Need for a Bad Bank

Why in news?

As the problem of non-performing assets (NPAs) persists stressed by the pandemic, the RBI Governor has agreed to look at a proposal for creating a bad bank.

What is a bad bank and how does it work?

- A bad bank conveys the impression that it will function as a bank but has bad assets to start with.
    - Currently, loans in which the borrower fails to pay principal and/or interest charges within 90 days are classified as NPAs and provisioning is made accordingly.
- Technically, a bad bank is an asset reconstruction company (ARC) or an asset management company.
    - It takes over the bad loans of commercial banks, manages them and finally recovers the money over a period of time.
- The bad bank is not involved in lending and taking deposits.
- It just helps commercial banks clean up their balance sheets and resolve bad loans.
- The takeover of bad loans is normally below the book value of the loan and the bad bank tries to recover as much as possible subsequently.
- US-based Mellon Bank created the first bad bank in 1988.
- After this, the concept has been implemented in other countries including Sweden, Finland, France and Germany.
- However, resolution agencies or ARCs set up as banks, which originate or guarantee lending, have ended up turning into reckless lenders in some countries.

How serious is the NPA issue in the wake of the pandemic?

- Bad loans are expected to multiply in the wake of contraction in the economy and the problems being faced by many sectors.
- The RBI noted in its recent Financial Stability Report that the gross NPAs of

the banking sector are expected to shoot up to 13.5% of advances by September 2021, from 7.5% in September 2020.
- If the macroeconomic environment worsens into a severe stress scenario, the ratio may escalate to 14.8%.
- Among bank groups, the NPA ratio of PSU banks, which was 9.7% in September 2020, may increase to 16.2% by September 2021 under the baseline scenario.
- Corporate sector debt worth Rs 15.52 lakh crore has come under stress after Covid-19 hit India.
- Another Rs 22.20 lakh crore was already under stress before the pandemic.
- This effectively means Rs 37.72 crore (72% of the banking sector debt to industry) remains under stress.
- This is almost 37% of the total non-food bank credit.

What is the need for a bad bank?

- The RBI has taken a series of measures for better recognition and provisioning against NPAs.
- There have also been massive doses of capitalisation of public sector banks by the government.
- Despite these, the problem of NPAs continues in the banking sector, especially among the weaker banks.
- The idea of a bad bank gained currency during Former RBI Governor Raghuram Rajan's tenure.
    - The RBI had then initiated an asset quality review (AQR) of banks.
    - It found that several banks had suppressed or hidden bad loans to show a healthy balance sheet.
- However, the idea remained on paper amid lack of consensus on the efficacy of such an institution.
- ARCs have not made any impact in resolving bad loans due to many procedural issues.
- Now, with the pandemic hitting the banking sector, the RBI fears a spike in bad loans in the wake of a six-month moratorium announced to tackle the economic slowdown.

How will it help?

- A professionally-run bad bank, funded by the private lenders and supported the government, can be an effective mechanism to deal with NPAs.
- The bad bank concept is in some ways similar to an ARC but is funded by the government initially, with banks and other investors co-investing in due course.
- The presence of the government is seen as a means to speed up the clean-up

process.
- Many other countries had set up institutional mechanisms such as the Troubled Asset Relief Programme (TARP) in the US to deal with the problem of stress in the financial system.

What are the concerns?

- Former RBI Governor Raghuram Rajan had opposed the idea of setting up a bad bank in which banks hold a majority stake.
- Bad bank idea is like shifting loans from one government pocket (the public sector banks) to another (the bad bank).
- Indeed, if the bad bank were in the public sector, the reluctance to act would merely be shifted to the bad bank.

What are the suggestions in this regard?

- Viral Acharya, when he was the RBI Deputy Governor, had suggested the following.
- It would be better to limit the objective of the asset management companies to the orderly resolution of stressed assets, followed by a graceful exit.
- Acharya suggested two models to solve the problem of stressed assets.
- The first is a private asset management company (PAMC).
- PAMC is said to be suitable for stressed sectors where the assets are likely to have an economic value in the short run, with moderate levels of debt forgiveness.
- The second model is the National Asset Management Company (NAMC).
- An NAMC would be necessary for sectors where the problem is not just one of excess capacity but possibly also of economically unviable assets in the short to medium terms.

Source: The Indian Express