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2021

THE BOTTOM LINE

Exploring Alternative Investments

BOTTOMLINE FOREWORD

Dear Readers,
Hope this finds you well.

We are pleased to launch the eighth edition of The Bottomline – a joint initiative of the finance and investment clubs of IIM Ahmedabad, IIM Bangalore, IIM Calcutta and IIM Lucknow.

Indian Banking sector has seen remarkable change over the last decade. India has seen a full blown credit crisis unfold where we have had systematically important financial institutions failing and the ballooning of NPA ratios especially in the public sector banks.
Just when India was recovering, Covid-19 hit the economy and crushed the repayment capacity for most borrowers. To provide respite, a moratorium on loan payments was put in place with the option for banks to not report assets under moratorium as NPAs. However, the Supreme Court has vacated its earlier relief to not declare these accounts as NPAs and this can further bring to fore the high credit costs that banks may have to bear.

This budget started a discussion to clean up the NPAs from the system by establishing a bad bank like institution which can help to resolve these loans efficiently and help to clean up the bank books and provide confidence to the bankers to resume lending again for India's growth story to play out.

Last year marked a change as in order to improve competition in banking space, the RBI talked about giving Banking licenses to established corporate houses and some Non-bank financial Institutions which can potentially lead to an incentive problem where a borrower is also the creditor with all perverse incentives to lend recklessly.

As always, any feedback from our readers is welcome and we strive to achieve new heights of quality with each subsequent edition.

Happy reading!

Global Macro Trends

Bonds

Since breaching the 100-bps mark in early January, US Benchmark 10 year- yields have steadily risen to around 1.7%. The Federal Reserve has committed to continue with near zero target funds rate and $120 billion a month bond buying programme. At the US treasury, Yellen and Biden have brought up a $2.3 trillion infrastructure proposal on top of the $1.9 trillion stimulus in January, partially financed by a corporate I-T raise from 21% to 28%.

Meanwhile, ECB chief Lagarde vowed to accelerate bond buying using its $2.25 trillion Pandemic Emergency Response Programme (PERP) to put a lid on Eurozone borrowing costs, while retaining negative 50 bps yield on ECB's deposit facility.

At home, Indian G-secs have yielded 6.0 to 6.25% since February, continuing the rising trend triggered by the RBI's proposed restoration of normalcy, starting with variable rate repo. Following multiple devolvement of fresh issues on PDs in February, the RBI made peace with 600+ basis point yields in March.

Commodities

The yellow metal "Gold" has seen downs and falls in the last year. Gold Prices reached an all-time high of Rs 56,191 per 10 grams at MCX. But since then, the prices started falling with an expectation of a strong recovery. The second wave of covid 19 might provide support to the falling prices. With uncertainties and lockdowns, the price is expected to move upwards. Gold price is inversely related to dollar and yield rates. An upward trend in dollar and yield rates might limit the potential upside.

Brent Crude Oil is currently trading at $63.20, which is the benchmark for international markets. Oil prices are mainly driven by future expectations and OPEC + supply. Dollar movement can also add volatility to the oil price. The decision of OPEC+ to cut the supply might put upward pressure on the oil price. However, with increasing cases and the second wave of Covid 19 the demand might be muted, leading to excess inventory and a fall in oil price. A combination of these factors might keep oil prices in the 55-65$ range in spite of supply cuts.

Currencies

USD/JPY: The Dollar advanced 3.6% against Yen in March 2021. The greenback gained against Yen supported by passage of the $1.9 trillion U.S. economic stimulus by the U.S. government coupled with strong economic data, the quickening pace of the U.S. COVID-19 vaccine program and announcement of the infrastructure plan outlining sweeping use of government power to reshape the economy and counter China's rise in a $2 trillion-plus proposal that has been met with swift political resistance.

USD/INR: The rupee has advanced 1.3% in March 2021, boosted by the prospect of an economic recovery supported by mass vaccination drives, a current-account surplus, foreign-exchange reserves approaching $600 billion and $2.4 billion of overseas purchases of local stocks, including inflows related to initial public offerings. Additionally, nine share-sale offers worth about 59 billion rupees ($813 million) in March have added to one of the highest inflows into emerging Asia, putting India in a strong position to ward off the impact of the U.S. Treasury-led selloff that's roiled global risk assets.

USD/EUR: The Dollar strengthened 3.1% against Euro in March, amid expectations of strong U.S. economic growth, supported by accelerating vaccine rollout resulting in large parts of the country reopening, the passage of $1.9 trillion coronavirus relief package coupled with the unveiling of $2 trillion-plus infrastructure rebuilding plan injecting more funds into the U.S. economy. The environment is clearly supportive for USD, with large parts of Europe struggling with a third wave of the Covid-19 virus, shutting down much of the region, resulting in Germany's retail

sales dropping 9.0% year-on-year in February.

USD/GBP: USD/GBP rose by 1.7% in the month of March. Sentiment for the dollar improved in March, while Treasury yields spiked, as the Biden administration's passage of $1.9 trillion coronavirus relief package coupled with the unveiling of $2 trillion-plus infrastructure rebuilding plan, strong macroeconomic data showing an increase in job creation and a lower unemployment rate for the month, and a rapid COVID-19 vaccine roll out spurred economic optimism as well as inflation fears.

Equities

Equity **indices in the U.S.** ended higher in March 2021 with Dow Jones scaling record highs and ending 6.6% higher, while S&P 500 registered a notable growth of 4.2%. NASDAQ has inched up only marginally by 0.4%. The gains could be primarily ascribed to sharp recovery in the U.S. economy reflected by robust macroeconomic data, faster than expected vaccination drives and clearance to the U.S. economic stimulus package aggregating $1.9 trillion.

Major **European stocks** closed higher in March 2021, with DAX rising by 8.9%, CAC40 by 6.8% and FTSE 100 by 3.6% in March. The gains were supported by expectations of swifter economic recovery due to the ongoing vaccination drive, pick-up in crude oil prices supporting oil stocks, passage of the U.S. economic stimulus bill and accommodative monetary policy stance by key central banks.

The benchmark **indices in Japan** (Nikkei 225) have ended marginally higher by 0.7%, supported by strong global cues of economic recovery and domestic news of easing of government restrictions in Tokyo and commencement of vaccination drives in Japan.

Shanghai composite, ended lower by 1.9% during March 2021, led by concerns around policy tightening, bubbles in the Chinese economy, inflationary concerns, rising coronavirus cases in China, sanctions by the U.S. and others (including EU) on China's human rights abuse, and delisting of Chinese companies from U.S. stock exchanges following non-compliance of U.S. auditing standards.

The **Indian equity markets** ended higher by 2% in March 2021 on account of growing optimism around sharp recovery in the Indian economy amidst mass-vaccination drives across the country, coupled with positive GDP growth of 0.4% for Q3-FY21, passage of the U.S. economic stimulus bill and positive sector specific news like spectrum auctions in the telecom.

The Microfinancing Trap

(Article courtesy of Finshots : Join Finshots (finshots.in) and get your daily dose of latest, most important Financial developments delivered in plain English.)

The Story

The year is 1976. Mohammad Younus, a young professor in economics at the Chittagong University in Bangladesh meets a 21-year-old woman, Sufia Begum. She is desperately trying to make ends meet, but life can hit you hard sometimes. She has borrowed Rs. 10 from local moneylenders at an interest rate of almost 10% a day and it is crippling her financially. She doesn't have a lot to her name, apart from the daily wage she makes selling bamboo stools. And she is often forced to sell most of her work back to the moneylenders— making next to nothing. The young professor is moved when he sees this. He compares it to bonded labour and vows to end their suffering.

He finds 42 more people like Sufia, stuck in this poverty trap and starts lending them small amounts of money at reasonable interest rates. To his surprise, nobody in the group defaults. He decides to replicate his model throughout Bangladesh. Banks turn him down. Critics argue that providing loans without collateral is akin to throwing money away, but professor Younus perseveres. He creates his own institution and calls it Grameen Bank which eventually spurred on the Micro-finance revolution.

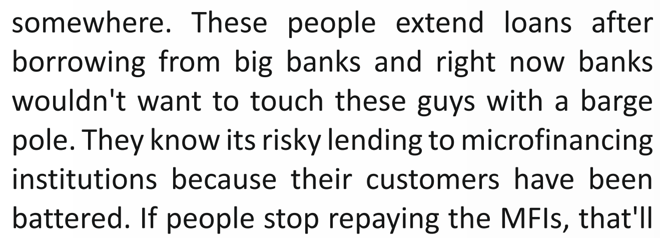
The premise here is extremely simple. Microfinancing almost always has a social angle to it. They target the unbanked and the underprivileged by offering them small loans at reasonable interest rates. And more often than not, they cater to women. After all, the academic evidence is unanimous here. Women prove to be good borrowers and good payers. And if you're a bank, that kind of assurance can go a long way. So to summarize, microfinancing institutions (MFIs) have been on the up since the turn of this millennium.

But the pandemic is pushing this model to the brink. As this article from BloombergQuint notes — “With default rates across India soaring on the mainly unsecured loans, the virus is undoing the business models of dozens of MFIs as funds dry up.” And this shouldn't come as a surprise. When India imposed the dreaded lockdown, it particularly affected those at the bottom of the pyramid— the daily wage workers, the street hawkers and the neighbourhood Kirana stores. These people had no recourse because they simply couldn't make a living. And since they couldn't repay their loans, most of them were forced to default on their obligations.

Now the government did offer moratoriums on these loans, but they only last for so long. Eventually, you'll have to start paying up. However, the past few months have completely crippled most of these micro-entrepreneurs. They can't start afresh either because that requires new capital. Capital they don't have access to. And they can't get new loans unless they repay the old ones. It's a complete mess and some of them are now being forced to turn to moneylenders who charge interest rates of upwards of 100%. And if you know anything about moneylenders, you know they are not the most scrupulous bunch. As we wrote in one of our articles last year—

The Indian Moneylender is like the nine-headed Hydra. Cut one head and two will take its place. So long as the demand remains robust, moneylenders will continue to thrive. There's simply no way around it.

So this is an unfortunate situation for everyone involved. And I say everyone because it's also hurting the MFIs. After all microfinancing companies don't have a pot of gold hidden



somewhere. These people extend loans after borrowing from big banks and right now banks wouldn't want to touch these guys with a barge pole. They know its risky lending to microfinancing institutions because their customers have been battered. If people stop repaying the MFIs, that'll mean MFIs will have trouble repaying the banks. You can't get around this problem. And so experts contest that this could be the great reckoning for the microfinance industry. Maybe we will see many MFIs go bust over the next couple of years. Unless that is, the government intervenes.

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ARC Model and how the public ARC-AMCseeks to clean the bank books

The Union Budget contained a provision on ARC-AMC-AIFs to resolve bad loans which launched the Bank Nifty into orbit.

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 Limited and Asset Management Company would be set up to consolidate and take over the exiting stressed debt and then manage and dispose of the assests to Aalternate Investment Funds and other potential investors for eventual value realization.

Excerpts from the Union Budget Speech delivered by Ms. Nirmala Sitharaman on February 1, 2021.

Excerpts from the Union Budget Speech delivered by Ms. Nirmala Sitharaman on February 1, 2021.

In 2019, Ambit exited the ARC business. Its then CEO, Mr. K M Jayarao, listed two primary reasons for the ARC model to fail, the reluctance of consortium of bankers to first agree to sell the assets to a single ARC so something beyond salvage value could be obtained, and secondly, their inability to agree to a realistic haircut.[1]

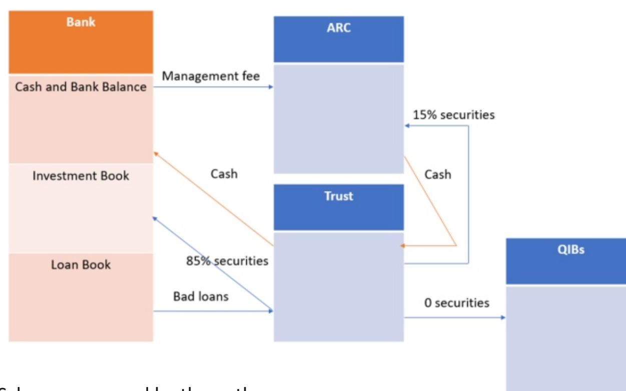
The ARC proposed in the Union Budget 2021-22 solves both.[2]

i. Loans would be transferred to the new ARC at Net Book Value (NBV), which is book value minus any specific provisions held. So, the PSBs would not need to decide how much of a haircut to be taken.

ii. The Inter-Creditor Agreements under IBA would ensure united action by consortia.

Before digging deeper, let us understand the business model of an ARC.

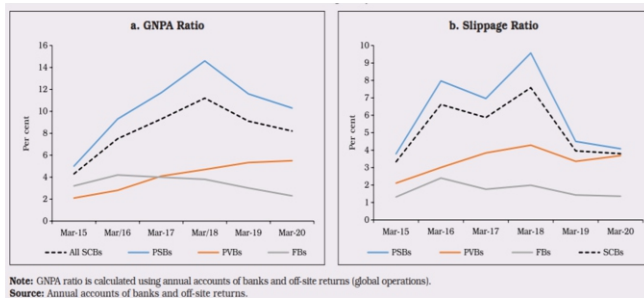
The bad loans taken off bank books by an ARC and housed in a trust managed by the ARC for a fee. The trust issued securities backed by the loan assets, which were either subscribed to by the banks, held by the ARC on its books against cash consideration paid to the bank or sold to qualified institutional buyers (QIBs) in the secondary market.



Schema prepared by the author.

The ARC was required to purchase only 15% of the securities upfront, and it was this 15% which went to the bank compulsorily.[3]In the absence of QIBs in distressed debt, the securities were housed in the banks' investment books and booked MTM losses, as valuations fell over time. These valuations were done by approved valuers in the absence of a strong secondary market.

In the proposed ARC-AMC, hence, the AMC arm can hold these assets after purchasing them from the ARC arm. Capital requirement will be low because the peak NPAs have already seen major provisions. The peak NPAs of 11.6%identified in March 2018 will see 100% provision on the entire portion by March 2022 while those which had turned NPA by March 2020 will require 100% provision on their unsecured portion by 2021.[3][4]So, the NBV will be significantly low in 2021-22 and the ARC-AMC will not need to shell out significant upfront cash. With the eased global monetary position, this sum should be easy to raise by global players.



Source: Report on Trend and Progress of Banking in India, RBI, December 2020.[5]

However, the composite ARC-AMC structure and easy liquidity may not be enough to develop a

secondary market. With AQR ongoing since September 2015, global players jumped in. Edelweiss raised capital from Avenue International, KKR received an ARC licence and Blackstone setup International ARC in India.[6]However, they could not gain a foothold. In the last week, Edelweiss ARC's partnership with CDPQ is being investigated by the Ministry of Corporate Affairs for siphoning of funds alleged by a minority shareholder.[7]

Another issue is the celebrated IBC system. When the RBI mandated the usage of IBC starting February 2018, SARFAESIprevented ARCs from participating in the resolution process as sole bidders.[8]The Act states that they can only accept equity in a stressed firm through conversion of debt and not through direct purchase. Further, its June 7 circular, which mandates that all such loans in default for 270 days must be referred to the NCLT.[9]Hence, loans above ₹2000 crore can be transferred to the ARC only after the RBI the celebrated circular is updated.

Issues notwithstanding, the structure brings much promise for cleaning up the bank books.

[574 words]

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Bad Bank – Will it be good for the NPAs?

In the latest Union budget presented by the finance Minister Nirmala Sitharaman, one announcement that caught the attention of the financial sector and was hailed by most of them was the creation of the National Asset Reconstruction Company (NARC) and National Asset Management Company (NAMC). The concept of ARC is not something new and has been existing in India for over a decade now. So, what is the new announcement all about?

Asset Reconstruction Companies emerged post the SARFAESI Act 2002. ARC's are a special type of financial institution that take over the debt portion of the Non-Performing Assets (NPA's) of conventional banks at mutually agreed haircuts to the original debt value. ARC's then try to realize the maximum possible value out of the debts owned by these NPA's. All the rights that were held earlier by the original lender in respect of the debt would be transferred to the ARC.

The rationale behind having separate NRC's lies in the logic that freeing up conventional banks from the difficult task of recovering dues from their NPA's allows them to focus on lending fresh loans. A specialized agency for the recovery of bad loans is also expected to perform much better than a normal bank in turning around these NPA's.

At present, there are 28 ARCs in India withthe top 3 players accounting for nearly 75% of industry capital employed in ARCs. However, thecapital base of existing NRC's is highly insufficient to tackle the country's nearly Rs 8 lakh crores NPAs. Apart from the low capital base of ARCs, valuation mismatch of bad assets between banks and ARCs is the single major issue hampering the resolution of NPA's through ARCs.

So where does the setting up of the proposed NARC help? A majority of the bad loans in

India is in the books of PSBs . These PSB's are reluctant to sell the bad debts to the existing ARCs at a significant haircut as they are apprehensive of the criticism that they might attract once thevalue of these stressed assets shoots up post-resolution.

It is expected that since the proposed NARC is being promoted by the Govt of India unlike privately promoted ARCs, the PSB managers will be more at ease in the selling of these NPAs for quicker resolution. However, it is to be noted that even now there are NRCs primarily promoted by PSBs which exist in India such as ARCIL, which is incidentally the first and most well-recognized ARC in India.With the RBI governor Shaktikanta Das clarifying recently that the new entity will be set up by PSBs and the GoIwon't invest in it, the expected benefits of the new ARC are not very clear.

Schema prepared by the author.

The major challenge for the proposed bad bank will be developing a unique and sustainable business model. Unless the government provides some sort of sovereign guarantee to the securities issued by the new bad bank in order to develop this market further and finds out a way to bring in the huge capital needed for this new ARC to make any significant change in the ecosystem, there is not much change that one can expect at the ground level.

The proposal to establish a bad bank may at best be a positive move to relieve banks of their stress temporarily and kickstart higher credit flow into the economy. This assumes added significance in the face of Covid induced crisis and the resultant stagnation of the Indian economy. However, it is to be remembered that this proposal of a bad bank won't be the panacea for solving the structural problems inherent in the Indian banking sector that led to the huge NPA's in the first place.

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Indian Non-banks – Flagbearers of Leverage and Systemic Risk

Since its inception, non-banking financial companies (NBFCs)have contributed significantlyto the financial intermediation and development of the Indian economy as a whole. Non-banks often referred to as shadow banks, are financial institutions engaged in the business of offering last-mile credit access to serve the diversified financial needs of less-banked customers.As of March 2020, the asset under management of the NBFC sector (including housing financing companies) stood at INR 51.47 trillion. These institutions have grown rapidly (CAGR of 18.6% vis-à-vis CAGR of 10.7% for scheduled commercial banks between March 2009 and March 2019) and have contributed to the economy through channelizing the scarce financial resources inducing capital formation and thereby, stimulating wealth creation, bank credit, employment generation, promoting inclusive growth and mobilization of funds all across the country with a special focus in the rural sector.

Non-banks source close to 70% of their funding needs from the mainstream financial system with scheduled commercial banks being the topmost creditor (about 50% of total external liabilities) followed by asset management companies – mutual funds (AMC-MFs) and insurance companies. According to the RBI Supervisory Returns Report, NBFCs (including HFCs) are the largest net borrowers of funds from the financial system, with INR 14.75 trillion amount outstanding as gross payables and gross receivables of INR 1.34 trillion respectively. Owing to large growth in size and interconnectedness, non-banks have become increasingly significant in terms of systemic risk and must be subject to prudential regulations so as to ensure financial stability.

Several recent crises including IL&FS (Sep'18) and DHFL(Jun'19) have significantly altered the funding scenario for non-banks in the country. These crises have led to a differentiation in market access and financial conditions for these institutions, restricting market fundraising to only a few entities with a strong parental brandpossessinggood governance standards and higher operatingpractices. Most mid-sized and small-sized NBFCs (including microfinance institutions), that were creating significant impact in the rural sector, have been shunned by the markets including banksthereby leadingto a shockingcollapse of the entire sector.

Incidentally, the share of the commercial paper(CPs) market in the funding mix for non-banks has been experiencing a constant declineduring recent yearsmainly due to the waning market confidence. Additionally, the share of non-converting debentures (NCDs) has reduced which is a big concern because this funding gap for NBFCs is been met through bank borrowings which can potentially accentuate liquidity risk not just for non-banks but also for the entire financial system. Consequently, most non-banks have been focussing on stabilizing their balance sheet by maintaining liquidity instead of aggressively growing their assets under management (AUM) despite this being very costly ultimately driving their profitability downwards.

With the onset of this pandemic,the situation has worsened for non-banks especially, for the lower-rated entities. Non-banks are estimated to have close to INR 6.0-6.5 trillion of long-term debt/borrowing maturities in the current fiscal. The total outstanding CP maturitieswere estimated to be around INR 1.2 trillion between May 2020 to March 2021.Assuming that non-banks would want to hold on to the stable AUM level, these entities would have to refinance the same. Additionally, entities augmenting their on-B/S liquidity profile or growing their AUM would warrant further funding.This phase of refinancing and further rounds of funding is expected to be very difficult especially for lower-rated entities and is most likely to be met by bank funding (primarily public sector banks as most private banks are reluctant to increase their exposure to this segment). Additionally, loan sell-downs which is also considered to be an important form of fund-raising

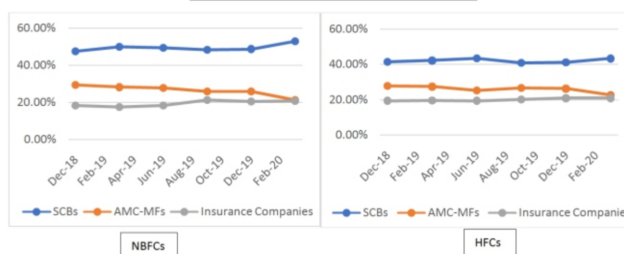
for these entities are expected to be muted in this fiscal year and the remaining proportion is expected to be mainly bought by public sector banks especially in these uncertain market conditions thereby, further increasing the level of systemic risk in the financial system.

The Global Financial Crisis could be primarily attributed to the lack of a calibrated regulatory framework for unabated financial innovation. Currently, the Indian financial system is experiencing a similar form of innovation especially with fintech and other technology completely changing the dynamic land scape of financial intermediation. Stringent regulations for NBFCs are essential to mitigate the systemic risk posed by them. These institutions are exposed to multiple risks like counter party, funding, etc. Besides, their inter linkages with the financial system, capital markets, and other financial entities augment systematic risk.
However, we must not forget that much of the success of these institutions in providing last-mile credit access could be attributed to the regulation light structure which provides them the flexibility. Therefore, the right balance between tight regulations and the requisite flexibility would be the cornerstone for the future of regulations for NBFCs and ultimately, for their contribution towards financial intermediation.

One can argue that the regulations must be based on the principle of proportionality i.e.,regulations calibrated for individual entities in connection with their contribution to systemic significance. In line with the new recommendations of RBI's Internal Working Group, non-banks must be allowed to transform themselves into a commercial bank. The design of the regulatory framework for large NBFCs with significant externalities must be such that beyond a certain degree of criticality to systemic risks, these institutions must be compulsorily asked to transform themselves into a commercial bank which would be subject to stricter regulations or asked to scale down their network externalities within the financial sector. This would therefore make our financial sector sound and resilient thereby, ensuring better financial stability in the economy.

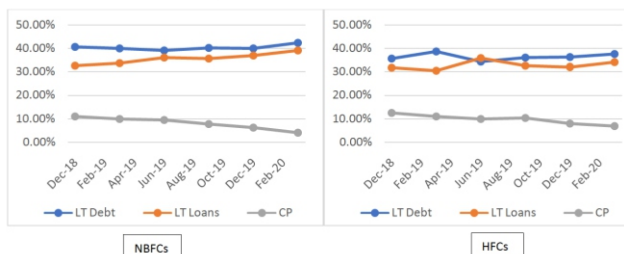
Exhibits

Chart 1 - Share of Top 3 Lender Groups



Source – RBI Supervisory Returns and Staff Calculations

Chart 2 - Share of Top 3 Lender



Source – RBI Supervisory Returns and Staff Calculations

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IMPACT OF FOREIGN AID ON ECONOMIC GROWTH

Official Development Assistance (ODA), commonly known as Foreign Aid has been a significant driver of economic growth for the poorest of nations throughout the history of economic development. These aids essentially comprise social and economic infrastructure as well as services and production sector's aid. This topic is not as contemporary as we think it is, because the history of ODA can be traced back to the 1870s when Great Britain began the narrative of financing its poor colonies. Officially, the provision of ODA can be attributed to the Marshall Plan of 1947 when the USA started out on a journey of rebuilding Europe after WWII through aid.

Due to apparent reasons, this topic enjoys an extreme amount of attention from politicians, policymakers, and the media. Scholars are no behind, and the question of aid translating into growth has been explored by many. While aid is seen as a way of escape from poverty traps and an impetus to development, empirical studies clearly demonstrate that incremental aid adds to economic growth only under robust macroeconomic policy conditions and a strong regulatory framework.

There are various crystal clear ways of putting ODA to efficient use- infrastructural investment, pro-public expenditure in the form of extensive and inclusive social welfare, and technological investments (which have a spillover effect on various sectors of the economy) are some among many. However, in the absence of prudent governance and strict policies to allocate aid efficiently amongst multiple areas, there are high chances of the economy being propelled into the aid dependency syndrome, which will eventually limit the impact on growth as well as poverty reduction.

Additionally, the CoVID-19 situation has imposed another challenge to the aid landscape. Aid disbursements, if highly volatile, remain of little value to the recipient countries. Aid shocks in the past have been rare, but quite impactful as the poor
countries were disproportionately impacted by the global recessionary forces. There have been disruptive effects on inflation, exchange rates and public investments.

Conclusively, development aid has positive impacts on economic growth and poverty reduction in the long run, given that strong macroeconomic policies are in place. Empirical evidence, too, indicates that continuing development assistance programs will enhance the standards of living of the world's most impoverished – if aid to Sub Saharan Africa is curtailed, it's going to propel more people towards the perils of poverty. The challenge is to enhance the effectiveness of aid and Taiwan, Korea and Mozambique have set persuasive examples of the same as aid has been a reliable driver of the growth and development of these countries.

This is where blended finance (public-private partnership) steps in- development projects can reach their full potential if supported by home-grown organisations. National development banks not only de-risk the implementation of projects but also provide concessional funds by blending local and foreign private capital. These banks can also catalyse the scaling-up process by partnering with domestic organisations.

The number of net donors in the world is growing, a vital sign of global progress and an indication of countries' positive sentiments concerning aid and

its usefulness. However, it is imperative that political motives do not drive this positive sentiment. Effective management entails a robust legal and political framework, not letting short term incentives jeopardize the long term goal of development, increasing public awareness with respect to aid utilisation, decentralising the leadership and management to the field and finally, promoting accountability.

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Private Equity in India – Appetite for a Market of Domestic Limited Partners

Over the last decade, India has witnessed a steady flow of capital in startups and other promising growth-stage companies via the private equity (PE) or venture capital (VC) route. They are a subset of what we call Alternative Investment Funds (or AIFs). Let us take a few steps back and understand who channels money via these PE funds. Promoters of PE funds do not invest their own money in the fund. Only a small portion of the total fund comes from their pocket, but most of the funds are raised from a set of large wealthy investors known as limited partners (LPs). LPs comprise of sovereign wealth funds (SWFs), pension funds, insurance companies, etc. Most of the PE firms that invest in India raise large amounts of capital from such LPs and invest that amount in companies which fit their evaluation criteria. However, a pertinent point to note here is that most of the LPs that end up investing in the Indian market are foreign entities.This is primarily because India does not have a developed market of LPs. Lately, there has been a growing call among Indian PE managers to look at ways to mobilize domestic capital into these asset classes. Yes, we do have pension funds (EPF and NPS), insurance behemoths (LIC) and a quasi-SWF (NIIF), but none of them has created a dent in the LP market.

Pension funds:

In India, pension (or provident) funds are entrusted with the Employee Provident Fund Organisation (or EPFO) and Pension Fund Regulatory and Development Authority (or PFRDA). EPFO is the largest pension/provident fund manager in India with an asset base of more than Rs 12 lakh crore. PFRDA manages the National Pension Scheme (NPS) with a corpus which is expected to touch Rs 6 lakh crore in 2021.The pension funds are large, but the dampener is that they do not invest even 1% of that amount in PE funds in India.

Contrary to the scenario in India, if we look at the international arena pension funds such Canadian Pension Plan Investment Board (or CPPIB), Ontario Teachers' Pension Plan (or OTPP), Caisse de dépôt et placement du Québec (or CDPQ), Australian Super, California Public Employees' Retirement System (or CalPERS), etc. are prominent investors in the PE VC market. While thesepension funds are larger in size and sometimes invest directly in private companies, they commit a significant sum as LPs to PE VC funds – almost 10% of their entire fund allocation. No wonder we see large PE houses emerging from North America.

In the case of India, the PE industry is not a nascent one but at the same time not well developed. Domestic institutions and capital can provide the fillip needed to support private businesses and startups.The Government's recent move to allow private domestic provident funds to invest up to 5% of their corpus in certain categories of AIFs is a welcome move in that direction.

Insurance companies:

Worldwide, life and general insurance companies are regular contributors to private equity funds. The Insurance Regulatory and Development Authority of India (IRDAI) permitted Indian life/general insurers to invest upto 3%/5% of their investment corpus in AIFs. Life Insurance Corporation of India (or LIC), being the largest life insurer in India, is also the largest domestic wealth manager. It is only prudent to assume that it would have participated as an LP in many PE funds. However, the truth is that most of the times LIC has only partnered with Small Industries Development Bank of India (SIDBI) and provided capital for funds incorporated under SIDBI Venture Capital (SIDBI VC). It has seldom partnered with a private sector-led PE fund, and even if it did the contribution to

the fund kitty has been very low when juxtaposed with LIC's massive size. Other state-run insurers such as GIC have followed a similar path. Thus, Indian insurers have not been that active in the PE VC space.

A decade ago, LIC took a more direct approach and launched a PE vehicle under its housing finance subsidiary LIC Housing Finance Limited (or LICHFL). Since then it has launched two funds with a target size of Rs 1,500 crore in total, out of which only 10% of the corpus came from LIC – again a meagre amount.

SWFs:

The idea behind setting up an SWF is to manage excess wealth in a nation such that it can benefit not only the current generation but the future generations as well. We see SWFs come up in countries which are either rich in natural resources (say oil-dependent economies such as Saudi Arabia, UAE, Norway, etc.) or have a trade surplus (say China or Singapore). India does not fall in either of the categories; hence we do not have a traditional SWF setup. However, a few years ago the Govt set up a quasi-SWF in the form of National Investment and Infrastructure Fund (or NIIF). One arm of the NIIF operates a billion-dollar-plus 'Fund of funds' to provide capital to PE VC funds, from which capitalcommitments have been made to a few PE firms already. While it is a good start to encourage general partners (or GPs) to seek domestic capital, we must acknowledge that it will be equivalent to a drop in the ocean. We will have to wait and see how swiftly and easily this model can be scaled up.

Don't we have SIDBI?

Yes, the Government has used SIDBI to promote investments in PEVC funds. In 2016 it constituted a Fund of Funds (or FoF) under SIDBI and allocated a large sum of Rs 10,000 crore for that purpose. Since then it has been the torchbearer of the domestic LP market over the last few years, and almost all domestic PEs have received some contribution from SIDBIFoFas an LP. However, out of the Rs 10,000 crore kitty less than 40% has been earmarked as capital commitments yet. SIDBI also has a separate VC arm by the name SIDBI VC, which makes investments like a regular VC fund. As a sponsor, SIDBI has contributed significantly to all the funds instituted under SIDBI VC – 7 till date. However, across all the seven funds they have managed to raise only Rs 1,754 crore over the last two decades – not a very impressive feat, one may contend.

At present,the Indian domestic LP market, which witnesses a dearth of traditional LPs, is ruled by high networth individuals (HNIs) and family offices. These sources have a limited tap of funds to invest from and cannot match the size of a pension fund or an insurer or an SWF. While India has done some work around the concept of an SWF in the last few years, a lot more needs to be done to encourage pension funds and insurers to diversify their investments and look at PEs or AIFs in general as a viable investment destination.

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BAD BANKS

Let's start with diagnosing the name itself. It is interesting to note that Bad Banks are neither bad, nor are they banks! It is named "bad" banks because it takes up the banks' bad loans (NPAs).

Technically, a bad bank is an asset reconstruction company (ARC) or an asset managementcompany that takes over the bad loans of commercial banks, restructures them and finally recovers (or sells them to investors who then recovers) money over a period of time.

Due to rising NPA problems and other related issues like liquidity constraints because of provisioning, the budget 2021 proposed establishing publicly owned (Govt. supported) bad banks in the form of asset reconstruction company to address Rs. 2.25 lakh crore of stressed debt in the banking sector. The Economic Survey, 2016-17, also proposed the Public Asset Rehabilitation Agency, which is nothing but bad banks.

BAD BANK MODEL:

Initial Capital: The initial capital will be provided by lenders and financial institutions like Alternate Investment Funds (NOT entirely by GOVERNMENT). The idea here is that since lenders will reap the most benefit, in the long run, the initial capital must be funded by them. Moreover, private investment will also ensure transparency in the system and less stress on the exchequer.

Government guarantee: These institutions will be backed by the sovereign body, which will provide security to banks to participate in capitalizing bad banks.

BENEFITS:

- **Overcoming the Twin Balance Sheet problem:** It helps the banking industry to get rid of twin balance sheet problems as it frees banks from NPAs and, therefore, of the provisioning requirements.
- **Credit Growth:** It will create better liquidity in the economy, which will allow the firms to expand better as they will be getting funds easily, which would then lead to investment growth in the economy.
- **Deeper pockets:** Since it's a public sector institution, it will have deeper pockets than the private ARCs as the government can support it anytime that it requires. Moreover, it will also have a better legal authority that is not entirely concentrated towards profit earning.
- **Credit Management:** Better coordination in credit management due to the single management source for all loans.

CHALLENGES:

- **Corporate influence and favouritism:** Corporates will highly influence write-offs by these institutions due to the strong government-corporate link, which will not favour general taxpayers. Politicizing these institutions will lead to a massive loss for the entire economy. *To overcome this, the government can continue to support it but can establish it as an autonomous body run by professionals and industry experts with a nominal target of profits to recover.*
- **Moral Hazard Issue:** Banks will feel complacent while extending risky loans as they have the assurance that in case of default, these will be taken over by bad banks. It thus might cause just shifting the issue of NPAs from one public institution (PSBs) to other (bad banks). *To solve it, partially, the finance minister's step to privately finance these institutions will let them have a stake in it, making them more rational while extending loans.*

- **High price paid for NPAs:** The publicly owned bad banks might have an incentive to pay a high price to banks (more than their worth) while taking them over from bank's balance sheet. *To solve this, a large market for bank collaterals can be created to set market-based price for these loans.*

THE PANDEMIC EFFECT

NPAs are expected to balloon in the wake of contraction in the economy. In its recent Financial Stability Report, the RBI noted that the gross NPAs of the banking sector is expected to shoot up to 13.5% of advances by September 2021, from 7.5% in September 2020.

The sectors need funds to get out of the pandemic-stress, and banks need liquidity and security to lend to the companies and growth projects. Thus, setting up bad banks is crucial in the current scenario.

However, the vicious cycle emerging in India's banking sector needs to be addressed with a permanent solution that bad bank will not offer in the long run.

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Corporate houses in Indian Banking- is it the right time?

Typically, as a corporation, I can either raise funds privately or from financial markets. These financial markets can be further broken down into different segments based on the intermediaries involved. These can be banks, insurance companies, money markets and capital markets etc. based on my requirements and capabilities.

In the Indian commercial sector, bank credit accounts for more than 60% of the total funds flowing in, which highlights the inclination of this sector towards bank credit over other sources. This inclination arises from the cost certainty offered by bank credit which usually goes well with the volatility associated with markets in a developing country like India. Apart from this, domestic credit offered by banks is also encouraged to set the credit cycle in place using funds generated within the economy rather than relying on foreign capital. However, as of 2018, domestic credit to the private sector by banks as a proportion of GDP has been dismally low as compared to other countries. It stood at a meagre 50% in India, as compared to 158% in China and 141% in South Korea. This leads to the thought that despite the demand, the Indian banking system in its current state is not capable of supporting the growth requirements of the country, thus creating a roadblock on its way to achieving the objective of a $5 trillion economy. What the country needs right now is favorable capital infusion to induce better jobs as well as production in labour intensive sectors to emerge as a global exporter.

The expectations stated aboveinduced the idea of allowing corporate houses in the Indian banking sector to strengthen enough to self-sustain the demand of the private sector. The suggestion came up back in 2013 and once again in RBI's meeting in late 2020 and is still under contemplation. The reason for this cloud of doubt is the potential negatives of the scheme against its stated benefits

1) **Concentration of economic power:** Large corporate houses like Tata, Adani Group and Reliance Industries own and control majority of the assets of the country. With the possession of banking licenses, their unadministered power would increase exponentially. It was precisely this thought that led Indira Gandhi to enact the Monopolies and Restrictive Trade Practices Act of 1969, which tied all enterprises and corporate houses with assets worth Rs 20 crore or more into knots. In parallel, she limited investments by business houses with Rs 35 crore in assets to a list of just nine highly capital-intensive “core” industries

2) **Reckless lending:** It is argued that once these houses have banking licenses to themselves, they will assume the autonomy to lend as per their own rules in a sub-par manner, including to themselves. This might establish a route for such players to divulge funds without any scrutiny. The issue is that the mere existence of regulation and supervision cannot stop such lending as evidenced by the episodes of NPA accumulation in the last two decades.

Now while it comes across as the only feasible solution for the problem of credit crisis in the country along with providing an opportunity to productively tap the large amount of funds at disposal of these houses, given the complexities associated with the country, it's imperative we weigh it against the mentioned costs and exploit the opportunity accordingly.

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Drivers of Intercorporate Investments in India

Firms have the practice of investing either in equity or debt instruments of other firms. The investments made by one company in the securities of another firms are defined as intercorporate investments(ICI). This investment can take the form of subscription of shares, subscription or purchase of share warrants, subscription (purchase) of debentures, bonds, and similar securities (Sec 186(1) of Companies Act, 2013). Both short-term and long-term motives can drive such investments. Companies buy (or sell) marketable securities of other firms as an alternative to holding excess (idle) cash and earning short-term returns. Long term motivations of ICI include strategic considerations of gaining competitive advantage by achieving additional profitability, diversifying their asset base, entering a new market, strengthening relations with suppliers, etc. Intercorporate investments can significantly impact the investing company's financial performance and position both in the short term and long run. For example, the book value of Bajaj Auto Ltd.'s intercorporate shareholdings rose from INR 93,448.9 million on 31 March 2015 to INR 1,81,649.2 million on 31 March 2020. We therefore, seek an explanation for the key driving factors of a firm that induce intercorporate investments.

We studied the pattern of intercorporate investment for five years, i.e., from March 2015 to March 2019 (for 200 firms listed on NSE).Over the entire sample period, it is empirically observed that free cash flows (FCF) have a positive and significant relationship with ICI. This indicates that the higher the free cash flows, the higher are the intercorporate investments. There are a couple of observations that can be made of this relationship. First, cash-richfirms' have strong capabilities to expand their investment in the high-growth avenues not only in the same firm but also in other firms having premium growth stories. Second, firms with larger free cash flows might not see enough growth opportunities in the same firm. Hence, the management prefers to invest in other firm's equity. Third, excess cash does not earn a premium return for the firm unless the excess cash gets invested in firms with a higher return on equity than the investor firm.

The correlation between promoter's shareholding and cash holdings is found to be negative, indicating that promoter-dominated firms shy away from investing in another firm's equity. This is found conceptually appealing that the closely held firms are not in favour of diversifying their investments in terms of another firm's equity; instead, they prefer to invest in their firm. Put differently, managers of firms with low promoter's holding diffuse ownership structure by way of more ICI to lower divers if i able risk and protect their human capital in the market against corporate control. Additionally, a levered company is observed to step up intercorporate investments. A plausible explanation for this relationship is that levered firms being at a high risk wish to reduce (or diversify) risk and thereby look for investing in profitable ventures in the form of increasing intercorporate shareholdings, which adds to their profitability. So, this can also be understood as maintaining a trade-off between risk and profitability for such companies so that when ICI fetches more profitability, high leverage can be compromised.

High dividend-paying firms invest heavily in equities of other firms as part of intercorporate investments. High dividend yield firms are characterized by depressed share prices and

declining market conditions. This calls for a higher ICI by such firms to broaden their growth and investment opportunities to fetch premium returns and thereby enhance the firm's value. In the Indian context, a significant difference in ICI between different industry clusters is also observed. The value of intercorporate shareholdings of the consumer and retail sector is found to be significantly lower than the value of intercorporate equity holdings for manufacturing and services sectors. The above empirical evidence would help the investor firms understand the empirical evidence of firm-level variables and their impact on intercorporate investment. It shall also serve the policymakers who are consistently involved in framing rules and restrictions governing intercorporate investments. For a detailed understanding and discussion of the topic, please refer to the research paper (DOI: 10.3390/ijfs9010001)

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What hinders the privatisation of banks in India?

Asset Quality Review (AQR) of 2015, undertaken by Reserve Bank of India (RBI), made the structural weakness of the Indian Banking industry evident. Further, given the capital inadequacy in some banks, Prompt corrective action (PCA) was imposed by RBI in late 2018, restricting banks' lending activities and management compensation in several ways. Most of these banks to come under RBI's PCA were public sector banks (PSBs).

The state runs banks or PSBs, which dominates the Indian Banking industry, were at the centre of the crisis. Consequently, to save the Indian banking sector from mayhem, the Indian government infused capital in these banks and merged some of them with anchor banks to form relatively stronger banks. However, that didn't mean the end of financial woes for all PSBs. Repeated infusion of capital in banks by the government to cover up their losses, precisely the taxpayer's money, wasn't an efficient solution either. Hence, the idea of privatising PSBs was propounded by the government on the same rationale as for other ailing Public Sector Units (PSUs).

However, privatising PSBs is not the same as privatising PSUs and hence, since crises started, the government has not been able to privatise even a single bank1. So, let's try to understand what ails the process of bank privatisation, which was once seen as a sure solution to banking crises and the alternatives available.

One of the first alternatives is to sell banks to corporate or industrial houses. It has also been recommended by RBI's Internal Working Group on the corporate structure of banks in its Nov'20 report. However, what might seem all rosy, experts warn of the risky situation where such corporates may lend to themselves or their own entities, leading to disastrous outcomes. The second alternative is selling financially unsound PSBs to larger and financially sound private sector banks, just like the mergers among the PSBs themselves have done earlier. However, other than HDFC Bank, ICICI Bank and Axis Bank, there seems no bank in the private sector which could buy out these ailing PSBs given their size. Further acquisition even by these banks would create a banking mammoth too risky on TBTF2 basis, which any government would best avoid. The third alternative is selling it to Foreign financial institutions; however, this could be a politically volatile decision.

The last option is to evolve these ailing PSBs into publicly owned private banks, with no or minority stake held by the government. This might be the most prudent alternative; nevertheless, it the most difficult to execute too. There seems a slight possibility of investors willing to buy one to five per cent stake in these ailing banks. In this case, ideally, the process would be to turnaround the bank and then offer it to market, although had that been possible government would have done this by now. In this situation, what is required is that such banks' immediate pain points are addressed in the short run to enable their sale in markets, and long-term measures can be left for post-privatisation management to address. The short-term measures would include organisational rejig and recruitment of competent professionals to manage this turnaround. Further, specialised legal professionals can expedite the resolutions of large NPAs under the IBC. Provision of variable pay and higher salaries to motivate the management to make significant improvements in the operations would be necessary. Most importantly, freeing the bank's

decision-making powers from bureaucracy's clutches and reducing the political pressure on the bank's management would be required.

These actions may not completely turnaround the ailing PSBs, but would hopefully push them into the transition stage where private investors find them attractive to buy and polish up further.

Notes:

1) IDBI Bank has been classified as a private bank by way of its sale to LIC(a government entity); hence it has been not considered here
2) Too big to fail

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