# How Bad Banks will help to Tackle NPA

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**ABSTRACT**

**Purpose:** *This paper presents a brief overview of bad banks, how they work, impact NPAs, a view on how bad banks can help to remove the stressed asset, the necessity for implementing bad banks, and a few key positive and negative opinions on basis of SWOT analysis or point of view on the establishment of bad banks.*
**Methodology:** *The data has been collected from a variety of sources, including newspapers, research papers, websites, and journals. The information has been analyzed and synthesized to provide a comprehensive overview of the topic.*
**Findings:** *A bad bank is a financial institution specializing in managing assets that are likely to default and is characteristic of troubled loans. The bank aims to separate risky assets from traditional banks so that they can be dealt with separately, either sold or restructured. High NPA's suggest that banks' funds are locked and the bank does not have enough money to lend.*
**Originality**: *A bad bank is a financial institution that holds non-performing assets (NPAs) of another bank or financial institution. The purpose of a bad bank is to remove these NPAs from the original institution's balance sheet so it can focus on its core operations. A bad bank is also sometimes known as an "NPA resolutions bank."*
**Type of Paper:** Conceptual Paper.
**Keywords:** NPAs, ARC, Bad bank, financial stability, Stressed assets, SWOT analysis

## 1. INTRODUCTION :

Banks are the wheel of the financial system of the country. Its major role is the movement of funds in all sectors of the economy. India is a developing economy, if the health of a bank starts to deteriorate, the entire economy starts to collapse [1]. Therefore, a sound banking system is very important to have a good financial and economic well-being status for the country. It also acts as a financial intermediary for its customer by providing them with a financial product to meet their needs in cash management. A bad bank is a perfectly sound idea when it comes to managing the NPA burden of banks. It is a vehicle to clean up banks' balance sheets so that they can focus on their primary lending business. The government has proposed the setting up of two entities- an ARC and an AMC- which together will act as the bad bank [2]. This is a welcome move and will go a long way in solving the NPA problem in India. A Bad bank is a financial institute that purchases and manages NPA from banks in distress. However, in recent years the issue of NPA has become a huge burden for banks to perform their functions smoothly. It creates credit crunch problems and reduces the economic growth of the country [3]. On the other hand, when there is a high NPA ratio it troubles the confidence of the investors, deposit holders, and Board. Chances may likely withdraw their money. It leads to huge problems for the banks. To avoid such problem banks wants their assets so that they can reduce their risk [4]. So, if the concept of a bad bank is introduced it will be a great benefit to the country.
The concept of a Bad bank is to clean up NPAs of banks [5]. The proposal is a commitment by the government towards strengthening the financial institution and ensuring the credibility of the Indian banking system as a whole. As a part of the money management crisis, many governments across the globe started to establish bad banks to isolate their banking industry's toxic assets so that they could sell at fair market prices. US-based Mellon was the first bad bank in 1988. A working group, on behalf of the Indian Banking Association (IBA), in its report has said that there is a need for setting up a bank

asset management company, which will acquire the asset from banks and help to offer fresh capital. Proponents of bad banks argue that they can be an effective way to address the problem of NPAs. By transferring NPAs to a bad bank, the originating institution can clean up its balance sheet and improve its financial performance. In addition, a bad bank can provide capital to the originating institution so that it can loan money to other borrowers [6].

### What is Bad Bank

The term "bad bank" is used to describe a financial institution that is created to hold and manage the non-performing assets of another financial institution. A bad bank is usually created when the original financial institution is struggling with bad loans and other non-performing assets [5]. The bad bank is intended to remove the bad assets from the original financial institution's balance sheet, allowing it to focus on its core business. Non-performing assets are loans or other investments that are not generating any income [6]. The purpose of a bad bank is to isolate these assets so that they can be managed more effectively.

## 2. RELATED RESEARCH WORK :

There has been a great deal of research conducted on the topic of bad banks and their role in economic development. Below is a list of contributions made by different authors on this subject. A Systematic literature search is conducted using the Google Scholar database to review papers published from 1995-2022 with the keywords “Removing toxic assets”, and “Bad Bank Proposal” the key results found are listed in table 1.

**Table1:** Contribution by different authors

| S. No | Field of research | Focus | Outcome | Author |
|---|---|---|---|---|
| 1 | An outline of Bad Bank | How importantly the concept grew up to resolve the growing problem of non-performing assets. | The outline on the bad bank and how it helps the NPAs of current banks. | Vijaya kumar & Venkatesh (2021). [7] |
| 2 | Bad Bank Proposal for India | Overcome the difficulties of NPAs so that they can focus on core business. | To tackle the difficulty of resolving the problems of banks and overcome them. | Sabri Oncu, (2017). [8] |
| 3 | Removing toxic assets from balance sheets | Merits of differing approaches like asset guarantee, selling off troubled assets and ‘good banks’ and ‘bad banks. | How helpful it is for banks when toxic assets are removed. | Pinedo, (2009). [9] |
| 4 | Bank Insolvency | Focuses on the framework done on how banks need to manage insolvency. | To manage insolvencies, policymakers must develop a regulatory framework that allows banks to respond more robustly. | Caprio & Klingebiel, (1996). [10] |
| 5 | Bank Credit on the Risk of Recession | The empirical literature on macro-finance linkage and bank credit as a predictor of future recessions. | Shows how bank credit can predict future recessions. | Mamonov et al., (2022). [11] |

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|---|---|---|---|---|
| 6 | Bad bank resolution and bank lending | Focuses on the banking process of lending and deposits and how to reduce NPA loans. | Investigates recovery in the originating banks' lending and a reduction in non-performing loans. | Brei et al., (2020). [12] |
| 7 | Recapitalisation of banking | Focuses on banking sectors recapitalisation | How governments can efficiently relieve ailing banks by transferring toxic assets into bad banks. | Zimmermann & Schäfer, (2009). [13] |
| 8 | Experiential proof and guideline implication. | The impact of financial regulation on economic development. | Experiential proof of economic development. | Majnoni & Cavallo, (2001). [14] |
| 9 | A Good Solution for Stressed Assets in India | An outline of a bad bank on stressed assets. | The background of the bad banks and a detailed view of banking sectors as a whole and overall to know the structure of financials in banking. | Vijay & Kaur, (2017). [15] |
| 10 | Workable Superstructure on an unworkable infrastructure | A brief study on how bad banks can be favourable to the economy. | Bad bank- it's necessary and few outcomes on how bad banks would be helpful. | Gupta & Bhatheja, (2022). [16] |

## 3. RESEARCH GAP :

The current research gap on bad banks is still quite large. While some progress has been made in understanding why bad banks exist and what contributes to their creation, much more work still needs to be done. This is especially true in developing countries, where the bad bank phenomenon is relatively new and little is known about it. Why have Banks been under immense pressure in recent years and why are they facing financial difficulties?

## 4. RESEARCH AGENDA :

The present study is by understanding what are NPAs and how they can be handled by bad banks and a better understanding of bad banks by SWOT analysis. The paper contributes to the discussions on the topic of bad banks and whether or not they are a good way to tackle the issue of non-performing assets (NPAs). The contribution of some people is in favour of bad banks, while others believe that they are not the best solution.

## 5. OBJECTIVES :

(1) To study the overview of a bad bank.
(2) To know the impact of NPAs.
(3) To study the prerequisite of the bad banks in the present day.
(4) To highlight the point of view based on both good and bad sides by SWOT Analysis.

## 6. RESEARCH METHODOLOGY :

The research methodology used in this paper is descriptive. This means that the paper looks at the concept of the bad bank and analyses it based on data collected from sources such as newspapers, research papers, websites, and journals. Furthermore, the opinions and views of different people from different organizations have also been studied to get a better understanding of the bad bank concept.

## 7. WHAT ARE NPAS?

Non-Performing Assets are defined as the loans or advances made by banks and financial Institutions to customers/debtors which have remained un-serviced for more than 90 days at the end of the year, The NPA ratio is calculated as the percentage of total advances that can't be serviced within their respective due date [17].
There are different types of NPAs which are bifurcated into the following categories:

a) Sub-Standard: These are loans that do not meet the bank's policy for credit provision. For example, A loan where the collateral is insufficient or the borrower's ability to pay is doubtful
b) Doubtful: A loan where it is unlikely that interest or principal are not repaid for more than 12 months, based on current information and events.
c) Loss: These are those assets that cannot be recovered.

### Impact of NPAs on the Banking Sector:

Banks earn money through loan interest and other financial Instruments. To make a return, banks must have a good and considerable quantity of customers. In its simplest form, banking is the business of loaning money to individuals and companies with the expectation of interest payments [18]. When a borrower is not able to repay then the bank phases difficulty in repaying the depositor's money. When it's a small amount it doesn't harm much but when the amount is huge it affects the working of the bank. In this way, NPAs come into the picture of financial statements. A receivable account remains unpaid even after 90 days (or another agreed-upon period). This has led to a credit squeeze, with the resultant impact on the country's growth. The most effective method to manage non-performance loans is to make sure that the banks have a solid asset recovery plan. As part of this plan, the bank management team should analyze the collateral securing each loan and determine if they can sell it if necessary. If the security is an investment or real estate property, then the bank will have to take action to get the abid process started or find a purchaser for the property. If such security is not available, the banking sector may end up with bad debts or NPAs which affect the working system [19]. The current NPAs in the Indian economy of the bank system are the outcome of both cyclical and structural reasons [20]. The NPA level rose sharply during the latest worldwide economic crisis, as the lower growth and a sharp drop in corporate earnings led to an increase in credit losses for banks. Further, the regulatory forbearance to support the banking system accentuated the problem of NPAs.

## 8. OVERVIEW OF BAD BANK :

The Reserve Bank of India conceptualized a new type of bank termed as Bad Bank wherein the bad loans of public sector banks are to be parked. The object is to deal with the problem of mounting a Non-performance Asset from the financial record of banks [21] [22].
In the Economic Survey of 2017, a fresh set of ideas have been proposed for the resolution of stressed assets. To deal with legacy toxic debts, the government has proposed to create an asset management company PARA (Public Sector Asset Rehabilitation Agency). But the Bad bank proposal is to provide an exit route to the existing banks by transferring the stressed assets which can be sold off at a discount to asset reconstruction companies or investment firms that are willing to take over these loans at a steep haircut and try and recover their money by working out some sort of recovery scheme with the original borrower.

## 9. NEEDS OF BAD BANK :

The Indian economy has been slowing down for the last couple of quarters due to the legacy NPAs in the banking sector that turned the banks risk-averse. This has eventuated in lower credit growth and an improvement in borrowing costs [11] [12]. Evaluating the ideas of bad banks and their favourable outcome in other countries creates the question is there a necessity for bad banks in our country or not and why the government is taking its slow step toward it. Nevertheless, as we know the government has taken various steps and measures to reduce the adverse impact of NPAs on the profitability and financial stability of the banks. It was decided in June 2017, that PSBs Should take all possible steps for the resolution of stressed assets in 12 months, including the sale of viable assets to asset reconstruction companies [23]. Even though several mechanisms have been taken previously to figure, out the matter of NPAs, the condition is still the same and it has proved to be deteriorated by the epidemic of Covid 19.

## 10. HOW BAD BANK WORKS :

A bank provides various banking services like a deposit account, debit and credit cards, lending loans, foreign exchange trading, etc. If the repayment is on regular basis, then it is classified as a standard asset if they fail it is classified as a substandard and further Non-Performing Asset (NPA) [23]. Therefore, provisions made against NPAs are also causing pressure on the profitability and soundness of the bank, which affect the health of the banking sector.
They are usually created during a financial crisis when there are too many troubled assets for the bank to deal with on their own or the government wants them off the balance sheet.
The bad bank is expected to receive a considerable amount of capital from the government to cover losses and guarantees, thus helping banks to clean up their balance sheet. These actions will open the way for struggling companies to access credit during a time of recession. It also helps banks become more transparent, helps the banks recover some of their loans, and shows up a clean balance sheet.

## 11. SWOT ANALYSIS :

A bad bank is a financial institution that is created to hold and manage non-performing assets (NPAs) of another bank. The bad bank is typically a separate entity from the parent bank and is typically established through a sale or spin-off. The Indian government is currently considering the establishment of a bad bank to deal with the country's mounting NPA problem. This paper will provide a SWOT analysis of the proposed bad bank in India [24] [25]. The banking sector's contribution to the Indian economy can be seen in several ways but the total stressed asset in the banking system has risen over the years, and the e-government has tried out various options to resolve them [26] [27]. However, the bad loans crisis has put a brake on this growth. The banking sector is also faced with the challenge of managing huge amounts of data and dealing with cyber-security threats. The discussion on how good the bad bank can help resolve the NPA problem. In addition to that, there are also a few key arguments that don’t speak in favour of bad banks and the opinions vary from person to person which says that it has to look for its dark side before implications. The purpose of this SWOT analysis is to evaluate the strengths, weaknesses, opportunities, and threats of bad banks in India.

### (I) Strength of Bad Bank:

a) Bad banks can help to clean up the balance sheets of Indian banks a realized value that could not be otherwise realized from the bank as the bad bank specializes in recovery.
b) Bad banks can help to resolve the non-performing asset (NPA) crisis in India by accepting deposits and lending loans, so that they can concentrate, instead of focusing on unproductive matters, such as the recovery of the legacy loan by freeing up Management Bandwidth.
c) Bad banks can provide a fresh start for banks that are struggling with NPAs, Since the provision made for NPA is reduced there are more funds available for lending which benefits bank development.

### (II) Weaknesses:

a) There is no guarantee that bad banks will be successful in resolving the NPA crisis as the Private-run Asset Reconstruction Company has a poor record when it came to the recovery of loans.
b) Bad banks could make the NPA problem worse, if a bad bank fails, then it could cause a financial crisis that could spread throughout the economy.
c) Bad banks could cost the Indian government a lot of money as it would be an expensive affair for economies already hit by the covid -19 pandemic.

### (III) Opportunities:

a) Bad banks could help to improve the financial health of Indian banks as the bad bank are specialists in the field of asset recovery which can help in a quick decision. When Assets are under a single body, the entity has better coordination to resolve.
b) A bad bank will have expertise in valuation, the realizable value of stressed assets, and can be assessed more accurately.
c) As per the Reserve Bank of India, IRAC norms, provisions have to be made on bad loans which means these funds are tied up. Funds are freed up for lending when these assets are transferred to an ARC.
d) Bad banks could help to attract foreign investment into India

### (IV) Threats:

a) Bad banks are not a permanent cure for large major issues in a few opinions. the bank would turn into a repository for a bad loan.
b) ARCs in India don't talk about large loans. But it was successful when they were especially formed to tack housing loans, so the large loans would be in trouble.
c) There is no clear procedure and this may have a lack of clarity as to how these old loans have to be valued and transferred.
d) Bad banks may lead to irresponsible behaviours on the part of lenders, as they no longer have to worry about the recovery of such bad loans.

## 12. REQUIREMENTS FOR POSITIVE RESULTS OF A BAD BANK :

The success of a bad bank depends on several factors, including the quality of the NPAs being transferred, the strength of the overall economy, and the market conditions for selling off assets [17]. In addition, the bad bank must have a sound strategy for disposing of the NPAs and the necessary resources and personnel to carry out the plan. So, there are several prerequisites for the success of a bad bank.

a) it must be adequately capitalized.
b) it must have the support of the government.
c) it must be able to sell off its assets quickly.
d) it must be able to raise new capital quickly.
e) it must be able to manage its portfolio of assets effectively.

## 13. CONCLUSION :

In a country like India where the number of NPAs in the banking system has risen to alarming levels, people need to understand what exactly bad loans are. The NPA crisis in India is hitting banks from all sides, with no remedy being sought or provided so far by the government. In most cases, these NPAs have been given out as loans to companies on very lax terms and conditions. The bank is facing the heat. The stress on asset quality has increased with the overall increase in NPAsand also from write-offs due to various reasons. The banking system in India is currently facing two problems one is NPAs and the other is the low-interest rate. The former is a major problem for the Indian economy, as NPA reduces the profitability of banks which, in turn, influences the credit flow to the economy leading to a slowdown in growth. The inability to generate enough profits or increase their capital base has made a number of these banks vulnerable. Some lenders have been allowed to merge or seek amalgamation with stronger entities, while individually assessed under-capitalized banks are being assisted by the Reserve Bank of India through the influence of funds, among other steps. Since then, the bad bank has made significant progress in resolving NPAs and is seen as a key part of the RBI's efforts to clean up the banking sector. However, there are still some challenges that need to be addressed, such as the high cost of setting up and running a bad bank. Nonetheless, the RBI is confident that the bad bank will be a success and will help to revive the Indian banking sector.
While a lot of factors play here, this will not be an issue going forward if some key reforms are put into place. Therefore, to resolve this issue, the government has been taking measures to spur lending and economic growth. However, these measures have not been successful in resolving the NPAs in the short term. To bring down the overall NPA ratio, the government will need to act quickly and decisively to clean up bank balance sheets.

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