

Bad Bank Proposal for India

A Partial Jubilee Financed by Zero Coupon Perpetual Bonds

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There have been two main proposals to tackle the stressed assets problem of Indian banks since the beginning of this year. Both proposals are based implicitly on the financial intermediation theory of banking. The alternative credit creation theory of banking opens up other possibilities. One such possibility is a partial Jubilee financed by zero coupon perpetual bonds.

I closed the November 2016 HT Parekh Column article (Öncü 2016) as follows: “A global Jubilee is in order.”

This was my proposal to tackle the difficulty of resolving the “private debt overhang” problem in the current global environment of low nominal output growth. The International Monetary Fund (IMF) issued a warning in the title of its October 2016 Fiscal Monitor: “Debt—Use It Wisely” (IMF 2016).

In this article, I propose that India lead the world.

What Is Jubilee?

Jubilee comes from Judaic Law (Leviticus 25). It is a clean slate to be proclaimed every 49 years (seven Sabbath years—Sabbath means to cease, to end or to rest) annulling personal and agrarian debts, liberating bond-servants to rejoin their families, and returning lands that had been alienated under economic duress (Hudson 2013).

Jubilee is not a religious fiction or ideal as some think it is. It has been traced back to royal proclamations issued in Sumer and Babylonia in the third and second millennia BC. It used to happen quite often, and debt write-offs happen quite regularly even these days (Öncü 2016).

Zero Coupon Perpetual Bonds?

The oldest known perpetual bond in the world that still pays coupon (at an interest rate of 2.5%) was issued in 1624. It was originally floated to raise funds for the repair of a dike by the Hoogheemraadschap Lekdijk Bovendams, a Dutch water authority responsible for maintaining levees (Andrews 2016). As the name suggests, a perpetual bond never pays principal. It pays coupons with some stated frequency on the stated principal (the face value or the price it was issued) only.

But, what if a perpetual bond does not pay any coupon either? At what price would such a bond sell other than zero? How much would it cost to issue the bond to its issuer other than almost nothing?

As crazy as the zero coupon perpetual bond idea may sound, the banknotes we carry in our wallets are essentially zero coupon perpetual bonds. They pay neither coupon nor principal. Yet, they have face values written on them such as ₹100 or ₹500. And, they buy things at their face value.

The most recent zero coupon perpetual bond proposal belongs to the former chairperson of the Federal Reserve Bank of the United States (US), Benjamin Bernanke, and earned him the nickname “Helicopter Ben.” In July 2016, Bernanke proposed to “Japan that helicopter money—in which the government issues non-marketable perpetual bonds with no maturity date and the Bank of Japan directly buys them—could work as the strongest tool to overcome deflation” (Fujiko and Ujikane 2016).

I will propose zero coupon perpetual bonds to India also. But, not in the way Bernanke proposed it to Japan.

Non-performing Assets in India

The non-performing assets (NPAs) of the Indian banking sector have been on the rise since September 2008, with faster deterioration after September 2009. Interestingly, while the private sector banks were suffering from most of the NPAs in September 2008, from September 2009 the public sector banks started to take the lead, and now, the public sector banks are suffering from most of the NPAs (Unnikrishnan and Kadam 2016).

The deterioration that started in September 2008 continued until the last quarter ending 31 December 2016, and NPAs reached 9.3% of the total credit extended by the entire (public and private) banking system, while NPAs of public sector banks were 11% of the total credit they extended. What is worse is that five of the public sector banks had NPAs of above 15%. The size of the NPAs of the entire banking system at the end of this quarter was ₹6.7 trillion and 88.2% of this amount was on

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the books of the public sector banks (Mathew 2017).

As noted by Chandrasekhar (2017), the Indian Ministry of Finance's *Economic Survey 2016–17* recognised that under normal circumstances this would have threatened the banks concerned with insolvency, perhaps triggered a run on the banks, forced bank closure, and even precipitated a systemic crisis. Chandrasekhar (2017) also noted that according to the *Survey*, since there is a belief that these banks have the backing of the government, which will keep them afloat, the bad loan problem has not, as yet, become a systemic crisis. Whether the bad loan problem in India has become a systemic crisis or not can be debated. However, that India needs to decisively resolve her banks' stressed (non-performing, restructured or written-off) assets with a sense of urgency in the way the newly appointed Reserve Bank of India (RBI) Deputy Governor Viral Acharya mentioned in his 22 February 2017 speech cannot be.

Proposals on the Table

A "bad bank" is a corporation established to isolate stressed assets held by a bank or financial institution, or a group of banks or financial institutions. It might be established privately by the bank or financial institution, or the group of banks or financial institutions, or by the government or some other official institution.

There have been two main proposals to tackle the stressed asset problem of the Indian banks since the beginning of this year. The first one was the "bad bank" proposal made in the *Survey*:

NPAs keep growing, while credit and investment keep falling. Perhaps it is time to consider a different approach—a centralised Public Sector Asset Rehabilitation Agency [PARA] that could take charge of the largest, most difficult cases, and make politically tough decisions to reduce debt.

The PARA to resolve the stressed assets of the public sector banks is the "bad bank" the Finance Ministry proposed. The *Survey* gives a detailed description of how the PARA would work and mentions that the funding for PARA would come from three sources: (i) government issued securities; (ii) capital market; and

(iii) RBI. The first two of these sources are not unusual. However, the third source is rather unusual (although not novel as the *Survey* documents):

The RBI would (in effect) transfer some of the government securities it is currently holding to public sector banks and PARA. As a result, the RBI's capital would decrease, while that of the banks and PARA would increase. There would be no implications for monetary policy, since no new money would be created.

The second proposal came from Acharya on 22 February 2017. Although rumour has it that he was hired for his advocacy of "bad banks," Acharya clarified that his suggestion is not akin to creating a "bad bank," but is more to create a resolution agency. He suggested two models. A Private Asset Management Company (PAMC) and a National Asset Management Company (NAMC).

Under the PAMC, banks would come together to approve a resolution plan based on proposals from a variety of different restructuring agencies and this would also be vetted by rating agencies. As he explained, there

are ways to arrange and concentrate the management of these assets into a single or few private asset management companies (PAMCs), at the outset or right after restructuring plans are approved. These companies would resemble a large private-equity fund run by a team of professional asset managers. Besides bringing in their own capital, they could raise financing from investors against equity stakes in individual assets or in the fund as a whole, i.e., in the portfolio of assets. (Mathew and Dugal 2017)

As Acharya argued, the PAMC would be more suitable for sectors such as steel and textiles where some sectoral recovery is in sight whereas the NAMC—in which the government would play a larger role—would be more appropriate for infrastructure investments such as power where the assets may appear to be unviable in the short to medium term. However, even the NAMC would bring in asset managers such as asset reconstruction companies (ARCs) and private equity to manage and turn around the assets, individually or as a portfolio, although the government may retain a minority stake in the assets.

To sum up, while the finance ministry proposed a mainly public solution,

Acharya proposed mainly private or market solutions to the problems.

My Criticism of the Proposals

Although given the urgency of the situation both proposals have many merits, many have attacked both the proposals for a multitude of theoretical and ideological reasons. This is normal of course because economics is not even the "dismal" science as some call it. What is wrongly called economics these days used to be correctly called political economy as the following title from the 27 February 2017, *Times of India* demonstrates (Sidhartha 2017): "Few Supporters in Govt for 'Bad Bank' Proposal."

Here is a quotation from this article.

Sources in the finance ministry, however, said that the issue is best left to banks as the government did not have the required resources to meet the capitalisation needs. In addition, it does not want to be seen bailing out companies and banks when the same resources can be deployed elsewhere.

This is what I mean when I say there is no economics but political economy. Under these conditions, it would be unfair to criticise either of the proposals, but I have to criticise both on one account.

It is that both of the proposals operate under the implicit assumption that "banks are financial intermediaries."

The problem is that banks are not financial intermediaries. They are money creators. Banks create money either by extending credit or by buying government securities while in the process creating corresponding deposits. In other words, banks do not collect or mobilise deposits to lend them out. Although banks can collect deposits from each other, when we look at the entire banking system as a single bank, there is no other place from which this bank can collect deposits

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except the holders of currency in circulation. That is, the banking system does not collect or mobilise deposits first and then extend credit or buy government securities. It is the other way around.

Lost Century in Economics

In an article titled “A Lost Century in Economics: Three Theories of Banking and the Conclusive Evidence,” Werner (2016) argues the following:

During the past century, three different theories of banking were dominant at different times: (1) The currently prevalent financial intermediation theory of banking says that banks collect deposits and then lend these out, just like other non-bank financial intermediaries. (2) The older fractional reserve theory of banking says that each individual bank is a financial intermediary without the power to create money, but the banking system collectively is able to create money through the process of ‘multiple deposit expansion’ (the ‘money multiplier’). (3) The credit creation theory of banking, predominant a century ago, does not consider banks as financial intermediaries that gather deposits to lend out, but instead argues that each individual bank creates credit and money newly when granting a bank loan. The theories differ in their accounting treatment of bank lending as well as in their policy implications. Since according to the dominant financial intermediation theory banks are virtually identical with other non-bank financial intermediaries, they are not usually included in the economic models used in economics or by central bankers. *Moreover, the theory of banks as intermediaries provides the rationale for capital adequacy-based bank regulation. Should this theory not be correct, currently prevailing economics modelling and policy-making would be without empirical foundation.* (emphasis added)

In a working paper by the Bank of England titled “Banks Are Not Intermediaries of Loanable Funds—And Why This Matters,” Jakab and Kumhof (2015) describe the money creation process as follows.

In the intermediation of loanable funds model of banking, banks accept deposits of pre-existing real resources from savers and then lend them to borrowers. In the real world, banks provide financing through money creation. That is, they create deposits of new money through lending, and in doing so are mainly constrained by profitability and solvency considerations.

In this paper, Jakab and Kumhof quoted Alan Holmes (1969), a former vice president of the New York Federal

Reserve, who wrote the following: “In the real world, banks extend credit, creating deposits in the process, and look for the reserves later.”

How Is Money Created in India?

In 1969, Holmes was talking about the us. The situation is somewhat more complicated in India because there have been two liquidity requirements imposed on the banks by the RBI after independence. These two requirements are called the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR).

Prior to further progress, let me clarify what the RBI means by “cash.”

In the language of the RBI, “cash” does not mean just rupee banknotes, and the rupee and smaller coins. Beyond these three are the “bank deposits” with the RBI which are just some numbers on some computers these days. So, rather than “cash” and consistent with the rest of the world, I will use the word “reserves” for these “bank deposits” with the RBI and save the word “cash” to mean what we ordinary people think “cash” is in our daily lives. The economists call the sum of cash and reserves, base money, whereas the sum of cash and deposits is broad money. It should be mentioned that while cash and deposits can buy things in the real world, reserves cannot. Reserves are common currency only among the banks and the RBI, and cannot go out of the banking system.

To sum up, the CRR is what the most of the rest of the world calls the “required reserve ratio.” As Holmes (1969) described for the us, in India also, banks first create deposits by extending credit or by buying government securities, and then look for reserves to meet the CRR requirements. The most recent banking data available on the RBI website—as of 17 February at the time of writing—shows that the reserve to deposit ratio was about 4%, which is consistent with the current CRR requirement.

And, had the CRR been the only liquidity requirement, the money creation process in India would have been no different than the money creation process in the us, for example. What sets India apart from most other countries is the SLR requirement. Because, the SLR

requirement can be met not only by holding “reserves,” but also by holding gold and “government approved securities.”

When we look at the SLR historically, we see that the commercial banks in India have met their SLR requirement by holding “government-approved securities” mostly. In addition, if we look at the earlier mentioned RBI data we see also that above 99% of the “government approved securities” were “government securities.” This comes as no surprise because these securities are very safe and pay high interest rates.

Further, as of the same date, the credit-to-deposit ratio was roughly about 70%, while the government-approved securities-to-deposit ratio was roughly about 30%, and these two ratios nearly added up to 100% despite the expected measurement errors. Given that the current SLR requirement is 20.5%, this also indicates that the banks are holding way more government securities than they require. This is understandable, because the banks need non-SLR government securities to repo (or repurchase option) with the RBI to obtain reserves to meet their CRR requirement.

To sum up, while the CRR is a tool of the RBI to manage the liquidity in the banking system, the SLR is a tool to manage the liquidity in the economy, although nowadays the RBI uses the CRR to manage the liquidity in the economy also. To clarify these further, let me summarise the 17 February RBI data in Table 1.

Table 1	(in trillion)
Aggregate deposits	₹104.9
Other demand and time liabilities	₹4.9
Cash in Hand	₹0.6
Balances with the RBI (reserves)	₹4.3
Government and other approved securities	₹33.4
Credit	₹74.9

And, let me add to this that the total of all outstanding government securities is ₹47.2 trillion.

These data show that the commercial banks in India hold about 70% of all outstanding government securities, and hence the SLR is not only a monetary policy tool, but also ensures that banks in India lend to the government. Furthermore, the availability of government

securities puts an upper bound on the deposits the Indian banks can create.

If the banks buy all of the government securities and use them to meet the 20.5% SLR requirement only, then the banks in India can increase the aggregate deposits to ₹230.4 trillion by extending additional credit. In this case, the credit extended to the rest of the economy other than the government would be ₹183.2 trillion. This is the maximum amount of credit that can be extended to the rest of the economy, if the government does not issue new securities and the SLR remains 20.5%. Further, in this scenario, the RBI has to increase the reserves to ₹9.2 trillion so that the banks can meet their 4% CRR requirement.

Of course, the above is just a hypothetical scenario I constructed to give the readers some idea about how these two ratios, reserves, and government securities affect the availability of money and credit to the economy.

My Bad Bank Proposal

In light of the discussion so far, I now make my “bad bank” proposal for India and, for want of a better name, call it the Bad Bank.

- (i) The Bad Bank would be promoted by the Government of India and capitalised with zero coupon perpetual bonds the government would issue;
- (ii) The Bad Bank would swap the zero coupon perpetual bonds with reserves the RBI would create. These reserves would be excess, because they would not back any of the deposits of the banking system;
- (iii) The Bad Bank would swap the excess reserves with the banks (public and private) for the bad loans.

Two things will happen to the banks (not just public, but also private):

- (i) They are relieved of the bad loans;
- (ii) Since the excess reserves have zero risk weights, their capital ratios go up so that there is no need to recapitalise any of the banks.

Furthermore, although the base money was increased by the amount of the issued zero coupon perpetual bonds, since the existing deposits remained intact, the broad money neither increased (no immediate inflation) nor decreased (no immediate deflation). In addition, this

operation would cost nothing either to the Government of India or to the Indian taxpayers, because the Government of India will pay neither coupon nor principal on the issued zero coupon perpetual bonds.

At this point, a decision has to be made regarding what to do with the bad loans. One possible decision is to erase all of the bad loans against the Bad Bank's equity and dissolve the Bad Bank. This is what I call a partial Jubilee. It is partial because in a full Jubilee, all of the debts in the country would be annulled and the country would start from a clean slate.

Of course, this is not the only possible decision. As in the case of the NAMC proposed by Acharya, the Bad Bank might bring in asset managers such as ARCs and private equity to manage and turn around the assets, individually or as a portfolio, and the like. Other possibilities can also be considered.

Let me conclude by noting that although what I proposed above solves the immediate stressed asset problem of the Indian banking system cheaply, it does not solve any other problems, be those economic, financial, political, social and the like. It only gives the country some breathing time so that she can attack and tackle all of her other problems.

Last Words

One last issue I would like to discuss is the excess reserves the RBI created. As readers familiar with the quantitative easing (QE) programmes implemented in the US would recall, many have expressed concern that the large quantity of excess reserves created through the QE programmes will lead to an increase in the inflation rate unless the Federal Reserve acts to remove them quickly once the economy begins to recover.

In an article titled “Why Are Banks Holding So Many Excess Reserves?” Keister and McAndrews (2009) addressed this issue and argued that if interest is paid on the reserves, this allows a central bank to maintain its influence over market interest rates independent of the quantity of reserves created by its liquidity facilities. This can also be considered in India. Furthermore, despite

all these concerns in the beginning, no significant inflation took place in the US and, indeed, in 2015, the US was flirting with deflation.

And, of course, there is the luxury of the SLR that the RBI can use to manage the liquidity in the economy.

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