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# Deconstructing The Notion Of Bad Bank: Construing The Indian Perspective

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## Abstract

Banks and financial institutions play a significant role in accepting deposits from the public and lending loans. For banks, loans are assets since they generate periodic income in the form of interest payments from customers. When, however, such assets stop producing profit and earnings, it becomes non-performing assets (NPAs). As per the norms of the Reserve Bank of India (RBI), when an interest or principal payment is overdue for more than 90 days, it is usually referred to as NPAs. NPAs have always represented a significant concern in India. To deal with the growing menace of NPAs in India, various legislative and regulatory measures have been taken, including the establishment of Debt Recovery Tribunals, or the creation of Asset Reconstruction Companies (ARCs) etc. However, these measures did not succeed in resolving the issue of mounting number of NPAs. In order to address this problem, the Indian government established a bad bank which essentially is an Asset Reconstruction Company (ARC) known as the National Asset Reconstruction Company Limited (NARCL), the bad bank would purchase bad loans from the commercial banks at a discounted rate and will attempt to recover the debt from the defaulters by providing a systematic solution over a period of time. The unique feature of this bad bank is that a government-backed guarantee is provided, which may be used by NARCL to cover the difference between the face value of the security receipt and its actual value. In order to give an insight into the benefits and challenges associated with the creation of bad bank, this study attempts to analyse it from an Indian perspective with a view to generate a better understanding of its advantages and challenges.

**Keywords**: Bad Bank, Non-Performing Asset, Asset Reconstruction Companies, Security Receipt.

## Introduction

An efficient banking sector is necessary for a robust financial ecosystem. In contrast, non-performing assets (NPAs) pose a serious threat to the smooth operation of the banking sector. Consequently, credit defaults are likely to be high when NPAs are high, and the lending system as a whole will be less efficient and effective. In turn, this negatively impacts the economy's growth as well. Further, the Reserve Bank of India (RBI) reported in its 24th Financial Stability Report (FSR) that "the gross NPAs of banks may increase from 6.9% in September 2021 to 8.1% by September 2022" As part of the legislative effort to combat NPAs, the legislature has constantly introduced new legislations such as the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI) the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) and the Insolvency & Bankruptcy Code, 2016 (IBC). However, these legislations have not been able to ensure timely debt recovery, despite making promising advancements in reducing NPAs in India. Likewise, the establishment of Asset Reconstruction Companies (ARCs) was a major development in this regard. However, this step was impeded by a lack of capital investment, significant regulatory interference, insufficient government funding, and the private nature of the management of these companies, thereby preventing it from achieving success.

To restore the banking sector, and thus the economy, the clearing of the NPAs pile is an urgent imperative. Nonetheless, one must keep in mind that the clean-up is only the beginning of a process that will ultimately bring about the revival of the banking system. Following this, there needs to be comprehensive reforms in the banking sector that address the systemic weaknesses in the system. This requirement eventually led the Indian Bank Association (IBA) to submit a proposal in 2020 to the Ministry of Finance and the RBI for the establishment of a bad bank in India to deal with the stressed and sticky assets of the banks and clean their books.

## Objectives of the Study

In light of the above background following are the objectives of the study:

1. To analyse the concept of bad bank.

2. To understand the advantages and benefits of establishment of bad bank for the resolution of NPAs in India.

3. To study the challenges and obstacles of the creation of bad bank in India.

Research Questions of the Study

Following are the research questions of the study:

1. Whether the bad bank can help the Indian banking sector in reducing the stressed assets?

2. What mechanism will be implemented by the bad bank in order to address the issue of NPAs?

3. What are the challenges and hurdles which can affect the effectiveness and working of the bad bank in India?

Deconstructing the notion of bad bank in India

Garima Goswami

Bad banks are those banks that buy distressed assets from existing banks with the intention of recuperating and realising them. Establishing these specialised institutions is aimed at freeing existing banks from NPAs. “A bad bank may be controlled by the government, but other private investors may also invest in its equity. Loans can be raised through other participants. Bad banks are managed by professionals experienced in managing stressed assets and these transactions occur at arm's length.” According to layman's terms, a bad bank is an ARC or an Asset Management Company (AMC) which takes over the bad loans of commercial banks, manages them, and ultimately recovers them over a period of time. In her budget speech, the Union Finance Minister stated that an ARC and an AMC would be set up to deal with the bad loans of public sector banks.

To address the challenges faced by the Indian banking sector in relation to NPAs , as part of the government's initiative, a committee was established in 2018 that was created to look into the establishment of ARCs and AMCs. The government, under the chairmanship of Sunil Mehta who was then the Non-Executive Chairman of the Punjab National Bank, had set up a committee to explore the possibility of setting up Asset Reconstruction and Asset Management Companies in order to address the issue of NPAs in India. In order to assist with the consolidation of stressed assets, Mehta committee recommended for the initiation of project Sashakt. It was recommended by the committee that formula of five factors would be used to address the menace NPAs. While the committee did recommend setting up a mechanism to reduce NPAs, most notably by setting up an ARC, an AMC, and Alternative Investment Funds, it did not explicitly recommend the establishment of bad banks in India. Further, the IBA had recommended in 2020, that there should be a creation of bad bank in India to deal with the issue of NPAs to the Ministry of Finance and the RBI.

Afterwards, the government announced in September 2021 the establishment of National Asset Reconstruction Company Limited (NARCL). This company will be responsible for consolidating stressed assets in order to resolve them. The NARCL will be primarily owned by the public sector banks. This means that public sector banks are expected to maintain 51% of the interest in NARCL. Further, in phases, NARCL intends to acquire stressed assets to the tune of two lakh crore. Specifically, NARCL has further agreed to pay 15% upfront cash and the remaining 85% through government-guaranteed security receipts for the bad assets, thus obtaining the bad assets. There is also another entity, known as India Debt Resolution Company Limited (IDRCL), which has been set up to look for the market for distressed assets and sell them. Public sector banks and public financial institutions will hold a maximum of 49 percent of IDRCL's share capital while 51% of the capital of IDRCL will be held by private sector lenders. It will be important to note that the “Debt Management Agreement” between NARCL and IDRCL will have an exclusive nature. This will be outlined in the agreement to be executed between the two entities. The agreement will be on a Principal-Agent basis, whereby NARCL will act as a principal and will be responsible for final approvals and resolutions. As a result, NARCL-IDRCL would operate as a new bad bank. It is for this reason; the government has approved the use of Rs 30,600 crore as a guarantee in relation to the security receipts issued by the NARCL. If the face value of the security receipt is less than the actual realisation value of the asset from the sale or liquidation, this government guarantee will cover the difference. Moreover, this government guarantee shall be valid for a period of five years.

With regard to the process, in the event that the lead bank receives an offer from NARCL, it will then embark on a Swiss challenge wherein other ARCs will be invited to improve the offer and, in this way, discover a higher value for the NPAs. As mentioned earlier, the acquisition of stressed asset by NARCL shall be done in a phased manner, in the first phase, there are 22 fully provisioned assets with an aggregate value of Rs 90,000 crores which has been identified for transfer to NARCL. NARCL and IDRCL will work together in a cooperative structure where NARCL will acquire stressed assets and IDRCL will be responsible for their management and value addition.

There are several advantages to the NARCL and IDRCL model, among which are: a majority of NARCL's initial capital base is owned by public sector banks. The private sector banks and non-banking financial companies will retain a majority stake in IDRCL while public sector banks are to retain the remaining shareholding. As a result, the government's financial resources will not be stretched. Moreover, IDRCL in its capacity as a service entity would engage professionals and turnaround experts, the company will ensure that stressed assets are better managed and resolved by the professionals who will handle bad assets in a timely and professional manner and thereby increasing the likelihood of a successful recovery. Another significant feature of this model is a government guarantee. NARCL is expected to issue security receipts backed by a guarantee from the government up to the amount of Rs 30,600 crores. Further, the guarantee would remain valid for a period of five years. The government guarantee may be invoked if there is a loss which is greater than the security receipt threshold. Also, the government support in the form of government guarantee would certainly contribute in improving liquidity and tradability of the security receipts, thereby helping to develop a secondary market for them and, in turn, helping to improve the gains of the market. In addition to the structure, ownership pattern, and with the government guarantee backing the security receipts, it is expected that the security receipts will gain credence.

As already mentioned, as a first step, NARCL will acquire stressed assets of approximately two lakh crores in phases, starting with Rs 90,000 crores in bad loans. Additionally, up to 15% of the agreed value for the NPAs will be paid to public sector banks in cash, while the remaining 85% will be transferred to public sector banks as security receipts. By implementing this mechanism, the balance sheets of banks will be strengthened immediately following a recovery. In addition, the NARCL may contribute to faster resolution of overall stress assets by concentrating on legacy large value accounts with a value greater than Rs 500 crores. In furtherance to this, it is to be noted that under the current mechanism, NARCL is obligated to use the Swiss challenge method to choose the best offer for stressed assets. In the Swiss challenge method, the existing ARCs registered with the RBI under section 3 of the SARFAESI will be asked to participate and develop a better offer for stressed assets under consideration. Therefore, NARCL will not serve as a replacement for or competitor in the market of stressed assets for ARCs, but rather it would work as a complementary player. Therefore, it will reduce the amount of time required for aggregating bad loans, as well as preventing inter-lender disputes. It is to be noted that under the current framework for the existing ARCs, since mostly they are a private company, they primarily raise funds from qualified institutional buyers by taking possession and selling secured debt. ARCs under the regulatory framework of SARFAESI have become significant market participants by allowing secured creditors to realise long-term assets, addressing the issue of liquidity, and recovering dues that have remained unpaid without the interference of a court or tribunal. However, in spite of having entered the Indian market many years ago, ARCs are still facing significant number of challenges to be able to perform its functions effectively. ARCs are finding it more difficult to acquire assets due to the norms of the RBI which mandate 15 percent cash payment and raising the capital from Rs 2 crores to 100 crores. There are a number of other challenges that the ARCs in India face such as a lack of capital, difficulties in acquiring NPAs from banks due to mismatch in pricing between ARCs and banks, problems in selling NPAs in the market, etc. As a result of these factors, the Indian ARCs have not been able to become an important means of resolving the issue of NPAs in India.

The benefits of the proposed bad bank in India should not overshadow the concerns and challenges it may face in the future, as fears have already been raised that the NARCL may merely become a storehouse for stressed assets. In addition, the public sector banks will be both shareholders and customers of the bad bank- which leads to the potential for the bad bank to serve only as a means to shift some bad debt from one book to another. Another aspect is in relation to the valuation of NPAs, which is not being done by the public sector banks in most instances through the adoption of independent valuation processes. Therefore, the issue of transparency regarding the valuation of NPAs continues to be raised. In furtherance to this, the most crucial factor when determining what assets should be transferred to the bad bank is how banks will determine the valuation for the transfer of the assets.

Further, most of the NPAs have been fully provisioned for by the bank, or have been written down from the books. consequently, the banks may feel that the chances of a recovery for the banks are slim to none. Another issue, which may arise, is the sale of stressed assets to potential buyers since there have already been ARCs in the system that have not proven effective; therefore, investors may not be interested in the idea of bad bank. Also, it is still an issue of highly influential importance to finance the bad bank. This is primarily due to the fact that the costs of setting up a centralised bad bank are borne by resource-constrained governments and ultimately by taxpayers. Interestingly, creating a bad bank, according to Raghuram Rajan, a former Governor of the RBI, may also create moral hazard issues that would allow banks to engage in reckless lending practices, which could further worsen the problem.

## Conclusion

At this point in time, creating a bad bank may be beneficial in reducing banking stress and reviving the credit cycle. For a commercial bank with high levels of NPAs, establishment of a bad bank shall be beneficial. As a result, such a bank will be able to quickly eliminate all of its fatal assets, which were eroding its earnings. Once the bank receives the recovery money, it will further strengthen the position of the bank. The bank can begin lending again after receiving the recovery money. However, in terms of the perspective of the tax payer and the government, the situation is somewhat more complicated. Ultimately it is the taxpayer who is responsible for spending the funds, whether this money is used to recapitalise public sector banks that have failed to make good on bad loans or guarantee security receipts. Nonetheless, it is important to note that solely creating bad banks will not solve the issue; instead, a cooperative and logical framework must be designed to ensure the sustainability of bad banks as well as their profitability.

In connection with the establishment of a bad bank, there is no clarity regarding the measures that will be taken to facilitate debt aggregation and promote the transfer of early stage stressed assets to NARCL. Also, if we are to achieve the best results, we should adopt an incentives and sanctions strategy, which would include regulatory forbearance on early transfer to NARCL. Also, the primary as well as secondary markets for stressed assets and security receipts have to be made appealing to investors in order to enhance investors' interest in these markets, respectively. The best way for the exercise to be cost and time effective will be to continue to demonstrate commitment, employ professional staff and adhere to transparency in the operation process. In the same manner, however, care also has to be taken to prevent a relapse of existing slippages, as well as to strengthen bank balance sheets to prevent the occurrence of future stress. By supporting this plan, the government should ensure that a resolution will not be delayed due to issues related to governance, slow-moving judicial systems, ill-designed regulations, etc- these are the main issues associated with the existing ARCs.

Finally, bad bank may end up being a significant boost to the economy both on a macro and micro level. However, it should not be forgotten that bad bank certainly does not have the ability to prevent the occurrence of NPAs in the future. As a result, it is imperative that the government examine ways of reducing NPAs, which are a major contributing factor to banks' losses accumulating, and thus causing the economy to suffer. Thus, I am of the opinion that the creation of a bad bank is certainly a step in the right direction for the liberation of our economy from the burden of stressed assets. However, as stated above, with the passage of time structural reforms will need to be implemented in order to achieve an efficient process for effective and timely recovery of NPAs.

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