Bad Bank

For Prelims: Bad Bank, Non-Performing Assets, NARCL

For Mains: Significance of Bad Bank and Associated Challenges

Why in News?

Recently, the Ministry of Finance has announced that the **National Asset Reconstruction Company (NARCL)** along with the India Debt Resolution Company (IDRCL) will take over the first set of bad loans from banks and try to resolve them.

- The health of the balance sheets of Indian banks has improved significantly over the last few years with their Gross Non-Performing Assets (GNPA) ratio declining from a peak of 11.2% in FY18 to 6.9% in Q2FY22.
- NARCL has been set up by banks to aggregate and consolidate stressed assets for their subsequent resolution. PSBs will maintain 51% ownership in NARCL.
- IDRCL is a service company/operational entity which will manage the asset and engage market professionals and turnaround experts. Public Sector Banks (PSBs) and Public FIs will hold a maximum of 49% stake and the rest will be with private sector lenders.
- The government had already announced sovereign guarantees of Rs 30,600 crore for Security Receipts (SRs) to be issued by NARCL, which will be buying Rs 2 lakh crore non-performing loans from banks.

What is a Non-Performing Asset?

- NPA refers to a classification for loans or advances that are in default or are in arrears on scheduled payments of principal or interest.
- In most cases, debt is classified as non-performing, when the loan payments have not been made for a minimum period of 90 days.
- Gross non-performing assets are the sum of all the loans that have been defaulted by the individuals who have acquired loans from the financial institution.
- Net non-performing assets are the amount that is realised after provision amount has been deducted from the gross non-performing assets.

What is a Bad Bank?

- A bad bank is a financial entity set up to buy **Non-Performing Assets (NPAs)**, or Bad Loans, from banks.
- The aim of setting up a bad bank is **to help ease the burden on banks by taking bad loans off their balance sheets** and get them to lend again to customers without constraints.
- After the purchase of a bad loan from a bank, the **bad bank may later try to restructure and**

sell the NPA to investors who might be interested in purchasing it.
- A bad bank **makes a profit in its operations if it manages to sell the loan at a price higher than what it paid to acquire the loan** from a commercial bank.
- However, **generating profits is usually not the primary purpose of a bad bank** — the objective is **to ease the burden on banks, of holding a large pile of stressed assets**, and to get them to lend more actively.

What are the Pros and Cons of a Bad bank?

- **Pros:**
  - **Single Exclusive Entity:**
    - It **can help consolidate all bad loans of banks under a single exclusive entity.**
      - The idea of a bad bank has been tried out in **countries such as the U.S., Germany, Japan and others in the past.**
    - The troubled asset relief program, also known as TARP, implemented by the U.S. Treasury in the aftermath of the 2008 financial crisis, was modelled around the idea of a bad bank.
  - **Freedom to Use Freed-up Capital:**
    - By taking bad loans **off the books of troubled banks, a bad bank can help free capital of over Rs 5 lakh crore** that is locked in by banks as provisions against these bad loans.
    - This will give **banks the freedom to use the freed-up capital to extend more loans** to their customers.
  - **Improving Capital Buffer:**
    - It can help improve bank lending not by shoring up bank reserves but **by improving banks' capital buffers.**
    - To the extent that a new bad bank set up by the government can improve banks' capital buffers by freeing up capital, it could **help banks feel more confident to start lending again.**
- **Cons:**
  - **Merely Shifts one Pocket of Government to another:**
    - Bad bank backed by the government will merely shift bad assets from the hands of public sector banks, which are owned by the government, to the hands of a bad bank, which is again owned by the government.
    - There is little reason to believe that **a mere transfer of assets from one pocket of the government to another will lead to a successful resolution of these bad debts** when the set of incentives facing these entities is essentially the same.
  - **Nature of Ownership:**
    - Unlike private banks, which are owned by individuals who have strong financial incentives to manage them well, **public sector banks are managed by bureaucrats who may often not have the same commitment to ensuring these lenders' profitability.**
    - To that extent, bailing out banks through a bad bank **does not really address the root problem** of the bad loan crisis.
  - **Risk of Moral Hazard:**
    - Commercial banks that are bailed out by a bad bank are likely to have little reason to mend their ways.
    - After all, the safety net provided by a bad bank gives these banks more reason to lend recklessly and thus further exacerbate the bad loan crisis.

What are the Associated Challenges?

- **Mobilising Capital:**
  - Finding buyers for bad assets in a pandemic hit economy will be a challenge, especially when governments are facing the issue of containing the **fiscal deficit.**
- **Not Addressing the Underlying Issue:**
  - Without governance reforms, the **Public sector banks** (accounted for 86%, of the total NPAs) may go on doing business the way they have been doing in the past and may end up

    - piling-up of bad debts again.
    - Also, the bad bank idea is like shifting loans from one government pocket (the public sector banks) to another (the bad bank).
- **Provisioning Issue Tackled Through Recapitalization:**
    - Union Government, in the last few years, has infused nearly Rs 2.6 lakh crore in banks through **recapitalisation.**
    - Those who oppose the concept of bad banks hold that the government has on its part recapitalised the banks to compensate for the write-offs and hence, there is no need for a bad bank.
- **Market-related Issues:**
    - The price at which bad assets are transferred from commercial banks to the bad bank will not be market-determined and price discovery will not happen.

Way Forward

- 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 announcing reforms accordingly.

Source: TH