Budget 2016: Here’s why a sovereign ‘bad bank’ will be a bad idea

The mainstream business media is abuzz with reports that Finance Minister Arun Jaitley will announce the proposal for establishing a sovereign asset reconstruction company, popularly known as "bad bank", to acquire the NPAs from public sector banks, in the upcoming Union Budget 2016-17 on February 29.

As it is widely known, public sector banks have been suffering from a spurt of NPAs for a while now with the third quarter of FY16 witnessing a sharp rise as fallout from stress in sectors like steel, power and infrastructure.

Before we proceed. a quick word about how asset reconstruction companies function is in order; an asset reconstruction companies, or a "bad bank" essentially purchases all the NPA loans from a bank against cash at the NPV of the loans. By thus purchasing all the NPAs on the balance sheet, it frees up capital that the banks have to otherwise "lock in" to provision against the NPAs and the banks may use the extra capital to create more loans to corporates and consumers, and thus giving a fillip to the economy.

The "bad bank", in turn, resolves the NPAs on its balance sheet by taking several steps against the borrower (these may inter alia, include filing a suit, foreclose the debt and the like).

So what's not to like? Let the bad bank take care of the bad loans and the good banks get back to business again; sounds like a plan. Except that it's not and that too for several reasons.

Firstly, India's banking sector is a peculiar mix of state owned banks (public sector banks or "PSBs") and private sector banks. As the shareholder in public sector banks, the government (and therefore the tax payer in substance) is already underwriting the risk for public sector banks.

Since the government will in practice almost never go bankrupt, the cost of capital demanded by investors in PSBs is always low relative to their true cost. The rating agencies too rate their debt taking into account the "taxpayer put".

This perpetual taxpayer put induces the risk of what economists call, moral hazard among the PSBs and their management; in other words, knowing beforehand that the government will always fund them (when the capital markets won't), PSBs were likely less than diligent in loan appraisals. Indeed, the government has already decided to recapitalize the PSBs over a three year period pursuant to the "Indradhanush" scheme.

In the light of this already existing capital subsidy, a publicly funded asset reconstruction company will aggravate the moral hazard already entrenched in PSB management. Instead of injecting market discipline and making prudent investments, knowing that they can offload debt to this sovereign bad bank will create a further disincentive to be diligent. And that would run contrary to one of the principal lessons of the financial crisis of 2008; the prevention or avoidance of moral hazard in banking.

Secondly, to the extent a clean-up of the balance sheet is necessary, India already has established a regulated asset reconstruction industry. Unlike the proposed sovereign-backed asset reconstruction company, these asset reconstruction companies are privately funded and therefore will only buy assets from the PSBs at their true cost, inflicting losses and preventing moral hazard (and thus inject market discipline among PSBs).

The government should push the management to utilize this route. Admittedly, certain regulatory restrictions and restrictions on raising capital are limiting emergence of a thriving market in bad loans; but the solution to the issue lies in engaging the stakeholders and correct the regulatory architecture all banks may utilize. (Illustratively, the RBI recently enacted a rule that requires asset reconstruction companies to bring not less than 15 % of the purchase consideration in cash. This rule foreclosed the option of bridging "valuation gaps" through security receipts and froze the markets).

Instead of proposing a sovereign "bad bank", the Union Budget-2016 should focus on policies aimed at enabling emergence of a thriving distressed debt trading and resolution market. Finally, the Budget should complement the capital infusions pursuant to "Indradhanush" by augmenting human capital at PSBs inter alia, by allocating moneys for hiring top talent at directorial and executive positions.

Finally, the government should privatize control over PSBs consistent with Nayak Committee recommendations as a step towards complete privatization.

To conclude; it's easy to enact a law for a sovereign "bad bank" and ease the short term pain of PSBs and let the imprudent lending continue to hurt the economy in the long run. But ensuring long term robustness in banking requires the Finance Minister to be the Ulysses and tie himself to the mast so he may resist these siren calls of doom.

(The article is authored by Mandar Kagade, policy analyst with the Bharti Institute of Public Policy at the Indian School Of Business)

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