Bad bank

September 23, 2021

The Union Cabinet on Wednesday approved a ₹30,600-crore backstop facility for guaranteeing securities to be issued by the National Asset Reconstruction Company Ltd. (NARCL), the so-called 'bad bank' that is being set up to help aggregate and consolidate lenders' non-performing assets (NPAs) or bad loans. Will the new financial entity help to solve the problem of non-performing assets or bad loans?

In news: What is the need for a 'bad bank'?
Placing it in syllabus: Economy
Dimensions:

- What is a bad bank?
- Non Performing Loans and the extraction of better value from them
- Existing debt recovery process through Insolvency and Bankruptcy Code (IBC)
- Sovereign Guarantee offered to bad bank
- Functions of National Asset Reconstruction Company Limited (NARCL) and India Debt Resolution Company Limited (IDRCL)

Content:

What is a bad bank?

- A 'bad bank' is a **financial entity set up to acquire NPAs** from banks and resolve them.
- It is an **Asset Reconstruction Company (ARC).**
- ARC or Bad Bank **buys bad loans from the commercial banks at a discount and tries to recover the money from the defaulter** by providing a systematic solution over a period of time.
- It will manage these Non-Performing Assets in suitable

ways, some may be liquidated, others may be restructured, etc.

- The **aim of setting up a bad bank is to help ease the burden on banks** by taking bad loans off their balance sheets and **get them to lend again to customers without constraints.**
- The bank, which sells the stressed assets to the bad bank, is now **relieved of the burden of the bad loans** and can **focus instead on growing its business** by advancing fresh loans to borrowers requiring credit.
- The **cleaner balance sheet also makes it relatively easier for the lender to raise fresh capital,** if required.
- The government is keen to try out this idea now, given that banks are grappling with legacy bad loans and are now seeing fresh slippages from Covid.

Non Performing Loans and the extraction of better value from them

- According to RBI data, **7.5% of all bank loans had turned bad by the end of March 2021.**
- Indian banks were said to be **sitting on over ₹8.3 lakh crore worth of gross non-performing assets or NPAs** in March 2021.
- **Covid related defaults are expected to push this number to ₹10-11 lakh crore** by March 2022.
- When banks are dealing with bad loans, their capital and management bandwidth gets tied up and they go slow on lending.
- Since enhanced credit flow is key to a quick recovery from Covid, a spring-cleaning of bank balance sheets is in order.

Sashakt Plan: Sunil Mehta Panel Recommendations

The panel under the chairmanship of PNB non-executive chairman Sunil Mehta had recommended a five-pronged approach in Project

“Sashakt” consisting of the following:

- **SME resolution approach** for dealing with bad loans up to Rs 50 crore, involving the creation of a steering committee by banks for formulating and validating the schemes, with a provision for additional funds.
- **Inter-creditor agreement**: Bank-led resolution approach for loans between ₹50 crore and Rs. 500 crore, with the resolution being achieved in 180 days.
- **Asset Management Company (AMC)/Alternative Investment Fund (AIF)** led resolution approach to deal with NPA cases of more than Rs 500 crore. Alternative Investment Fund will raise resources from banks and institutional investors so that it can bid for the insolvent assets under insolvency and bankruptcy.
- **National Company Law Tribunal (NCLT)/IBC approach** for assets larger than Rs 500 crore already before the NCLT and any other assets whose resolution is still pending.

Asset-trading platform for both performing and non-performing assets.

Existing debt recovery process through Insolvency and Bankruptcy Code (IBC)

- **Insolvency and Bankruptcy Code (IBC) 2016** consolidated the existing framework by creating a single law for insolvency and bankruptcy in India
- Provisions under the Code **provides for time-bound and market-linked resolution** of stressed assets
- IBC was intended to tackle the bad loan problems that were affecting the banking system.
- The IBC process has **changed the debtor-creditor relationship.** It provides for a time-bound process to resolve insolvency.
- When a default in repayment occurs, creditors gain control over debtor’s assets and must take

decisions to resolve insolvency.

- **Under IBC, debtor and creditor both can start 'recovery' proceedings against each other.**

- Companies have to **complete the entire insolvency exercise within 180 days** under IBC. The deadline may be extended if the creditors do not raise objections on the extension.
- For smaller companies, including startups with an annual turnover of Rs 1 crore, the whole exercise of insolvency must be completed in 90 days and the deadline can be extended by 45 days.
- If debt resolution doesn't happen the company goes for liquidation.

Performance of IBC so far:

- Despite laws such as the Insolvency and Bankruptcy Code (IBC), 2016, **recovery of dues from defaulters remains a prolonged process f**or banks as courts are burdened with cases.
- Under the new regime, the amount lenders have managed to recover from defaulters has improved significantly when compared to the pre-IBC regime.
- However, c**ases have been piling up and the existing Benches of the National Company Law Tribunal** have been unable to dispose of cases within deadlines.
- **This may extend the resolution process of troubled companies** into several years, which was the case before the IBC regime.
- Further, when the resolution of a company is deemed infeasible and the company is liquidated, the **recovery made by lenders is abysmal due to the absence of a robust market** for the sale of stressed assets.
- For example, when banks tried several times in the past to sell assets such as various properties owned by Mr. Mallya, the sales did not attract significant buyer

interest.

- So, it is likely that banks may face hurdles trying to sell illiquid assets owned by the fugitive offenders and may not actually be able to recover the amounts cited by the ED

Sovereign Guarantee offered to bad bank

- Finance Minister Nirmala Sitharaman said the **NARCL would make a 15% cash payment** to the banks **based on a valuation** and the **rest would be given as security receipts.**
- These **receipts, in turn, would be guaranteed by the government's ₹30,600-crore backstop** facility.
- To assist the NARCL, public and private banks together would set up an India Debt Resolution Company Ltd. (IDRCL) that would manage the acquired assets and try to improve their value for final resolution.
- And on completion of resolution, the balance 85% of value, being held as security receipts, would be given to the banks.
- Given the large volume and individual sizes of these NPAs, a backstop from the government (sovereign guarantee) **helps lend credibility to the resolution process** and provides for **contingency buffers**.
- The guarantee, which will be valid for five years, would be invoked either at the time of resolution or liquidation to cover the shortfall (if any) between the face value of the security receipts and the actual realisation.
- The Union government's guarantee will also **enhance liquidity of Security Receipts**, which are tradable.
- The idea of the government guarantee is to assure the banks that the SRs are secured. In fact, there will be many investors interested in investing in SRs because of the sovereign guarantee.
- Instead of directly bailing out public sector banks by

infusing capital, the government is nudging banks to promote NARCL to rid them of some of their bad loans, while offering some sops to NARCL to smoothen its path.

Functions of National Asset Reconstruction Company Limited (NARCL) and India Debt Resolution Company Limited (IDRCL)

National Asset Reconstruction Company Ltd. (NARCL):

- National Asset Reconstruction Company Ltd. (NARCL), the so-called 'bad bank' that is being set up to help aggregate and consolidate lenders' non-performing assets (NPAs) or bad loans.
- The NARCL is being **set up by lenders and will be 51% owned by public sector banks**,
- It proposes to take over the fully provisioned stressed assets of about ₹90,000 crore in the first phase.
- The minimum size of each NPA to be acquired will be ₹500 crore as the focus is on resolving big-ticket bad loans.
- The **longer-term goal for the NARCL is to help resolve NPAs worth ₹2 lakh crore**, with the remaining assets with lower provisions expected to be transferred in a second phase.
- NARCL will buy the bad loans from banks by paying upfront cash of 15 per cent and balance 85 per cent by way of security receipts (SRs).

India Debt Resolution Company (IDRCL):

- It is a step-down asset management company with a capital of Rs 50 crore
- PSBs will own 49 percent of IDRCL
- It is tasked with the resolution and restructuring of bad loans bought by the NARCL.
- IDRCL will get a time period of five years to resolve the bad loans.

Mould your thought: Discuss the need for setting up a bad bank for the Indian economy. How does the sovereign guarantee affect the performance of the bad bank?

Approach to the answer:

- Introduction
- Define bad banks / NARCL
- Discuss the magnitude and issues of NPA on banking
- Discuss shortcomings of the IBC process and how bad bank solves these problems
- Discuss the scheme of NARCL / IDRCL
- Discuss how sovereign guarantee is helpful
- Conclusion