

## Bad Bank- a Workable Superstructure on an unworkable infrastructure?

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Nirmala Sitharaman, the Finance Minister of India presented the 2020-21 Budget on February 1, 2021. One of the proposals was the set up of two entities- an Asset Reconstruction Company Limited (hereinafter ARC) and an Asset Management Company (hereinafter AMC). The [objective](#) of the two entities is to take over the bad/stressed loans and then manage and dispose of the assets and value realization of the same. The two entities taken together are what is called a 'bad bank'.

Section I discusses what are NPAs and what are the factors which have led to the high level of NPAs in the economy. Section II discusses the idea of a bad bank. Section III discusses why bad bank is not a viable option for India. Lastly, Section IV discusses the measures which can be taken to resolve the NPAs instead of setting up a bad bank.

### I. What are NPAs?

Non-Performing Assets (NPAs) are the loans given by the banks which have stopped generating any income for the bank i.e., they have stopped performing. A loan [becomes](#) an NPA on the balance sheet when the principal or interest payment remained overdue for a period of 90 days.

NPAs reflect the financial growth of a country's banking system and thus, the economic conditions of the country. India's NPA ratio [was](#) 7.5% as of September 2020; however, the pandemic has hit the banking sector hard, leading to an estimation of NPAs to be as high as 14.8% in by September 2021. Even before the pandemic, the amount of bad loans in Indian banks was as high as [9.1%](#) in September 2019; the COVID19 pandemic has only increased the same as the economic activity plummeted for one year in the whole country. The situation doesn't seem to be improving as India is witnessing an increasing number of cases yet again.

### Reasons for India's rising NPAs

There are a number of reasons for India's rising NPAs, the main being the lack of acknowledgment of the problem. Banks choose not to recognize the problem of their rising NPAs and continue to live in denial rather than facing the consequences. NPAs make the Balance Sheet heavy with loans which are not going to perform. With the hope of reviving the business of the borrower, banks lend further loans to the investors to invest in the business in addition to paying back the old loans. This practice of issuing new loans to pay back older loans is called ever-greening. It may work in some cases but mostly it doesn't. It leads to further loans which will not be paid back by the investors. Ever-greening also prevents economic growth as the funds continue to be invested in businesses which are likely to fail leading to a dearth of funds for potentially good projects that the bank could have funded. In such cases, there is a need for the bank to have a competent management with foresight which can analyse the growth potential of the concerned business and accordingly take a decision to provide further loans or not.

Another lacuna in dealing with NPAs is the lack of provisions. Provisioning is the practice which involves setting aside a part of the profit to deal with bad loans.[\[1\]](#) In case the concerned loan turns

bad, the bank can simply deduct it from the provision and avoid sudden losses in the concerned financial period.<sup>[2]</sup> In case the loan doesn't turn bad, it can add the provision to the profits of that financial period. Banks tend to avoid provisioning as it reduces the profits for the time-being. What they don't realise is that losses will likely incur in the future nonetheless so it is better to be prepared for it rather than showing a false, healthy image of the bank in the balance sheet while in reality, the bank's capital is lesser than what is shown. The earlier the bank realises there is a problem, the sooner it can solve it. It will also help in long-term growth of the banks.

There are some factors, specific to the Indian context, which increase the possibility of the failure of a business resulting in the debtor's inability to pay back the loans. These [include](#) high interest rates, inefficient banking system, unhealthy lending practices and lack of enforceability of various corporate laws.

But given the inevitable possibility of losses, optimal amount of NPAs (around 4%) is [healthy](#), as they signify that enough of people are taking risks and a few of them are failing. But when NPAs mount up, they become a problem for the economy. First, they harm the balance sheet of the lending institutions and decrease their lending capacity. Second, they detrimentally impact the economy and its perception, thereby reducing investor confidence.

Numerous solutions have been offered by economists to solve India's NPA crisis. One solution which has been recurring is the set-up of a bad bank.

## II. What is a Bad Bank?

A bad bank is an entity which buys bad loans from public and private sector banks.<sup>[3]</sup> The NPAs are taken off the balance sheets of the banks and resolved and managed by the bad bank.<sup>[4]</sup> The bad bank buys the NPAs at a discounted rate. For instance, an NPA is worth Rs. 100 so the bad bank will buy the loan at a discounted rate of 60%. A series of negotiations takes place between the bad bank and the concerned bank wherein the bad bank attempts to buy the loan at a lower rate and the bank tries to sell it at a higher rate.<sup>[5]</sup> Thus, a pricing is one of the major issues when it comes to the setting up of a bad bank.

In the Budget 2021-22, a concrete idea of a bad bank for India was [introduced](#) by setting up two entities - the ARC and the AMC. While the details about ownership, control and mechanics are yet to be declared by the government, it is reported that the majority stake in the ARC will be held by the public sector and the majority stake in the AMC will be held by the private sector. This is because the private sector will better be able to manage the assets given their better skills, expertise and knowledge.

## III. Bad Bank- Not a viable solution for India

The idea of bad bank looks interesting at a first glance, however, as Raghuram Rajan [says](#) "the devil is in the details."

The primary objective of every business is profit maximisation. However, every investment has the obvious downside of possibility of losses. Given the inherent nature of any business, creditors stand on a disadvantaged footing because they lend out to the business and are vulnerable to losing out on the money, in case the business fails.

From the independence up till the late 1980s, the government was reluctant to close down the sick industries, when defaulted on the loan as they wanted to safeguard the jobs of the employees. However, closer to the end of the decade, the World Bank and other international institutions [exhorted](#) the government to strengthen the insolvency laws. This was followed by concerted attempts to tackle the problem of mounting debts, defaults and insolvencies. The piecemeal attempts included enactment of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) and the enactment of Insolvency and Bankruptcy Code, 2016 (IBC), amongst others. Further, Asset Reconstruction Companies (ARCs) were constituted. There are 29 ARCs in India which have been disappointing in resolving the issue of NPAs.[\[6\]](#) The first ARC was set up in India in 2002. The concept gained further importance and concreteness after the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (the SARFAESI Act). The experience shows that all these attempts were reactive and came as an emergency response to the mounting NPAs. The establishment of bad bank in India is another addition to this list.

The failure of sick industries act due to inordinate delays and the failure of ARCs due to larger structural problems and lack of expertise[\[7\]](#) shows that India's mounting NPAs need a pro-active structural response instead of a piecemeal reaction.

Pursuant to the establishment of a bad bank, the NPAs would be transferred from the banks to the bad banks. This would definitely clean up the balance sheets of the bank but it would not solve any of the two problems caused by the mounting NPAs. First, it would not enhance the lending capacity of the bank and as former RBI governor, Raghuram Rajan [points out](#), a bad bank is a moral hazard. This is because the banks will get an opportunity to clean their balance sheets, without learning any lessons. The banks will tend to continue their incautious lending practices and become complacent as they would have the bad bank to fall back into.

Second, the NPAs will stay in the system. This becomes likely because, as of now the government does not have any road map regarding the functioning of the bad bank. Some issues which need to be addressed are- bad loans to be prioritised, the industry to be prioritised, the timeline of their sale and the action plan, if the bad bank is unable to sell off the NPAs. Given that India does not have a market for NPAs, the NPAs are [likely to just change hands](#), but they will still continue to plague the system and impact investor confidence. It has been [reported](#) that nine banks including the State Bank of India (SBI) and the Punjab National Bank (PNB) are likely to put in Rs 7,000 crores as initial capital in the bad bank of India. It should be noted that these shareholders are the banks with the maximum amount of NPAs. This essentially means that the setting up of a public ARC would merely entail transferring the NPAs from one public bank to another.

In the Indian banking landscape, policies and institutions have failed due to lack of compliance, lack of enforceability of corporate laws and poor lending practices. It is unlikely that building another super-structure with similar characteristics on the same broken infrastructure will yield results. It will rather lead to diversion of resources that could have been invested in fostering structural reforms in the banking sector. For instance, the bad banks are unlikely to attract investments from the private investors at the onset. This is because India does not have a market for NPAs and the past experience with such asset recovery and management institutions has been underwhelming. In this scenario, the government is [planning](#) to infuse an amount of 20,000 crore to set up the bad bank. It is submitted that the public resources should be allocated to fix the structural problems instead of building super structures, which are likely to collapse on a weak infrastructure of lacklustre implementation of corporate laws and excessive lending to big businesses alone.

The IBC was enacted to overcome the failures of the SICA and other preceding enactments. Experience [had shown](#) that insolvency laws were failing due to judicial over-intervention and due to the scheme of the acts, as per which management vested with the Board of Directors and not the creditors. Pursuant to these challenges, the role of judiciary was limited and the power to approve the resolution plan was left to the committee of creditors. National Company Law Tribunal (NCLT) And National Company Law Appellate Tribunal (NCLAT) had limited powers of review within the limited fold of [Section 32](#) and [Section 61\(3\)](#) of the IBC. But the NCLT and NCLAT have constantly tried to water down the provisions pertaining to limited judicial intervention and have often overturned the decision of the Creditors, whose commercial wisdom ought not be questioned as per the scheme of the IBC. The principle of the primacy of the commercial wisdom of the COC has been upheld by various courts in a line of cases including the recent case of [Kalpraj Daramshi](#). But the NCLT and NCLAT more often than not, deviate from the dictums of the Supreme Court.

Further, during the pandemic, the government suspended the code on 24<sup>th</sup> March 2020 by amending the code. Instead of a blanket suspension, the government could have raised the threshold for the applicability of the IBC to the defaulters, as [Section 4](#) vests the government to extend the threshold (which is otherwise 1 lakh), to higher amount. Raising the threshold would have ensured that lesser number of defaulters could have been subjected to CIRP. It is clear that India needs stricter enforcement of the IBC, which will be more effective in handling the NPA crisis than newer banks, to hold the NPAs in that very system itself.

In this regard, instead of setting up another debt recover institution; there is a need to focus on structural reforms.

#### **IV. What should be done instead**

Instead of setting up new institutions, there is a need to revive and manage the already existing ones. The RBI and the government have time and again implemented many laws and regulations which have been incapable of resolving the NPAs. The way to move forward is firstly, recognising the problem and secondly, finding viable and optimal solutions to solve it. The banks with the help of the government and other existing institutions should revive the projects and companies which can be revived and restructure the debt.

As mentioned earlier in the article, ever-greening for every business should be avoided and the management of the bank needs to deploy proper resources including money, skills and knowledge in reviewing a business and calculating the potential of revival.

Firstly, banks are more inclined towards lending out to big businesses, even when they constitute the biggest chunk of defaulters. Data [shows](#) that 73.2% of the total loans are advanced to the large borrowers. The retail businesses require lesser investment and thus, pose a lesser risk to banks in terms of defaulting. Further, the return rates from retail businesses are higher, as compared to big businesses.[\[8\]](#) Despite that, they form the bottom of the credit pyramid. This shows that there is a need to structurally change our lending policy, so that the problem of NPAs can be nipped in the bud.

Further, various experts have pointed out that interest rates in India are relatively higher, when compared with the rest of the world. Consequently, the defaults are bound to be higher.[\[9\]](#) thus, there is a need to tone down the interest rates, by infusing some capital into the banks so as to

decrease defaults, instead of diverting the valuable public resources in setting up another institution which will just add up to the multiplicity of authorities and sunk cost.

Secondly, there is a need to ensure better enforcement of corporate laws. For instance, South Korea had also set up KAMCO (Korea Asset Management Corporation), on the lines of a bad bank. The experiment was successful in South Korea due to accompanying factors like strict enforcement of corporate laws, better coordination of government departments and requisite inputs from experts.<sup>[10]</sup> These material factors are missing in India and unless these structural reforms are undertaken, establishment of new institutions would not help.

### **IBC Channel**

The IBC requires a Corporate Insolvency Resolution Process (CIRP) which allow the company to come out of the state of insolvency. The CIRP is to be completed in 180 days, which can be extended by another 90 days to a maximum of 270 days. CIRP under IBC can be initiated even if default is wilful, i.e. when the borrower has the capacity to pay but chooses not to. Therefore, under IBC, the focal point is “default” of a payment obligation.

According to the Economic Survey 2020-21, recovery of NPAs was the highest under the IBC as compared to other debt recovery methods. While IBC is a sound channel to solve the NPAs, it has its own shortcomings. There is judicial delay, lack/absence of feasible resolution plans and lack of capacity i.e., lack of National Company Law Tribunal (NCLT) benches. However, these are procedural and structural issues which can be resolved, for instance, by setting up of more NCLT benches.

A way to solve the problem without overwhelming NCLT is to set up a functional out-of-court restructuring process, which can be tried without taking the matter to the NCLT. The NCLT should be used as a last resort. This will solve the problem of judicial delay and will also protect the stakeholders from eyes of the investigative authorities.<sup>[11]</sup>

Instead of attempting to recover the debt closer the death of the corporate, a compliance officer ought to be appointed to ensure due diligence before lending out. The banking policies ought to be re-shaped on the tenant of prevention before cure and such a policy switch will be more fruitful than investing in bad banks, which do not have the capacity to reform the system radically.

### **V. Conclusion**

The problem of NPAs has been a long standing challenge for the banking sector due to various factors *inter alia*, bad lending practices and blatant denial of the problem. These NPAs are a challenge for all the stakeholders including the lenders and the borrowers, as they reduce investor confidence and detrimentally impact the lending capacity of the lenders. The governments have been trying to find the remedy to the problem of bad loans through enacting legislations and setting up institutions. But none of these attempts has shown substantial results.

The idea of a bad bank, which took the most concrete shape and form, in so far as India is concerned, is another such institution that is purportedly being set up to solve the problem of NPAs. However, the authors through the means of this paper submit that establishing a bad bank on a weak infrastructure of inefficient banking system, unequipped banking staff, unawareness

regarding health lending practices and lacklustre implementation of corporate laws cannot solve the problem. There is a need to bring in structural and fundamental reforms, so as to ensure that the problem of NPAs is nipped in the bud. The piece meal approach has not been successful in the past and the bad banks are bound to add up to the already existing multiplicity of authorities and the government expenditure, unless the banking sector is transformed in a more substantial way.

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