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## Policy Brief: A Brief Comparison of the Bad Bank Experience across Jurisdictions

*Amulya Neelam, Deepti George, Dwijaraj Bhattacharya & Madhu Srinivas*

### **Summary:**

Bad Banks are typically Government sponsored Asset Reconstruction Companies (ARCs) setup with the primary objective of cleaning up bank balance sheets. Unlike private ARCs, the Bad Banks are setup as a one-time measure with the primary objective of reducing the build-up of Non-Performing Assets (NPAs) post a financial or economic crisis. India is the latest jurisdiction to setup a Bad Bank with the establishment of the National Asset Reconstruction Company Ltd. (NARCL). In this policy brief, we compare the design and historical experience of Bad Banks in other jurisdictions with the newly setup NARCL across dimensions relating to legal character, government control, objectives, funding sources, resolution process and level of haircuts. We perform this analysis for the Resolution Trust Corporation in US, Securum and Retrieva in Sweden, Korea Asset Management Company in South Korea and Fondo Bancario de Protección al Ahorro in Mexico. Using the insights from our comparative analysis, we identify certain design flaws in NARCL and propose some policy measures to rectify them.

### ***About the Financial Systems Design:***

The Financial System Design Initiative (FSD) within Dvara Research aims to build and further the vision of a well-functioning financial system for India that is built on three fundamental pillars: High Quality Origination, Orderly Risk Transmission, and Robust Risk Aggregation. Our mandate is to undertake research around extant and emerging themes, gaps, and risks in financial sector policy, and recommend regulatory responses, keeping in mind the need to increase meaningful financial access and depth in a manner that enhances systemic stability.

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## 1. Introduction

The Asset Quality Review (AQR) conducted by RBI in 2015 brought to light the true level of Non-Performing Assets (NPAs) in the Indian banking system. Post the AQR, the GNPA ratio of the banking system rose from about 2% in 2010 to more than 6% in 2016<sup>1</sup>. The level of NPAs in the system rose to a high of 11.18% in 2018, after which it started to decline<sup>2</sup>. With a slowdown in the economy due to the pandemic, RBI has projected that the bad loan pile will likely end up close to 10% by March 2022<sup>3</sup>. In addition to blocking scarce capital, that is needed to restart lending, the high levels of NPAs also necessitate redirecting resources from lending to collection and resolution activities. Thus, the clean-up of the NPA pile is an urgent imperative to ensure the revival of the banking sector, and consequently, the economy. However, it should be noted here that the clean-up is only the first step in reviving the banking system. This needs to be followed by comprehensive reforms in the banking sector that addresses the structural weaknesses in the system. As part of operationalising the clean-up, the National Asset Reconstruction Company Ltd. (NARCL) was created to buy the large ticket NPAs from banks and attempt to resolve or manage these NPAs to extract value from them<sup>4</sup>.

## 2. The NPA Resolution Ecosystem

There are multiple players and regulations comprising the ecosystem for resolution of bad loans. The Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act), the Insolvency and Bankruptcy Code (IBC) and RBI regulations form the legal framework for the ecosystem while Debt Recovery Tribunals (DRTs), Lok Adalats and the National Company Law Tribunals (NCLTs) provide the institutional support. Asset Reconstruction Companies (ARCs) were setup as part of the SARFAESI Act and provided an alternative channel for NPA resolution<sup>5</sup>. Currently, DRTs, ARCs and IBC are the most dominant channels for resolution of NPAs with the IBC route being the most successful, with a recovery rate of around 45%<sup>6</sup>. While ARCs had an impressive recovery rate in their initial years, it has since come down to 26% as of 2019-20<sup>7</sup>. The Government backed NARCL is the latest addition to this ecosystem. Registered as an ARC, it's powers and functions are the same as those available to existing ARCs, the exception being that the Security Receipts (SRs) issued by NARCL are guaranteed by the Government.

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<sup>1</sup> Asset Quality of Indian Banks: Way Forward - Keynote address delivered by Shri N. S. Vishwanathan, Deputy Governor, Reserve Bank of India at National Conference of ASSOCHAM on 'Risk Management: Key to Asset Quality' in New Delhi on August 30, 2016.

<sup>2</sup> Financial Stability Report, June 2019, RBI

<sup>3</sup> Financial Stability Report, July 2021, RBI

<sup>4</sup> <https://pib.gov.in/PressReleaseDetailm.aspx?PRID=1755466> – retrieved on 19-11-2021

<sup>5</sup> Section 1, ARCs in India: A Study of their Business Operations and Role in NPA Resolution, RBI Apr 2021 - [https://www.rbi.org.in/Scripts/BS\\_ViewBulletin.aspx?Id=20203](https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=20203)

<sup>6</sup> Ibid

<sup>7</sup> Ibid

### **3. Comparison of NARCL with the Bad Bank Experience in Other Jurisdictions**

Bad Banks are typically Government sponsored Asset Reconstruction Companies (ARCs) setup with the primary objective of cleaning up bank balance sheets. Unlike private ARCs, the Bad Banks are setup as a onetime measure with the primary objective of reducing the build-up of NPAs post a financial or economic crisis. In the following sections we describe the Bad Bank experience of the Resolution Trust Corporation in US, Securum and Retrieva in Sweden, Korea Asset Management Company in South Korea and Fondo Bancario de Protección al Ahorro in Mexico across the dimensions of – 1) Legal Character, 2) Government Involvement, 3) Objectives, 4) Funding Sources, 5) Resolution Process and 6) Haircuts or Loss. We then compare this with NARCL and attempt to glean insights for the Indian context.

#### **3.1. Resolution Trust Corporation (RTC)<sup>8</sup>**

The RTC is not strictly a Bad Bank in that it was responsible for the clean-up of insolvent Savings and Loan Associations (S&L)<sup>9</sup>. Thus, it was often the case that the RTC would handle the liability operations of the insolvent S&L until the best method for resolution could be arrived at. However, their objectives and operations in resolving the assets of these failed entities were similar to Bad Banks and hence we have included them for comparison.

##### **3.1.1. Legal Character**

The RTC was established by the Congress as a temporary federal agency to clean up the S&L crisis. It was established under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), 1989 and existed from August 1989 to December 1995. FIRREA also authorised RTC to takeover or resolve any insured state depository institution if certain criteria were met.

##### **3.1.2. Level of Government Involvement**

The RTC was a federal institution tasked with the responsibility of resolving all failed

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<sup>8</sup> This section is based on the report - Managing the Crisis: The FDIC and RTC Experience Volume 1: History, FDIC

<sup>9</sup> Federal Savings and Loan (S&L) refers to financial institutions that provide checking accounts, loans and residential mortgages to consumers. These entities are mutually owned by their customers – Comparison of the powers of National Banks and Federal Savings Association, OCC July 2019

depository institutions. While the FIRREA set the main objectives of the RTC, it also mandated the contracting of private firms to expedite the process of disposition of assets of the failed thrifts. Thus, the Government involvement in RTC was only at a strategic level and the entity had wide operational flexibility to achieve its objectives.

### **3.1.3. Strategic and Operational Objectives**

The main objectives of the RTC, as defined by FIRREA, were (1) to maximize the net present value (NPV) return from the disposition of failed thrifts and their assets, (2) to minimize the effect of such transactions on local real estate and financial markets, and (3) to maximize the availability and affordability of residential real property for low- and moderate-income individuals. In achieving these objectives, the RTC was accorded a considerable degree of operational freedom to engage private players and adopt various marketing and financial techniques to dispose of the assets. Also, the FIRREA was amended from time to time to accommodate the evolving situation on the ground.

However, it should be noted that each of the 3 goals of RTC was, in some manner, at odds with the other two goals. For instance, maximising the NPV of sale of failed thrifts meant selling them as quickly as possible. But selling down of such a large quantum of assets in a short timeframe would distort the asset prices in local markets. Thus, the RTC often had to walk a tightrope to achieve its objectives.

### **3.1.4. Funding Sources**

The RTC was almost entirely dependent on congressional appropriations, along with some indirect sources of funding. This heavy dependence on Government appropriations somewhat curbed its operational freedom as there were often delays in getting these funds.

### **3.1.5. Process of Resolution/Sales/Management of Bad Assets**

The RTC was responsible for the overall resolution of failed thrifts and not just their bad assets. To that extent, its functions were greater than India's NARCL. However, with regard to disposition of bad assets, RTC employed a variety of methods to realise value from the assets, subject to its statutory goals. Some of these methods include - 1) Auctions and sealed bids, 2) Contracting out the asset management process through equity partnerships, 3) Securitisation programs, 4) Partnership programs and 5) Direct Loan Sales.

### **3.1.6. Haircuts**

Given that RTC was a resolution institution setup to resolve failing/failed banks the concept of haircut is not directly applicable to it. However, the RTC used a plethora of methods to dispose of the assets that it acquired from failing banks, with recovery rates ranging between 70-40% of book value.

## **3.2. Securum and Retriva**

### **3.2.1. Legal Character**

Securum and Retriva were set up as asset management companies. Securum was initially set up for taking on and resolving the NPAs of Nordbanken, a large, majority state owned bank which was failing. Similarly, Retriva was to take over the NPAs of a Gotabanken, a large, private insolvent bank<sup>10</sup>. These did not have any legislative act backing their creation and operated as ordinary companies<sup>11</sup>.

### **3.2.2. Level of Government Involvement**

While Securum was fully government owned, it had an independent board (with one representative from the Ministry of Finance) and a managing director, whereas Retriva started as an independent AMC and was later acquired by Securum<sup>12</sup>. The Government largely kept away from the operational decisions of the entities.

### **3.2.3. Strategic and Operational Objectives**

In addition to their main objective of resolving the bad assets of Nordbanken and Gotabanken, they were also tasked with preventing further price deterioration of the assets<sup>13</sup>.

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<sup>10</sup> Jonung.L. February 2009. The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful. Economic Papers. Directorate-General for Economic and Financial Affairs. Retrieved from: [https://ec.europa.eu/economy\\_finance/publications/pages/publication14098\\_en.pdf](https://ec.europa.eu/economy_finance/publications/pages/publication14098_en.pdf)

<sup>11</sup> Dreyer, Mallory (2021) "Swedish AMCs: Securum and Retriva," The Journal of Financial Crises: Vol. 3 : Iss. 2, 247-263 - <https://elischolar.library.yale.edu/journal-of-financial-crises/vol3/iss2/12>

<sup>12</sup> Ibid

<sup>13</sup> Dreyer.M. 2021. Swedish AMCs: Securum and Retriva.The Journal of Financial Crises. Volume 3, Issue 2. Yale University. Retrieved from: <https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=1174&context=journal-of-financial-crises>

### 3.2.4. Funding Sources

Securum was provided with a considerable amount of share capital (24 billion SEK) from the Swedish government. This amount was estimated to sustain Securum's operations for 10-15 years. The upfront equity allocation provided some level of independence. Securum was also provided loans worth 27 billion SEK by Nordbanken, of which 10 billion SEK loans were guaranteed by the government<sup>14</sup>.

### 3.2.5. Process of Resolution/Sales/Management of Bad Assets

The common management solution opted by Securum and Retriva was to pursue bankruptcy of the companies, foreclose the loans, and take over the collateral. It is to be noted here that the majority of their loan portfolio consisted of real estate loans. Thus, takeover of the collateral and their sale in the local real estate market was a dominant strategy<sup>15</sup>.

Securum also set up subsidiary companies to manage specific types of assets such as regional properties, hotel and tourism, industry focussed, and foreign assets<sup>16</sup>. Other strategies employed include – 1) Private negotiations with potential buyers, 2) Individual/bulk sale of properties (including sale of the holding company of the property) and 3) IPOs of the property holding companies<sup>17</sup>.

### 3.2.6. Haircuts

Overall, the assets were transferred to Securum/Retriva at ~59% their book value. Around 80% of the assets were related to the real estate market. At that time, the Swedish Financial Supervisory Authority tightened the rules and forced banks to disclose expected loan losses in full to help assign realistic prices to real estate and other assets<sup>18</sup>. This ensured that much of the losses were borne by the equity investors of the bank instead of the taxpayer. In fact, the 'cost to taxpayer', also known as the net fiscal cost,

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<sup>14</sup> Ibid; It is to be noted here that the Swedish Government took over Nordbanken by infusing additional capital. Then the bad assets were transferred to Securum, leaving Nordbanken with only the good assets.

<sup>15</sup> Ibid

<sup>16</sup> Ibid

<sup>17</sup> Ibid

<sup>18</sup> Treatment of impaired assets in the EU banking sector. Draft Commission Guidance Paper. European Commission, 2009

turned out to be very low<sup>19</sup>.

### **3.3. Korea Asset Management Company (KAMCO)<sup>20</sup>**

#### **3.3.1. Legal Character**

KAMCO is a state-owned asset management company. It was established in April 1962 as a subsidiary of the Korea Development Bank (KDB). The corporation's main mission initially was to liquidate KDB's NPAs. In 1966, KAMCO's scope of operations was expanded to other financial institutions, and it gradually established itself as a specialized real estate management company. In the 1980s and 1990s, KAMCO was commissioned by the government to manage and sell properties confiscated by the state in the context of tax investigations and other state-owned properties.

In November 1997, KAMCO was reorganized under the newly enacted "Act on Efficient Management of Non-performing Assets of Financial Institutions and Establishment of Korea Asset Management Corporation" (the KAMCO Act). However, the KAMCO Act does not provide any special legal powers to KAMCO. This is in contrast to RTC, where the FIRREA authorised it to unilaterally take over failing S&Ls that satisfy certain financial criteria.

#### **3.3.2. Level of Government Involvement**

Its major shareholders are the Korean government and KDB. The Ministry of Finance and Economy own 42.8%, KDB 28.6%, and other financial institutions own 28.6% of its paid-in capital. Further, KAMCO is governed by a Management Supervisory Committee, which is composed of eleven members, including the Managing Director of KAMCO. The supervisory committee consist of representatives from the Government, the banking industry and independent professionals.

#### **3.3.3. Strategic and Operational Objectives**

Under the Act, KAMCO was empowered: first, to support financial institutions by normalizing their asset quality through cleaning up operations; second, to perform the

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<sup>19</sup> Jonung.L. February 2009. The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful. Economic Papers. Directorate-General for Economic and Financial Affairs. Retrieved from: [https://ec.europa.eu/economy\\_finance/publications/pages/publication14098\\_en.pdf](https://ec.europa.eu/economy_finance/publications/pages/publication14098_en.pdf)

<sup>20</sup> This section is based on Dong He. 2004. The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea. Retrieved from: <https://www.imf.org/external/pubs/ft/wp/2004/wp04172.pdf>



role of a “bad bank” that supports corporate restructuring by extending loans, debt-equity swaps, and payment guarantees<sup>21</sup>; and third, to recover public funds through efficient management and disposal of these assets. In doing so, the primary objective of KAMCO became the operationalization of a NPA (Non Performing Asset Management) fund.

#### **3.3.4. Funding Sources**

Under the KAMCO Act, KAMCO’s main mandate of purchasing and resolving NPAs is to be exercised through the NPA Fund, which is distinct from KAMCO’s own accounts. Thus, KAMCO is the fiscal agent of the NPA Fund, which has a separate legal identity and funding sources different from KAMCO itself. The size of the NPA Fund amounted to 21.6 trillion won, of which 20.5 trillion won came from issuance of government-guaranteed bonds, 573 billion won were assessments on financial institutions in proportion to their holdings of NPAs, and 500 billion won were loans from the KDB.

#### **3.3.5. Process of Resolution/Sales/Management of Bad Assets**

KAMCO’s purchase of NPAs was selective and based on certain eligibility criteria. Eligible for purchase were saleable loans whose security rights and transfer were legally executable, from among loans classified as substandard and below. KAMCO also assigned priority to purchase of NPAs whose removal was considered critical to the rehabilitation of the institution concerned, and NPAs that had multiple creditors. The decision to purchase would be made by the Management Supervisory Committee, after which KAMCO would enter an “assignment and assumption agreement” with the seller. Usually, these assets were bought at Net Book Value (NBV)<sup>22</sup>.

With regard to the disposal of these assets, KAMCO used traditional methods such as competitive auctions, collection of rescheduled repayments and recourse to the original seller, and also developed innovative techniques that broadly include bulk (pooled) sales, individual sales, and joint venture partnerships. The choice of a particular method depended on the nature and size of NPAs. Bulk sales typically include the issuance of Asset Backed Securities (ABS) and international bidding, and aim for early resolution of NPAs and quick cash flows. In contrast, individual sales focus on discovering the market value of each individual asset. Individual sales include public auction of collateral, foreclosure auction, and sales of individual loans. Joint venture partnerships were used as

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<sup>21</sup> Payment guarantees are financial commitments that provide the beneficiary, in this case the creditor of the restructured corporate, with guarantee of payment should the corporate fail to pay

<sup>22</sup> Net Book Value is Book value less provisions

a vehicle to cooperate with foreign and domestic investment companies who have specialized technology and know-how in asset management and corporate restructuring.

### **3.3.6. Haircuts**

On average KAMCO paid 36% of the face value of the NPAs it purchased. The type of loans bought appeared to be the primary factor determining the price. The highest prices were paid for secured ordinary loans (67%) and the lowest prices were paid for unsecured ordinary loans (11%). The variation of prices paid for loans bought from different lenders did not appear to be significant, except for the fact that loans bought from institutions to be closed and resolved by the KDIC were priced much lower than loans bought from institutions that were going concerns.

## **3.4. Fondo Bancario de Protección al Ahorro (FOBAPROA)<sup>23</sup>**

### **3.4.1. Legal Character**

The FOBAPROA was established as a Government Depositor Protection Fund. However, during the 1995 banking crisis in Mexico it acted as a contingency fund for helping out the failing banks by buying their NPAs.

### **3.4.2. Level of Government Involvement**

The Government acted through FOBAPROA as the buyer of NPAs. FOBAPROA did not have any operational objectives as they were not directly handling the NPAs<sup>24</sup>.

### **3.4.3. Strategic and Operational Objectives**

The Government bought the NPAs from the banks at above market value with the condition that existing shareholders inject 1 peso of new capital for 2 pesos of bad assets that were bought. The government bought the NPAs with promissory notes issued by FOBAPROA. These notes substituted the NPAs in the asset side of banks' balance sheets. They were zero-coupon bonds with long-term maturity (about ten years), bore an interest rate equivalent to that on 3-months Treasury bills when denominated in pesos, and LIBOR plus 400 basis points when denominated in US dollars (below normal lending rates) and were non-tradable. When the FOBAPROA paper became due (after 10 years),

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<sup>23</sup> This section is based on Bank Restructuring in Practice, BIS Policy Papers No. 6 – August 1999

<sup>24</sup> FOBAPROA did constitute a loan workout subsidiary to sell the loans it acquired. However, the subsidiary was liquidated one month later.

the amount not recovered from the NPA constituted a loss. A general rule established that banks would bear 20–30% of this loss, with the Government covering the remainder. Banks continued to administer these assets while FOBAPROA received the right to all cash flows, including recoveries, that arise from the bad assets.

#### **3.4.4. Funding Sources**

The entire funding for the scheme came from the Government.

#### **3.4.5. Process of Resolution/Sales/Management of Bad Assets**

While FOBAPROA retained the right to receive all cash flows from the purchased assets, the servicing and collection of payments from these assets still rested with the originating banks. This reduced the incentives for banks to pursue recovery, especially where the costs of recovery outweighed the benefit from holding on to the zero-coupon bonds. A mitigating factor here was the stipulation that banks would have to bear 20-30% of any loss that was realised on the maturity of the bonds

#### **3.4.6. Haircuts**

While the loss for banks was capped between 20-30%, the rest of losses had to be suffered by the Government. With an average recovery rate of 30% on the NPAs, the Government suffered a loss of 40% on the assets it purchased.

### **3.5. National Asset Reconstruction Company Limited (NARCL)**

#### **3.5.1. Legal Character**

NARCL is set up as an ARC with equity investments from Public Sector Banks (PSBs) and Private Sector Banks<sup>25</sup>. Along with NARCL, a service company called India Debt Resolution Company Limited (IDRCL) has been setup to manage the assets bought by NARCL. PSBs and other public Financial Institutions (FIs) will have a maximum stake of 49% in IDRCL with the rest in the hands of private sector lenders<sup>26</sup>.

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<sup>25</sup> <https://www.moneycontrol.com/news/business/economy/explained-all-you-need-to-know-about-narcl-or-bad-bank-7546491.html> - retrieved on 19-11-2021

<sup>26</sup> <https://pib.gov.in/PressReleaseDetailm.aspx?PRID=1755466> – retrieved on 19-11-2021

### **3.5.2. Level of Government Involvement**

The Government has indirect control of NARCL through equity participation by PSBs. The Government is also guaranteeing the Security Receipts (SRs) issued by NARCL<sup>27</sup>.

### **3.5.3. Strategic and Operational Objectives**

At an operational level, NARCL is expected to buy bad assets of ticket size Rs. 500 Cr and above from banks, while IDRCL will be engaged for managing these assets and value addition<sup>28</sup>. NARCL will buy these assets from banks at NBV<sup>29</sup>. It is unclear if its objective is to maximise profit or to maximise residual value of the assets being purchased. From FAQs released by the Ministry of Finance, it can be concluded that the overall objective of NARCL-IDRCL is to ensure that the assets being bought are resolved in a fast and timely manner<sup>30</sup>.

### **3.5.4. Funding Sources**

It will be a combination of equity and debt, with PSBs having a combined majority stake in the entity<sup>31</sup>. Private sector banks and other entities are also expected to make equity investments in the firm.

### **3.5.5. Process of Resolution/Sales/Management of Bad Assets**

NARCL is an ARC and will be subject to the same legal and regulatory framework as applicable to other ARCs. However, unlike other ARCs, NARCL is expected to better aggregate the exposure of borrowers under consortium lending. This will enable quicker decision-making under the IBC route and thus result in faster resolution of bad assets. NARCL will engage IDRCL to manage the bad assets, where it is profitable to do so for a certain period of time, and then sell it at market-determined prices to AIFs and other investors<sup>32</sup>.

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<sup>27</sup> Ibid

<sup>28</sup> Ibid

<sup>29</sup> Report of the Standing Committee on Finance, Demand for Grants (2021-22)

<sup>30</sup> <https://pib.gov.in/PressReleaseDetailm.aspx?PRID=1755466> – retrieved on 24-11-2021

<sup>31</sup> <https://pib.gov.in/PressReleaseDetailm.aspx?PRID=1755466> – retrieved on 19-11-2021

<sup>32</sup> Ibid

### **3.5.6. Haircuts**

The process of buying the bad assets has just started and it is not yet known how much loss, if any, NARCL would have to take when they attempt to sell these assets.

## **4. Insights from the Study and Comparison with the Indian Context**

Our brief comparative study of the Bad Bank experience in other jurisdictions indicates that Government ownership, directly or indirectly, of the Bad Bank seems to be a necessity. The necessity might have arisen because the realised recovery value of the NPAs purchased by the Bad Bank, even if they were purchased at market price, is typically much lower than their purchase price. Thus, some level of capital infusion from the Government becomes necessary. However, the Bad Bank succeeded only in those jurisdictions where there was clear separation of the ownership and management of the Bad Bank, with the management being done by independent professionals with the requisite expertise. Success here is measured by the ability of the Bad Bank to resolve the bad assets with as little cost to the exchequer as possible. This is most clearly seen in the case of Securum and Retriva, where the Government fully owned the Bad Banks, but their asset disposition activities were handled by an independent and professional management. We see a similar scenario in the case of KAMCO as well.

Secondly, we see that clarity of objectives played an important part in the success of the Bad Banks. While, RTC had multiple objectives, both KAMCO and Securum and Retriva had maximising of recovery value as their main objective, and they succeeded, in large part, in achieving it.

Finally, the success of the Bad Banks depended, in large part, on the price at which they were able to buy the bad loans from the insolvent banks. In the case of Securum and Retriva and KAMCO, the Bad Banks had the power to buy the bad loans from the banks at market value. This not only ensured that most of the losses on the bad loans were borne by the equity investors of the seller bank but also increased the recovery rate on the assets for the Bad Banks. In contrast, by buying the assets at above market price, and capping the maximum loss of banks, FOBAPROA transferred a large component of the loss to its taxpayers.

Comparing this with NARCL, we see that the current structure, while having some positives, does suffer from some design flaws. By tasking IDRCL, which is majority private-owned, to manage the bad assets, the NARCL-IDRCL structure has some measure of

separation of ownership and management of the assets. However, it remains to be seen how this will play out going forward.

More importantly, the incentives of NARCL-IDRCL is yet unclear. To elaborate, NARCL buys the bad loans from banks at NBV, which is usually much higher than the market value or the expected realisable value of the asset. Thus, it is likely that NARCL will not be able to recover the full value of the asset and thus there will be a substantial difference between the face value of the SRs and the realised value of the NPAs. However, this loss can be avoided if the resolution or sale of the asset is done within the next 5 years as the Government guarantee, which would make good any difference between the face value of the SR and the realised value<sup>33</sup>, is valid till then. Such a structure is similar to the case of FOBAPROA. This is because NARCL-IDRCL, which will manage or resolve the bad assets, is owned by the same set of banks whose NPAs it is trying to resolve while any losses on these NPAs are covered by the Government guarantee. Thus, there is little incentive for NARCL-IDRCL to engage in pursuing recovery efforts and more incentive to liquidate the asset before 5 years irrespective of the quantum of loss. This could result in the Government having to pay out a substantial amount under the guarantee scheme thus adding to the cost of the exchequer at a future date.

## 5. Conclusion

The clean-up of bank balance sheets is integral to the revival of the economy and the setup of a Bad Bank is a good first step. However, for the Bad Bank to be effective, its objectives need to be clear and supported by a corresponding incentive framework. Currently, these seem inadequate in the NARCL-IDRCL structure. It remains to be seen how these lacuna will surface in its operations and what parameters would be chosen to measure NARCL's performance.

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<sup>33</sup> <https://pib.gov.in/PressReleaseDetailm.aspx?PRID=1755466> – retrieved on 24-11-2021