The festering twin balance-sheet problem

Why a PARA is paramount

Other efforts haven’t worked—and won’t work. So, time India considered a public sector asset rehabilitation agency.

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Ever since the Global Financial Crisis, India has been trying to come to grips with its twin balance-sheet problem—overleveraged corporates and the bad loans that have encumbered banks. But decisive resolution has proved elusive, and the problem has continued to fester. Perhaps, it is time to take a different approach—a centralised Public Sector Asset Rehabilitation Agency (PARA) that could take charge of the largest, most difficult cases, and make politically tough decisions to reduce debt.

For some years, it seemed possible to regard TBS as a minor problem, which would largely be resolved as the economy’s recovery took hold. But as time has gone on, the problem has only continued to worsen. Earnings of the stressed companies have kept deteriorating, forcing them to borrow more and more to sustain their operations. Since 2007–08, the debts of the top 10 stressed corporate groups have multiplied five times, to more than Rs 6 lakh crore. Even with such large infusions of funds, corporates have still not been able to service their debts, so much so that by September 2020, the debts of the top 10 stressed corporate groups are now more than 12% of the gross advances of public sector banks, and turning non-performing. According to some private sector estimates, the numbers are considerably greater.

This situation is beginning to take a toll on the economy. With balance-sheets under such strain, the private corporate sector has been forced to curb its investments, while banks have been reducing credit in real terms. To sustain growth, these trends will need to be reversed. And the only way to reverse these trends is by fixing the underlying balance-sheet problems.

The question is how to do this. So far, the strategy has been to solve the TBS problem through a decentralized approach, under which banks have been put in charge of restructuring decisions. A number of such schemes have been put in place by RBI. None of the time, this is indeed the best strategy. But in the current circumstances, effectiveness has proved elusive, as banks have simply been overwhelmed by the size of the problem confronting them.

Eight steps lead to the conclusion that the time may have arrived to try a centralised approach, the PARA. A detailed case is set out in the new Economic Survey 2016–17, Chapter 4.

It’s not just about banks, it’s a lot about companies. So far, public discussion of the bad loan problem has focused on bank capital, as if the main obstacle to resolving TBS was finding the funds needed by the public sector banks. But securing funding is actually the easiest part, as the cost is relatively small compared to the resources the government commands (no more than 2.5% of GDP in a worst case scenario). Far more problematic is finding a way to resolve the bad debts in the first place.

It’s an intractable problem, not a morality play. Without doubt, the stench of crony capitalism permeates discussions of the twin balance sheet problem. And it is true that there have been cases where debt repayment problems have been caused by diversion of funds. But a vast bulk of the problem has been caused by unexpected changes in the economic environment—timetables, exchange rates, and credit growth assumptions that haveMANAGEMENT ORGANIZATION REVIEW
consider new investments.

Of course, all of this will come at a price, namely accepting and paying for the losses. But this cost is inevitable. Loans have already been made, losses have already occurred, and because state banks are the major creditors, the bulk of the burden will necessarily fall on the government (though the shareholders in the stressed enterprises will need to lose their equity as well). In other words, the issue for any resolution strategy—PARA or decentralised—is not whether the government should assume any new liability. Rather, it is how to maximise the effort, given the size of the losses that have already incurred by resolving the bad loan problem as quickly and effectively as possible. And that is precisely what creation of the PARA would aim to do.

That said, the capital requirements would nonetheless be large. Part of the funding would need to come from government issuance of securities. Part could come from the capital markets, if stakes in the public sector banks were sold or the PARA was structured in a way that would encourage the private sector to take up equity share. A third source of capital could be RIL. The Reserve Bank would (in effect) transfer some of the government securities it is currently holding to public sector banks and PARA. As a result, RIL’s capital would decrease, while that of the banks and PARA would increase. There would be no implications for monetary policy, since new money would be created.

Creating a PARA is not without its own difficulties and risks; the country’s history is not favourable to public sector endeavours. Yet, what one has to ask is how long India should continue with the current decentralised approach, which has still not produced the desired results eight years after the Global Financial Crisis, even as East Asian countries were able to resolve their much larger TBS problems within two years. One reason, of course, was that East Asian countries had been under much more pressure; they were in crisis, whereas India has continued to grow rapidly. But an important reason was that it deployed a centralised strategy, which allowed debt problems to be worked out quickly using the vehicle of public asset rehabilitation companies.

In sum, current efforts have not been successful in addressing the twin balance-sheet problem. New solutions must be tried. Perhaps it is time for India to consider a PARA as one such solution.

The authors worked on this year’s Economic Survey.