Mains Practice Question

Q. In the wake of the slowdown in economic activities due to the lockdown, the rise in Non-performing assets (NPAs) is inevitable. In this context, critically analyse the need for the bad bank. (250 words)

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References: “Bad Bank”

Approach

- Start your answer by explaining the challenge of rising Non-performing assets (NPAs) in the wake of an economic slowdown in lockdown. Along with that, you should briefly define Bad bank and how it can help in resolution of NPAs.
- As the question demands you to critically analyse the bad bank, first state the benefits of Bank bank and then challenges associated with it.
- Summarise your answer and conclude by suggesting some measures in terms of implementation.

Introduction

In wake of due to economic slowdown induced by lockdown, credit rating firm Crisil held that NPAs are expected to cross Rs 11 lakh crore by the end of this fiscal year. In this context, the Indian Banks Association (IBA), have refloated an old idea of creating a ‘bad bank’.

A bad bank is similar to an asset reconstruction company that buys bad loans(NPAs) from the commercial banks at a discount and tries to recover the money from the defaulter by providing a systematic solution over a period of time.

Body

Feasibility of Bad Bank

- **Alleviating Provisioning Requirement**: The banks have to keep supplementary capital (provisioning requirement) under the Basel Accord. High burden of NPAs further reduces its capital base and the resulting losses erode depositor confidence
    - Bad bank by way of absorbing NPAs, will ease the provisioning requirement by the banks and help them to get on with business as usual.
- **Greater Reliability:** The creation of a bad bank allows the segregation of a bank’s good assets from its bad assets. This allows investors to assess its financial health with greater clarity and for banks to grow financially.
    - Being a government-led initiative may perhaps make it more attractive for investors to invest their money- both domestic and foreign.
- **Existing models:** The 2007-2010 financial crisis led to the creation of bad banks in many countries.
    - In this period, in the US and Ireland, bad banks were created to deal with the growing NPAs

in the impending financial emergency.

- **Complementing IBC Code:** Many lenders are concerned over huge haircuts they have to endure after a resolution through the Insolvency and bankruptcy code.
    - Also, NPAs in the sectors such as power can't be resolved through the IBC system as factors like the lack of coal linkages and the absence of purchase power agreements make them unfit for a resolution through the IBC.
    - If banks feel the assets having future demand-supply issues face liquidation under the IBC, such a problem can be solved under the bad bank.
    - Thus, a bad bank may save a defaulting firm from liquidation and closure.

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 may go on doing business the way they have been doing in the past and may end up piling-up of bad debts again.
- **Provisioning Issue Tackled Through Recapitalization:** Union Government, in the last few years, has infused nearly Rs 2.6 lakh crore in banks through recapitalisation. Thus, recapitalisation of the banks to compensate for the write-offs contests the 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.
- **Moral Hazard:** A former RBI Governor had said that a bad bank may create a moral hazard and enable banks to continue reckless lending practices, without any commitment to reduce NPAs.

Conclusion

Bad bank seems to be a viable option to tackle the escalation of NPAs in the lockdown induced economic slowdown, but structural issues like **the deficit in the professionalism** of management and **non-adoption of greater prudential discipline** by the Public sector banks needs to be addressed simultaneously. Therefore, the debate regarding setting up a bad bank must be preceded by proper implementation of holistic reforms in the banking sector.