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THE BIG DILEMMA OVER BAD BANK AND GOOD MONEY

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

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What exactly is a bad bank and its function?

A bad bank is an institution that takes over dud loans and other illiquid assets of lenders, helping them restart with a clean slate. Such a mechanism helps a bank segregate its good assets from bad ones, making it easier for it to raise capital by issuing equity or debt or both. The segregation of toxic assets helps generate confidence among potential investors who can then examine the financial health of the lender with greater clarity. Further, by transferring sour loans to a bad bank, lenders can prioritize financing businesses, while letting a specialized institution focus on maximizing loan recovery.

Why is it being talked about now suddenly?

The Indian economy slipped into a technical recession, contracting during the first two quarters of this fiscal year. It is likely to shrink 7.5% this year. The pandemic-led lockdown, imposed to curb covid infections, has already crimped earnings of businesses and individuals, impairing their ability to repay loans and potentially fuelling a jump in non-performing assets of banks. Despite regulatory forbearance in the form of a loan moratorium, many borrowers may find it difficult to service their loans, requiring lenders to set aside capital to cover those losses. A bad bank can free them up to start lending.

Have there been any such parallels around the globe?

Yes, the idea of a bad bank found strong resonance during the global financial crisis of 2007-09. Citigroup moved about $900 billion worth of loans to its bad-bank unit Citi Holdings, which in later years reported profits. Bad banks also helped Barclays and Bank of America overcome their stress. The Republic of Ireland formed a bad bank to tackle its own financial mess.

Why is it crucial to tackle toxic loans?

Banks and other financial institutions are key drivers of economic growth, as they are the formal channels of credit. As things stand, lenders, particularly state-owned ones, are saddled with massive bad loans. This has made them risk-averse, and eroded their capacity to lend to help spur economic recovery from the covid shock. Banks will find it tough, and exorbitantly expensive, to raise capital from the market if the asset-quality trajectory remains uncertain, delaying, even jeopardizing, economic growth.

Should the Centre set up a bad bank?

To the extent that a bad bank will take sour loans off banks’ balance sheets, it’s a good idea. But the Centre isn’t smitten by the idea yet. After all, there exist several private asset reconstruction firms that buy bad loans at a discount. Also, the Bankruptcy Code, though not perfect, has helped in higher recoveries. There is also the question of moral hazard that a government-funded bad bank can create by allowing reckless lending to continue. Can it end up as another case of throwing good money after bad?

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