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NPA of Indian Banking System and its Impact on Economy

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Abstract:

Banks are playing a very important role in providing financial assistance for the various business sectors and agricultural sectors. But from the last few years banking institutions financial health is not in good condition. Major public banks are going through a liquidity crisis. The large volume of NPAs is negatively impacting the growth of the Indian economy. The 'District co-operative banks bad loan ratio hinting towards 12.6 per cent. The bad-debt ratio of commercial banks stood at 7.5 per cent as of March 2021 according to an RBI report. The spread of Covid-19 had stalled major economic activities in our country. Indian's $ 1.86 trillion financial system is at risk due to this pandemic. Presently $ 140 billion of bad loans at banks and the liquidity position is adversely affected. The Indian Bank's Association moved the application to RBI for setting up RS 6000- crores bad bank. Proposed National Assets Reconstruction Company (NARCL) or Bad bank will take over the non-performing assets/ bad assets of the public sector and private sector banks. The Finance Minister too in Union Budget FY 21-22 proposed to set-up to an Asset Reconstruction Company (ARC) or a bad bank to clean up NPAs of public banks. The institution, which set to start operations by the next month. This strategy may help to bring financial stability to the banking sector. This particular bank is going to have an effective structure and specialised management to handle the bad debts problems. This enables the banks to focus on the primary functions without worrying about the high-risk assets. Bad banks have been considered a success in many countries in recovering bad debts. Through this paper, researcher attempt to know about the bad bank, the need of bad bank in India, and the challenges exist for its effective implementation in India.

Keywords: Bad bank, Non-performing assets, Challenges, Pandemic, Implementation.

Introduction:

Non- performing assets are those assets that won't be yield any revenue to the bank, and remain idle over some time. The rise in NPAs leads to incur losses by the banking institutions. It increases the stress on the banking sector. Many new projects may not be able to get financial assistance from banks due to a shortage of funds, and it also affects the national growth adversely. Banks may increase the interest rates to maintain their profit margin. Due to a lack of investments to invest in economic activities, people face the unemployment problem. Many countries adopted a bad bank strategy to come out of the liquidity crisis. Major public banks in India are suffering from credit risk and liquidity crises. Even though RBI adopting various strategies and frameworks to minimise the credit risk and liquidity risk, but these are not yielding good and effective results. Finance Minister proposed to set up NARCL/Bad Bank so that public banks can transfer their bad assets to the bad bank, and focus more on the primary functions.

NARCL has been registered in the last month in Mumbai, with a capital of Rs.74.6 crore. RBI also thinking to provide a licence for this. Eight public sectors have come on the board to lead the first round of capital infusion. Canara Bank has invested in NARCL by purchasing 12 million shares, Bank of Baroda, SBI, Union Bank of India and Indian Bank have bought 9.9 million shares each respectively. Punjab National Bank and Bank of India also became investors in the bad bank by purchasing 9 million shares. Bank of Maharashtra has subscribed 5 million shares in the Bad Bank. (Mint). It is expected that establishing a bad bank, will clean up the bad assets in the public banks, and allow the banks to focus the lending to increase the economic activities. The public sector banks are going to hold the majority of shares in the bad bank. The new bad bank will be headed by Mr Padmakumar Madhavan Nair, a stressed assets expert from SBI.

Review of literature:

Rathore, (2016). The existence of NPAs there is an adverse effect on the liquidity position of the banks due to the mismanagement in the banking system. The major reason for this is the slow recovery in the global economy, fluctuations in the global markets and the natural calamities which are occurring in the environment at the global level and the domestic level.

Ravi Thangjam, (2018). There is a significant and positive relationship between the NPAs and the GDP of the country. If NPAs volume increases in the banking institutions the GDP of the country decreases, due to insufficient investment in the economic activities.

Mohapatra and Jha, (2018). Public sector banks in India are considered the best channel for economic and social development in the country. These banks can reach and provide financial services to people belong to various social classes and also the different sectors. Public banks are running the banking operations with a service motive, not with a profit motive. The government often provides financial assistance to these banks, so that banks can survive. Bank recapitalisation serves as a band-aid, while the underlying sickness continues to spread.

Rajendra Ganatra (2021) NPAs are part of the outcome of credit risk, if there is no NPAs the banks are taken the lowest level of risk and or it can be understood that, the banks are effectively recovering the NPAs. Banks must adopt an early warning system to minimise bad debts. RBI must monitor that, it won't allow political interference and corrupt businessman to influence the government and Banks. It is needed to implement professional management autonomy for public sector banking.

Research objectives:

- To understand the Concept of Bad bank.
- To analyse the need for Bad bank Strategy in India.
- To analyse the various challenges that exist in India for its effective implementation.

Research Methodology

The research was done, based on secondary data resources, which have already been collected by other researchers. The researcher collected the data, from various related sources by utilizing Articles, Journals, Newspapers, and various RBI published statistical statements, and from other internet sources.

Bad bank:

A bad bank is an institution with a corporate structure that acquire the illiquid assets and high-risk assets held by the banking or financial institutions, at discount and tries to recover the money from the default borrowers. The first bad bank was established by the US-based Mellon bank in the year 1988 to hold its non-performing assets. This US-based bank used the bad bank as a strategy to manage and recover the Non- performing assets effectively. Several countries such as the US, Sweden, Finland, Belgium and Indonesia are also institutionalised this concept and considered it has a successful strategy in managing bad debts.

The financial crisis in the years 2007 to 2010, resulted in the setting up the bad bank by many countries. This was also suggested as part of the "Emergency Economic Stabilisation Act of 2008 to address the high-risk borrowers in the US. In response to the financial crisis in the year2009, Ireland has introduced the bad bank in the name of the National Assets Management Agency to overcome the financial crisis in the Banks.

Models of the Bad banks:

McKinsey and company introduced four models of the Bad bank. Those areas under,

- **On–balance -sheet guarantee model**: while taking over the NPAs, under this model bad bank uses the Government securities or guarantees to protect from the losses.
- **Internal Restructuring Model**: According to this model, the bank creates the sub-bank under its control and transfer the entire NPAs into this. This model won't isolate the bank from the credit risk.
- **Special Purpose Entity**: Under this model, the entity required direct participation of the Government. The bank transfers its bad debts to another institution that is backed by the government.
- **Independent Model:** under this model, an independent institution will be created and all the bad assets transfer to this institution to handle it. Original banks can completely

isolate the High-risk assets under this approach.

Indian Government planning to adopt special purpose entity model for transferring bad loans of public sector banks. According to ARC regulations, NARCL will pay banks 15 per cent in the form of cash. The remaining 85 per cent payment will be in the form of government-guaranteed securities. The securities redemption period will be five to eight years. (Anand Adhikari)

Objectives of Bad Bank:

- To carry out the business of an assets reconstruction institution.
- To manage and enforce any selling activities of any property that may come into its control.
- Repairing the balance sheet of the banks, to get the banks back to normal lending activities.
- To get all the assets that are left after the credit work-out process.
- To attract alternative investment funds (AIFs) run by the private equity and other investors and will assure security receipts issued to banks.

Experience of other countries with the Bad bank strategy adoption:

Millon Bank was the first to use a bad bank strategy and set up the Grant Street National Bank in the year 1988 to hold $ 1.4 billion of bad assets. It didn't accept any public deposits. The shareholders of Mellon Bank got shares from good banks as well as from bad banks on a one - to one basis in the form of a dividend. After fulfilment of its objective, it issued the preference shares and equity purchasing contracts to finance the purchase of one billion dollars in Mellon bad loan at 57 per cent of face value. After completion of the task successfully, it got liquated.

In 1992 the Swedish banking crisis lead to the establishment of two bad banks. Swedish Government authorities approached McKinsey and company to help in finding the solution to overcome the financial crisis of three major banks. McKinsey established two bad banks, Retriva and Secured. Both of the banks took over the NPAs of the insolvent banks. Retrieved took over all the bad loans from Gota Bank and Securum took over the bad loans from Nordbanken, with the good bank operations continuing as Nordea. eventually, both bad banks performed well and made a positive return. International commentators Brad DeLong and Paul Krugman have opined that the Swedish bad banking model is adopted internationally.

The Indonesian government established the Indonesian Bank Restructuring Agency (IBRA)in the year 1998, as an official body to take care of the asset disposals of an extensive number of distressed banks.

UK government introduced UK Assets Resolution in the year 2010. UK authorities created an institution called Northern Rock (Assets Management). It is a state-owned institution to take care of a total mortgage value of 62.3 billion pounds of two nationalised mortgage Banks i.e. Bradford and Bingley.

In 2013, the Royal Bank of Scotland, and in the year 2014 Barclays Bank transferred their bad debts in its internal bad banks as a part of the restructuring and it greatly benefited the investment banking activities.

The Philippines has also established a bad bank in 1987, with the objectives of cleaning up and restructuring the banks. It transferred 21.7 per cent of bad debts at book value. It was planned to run this bank for 4 years. The bad bank set by the country was not so successfully. The major factors, which impact this bad bank were, weak governance, politically connected assets and fraudulent assets. Even Spain used the bad bank strategy in the year 1997. It was a publicly owned institution, but it was achieved partly as a success. Rapid disposal of bad debts did not happen by the bad bank.

Bad bank strategy has been implemented effectively and became a success in several countries including Germany, France, the US, Sweden, Finland, Belgium, and Indonesia etc., but some countries are failed to achieve, what they have intended.

In our country, the government is planning to establish a bad bank. In the latest budget presentation in February 2021 for FY22, the Finance Minister, Nirmala Sitharaman announced that government will set up a bad bank to transfer the non-performing assets that existed in the public sector banks i.e. an Asset Reconstruction Company(ARC) and an Asset Management Company (AMC) like structure.

What is the need for a bad bank in India at present?

The banking sector in India has been going through a lot of liquidity crises. The major reason for this situation is an increase in the volume of Non-performing assets in the banks from the last few years. Some corporate persons become the default in repayment of the loans. They took advantage of the political influence and bribe the banking officers and took high volume loans from the public sector banks. They are the will full defaulters, name them Vijaya Mallya, Nirav Modi, Mehul Chowkis, and Anil Ambani etc., The total non-performing assets in our country had reached Rs.10 lakh crore in the banking industry including public and private sector banks as of this March 2020.

Even the government policies and certain decisions were also the reason for the growth of non-performing assets in the banks. The decision of demonetization in 2016 by the central government in our country devastated the economy and create an imbalance in the financial system.

Table: 1. The gross NPAs at Public Sector Banks ;

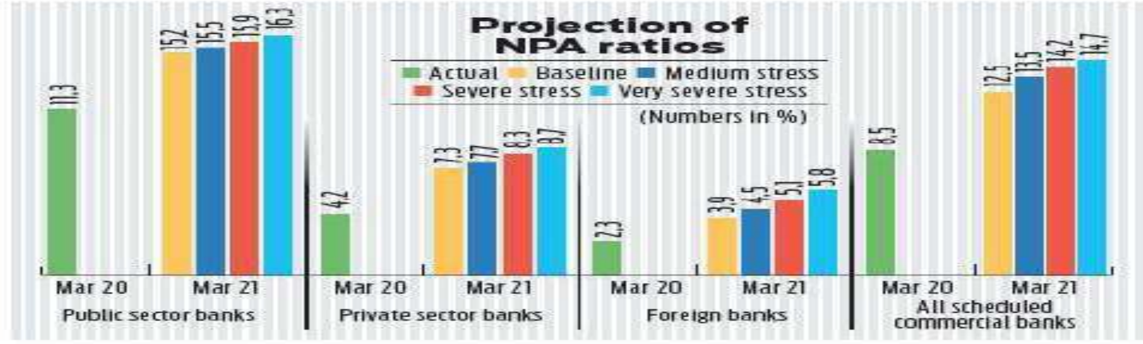
Bank Name	**Gross NPA**
1. State Bank of India	**Rs. 2.01 trillion**
2. Punjab National Bank	Rs. 552 billion
3. IDBI Bank	Rs. 445 billion
4. Bank of India	Rs.434 billion
5. Bank of Baroda	Rs. 416 billion
6. Union Bank of India	Rs. 380 billion
7. Canara Bank	Rs. 377 billion
8. Central Bank of India	Rs. 324 billion
9. Indian Overseas Bank	Rs. 317 billion
10. UCO Bank	Rs. 243 billion
11. Allahabad Bank	Rs. 231 billion
12. Andhra Bank	Rs. 215 billion
13. Corporation Bank	Rs. 218 billion

Sources: RBI reports

The highest amount of gross NPAs is held by the country's largest bank SBI in the country held an NPA volume of Rs. 2.01 trillion which is equal to 24.39% of the gross NPAs. Punjab National Bank (PNB) holds Rs. 552 billion and IDBI Bank has Rs. 445 billion worth of NPAs. The public sector banks are having the major volume of NPAs in the Indian Banking sector. it accounts for 88.74 per cent of the total gross bad assets. State Bank India, Punjab National Bank, IDBI Bank, Bank of India and Bank Of Baroda are the major public sector banks are responsible for the increase in the volume of NPAs. Its share is 46.76 per cent in the gross NPA. As per December 2017 RBI reports.

The non-performing assets ratio of banks may rise to 9.8% by March 2022 in March 2021, according to the Financial Stability Report (FSR) released by the Reserve Bank of India.

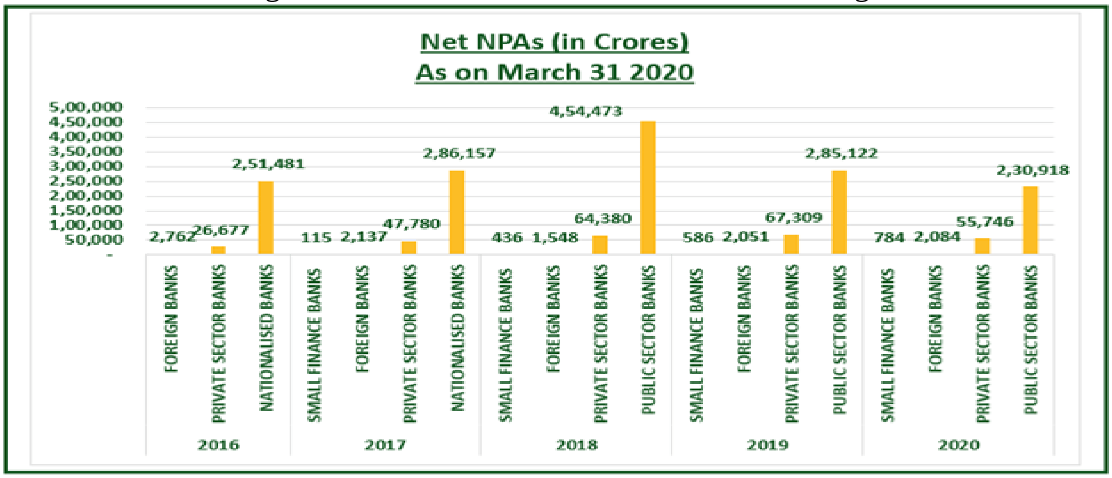
Figure:1: projected NPAs by the RBI stress test in various banking sectors



Sources: RBI. Statistics.

The results of the RBI stress tests revealed that public sector banks predicted that, their gross NPAs rise to 15.2% by March 2021 against the last year NPAs,i.e 11.3% in the baseline scenario. In the chart, it is understood that the very severe assets and severe assets rise, this may reach to15.9% and 16.3%. respectively, the worsening macroeconomic factors impact the rise of bad loans in the private banks and foreign banks too. Stress test results indicate that few banks may fail to meet the minimum capital level by March 2021 in a very severe stress scenario. This, however, does not take into account the mergers or any further recapitalisation, which will further increase systemic resilience," (the RBI)

Figure 2: Net NPAs exist in the different banking sectors



Sources: RBI reports

Bad debts in Indian Public sector banks had been increasing. In the years 2019 and 2020 there is an improvement in the recovery of NPAs, RBI declared a moratorium in the lockdown period, it provided enough time for banking institutions to analyse the NPAs existing in it. And various mechanisms introduced by the RBI helped the institutions to recover the NPAs to some extent In these years. So the bad debts were declined in 2019 and 2020.

Reasons for the NPA:

- **Global recession**: exports from the country were reduced due to the crisis in the global market.
- **Commodity price cycles**: fluctuations in the demand and supply largely impacted the prices of the goods and services in the international market. Many businesses/corporates were under losses due to this.
- **The government policies**: waving of agricultural credits during natural calamities like floods, droughts, and other calamities increased the bad debts in the public sector banks.
- Business sectors like the hotel, mining, leather, fuel, education institutions, tourism, real estate. petroleum and transport industries etc. were struggled a lot due to the Pandemic. Credit growth was declined and the large volume of NPAs has resulted.
- **Impact of the** pandemic on economic activities. People lost their jobs, purchasing

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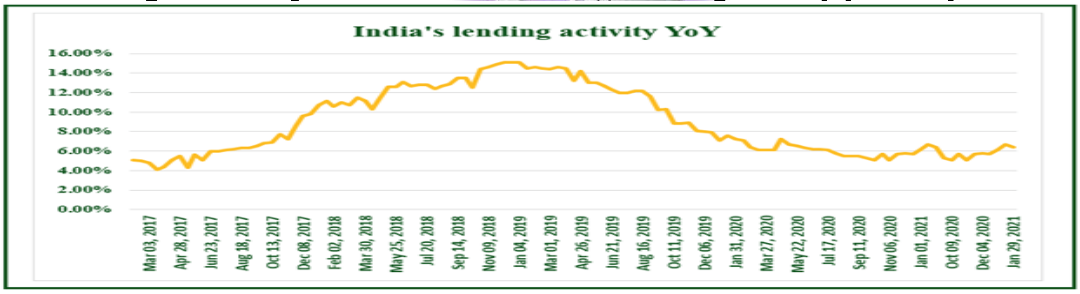
power decreased due to because of low income.

Impact of NPAs

- Increase the stress on the banking sector.
- Lack of funds to provide fresh loans and advances to the borrowers
- Banks increase the Interest rates to maintain their profitability.
- The rise of NPAs decreases the confidence of the stakeholders to invest in the banking sector.
- Increase the unemployment problems and the country GDP gets the adverse effect.

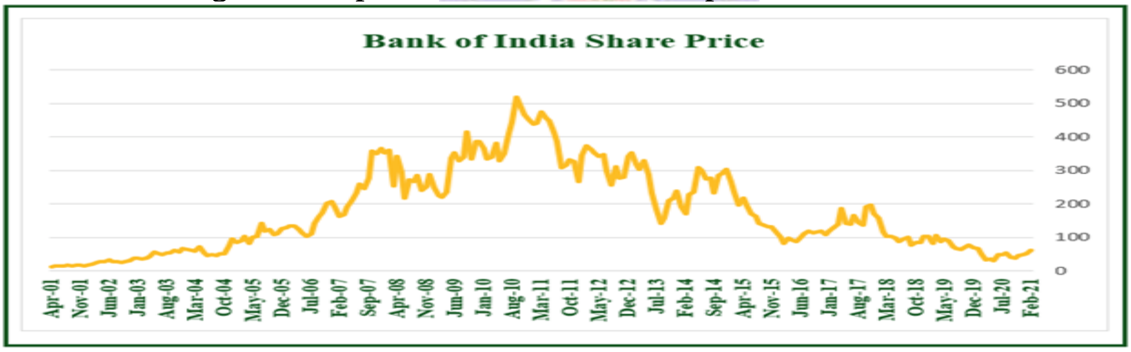
Figure:3: Impact of Bad loans on the lending activity year to year basis



Source:: investing.com, Tavaga Research

The lending activity in the banking institution was high compare to the present scenario in India, as is seen in the above chart has shown a rising trend between 2017-2019, it gradually started falling after the covid- 19 pandemic crisis. Pandemic impacted negatively on many business sectors, especially SMEs and MSMEs.

Figure:4. Impact of NPA on the share price of Bank Of India



Sources: RBI, Tavaga research

From the above chart, it can be understood that the share price of BOI bank falling continuously. The major reason behind this is the growth of Non- performing assets level.

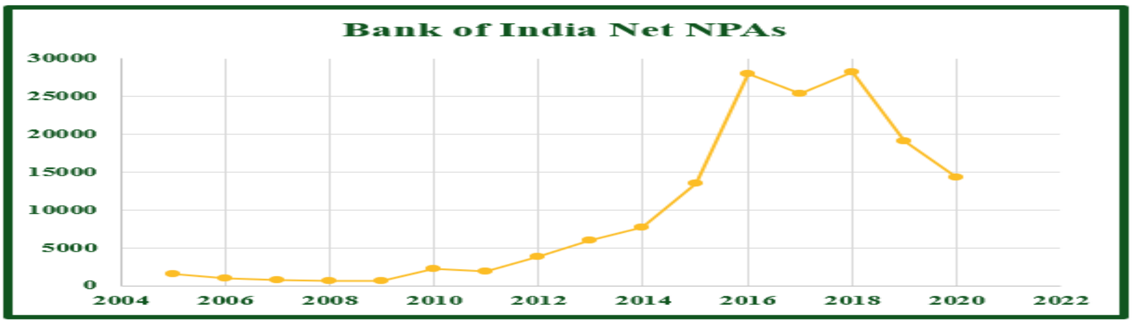


Figure :5: The rise of NPAs in the Bank of India year on year basis

Sources: RBI, Tavaga research

Bank of India's share price presently stands at around Rs. 60 per share. In 2010 the share price was more than Rs- 500 per share. The government of India is planning to privatise the public sector banks, if this bank gets privatised, it would be difficult to find a willing investor to invest in this bank.

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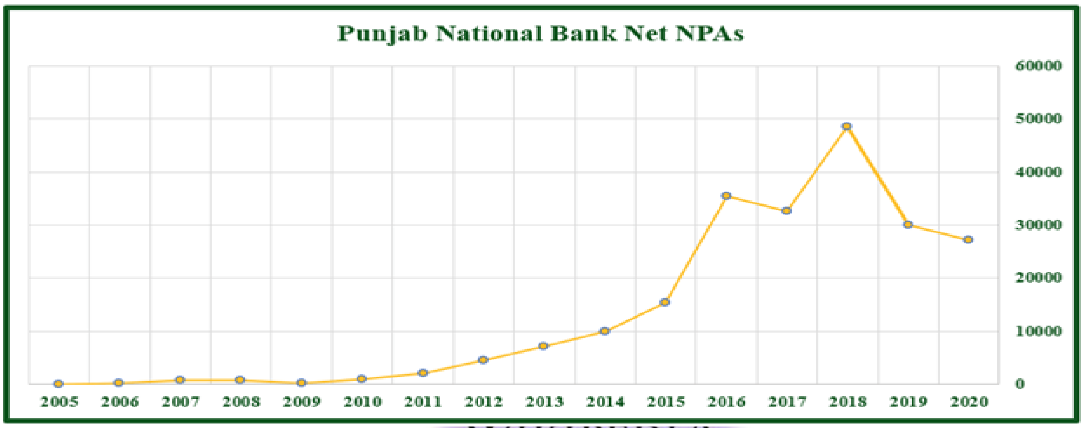
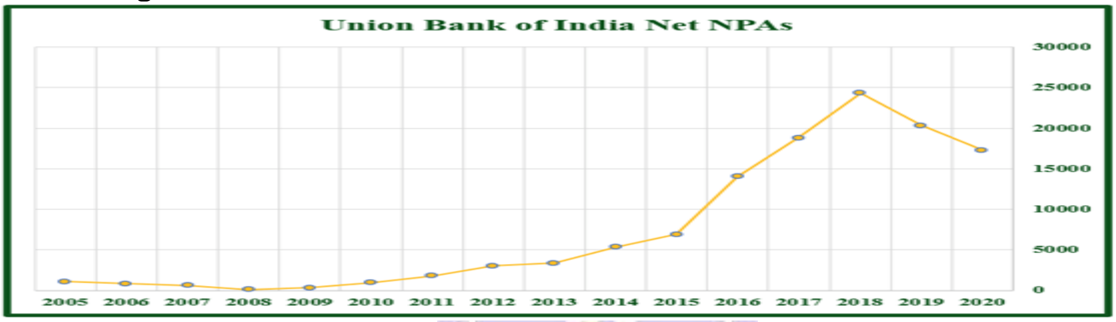
Figure:6. The rise in the volume of NPAs in the Punjab National Bank year on year basis



Source: RBI, Tavaga Research

There is an increase in NPAs from 2012 onwards, but in 2018 it was recorded the highest volume of NPAs in the Punjab National Bank, the main reason was Nirav Modi. He cheated the bank by remaining default in the repayment loan, he took a loan that amounted to Rs.11,400 crore by providing invalid/fake documents as collateral.

Figure:7. The rise in the volume of NPAs in the Union Bank Of India



Source: RBI, Tavaga Research

Even in the Union Bank of India, the volume of bad debts rises from 2014 onwards. In the year 2018, it reached its highest point. In 2019 and 2020 years the NPAs volumes at banks declining slowly, but still the bank NPAs level is very high in all the banks.

Thus, these banks would be the most benefitted from the establishment of a Bad Bank, to bring in efficiency in operations and an increase in profitability.

Recovery Mechanisms to Recover Bad Debts practising in India:

RBI came out with various strategies to resolve the NPAs in the banking sector over the years. Some of the ways used by the RBI to tackle NPAs.

- **The Debt Recovery Tribunals**-(DRTs) were formed to decrease the time required for resolving the claims of the banking and financial institutions against the borrowers who failed to repay the loans. The realisation of collateral assets to recover the bad debts.
- **Lok Adalat programmes** are hosted to resolve bank disputes and to recover the bad debts of up to five lakh rupees at the fast track. It was introduced to handle short term loans, which became NPAs over a while.
- **A compromising settlement mechanism** is introduced to recovery the NPAs extent to Rs- one crore.
- **The securitisation and reconstruction of financial assets and the enforcement of the security interest Act** (SARFAESI act) were introduced in the year 2002. The major purpose of this is to recover the bank's NPAs.
- **Assets Reconstruction Companies (ARC):** The RBI issued a licence to set up 14

new ARCs after the amendment of the SARFAESI Act of 2002.

- **Insolvency and Bankruptcy Code (IBC)**: This was introduced in the year 2016 by the ministry of finance. It was framed to expedite and simplify the process of insolvency and bankruptcy proceedings in India, ensuring fair negotiation between the creditor and debtor by removing the asymmetry of debt and default information.

At present banks are facing delays in the sale of stressed assets to the ARCs. ARCs take the stressed assets at deep discounts, which is unable to recover their true value of the assets, and sometimes assets value is more than the sale value. Small ARCs cannot recover huge bad assets. It is very difficult to find potential buyers for stressed assets. ARCs need to wait for getting approval from various lenders before the deal, it consumes more time in settling the matters. IBCs are very slow in resolving bad debts. In the current situation, the economic conditions are deteriorating and the Insolvency and Bankruptcy Code (IBC) is suspended. If a bad bank is formed, it will be possible that NARCL can buy bad assets at a fair price.

The major challenges for the effective implementation of bad banks in India:

- **Ineffective recovery practices**: The banking system is not so effective in the recovery of bad debts in India when compares with the other countries. Japan the recovery rate of bad debts is 92.%. OECD countries were at 68.6 per cent. East Asia and Pacific region 28.4%, South Asia region recovery percentage was 19.9% and India recovery rate is 13.7%.
- **Political interference**: India is a democratic country, it is very difficult to recover the bad assets. All the major public banks and private banks are under the control of political powers. bad banks in other countries were yield positive results, because of the non-interference of politics.
- **Funds mobilisation**: to set up a bad bank, the government must mobilise capital, to buy the bad assets, at present Indian economic conditions worsen due to pandemics. According to experts at least Rs. 25000 to Rs.30000 crore of capital will be required to set up a bad bank in the initial stages, (Acharya, The Hindu).
- **Transfer of risk**: bad bank strategy is used here to transfer the NPAs from Public sector banks to another institution to make the balance sheet look healthy. But it won't be considered as a solution until it effectively recovers the NPAs in the specified duration.
- **The large number of NPAs:** this is one of the challenges for a bad bank. The NPAs have resulted in different situations concerning the geographical area, industry type and its size and at different circumstances. Bad banks need to take quick measures to recover it. Otherwise, the bad loans may lose their value.
- **Setting- up Well - defined process**: need to be adopted by the bad bank to address the various types of Bad assets. Setting up the framework itself is a big challenge for Bad bank in India. And it is also difficult to implement those rules effectively in a country like India. This process has to be followed, and managed, with force and speed in the organisation. If not, the bad bank will easily end up in disorder.
- **Moral hazard**: a bad bank may become a moral hazard. It enables the banks to continue lending to the borrowers without following proper guidelines. They may not take serious steps to reduce bad debts. They may consider a bad bank as a place to dump the bad assets, without taking any risk.

Conclusion:

In many countries, bad bank strategy was proved effective in resolving the NPAs problem. It is expected from the bad bank that, it solves the problems associated with bad loans in the public banks. The Bad bank is a good strategy, but it will become a success when it will be implemented and executed effectively in India. Bad banks need to be considered as a last resort to handle NPAs. Bankers must also focus more on the implementation of banking rules and regulations while making lending decisions.

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