

Bad Bank, Full Form, Meaning, Benefits, Framework, Challenges

September 4, 2025 • vajiramandravi.com



Bad Banks were established in India in 2021 and address India's growing problem of non-performing assets. These banks are established for especially taking over and resolving stressed loans with the aim of reducing the burdens of non-performing assets on the banking system. These bad banks not only help clean up balance sheets but also revive credit flow in the economy. In this article, we are going to cover Bad Banks, their evolution, framework and benefits and challenges.

Bad Bank

A Bad Bank is also known as an asset reconstruction company specialised in purchasing non-performing assets from commercial banks and works towards restructuring and recovery. While normal banks are conventional in nature, bad banks don't engage in lending or accepting deposits and its specialized role is to free commercial banks from the problems of bad banks. The Non- Performing Assets are collected at a discounted rate in comparison to its book value and the bad bank then tries to recover as much value as possible.

Bank banks play an important role in bringing down the burden of NPAs and improve the quality of banks' balance sheets, release locked capital and allow new credit creation. In this manner, it is also linked to break down the vicious cycle created by the Twin Balance Sheet problem, and its impact on both banks as well as corporations.

Bad Banks in India Evolution

The concept of Bad Bank is not new in India. It was first suggested through the establishment of the Central Public Sector Asset Rehabilitation Agency in the Economic Survey 2016-17. The economic survey suggested that India requires a centralised mechanism to address the stocking up of NPAs that were responsible for dragging down the financial system. It was in the 2021 Union Budget that Bad Banks were set up by announcing the setting up of a bad bank under a dual structure. This initiative comprises an Asset Reconstruction Company and an Asset Management Company. While ARC would take over stressed assets from banks, the AMC would manage and resolve them with the expertise required for complex debt restructuring.

Bad Bank Requirement in India

Bank Banks in India are needed for many reasons:

1. **Economic Recovery:** Due to the COVID-19 pandemic, the banking sector came under high stress and the **RBI** predicted a sharp rise in NPAs due to the six-month loan moratorium and the slowdown in economic activity.
2. **Government Support:** A Bad Bank, if managed and funded by professionals like private lenders, and supported by government support, was seen as a smooth approach to deal with the NPA crisis. The involvement of the government provided confidence and was expected to expedite the clean-up process.
3. **Rising NPAs:** According to the K.V. Kamath Committee, corporate debt worth ₹15.52 lakh crore became stressed after the pandemic, in addition to ₹22.20 lakh crore already under stress. This huge figure highlighted the need for a centralised mechanism.
4. **Twin Balance Sheet Problem:** The growing debt on both banks and corporates created a vicious cycle for banks saddled with bad loans were unable to lend, and corporates trapped in debt were unable to invest affecting the economic growth.
5. **International Precedents:** Countries like the USA, Ireland, Sweden, and South Korea had successfully set up Bad Banks or similar mechanisms to manage systemic stress in their financial systems. Their experiences help add weight to India's decision.

Bad Banks Framework in India

To establish the Bad Bank concept in India, the government introduced two institutions in India:

- **National Asset Reconstruction Company Limited (NARCL)**
 - NARCL was set up under the Companies Act and later applied to the RBI for registration as an ARC.
 - The goal was to collect stressed assets worth Rs. 2 lakh crore from commercial banks in a phased manner.
 - Public sector banks have 51% equity holding in NARCL and make sure that control remains with them.

- India Debt Resolution Company Limited (IDRCL)
 - The organisation works with NARCL and works as a resolution manager. The job is to sell stressed assets in a market and recover maximum value .
 - When it comes to ownership, PSBs and other public financial institutions hold up to 49% in IDRCL, and private sector lenders hold a majority stake of 51%.
 - NARCL-IDRCL together present the institutional framework of Bad Banks of India.

Bad Bank Benefits

Setting up of bad banks has the following benefits:

- Improved Balance Sheets: By transferring NPAs, banks immediately reduce their burden of stressed assets, which helps strengthen their balance sheets.
- Unlocking of Capital: With reduced provisioning requirements, banks can release previously locked capital, which can then be redirected towards fresh lending.
- Focus on Core Functions: Banks are freed from the task of loan recovery and can concentrate on their primary roles of deposit mobilization and credit extension.
- Better Coordination: When multiple banks have exposure to the same stressed borrower, resolution becomes difficult. A Bad Bank consolidates such cases, improving efficiency and speeding up the process.
- Stimulus for Growth: By reviving credit flow and easing the financial stress of banks, a Bad Bank can contribute indirectly to economic recovery and growth.

Bad Bank Challenges

While Bad Banks have many benefits, there are certainly many challenges that come along with the implementation:

- Moral Hazard: Bailing out inefficient banks with taxpayer money creates complacency. Banks might continue risky lending practices, relying on government-backed bailouts in the future.
- Pricing Dilemma: Determining the right value of NPAs is complex. If assets are sold too cheap, banks suffer heavy losses; if overpriced, the Bad Bank itself risks collapse.
- Superficial Solution: Just transferring NPAs from one institution to another does not remove the underlying problem. It just covers the problem for some time.
- Lack of Structural Reform: Unless deeper reforms in governance and accountability are implemented, particularly in PSBs (which account for over 80% of NPAs), bad loans may pile up again.
- International Lessons: Global experience, such as Sweden's, shows that Bad Banks work best when NPAs are concentrated in small-value housing loans. In India, however, NPAs are spread across diverse and complex sectors.
- Financial Constraints: Using funds to set up and sustain a Bad Bank is a challenge in a fiscally strained environment. Also, in a pandemic-hit economy, finding investors willing to buy distressed assets is not easy.

Source: <https://vajiramandravi.com/current-affairs/bad-bank/>

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