by the Sweden government. Sweden Government took full control over Nordbanken and separates the bank's assets into two parts: the "good" assets were still within the bank while the "bad" assets were transferred to separate legal entity, an asset holding company, called Securum, established in 1992. Nordbanken and a government equity infused into Securum for the purchase of bad assets. A second "bad bank" was also created for Gota Bank when it failed in early 1992 and bad assets were transferred to the asset management company, called Retriva. The "good" assets of Gota Bank were auctioned off and bought by Nordbanken in 1993 with no payment to Gota. Securum's primary aim was to liquidate the "bad" assets to maximizing recovery. Assets were successfully liquidated. Sweden also issued a blanket guarantee of all bank loans in the banking system, until July 1996 and benefited existing bank stockholders. Also, Swedish Central Bank provided liquidity by depositing large foreign currency reserves in troubled banks and by borrowing freely at no risk the Swedish currency. Government's cash infusion limited to these two banks. Established guidelines for banks receiving government support such as a government member in board composition's management, balance sheet restructuring targets and risk management. The final results were a relatively speedy recovery, a return to robust economic growth and banking crises were relatively short-lived.

RECENT PROPOSAL OF BAD BANKS BY INDIAN BANKING ASSOCIATION

Indian Banking Association (IBA) has submitted a proposal to both the Government and the RBI to establish a 'Bad Bank.'

As per IBA estimates the 'Bad Bank' would require approximately Rs 10,000 crore of capital initially. The exact quantum of capital and amount of bad loans to be housed in the proposed 'Bad Bank' would only be finalised after discussions with the Government and Reserve Bank of India (RBI).

How Does 'Bad Bank' Work?

1. Banks will be able to demarcate its assets into good assets and toxic or bad assets.
2. Good assets are ones in which loans are repaid as per schedule, and defaulted ones are classified as toxic assets or bad assets.
3. Toxic assets can be removed from Banks books and transferred to Bad Bank which has the sole purpose of aiding the recovery of risky assets.
4. Hence the banks will clean up and reduce its exposure to risky assets.
5. Bad Bank will absorb all the toxic assets of banks at a price below the book value of these loans.

Bad Bank Structure – IBA Proposal

The 'Bad Bank' will be a 2-tiered structure.

Tier 1:

1. There will be an Asset Reconstruction Company (ARC) backed by the Government which would buy bad loans from banks and issue Security Receipts to the Banks.
2. As per RBI guidelines, ARC will hold Security Receipts of 15%.
3. Banks will get 15% of the cash and will hold 85% of Security Receipts. Hence it is called 15:85 structure.

Tier 2:

1. There will be an Asset Management Company (AMC).
2. AMC would be run by public and private bodies which includes banks as well.
3. Turnaround professionals.

FINDINGS

1. In most cases, bad bank was implemented by establishing government owed bad bank with fully government funding or partly government and partly privet funding.
2. It is more effective when the funding to purchase impaired assets from the originating bank is private.
3. Bad bank resolutions are only effective if they combine recapitalisation with asset segregation

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SUGGESTIONS

1. It is advised to do banks recapitalisation with asset segregation as it reduces future NPLs and also increase loan growth.
2. It is advised to fund impaired asset purchase from private as it saves taxpayers money. In case of public funding, if anything went wrong the ultimate burden falls on taxpayers.
3. It is suggested to establish an independent institution to decide the purchase price. As it solves the conflict between buyer bank and seller bank.
4. Make bad bank free from political pressure.

CONCLUSION

The main aim of this study is to understand the different structures followed by various countries for Bad bank implementation. The main findings are that recapitalisation of banks with asset segregation gives better results and also country can save the tax payers money by private participation and make it free from political pressure. Conclusively, Bad bank continued to develop as most preferable measure for NPLs and countries welcoming it positively.

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