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Bad Bank: The Concept of Making Good the Bad Assets of Banks

[1]Harshitha H, [2]Dr. M L Shailaja

[1] 4th Sem, Department of MBA,Dr. Ambedkar Institute of Technology,Bengaluru-560056, Karnataka

[2]Associate Professor, Department of MBA, Dr. Ambedkar Institute of Technology, Bangaluru-560056, Karnataka

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ABSTRACT

The study mainly focused on the concept of bad banks. Bad bank concept emerged as a solution to the crisis of non-performing assets. When bad bank is established with sufficient government and legal support, it works best. In India, the concept of a bad bank as long been shunned. The opportunity exists for the financial sector to be prepared to release cash thanks to bad bank that is actually an asset reconstruction company (ARC). As the effect of the global monetary crisis continue to be felt, there has been a rise in recent times in amount of public discussion surrounding ideas to place stressed assets in one or many bad banks. Globally, it is believed that managing non-performing assets requires government and legal support for a bad bank to succeed. The paper provided information on nonperforming assets and measures that banks can use to resolve them. Bad bank is a concept to solve the issues of stressed assets. The features of bad bank have been explained and the evolution of bad banks globally is also included in this study. The secondary source of data collected is from the analysis of various articles. The main goal is to identify the challenges faced by India in implementing bad banks.

Key Words: Bad Bank, Stressed Assets, Asset Reconstruction Company, Non-Performing Asset

1. Introduction

In 2014 RBI circular said that any advances with outstanding interest or principal instalments of more than 90 days will be categorized as "non-performing assets." If the outstanding debt on an overdraft or cash credit is continuously higher than the authorized limit or drawing power for more than 90 days, it would be considered a non-performing asset. Any amount that is past due to the bank for longer than 90 days is categorized as an NPA. The RBI's main responsibility is to control the amount of money available to the economy. They use instruments like the Statutory Liquidity Ratio, the Repo Rate, and the Reserve Repo Rate to achieve this. When banks make bad lending decisions, bad loans result.

The latter default on loan repayment by corporate and independent borrowers has resulted in the banks in India amassing a significant amount of troubled assets. Just before the global economic crisis, in September 2008, Indian banks' non-performing assets (NPAs) were worth Rs. 53,917 crores. By March 2015, they had grown to Rs. 3,23,335 crores. Since then, NPAs have gotten worse and are currently expected to cost banks Rs.9 lakh crore in March 2020. In particular, public-sector banks (PSBs) have been greatly concerned about NPAs. As of March 31. 2020, public-sector banks non-performing assets totaled Rs. 6,78,317 crores, accounting for 10.3 percent of all unsettle loans. The banks are unable to recover a portion of the legacy NPAs, which total around Rs 2.2 lakh crore. As NPAs are growing, many measures are adopted by other countries. Following this, India is implementing methods to tackle the non-performing assets, one of which is a bad bank.

A bad bank is a bank or financial organization, also known as an asset management company (AMC), that is established with the goal of purchasing non-performing assets, bad loans, or toxic assets from conventional banks that result from both individual and corporate borrowers failing to repay their loans.

By absorbing their toxic assets often for less than the book value of their loans and managing them properly, the bad bank was anticipated to assist conventional banks. Some may be restructured, while others may be liquidated, with the end esult being that the bad bank eventually recoups the money over time.

Regular banks won't have to worry about their poor loans going forward. A bad bank makes profit in its operation if it manages to sell the toxic assets or bad loans at a higher price than what it paid to regular banks. Despite having the name "bank," they don't operate in the same way as conventional banking systems.

Acquire the bad loans or toxic assets from a bank. However, earning profits are not the motto of a bad bank. A significant amount of toxic assets has recently been accumulated by Indian banks as a result of individual and corporate borrowers' failure to repay their loans.

2. Other Related Measures to Tackle the Non-Performing Asset Crises in Banks

NPA is not a recent issue, despite the fact that its prevalence has increased dramatically recently.The government has implemented a number of reform initiatives at various levels throughout the years to bring it down. Among the significant ones are.

- **Debts Recovery Tribunal (Procedure) Rules** - 1993: Financial institutions are given the authority to promptly recover debts ten lakhs or more according to the act, which was approved by the Indian Parliament in 1993. Because there are less delays in the initial procedures, DRTs can handle more cases than traditional courts.
- **The Credit Information Bureau (India) Ltd** - 2000: A third party organization called CIBIL gives banks information about your financial situation. The credit information bureau maintains personal defaulter records, which it makes available to banks so they can make better credit judgements. Banks might be charged a fee for this service.
- **Lok Adalat -2001**: Lok Adalat can be used to recover small loans under 5 lakhs, according to RBI rules released in 2001. Both lawsuits and non-suit situations are covered by this alternative dispute resolution method.
- **Compromise Settlement-2001**: with such a simple non-discretionary approach, this program helps with the recovery of NPAs up to 10 crores.
- **SARFAESI Act – 2002**: By using asset reconstruction, security enforcement, and securitization as alternatives without going to court, the SARFAESI offers banks three ways to deal with non-performing assets (NPAs). It is capable of handling any unpaid debt interest. In accordance with the Act, banks are also permitted to notify and requested that the money be released within a month of getting the notice.

There are many other methods to combat non-performing assets, but they are not as effective as the aforementioned methods. The other methods are as follows: Corporate debt restructuring-2005, Joint lenders' forum-2014, Mission indradhanush-2015, Strategic debt restructuring-2015, Asset quality review-2015, Sustainable Structuring of stressed assets-2016, Insolvency and bankruptcy code-2016, Public ARC vs Private ARC-2017.

3. Review of Literature

Alok Bandhu, Sandeep Kumar, Sushil Kumar (2022) in their study evaluated the impact of recapitalization, determined whether a higher level of recapitalization improves profitability, and assessed the operation and effectiveness of asset reconstruction companies in India. **Snehal, S Herwadkar, Arpita Agarwal, Sambhavi Dhingra (2022)**, concluded in the study that is, in order to comprehend the qualities that contributed to National Asset Reconstruction Company Limited's (NARCL's) success, the current article analyses cross-country bad bank practices. The potential for the NARCL's success is then assessed by contrasting its qualities with the lessons learned from other countries experience. **Vijay Kumar A.B. and S.N. Venkatesh (2021)**, Their study focused on the evaluation of bad banks all over the world and showed the bad bank structure of the Indian bank association. The study demonstrates the poor handling of toxic assets by conventional banks. **Pankaj Grover (2021)** in this article he examined the idea of a "bad bank." To emphasize the global perspective of the implementation of bad banks and the Indian Banks's Association suggested model of bad banks, and to research the applicability of this idea to the Indian economy as well as its benefits and obstacles to the development of these new types of bad banks. **Fareed Ahmed (2021)**, suggested an alternative strategy that blends equalization claims, a tool that has been effectively applied in other regions of the world, with the bad bank solution. **Raghu Ram Rajan and Viral Acharya (2020)** proposed the establishment of private asset management and national asset management "bad banks" in addition to an online platform for distressed loan sales. **Michael Brei, Leonardo Gambacorta, Marcella Lucchetta, Bruno Maria Parigi (2020)** examine whether bad banks, also referred to as impaired asset segregation tools, and recapitalization result in an improvement in lending.

Sajoy P.B. (2019), suggested that as long as toxic assets costs are covered by the concerned banks or private competitors, the control on the economy will be minimal and the authorities will only need to exercise regulatory control over the entire practice. In their study, **Stephanie Medina Cas and Irena Peresa (2016)** looked at the experiences of 3 asset management companies. The study examined how the design of the AMCs was affected by the European regulatory framework, especially the rules governing Eurostat, state aid, and bank resolution. The study discovered that effective asset disposals depend greatly on the type of assets moved and the macroeconomic context. A novel strategy was put froward by **Ulrich Van Suntum and CordeliusIlgmann (2013)** that blends equalization claims, a tool that was effectively employed in two prior German debt crises, with the bad bank solution. **Saed Khalil and Stephen Kinsella (2011)** discussed the study in a two-country scenario, looking into how contagion spreads through bank balance sheets. The study demonstrates that the credit crisis undermines each economy's stability in the short term and lowers potential output in the long term and calculates this loss. According to a strategy put by forward **Dorothea Schafer and Klaus F. Zimmermann (2009)**, governments might effectively relieve struggling banks of hazardous assets by moving those assets into a publicly supported work-out entity known as a "bad bank".

A research gap is an area in which there are missing details to establish a conclusion on a matter Based on an initial review of related articles by the researchers, it was discovered that no study had been conducted on the topic "Bad Bank: the concept of making good the bad assets of a bank," and the concept of issues had not yet been addressed. The research papers mentioned above focused on the bad bank concept, NARCL's success, evaluation of bad banks, needs and benefits of bad banks, and bad bank solutions. This study mainly focused on the issues and challenges of bad banks. The study includes a statement of the problem. No other review mentioned the statement of the problem in their literature.

4. Statement of the problem

Establishing a bad bank merely moves the issue from one location to another. In the absence of significant measures to address the non-performing asset issue, the bad bank is likely to turn into a storehouse for bad loans without any recovery taking place. Mobilizing funds for the bad bank is another significant problem. Stressed assets are difficult to sell in a pandemic affected economy, and the government is likewise in a tight financial spot. There is no clearly defined process for deciding which loans should be transferred to bad banks and at what price. The government may also face political difficulties due to this. Establishing a bad bank may lead to moral hazard issues among banks. Therefore, the paper stated that by establishing a bad bank, there are benefits as well as drawbacks. The bad bank merely moves the issue from one location to another and the non-performing assets need to be addressed with serious effort.

5. Objective of the Study

- To understand the concept of bad bank
- To Identify the issues and challenges of implementing bad bank in Indian financial system.

6. Major Features of Bad Bank

6.1 Stressed assets are transformed

Transferring the stressed assets to the bad banks separates the good assets from the bad assets, giving the banks cash and improving the management of the good assets. The government sponsored asset reconstruction companies are a key component of the Indian Banks' Association's planned replica for bad banks, which will encourage banks to transfer their bad assets to them.

6.2 Managing stressed assets

These ARCs will be managed by the well qualified individuals in the envisaged bad bank structure. Qualified experts who will help with improved management and execution of the assets; the entity making the sale decision. As the stressed assets are settled through bad banks. The person agreeing to take that offer will set a different price. As a result, corruption and conflicts of interest are abated.

6.3 Implementing strategies by bad bank

Buyers of stressed assets will benefit from having all of the poor assets in one location since it will make it easier for them to identify the ideal match for their needs. The establishment of bad banks aids the original banks' efforts to rid their balance sheets of hazardous assets by streamlining, centralizing, and simplifying the process of recovering and managing bad assets. The assets, which banks sell to troubled financial institutions at a discount, but when the primary assets are realized, the value is split according to the banks' proprietorship percentage in the Asset Reconstruction Companies, so the previous discount can also be recouped.

6.4 Efficient Supervision

By establishing bad banks, active banks are relieved of the responsibility of meeting the provisioning requests necessary in the event of NPAs in their banks. Proficient supervision of the bad assets aids in preventing insolvency for those businesses. else be liquidated in accordance with the Insolvency and Bankruptcy Code (IBC). The IBC is unable to fix the challenges the power sector is experiencing, but bad banks can.

6.5 Holding the customer's trust

The division of assets gives depositors a clear-cut picture of the bank to consider when making an investment decision. If commercial banks sell their troubled advances to the bad banks, it will shield them from being subjected to Central Bank of India and Card Verification Code probes. The establishment of bad banks has the potential to restore people's trust in the banking industry.

6.6 Implementing a bad bank yields the benefit

The establishment of bad banks will improve the banks' liquidity condition. The banks will be able to successfully satiate the capital adequacy criteria. The establishment of a bad bank will result in a growth in the rearrangement of cash obtained from bad banks into useful industries. The establishment of bad banks will protect the tax payers' money.

7. The Evolution of Bad Banks in the World

7.1 United States of America

The United States of America's banking crises in the late 1980s gave rise to bad banks. Several banks were on the edge of failing at the time due to the sharp decline in real estate and oil rates. The Pittsburg, Pennsylvania-based Mellon Bank was the worst hit. That bank needed to be reinvested since it was consistently losing money. Mellon Bank established the Grant Street National Bank as a second institution with this goal in mind. The goal of establishing GSNB was to sell its toxic assets from Mellon Bank to it. The assets moved to GSNB at a discount book value of $640 million were the hazardous assets of Mellon Bank, which had an initial value of $1.4 billion.

7.2 Japan

The good bank-bad bank strategy has been used by Japanese banks to rearrange their bad debts. The Bankers' Association of Japan established Credit Cooperative Purchasing Company as a bad bank in 1992 (CCPC). This business bought and maintained the impaired assets of Japanese banks. The banks that extended a loan for the vending value and traded the bad assets to CCPC at a reduced price paid for the sale themselves. The CCPC then used the proceeds from the sale of the real estate and other assets used as refuge for the toxic assets to pay back the loan issued to it by the bank that had purchased the bad assets from it.

7.3 Germany

Berliner Immobilien Holding (BIH), a bad bank in Germany, was established in 2006 to isolate the stressed assets of Berliner Bankgesellschaft. Nevertheless, when a much more severe economic crises struck Germany in 2008-2009, the German Federal Council passed a bill in July 2009 to provide a good bank-bad bank solution that placed very little monetary strain on the tax payer. The aforementioned statute established two distinct bad bank methods for private and state banks. German law developed a unique purpose unit concept specifically for private banks.

7.4 Ireland

Ireland's National Asset Management Agency (NAMA) was formed by legislation in 2009 to address the banking crisis brought on by the universal collapse of the real estate market. All stressed assets of an active bank were transferred to NAMA under this arrangement at a reduced value. Irish government bonds were used to pay the transferring bank. Banks transferred a total of 74 billion euro to NAMA at a 57 percent discount by the middle of 2015, NAMA settled more than 70% of its significant debt, and by the time it is wound up, it is anticipated to make money for the Irish government.

7.5 Spain

The Spanish government established SAREB, an acronym for the Spanish name "Company for the management of assets ensuring from the reformation of the banking system," as a bad bank in the year 2012 many Spanish banks transmitted their stressed assets to SAREB. SAREB possessed assets valued at more than 50 billion euro as of the middle of 2016, and it anticipated selling such assets profitably within 15 years of its funding.

The aforementioned, succinct review of significant historical examples of failed banks amply demonstrates that failing banks do not have a regular or consistent structure. To meet their own national needs, numerous nations have developed various bad bank regimes. But the fundamental goal of bad banks remains the same, namely to remove stressed assets from the balance sheets of regular banks in order to prevent the latter from collapsing.

National Asset Reconstruction Company Limited, India's first bad bank, was established in July 2021 as a bad bank to assist commercial banks in disposing of toxic assets. NARCL was incorporated under the Companies Act (ARC). The government essentially turned NARCL into a bad bank by modelling it after an asset rehabilitation firm. State-owned banks will own 51 percent of the company, compared to 49 percent held by financial institutions or debt management firms. The authority will also establish the India Debt Resolution Company Ltd. In addition to NDRCL, The IDRCL is a service provider that will handle asset management as well as bring in market experts and turn around specialists.

8. Issues of Bad Bank

- Government normally refrains from funding bad banks as they deal only with toxic assets, the government believes that selling/ realizing toxic assets is not an easy task.
- The bad bank must overcome obstacles to create a viable and distinctive business model.
- Creating bad banks does not offer any unique tools to quicken the recovery operations.
- Finding buyers for stressed assets is extremely difficult at the moment when the economy is worsening and the IBC has been stopped.
- The major area of worry for the creation of bad banks is the setting of prices.
- The public owned banks will sell their stressed assets to state owned ARCs because of this the government-controlled ARC's will result in conflicts of interest.

9. Challenges Faced by India for Implementing Bad Bank

- In the bad bank, the majority of these problematic assets have already been adequately budgeted for and recorded on banks' accounts.
- The fact that they have been removed from the bank's records suggests that the bank no longer nurture expectations of a substantial return.
- Selling stressed assets to potential buyers and resolving system's fundamental dilemma may also become a problem. For the banks, this may provide a serious difficulty.
- Finding prospective buyers for stressed assets might be extremely difficult at the moment, with the economy failing and the Insolvency and Bankruptcy Code stalled.
- The public sector banks will suffer additional harm because they will simultaneously be stockholders and clients of the bankrupt bank.
- The National Asset Reconstruction Company Ltd (NARCL) may easily end up being a storage facility for toxic assets after failing to find buyers for them, which would be a regrettable consequence. Such a situation must be avoided because it would only make the issue worse in the long term.
- The problems with the government's earnings and financial shortages have been written and discussed for a time. There has been debate about whether the government would be better off supporting the bad bank rather than recapitalizing the bank itself.
- The majority of public sector banks (PSBs) deny contesting in independent valuations; the method is not clear or market-driven, which could make it difficult to value non-performing loans.
- The NARCL may encounter an initial statistical issue due to the development of comprehensive recovery strategies and the management of adequate resources in fields including reformation and restore, commercial real estate, IT, and portfolio sales.

10. Conclusion

The research presented above will demonstrate unequivocally that the primary responsibility of the bad bank is to clean up the messes that the conventional banks make when managing their toxic assets. In addition to improving the management of the transferred assets, the toxic assets of a normal bank are transferred to the bad bank in order to improve the regular bank's balance sheet. But there is a cost associated with this process. The impact on the economy will be minimal as long as these expenses are covered by the involved banks or private parties, and the government will simply need to exercise regulatory supervision over the entire process. The establishment of a bad bank at this time may help to ease banking pressure and jump-start the lending cycle. The recent increase in non-performing assets is still a source of interest for Indian banks, especially public sector banks, and it needs to be addressed with serious efforts.

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