Indian Economy

Bad Bank - Time for Armageddon

Right time to shoot the bullet of bad bank to stimulate economic growth, credit revival and lower interest rates

May 2020

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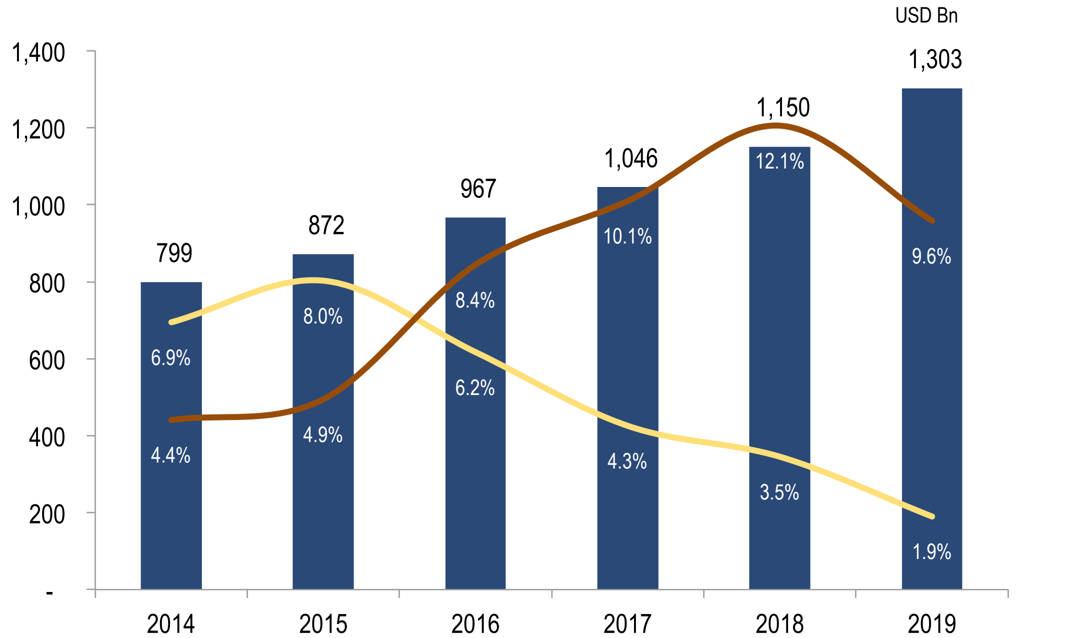
How big is the stressed assets problem in India?

Financial System in India has seen a lot in the last two decades, from the regime of Development Financial Institutions to the current tech efficient Commercial Banks, but it has not been able to lay the ghost of bad assets off from its back. With Gross Non-Performing Assets (GNPA) of 14.40% in 1998 to 12.05% in 2018, the problem of bad assets keeps chasing the banks in terms of credit growth, ability to raise capital and access to low cost funds.



Source: Reserve Bank of India

GNPA stood at USD 125 Bn or 9.58% of the total gross advances as of March 2019

The total gross advances outstanding as on March 2019 was around USD 1,303 Bn and GNPA stood at USD 125 Bn or 9.58% of the total gross advances as of March 2019. The total restructured advances as on March 2019 stood at USD 25 Bn or 1.90% of the total gross advances. We have seen a quantum jump in non-performing loans from 4.95% in 2015 to 12.05% in 2018 majorly due to transmission of restructured loans to non-performing assets. (prior to RBI Circular dated February 25, 2016, restructuring packages had a special treatment for classification of assets). With resolution of assets under Insolvency and Bankruptcy Code (IBC), GNPA reduced from 12.05% to 9.58% in 2019.

The problem not only rests with restructured accounts and NPAs, we need to closely look at the bubble brewing in the standard advances

But the problem not only rests with restructured accounts and NPAs, we need to closely look at the bubble brewing in the standard advances, with the Special Mentioned Accounts (SMA) 0 to SMA 2 categories (defaulted on loans but not turned into NPAs). On analyzing the total credits based on the various interest rate categories, we have placed the advances with interest rate higher then 13% as high-risk borrowers.

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Total high risk advances stands at approximately USD 200 Bn or 16% of the total Gross Advances

High Risk Advances

USD Bn

Type of Credit	Gross Advances	Gross Advances %	Gross Advances having Interest Cost <13%	Gross Advances having Interest Cost >13% [1]	% High Risk Loans
Agriculture	179	13.80%	155	25	13.80%
Industries and Services	655	50.20%	557	98	54.50%
Personal Loans	285	21.90%	240	45	25.10%
Financial Sector	120	9.20%	117	4	2.10%
All Others	64	4.90%	55	8	4.50%
Total Loan	**1,303**	**100.00%**	**1,124**	**179**	**100.00%**

[1]13% is considered on the basis of average BBB- (Investment Grade) spread over G-sec yield.

Source: Reserve Bank of India

High Risk Loans include non-performing loans[2] but may not include restructured loans[3]. If we add the restructured loans to the total high-risk loans, then the total high risk advances stands at approximately USD 204 Bn (Say 200 Bn) or 16% of the total gross advances. Industries & Services and Restructured Accounts constitute almost 61%% of the high-risk credit, which are more susceptible to turn into bad loans.

Three primary phases for revival and rehabilitation of stressed assets in the past two decades, apart from the monetization of bad assets through Securitization Act and Board of Industrial and Financial Reconstruction

Solutions in the past

Over the years, RBI has issued various frameworks and guidelines aimed at the resolution of stressed assets in the economy. Three primary phases for revival and rehabilitation of stressed assets in the past two decades, apart from the monetization of assets through Securitization Act and rehabilitation scheme under Board of Industrial and Financial Reconstruction (BIFR) are:

Starting 2002 till 2013

Restructuring under Corporate Debt Restructuring Mechanism; Under which a Corporate Debt Restructuring Cell was created with IDBI being the nodal agency and implementation of restructuring Scheme based on 75% of the creditors approval

2014 till 2016

Joint Lenders Forum (JLF) Mechanism; Decisions on resolution was made based on 75% majority. Various schemes under the JLF and CDR was prescribed by RBI over a period of time. Such as:

- Strategic Debt Restructuring (Converting Debt into Equity)
- 5:25 Scheme (Banks restructure loans for longer repayment period; maximum upto 25 years)
- Scheme of Sustainable Structuring of Stressed Assets (S4A) (Segregation of viable and unviable debt based on cash-flows)

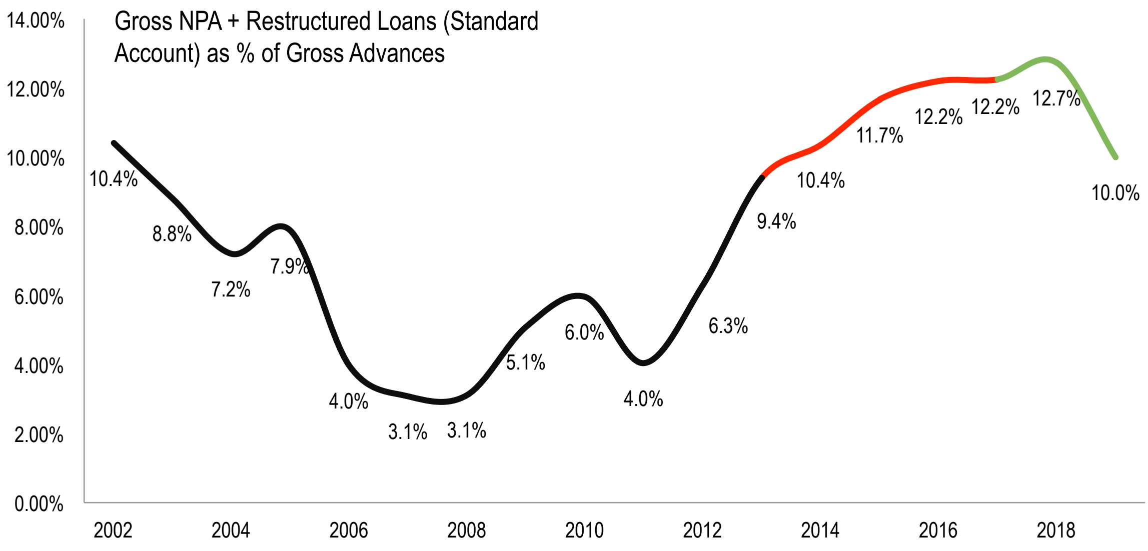
2017 Onwards

Resolution and liquidation under Insolvency and Bankruptcy Code, 2016. Government of India announced to put hold on new insolvencies for one year.

[2] Non-performing loans are typically D rated and have higher interest rate

[3] Loans are typically restructured at coupon of 10%-12% for a viable restructuring proposal

Stressed accounts saw reduction thrice during CDR regime but failed to see reduction during JLF / SDR / S4A regime; IBC also started giving positive results in overall reduction of stressed accounts



Source: Reserve Bank of India

What is adding to the woos?

A corporate having positive EBIDTA is viable and have economic value. The difference in the economic value of an entity and the value that Banks peruse basis the borrowings is the major contention point. We have witnessed series of restructurings of the standard accounts under the Corporate Debt Restructuring Forum and Joint Lenders Forum mechanism with a peak of total restructuring at 6.71% of the total advances.

One size fits all approach and reluctance in giving additional liquidity added to further woos

One size fits all approach

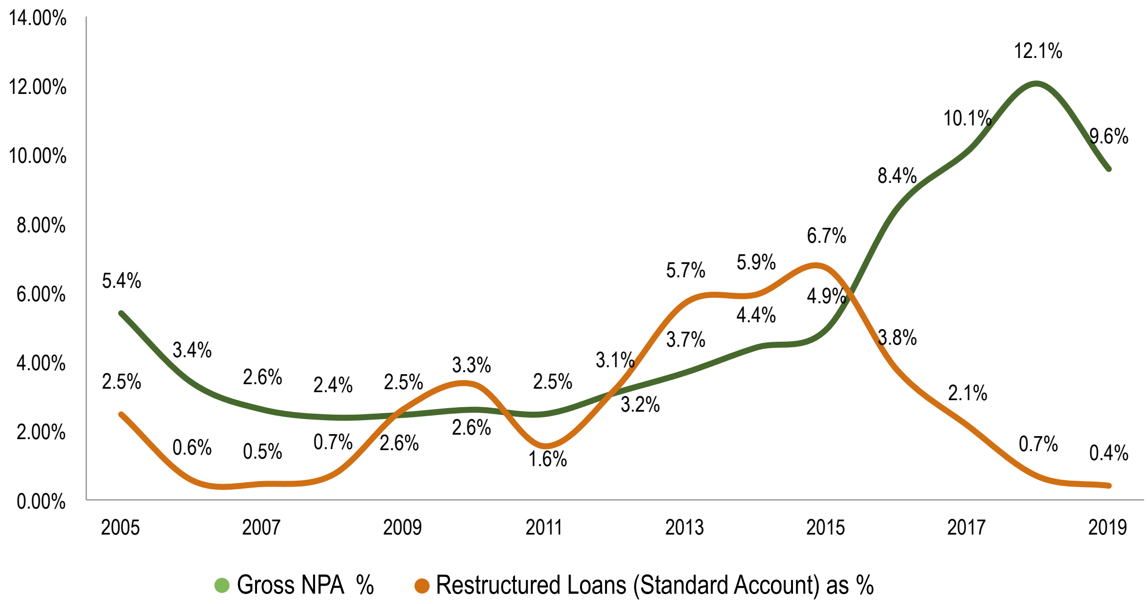
Majority of the restructurings done before the RBI directives on Strategic Debt Restructuring, 5:25 Scheme and Scheme for Sustainable Structuring of Stressed Assets (all introduced in 2015 and 2016) were mainly focusing on maximum 10 year door-to-door tenor, interest reduction, 1-2 year of interest and repayment moratorium. A one package fit all approach was followed regardless of it being a long gestation infrastructure project or a manufacturing company or a trading concern.

Reluctance of giving additional liquidity

Secondly, corporates required additional liquidity support to survive and grow post restructuring. However, bankers found it difficult to lend more good money after bad money and so the majority of restructuring packages survived till the end of moratorium on interest and repayments. Once the repayment started, the corporates were again in lurch of money.

Accounts restructured between 2012 to 2015 started shifting to non-performing loans from 2014 onwards

We estimate a potential transmission of USD 50 to 60 Bn from normal category to high-risk category post Global Covid Crisis (GCC). Total addressable market for high risk borrowers will be around USD 230 Bn to USD 240 Bn, which is about 18% of the gross advances.



In the above chart we have seen how the accounts restructured between 2012 to 2015 started shifting to non-performing loans from 2014 onwards

Covid and its Impact on High Risk Loans

The ongoing pandemic due to Covid–19, has resulted in great economic stress. This systemic event has impacted majority of businesses across the globe. With lockdown in India entering into 4th phase, passive demand and low industrial activities are going to create another wave of NPAs in the medium term. The current situation will be marginally evened out by the government's support to MSMEs and Corporates, but we estimate NPAs would re-emerge in the near to medium term. The key factor is to quickly resolve the stressed assets in good and viable businesses and to save them from collapsing. Banks, NBFCs, ARCs and Stressed Asset Funds will have to function even more cohesively.

Though the current situation is very dynamic, and it is difficult to estimate and envisage the future impact but we estimate a potential transmission of USD 50 to 60 Bn to the category of high-risk borrowers. Total addressable market for high risk borrowers will be around USD 230 Bn to USD 240 Bn, which is about 18% of the gross advances.

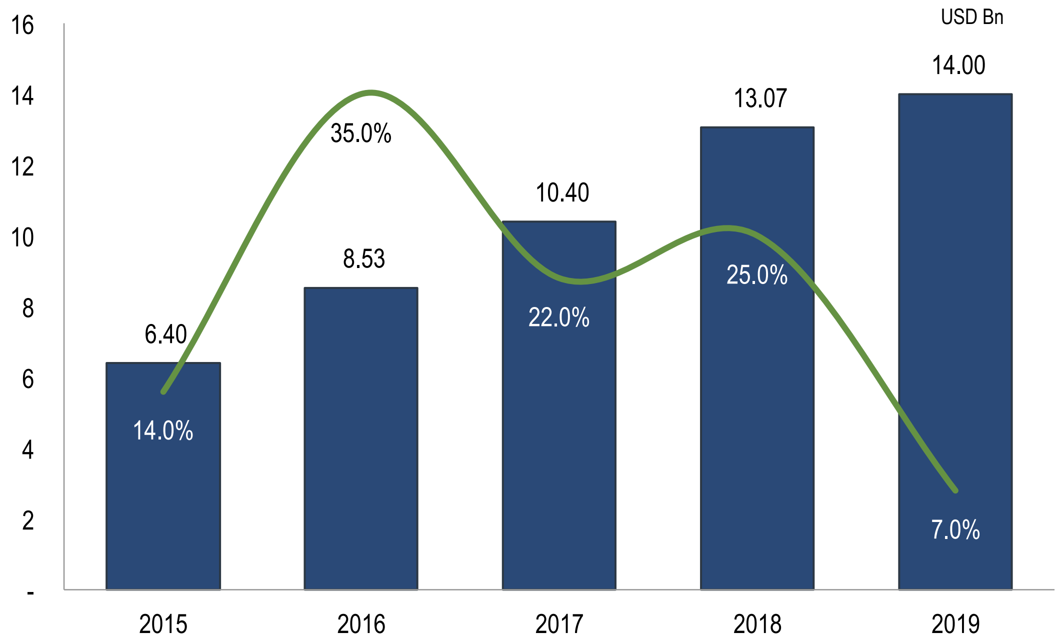
USD Bn

Type of Credit	Total Loan O/s	Gross Advances having Interest Cost >13%	Post GCC Transmission from Normal to High Risk	Total High Risk post GCC	Total High Risk %
Agriculture	179	25	7	31	13.1%
Industries and Services	655	98	41	139	58.2%
Personal Loans	285	45	9	54	22.6%
Financial Sector	120	4	1	5	2.1%
All Others	64	8	2	10	4.0%
Total Loan	**1,303**	**179**	**59**	**239**	**100.0%**

Assets under Management of ARCs, as measured by Security Receipts outstanding, crossed the USD 14 Bn mark as on March, 2019.

Current Dry Powder in Special Situation Investment in India

Asset Reconstruction Business is not new in India with the first Asset Reconstruction Company (ARC) starting operations way back in the year 2002. Today we have about 28 ARCs in business. Assets under Management (AUM) of ARCs, as measured by Security Receipts (SRs) outstanding, crossed the USD 14 Bn mark as on March 31, 2019. While the value of debt acquired remained range-bound at around USD 5 Bn, but AUM growth, which was 25% in fiscal 2018, slowed on higher discount rate and increase in SR redemptions.



Source: Industry Reports

Post GCC we are staring at a big pile of high risk borrowers estimated to be around USD 230 Bn to USD 240 Bn and we have as ammunition to combat the crisis is USD 14 Bn of ARC AUM and about USD 6-8 Bn of committed capital by Special Situation Funds.

Problem so Big and Liquidity availability is Less

Post GCC we are staring at a big pile of non-performing loans estimated to be around USD 200 Bn to USD 250 Bn and what we have as ammunition to combat the crisis is USD 14 Bn of ARC AUM and about USD 6-8 Bn of committed capital by Special Situation Funds. The mismatch here is more than 10 times of the demand. Necessarily, creating a demand to immediately address the same through the creation of a bad bank, which along with IBC will be able to address the large size of high risk borrowing in the economy.

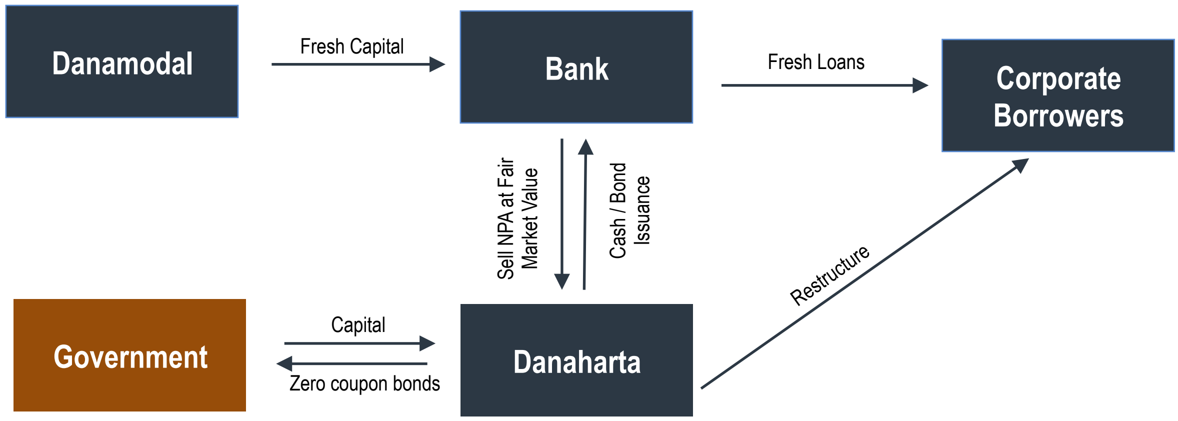
Bad Bank - Time for Armageddon

Indian Banking Association (IBA) is actively pursuing the concept of a bad bank with the Government and Reserve Bank of India. The concept of Bad Bank is similar to an Asset Restructuring Company, wherein, the only difference is that the bad bank would be sponsored through sovereign money. The concept of Bad Bank is successfully implemented in Italy, Germany, Sweden, Malaysia and the largest being the Troubled Asset Relief Program (TRAP) of US Treasury in 2008. We particularly like the Malaysian Model of Bad Bank, primarily, because of the its structure and ability to review credit growth.

Malaysian Government set-up two asset management companies to tackle NPA post currency crisis in 1997 - one to take over bad loans named "Danaharta" and another for infusing capital into the weak banks called "Danamodal".

About seven years later, both the AMCs shut shop as the mission was accomplished.

Malaysian Model of Bad Bank



Source: Industry Repot

Danaharta - To deal with the rising levels of Non Performing Loans
Danamodal - To recapitalize the banking sector and act as a catalyst for the financial sector

When the currency crisis engulfed several Asian countries in 1997, NPAs of Malaysian Banks rose from 3.5% in March 1997 to 13.20% in November 1998 leading to erosion of their capital. The Malaysian government reacted fast by setting up two asset management companies (AMCs) - one to take over bad loans named "Danaharta" with special powers and another for infusing capital into the weak banks called "Danamodal". About seven years later, both the AMCs shut shop as the mission was accomplished.

How did the Malaysian Bad Bank process work?

- Danharta's sole purpose was to purchase NPAs through a shortcut procedure at fair value from the banking institutions and relieve the banks from the burden of managing the capital adequacy for NPAs
- In exchange for the purchase, Danharta issued government guaranteed five year zero coupon redeemable bonds to the selling banking institution
- The total NPA's that were targeted by the government to be restructured under this scheme was approximately RM 15 billion. Out of this RM 1.5 Billion was provided by the government while the rest was covered by way of issuance of bonds.
- For viable assets, Danharta either restructured the loans or injected additional funding to regularize the accounts but unviable loans were transferred to Asset Management Unit for disposition or rehabilitation using various monetization methods
- Danharta had the powers conferred with itself to remove the existing management of the corporate and appoint an administrator
- The process of acquisition was completed in three stages:

In 2004, the Indian government decided to set up a Stressed Asset Stabilization Fund ("SASF") to hive off 636 non-performing assets ("NPA") of Industrial Development Bank of India ("IDBI") with an aggregate loan of over USD 1.2 Bn.

How did the process of Recapitalization Work?

- Danamodal's clear role was to recapitalize and consolidate the stressed assets and not provide bail outs and therefore, Danamodal's operations were based on commercial and market oriented principals
- Primary objective was to take the Risk Weighted Capital Ratio ("RWCR") of Banking Institutions to atleast 9%
- Weaker banks were analyzed and either recapitalized or merged with stronger banks
- A total of RM 16 Bn was the recapitalization required to maintain a RWCR of 8%. Out of the above, an amount of RM 1.5 Bn was provided by Bank Negra Malaysia and the remaining amount was raised through issuance of zero coupon bonds.

India also had Bad Bank in the past

In 2004, the Indian government decided to set up a Stressed Asset Stabilization Fund ("SASF") to hive off 636 non-performing loans of Industrial Development Bank of India ("IDBI") with an aggregate loan of over USD 1.2 Bn.

Under the structure, Government extended a loan of USD 1.2 Bn to the fund, which bought long-term securities of the government with 20 year maturity and exchanged the same with IDBI for its Non-Performing Assets. However, as per 2014 CAG Report, SASF recovered only USD 535 Mn as of March 2013 with majority of it (59%) recovered in first two years. Major challenges for failure of SASF model were lack of private participation in the process, limited resolution options (only Securitization Act and CDR was available as recovery mechanism), less emphasis on economic value of assets.

Ideal Scenario for a Bad Bank

To make it a successful model, a large scale private participation is suggested in form of capital, human resources, management experts various fields and political interference should be kept to a minimum. Transfer of NPAs to the Bad Bank should be at a fair value considering both asset value and as well as long term economic value.

Pillars for Revival of Corporates under Band Bank Mechanism
Quick resolution of Viable
Professional Management for Bad Bank
Additional Working Capital for Viable Unit
Engagement of Professional Agencies
Liquidity for the Security Receipts

Challenges for Band Bank Mechanism
Capital Requirement
Government Intervention
Personal Loans
Value Gap

The government has infused over USD 42 Bn into the public sector banks in the last 11 years. Between FY09 and FY19, PSU Banks have mobilized over USD 37 Bn of capital through sources other than government.

The Success Mantra for Bad Bank

Prepack for Insolvency

While the IBC in India, in its current form, does not facilitate the pre-pack concept, Bad Bank would play a key role in the effective implementation of prepacks under the IBC. The Bad Bank can be a front-runner to lead pre-pack resolutions under the IBC.

Lower Bank re-capitalization

The government has infused over USD 42 Bn into the public sector banks in the last 11 years. Between FY09 and FY19, PSU Banks have mobilized over USD 37 Bn of capital through sources other than government. Hopefully, after a clean-up of bad debts, the requirement for re-capitalization will reduce and lead to credit creation and improve the earnings of banks substantially.

Low Interest Regime

Bad Bank will help banks to capitalize their balance sheet and fix asset liability mismatch and will lead to reduction in term deposit rate, ultimately, leading to lower rate regime in the medium term.

Access to Lower Cost Capital and bridging the valuation mismatch

Since Bad Bank will have sovereign capital, the return expectation would be relatively low as compared to so called vulture funds. With about 12%-15% return on investment, the valuation gap between the Banks selling the stressed assets and acquisition price will reduce and also help the viable units to revive.

Improve efficiency of Banks

Banks will start doing the activity which they are meant to – provide credit - instead of firefighting for balance sheet management and addressing the stress asset.

Right time to shoot the bullet - Time for Armageddon

Our estimate is that Bad Bank to have actual impact needs a massive capital of approximately USD 15-20 Bn over a period of 1-2 year

Our estimate is that Bad Bank to have actual impact needs a massive capital of approximately USD 15-20 Bn over a period of 1-2 year, so it can create an AUM of USD 100 Bn – USD 150 Bn. The challenges are huge in terms of availability of capital, structure, acquisition price, etc., but the same have huge set-off against the benefits to the banking and financial sector and the economy as a whole. With IBC put hold for one year, the only recovery options available for banks is monetisation or restructure of stressed loans, both have not had much impact in reduction of stressed assets over the last 5 years.

In this blessing in disguise, the Government should shoot the bullet and create the Bad Bank.

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