Cleaning up balance sheets

What is a ‘bad bank’?

The Central government has revived the idea of setting up an asset reconstruction or asset management company, a sort of ‘bad bank’ first mooted by Chief Economic Adviser Arvind Subramanian in January 2017. Mr. Subramanian had envisaged a Public Sector Asset Rehabilitation Agency that would take on public sector banks’ chronic bad loans and focus on their resolution and the extraction of any residual value from the underlying asset. This would allow government-owned banks to focus on their core operations of providing credit for fresh investments and economic activity. Unlike a private asset reconstruction company, a government-owned bad bank would be more likely to purchase loans that have no salvage value from public sector banks. It would thus work as an indirect bailout of these banks by the government.

How will it be capitalised?

The bad bank will require significant capital to purchase stressed loan accounts from public sector banks. The size of gross NPAs on the books of public sector banks is currently over 10 lakh crore. The chances of private participation are low unless investors are allowed a major say in the governance of the new entity. Private asset reconstruction companies have been operating in the country for a while now, but have met with little success in resolving stressed loans. The CEA had proposed a significant part of the bad bank funding to come from the Reserve Bank of India, which is likely to be a tricky proposition. That means the government, which is already committed to recapitalising state-run banks, will have to be the single largest contributor of capital even if private investors are roped in.

How will it help the NPA problem?

Hiving off stressed loan accounts to a bad bank would free public sector bank balance sheets from their deleterious impact and improve their financial position. As the quality of a bank’s assets deteriorates, its capital position (assets minus liabilities) is weakened, increasing the chances of insolvency. Some analysts believe that many public sector banks are effectively insolvent due to their poor asset quality. Consequently, banks have turned risk-averse and credit growth has taken a hit. If managed well, a bad bank can clean up bank balance sheets and get them to start lending again to businesses. But it will not address the more serious corporate governance issues plaguing public sector banks that led to the NPA problem in the first place.

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