

## The Bad Bank: Is it the solution?



Indian banks' pile of bad loans is now a huge drag on the economy. The stressed assets now stand at over 12% of the total loans in the banking system. Public sector banks, which own almost 70% of banking assets, have a stressed-loan ratio of almost 16%. The measures taken till now to tackle the burgeoning bad loans in the country's banking system are still short of yielding any tangible results and the problem is not just draining the bank's profits but also hampering the financial sector's ability to fund productive sections of the economy. Therefore, effective resolution of stressed assets issue is the need of the hour.

With recapitalization of banks being difficult given the capital constraints of the government, many other attempts of handling the problem have been explored and are being explored. Flexible Refinancing of Infrastructure (5/25 scheme), a scheme that permitted banks to extend the maturity of loans given to companies in the infrastructure sector, Asset Reconstruction (ARC), Strategic Debt Restructuring (SDR) - the option of converting a part of the debt into equity and taking a controlling stake in overleveraged companies, Asset Quality Review (AQR) – a review by RBI with a view to clean up bank's assets, and Sustainable Structuring of Stressed Assets (S4A) where lenders are allowed to split the outstanding debt of a stressed company into sustainable debt and equity with some riders, are few to name.

Recapitalization of banks gives life to new projects but the problem of toxic assets is still there slowing down the overall growth of the bank. One radical way of addressing this issue is creation of a “BAD BANK”. The idea of a bad bank is to transfer all the non-performing assets (NPAs) of bank/s into the bad bank thereby cleaning the bank’s balance sheet. The bad bank is then expected to manage these NPAs in suitable ways — liquidation, restructuring, etc., by focusing on the task of recovery.

The bad-bank concept has been used with remarkable success in the past in countries including Sweden, France, and Germany and is today being discussed as a probable solution for the struggling Indian banks. While the idea is simple, practice is quite complex and involves many organizational, structural, and financial trade-offs to consider and, a one-size-fits-all approach to designing a bad bank can be very expensive and less effective. Additionally, there are also concerns of bad bank incentivizing risky lending in future. In the recent past, during the reigns of the governor Raghuram Rajan, the idea of bad bank has not received encouragement as the governor believed that it would make sense for the banks themselves to recover the dues and that the concept of bad bank is intended for situations where the projects are not viable, and that in case of India, the projects are viable.

However, with other alternate ways of resolving the issue not yielding considerable results, the policy makers are again brooding on the idea of bad bank. Making a success of bad bank in the Indian context poses several challenges starting from who will have the majority stake. Some financial experts believe in solutions like private-public partnership in banks where in the pumping of additional capital from private sources into the private-public banks shall create a fresh start for the banks with clean balance sheets after all the NPAs are transferred and managed by creating a bad bank. Further, PSBs (with the cleansed balance sheets) would also be able to access the equity markets for funds and would not be as dependent on the government for capital. Another alternative would be to create a bad bank just for the weaker PSBs instead of one bad bank for all PSBs.

Whatever is the route chosen, the concept of bad bank must be complemented with other steps and requires response on multiple fronts from different parties. It requires some capital infusion from the government and creation of a body like apex Loan Resolution Authority, for tackling bad loans, through an act of Parliament. Such an authority could vet restructuring of the bigger loans at PSBs thereby mitigating the paralysis set in PSBs due to fear factor and get the funds flowing into the stalled projects.

While the concept of bad bank is well appreciated, the devil is in the detail. Let us wait and watch what policy makers are going to decide and how the execution will be planned if a bad bank is to be formed. The extent to which government shall assume the risk or support the banks in their many regulatory, accounting, and tax issues needs to be seen. But the consensus is that whatever is to be done for the respite of the bleeding banking system, it should be done immediately.