Does Indian Banking Sector Need A Bad Bank to resolve Non-Performing Assets

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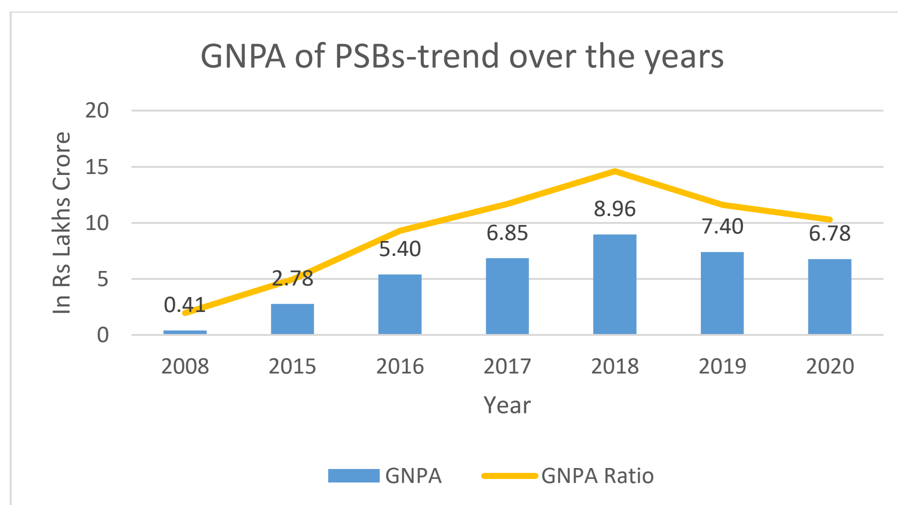
Abstract: *Accumulation of Non Performing Assets in recent years remains an area of concern for Indian Banks particularly Public Sector banks and they are expected to rise further in the coming months on account of COVID-19 pandemic. They should be tackled with sincere efforts. The role of IBC has been significant yet not sufficient to resolve enormous number of NPAs. The idea of Bad Bank has been avoided for a long time in India. Bad Bank, which is essentially an ARC, has the potential to get financial sector ready to release funds. Having a Bad Bank will let the banks continue the lending however, it will bring its own challenges, but this seems be to be the best suited time for its incorporation for the recovery of the banking sector. A challenge for a bad bank may be developing a sustainable and unique business model. In this paper, we suggested a model, which rests on an idea that combines the conventional bad bank approach with the instrument of equalization claims. This model effectively addresses three key challenges., the transparent removal of stressed assets and gives the banks to start fresh lending, offers the chance to keep the cost to taxpayers low and avoids the risk of moral hazard. It is suggested that the bad bank shall be established with finite life period of maximum 8 years and then this bank can be dissolved. The bad bank can have majority of employees on contract basis for fixed salaries and some activities may be outsourced which will be proved cost-effective. The turnaround of stressed assets by an ARC & AMC, public or private, needs an efficient insolvency law, experienced restructuring professionals and other experts, and a market for stressed assets.*
Key Words: *Asset Management Company, Asset Reconstruction Company, Bad bank, Non Performing Assets, Stressed assets,*

I. INTRODUCTION

The banks in India have in the recent past accumulated a large number of stressed assets arising from the default in repayment of loans by both corporate and individual borrowers. The non-performing assets of Indian banks (NPAs) increased from Rs. 53,917 crore in September 2008 (just before Global Financial Crisis) to Rs. 3,23,335 Crore in March 2015. Since then, NPAs have become a critical problem for banks and now have grown to Rs. 9.00 lakh crore for March 2020. Public Sector Banks in particular (PSBs) have been facing major concern of NPAs. The NPAs of PSBs as of 31st March 2020 was Rs. 678317 Crore constituting 10.3% (Gross NPA ratio) of total outstanding advances.



There are some legacy NPAs of approximately Rs 2.2 lakh crore and the banks are not able to extract the money. They are all stressed assets, around 70 assets of more than Rs 500 crore. credit costs on the corporate book are likely to amount to 2.15% of the system debt in the base case.

India has been trying to solve its Twin Balance Sheet problem–overleveraged companies and bad-loan-encumbered banks – using a large number of solutions to tide over this crisis. The RBI has over the past few years introduced multiple schemes to deal with the stressed asset problem. Most important schemes of them are Flexible

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Refinancing of Infrastructure (5/25 scheme), Strategic Debt Restructuring (SDR), Asset Reconstruction (ARC), Sustainable Structuring of Stressed Assets (S4A) and Asset Quality Review (AQR). Initially, the schemes focused on rescheduling amortisations to give firms more time to repay. But it became apparent that the financial position of the stressed firms was deteriorating. Decisive resolutions of the loans, concentrated in the large companies, have eluded successive attempts at reform. These decentralised approaches have not yielded the expected results. The problem of NPAs keep growing, while credit and investment keep falling and their adverse impact on the overall economy. Perhaps it is time to consider a different approach to tackle this problem.

A bad bank is an entity established for the purpose to isolate stressed assets held by a regular bank from its performing assets. The said separation is achieved by transferring the stressed assets from the regular bank or financial institution, or a group of banks or financial institutions to the bad bank. The ultimate objective is to maximize the value of the core-operations and minimize the amount of NPAs, contributing to the stability of the financial system.

II. REVIEW OF LITERATURE

Dorothea Schafer & Klaus F. Zimmermann, (2009), suggested a plan how governments can efficiently relieve ailing banks from toxic assets by transferring these assets into a publicly sponsored work-out unit, a so-called bad bank. The key element of the plan is the valuation of troubled assets at their current market value – assets with no market would thus be valued at zero. The current shareholders will cover the losses arising from the depreciation reserve in the amount of the difference of the toxic assets' current book value and their market value. Under the plan, the government would bear responsibility for the management and future resale of toxic assets at its own cost and recapitalize the good bank by taking an equity stake in it. The government would cover the bad bank's losses, while profits would be distributed to the distressed bank's current shareholders.

HM- treasury (2013) observed that the internal bad bank announced by RBS will quickly and efficiently dispose of risky legacy assets that remain on its balance sheet, without the use of fresh taxpayer funds and without the significant operational and delivery risks an external bad bank would bring. By tackling its legacy of high-risk assets, strengthening its balance sheet, committing capital to its UK 'core' operations and boosting returns, RBS's comprehensive new direction will focus the bank on supporting the British economy while ensuring best value for the taxpayer.

Ulrich van Suntum & Cordelius Ilgmann (2013) proposed a new approach which combines the bad bank solution with equalization claims, an instrument that has successfully been used in two previous German debt crises. The main idea is to temporarily swap toxic assets for government bonds with an open maturity date. This approach not only leaves total losses with the banks, but also avoids the problem of evaluating the toxic assets in advance.

Stephanie Medina Cas, Irena Peresa (2016) examined the experience of three asset management companies (AMCs) or 'bad banks' established in the euro area following the 2008 global financial crisis, which were setup to purchase growing nonperforming loans on banks' balance sheets with the aim of their eventual disposal. The study also sought too identify factors that support an AMC's success. It also analysed the impact of the European regulatory framework, including the Eurostat rules, State-aid regulations and bank resolution rules, on the AMCs' design. The study found that the type of assets transferred and the macroeconomic environment are crucially important for successful asset disposals. The study also identified additional success factors, such as clean asset documentation, a solid valuation process, efficient asset servicing, a strong legal framework and skilled staff. It observed that though challenges remain, the three AMCs have contributed to banking sector stabilisation as they have been undertaken alongside bank restructuring measures.

Fareed Ahmed (2017) suggested for formation of two banks/funds namely 'Samrakshana' Bank (SB)' (Protective Bank) or 'Samrakshana Fund' (Protective Fund) and 'Prarakshalana Bank (PB)' (Cleansing Bank) or 'Prarakshalana Fund' (Cleansing Fund) with nominal capital with Government support and to be established for a period of 6 years only and then these two banks to be dissolved. It was suggested to transfer bad assets at a fixed haircut. These banks/funds can have employees only on contract basis for fixed salaries and administrative expenses can be met by the selling banks proportion to their NPAs transferred.

Sajoy P.B(2019), observed that the toxic assets of a regular bank are transferred to the bad bank not just for the purpose of better management of the transferred assets but also for the purpose of cleaning up the balance sheet of the regular bank. This process however involved some costs. He suggested that, as long as these costs are borne by the concerned banks or private players, the impact on the economy will be limited and the government need to have only a regulatory control over the entire process and if these costs are financed with taxpayer's money, a mere regulatory control by the government agencies will not be sufficient and a more strict and watchful control of the bad banks by the government will be necessary.

Raghu Ram Rajan and & Viral Acharya (2020), in their paper 'Indian Banks: A Time to Reform?' suggested creation of private asset management and national asset management 'bad banks' in parallel to online platform for distressed loan sales. According to them, the national public sector 'bad bank' could serve as a vehicle

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to aggregate loans, create management teams for distressed firms, and possibly buy and hold distressed assets in a sector like power till demand returns.

In this paper, we attempted to discuss the need and benefits of bad bank and design and operational model of the proposed bad bank.

III. METHODOLOGY

The present study is analytical and Descriptive study and the necessary secondary data was collected from "Trends and Progress of Banking Report", RBI. The objectives of this study are

1. To analyse the need for a bad bank
2. To discuss benefits of a bad bank
3. To suggest design, structure and operational model

IV. RESULTS AND DISCUSSION

A. Need for a Bad bank

Before COVID-19 crisis hit India, the economy was already decelerating, real gross domestic product (GDP) growth 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. This unprecedent pandemic has hit the Indian economy and the lockdown that was imposed due to pandemic to curb covid spread has crimped the earnings of the businesses and individuals. It impaired their ability to repay loans which will have an adverse impact on the asset quality in the coming days.

The growth projections for the current year by various global and domestic agencies indicate a sharp contraction of Indian economy. With the economy contracting this fiscal year, NPAs will balloon. The impact of Covid-19 and the associated policy response is likely to result in an additional Rs 1,67,000 crore of debt from the top 500 debt-heavy private sector borrowers turning delinquent between FY21 and FY22, according to a report by India Ratings and Research (Ind-Ra). This is over and above the Rs 2,54,000 crore anticipated prior to the onset of the pandemic, taking the cumulative quantum to Rs 421,000 crore, the report said.

The Financial Stability Report (FSR) of the RBI also estimated that NPAs may increase to a to a level of 13.5% in baseline stress and to a high of 14.8% in severe stress. Public sector banks may end up having 17.6% of toxic assets by September 2021. Banks suffer enormous losses in provisioning for already existing NPAs. The economic slowdown particularly due to the Covid-19 pandemic, has forced the Reserve Bank of India ('RBI') to allow a moratorium period and the government to suspend resolution procedure under Insolvency and Bankruptcy Code. Despite the regulatory forbearance as a loan moratorium, borrowers are finding it difficult to service their loans. This then requires lenders to set aside their capital to cover such losses.

There are Asset Reconstruction Companies (ARCs) registered with the RBI and regulated under the SARFAESI Act, 2002 that purchase NPAs from the banks at a discounted price and then focus on realisation. ARCs, under SARFAESI Act, 2002 are authorised to issue security receipts to qualified buyers evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitisation. However, ARCs have not been able to provide relief to the stressed banking sector. Of the existing ARCs, only 3-4 are adequately capitalised, while more-than-dozen are thinly capitalized to purchase NPAs from the banks and to make 15% of upfront payment as required. Even if ARCs have capital to purchase NPAs, the price offered by them after haircut is far too less for banks to agree upon which is why the banks delay sell of NPAs. This necessitates the need to set up a new structure to resolve stressed assets urgently. Therefore, it is the time to adopt a centralized approach i.e bad bank.

The concept of moving stressed assets to a special purpose vehicle is not new to India. The Asian Development Bank had commissioned a study on the subject at the request of the central government when the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act (SARFAESI) was enacted in 2002. The report provided a comprehensive analysis of similar initiatives in other parts of the world. In terms of experience, the Stressed Assets Stabilisation Fund (SASF) was set up pursuant to a provision in the Union Budget of 2004-05, as a special purpose vehicle trust for acquiring stressed assets and NPAs of the erstwhile Industrial Development Bank of India (IDBI).

Even the Economic Survey 2017 had proposed this idea, suggesting the creation of a bad bank called Public Sector Asset Rehabilitation Agency (PARA) to help tide over the problem of stressed assets. The author himself also recommended two such institutions Viz., Parirakshana Bank (Protective Bank) and Prakshalana Bank (Cleansing Bank) in his thesis "Analysis and Modeling of Asset Quality of Public and Private Sector Banks in India" in 2017. In 2018, the government proposed a five-pronged strategy under Project Sashakt to tackle stress in the banking sector, and had formed a panel led by Mehta, the non-executive chairman of Punjab National Bank (PNB). The committee also recommended to float an AMC and an AIF to resolve non-performing assets (NPAs) over ₹ 500 crore. A formal agency may be needed to resolve the large bad debt cases – the same solution the East Asian countries employed after they were hit by severe TBS problems in the 1990s. In short, the time may have arrived to create a bad bank, which can provide banks with the freedom to restart lending. In May2020, Indian Banks Association has also proposed to set up a 'Bad Bank' for the recovery of stressed assets.

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Now Government proposed Asset Reconstruction Company (ARC) in the recent budget and stated that an asset reconstruction company (ARC) and an asset management company (AMC) would be set up to consolidate and take over the existing stressed debt of the banks and then manage and dispose the assets to alternate investment funds (AIFs) and other potential investors for eventual value realisation.

B. Benefits

- Indian banks especially the public sector banks are heavily burdened with bad loans and an ongoing pandemic is further making the crisis worse. For banks to effectively operate, it's imperative that they continue lending and make loan recovery. In addition to segregating or removing the bad assets from parent banks' balance sheets, a bad bank structure permits specialized management to deal with the problem of bad debts with maximizing loan recovery. The approach allows good banks to focus on their core business of lending while the bad bank can specialize in maximizing value from the high-risk assets.
- The stressed debt is heavily concentrated in large companies. Concentration creates an opportunity, because Twin Balance Sheet(TBS) problem could be overcome by solving a relatively small number of cases. The RBI has encouraged creditors to come together in Joint Lenders Forums, where decisions can be taken by 75 percent of creditors by value and 60 percent by number. Banks are finding it difficult to resolve these cases, despite a proliferation of schemes to help them. Among other issues, they face severe coordination problems, since large debtors have many creditors, different banks have different degrees of credit exposure, capital cushions, and incentives. So, when stressed assets are transferred to a bad bank, it could solve the coordination problem, since debts would be centralised in one agency.
- Most commercial loans are granted by a group of banks either as a consortium or Multiple Banking Arrangement. As there are number of financial creditors, they are not able take full advantage of IBC as they are taking time come to consensus. The ARC will help in aggegation of stressed assets in one organization, focused resolution, with better monitoring and professional management and decision making will become faster and good price discovery can happen.
- Many lenders are concerned over huge haircuts they have to endure after a resolution through the Insolvency and bankruptcy code. NPAs in some sectors like power sector can't be resolved through the IBC system as factors like the lack of coal linkages and the absence of purchase power agreements make them unfit for a resolution through the IBC. The bad bank structure could help banks park their money to separate agencies to find a solution in a long time. Moreover, banks feel the assets having future demand-supply issues face liquidation under the IBC, a problem that can be solved under the bad bank. Thus, a bad bank may save a defaulting firm from liquidation and closure.
- The bankruptcy framework is already overloaded and it will be unable to deal with this huge additional burden. It is important, therefore, that much of the resolution takes place outside the Insolvency and Bankruptcy Code (IBC) framework. With the introduction of IBC, there has been a change in promoter behavior towards repayments, and there is now a conscious move by promoters/directors, to engage earlier into discussion with lenders, at the first signs of distress, so an alternative mechanism for resolution can be developed and settle debts outside of an IBC process. The IBC would then be used only as a deterrent against default. Bad bank enables it.
- It is not only recovery of NPAs, but also protecting quality of other assets is the most important. Therefore, banks focus on close monitoring by all EWS, red Flagging and can take steps for resolution and protecting the economic value assets. Banks can also focus on fresh lending which is need of the hour for reviving the economy.
- The standard advantage of a bad bank is that the entity taking a decision on the sale price is different from the entity sanctioned the loan and accepting that price. Conflict of interest is avoided. This approach could eliminate most of the obstacles currently plaguing loan resolution.
- The increased burden of stressed assets gets reflected in the balance sheet of the banks resulting in lower investor confidence and other associated problem. The stressed assets separation helps in generating some confidence among potential investors so that they can then clearly examine the financial health of the lenders. This will result in improvement of Equity valuation of banks.

C. Design and structure

In this section, we analyse how a bad bank plan can be efficiently designed. Economic and Banking experts have unanimously agreed that the structure and design of the bank would be most significant factor in the success of bad bank. While setting up a bad bank or an AMC, its policy and legal framework, architecture and design, and implementation will have to be carefully decided. From the experience of other countries, it is observed that major determinants of success of the AMCs for restructuring or speedy disposal of assets were efficient legal framework, effective management and governance structure and speedy processes. So. for Bad Bank to resolve NPAs effectively there must be adequate guidelines and frameworks from the very beginning. The organisational structure of the bad banks should be such that there is transparency, independence and efficiency. Determination of the appropriate governance structures and key management objectives of the bad bank should begin immediately.

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Some of the significant factors that will help the Bad Bank to effectively operate and resolve the enormous amount of bad loans in India are as follows:

i. Ownership:

In order to be efficient, a bad bank model has to address three key challenges. It has to provide for the transparent removal of stressed assets and give the lenders a fresh start. At the same time, the cost to taxpayers has to be kept to a minimum. Finally, the risk of future moral hazard has to be curtailed.

The structure of the Bad Bank will be the main area which will distinguish it from the already existing Asset Reconstruction companies (ARCs) in India. It might be established by the government or privately by the bank or financial institution, or the group of banks or financial institutions. Globally, such banks are capitalized by the government, and other private players invest in its equity, and are run by professional experts. Setting up of a government backed ARC which can buy the bad loans from banks in return of security receipts is a better option. Success of bad banks depends on several factors. Chief among these,, is government support to help banks, understand and manage the many regulatory, accounting, and tax issues, and to provide financial backing.

There are many global models from Czech Republic to Hungary, Japan, China, Malaysia, Finland, Indonesia, Belgium, Sweden and US, where the governments or regulators have used creative ways to deal with mounting bad loans. As such several financial and organizational choices are available while designing a bad bank. "Again, each country's case is different, depending on the health of its banks, but broadly speaking, governments must smooth the way for the creation of bad banks and clearly establish the extent to which the state will assume the risk of the bad assets," McKinsey said in a report.

While there seem to be varied experiences in different countries, experiences of United States of America, Ireland, Germany, Sweden, Malaysia suggest various significant features behind success of Bad Bank. Mellon Bank of USA was the first bank to use the Bad Bank approach in 1980s to resolve stressed assets. Further, The United States established, the Resolution Trust Corporation in the year 1989 funded by government and a few private investors. Thereafter, in the year 1992 Sweden incorporated Securum, a state sponsored company to resolves stressed assets, which successfully resolved ailing assets and was closed in the year 1997. During the 2008 crisis, various banks around the world created bad banks which dealt with NPAs on an ongoing basis. Various countries such as, Sweden, Finland, France, Germany, Indonesia have implemented bad banks. The bad bank solution was successfully and widely used around Europe to deal with the bad loan crisis in the banking sectors. Some of the major factors behind its success were state intervention, well framed laws and policies, transparency and political unity.

Another significant model is *Danaharta*, established by the Malaysian government in the year 1998, a government funded asset management company with finite life to resolve stressed assets and recapitalisation. The Malaysian Government reacted swiftly by setting up two asset management companies—one to take over bad loans named Dan Harta with special powers and another for infusing capital into the weak banks called Dana modal. Malaysian government also focused on strengthening its laws to support the effective operation of Danaharta and stressed upon involving experts around the world which contributed immensely towards its success. Later, both the AMCs were closed as the purpose was accomplished.

These global models are good guides and these models can be initiated in India with modifications suitable for our circumstances and economic environment. So, there is a need for such AMC / Bad bank (BB) in India to tackle the NPAs with its objective to achieve maximum recovery by adopting the most appropriate recovery strategy on a case-to-case basis. Additionally, a regulatory framework may very well need to be established before setting up a bad bank. Despite there being various bankable examples to look at when setting up a regulatory framework, the Indian economy is its own beast and may take some niche set of rules and regulations to deal with the NPAs and to keep the banking system buoyant.

Indian Banks Association (IBA) has proposed a Bad Bank which includes an ARC which will house the NPAs, an AMC and an Alternate Investment Fund ('AIF'). The ARC will be owned by the Government of India, the AMC will be a professional body with participation from public and private sector, and the AIF is where a secondary market can be created for security receipts. The association recommended that the capital of Rs. 10,000 for Bad Bank to start operating shall be funded by the government. This may imply that a bad bank may be governed by similar regulations that govern these entities.

However, in the recent budget for the year 2021-22, Government had proposed an ARC floated by lenders themselves along with an AMC and an AIF to resolve NPAs over Rs 500 crore. But experiences around the world are a testimony that the state cannot be entirely excluded from the ownership structure of Bad Bank and in India, keeping in view the Size of NPAs in public sector banks, the Government cannot be entirely excluded from the ownership. Government may be a minor stake holder and at the same time, the bad bank must have the commercial freedom and transparency.

ii. Funding:

In order to purchase the stressed assets, the bad bank requires to be capitalized and the owners of the bad bank will have to find financial resources for the same. Acquisition costs and operation costs are the two main costs that determine the extent of capitalization that a bad bank requires (Schäfer & Zimmermann, 2009). The

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extent of liquid funds required by the bad bank depends on how the acquisition costs are paid. Bad bank may make cash payment to an extent of 15% of acquisition cost and security receipts (SRs) may be issued in lieu of balance of amount. In such situations the requirement of liquid fund is comparatively less. A large share of the funds required to capitalize the bad banks are often provided by the governments in other parts of the world. But Indian Government had proposed an ARC floated by lenders themselves. The bad bank may be established with nominal initial capital and the same may be contributed by regular banks. Once capitalized, the bad bank can borrow money from different agencies or selling banks to finance to acquire stressed assets. Further the bad bank can raise zero coupon bonds to be subscribed by the lenders who are transferring the stressed assets to it. These Zero- Coupon bonds shall be for a period of 6-7 years with a recall option. These bonds must be guaranteed by the Government to carry zero risk weight. The lenders can classify them as Held to Maturity (HTM) investments so that there is no impact of depreciation. These bad banks should be exempted from maintaining capital ratios and provisioning as required as per extant guidelines of RBI as special dispensation.

iii. Transfer of stressed assets

NPAs can be transferred based on outstanding balance beyond a cut off limit say Rs.100 Cr. At the first instance, loans sanctioned under Consortium or Multiple Banking arrangement with outstanding balance of Rs.500Cr and above can be transferred followed by loans outstanding of Rs. 500 Cr and above under sole banking arrangement, if any. Loan outstanding above Rs. 100 Cr and above may be transferred in the second phase leaving smaller NPAs with respective banks.

iv. Asset management and Disposal

How the stressed assets acquired by the bad bank will be managed and/or liquidated is another important aspect that must be addressed at the time of establishing a bad bank. The first issue to be decided is whether the transferred assets should be liquidated quickly or held till its maturity. So the assets to be categorised properly.
The ARC may have two divisions one, *Samrakshana* Division (SD) for the type of stressed that are having economic value or where there is possibility of revival or restructuring or resolution and some positive outcome is expected and the second one, *Prarakshalana Division* (PD) for other stressed assets.

The SD can make efforts to revive or resolve or initiate the steps for disposal of the asset. If the particular industry/assets are showing signs of revival, such assets can be continued in the books, these assets can become income yielding and can create economic value to the country. Suitable resolution may be found by the bad bank in respect assets having future demand-supply issues, which otherwise face liquidation under the IBC. Certain sectors like Power Sector require long time for resolution. This arrangement is also beneficial as loan restructuring generally yields higher recovery rates compared with other recovery methods. There shall be a repurchase agreement wherein, the selling banks agree to repurchase viable resolved / restructured accounts

The cash flow of these assets may be sufficient to repay the liability in extended repayment period. These viable assets may be sold back to banks at sustainable debt levels and banks can write-off the remaining balance as they have already made provision.

With the introduction of IBC, there has been a change in promoter behavior towards repayments, and there is now a conscious move by promoters/directors, to engage earlier into discussion with lenders, at the first signs of distress, so an alternative mechanism for resolution can be developed and to settle debts outside of an IBC process. The IBC would then be used only as a deterrent against default. The bad bank could find a solution in such circumstances. In respect stressed assets showing signs of non-revival, step may be initiated immediately without further loss of time, for disposal of assets including invoking through IBC. The PD may initiate the process of disposal of NPAs right from the date of acquisition. Even in case of worst cases, bad bank will get sufficient time for liquidation or to dispose of assets as a slump sell to reduce the losses.

There is no securitisation market where bad bank can sell the NPAs in India and therefore, efforts are needed to develop the market for stressed assets. An active secondary market and funding from banks could foster entrepreneurial interest, helping in faster redeployment of these assets and ensuring better price discovery.
The bank can deduct the expenses incurred for realizing the dues of a particular asset from proceeds of sale of stressed assets and a standard share of say 1% of amount realised from the sale proceeds. The remaining balance can be used for recovering its 15 % cash payment made to selling bank and to redeem SRs. If the selling bank receives surplus, it can account it to its Profit & Loss account of corresponding year of realization. If it receives deficit, it can adjust against the accumulated provisions held in respect of that particular account outstanding in Provisions Fluctuation Fund and if still deficit, then to be debited to PL account. If there is excess provision outstanding in respect of this account, then excess can be transferred from Provision Fluctuation Fund to General Reserves.

v. Determination of value/ Transfer Price

The determination of transfer price at which a bad bank has to acquire stressed assets is a very crucial factor that must be taken into consideration before establishing the bad bank. The major issue existing ARCs have been facing is to reach an agreement on the value at which banks can sell off the NPAs. Banks have been selling NPAs to ARCs either by an auction or bilateral negotiations. However, auction cannot be a suitable way for Bad Banks to acquire NPAs as it will further complex the entire time bound procedure the Bad Bank needs to follow.

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So, a key problem of every bad bank scheme is how to determine the take-over price of the stressed assets. Given that financial institutions normally enjoy an informational advantage regarding the quality of their own portfolio, they should succeed in selling their distressed assets at a price above the fundamental value to the bad banks. Hence, there arises a moral hazard problem, because knowing in advance that their stressed assets will be taken over above market value by an ARC in the case of a crisis, financial institutions will become more risk prone.

Thus, any sustainable bad bank approach must necessarily avoid setting incentives for future speculative behavior and it is crucial that the assets are taken over only for their actual value. However, evaluating the expected yields of distressed assets is a difficult task. If the estimate is too optimistic, part of the economic burden is transferred to the public. On the other hand, with too pessimistic an estimate, the financial sector would be faced with an unnecessary burden which could hamper credit supply. Moreover, while the market price did no longer reflect the fundamental value of the securities, fair value accounting nevertheless required financial institutions to write off substantial sums immediately.

As such, we proposed a different approach, which combines the bad bank solution with equalization claims, an instrument that has successfully been used in other parts of the world. This approach not only leaves total losses with the banks, but also avoids the problem of evaluating the stressed assets in advance and curtails moral hazard. This will lead to stabilization of financial sector and banks will be able to participate in fresh lending thereby support to the economic development of the country

Under the Government proposed ARC–AMC model, it is contemplated that the transfer of stressed assets to the ARC will happen at net book value, which is value of assets minus provisioning done by banks against these assets. This is neither much useful to lenders nor to the economy except reduction of GNPA from the balance sheet of banks.

Under our proposed model, banks can transfer their NPA at a fixed hair cut irrespective of provision held by them with recourse basis as mention below.

Substandard Assets	20 % discount i.e 80 % of outstanding balance
Doubtful Assets up to 2 years	30 % discount i.e 70 % of outstanding balance
Doubtful Assets > 2 years, Loss Assets & Fraudlent accounts	50 % discount i.e 50 % of outstanding balance

The proposed discount in respect of substandard and Doubtful Assets upto 1 year is more than the regulatory provision and it acts as deterrent to the banks from transferring accounts immediately after becoming NPA without making the required efforts to recover. Practically it can be observed from the past experiences the actual fraudulent amount involved has been a part of total exposure in most of the cases, but the banks have been providing 100% provisioning as per regulatory norms. Surely there may be underlying assets in all these cases and as such it is logical to transfer at 50% provision.

Bad bank will make cash payment to an extent of 15% of respective amount (80%/70%/50% of outstanding amount) and security receipts (SRs) will be issued in lieu of balance of amount. If there is deficit in the provision held and amount to be written off on account of discounted sale, the difference shall be debited to Profit and Loss account of transferor bank. If there is excess, the surplus may be transferred to a new account "Provision Fluctuation Fund". This Fund shall be made eligible to be treated as component of common equity capital. This will lead to increase in the growth capital and help the banks to increase fresh lending.

In terms of extant instructions of the Reserve Bank, all instruments received by banks from SC/RC as sale consideration for financial assets sold to them are non SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's FI's investment in debentures/ bonds/ security receipts/PTCs issued by SC/ RC. Therefore, these SRs must be guaranteed by the Government to carry zero risk weight. The lenders can classify them as Held to Maturity (HTM0 investments so that there is no impact of depreciation.

If the Security Receipts (SRs) held by a bank comprises more than 10 per cent of the Non Performing assets of the same bank, it will attract higher provision in accordance with existing RBI guidelines, assuming, the NPA was still on the books of the bank. As the SRs issued by bad bank will be guaranteed by Government, they may be exempted from provisioning norms. However, the selling banks may be advised to provide annual provision @ 15% of the original amounting outstanding in NPA accounts (at the time of transfer) till the accounts are fully provided for or disposed of by the bad bank. This provision is to be credited to Provision Fluctuation fund. The process of disposal of asset is expected to take at least about two years even through NCLT route. Meanwhile, selling banks can accumulate further provision of about 30% of original outstanding in this two-year period and even if the assets realize 50%, banks will be in position to book the losses on redemption of security receipts without any impact on their Profit and Loss account during the year of closure of the account. With this model, there are also other positive effects. The stressed assets are removed transparently from the financial sector and the overall exposure to the stressed assets of an institution is revealed. Banks can focus on normal lending

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activities. The government would not bear any part of the banks' losses (except at the time dissolution of bad bank , if any)

vi. Timeline

The proposed bad bank should not develop any sense of complacency among banks or the borrowing community to adversely impact the credit culture of the country. Most banking crises are over in a 6–7 year period. A 6-7 year time span is the logical time to use for planning purposes and the timeline to use for realisation. Therefore, the bad bank shall be established for a period of maximum 8 years only and then this bank can be dissolved. Banks can transfer the outstanding NPAs immediately. New additions may happen on account of COVID-19 during 20121-22 and therefore banks can be permitted to transfer stressed assets as early as possible but not later than o March 2022.Timeline in which the assets need to be resolved by the Bad Bank is crucial to the entire resolution process and must be strict. Bad Bank should be able to resolve the acquired NPAs within maximum period of 5 years which can be extended up to 6 years in special circumstances. So, the bad bank can be dissolved in the 8th year.

vii. Administration and Revenue

The first year of the bad bank determines its success. The challenge is the large number of non-performing loans in a wide variety of situations with regards to geographical location, type of industry, size and type of problem. The bad bank has to quickly get control of these loans, otherwise, a lot of value is lost. To be successful, a well-defined process on how to handle the different loans has to be established. This process to be followed and managed with force and speed in the organisation.

The Executive Board of the bad bank shall be staffed to ensure that it could adequately input into the final structure, governance and operational aspects of the bad bank. Skilled management is essential, be it for valuation, development of a successful asset disposal strategy, collections or sale decisions. Some stressed assets taken over will need some form of restructuring and this process includes conducting negotiations with debtors, debt rescheduling, debt reductions to avoid default etc,. This necessitates a comprehensive yet expedient recruiting of specialized staff, often on competing terms. Recruiting efforts need to be matched with retention policies and an incentivising compensation system given the bad bank's temporary nature.

The bad bank can have majority of employees only on contract basis for fixed salaries. Bank shall also include experts from all fields to deal with complex NPAs. Also, in an event when it takes time to resolve NPAs, it's the experts who can use their expertise to deal with the assets meanwhile a suitable buyer can be found. The active management of the stressed assets should be outsourced to specialised asset managers.

Keeping in view the huge costs and time in establishing the necessary systems to manage a relatively small pool of assets, some of the activities of the bad bank could be contracted out using Long Term Service Agreements. To the extent possible, such agreements could be structured in a way to have performance-related incentives to ensure high standard services. The bad banks must however be made accountable for its actions.

It can charge standard rate of annual management fee for meeting the regular administrative and operational expenses from the selling banks in proportion to their NPAs balance transferred at the time of transfer and outstanding in its books at the beginning of every year. In fact, operational cost and cost of realization of NPAs even through NCLT route will come down substantially.

viii. Legal Framework

Necessary legal framework is essential for the proper functioning of a bad bank as stressed assets more often involve a number of disputed claims and associated litigations. The legal framework must also ensure a hassle-free transfer of stressed assets including title from the regular bank to the bad bank and from bad bank to prospective buyers.

An adequate legal framework, including sufficient legal powers to restructure or enforce on their assets is paramount for AMCs effectiveness. A special legal status also supports a speedier preparation of the assets for sale. Insolvency and bankruptcy laws need to be robust to ensure that the AMC as well as prospective asset buyers can access insolvent debtors' collateral under fair terms and a reasonable timeframe.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has already laid down the general legal framework for the efficient functioning of bad banks registered under that legislation. If needed necessary, it has to be amended to further strengthen the act. Insolvency law Insolvency and Bankruptcy Code (IBC) has been enacted and operational since December 2016. Indian banks are putting the IBC to effective use to resolve NPAs. Even a bad bank will have to rely on the IBC to turn around some of the assets. The emphasis, therefore, should be on sustaining the impressive momentum that the IBC has gathered. In addition, the informal restructuring framework should be strengthened.

ix. Dissolution of Bad bank

The bad bank should start process of dissolution earlier or atleast from the beginning of 7th year, so it can be dissolved during the 8th year after meeting all regulatory norms.

When a bad bank has gone through its credit work-out process, the remains of the bad bank is either viable restructured accounts or the assets whose worth is meagre or nearly zero, that are left after the credit work-out process. The viable restructured accounts outstanding in the books of bad bank at the time dissolution can be

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transferred back at sustainable debt level to selling bank and redeem SRs. Banks can write off the balance, if any, against the accumulated provisions held in respect of that account outstanding in Provisions Fluctuation Fund. In case of worthless assets, if any, can be sold under slump sell or write off and redeem SRs at zero value. Banks can write off the balance against the accumulated provisions held in respect of those accounts outstanding in Provisions Fluctuation Fund.

Framework may also include links of profit sharing among the owners of the Bad Bank so that once the bad assets have been resolved by the Bad Bank, if there is surplus, the profit will accrue to the owners of Bad Banks i.e., the banks, the original institutions themselves as a return to their investment/Debt (zero-coupon bonds) and capital. Losses, if any, Government would bear the losses over above nominal capital, if any, to meet redemption of zero-coupon bonds at face value (as these bonds originally to be issued under a guarantee structure). The government bearing the loss is acceptable as the banks would contribute in the form tax and dividend to Government once the banks are freed from stressed assets and focus on fresh lending. Moreover, the benefits of changing balance sheets of selling banks (after transfer of stressed assets), accrue to the economy by increased credit flows would justify government bearing the losses.

The idea of Bad Bank has been avoided for a long time in India. However, looking at the enormous number of distressed assets it becomes significant to find a way to resolve them. Stressed loans when transferred to a bad bank, can help lenders prioritize their financing business and the specialized institution deals with maximizing recovery/ resolution of stressed assets. However, Bad bank alone cannot be effective and panacea for NPA problem of the banking industry. It should be supported by banking sector reforms and an adequate legal framework and robust Insolvency and bankruptcy laws and separate NCLT benches with adequate infrastructure to deal with stressed assets for speedy resolutions and to induce sustained discipline among the Indian corporates.

V. CONCLUSION

Rise of Non Performing Assets in recent years remains an area of concern for Indian Banks particularly Public Sector banks and should be tackled with sincere efforts. The role of IBC has been significant yet not sufficient to resolve enormous number of NPAs. The idea of Bad Bank has been avoided for a long time in India. Bad Bank, which is essentially an ARC, has the potential to get financial sector ready to release funds. Having a Bad Bank will let the banks continue the lending however, it will bring its own challenges, but this seems be to be the best suited time for its incorporation for the recovery of the banking sector. A challenge for a bad bank may be developing a sustainable and unique business model. We suggested a model, which rests on an idea that combines the conventional bad bank approach with the instrument of equalization claims. This model effectively addresses three key challenges, the transparent removal of stressed assets and gives the banks to start fresh lending, offers the chance to keep the cost to taxpayers low and avoids the risk of moral hazard. However, Bad bank alone cannot be effective and panacea for NPA problem of the banking industry. It should be supported by banking sector reforms and an adequate legal framework and robust Insolvency and bankruptcy laws and separate NCLT benches with adequate infrastructure to deal with stressed assets for speedy resolutions and to induce sustained discipline among the Indian corporates.

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