Bad Bank : A Good Alternative Mechanismfor Resolution of the Stressed Assets

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Abstract

A Bank is a financial institution entrusted with the responsibilities of accepting deposits, lending money and performing other related activities. The deposits received by the bank from variety of the customers are further distributed in the form of loans to the masses. If everything goes right, the repayment of the loan is regular and the loan is classified as standard asset, but in adverse situation the same asset can become a burden for the bank too wherein the repayment is not regular owing to several reasons. These assets are termed as substandard and consequently NPAs (Non-performing assets).

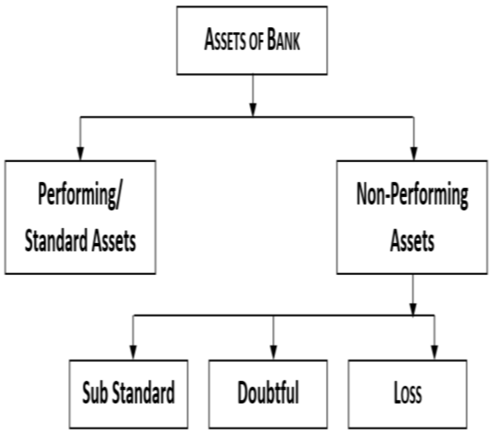
In India, the concept of bad banks has been floated by various experts from time to time but the idea got some serious implications on the govt. and RBI during the pandemic period of COVID 19. Therefore, the Union Finance Minister proposed the establishment of these new forms of banks while presenting the budget for the year 2021-22. The RBI governor has also shown his openness to this new concept for ensuring the growth and stability of the banking sector. The final decision on the structure of these banks is still awaited.

The present paper focuses on the concept of the bad banks, its origin and applications across the globe.

Keywords: *NPA, Bad bank, Financial Stability, IBA, PCR, CRAR, GDP.*

Introduction

The assets of the banks are classified as follows:



The non-performing assets of the bank are classified in the 3 categories on the basis of length of the time overdue and probability of repayment.

An asset of a bank is classified as non-performing wherein the loan payments have not been paid for a period of 90 days.

In case of CC/OD accounts: the account is treated as Non-performing if it is left out of order more than 90 days.

In case of Agricultural advance wherein the interest or principal installment remains overdue for 2 harvest seasons in case of short duration crops and 1 harvest season for long duration crops is considered as Non performing.

An asset classified as NPA for less than 12 months is considered as Substandard Asset.

An asset that is not performing for more than 12 months is termed as Doubtful Asset.

An asset in which there are no chances of repayment and is required to be written off are termed as Loss Assets.

The non-performing assets of the bank is not a new concept and has been always remained a matter of concern for all the policy makers, government and the bankers. Since Industrialization, the amount and the no. of NPAs in the financial sector has witnessed an increasing trend.

Various policy measures are adopted by RBI and the government of India from time to time to solve the problem of mounting NPAs such as SARFESI Act, IBC etc. The latest concept introduced in this direction is of Bad Banks.

Bad banks are not the banks entrusted with the responsibility of performing normal banking operations of accepting deposits and lending but these are the specialized financial institutions that will buy the toxic and non-performing assets of the bank and thus relieve their burden.The concept of Bad banks was although recommended by various experts earlier too but the concept gained utmost importance in the year 2020 when the Finance Minister gave approval to this new form of banks during budget presentation for the year 2020-21.

Objectives of the study:

- To study the concept of bad bank.
- To highlight the international perspective of the implementation of Bad bank and IBA proposed model of Bad Bank.
- To study the relevance of this concept with Indian Economy along with its advantages and hindrances in the path of the establishment of these new forms of Bad Banks.

Research Methodology

The present paper is a mix of conceptual and analytical study. The study of the concept of the bad banks and the international perspective of the same has been done on the basis of the data collected from newspapers, websites and the journals. The RBI's Report on trend and progress of banking 2019 and 2020 has been analyzed to study the NPA position and the achievements of the existing mechanisms in solving the problem of NPAs in the banks.

Concept of Bad Bank

With an objective to tackle the problem of the mounting NPA's effecting the profitability and soundness of the banking sector, a new type of bank termed as Bad Bank has been conceptualized. Bad bank refers to the special type of banks which buys the distressed assets from the existing bank for the purpose of recovery and realization. The basic purpose of setting these specialized institutions is to free the books of existing banks from NPAs. Bad banks purchase these assets at discount with the purpose of managing them for speedy recovery. The establishment of these new banks will not certainly wipe out the NPAs from the banking sector but certainly the segregation of good and bad assets will help in better management of assets and increased focus on fresh landings.

The concept of the bad bank was proposed in the Economic Survey 2017 which highlighted the establishment of Public Sector Asset Rehabilitation Agency (PARA) to tackle the problem of stressed assets. The focus of this agency is to buy the toxic NPAs from the banks for the purpose of speedy recovery and enforcement of stringent actions against the defaulters. Till now the government is toying with the idea of formation of the bad banks.

The first bad bank was established in the United States in 1980s by Mellon Bank. During 2008 crisis various countries across the globe used the concept of bad banks to tackle the problem of NPAs for example Sweden, Finland, France, Germany, Indonesia are among those few countries. The success story of the Malaysia's bad bank termed as Danaharta, can be used as a model in our country to establish bad bank.

IBA proposed model of Bad Bank.

Due to the outbreak of COVID-19, it was expected that the NPAs of the banks will increase owing to the reduced demands in the markets and failure of few businesses. Therefore, to protect the banks beforehand, IBA has made a proposal before the RBI and the ministry of finance for the establishment of Bad banks. The proposed structure is based on the recommendations of a panel headed by former PNB chairman Sunil Mehta, called 'Sashakt' two years ago. The proposed initial capital of Bad bank is Rs 1000 crore which is required to be supplied by the government.

The IBA has purposed 3 tier structures for Bad Bank comprising of:

(a) Asset reconstruction company (ARC)
(b) Asset management company (AMC)
(c) Alternate Investment Fund (AIF)

* The Asset Reconstruction Company will be backed by the Government and is entrusted with the responsibility of buying bad loans from the banks and issue Security Receipts in return.
* The ARC will hold Security receipts of 15%.
* Banks will get 15% of the cash and will hold 85% of Security Receipts. Therefore, it is termed as 15:85 structures.
* AMC would be managed by both the public and private bodies including banks as well.
* AMC will have trained professionals to support the efficient management and speedy recoveries.

* Alternate Investment Fund (AIF) to support the trading of these security receipts in the secondary market.

Need of Bad Bank in India

The study of the concept of the bad bank and its success stories in the other countries raises the questions that whether there is a need of bad bank in our country or not and why the government is reluctant to this new form of banks. In our country, as mentioned earlier various efforts have been done from time to time to reduce the adverse impact of NPAs on the profitability and the financial stability. But still the problem of NPAs persists in the economy.

Although various mechanisms are already in place to solve the problem of NPAs but the situation is still very serious and has been worsened by the outbreak of COVID 19. Following points highlights the performance of the existing mechanisms in the recoveries of the NPA and thus led to origination of Bad banks.

NPA Recoveries of all SCBS 2019-20

Amount in Rs crores

	2018-19				2019-20			
Recovery Channel	No. of Cases Referred	Amount Involved (1)	Amount Recovered (2)	(2) as % of (1)	No. of Cases Referred	Amount Involved (3)	Amount Recovered (4)	(4) as % of (3)
Lok Adalats	4087555	53484	2750	5.1	5986790	67801	4211	6.2
DRTs	51679	268413	10552	3.9	40818	245570	10018	4.1
SARFESI Act	235437	258642	38905	15.0	105523	196582	52563	26.7
IBC	1152	145457	66440	45.7	1.953	232478	105773	45.5
Total	4375823	725996	118647	16.3	6135084	742431	172565	23.2

Source: RBI Annual Report on trend and progress of Banking 2019-2020.

The increase in the % of standard assets highlights the improved performance of the banks especially the PSBs.

* NPA in the large borrower accounts (exposure of 5 crore or more) had contributed 91% of the total GNPAs in 2017-18 reduced to 82% on the 31 March, 2019.
* Recovery of the stressed assets have been improved. The Recovery though IBC accounted for more than 50% of the total amounts recovered in the year 2019.
* The recovery rates shown by all the recovery mechanisms (including Lok Adalats, DRTs, Sarfesi Act, IBC) has been declined except the Lok Adalats in the year 2019 as compared to 2018.
* Sale of stressed assets to Asset Reconstruction Companies declined as a proportion to GNPAs in the beginning of the year 2019.

Following points highlights the need and urgency to set up bad banks in the country:

* The outbreak of COVID-19 is expected to bring surge in the bad loans therefore the problem is required to be tackled beforehand.
* According to the RBI's Financial Stability Report, gross NPAs of banks may rise to 12.5 per cent by March 2021 under a baseline scenario, from 8.5 per cent in March 2020.
* The Growth in its real gross domestic product (GDP) had moderated from 7.0 per cent in 2017-18 to 6.1 per cent in 2018-19, and 4.2 per cent in 2019-20.
* The capital to risk-weighted assets ratio (CRAR) of Scheduled Commercial Banks (SCBs) edged down to 14.8 per cent in March 2020 from 15.0 per cent in September 2019.
* Bank credit was considerably weakened during the first half of 2019-2020.
* The provision coverage ratio (PCR) improved to 65.4 per cent from 61.6 per cent highlighting the adequate provisions held by

the banks to support establishments of bad banks.

* The heavy burden of the non-performing assets has adverse impact on the appetite of the banks for fresh lendings.
* The segregation of the bad and good assets fuels the growth in the economy for post COVID recovery.
* It will give competition to the private ARCs (Asset Reconstruction Companies) and will help banks to dispose off their stressed assets at competitive prices.

Advantages

The creation of the bad banks in this scenario of mounting NPAs has not only become a necessity but unavoidable according to the former RBI Governor D Subbarao. The inefficiencies of the existing legislative measures to solve the problems of the NPAs forced the policy makers and the regulators to come up with new solutions to tackle the present situation as well as to prepare beforehand for the problem which is expected to come in the coming time.

The idea of forming special type of financial institution to buy the toxic assets of the banks termed as BAD BANK is expected to bring the following Advantages:

* Segregation of good assets from the bad assets by selling the bad assets to the Bad Banks provides liquidity to the banks and better management of the good assets.
* The IBA proposed model of Bad banks emphasis on creating govt. sponsored Asset Reconstruction Companies, therefore the banks will not hesitate to sell their stressed assets to these ARCs.
* The management of the AMCs in the proposed Bad Bank structure will comprise of the well trained professionals which will contribute in the better management and realization of the assets.
* As the bad assets are disposed off through Bad Banks the entity taking a decision on the sale price will be different from the entity accepting that price. Thus conflict of interest and corruption are avoided.
* The collection of the bad assets at one place will become the one-stop-shop for the buyers of the stressed assets and will help them to find the perfect match according to their requirements.
* Bad banks will make the process of the recovery and management of the stressed assets streamlined, straight forward and centralized thus leading to better regulation.
* The creation of bad banks helps the original banks to clear their balance sheets from the toxic assets.
* The assets are sold at discount price by the banks to the bad banks but when the underlying assets are realized the value is shared in the proportion of the ownership of the banks in the ARCs thus the discount given earlier can be recovered too.
* The trust and confidence of the general public in the banking sector can be revived by the creation of bad banks.
* The creation of bad banks relieves the existing banks from the burden of fulfillment of provisioning requirements required in case of NPAs in the banks.
* Professional management of the stressed assets help to protect those firms from insolvency which otherwise be liquidated under IBC.
* The problems faced by the power sector can't be resolved by the IBC which can be resolved by the Bad Banks.
* The segregation of the assets presents a clear picture to the investors about the bank while taking investment decision.
* The creation of bad banks will free the commercial banks from investigations by the central agencies like CBI and CVC if they sell their bad loans to the bad banks.
* The creation of bad banks will bring positive impact on the liquidity position of the banks.
* The banks will be able to meet the Capital Adequacy requirements effectively.
* Redeployment of the funds received through Bad banks in the productive activities will increase through formation of Bad Bank.
* The funds of the tax payers will be saved through formation of Bad banks

Hindrances/ Challenges

The idea of the bad bank is not new but has been toyed by the RBI and the government from so many years. There are certain hindrances in the path of the formation of the bad banks which are discussed as bellow:

* Source of Fund: The main challenge in the formation of the bad banks is decision on the source of funds required for its formation. As the capital infusion only by the private sector will led toward capitalism, on the other hand govt. is already providing capital support to the respective banks so it is reluctant to infuse capital in the bad banks.
* The success of the bad banks depends on its ability to sell the stressed assets in the market, if there are no buyers in the market then it will adversely impact on the working of the Bad banks.
* The structure of Bad banks is some-what similar to the existing structure of ARCs, which warrants the formation of the similar structure for the same problem.
* In India there is no securitization market to sell NPAs therefore, bad banks just become the warehouse of the bad loans.
* The Bad bank has to face challenges in developing a sustainable and unique business model.
* The formation of bad banks may lead to banks and financial institutions to take rash decisions and undue risks.
* The proper management of the stressed assets requires the efficient management by the trained workforces, non-availability of the trained personnel's hampers the working of the bad banks.
* The determination of the prices is also a main area of concern for establishment of bad banks.
* The setting up of govt. owned ARCs will lead to conflict of interest as the public owned banks will sell their stressed assets to state owned ARCs only.
* The setting up of bad banks does not have any special tools to speed up the recovery processes as believed by few industry experts.
* The problem of fair transfer pricing warrants the formation of this new form of banks.

Conclusion

The analysis of the NPA position of the country and the expected increase due to the outbreak of COVID-19 highlighted the urgency of setting up a robust institutional framework to convert these challenges into the opportunities. The dismal performance of existing ARCs and the inadequate infrastructural support for implementation of IBC has encouraged the policy makers to revive the concept of Bad Banks in our country keeping in mind the benefits it can brought along with it and its successful application in the foreign countries like Malaysia, Sweden. The main challenge that this new structure has to face is of the source of the capital and pricing of the assets. The main fear regarding the concept is that these banks may not become just a dumping ground for stressed assets with no improvement in the amount of recoveries thereby defeating the very purpose of their formation. The outbreak of the pandemic no doubt has brought challenges but at the same time brought opportunities for the others too. The foreign countries like Canada are planning to invest in Asset management business in India to reap the advantage of buying low cost stressed assets. Responsible Ownership, Good Governance and Adequate Support from the Government and RBI are must to make the model viable, otherwise it will result in mere shifting of assets from one pocket to other.

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