

Benchmarks &gt;

**Nifty** **CLOSED**  
9,972.90 **70.90**

Stock Screener &gt;

Top Growth  
StocksStocks with  
Regular PayoutMid-Cap Growth  
Stocks

Search, Select &amp; Invest in Top Stocks

FEATURED FUNDS

**Aditya Birla Sun Life Tax Relief  
96 Direct-Growth..**

★★★★★

5Y RETURN

**7.74 %****INVEST NOW**Stock Analysis, IPO, Mutual  
Funds, Bonds & More**Market Watch**

# View: Why India needs a new bad bank

BY T K ARUN, ET BUREAU | UPDATED: JUN 12, 2020, 08.30 PM IST

Post a Comment

**State Bank of India** and the Indian Banks' Association have once again revived the proposal for a bad bank. It is not just desirable but imperative, if India's broken banks are to start lending again, to fuel growth, as the economy recovers from Covid. India needs not just any bad bank, but a **bad bank** jointly owned by the banks themselves.

The Chief Economic Advisor, K Subramanian, has expressed himself not in favour, on the ground that there already are 28 asset reconstruction companies in operation and banks have been unable to sell their bad loans to these entities. This ignores what the nature of ownership could do to make a new bad bank viable.

What is a bad bank, to begin with? It is a bank which takes over, that is, buys at a discount, the non-performing loans of banks and then resolves the assets over time, say five years, leaving the banks that sell off their bad loans with clean books, clarity on their finances and capable of making a fresh start, to raise capital with better ratings and on better terms and to make loans.

When a bank is already saddled with a high proportion of bad loans, its appetite for making a fresh loan that could turn sour is decidedly lower than when a bank has no bad loans on its books. For post-Covid recovery, banks must be free of their bad-loan burden. And the only way they can do this fast is to unburden their bad loans by selling them off to a bad bank.

Why can't the banks sell their bad loans to the existing asset reconstruction companies, set up to buy bad loans and resolve them? Bad loans have to be sold at a discount. If a loan of Rs 1,000 crore has turned non-performing, it cannot be palmed off for Rs 1,000 crore. The

## RELATED COMPANIES

EXPAND

State Bank O...

### Big Change:

The end of Five-Year Plans: All you need to know



Insight-rich stories you won't find elsewhere  
Trusted by 10,000+ CXOs & industry leaders

START YOUR TRIAL

of causing a loss to the bank, and indirectly, to the exchequer, in the case of public sector banks. Worse, a future Vinod Rai might accuse them of causing a notional loss to the exchequer. Bankers don't want to be in the place of the telecom secretary Behuria or coal secretary HC Gupta, who went to jail because of notional losses.

The key to the success of a new bad bank is ownership. It should be owned by all the public sector banks, which account for the bulk of non-performing assets on banks' books, and by private sector bank that want to join in. Their respective shares of ownership can be their share in the total bad loan portfolio. The advantage of having a bad bank owned by the banks collectively is that when the assets underlying a bad loan is resolved, the profits will accrue to the owners, that is, the banks themselves. This would make the loss they book on selling the non-performing assets at a discount more palatable. The better-quality assets would sell at a premium, say power assets that turned non-performing just because a state government went back on its [power purchase agreement](#).

Banks are good, or are supposed to be good, at making loans, not playing patient capital that acquires an asset cheap, looks around and waits for a buyer who would buy it at a good price and makes a killing on the difference between the acquisition price and the selling price. The bad bank need not be just a financial entity. It could employ professional managers to run some of the assets it acquires, sell them as going concerns and make even better profits.

Unlike a bank desperate to clean its books of bad loans, a bad bank is not in a hurry to find buyers for the assets on its portfolio. A bank's managers have no expertise in selling assets or running them as businesses. A bad bank could acquire such expertise.

The first bad bank experiment was a complete success. In 1988, Mellon Bank of Pittsburgh convinced the Fed to let it set up another bank that would take no deposits but just buy Mellon's bad loans and resolve them. Mellon gave the bank, Grant Street National Bank, some equity and some preference shares. The rest of the money needed to buy Mellon's \$1.4 billion worth of bad loans at a discount of 53% was raised by issuing short-term bonds: collateralised loan obligations. Drexel Burnham Lambert, the investment bank that specialised in issuing high-yield bonds under junk bond king Michael Milken securitised Grant Street's assets. There were two tranches of bonds, senior and junior. The senior tranche received investment grade rating while the junior tranche had junk rating and offered a much higher yield. Reportedly, the whiz kids at Drexel dubbed the junior tranche bonds CLOWNS, or Collateralised Loan Obligations Worth Nothing Securities. But all securities were paid in full. And Grant Street was wound up.

Mellon hired Arthur Andersen & Co to price the loans for sale to Grant Street. The price arrived at by Arthur Andersen was reviewed by



Insight-rich stories you won't find elsewhere  
Trusted by 10,000+ CXOs & industry leaders

START YOUR TRIAL

Such arms-length pricing would be key to the success of the proposed bad bank in India, too. And if the sale is to a company owned by the banks themselves, and if it has the mandate not just to sell on an 'as is' basis but also to run/complete the asset and then sell it off, bankers would have much less to worry than when selling bad loans to private ARCs.

Private ARCs would be able to compete with the bad bank to buy [stressed assets](#) and pricing would become competitive.

Bad bank experiments have worked well around the world. It would, in India, too – provided the bankers' fear of being hounded for selling their bad loans cheap can be addressed.

*(Views expressed are author's own and not of [economictimes.com](#))*

Stay on top of business news with The Economic Times App. [Download it Now!](#)



Insight-rich stories you won't find elsewhere  
Trusted by 10,000+ CXOs & industry leaders

START YOUR TRIAL