The need for a ‘bad bank’

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(Mains GS 3 : Indian Economy and issues relating to planning, mobilization, of resources, growth, development and employment.)

Context:

- The Union Cabinet recently approved a ₹30,600-crore backstop facility for guaranteeing securities to be issued by the National Asset Reconstruction Company Ltd. (NARCL).
- The NARCL, also called ‘bad bank’, is being set up to help aggregate and consolidate lenders’ non-performing assets (NPAs) or bad loans.

The ‘bad bank’ or NARCL:

- A ‘bad bank’ is a financial entity set up to acquire NPAs from banks and resolve them.
- The bank, which sells the stressed assets to the bad bank, is now relieved of the burden of the bad loans and can focus instead on growing its business by advancing fresh loans to borrowers requiring credit.
- The cleaner balance sheet also makes it relatively easier for the lender to raise fresh capital, if required.

Provisioned stressed assets:

- The NARCL, which is being set up by lenders and will be 51% owned by public sector banks, proposes to take over the fully provisioned stressed assets of about ₹90,000 crore in the first phase.

- The minimum size of each NPA to be acquired will be ₹500 crore as the focus is on resolving big-ticket bad loans.
- The longer-term goal for the NARCL is to help resolve NPAs worth ₹2 lakh crore, with the remaining assets with lower provisions expected to be transferred in a second phase.

Operation of the NARCL:

- The 'bad bank' will acquire assets by making an offer to the lead bank of a group of lenders of an NPA.
- Finance Minister Nirmala Sitharaman said the NARCL would make a 15% cash payment to the banks based on a valuation and the rest would be given as security receipts.
- These receipts, in turn, would be guaranteed by the government's ₹30,600-crore backstop facility.
- To assist the NARCL, public and private banks together would set up an India Debt Resolution Company Ltd. (IDRCL) that would manage the acquired assets and try to improve their value for final resolution.
- On completion of resolution, the balance 85% of value, being held as security receipts, would be given to the banks.

Centre providing a backstop:

- Given the large volume and individual sizes of these NPAs, a backstop from the government helps lend credibility to the resolution process and provides for contingency buffers.
- The guarantee, which will be valid for five years, would be invoked either at the time of resolution or liquidation to cover the shortfall (if any) between the face value of the security receipts and the actual realisation.
- The Union government's guarantee will also enhance the liquidity of these receipts, which are tradable.
- Also, given that there would be a pool of assets, it is likely that the realisation of value in many cases would exceed the acquisition cost, obviating the need to draw down on the guarantee.

For the banking industry:

- The government expects that the setting up of the twin entities, the NARCL and the IDRCL, with adequate capital and its guarantee, will incentivise quicker action on resolving stressed assets, thereby helping in better value realisation.
- As the holders of these stressed assets and security receipts, banks stand to receive the gains accruing from a successful resolution process.

- In a bid to disincentivise delay in resolution, the government has also proposed that the NARCL pay a guarantee fee to the Centre, which would increase with the passage of time.

Criticism of concept:

- Critics of the bad bank concept contend that the government's role in guaranteeing some part of the NPAs could lead to laxity on the part of bankers in assessing risk and thus creating fresh dodgy loans.
- Separately, a January 2020 Bank for International Settlements working paper on 'Bad bank resolutions and bank lending', in fact, found that "bad bank segregations are effective in cleaning up balance sheets and promoting bank lending only if they combine recapitalisation with asset segregation".
- The study, based on data covering 135 banks from 15 European banking systems over the period 2000-16, observed that neither recapitalisation nor asset segregation used in isolation "would suffice to spur lending and reduce future" NPAs.

Conclusion:

- It is necessary that Public Sector Banks' managements will be free from the hold of politicians and bureaucrats for professionalism in lending.
- Thus the idea of a bad bank is a good one but the challenge lies in tackling the structural problems in the banking system and announcing reforms accordingly.