Bad Bank: A strategy to get rid of risky assets in the banking sector

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Abstract

Banks are back bone to the financial economy of every country. Lending system of the banks is highly defective, beside subjective. In consonance, huge amount of loans has turned in to toxic assets. Higher NPA impact the revenue strength of the banks and also lose the confidence level of consumers and depositors, banks are back bone to the financial economy of every country. The Gross NPA exists into sector is highest for Industry and Agriculture followed by Services and Personal loans. The problem of non-performing loans continues to expand, while lending and investment continue to decline, having a negative effect on the whole economy. The corona virus epidemic has wreaked havoc on banks and financial institutions worldwide, since the global economic crisis has resulted in an increase in defaults and bad loans. At a time when the country is on the threshold to achieve the desired growth, non performing asset has also become hindrance. In order to clean up the balance sheet of the banks, the state says that Bad Bank will provide financial stability in the banking sector. This paper will make an attempt to examine the pros and cons of the bad bank.

Keywords*: Bad banks, Non-performing, Asset Quality Review, Asset Reconstruction Companies.*

1. Introduction

Risk is present in all businesses, but particularly so in banking. Indian banks' stressed assets have been increasing as a result of a plethora of reasons, including a continuous global economic slowdown aggravated by Covid-19, stalled infrastructure projects accompanied by cost overruns, excessive delays in gaining various approvals, and land acquisition issues. The banking industry has undergone a sea of change after the first phase of economic liberalization in 1991. 14 nationalized banks in 1969, and 6 banks taken over in 1980, coupled with merger and privatization of some banks and radical reformation in the banking sector have become un common.

Back then, banks focused more on results, like expanding their branch networks, helping rural areas advance, lending to key sectors, creating more jobs, and prioritising the needs of minorities and the poor. For a long time, credit management and asset quality were not high on the agenda in India's banking sector because the primary job of banks remained on extending loans to diverse sectors including agriculture, industry, personal loans, housing loans, education loans, and such other loans. Banks have tightened their lending standards and been more cautious when making loans, but they have also failed to fully appreciate the credit risk inherent in lending, which has led to a buildup of bad debt. Non-Performing Assets are another name for this (NPAs).

Rising nonperforming assets (NPAs) have been a trend in the banking industry over the past few years. The regulatory organisations have been taking a number of steps to curb the growth of NPAs, with help from comments and recommendations made to them. None of these attempts have provided the banking industry with useful outcomes. The mounting nonperforming assets are having a negative effect on profits and pose a danger to the long-term viability of banks. To better track and manage the rising NPAs, the government has proposed combining the banks. Banking is especially vulnerable to the risks that plague other industries. There are a number of factors contributing to the rise in Indian banks' stressed assets, including the ongoing global economic slowdown exacerbated by Covid-19, the suspension of infrastructure projects due to cost overruns and prolonged delays in obtaining necessary permits and approvals, and problems with acquiring necessary land parcels.

Since banks are the backbone of every country's financial sector, a rise in nonperforming assets (NPA) has a negative effect on the banks' revenue strength and can reduce the confidence of customers and depositors. In addition to cutting into the bank's earnings, non-performing assets contribute to the loss the institution incurs. Another factor affecting a bank's bottom line is its provision for nonperforming assets, which typically ranges from 25% to 30%. Not only did several manufacturers disappear, but they also stopped making their monthly interest and principal payments to the banks. The least openness in the financing system is mostly to blame.

2. Need for the study:

Banks are the backbone of every country's financial system, thus a rise in nonperforming loans (NPA) can have a negative effect on their revenue and reduce the trust that customers and depositors have in them. Numerous economies' decision-making and advancement have suffered from large, unresolved NPAs. There is a growing call to relieve the banking system of non-performing assets and speed up the recovery process, as GNPAs in the Indian banking

industry have likely already surpassed INR 10 lakh crore and are expected to rise to upwards of INR 15 lakh crore in the near future. Increasing nonperforming assets (NPAs) have a negative impact on a bank's bottom line and its reputation. Unfortunately, the huge quantity of nonperforming loans at commercial banks is also endangering the capital basis of public sector banks, which accounts for roughly half of all institutions. There is a pressing need to lower the amount of bad loans held by other lenders and financial institutions in order to assist clear their books.

3. Objectives:

The objectives of the study are;

1. To analyze the reasons for sudden spike in NPAs.
2. To study and forecast the trend of GNPAs in India.
3. To examine how the Bad banks help containing NPA in the banking sector of India
4. To evaluate the status of NPA after the emergence of Bad banks
5. To suggest design and structure of Bad banks.

4. Methodology:

The present study is descriptive where analysis has performed using secondary data. The data is collected from the Reserve Bank of India (RBI) website (www.rbi.org.in). The study has focused on Gross NPAs data of past ten years i.e., from 2010 to 2020, as these data are more realistic in defining proper picture on loss assets of banks on the one hand and liquidity and capital adequacy on the other. The different statistical tools such as mean and standard deviations have been administered for describing the data. Further, based of ten years data, the trends for future were forecasted using Time series forecasting method of SPSS 26 version.

5. Status of NPA in India;

According to the RBI's Financial Stability Report for January 2021, gross non-performing assets in banking are expected to climb from their September 2020 level of 7.5% of loans to their September 2021 level of 13.5% of advances and then to their March 2022 level of roughly 15%. Furthermore, non-bank lending companies are also facing difficulties with GNPAs. As of March 2020, GNPAs of NBFCs were 6.3% of advances, according to the RBI FSR. The RBI FSR conducted sample stress tests on 200 big NBFCs, and the results showed that under both the baseline and high-stress scenarios, the GNPAs of these institutions might increase to between 6.8% and 8.4% of advances. If we extrapolate this to all NBFCs (including HFCs), we get a GNPA estimate of between Rs. 3.5 lakh crore and Rs. 4.3 lakh crore.

Since late 2015, the RBI has formally reviewed the banks' asset quality (AQR). Since they were granted leniency in recognising GNPA on some M&S and real estate loans, they have been subjected to strict oversight from the central bank.

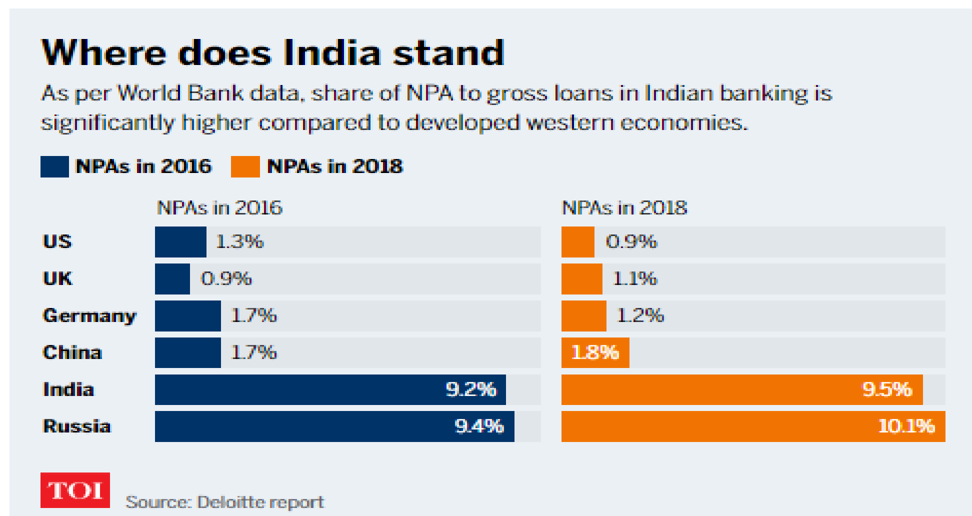
Additionally, there has not been a formal AQR for NBFCs. This includes HFCs. While the RBI's oversight and monitoring of NBFC books have increased over time, the much smaller share of GNPAs on NBFC accounts when compared to banks does raise suspicions. This casts doubt on the financial records of at least some NBFCs. The GNPA universe for the country

was estimated to be between Rs. 26.7 lakh crore and Rs. 28.8 lakh crore, or between 13.7 percent and 15.1 percent of GDP in 2020–21. (gross domestic product). Numerous financial services and the insolvency/bankruptcy ecosystem are impacted by the high numbers.

The Economic Survey recommended that banks be recapitalized and their balance sheets cleaned in order to solve this.

Comparison with global peers

As per World Bank data, share of NPA to gross loans in India is significantly higher compared to developed western economies. It also exceeds most other emerging economies.



India has been attempting to resolve its Twin Balance Sheet problem – overleveraged enterprises and bad-loan encumbered banks by implementing a variety of measures. The RBI has implemented a number of programmes in recent years to address the stressed asset problem in the banking sector. Among the most significant are Flexible Infrastructure Refinancing (5/25 scheme), Strategic Debt Restructuring (SDR), Asset Reconstruction (ARC), Sustainable Structuring of Stressed Assets (S4A), and Asset Quality Review (AQR). At first, the plans concentrated on rescheduling amortizations to provide enterprises with additional time to repay. Notwithstanding, the pressured enterprises' financial status started deteriorating and at present situation has become grim and alarming. The connivance is considered to be the prime cause for worst scenario. Decisions on how to resolve the loans concentrated in major corporations have eluded repeated reform initiatives. These decentralized strategies have not produced the desired outcomes.

The problem of non-performing loans continues to expand, while lending and investment continue to decline, having a negative effect on the whole economy. Perhaps it is time to seek a different strategy for resolving this issue on top most priority, for which Government could find Bad Bank as a solution. A Bad Bank houses Bad loans or Non-Performing Assets (NPA). In an endeavor to weed out the incessant problem of bad asset in the banking sector, the current study is of relevance as a viable approach for resolving the inferno in the banking system of the biggest democratic country in the world.

6. Measures to tackle NPAs;

In an endeavor to contain the burgeoned NPA in the Indian banking sector, there have been several steps taken by the GOI on legal, financial, policy level reforms. Narsimham committee(1991) recommended many reforms to tackle NPAs, some of them were implemented. In the last seven years, the Modi government has taken a series of measures aimed at systemic cleaning of the banking system, with a particular emphasis on recovery **.**

According to a report published in 2000 by the Credit Information Bureau (CIB), NPAs can be avoided by ensuring that loans do not end up in the wrong hands. It's useful for financial institutions since it keeps track of and distributes information about defaulters, both accidental and intentional.

In accordance with RBI regulations from that year, Lok Adalats - 2001; They deal with and recover small loans of up to Rs 5 lakh only.

For advances of less than Rs. 10 crores, the "Compromise Settlement - 2001" establishes a straightforward method for recouping nonperforming loans. Legal proceedings before courts or DRTs (Debt Recovery Tribunals) are included, although situations involving intentional default or fraud are not.

Since the SARFAESI Act of 2002 was updated, the RBI has licensed 14 new asset reconstruction companies (ARCs). These businesses are formed to recover lost value in troubled debt. Restructuring corporate debt in 2005 means negotiating new terms with creditors, such as longer payment deadlines and lower interest rates.

The purpose of establishing Debt Recovery Tribunals was to speed up the resolution of disputes. For this reason, the Recovery of Debt Due to Banks and Financial Institutions Act, 1993 governs these situations. Time delays plague many legal proceedings, and many cases remain open for more than two to three years.

In spite of the above, the machineries have not contained the alarming rise of NPAs. The NPA ratio for all commercial banks declined, but stressed assets inched up. Moreover, the NPA ratio of Indian banks is the poorest among emerging economies. However, the sheer scale and complexity of legacy non-performing loans split across various lenders necessitated the development of additional clean-up methods. While many banks have their own recovery departments dedicated to distressed assets, consolidating debt in a single company with specialized expertise should expedite the process of locating possible buyers, transferring assets, and renegotiating new debt terms. Additionally, because the guarantee expires in five years, banks have a strong incentive to speed their own processes. Giving SRs to banks rather than capitalizing them upfront also avoids any immediate impact on the fiscal deficit.

7. Reasons for sudden spike in NPAs:

The corona virus epidemic has wreaked havoc on banks and financial institutions worldwide, since the global economic crisis has resulted in an increase in defaults and bad loans. The situation is especially dire for Indian banks, which are already grappling with an increase in bad loans.

While banks have reported a drop in non-performing loans in recent months, there is a strong chance that forbearance on asset classification is hiding persistently rising bad loans, according to S&P Global Ratings. The rating agency is concerned that financial institutions in India will

struggle to maintain momentum following a reduction in the number of new non-performing loans in the first half ended September 30. Additionally, it anticipates that bad loans in the Indian banking system will increase to 10-11 percent of total loans as of March 31, 22 from 8% on June 30, 2020.Additionally, the global rating agency noted in its report that Indian banks outperformed forecasts in the second quarter, but noted that this was mostly due to the six-month lending moratorium and the Supreme Court's order prohibiting banks from classifying loans as non-performing assets

It is stated that banks' non-performing assets may have increased by 10-60 basis points in the absence of the highest court's order. The Supreme Court has previously permitted banks to maintain conventional loan accounts even when borrowers defaulted. Thousands of crores worth of loans have become non-performing due to borrower default, and the number of NPAs is projected to rise further. Additionally, the global credit rating agency is pessimistic about the loan restructuring proposal. While there are other issues, such as poor corporate loan growth, the NPA problem appears to be the most serious "hidden" concern that could erupt by 2022, when loan restructuring relaxations expire. However, the government and banks in the country are confident that there are sufficient buffers in place to absorb any upcoming shock. Consequently, Spike of NPAs had to have impact as under;

Unprecedented rise in NPA lead to cripple bank's revenue stream, shrink funds in Indian markets, shareholders lose money, price of loans and interest rates shoot up badly, negative impact on the retail consumers. All these factors fracture overall demand in the Indian economy, beside lower growth and higher inflation. Realising the severity of NPA and its ill effects on the economy, the Government has found Bad Bank, as a recipe to cure the ills.

8. **Bad Bank**:

Countries like Sweden, Finland, France, Germany, Indonesia, etc., all adopted the Bad Bank model. Mellon Bank, based in Pittsburgh, was the first to implement a bad bank in 1988. After the financial crisis of 2007, numerous countries in western Europe, including Ireland, Sweden, France, etc., adopted this policy. Nirmala Sitharaman, the Union Minister of Finance, stated in her budget address that a bad bank would be established in India in light of the findings of the Indian Bankers Association.

The goal of the Bad Bank is to ensure the continued health of the banking industry. For public sector banks, it will be a repository for troubled loans that may be resold to investors at a discount. Banks will be able to clean up their books by selling off toxic assets, reducing their capital requirements for the future. Non-performing assets (NPA) losses persist notwithstanding Bad Bank architecture. Investors, taxpayers of these institutions, and the failed bank itself all need to chip in. Non-Performing Assets will be handled by the bad bank in an appropriate manner, which may involve liquidating some, restructuring others, etc.

The GNPA ratio of all SCBs is projected to increase from 8.5% in March 2020 to 12.5% in March 2021 under the base case, as shown by macro-stress tests for credit risk included in the RBI's 21st Financial Stability Report (July 2020). Assuming further deterioration of the macroeconomic situation, the percentage may reach 14.7 percent during times of great crisis.

Another INR 1.68 lakh crore in corporate stress is possible if financing markets maintain their heightened risk aversion, bringing the total amount of stressed corporate debt in India in FY21-FY22 to INR 5.89 lakh crore.

According to the agency's stress case scenario, this means that 20.8% of existing debt may become problematic.

National Asset Reconstruction Corporation Limited (NARCL) is the legal name for the institution commonly referred to as "Bad Bank." According to Nirmala Sitaraman, Indian banks have recouped loans totaling Rs5 trillion over the past six years, with 60% of that amount being recouped over the past three. The NARCL would assume troubled bank loans worth Rs200,000,000,000. The NARCL will pay 15% of the net asset value (NAV) in cash and the remaining 85% in security receipts based on an evaluation of these loans. To illustrate, if the loan's actual NAV is 50% of the loan amount, the cash amount will be 7.5% of the loan amount.

One of the biggest benefits of this method is that the central government will guarantee security receipts (SRs) up to a value of Rs30600 cr. However, the duration of this guarantee is only 5 years. Let's take a closer look at this promise of satisfaction.
Government-owned banks (PSU banks) will own 51% of the NARCL, making it an ARC officially recognised by the RBI. Up to Rs2 trillion in bank assets will be held and liquidated by it if they are in distress. There are two stipulations attached to this government guarantee;

- Firstly, it will cover the net shortfall on overall basis, i.e. after adjusting for excess recoveries and limited to Rs30600 cr.
- Secondly, government will insist on the company going for liquidation before invoking guarantee.
- These SRs will be traded in the secondary market, so there will be liquidity and price discovery. The assets move out of the books of banks and also enable them to monetize 15% of the NAV. This obviously improves their cash flows and return ratios. In addition, the 5 year limit to the government guarantee will force a rapid resolution to the stressed assets. That will also entail freeing up of time, energy and bandwidth of banking staff to focus on deposit and credit growth.

9. Results and Discussions:

Trends of GNPAs across different banks in India:

Table No. 2. **Trend Analysis of GNPAs in Banks:**

Year	Public sector bank	Private sector bank	Foreign Banks	All Scheduled Commercial Banks
2010	2.2	2.7	4.3	2.4
2011	2.2	2.2	2.5	2.3
2012	3	1.9	2.7	2.8

2013	3.6	1.8	3	3.2
2014	4.4	1.8	3.9	3.8
2015	5	2.1	3.2	4.3
2016	9.3	2.8	4.2	7.5
2017	11.7	4.1	4	9.3
2018	14.6	4.6	3.8	11.2
2019	15.1	9.4	4.6	9.1
2020	17.6	8.8	6.5	8.2
Mean	8.06	3.84	3.88	5.83
Standard deviation	5.788	2.763	1.105	3.267

Inference:
From the above table it is cleared that, the mean (average) NPAs of public sector banks are the highest at 8.06%, followed by those of foreign banks (3.88%). The NPA trends is lowest for Private banks at average of 3.84%. Private banks have the lowest average NPAs at 3.84%. The standard deviation of public sector banks is also the highest at 5.79% indicating a high variation in their NPAs over the years. The source for this data is secondary database which is collected from RBI related to NPA.

Predicted value of GNPA; Based on the above data predicted value of GNPA has been calculated to show the trend for coming years

Table No. 3: Predicted value GNPA Trends

Year	Public sector bank	Private sector bank	Foreign Banks	All Scheduled Commercial Banks
2021	19.52	10.51	5.35	8.78
2022	21.49	11.91	5.58	9.36
2023	23.47	13.30	5.81	9.94

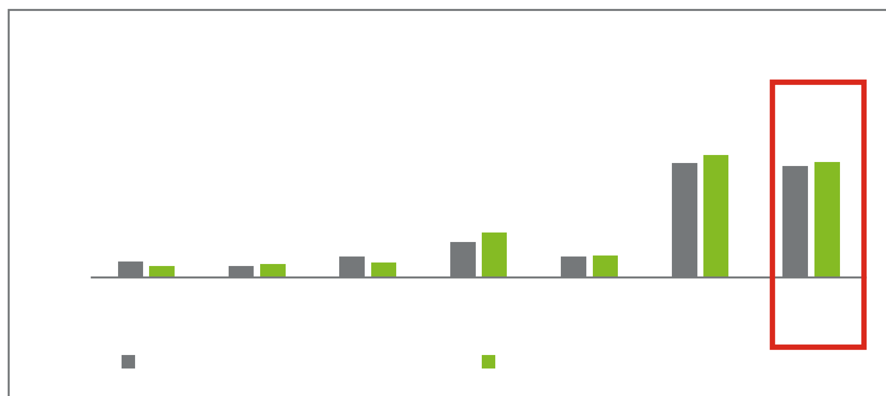
2024	25.44	14.69	6.04	10.52
2025	27.42	16.08	6.26	11.10

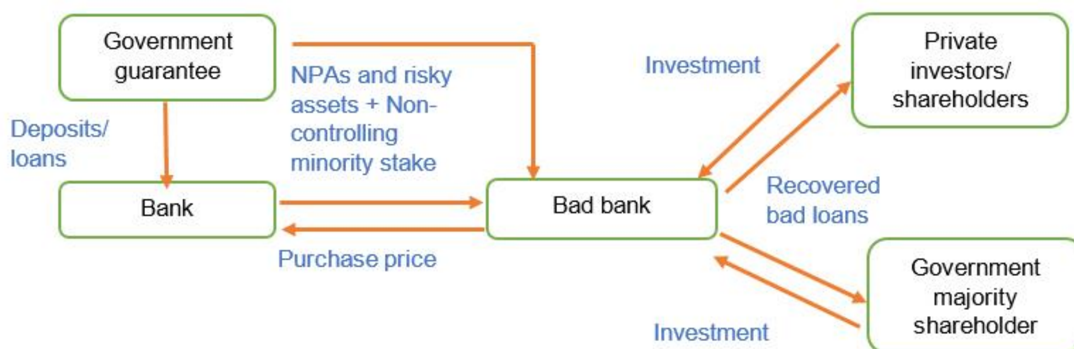
Inference: From the above table it is cleared that, the trend GNPAs of public sector banks are the highest at 27.42 by 2025, followed by those Private banks 16.08 which shows increase in GNPA.

Global Context

According to World Bank data, India's banking sector's NPA to gross loans ratio is substantially greater than that of rich western economies and also exceeds that of the majority of emerging economies, with the exception of the Russian Federation.

Large unresolved NPAs have historically been detrimental to policymaking and economic progress in a number of economies.





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The government guarantee will cover the difference between the asset's face value and its actual realized value, guaranteeing that banks do not lose money on distressed asset transactions and also assisting banks in cleaning up their balance books.

The finance minister shared details of the government's latest reform attempt to clean up the banking system, noting that banks have already recovered Rs 5,01,479 crore over the last six years. Since March 2018, Rs 3.1 lakh crore has been recovered.
Along with the National Asset Reconstruction Company, Sitharaman stated the government is establishing an India Debt Resolution Company. PSBs will own 51% of NARCL, while PSBs and public financial institutions will own up to 49%.
Over time, a vicious cycle has developed in the Indian banking sector: growing NPA levels necessitate increased provisioning, which results in decreased capital adequacy and depressed profitability. Additionally, this results in subdued expansion in lending capacity, which results in an increase in non-performing loans. Additionally, banks must invest in capacity building and re-skilling their own staff in areas such as loan recovery, risk management, and so on, in order to stay ahead of the learning curve.
While the government is eager to privatize public sector enterprises, this could result in a sell-off at unappealing valuations. In this circumstance, a bad bank appears to be the best option available. If the bad bank is built properly, it may address both India's twin balance sheet and capital adequacy concerns.
To ensure the success of a bad bank, the valuation of non-performing assets should be conducted by recognized, professional, and independent institutions. However, establishing the bad bank will not be straightforward, given the government of India's off-balance-sheet exposure and other legal obstacles.

10.Observation and Suggestions

- NPAs in India have reached an alarming level, owing to both short- and long-term concerns, as well as the regulators' and ruling governments' rigorous provisioning rules and norms.
- Inadequate credit risk management, a lack of transparency in operations, a lack of a democratic climate in the banking industry, and some indiscriminate lending have all contributed to the NPA pile. Significant provisions for write-offs, including unhealthy
- Provisions for prudential write-offs and IBC haircuts implemented during the last four years have exacerbated the problem.
- Generally, it is PSU banks that bear the brunt of such provisions.
- Smaller banks have also suffered as a result of their participation in smaller consortiums and a lack of loan diversification.

  To maintain a sustainable lending environment in the future, the Government must act quickly to resolve the NPA issue, impose accountability on lenders, and enact measures to prevent a repeat of the bad loan cycle.
- Banks are specialized in lending but not in resolving massive stressed assets; they lack both the necessary legal competence and a supportive climate for NPA recovery.
- The government may establish a bad bank with a predetermined capital base. The equity injection could be funded through subscriptions to Government of India re-capitalization bonds.
- Banks/NBFCs may acquire tranches of problematic loans. Assuming that the average fair value of transferred loans is 40% of the book value, Bank might acquire up to 2.5 times the value of gross non-performing loans from problematic lenders.

- By moving such assets to the Bad bank, the original institution's balance sheet may be cleared, though it would still be required to take write-downs.
- To safeguard taxpayers' interests and reestablish trust, this transfer would have to be made at fair market values, i.e., at a reduction to book value, as validated by Government-appointed independent valuers.
- If Bad Bank recovers more than the amount paid for acquired non-performing loans, it may be obligated to share a portion of the surplus with the transferring institutions. Bank would be solely liable for any recovery below such reasonable value.

11.Conclusion:

NPAs in India have reached an alarming level, owing to both short- and long-term concerns, as well as the regulators' and ruling governments' rigorous provisioning rules and norms. Inadequate credit risk management, a lack of transparency in operations, a lack of a democratic climate in the banking industry, and some indiscriminate lending have all contributed to the NPA pile.

Bad bank will be government-owned, it will be superior to existing Asset Reconstruction Companies. Once NPAs are transferred to the bad bank, PSBs are relieved of the requirement to increase provisioning and are better positioned to raise capital from the market. Due to the sharp increase in discount rates from 30% to 60% of the book value of bad loans as a result of the legal requirement for ARCs to pay 15% upfront cash, the timing of bad bank is right.

Banks in India have been extremely hesitant to sell assets to existing ARCs, as neither the ARCs nor the banks were willing to incur the losses, prolonging the recovery process.

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