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REVIVAL OF BAD BANK CONCEPT POST COVID-19: WILL IT WORK THIS TIME?

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Abstract

Indian Bank Association proposed to bring back BAD BANK concept in order to rescue the banking sector from post covid-19 credit crunch. 'Bad bank' as a concept is not new and has been in headlines previously as well, however, it could not be implemented due to lack of capital to the buyers of toxic assets. This time, taking into consideration the present situation and the economic slowdown, the bad bank seems to be the only viable option to shore up the financial system, which makes it a gamble of resurrection. In the present scenario however, the markets may be more receptive to the bad bank structure. A big question still persists here. Will this time the bad bank concept work for Indian economy? In this article, the author analyses the proposal led down by the Indian Bank Association .The author discusses the concept of bad bank and how it works and the past instances of successful bad banks which proved to be a boon for affected country's economy. Furthermore, the article highlights the factors that should be taken into account while preparing the plan and will also discuss the flaw in the proposal. This Article will also discuss India's past experience with bad bank like structure and reasons for its failure. Conclusively, the author advocates the imperative need of bad banks to sustain the Indian Economy.

Introduction

The year 2020 has caused a lot of turmoil all over the world. The outbreak of COVID 19 pandemic has hit very hard not only on physical health of the people, but also disturbed the financial health as well. Disruption of the economy on account of the COVID 19 is well acknowledged all over the world. India also happens to be among one of the countries that are facing economic crisis due to this pandemic. A long lockdown in India has brought business

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activities to a halt. People who had taken loan for businesses and other activities are now left with no means to repay the loan and this, in turn, has made them default on their installments which have eventually resulted in the growth of toxic assets in the banking sector and threat to Indian banking sector. The toxic assets indicate the ill health of any bank. The toxicity of assets of a bank is directly proportional to its ability to borrow, lend or conduct business affairs. More the toxic assets, the harder time the banks will have in dealing with these areas.

As per the report of a credit rating agency CRISIL, by the end of 2020, the percent of Non-Performing Assets (NPA) in banking sector would soar up to11-11.5 percent for the base case and it could increase higher.[2] Furthermore, as per media reports, the government officials were concerned about the NPAs which could double to 18-20 per cent by the end of the fiscal year, as 20-25 per cent of outstanding loans faced a risk of default.[3] Indian banks have already been overburdened with toxic assets as they had 9.1 per cent NPAs of their total assets at the end of September 2019[4] and a further proliferation of NPA would be a menace to the Indian banking sector.

Taking into consideration the potential threat to the banking sector post covid-19, the Indian Bank Association proposed to bring back **BAD BANK** concept to rescue the banking sector from post covid-19 credit crunch.[5] Creation of bad bank has now become imperative to tackle the toxic or troubled assets which are lying on the bank's balance sheet. The idea has been supported by the State Bank of India Chairman, Rajnish Kumar, and it is quite likely that the approval for the same could be given by RBI as well as the Government.

THE PROPOSAL PRESENTED BY IBA

This proposal of a bad bank was based on previously based model Project Sashakt model which was proposed by a panel led by former Punjab National bank chairman Sunil Mehta in the year

[2] *Covid impact: Crisil expects gross NPAs to rise by 150-200 basis points this fiscal*, FIN. EXPRESS (May 1, 2020) https://www.financialexpress.com/economy/covid-impact-crisil-expects-gross-npas-to-rise-by-150-200-basis-points-this-fiscal/1944954/.

[3] *Up to 25% of outstanding loans face default risk due to COVID-19: Report*, THE WEEK (May 04, 2020), https://www.theweek.in/news/biz-tech/2020/05/04/up-to-25-outstanding-loans-face-default-risk-due-to-covid-19-report.html.

[4] Id.

[5] Ankur Mishra, *IBA submits proposal on 'bad bank' to govt, RBI*,FIN. EXPRESS (May 13, 2020), https://www.financialexpress.com/industry/banking-finance/iba-submits-proposal-on-bad-bank-to-govt-rbi/1956981/#:~:text=The%20Indian%20Banks'%20Association%20(IBA,close%20to%20development%20told%20FE.

2018.[6]It proposed that there will be a three body structure bank wherein an asset reconstruction company (ARC) will be formed and all bad loans will be transferred to that and it will issue security receipts. Government will invest 15 % in the ARC. Furthermore, there will be an asset management company (AMC) to manage all the acquired assets and an Alternate Investment Funds (AIF) which will help create a secondary market for these security receipts. All the aggregated bad assets will be housed in the ARC. The two bodies AMC and AIF will act as market player; the main function of these bodies is an optimum recovery of the bad assets by creating secondary market and engaging with external parties.[7]

The banks proposed to invest Rs. 100 crore in this rescue plan. Further the government would capitalize to the extent of Rs 10,000 crore. The initial books of bank with start with an amount of Rs. 70-75,000 Crores worth bad loans.[8]As per the proposal, the bad bank will not pay whole amount to the rescue bank, instead, will pay only 15% of the value in cash and rest will be paid in the form of security receipts, which will be redeemable in future.[9] The bad assets will be held and managed by the bad bank until the opportune moment for their sale.

This proposal was carefully drafted considering the increasing number of NPA in the banking sector. The proposal carries that the bad asset will be purchased till March 31, 2021 and after that, no further assets will be purchased. The bad bank will have a 10-year life period to resolve the toxic assets after which the issued security receipts will be redeemed.[10]

WHAT IS BAD BANK AND ITS HISTORY

The bad bank or to put in other words, a 'good bank' rescues the banks which are under the distressed assets. It is created to revive the affected back and back to the position where they can continue their normalise lending.[11] Bad bank purchases the toxic assets from the affected bank at a price below the book value of these loans, and manage them to sell for optimum

[6]*Project Sashakt: Banks give shape to inter-creditor pact for bad assets*, THE ECONOMIC TIMES (Jul 06, 2018), https://economictimes.indiatimes.com/industry/banking/finance/banking/banks-give-shape-to-inter-creditor-pact-for-bad-assets/articleshow/64877560.cms?from=mdr.
[7] Id.
[8]*IBA submits 'Bad Bank' proposal to government, RBI*, CNBC TV18 (May 12, 2020), https://www.cnbctv18.com/finance/iba-submits-bad-bank-proposal-to-government-rbi-5901621.htm.
[9]VishwanathNair, *How The Idea Of A 'Bad Bank' Made A Comeback*, BLOOMBERG QUINT (May 12, 2020) https://www.bloombergquint.com/business/how-the-idea-of-a-bad-bank-made-a-comeback
[10]Id.
[11]Anna T. Pinedo, Removing toxic assets from balance sheets: Structures based on the good bank-bad bank model, 2 J. SEC. L. REG. COMP. 289, 290 (2009).

recovery.[12]

The Bad bank policy resembles to a bankruptcy procedure. The sole purpose of bankruptcy process is to save the good parts of a company and shut down the bad parts in order to get maximized profit from good parts. In this process, the creditors get paid back more and thus, a part of business is rescued.[13] Similarly, the main aim of creating a bad bank is to rescue the banks which are overburdened with the toxic assets. Bad banks help to reduce losses to creditors as well as allow the banks to resume normal lending. Just like corona virus toxic asset is also a virus for the banks, which contaminate the good assets also. Therefore, investors who invest for loan duration and the counterparties are skeptical on the bank's financial health and performance, impairing its ability to lend, trade and borrow.

So, it is essential to isolate the bad assets to rescue the good assets. As per this concept, all the bad assets will be transferred to bad bank to resolve it, the affected bank will get free from the toxic asset, and it can ring-fence its core business activity.[14]This isolation allows the bank to minimize its risk and to deleverage as initiation toward creating a sound business model for the future. It is certain that a more efficient and focused management with clear inducements for portfolio reduction will definitely helpful for maximize the value of bad assets. And isolation of good assets from bad assets can help banks regain the trust of investors, by providing more transparency into the core business and lowering investors' "monitoring costs.

The bad-bank concept has been used with great success in the past and is today being viewed as the most apparent savior in the resurrection of the banking system.

SOME SUCCESSFUL BAD BANKS

The first ever bad bank was established by the Mellon bank in 1988.[15] Mellon was overburdened with the bad real estate related loans when he decided to split into banks and all the bad assets were transferred to the newly formed bad bank called Grant Street. This split proved to be very successful as the removal of toxic assets eliminated the uncertainty among stockholders and creditors. The removal of this uncertainty provided Mellon an opportunity to raise additional capital and it went on to flourish and within seven years, the bad bank was

[12]Id.
[13]Daniel Gros , *Why a bad bank needs to be big*, CEPS commentary(Feb. 4, 2009).
[14] Id.
[15]Douglas J. Elliott, *Bad bank Nationalization", "Guaranteeing Toxic Assets": Choosing among the options, Initiative on Business and Policy at brookings*, Jan 30, 2009.

wound up without any additional capital injection.[16]The second example is Sweden's bank rescue plan from the early 1990's. In Sweden's case, which is much admired today, two of the largest banks were taken over by the state and were restructured using the bad bank approach.[17]

The 2007-08 European crisis is an another example in which various western European countries post the 2007 financial crisis like Ireland, Sweden, France, Spain and Germany[18] etc. have successfully been able to implement the bad bank concept.

Further examples include- In 2012, Spain also set up a bad bank (SAREB).In the year 2013, Slovenia has decided to restore its banking sector by means of a bad bank (DUTB). Ireland, Spain, Germany has also applied this concept to rehabilitate its banking sector.[19]

INDIAN HISTORY

IDBI in the year 2004 came up with a bad bank like structure wherein a Stressed Asset Stabilization Fund (SASF) was established in which stressed assets worth Rs 9,000 crore of the bank's stressed assets were housed. This structure was backed by the government where the government extended loans worth Rs 9,000 crore to the fund.[20]

It was year 2015 when NPAs was on surge in Indian banking system. But it was denied due to inadequate capital and lack of buyers. [21]

Again in the year 2017, when the Economic Survey of India came up with the proposal to establish Public Sector Asset Rehabilitation Agency (PARA), RBI also nodded to this structure and suggested to form two entities to eradicate the bad loan problems sick PSBs -- PAMC (Private Asset Management Company) and NAMC (National Assets Management Company).[22]

In the year 2018, the government formed a panel led by Sunil Mehta, the non-executive chairman of Punjab National Bank (PNB) under the Project named Sashakat to prevent the flare-up in non-performing assets (NPAs). It was proposed that the committee will forman AMC and an AIF to resolve non-performing assets (NPAs) over Rs. 500 crore.[23]

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[16]Id.
[17]Id.
[18]Stephanie Medina Cas & Irena Peresa, *What Makes a Good 'Bad Bank'? The Irish, Spanish and German Experience*, European Commission discussion paper 036 (Sep. 2016).
[19] Id.
[20]Nair, *supra* note 8.
[21]Id.
[22]Id.
[23]Economic Times, *supra* note 5.

Factors for a successful implementation of Bad Bank concept

Mulling over the examples of a bad bank found worldwide, it is advocated that bad bank structure is the only hope to save our drowning economy post Covid-19. On paper, this idea seems to be very easy to implement, however, the process is very much complicated and certainly not that simple as it seems to be. The success of the concept depends on many factors that vary considerably from country to country. It depends on the size and scale of the difficulties of the entire banking system or certain banks, and the financial as well as the political will and capacities.[24]

This idea has been recurring in our country for all these years but could not be implemented by the policymakers and ascertaining the big problems in implementing bad bank structure still persists. Nevertheless, it is believed that with a careful planning, many of these problems can be surmounted.

For the successful implementation of this concept, this time, some careful analysis should be done. The structure and design of the bank would be the most significant factor in the success of bad bank.

Prerequisites for the Success of a Bad Bank

1. Stressed assets have been bought/taken over at a low price;
2. There should be active management of these assets.
3. There should be involvement of financial experts who know how to deal with such assets;
4. There should be availability of time as this concept is time taking.
5. There should be implementation of clear governance structure.[25]

While transferring toxic asset to a bad bank, the bank has to keep in mind its choices of assets to be transferred into the risky category, business case, portfolio strategy, and the operating model.[26]These choices need to be made while considering the impact on funding, capital relief, cost, feasibility, profits, and timing. Before the implementation of this structure corporate,

[24]Tanja Markovic & Matej Tovec , Bad and Bank other Possible Banks' Rescuing Models – The Case of Slovenia, 1 Academia Brâncuşi128, 132 (2015).
[25] Dorothea Schäfer & Klaus F. Zimmermann, *Bad Bank(s) and the Recapitalisation of the Banking Sector*, INTERECONOMICS 215, 218 (2009).
[26]Medina cas, *supra* note 17, at 8.

banking and securities laws must be taken in to account[27]as the bad bank's sole purpose is the resolution of troubled assets, limited regulatory oversight is mandatory.[28] This structure involves a variety of security law issues e.g. there has to be necessary and appropriate disclosures to the potential investors in the special asset company and the spin-off and ongoing reporting requirements of the special asset company.[29]

The next factor which is very essential for successful implementation of this structure is the government support. Government should support the banks financially and it should also assist those banks who are facing the regulatory and tax problems. Indeed, the case differs from country to country basis depending upon the bank's financial health but, to speak in a broad manner, the government should step up and smoothen up the restrictions so that bad banks could be created and also establish the extent to which the state will bear the risk of bad assets.[30]

Important Bad Bank Models

There are four basic bad-bank models: On-balance-sheet guarantee, Internal Restructuring Unit, Special-Purpose Entity and Bad-Bank Spin-Off.

1. On-balance-sheet guarantee

In the on-balance-sheet guarantee structure, the government for a part of its portfolio gives bank a loss guarantee. This model is simple, reasonable and can carry on without delay. In this model, the transfer of risk is limited but the bad assets still remain on the bank's balance sheet which contaminates its core performance. This model is more practical for assisting the banks which are under distress assets. But a big flaw with this model that the bad assets remain in the balance sheet and this is not a good sign for a bank's financial health. This might be the reason that most of the banks do not use this model.

2. Internal restructuring unit

In this type of bad bank, an internal bad bank is set up. All the bad assets are transferred to that internal bad bank and a separate management team is assigned for that bank with clear incentives. This is considered as signaling mechanism in the market. As bad assets are

[27]Edward D Herlihy& Craig M Wasserman, Making the Good Bank/Bad Bank Structure Work, 11 Int'l Fin. L. Rev. 34, 35 (1992).
[28]Pinedo, *supra* note 10, at 291.
[29] Id.
[30]Tanja *supra* note 23.

transferred to different internal unit, the bank's transparency increases. In this model, the affected bank depends on the existing management team to restructure assets and the affected bank will have no autonomy over the bad assets. Now, it will be the newly set up internal bank which would be responsible for the bad assets. This model is preferable model to others among banks.

3. Special-purpose entity

In this model, a special purpose entity is set up and all bad assets are offloaded into that SPV, securitized and sold to a various set of investors. This model is mostly preferable for small, homogeneous set of assets. Infrastructure and basic metals is one of the most bad loan affected sector of India. Transfer of bad loans from these distressed sectors into sector-specific SPVs, securitize them and sell them in an auction would be the most effective solution to this problem. If the pricing is determined by the market, then PSU bankers will be held less liable for losses to the exchequer.

4. Bad-bank spin-off

Spinoff model is the less risky model because in this model, the bad assets are shifted into a separate banking entity. This model involves formation of a separate entity. This is a good model but it is an expensive and complex model as to run separate entity there will be need of IT systems, a skilled management team, and a regulatory compliance.

Asset valuation and pricing is the toughest task of this model. The Public Sector Asset Rehabilitation Agency (PARA) proposed by the Economic Survey 2016-17 falls under this category.

Advantage to Indian Banking Sector on Successful Implementation of this Idea

Once this concept is implemented in a proper way, this will certainly help in the resurrection of the banking sector. The Chairman of State Bank of India MR. Rajnish Kumar also supported this concept and as per his view, the time has come when a structure along the lines of a bad bank should bring back to rescue the banking sector from increasing NPAs as the provisions on the existing NPAs- most of the banks are holding a very high level of provisions. Therefore, a bad bank which was not feasible 3 years ago as the provisions were inadequate is now possible as we have the adequate provisions in place.[31]

[31]Mishra, *supra* note 4.

By implementing this concept, there will be an ease for the buyers of the bad assets also. In recent situation, when an asset has to be sold, a buyer has to go to different people. However, if there is a consolidated entity then even the buyer will have to deal with one entity and not various.

There are various lenders who think bad bank as the better option because when they go through bankruptcy code they have to face huge haircuts which result in larger losses for state-run banks.[32] Furthermore, in power sector, bad loans cannot be resolved through the IBC system. If a power sector asset goes to NCLT, "*practically nothing will survive, except the plant"*[33] So, any buyer will lose interest asset because of this.

Most of the times, the states don't sign Power Purchase Agreement so that power can be bought for a cheaper price over exchanges and hence, they cannot go for bankruptcy process. Therefore, for all these reasons, the idea of bad bank seems to be a good option for the banks wherein they can park their money to a separate agency to find a solution in long time.

CONCLUSION

The bad bank concept has been time and again presented before the government to tackle the stressed assets problem but has never been implemented. This time, considering the pandemic situation, the stressed assets are going to be very high as the various reports and officials said. Hence, bad bank is the only viable solution to curb this problem since the amount NPAs are at an all-time high, there seems no other alternative to this problem.

During Europe financial crisis, Ireland, Spain and Slovenia initially tried to solve the difficulties through recapitalization. However, they all later switch to bad bank.[34] Moreover, the bad bank structure has even been followed by some countries that had never encountered systemic problems in the banking sector. Germany is one among them. Despite the healthier economic situation and lesser problems in the banking system, it created a national bad bank to solve the issues.[35]Therefore, for big economic crisis which India would face post Covid19, a bad bank is

[32]*Government, bankers worried over high haircuts in IBC*, THE NEW INDIAN EXPRESS(Jan. 9, 2020) zhttps://www.newindianexpress.com/business/2020/jan/09/govt-bankers-worried-over-high-haircuts-in-ibc-2087175.html.
[33]IBC can't resolve power sector crisis, but ARCs can: Secretary SC Garg, ECONOMIC TIMES (Aug. 23, 2019), https://energy.economictimes.indiatimes.com/news/power/ibc-cant-resolve-power-sector-crisis-but-arcs-can-secretary-sc-garg/70804815
[34]Markovic, *supra* note 22, at 133.
[35]Markovic, *supra* note 22, at 134.

an imperative step. Bad bank can also address the issues emerging in the real-estate sector. The need of big bank cannot be denied. However, this time for its successful implementation, the authority should prepare a better plan and should not repeat their past mistakes.

A careful analysis of successful bad bank stories across the world and proper due diligence can help in the successful implementation of a bad bank this time. In the year 2004, a bad bank like structure (SAFS) was established by IDBI for resolution of its bad loans. As per the 125th report of Public Accounts Committee of the Ministry of Finance, the total bad loan for recovery was INR 9,000 Crores out of which only an amount of Rs 4,514 Crores was recovered. The committee was of opinion that the recovery of remaining assets was very "complex and difficult".[36] In that report Committee has pointed out the reason for such a low recovery of bad loans was inexperienced and untrained staff of SAFS in corporate banking and recovery of stressed assets. As per the report, the committee felt that "*The recoveries are majorly dependant on the efficiency of the officials deployed for recoveries and therefore incentives should be given for good performances".*[37]Now, considering the past instance, it is advisable that this time, the required manpower is deputed with requisite skills or background for better implementation of bad bank model.

On seeing the tremendous growth of NPAs, it is advisable that the proposed bank should be big enough to take away a meaningful chunk of bad loans from banks. As per the present proposal, the estimated size of the bad bank is about Rs 75000 crore, so, it won't make any substantial difference. In my view, the policy maker should reconsider the size. As per the 'lemon' analogy, a bad bank should be big. For example, if one buys machines for his factories one-by-one, he must be able to estimate the value of each. However, if he buys the entire lot of machines, all he has to do is estimate the average value of the machines which certainly makes the task easier.[38] Therefore, taking into account the potential growth of NPAs post Covid-19, the size of proposed bank should be increased.

It is true that bad bank may not rescue Indian banking sector absolutely or completely however, it would certainly prove to be a tranquilizer and provide some relief from the post Covid-19 economic crisis .The structure of band bank should be designed considering the political economy of India. Furthermore, for successful implementation of bad bank, it is vital that

[36] Stressed Asset Stabilisation Fund (SASF) , Public Account committee , Ministrry of Financce (Govt. Of India), 125 Rep (2018-19).
[37]Id. at 22.
[38]Gros, *supra* note 12.

government support is provided. The Government should provide adequate capital to the banks to cover write-offs and also facilitate a fresh loan growth.

Bad bank model can take up to a year to be implemented in application and financing process. Therefore, it is necessary for the authority to work for the better implementation of bad bank structure now on for post Covid-19 recovery.