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BAD BANK: IS IT A NECESSITY OR A MORAL HAZARD?

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ABSTRACT

A terrible debt is one that cannot be paid back. Insolvency is defined as a condition in which a person or a business is unable to meet its financial commitments. In contrast, bankruptcy occurs when a court of competent jurisdiction declares a person or other entity insolvent and issues necessary instructions to rectify the situation and safeguard creditors' interests. This article examines the long-standing issue of bad loans in the Indian banking sector and proposes a government-backed and well-structured Bad Bank instead of the existing ARCs to help the banking industry recover from its current predicament. The necessity for a bad bank stems from the rising number of bad loans, as well as the Covid-19 epidemic. The article's second section focuses on flaws in the present Asset Resolution System as well as a lack of legal clarity. The existing function of ARCs in connection to the planned bad bank is also discussed in this section. Furthermore, this article discusses the difficulties that may arise while establishing a bad bank, as well as the issues of moral hazard, and offers strategies to address these issues.

Keywords: Bad Bank, NPA, ARC.

INTRODUCTION

"if you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem." [1]**- J. Paul Getty**

The issue of bad loans in the Indian banking sector is persistent, and it has been a major drag on the Indian economy. Unfortunately, the situation has deteriorated as a result of the lockdown precipitated by the COVID-19 outbreak last year, as well as the RBI's six-month ban in the borrowers' best interest.[2] Maintaining a robust and healthy banking system is critical to the

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[1] 'J. Paul Getty Quotes' (BrainyQuote, 2021) https://www.brainyquote.com/quotes/j_paul_getty_129274 accessed 5 June 2021.

[2] 'Coronavirus | Supreme Court Directive To RBI On Loan Repayment Moratorium' (*The Hindu*, 2021) https://www.thehindu.com/news/national/coronavirus-supreme-court-directive-to-rbi-on-loan-repayment-moratorium/article31475358.ece accessed 6 June 2021.

country's development of a stable financial institution. Despite many efforts taken by the Reserve Bank of India (RBI), growing non-performing assets (NPAs) have remained a problem for the banking industry throughout the years.

The cycle of lending, borrowing, and repaying is disrupted when loans are not returned in full, including the principle and interest. As a result, the bank's ability to lend is severely harmed as bad loans pile up. When an asset, including a leased asset, becomes non-performing, it stops generating money for the bank[3]. This, in turn, hurts the economy. These bad debts or bad loans result in significant losses and influence the whole banking industry, resulting in poor money recycling and negative consequences on credit deployment. This causes even more trepidation among investors, depositors, and lenders, as well as a loss of trust. Though banks always have the option of taking legal action against defaulters, this does not fix the problem, and it is also time-consuming and economically unfeasible.

The issue of nonperforming assets (NPAs) and banks aren't going away anytime soon. The RBI has cautioned in its Financial Stability Report (FSR) that the GNPA (Gross Non-Performing Asset) Ratio might rise from 7.5 per cent in September 2020 to 13.5 per cent in September 2021, the highest level in over 22 years.[4] This will put a strain on our financial system as well as the economy.

BURGEONING NPA CRISIS

A non-performing asset (NPA) is a bank loan that has not been returned or reimbursed after 90 days (in some cases it is 180 days as well). [5]In basic terms, a loan provided or extended by a bank is an asset for the bank, and a non-performing asset is not performing or providing any revenue for the bank. This might cause depositors to be unsure whether or not they will get their money back. In such situations, banks often depend on provisioning, in which they sell assets to preserve sufficient liquidity. However, when the bank's assets are used in provisioning, the bank's lending ability is harmed. This is one of the reasons why banks are hesitant to recognise their nonperforming assets (NPAs). Provisioning was not required before since Indian commercial banks were unaware of nonperforming assets (NPAs) until 1991. When it was estimated in 1994 that the total NPA of Public Sector Banks (PSBs) was 3.2 lakh crore, the government opted to write it off, and recapitalization proceeded for many years without really addressing the main

[3] Reserve Bank Of India - Master Circulars' (Rbi.org.in, 2021) https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx%3FId%3D449 accessed 5 June 2021.
[4] Abhijit Mohan, 'Banks' Gross Npas May Rise To 13.5% By Sept: Financial Stability Report' (*Business-standard.com*, 2021) https://www.business-standard.com/article/finance/banks-gross-npas-may-rise-to-13-5-by-sept-financial-stability-report-121011200076_1.html#:~:text=The%20Reserve%20Bank%20of%20India's,20%2C%20under%20the%20severe%20stress accessed 5 June 2021.
[5] 'Reserve Bank Of India - Notifications' (*Rbi.org.in*, 2021) https://rbi.org.in/scripts/NotificationUser.aspx?Id=5090&Mode=0 accessed 5 June 2021.

issue.

The central explanation for the aggregation of NPA is the working of the over-controlled genuine and monetary area of the economy. There might be the reason for macroeconomic downturn sponsored by infrastructural bottlenecks that incite the business people to redirect their assets from the initially proposed use. Redirection of assets for the most part for business development as far as broadening or modernization from its unique reason can likewise be the reason for the development of NPAs.

At long last there are the unavoidable elements for the presence of the NPAs are government strategies, vital conduct of the borrower as persistent default, extortion, misappropriation and inadequacies with respect to the bank authorities in endorsing the borrowers, co-actuated by the deferral in the overall set of laws.[6]

When former RBI Governor Raghuram Rajan launched the Asset Quality Review (AQR) in 2015, it uncovered all the problematic loans that had been concealed under the carpet until then. After the AQR report, the truth was revealed, and the whole financial community was stunned. This clean-up effort stopped banks from evergreening loans, but it resulted in a rise in nonperforming assets (NPAs). NPAs increased as a result of PSBs' unwillingness to write off loans by accepting a haircut (Writing off the loans here does not mean waving off). Due to a lack of cooperation among lenders and creditors, loan recovery is extremely problematic.

The Yes Bank Crisis is a typical example of a bank on the brink of collapse owing to an increase in bad loans since they had sanctioned loans to even financially challenged businesses. Although the RBI has not yet caused any banks in India to collapse, it remains a source of worry for taxpayers who are forced to foot the tab for bailing out struggling institutions.

BAD BANK AS FINANCIAL INSTRUMENT

Following the issuance of the RBI's Financial Stability Report (FSR) on January 11, 2021[7], the concept of a bad bank has gained traction. Mrs Nirmala Sitharaman, the Finance Minister, has also resurrected the initiative. In her recent Budget Speech, she alluded to the notion of a bad bank, noting that the Centre intends to establish an Asset Reconstruction Company (ARC) to buy problematic loans from banks.

A bad bank is a 'Sarkari' Asset Reconstruction Company (ARC) that operates as a bank but has terrible assets. They are usually established during times of crisis, and they were even discussed

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[6] (2021) https://www.imf.org/en/Publications/CR/Issues/2018/01/19/India-Financial-Sector-Assessment-Program-Detailed-Assessment-of-Observance-of-the-Basel-45542 accessed 6 June 2021.
[7] 'Reserve Bank Of India - Financial Stability Report' (Rbi.org.in, 2021) https://www.rbi.org.in/SCRIPTS/FsReports.aspx accessed 5 June 2021.

during the 2008 Financial Crisis to help private institutions recover. Now that the epidemic has struck the banking sector, and the RBI has prolonged the six-month moratorium, a surge in bad loans is expected and anticipated. NPAs have risen dramatically in recent years, the economy is in decline, and recovery seems to be tough. Banks urgently want to remove problematic loans from their balance sheets so that they may concentrate on new lending. A bad bank takes over commercial banks' poor loans, administers them, and eventually recovers the money from defaulters.[8] It does not engage in traditional banking services such as lending or accepting deposits but rather assists commercial banks in cleaning up their balance sheets and resolving bad loans so that they may concentrate on bringing in new business rather than debt collection. With the bank's bad loans (NPAs) increasing, the establishment of bad banks seems to be a possible answer. It is considered a way to rebuild credibility in India's financial system at a time when huge portions of the country's bank loans are defaulting. As a result, the concept of a bad bank has taken on new relevance.

BAD BANK VIS-A-VIS ARCs

The goal of forming a bad bank is similar to that of forming an Asset Reconstruction Company (ARC), but the issue remains: why do banks need bad banks today since private ARCs are already in place? The ARC idea has been around for a long time, and there are now 28 ARCs operating in India. As stated in Section 3 of the SARFAESI ACT, 2002[9], ARCs must be registered and regulated by the RBI. An ARC, as the name implies, purchases poor assets, reconstructs them into good assets and resells them to possible purchasers, similar to what a bad bank does. Even though they are still operating and resolving assets, the NPA situation has not been resolved to that level. Because there is a lack of clarity on collateral or who owns the asset, it is difficult to locate purchasers ready to purchase the collateralized asset in India. Buyers are hesitant to purchase collateral since there is no formalised collateral market or legislation.

There is anticipation that the public ARCs, or 'Sarkari ARCs, would offer crisis-hit Indian lenders breathing room to combat NPAs and that since it is a government-backed body, there would be greater clarity in rules as well. It will also have a stronger legal standing, and the status of wiping off bad debts will improve. Because PSBs have more accumulated nonperforming assets (NPAs) than private banks, a bad bank will attract participation from PSBs and develop trust in these institutions to conduct business with them.[10] It will also lead to greater credit

[8] Kabir Tahir, 'Complete Lecture Notes For MAFS 616 Bank Lending And Credit Administration' (*Academia.edu*, 2021) https://www.academia.edu/33401121/Complete_Lecture_Notes_for_MAFS_616_Bank_Lending_and_Credit_Administration accessed 5 June 2021.

[9] The Securitization And Reconstruction Of Financial Assets And Enforcement Of Security Interest Act, 2002 (Act No.54 of 2002).

[10] IJMSBR Journal, 'Galloping Non-Performing Assets Bringing A Stress On India'S Banking Sector: An Empirical Study Of An Asian Country' (*Academia.edu*, 2021)

management coordination since all debts would be recovered by a single body.

Bad banks, if correctly implemented, would relieve banks' balance sheets from NPAs and, as a result, provisioning, resolving dual balance sheet difficulties. It will improve the economy's liquidity and enable businesses to grow more effectively. It will have a larger bank account, implying that it will be more wealthy, since it will be financed by PSBs and the government as required.

CHALLENGES AND A WAY FORWARD

The concept of a bad bank has been tested in several nations and has shown to be effective in addressing the issue of rising nonperforming assets (NPAs), with some models even earning a profit. The concept is sound, and it looks to be feasible, given that Indian banks have previously acknowledged the issue of rising nonperforming assets (NPAs) and have made 70-80% provisions after a significant clean-up effort.[11] Banks can get rid of the remaining poor assets by moving them to a separate corporation, but this comes with its own set of problems. Selling these loans to a possible buyer and resolving the system's whole dilemma might be difficult, and if there are no deep-pocket purchasers ready to put money on the table, or if there is a lack of private involvement, the whole resolution plane might crash.

Another issue, according to former RBI Governor Raghuram Rajan, is that a government-backed bad bank would simply move bad assets from one public sector to another since banks would be more comfortable issuing poor or risky loans, knowing that they would be taken over by bad banks, resulting in a moral hazard.[12] To address the issue of moral hazard, we must include bankers in the process so that they understand the consequences of making poor judgments and how the whole bank might collapse as a result.A business like this has to be a self-contained entity operated by experts to make a minimal profit in a short amount of time. A collateral market, which is currently underdeveloped in India, must be formed, and legal support is essential to reinforce the whole process. It may be a good idea to ensure that the collateral market has greater depth and that the agency is removed from the political system and given its own independent professional management structure, as the RBI, IRDA, and SEBI have done. Otherwise, the issue would persist without yielding any outcomes.

https://www.academia.edu/32290487/Galloping_Non_Performing_Assets_Bringing_a_Stress_on_Indias_Banking_Sector_An_Empirical_Study_of_an_Asian_Country accessed 6 June 2021.

[11] Business News, India News and Banks NARCL, 'NPA: Banks Likely To Transfer About 80 Large NPA Accounts To NARCL - Times Of India' (*The Times of India*, 2021) https://timesofindia.indiatimes.com/business/india-business/banks-likely-to-transfer-about-80-large-npa-accounts-to-narcl/articleshow/82799153.cms accessed 6 June 2021.

[12] 'Explained: The Arguments For And Against A Bad Bank' (*The Indian Express*, 2021) https://indianexpress.com/article/explained/npa-bad-bank-balance-sheet-loan-rbi-shaktikanta-das-7151841/ accessed 6 June 2021.

CONCLUSION

Throughout some stretch of time, an endless loop has arisen in the Indian banking area: rising NPA level calls for higher provisioning bringing about lower capital ampleness and stifled benefit levels.[13] This further prompts quieted development in loaning limit which thus expands NPAs. Banks are represented considerable authority in loaning however not in settling the mammoth focused on resources; they neither have the necessary degree of lawful ability nor the helpful climate to recuperate the NPAs.

As of present, the notion of a bad bank exists only on paper; there is no clarity on the planned bad bank's ultimate outlines or capital structure. According to the concept, the government may contribute to the structure's success, and eventually, banks may pool funds with outside investors, which might include private funders specialising in asset settlement. Although the concept of a bad bank is appealing, the ultimate resolution of nonperforming assets (NPAs) can only occur if the banking system is overhauled with improved protections and procedures.[14] We have previously recapitalised the PSBs and are continuing to do so since we have identified the issue of mounting NPAs. We are also focusing on the recovery and resolution of stressed assets. More clarity in the legislation on asset write-offs and the growth of the collateral market is required, otherwise, the bad bank would fall catastrophically.

[13] (*Core.ac.uk*, 2021) https://core.ac.uk/download/pdf/230938108.pdf accessed 6 June 2021.
[14] Business News, India News and What woes?, 'What Is 'Bad Bank' And Can It Resolve NPA Woes? - Times Of India' (*The Times of India*, 2021) https://timesofindia.indiatimes.com/business/india-business/why-bad-bank-could-be-a-good-move-for-an-ailing-economy/articleshow/80614795.cms accessed 6 June 2021.