GS FOUNDATION FOR CSE 2024
ECONOMY-9
BANKING SECTOR – INSOLVENCY AND BANKRUPTCY CODE, BAD BANK, AND DEVELOPMETNAL FINANCIAL INSTITUTIONS

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2. DEVELOPMENTAL FINANCIAL INSTITUTION

- What is a **DFI** (Developmental Financial Institution) or **DFC** (Developmental Finance Company)?
  - » Developmental Financial Institutions provide **long-term credit for capital-intensive investments spread over a long period and yielding low rates of return**, such as urban infrastructure, mining and heavy industry, and irrigation system.
  - » The role of a Development Financial Institution (DFI) is to take cognizance of the gaps in institutions and markets in the country's financial sector and to act as a **gap filler**.

- **Objectives of DFI**:
  - » **Economic Development** of the country via financing infrastructure project is the prime objective of the DFI.
  - » They also provide **technical assistance** like Project Report, Viability Study, and Consultancy Services.
  - » They provide credit enhancement for infrastructure and housing projects and also helps in improving debt flows towards infrastructure projects.

- **History of Development Banks in India**
  - » **Industrial Finance Corporation of India** (IFCI), set up in 1949, was perhaps India's first developmental bank.
  - » In 1955, the World Bank prompted the **Industrial Credit and Investment Corporation of India** (ICICI) - the parent of the largest private bank in India today - as a collaborative effort between the government with majority equity holding and India's leading industrialists with nominal equity ownership **to finance modern and relatively large private corporate enterprises**.
    - ICICI Bank limited was established in 1944 and in 2002 both were merged together making it the first universal bank of India.
  - » In 1964, **IDBI** was set up as an apex body of all development finance institutions.

- **How were DFIs financed in India?**
  - » In 1950s and 60s, the saving rate was low and the capital market was virtually absent. So, DFIs were mostly financed by:
    1. **Lines of credit from the Reserve Bank of India** (that is, some of its profits were channelled as long-term credit); and
    2. **Statutory Liquidity Ratio bonds**, into which commercial banks had to invest a proportion of their deposits.
  - » In other words, by sleight of government hand, short-term bank deposits got transformed into long-term resources for development banks. The missing capital market was made up by an administrative fiat

- **However these DFIs didn't perform well:**

- They **faced very high** NPAs allegedly caused by politically motivated lending and inadequate professionalism in assessing the projects.
- Therefore, after 1991, following the Narsimhan Committee recommendations on financial sector reforms, **the DFIs were disbanded and got converted into commercial banks**.

– **Result of disbanding these institutions**
  - **Steep fall in long term credit** from a tenure of 10-15 years to five years. This has contributed to **NPA crisis** of Indian PSBs.
  - Further, the development of debt market has failed to take off.

– **In China**, these developmental banks - the Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China - have been at the forefront of financing its industrial prowess.

– **Advantages of DFIs**
  - **Fill the gap in infra financing and long term financing:** The commercial banks have been reluctant to provide long term loans for infra projects especially after the huge NPA crisis
  - **Reducing future NPA burden on Banks**
  - **Utilize today's developmental capital and stock markets more efficiently** through specialized activities.

– Therefore, Finance Minister **Nirmala Sitharaman** while presenting the Union Budget 2021-22 stated that, India's Infrastructure needs long term financing and informed that India will set up a new **DFI** called the **National Bank for Financing Infrastructure and Development** (NABFID)

1) DETAILS ABOUT NATIONAL BANK FOR FINANCING INFRASTRUCTURE AND DEVELOPMENT (NBFID)

- NBFID Bill, 2021 was passed in Parliament in 2021.
- It was operationalized in Q1FY23.
- NBFID will be set up as a **corporate body with authorised share capital of one lakh crore rupees**.
  - Shares of NBFID may be held by: (i) central government, (ii) multilateral institutions, (iii) sovereign wealth funds, (iv) pension funds, (v) insurers, (vi) financial institutions, (vii) banks, and (viii) any other institution prescribed by the central government.
  - Initially, the central government will own 100% shares of the institution which may subsequently be reduced up to 26%.

– **Functions:**

- It will have both financial and developmental objectives.
- **Financial Objective** will be to directly or indirectly lend, invest, or attract investment for infrastructure projects located entirely or partly in India. Central government will prescribe the sectors to be covered under the infrastructure domain.
- **Developmental Objectives** include facilitating the development of the market for bonds, loans, and derivatives for infrastructure financing.
- **Functions of NBFID include**:
  - (i) extending loans and advances for infrastructure projects,
  - (ii) taking over or refinancing such existing loans,
  - (iii) attracting investment from private sector investors and institutional investors for infrastructure projects,
  - (iv) organising and facilitating foreign participation in infrastructure projects,
  - (v) facilitating negotiations with various government authorities for dispute resolution in the field of infrastructure financing, and
  - (vi) providing consultancy services in infrastructure financing

– **Sources of Funds**:
  - NBFID will raise money in the form of loans or otherwise both in Indian Rupee and Foreign Currency, or secure money by the issue and sale of various financial instruments including bonds and debentures.
  - It will borrow money from: (i) Central Government (ii) Reserve Bank of India (iii) Schedule Commercial Banks (iv) Mutual Funds, and multilateral institutions such as WB and ADB.

– **Management of NBFID**:
  - It will be governed by **Board of Directors**. The members of Board include:
    1. Chairperson appointed by the Central Government in consultation with RBI
    2. Managing Director
    3. Up to three deputy managing directors
    4. Two directors nominated by Central Government
    5. A few independent directors

– **Support from central government**:
  - **Government** will provide a grant of Rs 5,000 crores to NBFID.
  - It will also provide guarantee at a concessional rate of upto 0.1% for borrowing from multilateral institutions, sovereign wealth funds, and other foreign funds.
  - Upon request from NBFID, the government may guarantee the bonds, debentures, and loans issued by NBFID.

– **Other DFIs**:

» The Act also provides for any person to set up a DFI by applying to RBI. RBI may grant a license for DFI in consultation with the central government. RBI will also prescribe regulations for these DFIs.

- **How is NaBFID doing?**
  » As of 2023, entire shareholding of the institutions held by Central Government, which has invested equity of Rs 20,000 crore and provided a grant of Rs 5,000 crores.
  » **NaBFID** has raised Rs 10,000 crores via maiden issuance of listed bonds of 10 year duration at a coupon rate of 7.43%. It was oversubscribed by 4.7 times. (June 2023)
  » In less than a year of operation, the institution has sanctioned **25,000 crore** rupees loan. The aim is to reach Rs 1 lakh crore in terms of sanctioned amount by FY24. (July 2024)
  » It is also moving very cautiously with a **balanced portfolio** of completed projects (refinancing route), brownfield expansion and greenfield projects as a lopsided focus on green field carry high risks.
  » It is also exploring a larger role in the infrastructure segment and not in just financing, with the objective of playing a catalysing role in developing infrastructure and the entire ecosystem. For e.g. it is looking at a project advisory role in railways and transportation infra projects that are stuck, or that haven't moved at required pace.

- **Conclusion**:
  » **NaBFID** is working as a though leader and financier in the infra-financing space and is expected to deliver on its mandate of pushing infrastructure spending.

3. BAD BANK:

- **Example Questions**
  i. "Bad banks can play a crucial role in solving India's NPA problem" Critically Analyze. [12.5 marks, 200 words]
  ii. What is a Bad Bank? Discuss various advantages and limitations associated with setting up of a bad bank. [12.5 marks, 200 words

- **Need of Bad Bank**
  ▪ Various **available resolution mechanisms**, including Insolvency and Bankruptcy Code (IBC), SARFAESI Act, Debt Recovery Tribunals, etc. have proved to be useful to certain extent, however **a large stock of legacy NPAs are yet to be resolved.** In addition to this, while there are **28 ARCs existing in India**, due to limited capitalisation and low recoveries from existing portfolio, they are better placed for acquiring only smaller value loans.

  ▪ In order to **resolve the legacy NPAs and clean up the banking system**, the Union **budget 2021-22 announced,** *"The high level of provisioning by Public Sector Banks of their stressed assets calls for measures to clean up the bank books. **An Asset Reconstruction Company (ARC) Limited** and **Asset Management Company (AMC)** would be set up to consolidate and take over the existing stressed debt and then manage and dispose of the assets to Alternate Investment Funds and other potential investors for eventual value realization."* In line with this vision, two entities viz.

National Asset Reconstruction Company Limited (NARCL)**, and **India Debt Resolution Company Limited (IDRCL)** have been formed.

- **Understanding Bad Bank:**
  - A bad bank refers to a financial institution set up to buy the bad loans of another bank with significant NPAs and to resolve the stressed asset. This frees the original bank from the burden of resolving their bad loans.

  - **Advantages**
    - **Specialized and Efficient Recovery**: A bad bank specializes in managing the NPAs and would thus be more efficient in this field
      - It would be better focused on task of recovery and can have superior expertise in the area.
    - **Banks can focus on core business**
    - **Availability of fresh credit** will further boost economic growth in the count

  - **Challenges**
    - **Funding requirements**
    - Managing the sheer **size and diversity of the bad loans** acquired from multiple PSBs will be a tall order.
    - Government entity may not be able to pay specialists what it takes.
    - **Experience of Private asset reconstruction** companies haven't been very good in resolving stressed assets.
    - Bad banks will **not solve the existing governance issues** of the PSBs
    - **Moral Hazard:**
      - Former RBI Governor Raghuram Rajan says that bad bank will create a moral hazard for banks and would enable banks to continue reckless lending practices without focusing on reducing NPAs.

- **Understanding the two layered structure**
  - The bad bank's structure is two-layered with the **National Asset Reconstruction Company Limited (NARCL) operating as an ARC** and a separate asset management company called India Debt Management Agency (IDMA) restructuring and turning around bad loans.
  - NARCL was incorporated on 7th July 2021 and has received a certificate of registration from the RBI to commernce the business as an ARC in Oct 2021.
    - The NARCL is **51% owned by PSBs** and the remaining by private sector lenders.
      - **Canara bank** would be the sponsor of the NARCL and would be holding 12% equity in NARCL. Other public sector banks would pick up less than 10% each in the ARC.
    - The NARCL has an authorized capital of Rs 100 crore and the paid-up capital of Rs 74.6 crores.
      - This is going to **rise going forward** as NARCL is expected to have a capital base of Rs 6,000 - 7,000 crore eventually.
    - The **capital structure** of NARCL will have component of both equity and debt.
    - NARCL is expected to acquire stressed assets at net book value by offering 15% of it in upfront cash, and the rest (85%) in the form of security receipts (SRs).

- The **government** will not have any direct equity contribution to NARCL. But it will guarantee the security receipts issued by NARCL, which will buy the bad loans from banks.

- **Note:** The company has hired **P.M. Nair** - a stressed assets expert from the State Bank of India (SBI) - as the managing director.

» **IDRCL** was incorporated on 3rd Sep 2021 and will have a **min 51% ownership of private sector banks** and balance will be held by Public Sector banks.

» NARCL and IDCRL's relationship will be defined through a **debt management agreement** where in NARCL will aggregate and acquire the stressed assets and IDRCL, in turn, will provide stressed assets management and resolution services to NARCL on an exclusive basis. The **term of IDRCL** will be co-terminus with that of NARCL.

– **Resolution Mechanism**

» NARCL will acquire assets by making an offer to the lead bank and the lead bank with an offer in hand (of NARCL) will run a **'Swiss Challenge'** process wherein other interested ARCs / Bidders will be invited to better the anchor offer made by NARCL. Once NARCL is declared as a preferred bidder, NARCL shall initiate asset acquisition process and acquire the assets in the underlying Trusts.

- The company will pick up those assets that are **100% provided** for by the lenders.
- After acquiring the assets, IDRCL shall prepare and suggest the proposed restructuring / resolution plan, strategies, etc. for each Underlying Trust Assets. Post the approval of resolution from NARCL, IDRCL shall also assist in implementation of resolution. The assets acquired shall be resolved using existing resolution tools within the RBI framework for ARCs.

» Resolution mechanisms of this nature **typically require a backstop from Government** as it imparts credibility and provides for contingency buffers.

- **Globally**, bad banks have been set up with **Government participation in the form of equity** along with other regulatory dispensations, for instance, Danaharta Nasional Berhad (Danaharta) in Malaysia or Asset Resolution Ltd (UKAR) in UK.

- Therefore, taking the **precedence from international practices**, in India, the **government has provided a guarantee of up to ` 30,600 crore**, which will back Security Receipts (SRs) issued by NARCL. The government guarantee will be valid for 5 years. Guarantee available for these SRs may be invoked on completion of resolution or liquidation as the case may be to cover the shortfall between actual realization and face value of the asset. The guaranteed amount will be issued based on actual assets acquired by NARCL. This arrangement will not only safeguard the face value of Security Receipts but it will also take away the need for 100 per cent upfront capitalization of NARCL. The government will charge a guaranteed fee on the amount which it guarantees, which will increase annually to incentivize the early and timely resolution

– **E.g:**

- **In Jan 2023**, NARCL acquired its first stressed asset - Jaypee Infratech - from lenders. It acquired their exposure aggregating about Rs 9,200 crore at a 55% haircut.
  - **IDBI Bank**, the lead bank to the consortium of lenders with an exposure of Rs 3,750 crore, received Rs 253 crore (15% of Rs 1,687.5 crore recovery in cash) and Rs 1,435 crore (85% of the recovery) in the from of security.

– **Performance Analysis**:
  - The Bad bank had set a target to buy accounts of **Rs 50,000 crore**, it acquired **Rs 10,387 crore** loans from 3 accounts in FY23.

– **Why poor performance?**
  - **Primary issue plaguing NARCL's progress** is the **dual structure of NARCL and IDRCL**, which many within NARCL believe is not delivering the expected results.
    - Although IDRCL is engaged in the resolution of distressed assets, NARCL retain ultimate decision making authority, as it holds the ARC license from the RBI. This dual structure has led to **higher costs** and a **cumbersome structure,** contrary to initial expectations that private sector participation would expedite decision-making in the resolution process.
  - **NARCL's protracted due diligence process** and its **tendency to present offers that banks consider inadequate** have also contributed to the challenge faced by the initiative.
  - **Bid-Offer Spread** has remained a concern:
    - ARCs like NARCL typically discount the cost of capital at around 25%**,** given their expensive capital, while banks, which offload their NPA to ARCs, discount cash flows at a maximum of 12-13%. This difference in price expectation has deterred banks from selling their distressed assets, even when NARCL offers relatively higher prices compared to its peers.
  - **Public sector ARCs** like NARCL, subject to government audit and preferring safer options, may end up **incurring higher due diligence** costs by paying substantial fees to external consultants compared to private sector stressed asset firms.

– **Way Forward**:
  - **Merging of NARCL** and **IDRCL** can increase the effectiveness of NARCL. It will optimize the business opportunities and streamline operations, and potentially reduce cost.
  - **Implement recovery-linked incentive** for personnel at the bad bank could attract talent and increase efficiency.

4. INSOLVENCY AND BANKRUPTCY CODE (IBC), 2016

– **Basic Definitions**
  - **Insolvency** refers to a situation where individual, entity or a company is unable to meet its financial obligations (i.e., unable to pay off debts).
  - **Bankruptcy** is the legal declaration of one's inability to pay off debts. When bankruptcy is filed, two ways of resolving insolvency is available.
    1. **Reorganization:** debtor restructure their repayment plans to make them more easily met.
    2. **Liquidation:** Debtors assets are sold to pay the creditors.

- **Problems with India's Insolvency and Bankruptcy Process (Before IBC, 2016)/Need of IBC**
    - **Delayed Process** (9 years, (1.7 years in OECD))
    - **High Cost of Process** (9% of total asset cost, (5% in OECD)).
    - **Poor Recovery** (25.7% (72% in OECD))
    - **Archaic laws,** some more than 100 years old, governed the Insolvency and Bankruptcy procedures.
    - **Different acts for different entities created confusions.**
        - The **RDDB act and the SARFAESI** act applied only to Indian Banks and specific NBFCs which deal with housing loans.
        - **SICA** (Sick Industrial Companies Act, 1985) applied to only Industrial companies which created a major problem as India is increasingly becoming a services-led economy.
        - **Joint Lenders Forum and Corporate Debt Restructuring** also apply to only regulated banks and NBFCs. They too don't address insolvency in systematic manner.
    - **Creditors were relatively powerless** when faced with a default while promoters were, in the words of former RBI governor Raghuram Rajan, able to "insist on their divine right to stay in control".

- **Insolvency and Bankruptcy Code 2016 - passed by Parliament in May 2016**
    - IBC 2016 is considered one of the landmark economic reform by the Modi Government. It is based on the recommendations of **the Bankruptcy Law Reform Committee** headed by **TK Viswanathan.**

- **Provisions:**
    i. **Unified Framework: Applicable to both Individuals and companies**

    ii. **Clear Coherent and Speedy Process**
        - Code lays down a clear, coherent and speedy process for early identification of financial distress and revival of the companies and limited liability entities if the underlying business is found to be viable.
        - **Corporate debtors (LLPs and companies):**
            - **Corporate Insolvency Resolution Process (CIRP)**:
                - Under this steps are taken for revival, selling the company to a suitable buyer, etc.
                - Resolution plan has to be approved by CoC (at least 66% of the creditors in CoC).
            - **Time Bound Resolution:** Insolvency resolution - Max (~~180 + 90 Days)~~ **330 days** (including the liquidation process) (after the Aug 2019 Amendment)
            - **Came into force** on 1st Dec 2016).

    iii. It offers a paradigm shift from the existing **'Debtor in possession' to a 'Creditor in control' regime**.

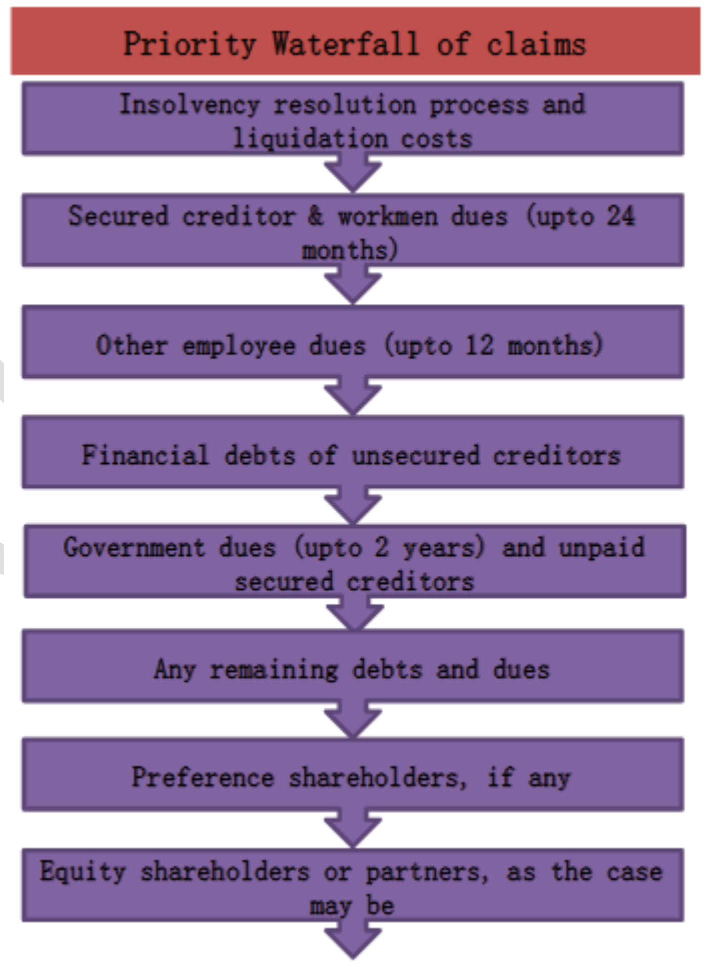
    iv. **Institutional Infrastructure for Insolvency and Bankruptcy Process under IBC**
        - **Insolvency and Bankruptcy Board of India ->** Insolvency regulator, oversees the functioning of insolvency intermediaries (IPs, IPAs, IUs)
        - **Insolvency Professionals and Insolvency Professional Agencies** -> private bodies -> specialized in helping sick companies -> license from IBBI required

- **Information Utilities**
  - Collate all information about debtors to prevent serial defaulters from misusing the system.
- **Adjudication** (Corporates: NCLT->NCLAT-SC; Individuals: DRT -> DRAT -> SC)

v. **Insolvency and Bankruptcy** fund
- For establishment and use by Insolvency and Bankruptcy Board of India and also for implementing various provisions of the act.

vi. **Provisions to address cross border insolvency** through bilateral agreements with other countries.

vii. **Protection of worker's interest**
- The code has provision to ensure that the money due to workers and employees from the provident fund, the pension fund and the gratuity fund shouldn't be included in the estate of the bankrupt company or individual.
- Further, worker's salaries for upto 24 months will get first priority in case of liquidation of assets of a company, ahead of secured creditors.
- It also enables workers to initiate the insolvency process and they will be first in line to get the proceeds of liquidations.



viii. **Disqualification of bankrupt from holding public office**
- Provisions that disqualify anyone declared bankrupt from holding public office, thereby ensuring that politicians and government officials cannot hold any public office if declared bankrupt.

– **Significance/Key Achievements of IBC:**
» IBC has created a **cohesive and comprehensive insolvency ecosystem**.
» It has **made it easy for creditors** to deal with default.
» It has **professionalized insolvency services** by creation of two professions namely: the insolvency profession and the valuation profession
» It has **fast tracked** the insolvency and bankruptcy process and has resulted into **higher recovery** and thus has benefitted all the creditors including banks. As per ESI 2021-22:
- In value terms **74%** of distressed assets were rescued.

        - The average time for resolution (428 days) and liquidation (375 days) is a reduction over the pre-IBC times.
    - IBC has also ensured fast track closing of businesses enhancing a key component in India's Ease of Doing Business.
    - **IBC** has also led to **Behavioural change**.
        - **Increased responsibility and accountability** have been ensured among borrowers. This has ensured that business entities are paying upfront before being declared insolvent.
        - Further, in case of distress, thousands of debtors are resolving distress in the early stage of distress.

- **Concerns:**
    - **Capacity of NCLT**: Large number of pending cases

- **Way Forward**
    - Institutional capacity should be strengthened, specially of NCLTs and DRT
    - Deal with delays and increase recovery.
    - Bankruptcy board of India should quickly develop a robust way to select the most qualified IPs.
        - It should be ensured that IPs are truly independent and are not influenced by promoters and key stakeholders in any unfair manner.
    - Centralized framework for IUs so that all data is easily accessible.
    - Finally, government should be ready to bring in changes as and when required to deal with issues that may emerge with time as has been done over the last 2 years.

- **Conclusions**
    - IBC has changed the credit culture in the country. It has made the borrowers more responsible.
    - This process can be made more effective by ensuring that the so-called pillars - insolvency professionals, information utilities, a strengthened adjudication mechanism and a regulator are institutionalized and function efficiently.