

# III. THE GOODNESS WITHIN THE BAD BANK IN INDIA

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## ABSTRACT

A bad bank is an entity that purchases distressed assets from a bank at sizeable discounts to book value and then searches for buyers for those assets. A proposal to establish a bad bank was outlined in the Indian Union Budget 2021-22. In this paper, an attempt has been made to explore the advisability of having a bad bank in India. To begin with, the evolution of the existing Indian legal framework for bad debt resolution is examined. This is followed by a discussion on the various features of a bad bank, particularly about how it can prove to be an effective tool to ameliorate a stressed banking sector. An analysis of the mounting bad debts in India is undertaken to appreciate how a bad bank can turn out to be a revolutionary initiative. The author also reviews the growth of bad banks established in various countries and weighs the potential of a similar experiment in India. Based on the experience of existing asset reconstruction companies in India, an evaluation of the potential impediments to the Indian bad bank is also made. The author proposes recommendations for the successful functioning of the bad bank and indicates areas for necessary legal and systemic interventions. It is also emphasised that a bad bank in isolation may not give the desired outcome and an overhaul of the Indian banking sector is the need of the hour. The paper is concluded by making a strong case for establishing a bad bank in India.

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## I. INTRODUCTION

In her 2021 Union Budget speech, the Finance Minister of India, Mrs Nirmala Sitharaman, announced the setting up of an Asset Reconstruction Company (“ARC”), heralding a paradigm shift in the government’s approach towards cleaning up the banking sector. The proposed ARC, also called a ‘bad bank’ in the financial world parlance, shall be mandated to take over and restructure the existing stressed assets of the Indian banks, principally the state-run banks, and eventually sell them to various funds or investors to realise a fair value.<sup>1</sup>

Assets of an ordinary bank comprise the loans extended by it and the investments made by it. The quality of a bank’s assets is reckoned in terms of how much of the loans taken are paid back by the borrowers by way of interest and principal. A loan on which either the interest or principal remains unpaid by the borrower within the specified period is called a Non-Performing Asset (“NPA”) or a bad loan.<sup>2</sup> Thus, the asset quality of a bank can be measured in terms of the NPAs existing on its books. The distressed asset situation across the Indian banks has worsened over the past many years because of factors ranging from undercapitalised projects, viability issues, global slowdown, delayed recognition of stressed assets by Indian banks and the consequent debt trap and mal-governance and policy paralysis at the banks’ level. Needless to overstate, a distressed banking system impacts the overall economy of the state and retards the envisaged growth plans. The proposed bad bank is a path-

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<sup>1</sup> Ministry of Finance, Government of India, Budget 2021-2022, Speech of Nirmala Sitharaman (Minister of Finance) (Feb. 1, 2021).

<sup>2</sup> Reserve Bank of India, *Master Circular- Prudential Norms on Income recognition, Asset Classification and Provisioning pertaining to the Advances Portfolio*, DBOD No. BP.BC/ 20 /21.04.048 /2001-2002 (Issued on September 1, 2001).

breaking step by the Indian government, to identify such distressed assets and put them under the care of a specialised agency, manned by experts, to ameliorate these assets by mainstreaming them back into the financial system and thereby, reviving the Indian economy.

In this paper, the author aims to explore the advisability of having a bad bank in India. In Part II, the evolution of the existing legal framework for bad debt resolution in India is examined, and its versatility to aid in the success of the bad bank is also assessed. In Part III, various features of a bad bank are discussed. Part IV analyses how in the given scenario of mounting bad debts in India, a bad bank can turn out to be a revolutionary initiative. In Part V, the bad banks established in various countries are reviewed to appreciate how such an experiment could fare in the Indian circumstances. Part VI evaluates the various impediments likely to be faced by a bad bank in India in view of the experience of the existing ARCs functional in India. The author proposes certain recommendations for the successful functioning of the bad bank in India and indicates areas for necessary calibrations. It is also emphasised that a bad bank in isolation may not give the desired outcome and a comprehensive overhaul of the Indian banking sector is the need of the hour.

## **II. THE EVOLUTION OF THE LEGAL FRAMEWORK FOR BAD DEBTS RESOLUTION IN INDIA**

India has a robust mechanism, at present, in the form of the Insolvency and Bankruptcy Code, 2016 (“**IBC**”) for bad debts resolution. However, before this 2016 legislation, there were four major laws that dealt with this problem:

(i) The Companies Act, 1956 did have specific provisions to deal with bad debts.<sup>3</sup> However, the major problem was that the regular courts were not well equipped to handle matters requiring business valuation or to suggest appropriate rehabilitation plans. Later, Section 271 of the Companies Act, 2013 provided for the winding up of companies by court orders for non-payment of loan dues. This provision also remained in the statute without being notified till as late as November 2016, when the IBC became functional. Thus, till November 2016, the provisions of the Companies Act, 1956 remained relevant in this context.

(ii) Sick Industrial Companies Act (“SICA”), 1986 addressed the deficiency in rehabilitation and gave the authority to the managing committee and board of directors to come up with a plan to rejuvenate the business. SICA failed because the companies took advantage of the protection provided by it without any successful scheme for rehabilitation.

(iii) Another attempt towards the resolution of bad debts was the Recovery of Debts due to Banks and Financial Institutions Act, 1993.

(iv) Before the year 2002, banks could not sell the pledged assets (pledged by borrowers while securing loans) to recover the due money without a competent court’s order. Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (“SARFAESI”) Act, 2002 changed that and authorised banks to sell assets without the court’s intervention. This act also brought in ARCs that were to be registered under this Act and with the RBI.

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<sup>3</sup> Companies Act, 1956, §391-394, No. 1, Acts of Parliament, 1956.

Post-2014, the present NDA government, after securing a decisive mandate, gave impetus to the debt resolution process. It made two serious debt resolution attempts in this regard –firstly, the Statutory Debt Restructuring (“**SDR**”), which permitted the creditors to take over the firms that were unable to pay and sell them to new owners.<sup>4</sup> Secondly, the Sustainable Structuring of Stressed Assets of 2016 (“**S4A**”) permitted creditors to take up to 50% haircut to restore the financial viability of firms.<sup>5</sup> The above two attempts did not yield the desired results. The SDR suffered because the Reserve Bank of India (“**RBI**”) specified that the SDR route is not to be taken for all the defaults but only in those cases where the change in ownership is likely to increase the economic value of the entity and better its recovery. This caused confusion and later disillusionment with the initiative. In contrast, under the S4A, the lender banks had to convert a part of their loan into equity. This conversion had to take place at face value or the fair value of the share, whichever was higher. This translated into huge mark-to-market losses to lenders right at the inception. Additionally, the RBI’s conditions required the concerned entity to be functional, generating cash and the total loans to the entity to be INR 500 crore or more. For the loans to be eligible under the scheme, at least 50% of the loan needed to be sustainable.<sup>6</sup> The fact that not many borrowers could meet this requirement became a testimony of the graveness of the bad debts problem.

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<sup>4</sup> Reserve Bank of India, *Strategic Debt Restructuring Scheme*, RBI/2014-15/627 (June 8, 2015).

<sup>5</sup> Reserve Bank of India, *Scheme for Sustainable Structuring of Stressed Assets*, RBI/2015-16/422 (June 13, 2016).

<sup>6</sup> *Id.*

The IBC mechanism which came into existence in the year 2016 is an umbrella legislation for insolvency resolution for all categories of entities, corporate as well as individual. This trailblazing economic measure is aimed at aligning India's insolvency infrastructure with global standards and providing greater coherence in law applicable to stakeholders affected by business failure or their inability to fulfil the debt obligations. For the above purpose, IBC has made amendments to many existing laws including the Companies Act, 2013, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, and the SARFAESI Act, 2002, to address their shortcomings and promote a time-bound resolution of insolvency matters through the newly codified legislation.<sup>7</sup> The mechanism follows the following four steps –

(i) Application to National Company Law Tribunal (“NCLT”) – A company becomes insolvent when its debts or losses are more than its net worth. Financial creditors, operational creditors and corporate debtors of the company can submit an application to the NCLT to start the insolvency process, which is called the Corporate Insolvency Resolution Process (“CIRP”). The NCLT has to accept or reject the application within 14 days of the filing of the application.<sup>8</sup>

(ii) CIRP Process – The board of directors is suspended, and management is placed under the control of an Interim Resolution Professional (hereinafter “IRP”). The management loses control of the company and is brought under

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<sup>7</sup> *Understanding the IBC Key Jurisprudence and Practical Considerations: A Handbook*, INSOLVENCY AND BANKRUPTCY BOARD OF INDIA & INTERNATIONAL FINANCE CORPORATION (2020), <https://ibbi.gov.in/uploads/whatsnew/e42fddce80e99d28b683a7e21c81110e.pdf>.

<sup>8</sup> Insolvency and Bankruptcy Code, 2016, § 7, No. 31, Acts of Parliament, 2016 [hereinafter “IBC, 2016”].

a moratorium.<sup>9</sup> Within thirty days of the initiation of CIRP, the IRP has to form a committee of all the financial creditors called the Committee of Creditors (“**COC**”).<sup>10</sup> The COC appoints a Resolution Professional (“**RP**”), which may be the same as IRP, depending upon the discretion of the COC.<sup>11</sup>

(iii) Resolution Plan and its execution – Within one hundred and eighty days of the start of the CIRP, a resolution plan is required to be prepared and approved by the creditors and the NCLT. NCLT could extend this time by ninety more days. The resolution needs to be prepared by any person, including former management creditors or RP or a third party, provided it gets approved by the NCLT. Once approved, the plan is binding on all the parties.<sup>12</sup> If no plan is approved within the stipulated time, NCLT shall order for the liquidation of the company. However, in July 2019, in order to ensure the resolution of much larger number of cases within the stipulated time, the government made a few amendments to the IBC to beef up the infrastructure and also revised the resolution time limit to three hundred and thirty days.<sup>13</sup> The rationale behind this was to grant more time for the resolution plan to be firmed up. The Insolvency and Bankruptcy Board of India (“**IBBI**”), the regulator for IBC proceedings, which came into existence in October 2016, is mandated to oversee the timely submission of the resolution plan.<sup>14</sup>

(iv) Liquidation process – Failure to reach resolution leads to liquidation. The RP is assigned the role of the liquidator unless the IBBI appoints someone else

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<sup>9</sup> IBC, 2016, § 13.

<sup>10</sup> IBC, 2016, § 18(c).

<sup>11</sup> IBC, 2016, § 24(4).

<sup>12</sup> IBC, 2016, § 31.

<sup>13</sup> IBC, 2016, § 12(3).

<sup>14</sup> Ministry of Corporate Affairs, S.O. 3110(E) (Oct. 1, 2016).

explicitly. Liquidator sells the assets of the company one by one through a method of auction. Section 53 of the IBC, 2016 indicates the order in which the proceeds of the liquidation shall be distributed.

Under the IBC, NCLT benches have been functional since June 1, 2016. There is, at present, one Principal Bench at New Delhi and benches at thirteen other locations distributed across the whole country. Appeals against the NCLT decision go to the National Company Law Appellate Tribunal (“NCLAT”) in New Delhi. Appeals against the NCLAT judgments are filed before the Supreme Court of India.

Thus, the statutory wherewithal to fight the menace of mounting bad debts is very much there, and the IBC mechanism holds the advantages of Insolvency Professionals (“IPs”) leading the campaign backed by IBBI, a regulator to perform legislative, executive, and quasi-judicial functions with respect to such IPs. This infrastructure, if put to optimal use, can be a major device to secure lasting and sustainable resolutions in the insolvency space in India.

### **III. INTRODUCTION TO THE CONCEPT OF A BAD BANK**

A bad bank is an entity similar to a special purpose vehicle that purchases distressed assets from a bank at significant discounts to book value and then finds buyers for those assets. A bad bank helps the stressed banks in two ways – firstly, it relieves the banks of their bad loan burden by setting up an ARC and transferring the NPAs to the ARCs. This way, the banks can concentrate on their core banking functions without having to bother for the

resolution of their bad loans.<sup>15</sup> Secondly, it augments the bank's balance sheet by freeing it from provisioning requirements against bad loans and enhances its ability to lend to the productive sectors of the economy to spur growth.<sup>16</sup> Needless to overstate, a cleaner balance sheet improves the prospects of raising fresh capital also. A bad bank normally takes up stressed assets of a multitude of financial institutions instead of a single bank to spread its risks. Once the buyers are found, the assets are sold, ideally at a profit. When all the bad loans are sold, the bad bank liquidates itself and returns money to its shareholders.

Bad banks are normally set up in difficult times when financial institutions are fighting to emerge out of trying situations to protect their reputation and prevail over the financial stress. In any country, the success of a bad bank hinges principally on the choices made by the banks in terms of which assets to be transferred, the structure and portfolio strategy of the bad bank, its operating structure, and above all, the role played by the government. In some countries, the governments have gone to the extent of considering the establishment of a national bad bank, but generally, it is not accepted everywhere that the governments need to support such initiatives. Thus, the

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<sup>15</sup> *Are bad banks effective options to tackle non-performing assets?*, DELOITTE (2021), <https://www2.deloitte.com/in/en/pages/tax/articles/are-bad-banks-effective.html> (last visited Sep 5, 2021).

<sup>16</sup> Akiko Terada-Hagiwara & Gloria Pasadilla, *Experience of Asian Asset Management Companies: Do They Increase Moral Hazard? - Evidence from Thailand*, Working Paper Series No. 55, ASIAN DEVELOPMENT BANK - ECONOMICS AND RESEARCH DEPARTMENT (2004), <https://www.adb.org/sites/default/files/publication/28188/wp055.pdf>.

ecosystem in which a bad bank operates varies from nation to nation that decides its success.<sup>17</sup>

#### IV. THE NEED FOR A BAD BANK IN INDIA

India sits on the legacy of burgeoning bad debts, which have piled up due to adverse market conditions, global slowdown, and incidence of lax underwriting standards in some banks, primarily the public sector banks. However, at present, the pandemic-hit Indian economy faces a twin problem – anaemic credit growth because the industry is taking time to recover and piling bad debts resulting from their delayed resolution. A glance at the present status would be appropriate.

The RBI's Financial Stability Report of January 2021<sup>18</sup> indicates that the Indian banking sector's gross NPAs may rise from 7.5% of advances in September 2020 to between 13.5% to 14.8% of advances by September 2021, which could be the highest in twenty-two years and has the potential to ruin not just the banking sector but the entire economy. The above situation is over and above the INR 8.8 lakh crores of assets that have been written off by banks between Financial Year ("FY") 2014-15 to FY 2019-20. In addition, two hundred large Non-Banking Financial Companies ("NBFCs") may also see their NPAs rise to between 6.8% to 8.4% of advances by September 2021. So, in aggregate, we may be staring at a figure between INR 26.7 lakh crore to INR 28.8 lakh crore as NPAs – this translates to between 13.7% to 14.8% of

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<sup>17</sup> Gabriel Brenna, Thomas Poppensieker & Sebastian Schneider, *Understanding the bad bank*, MCKINSEY & COMPANY (2009), <https://www.mckinsey.com/industries/financial-services/our-insights/understanding-the-bad-bank> (last visited Aug 15, 2021).

<sup>18</sup> Reserve Bank of India, *Financial Stability Report 2021* (January 2021).

our GDP in FY 2020-21.<sup>19</sup> The enormity of the problem calls for unprecedented steps, hence the pressing need for a bad bank.

We need to address the above unprecedented financial problem urgently to reinvigorate our economy. A reason why establishing a bad bank in present times shall be the most prudent is that over time the net value of NPAs has gone down substantially. The banks have made provisions for these loans in their balance sheets, which means setting aside a prescribed percentage of the bad loans, year after year, bringing the net book value of these NPAs very low. Thus, putting these NPAs into the bad bank resolution process shall cost lesser today than before. Besides, freeing up banks from bad loans can help them participate in the economic recovery, which is becoming visible now with the COVID-19 pandemic impact tapering. Moreover, so far the resolution of large cases has only happened through debt recovery tribunals and the IBC mechanism. With the bad bank in the lead, resolutions across loan types can become possible following an ARC route.<sup>20</sup>

Another very potent argument in favour of the proposed ARC stems from the effect of the RBI guidelines for loan provisioning.<sup>21</sup> The lenders, not being in a strong position to resolve the bad debts, shall see rising loan provisioning and a leaking balance sheet in short. Instead, if the loan is sold at a fair price, some cash (15% of the asset sold at present, in the ARCs

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<sup>19</sup> Ananth Narayan, *How to make India's bad bank workable*, LIVEMINT (Feb. 22, 2021), <https://www.livemint.com/industry/banking/how-to-make-india-s-bad-bank-workable-11613911668500.html>.

<sup>20</sup> Amarnath Yadav & Pallavi Chavan, *ARCs in India: A Study of their Business Operations and Role in NPA Resolution*, RBI BULLETIN APRIL 2021, 2021, [https://www.rbi.org.in/Scripts/BS\\_ViewBulletin.aspx?Id=20203](https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=20203).

<sup>21</sup> Reserve Bank of India, *Automation of Income Recognition, Asset Classification and Provisioning processes in banks*, RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01.005/2020-21 (Sept. 14, 2021).

functioning) accrues to the lender, which can be channelised meaningfully.<sup>22</sup> The ARC being a competent forum, rarely encounters a situation where it must sell the assets at a loss and bear the whole loss itself. Normally the ARCs are able to secure a good deal, and for every asset sold at a price higher than the one at which it was bought, the lender gets 80% of the price difference. ARC stands to gain because, besides the 20% retention, it also gets an annual fee of 1.5% to 2% of the total loans transferred from the lender.<sup>23</sup> Thus, it leads to a near win-win deal for ARCs, without a doubt.

Though the Indian Finance Minister in her FY 2020-21 Union Budget speech did not mention the term bad bank as such, however, she did declare the Indian government's resolve to bring in an ARC or an Asset Management Company ("AMC") mechanism to tame the menace of bad debts. The critics lost no time in questioning the advisability of a bad bank with the IBC mechanism already in place. Their criticism stemmed from the stand that without fundamental reforms to solve the NPA problem, a bad bank shall only mean shifting the problem from one place to another. They also saw a moral hazard problem in the banks as the bad bank could appear as a permit for them to continue with irresponsible lending. Besides, the fact remains that the market for stressed assets is not adequately developed in India. A bad bank can work efficiently only when a developed debt market with a large number of participants facilitates adequate price discovery.<sup>24</sup> They also referred to the

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<sup>22</sup> EY & ASSOCHAM, *ARCs – at the crossroads of making a paradigm shift* (2016), <http://www.arcindia.co.in/assets/img/EY-ARCs-at-the-crossroads-of-making-a-paradigm-shift.pdf>.

<sup>23</sup> *Id.*

<sup>24</sup> Nupur Anand & Aftab Ahmed, *ANALYSIS-Indian ARC may only give banks respite from toxic debt flood*, NASDAQ (2021), <https://www.nasdaq.com/articles/analysis-indian-arc-may-only-give-banks-respite-from-toxic-debt-flood-2021-02-01> (last visited Sep 5, 2021).

twenty-eight private ARCs functional in the country as duly registered entities under the SARFAESI Act, 2002 and suggested that the government be well advised to strengthen them instead of floating a new entity.

IBC is an excellent piece of legislation and carries a lot of promise. It has been able to establish a robust mechanism for settlement, resolution, liquidation and withdrawal of cases. The Economic Survey in 2020 indicated that the IBC has improved resolution processes compared to the earlier mechanism. For the first four years, it was able to clock recovery of 42.5% of the debt amount involved compared to 14.5% under the SARFAESI Act, 2002.<sup>25</sup> Similarly, the resolution time under the IBC averaged about 340 days compared to about 4 years and 3 months under the earlier system.<sup>26</sup> The IBC has suffered from various impediments also in this period. The various NCLT benches have not been able to run with full capacity as vacancies at various levels have always remained. The resolution period, which was 180 days, to begin with, now stands extended to 330 days. Besides, overall, the facilitative process for resolution has not been as productive as it was envisaged at the inception of IBC. Yet, in view of the COVID-19 pandemic, when NPAs are set to balloon even further, much of the resolution has to take place outside the IBC framework through a one-time clean-up.

As for the existing ARCs, they started getting bad loans aggressively only from 2013-14, owing majorly to the Security Receipts (“SRs”) route

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<sup>25</sup> Ministry of Finance Department of Economic Affairs, Government of India, Economic Survey 2019-2020 (Volume I) (January 2020).

<sup>26</sup> PTI, *Economic Survey: IBC reduces resolution time to 340 days from 4.3 years*, BUSINESS STANDARD (2020), [https://www.business-standard.com/article/pti-stories/ibc-reduces-resolution-time-to-340-days-from-4-3-years-earlier-eco-survey-120013101463\\_1.html](https://www.business-standard.com/article/pti-stories/ibc-reduces-resolution-time-to-340-days-from-4-3-years-earlier-eco-survey-120013101463_1.html) (last visited Aug 15, 2021).

taken. Against about INR 10,000 crore of bad loans in the year 2012-13, the same rose sharply to around INR 50,000 crore in the years 2013-14 and 2014-15. However, in August 2014, RBI raised the upfront cash payment by ARCs from 5% to 15%, which brought down the bad debt sales to about INR 20,000 crore.<sup>27</sup> The ARCs have not regained momentum after that instance. The ground reality is that the deals between the banks and the ARCs have slowed down in the recent past due to disagreement over the realisable value of an asset. Besides, the 28 odd ARCs with a tiny, aggregated capital are in no position to cater to a bad loans market of over INR 8 lakh crore, which is mushrooming further.<sup>28</sup>

With the government expressing its willingness to back its efforts in a significant way, the proposed bad bank or national ARC, as it is likely to be christened, stands out as the perfect fit in the given circumstances.

## V. BAD BANKS – A GLOBAL PERSPECTIVE

When we search for global parallels, we find almost all the successful bad banks have dealt majorly with housing loans. Some examples are the Resolution Trust Corporation, which dealt with the US savings and loan crises in the 1980s, Grant Street National Bank, also called the Mellon Bank of the US in 1988, Securum and Retriva in Sweden in the 1990s, Arsenal and Sponda in Finland in 1990s and UK Asset Resolution Company which took over the bad loans of Bradford & Bingley and Northern Rock in 2008. The reason why

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<sup>27</sup> EY and ASSOCHAM, *supra* note 22.

<sup>28</sup> Vishwanath Nair, *India's Asset Reconstruction Companies Dealing in "Monopoly Money"*, Says Kotak's Srinivasi Srinivasan, BLOOMBERG QUINT (2021), <https://www.bloombergquint.com/business/indias-asset-reconstruction-companies-dealing-in-monopoly-money-says-kotaks-srinivasi-srinivasan> (last visited Aug 15, 2021).

housing loans' bad bank succeeded was because such loans are small in value, relate to a single asset, mortgages are uncomplicated and entirely contained within a clearly saleable property.

But unlike the above, Indian stressed assets are mostly complexly hypothecated corporate fixed assets involving a consortium of lenders, typically to finance large industrial or infrastructure projects. Till now, bad banks have never worked in cases where industrial, corporate, and conglomerate level bad loans predominate. The fundamental cause for this is that such loans are normally large in size, are linked to global business cycles and often take years for the projects to get completed, exposing them to further risks. Such large loans are also linked to complex mortgages where the collaterals may also be exposed to market uncertainties. Some efforts made in Mexico, Brazil, South Korea, Thailand and of course India bear testimony of the same.<sup>29</sup>

Nearer home, the Danaharta of Malaysia is a great example of the carrot and stick model, which romped home with spectacular success. Established in 1998, this bank clocked an admirable 58.7% asset recovery and was wound up in 2005 after a successful stint. The bank was manned by seasoned debt specialists and renowned industry experts. The Malaysian government supported the bank strongly by ushering in structural reforms and accountability. But the inspiration stops beyond this point as the Danaharta was solely owned by the Malaysian government, something that the Indian Finance Minister has already expressly ruled out.

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<sup>29</sup> Omkar Goswami, *The ABCD of Bad Banks*, THE ECONOMIC TIMES (Feb. 12, 2021).

The Indian experiment is going to be a tight rope walking with the government, indicating no actual participation but, of course, the readiness to tweak the ecosystem favourably.

## VI. POSSIBLE IMPEDIMENTS TO BE FACED BY THE BAD BANK

As a concept, the most salient advantage of a bad bank lies in the fact that the entity taking a decision on the sale price of an asset is entirely different from the entity accepting that price. This not only leads to avoidance of conflict of interest, but this avoidance is discernible enough to instil confidence in the indulgent parties. Yet, in practice, the bad bank shall have to respond to daunting challenges like an absence of a developed debt market in India and the legacy burden of deteriorating bad debts situation. Its most prominent tests shall relate to the following:

(i) Structure of the Bad Bank: The foremost challenge is likely to be about the structure of the Bad Bank, which is still in the works. Yet, as indications suggest, the bad bank shall comprise an ARC which shall be the holding company of an AMC. Banks will sell these assets to the ARC, which in turn shall be managed by the seasoned professionals at the AMC.<sup>30</sup>

(ii) Ownership Pattern: The next hurdle is likely to be the ownership pattern, for which the views are as divergent as –

a) if the equity comes from the public sector banks, the inability of the public sector banks' chiefs to take bold decisions shall persist;

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<sup>30</sup> *Bad Banks in India*, DELOITTE (2020), <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/finance/in-fa-bad-bank-note-noexp.pdf>; David Woo, *Two Approaches to Resolving Nonperforming Assets During Financial Crises*, IMF WORKING PAPER WP/00/33 (2000), <https://www.imf.org/external/pubs/ft/wp/2000/wp0033.pdf>.

- b) if the equity comes from the private sector, allegations of crony capitalism are likely to spring up; and
- c) if the government is to subscribe to the equity, should it rather not capitalise the banks in question?

It would not be out of place to mention that, unlike the private banks, the public sector banks, in their functioning, are not only subject to the RBI's control but are also accountable to the Department of Financial Services in the Ministry of Finance, Government of India. The public sector banks are covered by the definition of 'State' under Article 12 of the Indian Constitution. These are also subject to the jurisdiction of the three Cs – Central Bureau of Investigation, Central Vigilance Commission, and Comptroller and Auditor General of India. Critics argue that the fear of being drawn into investigations by the above agencies has deterred the public sector banks' chiefs from taking bold and pragmatic decisions. Thus, the bad bank as a public sector entity shall mean shifting the reluctance to act from the public sector banks to the new bad bank.<sup>31</sup> Moreover, it is problematic to have the public sector banks as sellers of bad loans and also as the equity holders of the entity buying them.

In a first, nine banks, comprising seven public sector banks and two private sector banks, and two non-banks are likely to jointly invest INR 7000 crore as initial capital in the proposed bad bank. The non-bank lenders could be Power Finance Corporation and Rural Electrification Corporation.<sup>32</sup> In light of the marquee foreign investors like KKR, Blackrock and Brookfield etc.,

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<sup>31</sup> RAGHURAM RAJAN, *I DO WHAT I DO* (1st ed. 2017).

<sup>32</sup> Joel Robello, *Nine banks, two non-bank lenders to infuse Rs 7,000 crore in bad bank*, *ECONOMIC TIMES*, March 1, 2021, <https://m.economictimes.com/industry/banking/finance/banking/nine-banks-two-non-bank-lenders-to-infuse-rs-7000-crore-in-bad-bank/articleshow/81264978.cms>.

also evincing their interest, RBI, along with the Securities and Exchange Board of India, shall need to carry out necessary changes in the relevant regulations.<sup>33</sup> With the bad bank having become operational in July 2021, there is a community of experts who have strongly voiced their preference for a privately owned bad bank. It is felt that the expertise of the private management, free from the government control, can be employed to manage the assets in innovative ways like bundling of assets, brokerage services and better price discovery. In contrast, entrusting the public sector to lead the bad bank could mean that the inertia among banks to take pragmatic as well as tough decisions shall continue.<sup>34</sup> Besides, as discussed above, it could lead to a moral hazard problem in the banks to keep extending loans as earlier.

(iii) Functioning: The next challenge shall be as regards the functioning of the proposed ARC. As it appears, the bad loans of over INR 500 crores and with 100% provisioning shall be transferred to the new entity.<sup>35</sup> The partly provided loans can continue to be handled by the other existing ARCs. The SRs issued by the national ARC (bad bank) are likely to be backed by the Indian government for a few initial years, but not for their whole tenure. It is expected that RBI is likely to issue guidelines in this regard. The banks holding SRs may, in all likelihood, be made to pay an annual fee to the national ARC,

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<sup>33</sup> Dheeraj Tiwari, *BlackRock, KKR, Brookfield and others may join government's proposed "bad bank,"* ECONOMIC TIMES, March 2, 2021, <https://economictimes.indiatimes.com/industry/banking/finance/blackrock-kkr-brookfield-and-others-may-join-governments-proposed-bad-bank/articleshow/81285014.cms?from=mdr>.

<sup>34</sup> Sunny Verma & George Mathew, *Explained: The arguments for and against a bad bank*, THE INDIAN EXPRESS (2021), <https://indianexpress.com/article/explained/npa-bad-bank-balance-sheet-loan-rbi-shaktikanta-das-7151841/> (last visited Aug 15, 2021).

<sup>35</sup> Anup Roy, *Bad bank may follow Swiss challenge method for price discovery of assets*, BUSINESS STANDARD (2021), [https://www.business-standard.com/article/finance/bad-bank-may-follow-swiss-challenge-method-for-price-discovery-of-assets-121022500062\\_1.html](https://www.business-standard.com/article/finance/bad-bank-may-follow-swiss-challenge-method-for-price-discovery-of-assets-121022500062_1.html) (last visited Aug 15, 2021).

which could range from 1.5% to 2% of the loans transferred, in line with the prevailing practice among the existing ARCs at present.<sup>36</sup>

(iv) Development of a functional market for dud loans: Another aspect requiring serious consideration is the development of a functional market for dud loans.<sup>37</sup> Though after the enactment of the SARFAESI Act, 2002, many private ARCs emerged, but as India lacks a developed debt market and there are not many investors for stressed assets, not many bidders came forth and resultantly, most ARCs have come a cropper. In this regard, one recent development needs mention. As a first step towards building a secondary debt market in India, ten Indian banks, including the leading players like State Bank of India, the HDFC Bank and ICICI Bank, came together in the first week of August 2021 to set up the Secondary Loan Market Association.<sup>38</sup> This body has been set up as a self-regulatory body following the recommendations of the RBI's Task Force on the Development of Secondary Market for Corporate Loans.<sup>39</sup> The secondary debt market helps larger borrowers widen their lending base, avoid funding uncertainties and gain better access to market participants with different risk appetites. Such reforms can prove to be game changers for the success of the bad bank in India and can help it succeed in cases where the existing ARCs could not progress too well.

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<sup>36</sup> EY and ASSOCHAM, *supra* note 22.

<sup>37</sup> Narendra Kumar, *Function of Asset Reconstruction Companies & RBI Regulation for ARC*, ENTERSLICE (2017), <https://enterslice.com/learning/function-asset-reconstruction-companies/> (last visited Mar 21, 2021).

<sup>38</sup> Gopika Gopakumar, *SLMA launched to help secondary loan market*, LIVEMINT (2021), <https://www.livemint.com/industry/banking/banks-set-up-secondary-loan-market-association-11628689998479.html> (last visited Sep 5, 2021).

<sup>39</sup> Reserve Bank of India, *Report of the Task Force on the Development of Secondary Market for Corporate Loans* (2019), <https://rbidocs.rbi.org.in/rdocs//PublicationReport/Pdfs/DSMCLOANSBB7C3EDF738D4038B734E909AC054D68.PDF>.

A daunting challenge shall come in the form of the pricing of the assets to be transferred. The bad bank shall not buy a bad loan at book value; how would it make a profit then? It will insist on discounts, depending upon the asset and its saleability. Now, is the bank management protected if it sells loans at discounts? And if the eventual buyer is in the private sector, how would the allegations regarding favouritism and crony capitalism be handled? Similarly, if the loans are sold at too high a price, it would entail very slim chances of a resolution. It would be worthwhile to cite the IDBI Bank's experiment of Stressed Assets Stabilization Fund ("SASF"), which was not successful. In the year 2004, when the erstwhile IDBI Ltd. converted itself to a bank, the government went ahead with the setting up of a SASF with 636 stressed loan cases worth nearly INR 9,000 crore and extended a loan of INR 9,000 crore to the fund with a tenure of 20 years. The SASF failed to resolve most large cases and had to settle with part success in some small cases. The learning from this case was that not only the price discovery was faulty, in the beginning, the SASF was also ill-prepared to run the show with a very small team of experts.<sup>40</sup> Thus, the subset of India's present challenge, as regards the bad bank, is to improve price discovery and address the transparency-related problems given that state-owned banks are going to sell loans to a state-backed bad bank. Shall the bad bank be capable of crafting a miracle? One hopes so.

Another caveat to be encountered by the bad bank is the failure of the four major bank recapitalisation attempts in our country since 1992-93. Nothing much was achieved in terms of efficiency, return on equity and assets,

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<sup>40</sup> Vishwanath Nair, *Lessons from IDBI's experiment with a bad bank-like structure*, LIVE MINT (2016), <https://www.livemint.com/Industry/cM5Rb5szBMFPayYMNiVq1N/Lessons-from-IDBIs-experiment-with-a-bad-bank.html> (last visited Aug. 14, 2021).

or in creating a modern banking structure.<sup>41</sup> The country can ill afford another failure in the series.

## VII. RECOMMENDATIONS FOR THE SUCCESSFUL FUNCTIONING OF A BAD BANK IN INDIA

Why the bad bank took so long to arrive could remain a puzzle, but prudence demands that it should be turned into a huge opportunity to handle the challenges posed by bad debts; and hurriedly also, before the pandemic-hit economy releases the fresh flow of bad loans.<sup>42</sup>

We have seen the ARCs working in our country for over eighteen years, majorly in the private sector. Though these ARCs were well received and were highly successful in the beginning, the going got tougher after the RBI tightened their working norms. To add to their woes, the air around the true value of the assets became murky, and the absence of a market for bad loans started hitting harder. For the proposed bad bank to be a success, it is highly imperative to improve the ecosystem for resolutions and remove all the anomalies hurting it presently. Ideally, the bad bank should have a focussed mandate putting NPA resolution to timelines, backed by a supportive legal infrastructure catering to bankruptcy and personal property laws and a strong political will to make it a success.<sup>43</sup>

A conducive environment shall not only facilitate faster resolutions by the bad bank but shall be a shot in the arm for the existing ARCs. Since such

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<sup>41</sup> Goswami, *supra* note 29.

<sup>42</sup> Deloitte, *supra* note 30; Prathamesh Mulye, *The second wave of Covid-19 will deepen the bad loan crisis at Indian banks*, QUARTZ INDIA (2021), <https://qz.com/india/1996804/indian-banks-bad-loans-will-rise-as-lockdowns-hurt-businesses/> (last visited Sept. 5, 2021).

<sup>43</sup> Yadav and Chavan, *supra* note 20.

resolutions are going to come through legal proceedings or otherwise, it would be worthwhile to see the performance of the IBC mechanism in the last few years.

Under the IBC, various NCLT benches had admitted 4008 cases until the second quarter of FY 20-21, after which it was stopped from initiating a fresh corporate insolvency process until March 24, 2021 due to the COVID-19 pandemic. Out of the 4008 cases, 277 ended up as resolved cases till the end of September 2020 (firms continue as going concerns), while 1025 cases resulted in liquidation. For the resolved cases, the total claim was INR 10.48 lakh crore, out of which the realisable amount is INR 2.2 lakh crores, a haircut of INR 8.30 lakh crore. This translates to a debt recovery of 20.9% and a haircut of 79.1%. Out of the INR 18,917 crore that went into liquidation, the recovery was only INR 280 crore, meaning recovery of 1.5% and a haircut of 98.5%. The greater concern is as regards the pending cases where the ageing of a very high percentage of cases is over 270 days. The situation becomes of much larger concern when one factors the likely addition of nearly 4000 fresh cases every year, in view of the COVID-19 impact.<sup>44</sup>

Therefore, in view of the fact that the structural faults of the resolution mechanism have already caused massive value destruction of profitable or potentially profitable businesses, for a successful bad bank to usher, the following are a few must-do steps requiring immediate action.

First and foremost, the NCLT mechanism needs a thorough revamping and fine-tuning. The NCLT benches need to be increased tremendously. All the vacancies in such benches should be filled on a war footing. The presence

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<sup>44</sup> Narayan, *supra* note 19.

of technical or non-judicial members in the NCLT or the NCLAT needs to be increased.<sup>45</sup> Most matters before them seek a commercial or subject-matter appreciation more than the judicial one. The Supreme Court of India should proactively frame rules for the accountability of NCLT judges/benches as regards meeting resolution timelines and follow the prescribed procedure for the same.

Since bad loan cases emerge out of economic distress or financial distress, for the successful resolution, a clear differentiation at the end of the NCLT is essential to see where lies the incentive – in liquidation (most cases of economic distress) or in revival (most cases of financial distress). A company is economically distressed when the present value of its expected profits is less than the total assets of the company, and the prevailing economy also does not seem to be offering it any hopes of recovery. Liquidation, normally, is the best option for them. In contrast, a company is financially distressed when it cannot service its debts. Such companies can be sustained either by effecting the restructuring of the board and bringing in competent persons to steer the firm or by selling it to investors with stronger financial muscle. NCLT should, therefore, employ an appropriate approach while handling resolutions. A one size fits all strategy cannot successfully work here.

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<sup>45</sup> National Company Law Tribunal and Appellate Tribunal Bar Association v. Ministry of Corporate Affairs, 2021 SC 406; *See generally* Debayan Roy, *Supreme Court seeks response from Centre on plea to fill up vacancies at NCLT, NCLAT, asks to expedite President & Chairman's appointment*, BAR AND BENCH (2021), <https://www.barandbench.com/news/litigation/supreme-court-notice-central-government-vacancies-nclt-nclat> (last visited Sep 5, 2021). Arpan Chaturvedi, *240 Vacancies At 15 Tribunals Even As Tug-Of-War Continues On Tribunal Reforms*, BLOOMBERG QUINT (2021), <https://www.bloomberquint.com/law-and-policy/240-vacancies-at-15-tribunals-even-as-tug-of-war-continues-on-tribunal-reforms> (last visited Sep 4, 2021).

To make the resolutions smoother, the NPAs market needs structural flexibility to attract private participants from across the world. The mix of the cash and securities components also needs to align with demand and supply dynamics to get the best possible resolutions.

The NCLT as a forum has been following resolution as a default approach and keeping liquidation as a last resort. Needless to overemphasize that liquidation leads to a triple whammy – loss of the funds given as loan to the firm, loss of business which could have resulted from a successful firm, and loss of employment as a result of the shutting down of the business.<sup>46</sup> Quick resolution and disposal should be the guiding principle for the NCLT benches. For example, in the resolution of the cases like the INR 42,000 crores bad debt of Essar Steel, assuming the inflation rate to be 4%, the delay in a settlement shall cost INR 5 crores every day. So, judgments in NCLTs should be delivered in commercial time instead of judicial time.<sup>47</sup>

The final ownership pattern of the bad bank is yet to emerge, but for this entity to bear desired results, the ideal situation shall be to grant it private ownership. But short of private ownership, any structure which finally emerges should be allowed to function professionally and with optimum operational autonomy. The participation of the government, if at all, should be limited to issuing SRs to instil confidence in the system. Certain aspects of the

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<sup>46</sup> Prasanna Mohanty, *Rebooting Economy 65: IBC has failed; will a bad bank succeed?*, BUSINESS TODAY (2021), <https://www.businesstoday.in/opinion/columns/rebooting-economy-65-ibc-has-failed-will-a-bad-bank-succeed/story/430537.html> (last visited Mar 21, 2021).

<sup>47</sup> R Jagannathan, *Bankruptcy cases must account for the time value of money*, LIVEMINT (2021), <https://www.livemint.com/opinion/online-views/opinion-bankruptcy-cases-must-account-for-the-time-value-of-money-1565111192615.html> (last visited Mar 21, 2021).

resolution process like recovery rates and transparency in the whole mechanism shall remain very important.

Besides the above, the following steps can potentially arm the proposed ARC or the bad bank with much greater thrust and hope –

(i) Capital infusion of about INR 1 Lakh crore to support the purchase of about INR 2.5 to INR 3 lakh crore worth bad loans, assuming haircuts varying from 30% to 50%.

(ii) The ARC needs inspiring and acclaimed professionals to spearhead its operations.

(iii) The transfer of assets to the bad bank has to be at a goldilocks just-right price, neither too high nor too low.

(iv) The bad bank should have a pre-notified limited tenure. A fixed tenure shall bring a sense of urgency in its working and shall also send a loud message that this one-time exercise does not carry even an iota of invitation for perpetuating the evil cycle of bad assets.

(v) Most stressed assets belong to infrastructure, real estate, power and construction sectors, and a strong government policy action shall be imperative.<sup>48</sup>

Additionally, raising a bad bank alone shall not lead to sustainable results unless the government also unleashes a series of banking sector reforms.

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<sup>48</sup> Narayan, *supra* note 19.

Bank loan arrears have mounted in India over the decades because of the global slowdown, project viability issues, lack of focus and accountability in the bank management, slackness of the firms' auditors and protracted litigations heading nowhere. To improve the overall status of the public sector banks, the government would be well advised to consider Dr P. J. Nayak's report<sup>49</sup> outlining the much-needed reforms in the public sector banks' boards.

Public sector banks need a complete overhaul. Banks/financial institutions need to appoint an independent chief compliance/due diligence officer, who should report to the central regulator, the RBI, and not the firm's CEO. The credit underwriting department should be manned by personnel having relevant sectoral, legal, and due diligence backgrounds. This department should be energised to segregate the good from the not-so-good borrower and to timely identify the red flags.<sup>50</sup>

Public sector banks have to be provided with professional autonomy. Social obligations may remain a part of the banking system, but the government should address them through specific instruments and targeted transfers rather than leaning on such banks, which are commercial organisations answerable to their shareholders. Additionally, market-linked remuneration should replace the current repressed salaries of the public sector bank employees. Senior bankers' pay must be tied with larger components

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<sup>49</sup> Reserve Bank of India, *Report of The Committee to Review Governance of Boards of Banks in India* (2014).

<sup>50</sup> Jagriti Bhattacharya, *Will the proposed bad bank help?*, FINANCIAL EXPRESS (2021), <https://www.financialexpress.com/opinion/will-the-proposed-bad-bank-help/2196737/> (last visited Mar 21, 2021).

linked to long term performance. This would attract better resources towards these banks.<sup>51</sup>

## VIII. CONCLUSION

Starting with the Economic Survey, 2017, when the bad bank was first conceived in the form of a Public Sector Asset Rehabilitation Agency<sup>52</sup> and later through the Project Sashakt of 2018, which recommended a five-point plan for bad debts' resolution,<sup>53</sup> bad bank as an entity has attracted significant attention. Yet, the value destruction has continued over the years. In the last decade alone, bank loans of over INR 8,83,168 crores have been written off,<sup>54</sup> with nearly INR 2,37,206 crores written off in the year 2019 only.<sup>55</sup> Nobody shall relish squandering more good money over bad money.

Thus, the large overhang of non-performing assets in our banking sector ecosystem makes a strong case for a one time clean up through the proposed bad bank. A successful ARC shall also go a long way in contributing to the economic revival in the country. Mr Hari Hara Mishra, Director at UV ARC, very aptly remarked,<sup>56</sup>

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<sup>51</sup> Narayan, *supra* note 19.

<sup>52</sup> *Economic Survey 2016-17*, MINISTRY OF FINANCE, GOVERNMENT OF INDIA (2017) <https://pib.gov.in/newsite/PrintRelease.aspx?relid=157805> (last visited Aug 12, 2021).

<sup>53</sup> PTI, *Sunil Mehta panel incorporates "Sashakt India AMC" for large NPAs*, THE ECONOMIC TIMES (2018), <https://economictimes.indiatimes.com/industry/banking/finance/banking/sunil-mehta-panel-incorporates-sashakt-india-amc-for-large-npas/articleshow/66637519.cms?from=mdr> (last visited Aug 12, 2021).

<sup>54</sup> Reserve Bank of India, *Report on Trend and Progress of Banking in India 2019-20* (2020).

<sup>55</sup> *Id.*

<sup>56</sup> ET Bureau, *Why Budget proposal for setting up of a bad bank is a good idea*, ECONOMIC TIMES (2021), <https://economictimes.indiatimes.com/industry/banking/finance/banking/why-budget-proposal-for-setting-up-of-a-bad-bank-is-a-good-idea/articleshow/80639840.cms?from=mdr> (last visited Mar 28, 2021).

In COVID parlance, a bad bank is like setting up a jumbo quarantine centre for NPAs. However, the treatment it will require shall be a large number of ventilators which effectively are distressed debt funds with risk appetite to acquire these NPAs. Vaccine, or permanent cure, of course, lies in enhancing underwriting skills and oversight mechanism to arrest the deterioration of credit quality.

The long-awaited bad bank has finally taken shape with the National Asset Reconstruction Company Limited (“NARCL”), the name given to the bad bank, getting registered with the Registrar of Companies Mumbai in July 2021. Mr Padmakumar M Nair, a resolution expert from the State Bank of India, has been appointed as the managing director of NARCL.<sup>57</sup> This marks the beginning of India’s march towards a strong stressed assets resolution regime and makes it a decisive step in the direction of India’s dream of becoming one of the leading economies in the world.

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<sup>57</sup> *Daily News Digest by BFSI Board, ICAI*, , THE INSTITUTION OF COST ACCOUNTANTS OF INDIA (2021), [https://icmai.in/upload/BI/DND\\_1407\\_21.pdf](https://icmai.in/upload/BI/DND_1407_21.pdf) (last visited Sep 4, 2021). Vishwanath Nair, *Padmakumar M Nair Appointed As CEO Of National Asset Reconstruction Company*, BLOOMBERG QUINT (2021), <https://www.bloombergquint.com/business/india-bad-bank-padmakumar-m-nair-appointed-as-ceo-of-national-asset-reconstruction-company> (last visited Sep 4, 2021).