Pros & Cons of Bad Bank

This article is based on **"Bad bank, good move"** which was published in The Indian Express on 23/03/2021. It talks about the pros and cons of a bad bank.

For a banking sector-dependent economy like India, the good health of the banks is very important to ensure accessible financial services and flow of credit to support the growing economy. However, for many years, Indian banks have been dealing with the NPA crisis that has created problems for them and the entire economy.

Further, the economic fallout due to the coronavirus crisis has increased the banking sector's stress. Therefore, to restore banks' health, the **Budget 2021** has proposed one such measure i.e. the idea of setting up a **National bad bank**. However, the idea of a bad bank is itself much debatable.

What is a Bad Bank

- A bad bank is an entity that acts as an aggregator of bad loans or non-performing assets (NPA's) and purchases them from across the banking sector at a discounted price and then works towards their recovery and resolution.
- These loans are classified as non-performing and are at the verge of or already in the state of default. These bad loans negatively impact a bank's balance sheet.
- The bad bank is similar to an Asset Reconstruction Company (ARC), where they absorb these loans from the banks and then manage them to recover as much amount as possible.

Proposed Model for Bad Bank

The budget 2021 proposed an Asset Reconstruction Company (ARC)-Asset Management Company (AMC) structure, wherein the ARC will aggregate the debt, while the AMC will act as a resolution manager.

- The proposed structure envisages the setting up of a National Asset Reconstruction Company (NARC) to acquire stressed assets in an aggregated manner from lenders, which will be resolved by the National Asset Management Company (NAMC).
- A skilled and professional set-up dedicated to Stressed Asset Resolution will be ably supported by attracting institutional funding in stressed assets through strategic investors, AIFs, special situation funds, stressed asset funds, etc for participation in the resolution process.
- Further, transferring these stressed assets to bad banks will entail recovery of 15% in cash and 85% in sovereign guaranteed security receipts. This government guarantees but will carry a zero-risk weight, for a specified period of time.
- The net effect of this approach would be to build an open architecture and a vibrant market for stressed assets.

Arguments For Bad Banks

- **Providing Lending Leverage to Banks:** The benefits of bad bank include the recovered value, and significant lending leverage because of three factors:
  - Capital being freed up from less than fully provisioned bad assets.
  - Capital freed up from security receipts because of a sovereign guarantee.
  - Cash receipts that come back to the banks and can be leveraged for lending, also freeing up provisions from the balance sheet.
- **International Precedent:** There are several international success stories of a bad bank accomplishing its mission and there is no reason to believe why India cannot accomplish its objective.
  - The US implemented the Troubled Asset Relief Program (TARP) after the 2008 financial crisis, which helped the US economy after the subprime crisis.
  - It was modeled around the idea of a bad bank.
- **Revival of Credit Flow Post-Covid:** Some experts believe that a bad bank can help free capital of over ₹5 lakh crore that is locked in by banks as provisions against the bad loans.

Arguments Against a Bad Bank

- **Not a Panacea:** It is argued that creating a bad bank is just shifting the problem from one place to another.

  Without fundamental reforms to solve the NPA problem, the bad bank is likely to become a warehouse for bad loans without any recovery taking place.
- **Tight Fiscal Position:** Furthermore, an important concern is regarding mobilizing capital for the bad bank. In an economy hit by the pandemic, it is hard to find buyers for distressed assets and the Government is also in a tight fiscal position.
- **No Clear Procedure:** Also, there is no clear procedure to determine at what price and which loans should be transferred to the bad bank. This may create political challenges for the Government.

- **Moral Hazard:** Former Governor of the reserve bank, Raghuram Rajan believes that setting a bad bank may also create moral hazard problems among the banks that would enable them to continue with their reckless lending practices, further exacerbating the NPA problem.

Conclusion

So long as Public sector banks managements remain beholden to politicians and bureaucrats, their deficit in professionalism will remain and subsequently, prudential norms in lending will continue to suffer.

Therefore, a bad bank is a good idea, but the main challenge lies with tackling the underlying structural problems in the banking system and making reforms to improve the public sector banks.

Drishti Mains Question

Setting up a bad bank is the right step in tackling the NPA crisis, but it is not at all the panacea. Discuss.