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“Dharma is to protect the Needy”

Article on
‘BAD BANKS: SOLUTION TO NPA WOES’

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Banking is necessary, Banks are not. -Bill Gates

ABSTRACT

The banking sector had faced a lot of difficulties due to the pandemic & the increasing value of Non-performing assets is one of them. Here, we would be dealing with 'Bad Banks' and its viability to ease India's NPA woes. During 2018-19, the Reserve Bank of India introduced a prudential framework for resolution of stressed assets, which aimed to protecting the banking sector from the huge amount of Non-performing Assets and the government has proposed to form an Asset Reconstruction Company (ARC) and the purpose behind it is transforming the toxic or stressed assets of regular banks into performing assets.

The latest figures of Reserve Bank of India (RBI) states that the total number of Non-performing Assets has been steadily increasing since RBI launched its asset quality review procedure in 2015, from around 70,000 crore rupees in 2015 to nearly 2.4 lakh crore rupees in 2019-20 and the pandemic has even worsened it. As per the latest trends, the percentage of NPA is expected to cross double digits in the next quarter which is really alarming. A key factor in this surge is nature of bank's ownership because unlike private banks, who have alternative financial resources to manage them, Public sector banks may not have same commitment towards the bank to ensure the lender's profit. This paper would be linking the key issues and its solution with one another to provide a way forward in order to get Indian banking sector out from such crisis.

I. INTRODUCTION

The Confabulation over a 'bad bank' has been in the trend again since Indian Bank Association had sent a proposal to Reserve Bank of India (RBI) requesting them for establishing bad banks to clean the toxic assets of regular banks¹. Due to immediate spread of Covid-19, the world is facing huge financial crisis and India is no different in it. In recent times, the Indian banks have accumulated a very huge number of Non-performing Assets (NPAs). As per RBI's Financial Stability Report which got released in January, 2021 the Gross Non-performing Assets of Non-banking Financial Companies (NBFCs) increased to 6.3% as of March 2020 from 5.3% as of March 2019².

This augmentation in stressed assets is getting reflected in balance sheets of the banks due to which investors are losing confidence in order to invest in banks. Many economists across the country suggested several ways to clear these toxic assets but the most striking one among all was the formation of 'Bad Banks'. In the Fiscal Year 2016-17, The Indian Government in the Economic Survey of India had suggested to introduce the bad banks to alleviate the burden of banking sector³.

Recently, it is in much limelight because, In the Budget Session of 2020-21, Finance Minister Nirmala Sitharaman had discussed about the formation of Bad banks for the recovery of bad loans to get the Country's adversely effected economy back on track.

This paper attempts to analyse the concept of Bad Banks, need of bad banks, advantages & disadvantages, Government's view, RBIs view, Significance, and most importantly what are the measures on which we have to keep prime focus while establishing the bad banks.

Keywords: *Bad banks, Non-performing Assets, Reserve Bank of India, Economy, Toxic Assets, Capital.*

¹ Times of India, What is bad bank and can it resolve NPA woes? (Jan 31, 2021), https://m.timesofindia.com/business/india-business/why-bad-bank-could-be-a-good-move-for-an-ailing-economy/amp_articleshow/80614795.cms (last visited 21 March, 2021)

² PTI, 'NBFCs' stressed assets may rise to Rs 1.5-1.8 lakh cr. By March end, THE HINDU (17 Feb 2021) <https://www.google.com/amp/s/www.thehindu.com/business/Economy/nbfc-stressed-assets-may-rise-to-15-18-lakh-cr-by-march-end/article33854990.ece/amp/> (last visited 12 March, 2021)

³ PTI, CEA Subramanian pitches for private sector-led bad bank to deal with NPAs, THE

ECONOMIC TIMES(Jan 31, 2021),
https://www.google.com/url?sa=t&source=web&rct=j&url=https://m.economictimes.com/industry/banking/finance/banking/cea-subramanian-pitches-for-private-sector-led-bad-bank-to-deal-with-npas/amp_articleshow/80611678.cms&ved=2ahUKEwigmJL6rMTvAhV9wjgGHZ1-A8QQFjABegQIARAG&usg=AOvVaw3PMr5yTU4zuYI3ttTP51dh&cf=1 (last visited 20 March, 2021)



A. WHAT ARE BAD BANKS?

Over the recent years, India has worked on various alarming issues such as defence, health, etc. and has taken steps in order to alleviate them but one of the perennial challenges which India is facing right now is continuous increment of bad loans or NPAs in banks.

Bad banks are those entities which are established for the purpose of reducing the mounting burden on regular banks from bad loans/NPAs, Bad banks usually purchase the bad loans from other lenders and financial institutions and help them to clear their balance sheets and resolve these bad loans over a period of time which ultimately allows the bank to focus on providing fresh loans instead of getting stuck of clearing the previous loans.

B. ESTABLISHMENT OF BAD BANKS: A GLOBAL PERSPECTIVE

- **USA-** More than the theory, it was the period of 1980s when the idea of bad banks became practical approach for the purpose of liquidating the toxic assets. At that time, the real estate and oil prices saw an immense fall due to which many banks were in the verge of bankruptcy and US based Mellon Bank was one of the most affected banks among them. The bank was steadily making losses and required liquidation in order to survive in the banking sector. In the year 1988, they established another bank called Grant Street National Bank (GSNB) for the purpose of separating the toxic assets. The toxic assets worth \$ 1.4 billion were transferred to GSNB at a discounted price of \$ 6.4 million for the purpose of liquidation. It was the first experiment to clear NPAs through bad banks and it could not be anticipated that whether this will rejuvenate the crisis-hit banking sector or not. GSNB was created in the year 1988 and it liquidates all the NPAs transferred to it within a year and as a result Mellon Bank started making profits with an immediate effect. GSNB not only settled the toxic assets transferred by the Mellon bank but it also provided a new good bank-bad bank approach to be adopted by the banking sector not only in USA but other countries also⁴.
- **GERMANY-** In 2006, Germany introduced a bad bank named 'Berliner Immobilien Holding (BIH)' to reduce the number of bad loans. But 2 years later, a significantly bigger crisis hits the German banking sector and in order to tackle the crisis, German

⁴ Julia Kagan, BAD BANK Investopedia (Oct 31, 2020)

<https://www.google.com/url?sa=t&source=web&rct=j&url=https://www.investopedia.com/terms/badbank.asp%23::~text%3DExamples%2520of%2520Bad%2520Bank%2520Structures,bad%2520assets%2520of%2520Mellon%2520Bank.%26text%3DThe%2520purpose%2520of%2520this%2520would,to%2520begin%2520lending%2520once%2520more.&ved=2ahUKE>

[wj11rTgpcTvAhWKFLcAHXKNA_oQFjABegQIARAF&usg=AOvVaw04eFpTvP
it8RnK2hOhzbw5&cshid=1616430037970](https://www.scribd.com/document/511111111/International-Journal-of-Legal-Enforcement-Volume-1-Issue-1-2020) (last visited 12 March, 2021)



legislature enacted two laws to provide good bank-bad bank solution to the tax-payers. Under these laws, two separate bad bank models were created, one each for private and public banks. For Private banks, a special entity model was created under which Private banks need to transfer their toxic assets as per their book value and they will receive 90% of their of the book value of such toxic assets and this activity will be guaranteed by a state-funded body known as Special Fund Financial Market Stabilisation (SoFFin). On the other hand, the German legislation created another model called as 'Consolidated Model' under which not only toxic assets but also other types of assets such as business divisions can be transferable who had lost their profit-making strength⁵.

Many countries have successfully used good bank-bad bank transferring assets with the purpose of clearing off their banking sector's NPAs and After analysing two different case studies of one of the two most developed nations, It is inferable that the formation & structure of bad banks can vary from nation to nation as per their requirement and national demography but one thing is notable that the basic purpose of setting a bad bank is same which is to separate the toxic assets of regular banks to clear their books and to save the banking sector from collapsing.

C. LEGAL FRAMEWORK AND SCHEMES OF BAD BANKS

As we discussed already, the core objective of establishing the bad banks is to separate the stressed or toxic assets from the performing assets and to achieve this, it is not always necessary that the bad bank & regular bank should be a separate legal entity, a bad bank can also be set up as a separate entity within the regular bank⁶. On the basis of this statement, we can easily understand the four types of schemes of bad banks and it can be further divided as-

1. **On-balance sheet guarantee:-** Under this scheme, Bad bank is created as a separate legal entity, the bank protects it from suffering further losses under a guarantee by the government and government/public institution plays a major role in order to make it a profitable move. It includes two requirements,
 - **Firstly**, certain toxic assets of the bank will be protected by an agreement which is entered between the bank and the government wherein it guarantees the bank

⁵ Cordelius Ilgmann and Ulrich van suntum, Bad banks: The case of Germany (December, 2009)
https://www.google.com/url?sa=t&source=web&rct=j&url=https://www.econstor.eu/bitstream/10419/51266/1/671789066.pdf&ved=2ahUKEwjF_57IpMTvAhW7zzgGHaqNDxAQFjAAegQIARAC&usg=AOvVaw2ZbMGR_Yxyd0MlvegqjymhI&cshid=1616429464440 (last visited 20 March, 2021)

6 McKinsey & Company (August 1, 2009) <https://www.mckinsey.com/business-functions/risk/our-insights/bad-banks-finding-the-right-exit-from-the-financial-crisis> (last visited 22 March, 2021)



that there will be a minimum price of the stressed assets and will not go below it while selling it to the bad bank, &

- **Secondly**, those stressed assets would still be included in the balance-sheet of the respective banks.

2. **Internal Re-structuring unit schemes:-** Under this scheme, bad bank is not created as a separate entity instead an internal unit from within the institution is created as a bad bank wherein all the stressed assets are offloaded to that entity. But, as the case in On- balance sheet guarantee scheme, here also the stressed assets however, showcased in the balance-sheet of the bank.
3. **Off-balance sheet special purpose entity:-** In this structured scheme, the regular bank offloads parts of its stressed assets to a special purpose entity which is a public-sponsored body and it results as ultimate removal of all the stressed assets from the balance-sheet of the regular bank.
4. **Bad Bank Spin-off:-** This scheme is the one which usually referred as Good Bank-Bad Bank Scheme wherein Bad Bank is created as a separate legal entity and the regular bank transfers all its stressed assets to the bad bank with the purpose of clearing their bad loans. And as a result, it removes all the stressed assets from the balance-sheets of the regular bank then it is regarded as a good bank⁷.

II. INDIAN PERSPECTIVE

A. IMPACT OF PANDEMIC: NEW ISSUES

The Indian economy has been reeling under the stress of non-performing loans for quite some time now, and the government and the **Reserve Bank of India (RBI)** have, over time, introduced several measures to contain the rising growth of stressed assets.⁸ Even before the pandemic started, the situation was slowly moving towards crisis but the virus made the situation worse. After the speech by Finance Minister during presentation of Union Budget, the term 'Bad Bank' came into limelight & has been thought as a viable solution for the NPA.

⁷ McKinsey & Company (August 1, 2009) <https://www.mckinsey.com/business-functions/risk/our-insights/bad-banks-finding-the-right-exit-from-the-financial-crisis> (last visited 14 March, 2021)

⁸ Bijou George, Suvashree Ghosh, and Rahul Satija, How India finally got around to starting a 'Bad Bank' (February 04, 2021) <https://www.bloomberg.com/news/articles/2021-02-04/how->

[india-finally-got-around-to-starting-a-bad- bank-quicktake](#) (last visited March 03, 2021)



Acc. To the data, Indian economy suffered 23.9 % contraction in the April – June quarter during pandemic⁹. The Indian Economy after facing numerous lows is fighting back. The International Monetary Fund (IMF) has projected 11.5% growth this year¹⁰.

The constantly increasing amount of non-performing assets or NPAs i.e., bad loans is a key challenge faced by the finance ministry over the years. The gross NPA ration may reach 13.5% in September 2021 from 7.5% in September 2020, as submitted by RBI in its Financial Stability Report¹¹.

Due to the pandemic clubbed with the persistent economic crisis, many companies and crores of individual borrowers are unable to repay their loan leading to huge surge in NPA of banks.

B. EXPERT'S OPINION

Looking at the condition in which the Indian Economy was progressing, the Union Minister Piyush Goyal had in 2018 suggested the idea of 'bad banks' when he unveiled '*Project Sashakt*'¹².

During his tenure as RBI Deputy Governor, Viral Acharya had said it would be better to restrict the purpose of these asset management companies to orderly resolution of stressed assets, followed by a structured exit. Acharya, to resolve the problem of stressed assets had suggested two models. Firstly, private asset management company (PAMC), which is known to be acceptable for stressed sectors where assets are likely to have an economic value in the short run, with moderate levels of debt forgiveness. Secondly, the National Asset Management Company (NAMC), which would be required for sectors where there are two issues, such as excess capacity and economically unviable assets in the short to medium terms¹³.

C. PAST EXPERIENCE IN INDIA

India is not at all new to the idea of Bad Banks.

9 What is 'Bad Bank' and can it resolve NPA woes? (January 31, 2021) <https://timesofindia.indiatimes.com/business/india-business/why-bad-bank-could-be-a-good-move-for-an-ailing-economy/artideshow/80614795.cms> (last visited 24 Feb, 2021)

10 Latika K Jha, IMF projects 11.5% growth rate for India in 2021, only country with double digit growth (January 26, 2021) <https://theprint.in/economy/imf-projects-11-5-growth-rate-for-india-in-2021-only-country-with-double-digit-growth/592698/#:~:text=In%20its%20latest%20update%2C%20the,rate%20for%20India%20in%202021.&text=China%20is%20the%20only%20major,China%20by%205.6%20per%20cent.> (last visited 21 Feb, 2021)

- 11 Financial Stability Report, (January 2021)
https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=50949
- 12 Vasant G Hegde, Why Bad Bank is a good idea (March 05, 2021)
<https://www.deccanherald.com/opinion/in-perspective/why-bad-bank-is-a-good-idea-958218.html> (last visited 20 March, 2021)
- 13 Sunny Verma, George Mathew, Explained: The arguments for and against a bad bank (January 22, 2021) <https://indianexpress.com/article/explained/npa-bad-bank-balance-sheet-loan-rbi-shaktikanta-das-7151841/> (last visited 28 Feb, 2021)



In the year 2002, The Asset Reconstruction Companies begun to buy bad loans to clear off the balance sheets of regular banks and chased down delinquent borrowers to collect cash. At first, these were often floated by consortia of banks, with foreign investors such as Blackstone Group Inc. and Lone Star etc. But in 2015, Central Bank rules changed the previous bad loan limit which they could afford to buy.¹⁴

When the pandemic emerged in India in early 2020, the central bank allowed lenders to freeze loan repayment till Aug. 31. Jefferies estimated that borrowers accounting for 31% of outstanding loans took up the offer initially, though it was reduced to 18% by the end of June as businesses gradually reopened and soon they realized that postponing repayments could end up being costlier.

Then, the focus shifted to a one-time debt restructuring allowed by the Reserve Bank of India for borrowers that were on track to repay before the lockdown. Lenders could grant loan extensions maximum till two years with or without a freeze on repayments. They were having the time till end of the year to choose which loans to overhaul.

D. BENEFITS AND OBJECTIVES

Due to the ongoing pandemic, RBI allowed multiple relaxations to the borrowers, be it loan restructuring or an option to avail loan moratorium. But any such relaxation has not been allowed to the banks. Hence, transfer of NPA from bank's balance sheet will allow banks with much needed breathing space to function properly.

Broadly, banks would –

- Focus more on lending rather than the recovery of loan amount from defaulters.
- Have more available free capital which can be used effectively as additional provision in relation to transferred bad loans is not required to be made.
- Experience credit ratings going up.
- Experience surge in their business as every borrower, depositor and investor are willing to engage with profitable banks.

However, looking at India's past experience with bad banks, there is a feeling of skepticism. More than a decade ago, around 2004, when government funded IDBI Limited's bad bank were

¹⁴ *Supra note 1*

bought, neither did the fund realise sufficient value from it, nor did IDBI Limited's lending record improve substantially¹⁵.

But, this time the proposal for setting up the bad bank has been designed very differently, keeping in mind the past experiences as well the experiences globally. The proposal is to set up bad banks by private sector banks and state-owned banks, without any equity infusion from the government. These bad banks will be purchasing the stressed loan accounts over Rs 500 crore against issue of the security receipt to wide pool of investors, including Alternate Investment Funds (AIFs)¹⁶.

There may potentially be a sovereign guarantee to back the security receipts but that would fundamentally be to help banks meet regulatory requirements.

After understanding the proposal, there seems to many positives –

- The private banks stepping in i.e., part ownership by private banks of the bad banks seems to improve price discovery and related transparency in sale by the banks of the stressed loans.
- There will be less burden on the exchequer by only part ownership by government banks.
- Since there is a backing of sovereign guarantee, the private banks are expected to be incentivized to participate in the process to capitalize bad banks.
- The Capital pool would widen and involve market participation after allowing AIFs to invest in bad banks.
- The Credit guarantee schemes announced by the government to provide cheaper loans/credits to small businessmen i.e., micro, small and medium enterprises (MSMEs) might be complemented as the banks will be able to lend to MSMEs with increased availability of capital fund.

Across the globe, there are many successful models of bad banks present in foreign markets but its impact in the Indian market depends primarily on how it is implemented. To make sure that the proposal works effectively in the Indian market, the RBI along with the government must

¹⁵ Anish Mashruwala, Neelasha Neemani, Can 'Bad Bank' save our stressed economy? (March 13,2021)
<https://economictimes.indiatimes.com/small-biz/money/bad-bank-need-of-the-hour/articleshow/81478979.cms?from=mdr>
(last visited 13 March, 2021)

16 M Srikanth, P Saravanan, Bad Bank is actually a good idea. (February 15,2021)
<https://www.thehindubusinessline.com/opinion/bad-bank-is-actually-a-good-idea/article33841960.ece> (last visited 12 March, 2021)



make sure that there are enough checks and balances put in place - with a potential eye on improving lending behavior.

For instance, it is very important to make sure that the banks does not at any time compromise on the due diligence just because the bad bank is standing behind it. The price at which stressed assets are being transferred is also an important consideration, especially when the transferring bank is an investor in the proposed bad bank. Also, keeping in mind the experience of Germany and Sweden, expert professionals of distressed asset management must be brought in to run bad bank for it to be beneficial.

E. HOW BAD BANK MODEL OF ARC, AMC WOULD WORK TO MANAGE NPAs –

The Economic Survey in 2017 highlighted two balance sheet related problem, one being overleveraged companies & another bad-loan-encumbered banks and as a solution to both these problems suggested for establishment of Public Sector Asset Rehabilitation Agency (PARA).¹⁷ Now, in 2021 after the Financial Stability Report was published by RBI in January which predicted a likely surge in Non-Performing Assets (NPA) post COVID-19, the government in the budget announced the creation of Asset Reconstruction Company (ARC) & Asset Management Company (AMC) to tackle this issue. Now let's understand the finer details.

We need to understand the fact that NPA is not a standalone problem, but rather a two-fold issue. It includes both the stock at any given time, that is called gross NPA, and the other fold is accretion i.e., every year new NPA is created.

Gross NPA is around Rs 9 lakh crore as of March 2020 and everybody is rightly bothered. But does anybody examine the number and see that the addition in the last three years is a whopping around Rs 13 lakh crore and the actual reduction (excluding write off) is within Rs 5 lakh crore only¹⁸.

Therefore, the issue which should bother the policy makers is not only about how to manage outstanding NPA but also how fresh NPA accretion can be reduced, so that there is actual decline in NPAs.

¹⁷ The Economic Survey of India ,2016-17

¹⁸ Har Hara Mishra, How bad bank model of ARC, AMC would work to manage NPAs

(March 08,2021)<https://www.businesstoday.in/opinion/columns/how-bad-bank-model-of-arc-amc-would-work-to-manage-npas/story/433303.html> (last visited 19 march, 2021)



Now, it can be hoped that by the establishment of new Development Finance Institution (DFI) which is supposed to help the commercial banks get away from infra funding which is a potential NPA generating areas because of ALM mismatch and different parameters for lending.

Now on the present ARC, AMC construct part. The truth of the matter is that there is not much data or detail available in the public domain except for the pronouncements made in Union budget and few press meets. Therefore, it would be really great to seek feedback from the stakeholders.

The existing ARCs need to be a part of the consultative process around the construct¹⁹.

The success of Bad bank in few nations is due to active government involvement. But the main difference is that like India, no nation had already existing ARC-like structure. So, after 28 already existing ARCs, it needs a proper analysis and reading to start a new one.

One of the main issues is to resolve the assets. Entry gates are wide open with active government backing, but what about the exit? The resolution framework remains the same. When four out of five cases referred under IBC head for liquidation with an average 5% recovery in liquidation cases, and 4% in DRT recovery, as per the latest RBI data, it is time to introspect.²⁰

Now, the key issue which comes up is that why the investors or buyers are not interested? The framework around IBC and DRTs should be fortified for ideal outcomes. Simply making a mega NPA corporation to secure NPAs from banks at a value gainful to them may be a pain killer, not the cure.

The proposed two-level ARC, AMC system, apparently made considering both public and private sector for the separate entities, may make a larger number of issues than they serve. While one gains at a value, the other needs to organize a purchaser at a cost in addition to be commercially viable.

III. CONCLUSION

In this paper, we discussed the challenges faced by the banking sector of our nation during COVID-19 pandemic. Even before the pandemic had started, our economy was in a stressful situation but the crisis made it worse. The issue of surge in Non-performing assets i.e., NPA

¹⁹ Abhijeet Chandra, Mehak Khanna, How to make good assets with a 'Bad Bank' (March 16,2021)

<https://www.thehindubusinessline.com/opinion/how-to-make-good-assets-with-a-bad-bank/article34084967.ece>

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<https://www.rbi.org.in/scripts/PublicationsView.aspx?id=18060>

(last visited 20 march, 2021)



have been in consideration for a considerable amount of time but any suitable solution has yet not been found for this issue.

It is primarily due to the issue raised by RBI in its report published in January 2021 that the projected NPA is unreasonably high, in response to which the government in Union budget announced for the formation of Asset Reconstruction company (ARC) and Asset management Company (AMC).

Once the bad loans are transferred to bad banks, it would clear the balance sheet of the banks, and the banks would attract more investors and borrowers in their profitable set up. But looking at India's past experience with ARC, it can be truly said that we as a nation require a well formulated business model to make sure that it is beneficial for all the stakeholders. It needs to be taken care of that as much as the procurement of NPA by bad banks is essential for the healthy banking sector, the investor's interest in Bad banks is also required for a proper way of functioning.

