Mains Practice Quesstions

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Q. The Union Budget 2021 has proposed setting up a National bad bank to restore banks' health. Critically discuss the idea for ameliorating the banking sector's stress.

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Approach

- Start the answer by discussing the concept of bad banks.
- Provide arguments for and against the bad banks
- Conclude suitably.

Introduction

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

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.

Body

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.