Can Bad Bank be a mean for managing NPAs in India?

Dr. SushmaVerma, Prof. Lalit Bhole

Asst. Professor, Sinhgad Institute of Business Management Mum

Abstract: **Role of banks in the economic development of any country can hardly be overemphasized. However NPA poses a big problem to the smooth functioning of the banking system. The level of NPAs in banks in India has reached and alarming level gradually. This paper attempts to highlights the increasing level of NPAs and also various probable solutions to deal with it in an effective manner with a special focus on Bad Banks and tries to evaluate bad banks as a solution to India's NPA problem. It is an exploratory study based entirely on secondary data.**

***Key Words*: NPA, Recapitalization, Bad Bank**

I. INTRODUCTION

It is stated by various economists categorically that a well-developed financial system supports economic growth by facilitating smooth flow of savings and investments. (1)

It is an established fact that a sound banking system is a prerequisite for developing a sound financial and economic system. However NPA problem is a big hurdle in smooth functioning of the banking system. High level of NPA indicates a high probability of credit default thereby reducing the overall efficiency and effectiveness of the functioning of lending system. It significantly reduces the availability of credit. Thus it becomes a problem not only of the banks as a lender but also of policy makers as it affects the economic growth of the country.

In India, this NPA issue was not given due attention initially due to the promotion of the concept of social banking. It was only after recommendations of Narsimhan Committee (1991) that NPA issue received its due focus. Since then, several measures suggested by RBI to control this, the magnitude of the problem is only increasing.

II. CONCEPT OF NPA

As per RBI A 'non-performing asset' (NPA) was defined as a credit facility in respect of which the interest and/ or installment of principal has remained 'past due' for a specified period of time. (2).

NPAs are basically those loans which are not being paid by the borrowers (principal as well as interest) and also the chances of recovery are very low. Definition of NPA has been changing in India. As per Narsimhan Committee report, when the interest on an asset remains due for a period of 180 days, it should be treated as NPA. However from March 1995, this 180 days duration was reduced to 90 days. So, generally principal and interest are overdue by more than 90 days for NPA. . Though this is not very rigid and depends to a certain extent on terms and conditions between borrowers and lenders. NPAs are basically classified into following three categories :(3)

1. Substandard assets: These are those Assets which has been as NPA for a period which is equal to or less than 12 months.
2. Doubtful assets: Those assets fall into this category which has been in substandard category for a period of more than 12 months.
3. Loss assets*:* As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

III. MAGNITUDE OF NPA

For assessment of magnitude of NPAs, primarily two measures are used:

a. **Ratio of NPAs to GDP**: This ratio measures the loss from NPA in terms of overall size of the economy. This metric aids in inter country comparison. It gives an macro view of the problem. This ratio's limitation is that if fails to give any indication about the lenders ability to deal with NPAs using their capital.
b. **Ratio of NPAs to Loan**: Another more commonly used measure is NPAs to Loan ratio. This ratio tells about the proportion of loan turning bad. One major drawback of this measure is that it can be managed by managing denominator. However managing denominator is more dependent on external factors like overall economic environment, credit demand etc. So it leads to the thinking that NPA problem is more external as compared to the weakness of the lending process.

Considering the above limitations, there is a third measure suggested by Harsh Vardhan, Rajeshwari Sengupta(2017) (4),wherein the NPA has been measured in relation to Capital. Logic being the fact that Capital of Bank is a key factor deciding the ability of banks to deal with this crisis.

IV. LEVEL OF NPAS IN INDIA:

Level of NPAs is increasing at an alarming rate in India. As on 31st September 2017, the level of bad loans in India was approx. 8.40 crores. A break up of this makes it clear that bad loans of Public sector bank is 7.33 Lakh crores which is same as that of June 2017 values whereas the values for Private sector bank is 1.06 crores in September 2017, surging by 10.5% from June values. Following table shows the NPA positions: (5)

	NPAs(Rs Crores)	NPA Ratio
March- 2016	571,841	7.69
June-2016	618,109	8.42
Sep -2016	651,792	8.81
Dec-2016	677,443	9.18
March-2017	711,312	9.06
June-2017	829,338	10.21

Thus it is very clear from the table that NPA ratio in June 2017, stood out to be 10.21% which is highest when compared to last six quarters. In global terms also NPA ratio of India is higher as compared to other emerging market except Russia. High NPA significantly reduces the ability of the banking system to lend money. This has an adverse effect on the economic growth as growth is possible only when corporates are provided with adequate funds and commercial banks are the major source of funds in India. As per Economic Survey, Bank credit provided to corporate sector was negative eight percent till November 2016.(6)

V. SOLUTION TO INDIA'S NPA PROBLEM:

Government of India from its part had empowered the Central Bank, RBI for helping resolve this NPA issue. RBI directed the banks to form JLF(Joint Lenders Forum) way back in 2014 so that a collective mechanism can be formulated for solving this problem. However getting lenders consensus remained a problem.In June, 2015 SDR (Strategic debt Restructuring Scheme was also introduced by RBI. But this also met with little success only. In June 2016, a scheme was introduced to allow restructuring of large loans by banks for active projects. But this scheme can be applied only to active projects. Considering all these, the questions remains as to how to deal with the problem of these mounting NPAs. Bank Recapitalization has been a strongly suggested solution for Public Sector banks. But the issue here is very high capital requirement of Government owned banks. For example as per Moody(7) ,Government banks needs as much as Rs 95,000 Crores of capital infusion to have respectable financials. Whereas Government has only announced Rs 10,000 Crores for this purpose. Another viable solution which had been widely discussed is the creation of Bad Bank.

VI. BAD BANK AS A SOLUTION TO NPA PROBLEM

As per investopedia," A bad bank is one, set up to buy the bad loans of another bank with significant nonperforming assets at market price."(8)

Bad bank as a strategy for managing bad loans was first used by Melton Bank in US. This was created in 1988 to hold 1.4 billion of bad loans.

This mechanism of bad bank has worked in various countries like Us, Sweden etc. Even European Policy makers have also discussed this bad bank prospect to deal with the problem of Non-Performing Loans in Banks.

The idea of setting up a bad bank was first proposed in an Economic Survey conducted in Jan 2016.

Functioning of bad bank would be to buy bad loans from banks at a discount and then attempting to recover money from various defaulters .It should be a centralized agency in a position to take tough decisions.

There are various view points as to whether there is an actual need to bad bank in India and if yes, how should it be designed?

Actually bad bank concept is not a new concept in India. It is on this same concept that Industrial Reconstruction Company of India was set up in 1971. Purpose was rehabilitation of sick units. It was remodeled as IIBI that is Industrial reconstruction Bank of India in 1985 and was assigned the work of buying band loans of commercial banks and then recovers their debt. However IIBI became sick eventually due to lack of strict recovery laws. Government had to pay approx. 263 crores to IIBI in between 2004-2005 and from 2005-2006 for servicing of its debts. Finally IIBI closed down in 2012.

In 2004, IDBI (Industrial Development Bank of India) was provided with a 9,000 crores bailout package to shift its bad loans to Stresses asset stabilization fund which was a separate fund which can be considered to be a type of bad bank. However CAG (Controller and Auditor General of India) Report in 2014 strongly criticized this decision.

Designing of Bad Bank: Designing of bad bank will significantly affect the effectiveness of this as a solution to NPA problem.

As per McKinsey report titled," Understanding the bad bank"(9), there are basically four models based on the basic decision whether to keep the bad assets on bank's Balance sheet or not.

1. **On-balance-sheet guarantee:** In this Government gives bank, loss guarantee for some parts of its portfolio.
2. **Internal restructuring unit:** This model is like an internal bad bank. In this the concerned bank separates the bad assets internally and then assigns them to a separate team for management. Hence in this model, existing management is only expected to restructure the assets.

3. **Special-purpose entity:** In this, the bad assets of the bank are transferred to a SPV, then securitized and sold to investors. Best way to sell them is by an auction. In this manner, price would be market determined.
4. **Bad-bank spin-off:** This is the most common and considered to be the most effective model. In this bad assets of the bank are transferred to a separate entity equipped with the requisite skills to handle. This is the most complicated and expensive of all the models. In fact the PARA proposed in Economic Survey of 2016-2017 belongs to this category of model.

VII. WHY BAD BANK NOW

Probably the mounting NPAs along with problems with all other proposed and practices solution can be considered to be a significant factor behind this idea of bad bank. This idea of bad bank presently has been strongly backed by Mr. Arvind Subramanian, chief Economic Adviser of the Government of India and also by Mr. Viral Acharya RBI's Deputy Governor because of the worsening situation of NPA. PSU banks are the worst hit.

Thus probably a different approach of setting up a PARA, that is Public Sector Asset Rehabilitation Agency which would be a central nodal agency capable of taking a very tough decision. Experience from various East Asian Countries shows that government backed centrally run professional agency can go a long way to deal with this NPA issue.

Moreover a single government entity can be considered to be more competent in taking hard decisions as compared to different public sector banks taking decisions individually. Even the foreign investors would feel more comfortable in this kind of initiative which will go a long way in promoting transparency in the system.

VIII. CONCLUSION:

NPA problem needs an effective solution. One of the proposed solutions is the creation of bad bank. Foreign experience's in this regard may be taken into consideration while paying due attention to the local considerations for creation of bad bank. Appropriate designing is extremely important to ensure the success of this alternative.

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