

Making India's banks whole again is a good first step

For once, the fine print in India hasn't damped enthusiasm for the broad-brush plan.

New Delhi's Rs2.11 trillion bank recapitalisation, detailed Wednesday night, goes to the heart of state-run lenders' acute capital shortage. With a little help from the global economy—and from finance minister Arun Jaitley's forthcoming budget—India Inc. can finally rediscover its missing animal spirits. Soaring equity valuations will have a new leg to stand on.

The rescue is easy on the taxpayer, who—for reasons both anachronistic and increasingly inexplicable—must backstop a score of lenders that control 70% of the banking system's assets. The amount coming out of the current fiscal year's budget is only \$1.3 billion, and even this is from an existing allocation. Fiscal slippage would be restricted to interest on the \$12.6 billion portion, which New Delhi aims to finance by selling special recap bonds.

The interest on these 10- to 15-year notes will be the average yield on equivalent government securities, plus a spread. This will be the additional burden for the next fiscal year, which starts 1 April. But the expenditure may pay for itself.

As banks, the major holders of government bonds, swap some of their excess \$199 billion hoard of sovereign notes for the new non-tradable security, the pressure on them from mark-to-market losses in a rising yield environment will ease.

India's borrowing costs could still rise if global oil prices climb further, forcing the government to sacrifice taxes on petroleum products to blunt the blow on consumers. Still, with the central bank dropping hints that it won't give lenders extra time to book trading losses, it's more reasonable to expect Jaitley to be mindful of bond vigilantes.

Even Prime Minister Narendra Modi recently indicated that the 1 February budget won't be populist, so turbulence in the Indian bond market may recede.

What about the banks themselves? Among the 21 state-owned lenders on the distribution list for largess, only one—Indian Bank—gets nothing. Overall, the bailout would shore up the banks' core Tier 1 equity by 1.5% of risk-weighted assets, according to ICRA Ltd, the India affiliate of Moody's Investors Service. The rating company expects 0.5%age point of the infusion to get used up in loan-loss provisions.

That would still leave banks with 1%age point of capital, or \$9 billion, to boost new lending. At 8 times leverage, fresh credit would rise by \$72 billion. With the banking system's credit growth at only \$213 billion over the past year, this leg-up isn't to be scoffed at.

Yet it's important to remain realistic. The resolution of India's \$207 billion bad-loan mess by the national bankruptcy tribunal could lead to lowball bids for assets and higher losses for banks than currently expected. In that case, the capital injection is better viewed as maintenance activity: keeping zombies alive.

A 3:2 split of new capital in favour of the 11 weakest lenders versus the 10 relatively stronger ones should temper investors' expectations of rapid expansion of bank lending. Besides, New Delhi doesn't want the weaklings to pile back into corporate lending. The number of banks in consortium loans will now be restricted to seven—any lender not picking up at least 10% of a syndicated deal would have to stay away altogether, and focus instead on medium and small borrowers.

These restrictions, announced as a quid pro quo for a bailout, are necessary, but insufficient. State-run banks misprice risk knowing taxpayers' capital is free, while privately run lenders do so because their bosses love their stock options.

The solution to the latter lies with shareholders and the regulator—they need to wake bank boards from their slumber. As for free capital from taxpayers, this will haunt India until the government finds the political courage to keep no more than three or four state-run lenders and sell the rest.

Will Jaitley and Modi use the last budget before the 2019 election for sweeping reform of the banking landscape? I won't hold my breath. **Bloomberg View**

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