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RECAPITALIZATION OF STATE-OWNED BANKS: PRIVATIZATION SHOULD DO IT

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

India can fix its public-sector lenders by letting them raise enough equity capital to significantly reduce government control

As with the whole economy, the covid pandemic dealt a severe blow to India's banking sector, which was already reeling under a huge burden of non-performing assets (NPAs). Stress tests reported in the Financial Stability Report (FSR) indicate that the low ratio of capital to risk-adjusted-assets (CRAR) is likely to decline further. To revive the economy and resume sustained high growth, bold structural reforms will have to be combined with strong fiscal and monetary measures.

Here, the big challenge for the latter is the low and declining growth of credit. A credit-to-gross domestic product ratio of around 51% is not too low compared to other countries at comparable levels of per capita income. However, the worry is that credit growth is declining rapidly. It fell from around 13% year-on-year in April 2019 to 6% in November 2020. This is not attributable to the lockdown because credit growth was already down to 6% in March 2020, when the lockdown had just begun. It is mainly attributable to rising risk aversion among lenders, reflecting the high and rising level of NPAs. Risk aversion spiked during the economic contraction. But the underlying level of banking sector stress has been masked by the regulatory forbearance that the Reserve Bank of India (RBI) mandated, subsequently extended by the Supreme Court, to provide temporary relief for borrowers during the economic contraction. The FSR stress tests now indicate that the gross NPA ratio is likely to go up to as much as 13.5% by September 2021 in the report's baseline case and 14.8% in the 'severe stress' case.

Within the banking sector, conditions are much worse in public sector banks (PSBs) compared to private banks (PBs) or foreign banks (FBs). The gross NPA figure is forecast to rise to 16.2% for PSBs as compared to 7.9% and 5.4% for PBs and FBs in the baseline case. In the severe-stress case, gross NPAs could rise to 17.6%, 8.8% and 6.5% for PSBs, PBs and FBs, respectively. Clearly, high NPAs are primarily a problem for PSBs, which still account for 60% of India's total bank credit.

Given this background, how can we rapidly expand the banking sector and restore a high level of credit growth to support a strong, sustainable economic recovery?

One approach is to bypass PSBs and give a big push to private banking by issuing new bank licences. The recent report on Ownership and Corporate Structure for Indian Private Sector Banks submitted by an RBI internal working group (IWG) espouses this approach. Apart from many recommendations on better prudential regulation, strengthening the supervision capacity of RBI, etc, the IWG's main and most controversial recommendation is to enable large corporations and industrial houses to acquire banking licences.

The proposal has been strongly opposed by former governors and deputy governors of RBI, several former chief economic advisers, a former finance secretary, and, most significantly, all save one of the many experts the IWG consulted. The key issues, which have been intensively discussed, especially in Rakesh Mohan's three part article ('Ownership and Governance in Private Sector Banks', Business Standard, 14, 15 and 16 December), are briefly as follows:

One, with an industry CRAR of only 12%, the proposed raising of the promoter share cap to 26% could potentially leverage the promoter’s investment by 32 times. The very high risk appetite generated by such leveraging would subject depositors (i.e., individuals, small companies, large corporations and even governments) to a high level of systemic risk, given the limited deposit insurance provided in India.

Two, excessive risk appetite would lead to imprudent lending, especially connected lending to group companies. Conglomerates always find ways around regulatory restrictions against such connected lending.

Three, a conglomerate’s bank would have access to insider information on borrower companies that compete with its group companies.

Four, conglomerate banks would lead to massive concentration of economic power and political influence against not just competing companies, but even the regulator.

A safer and cleaner option would be to help the country’s banking sector grow through simultaneous privatization and recapitalization of PSBs. In the last three years, apart from merging some weak and strong PSBs, the government has spent some 2.5 trillion on recapitalizing PSBs. This has been financed partly by taxpayer money and partly recapitalization bonds, including the recently- introduced discounted zero-coupon bonds sold to PSBs that are to be recapitalized. However, these options do not change the ownership and governance structure of PSBs, which is what primarily is to blame for their poor performance.

A better option is for PSBs to recapitalize themselves by raising fresh equity. But there will be no appetite for this, unless: (a) the banks’ balance sheets are first cleaned up; and (b) it is announced that the volume of fresh equity being raised is more than the government’s holding (which would reduce the government’s ownership to a stake of less than 50%).

Such a bold reform would mobilize substantial resources from a buoyant capital market. It would recapitalize the banks, empowering them to resume lending, and simultaneously privatize their ownership structure, which would lead to improved performance.

It would be more prudent financially and also more acceptable politically to test this approach with one or two small PSBs. But first, the Indian government has to bite the bullet. These are the author’s personal views.

Sudipto Mundle is a distinguished fellow at the National Council of Applied Economic Research.

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