The stimulus and after

The *Financial Times* of London described the recent recapitalisation of public sector banks in India as collecting used tiffin boxes. It said banks are like intermediaries, not unlike the dabbawalas of Mumbai who deliver home cooked meals to offices, and return used tiffin boxes back in the evening. Banks collects savings from depositors and give it to borrowers. The intermediaries have not been collecting their deliveries back (that is, the bad loans), and the clean-up is as messy as uncollected used tiffin boxes!

The metaphor is a bit mixed up but catches the imagination. A better metaphor would be “cleaning the carburettor” of the credit pipeline. Bad loans have clogged the pipes, and new credit has stopped flowing.

One of the most reliable leading indicators of economic growth is the growth of non-food credit. High growth in credit foretells healthy growth of GDP, since credit goes mostly into investment and building of new capacity. India is predominantly a bank finance-led economy, so when bank lending slows down, it surely impacts future growth. Bank credit growth has been at nearly a 60-year low. Even the growth of money supply is at a 55-year low. This stark metric tells us about the growth slowdown. Of course, there are many proximate causes as well, such as demonetisation and the roll-out of the goods and services tax (GST).

Credit offtake slowed down because of both demand and supply side factors. On the demand side is the fact that industry has low capacity utilisation rates (factories lie idle); domestic industry is losing market share to low cost imports, made worse by GST, which has tilted the field in favour of imports, and also by the strong currency. The corporate sector is also deleveraging and paying off its past high debts. All this means demand from the private sector for large-scale new credit is muted.

On the supply side, the big constraint on fresh lending is the burden of non-performing assets (NPAs). The NPA ratio has been deteriorating for more than six years, and worse is yet to come. The diagnosis of worsening NPAs reveals five different causes, not all caused by the bankers themselves. The first is the disproportionate share of loans that went to infrastructure. These projects are of long gestation and long payback period, so unsuitable for bank lending. That creates an asset liability mismatch for banks, since the liability side is of a short-term nature. During the UPA regime, public-sector banks were under pressure to fund the ambitious $1 trillion infrastructure vision. Normally such projects ought to be funded by long-term bonds or developmental organisations like the World Bank or the Asian Development Bank, or the IDBI in its original avatar. But in the absence of those options of development finance, it fell to public sector banks to provide infrastructure finance. This led to over-exposure.

The second reason for deterioration of loans could be the impact of key judicial decisions like abrupt cancellations of coal mines and spectrum allocation. When the same were re-allocated through expensive auctions, it proved to be a fatal burden on respective business models of power, steel and telecom. The third reason for worsening NPA ratios could be the delays caused by land acquisition and environmental clearances. This reason for NPAs was adequately documented in the Economic Survey. The fourth reason is the Asset Quality Review mandated by the Reserve Bank of India (RBI) in 2015. This was much needed, since it put a stop to the “extend and pretend” culture around worsening credit.

To be fair, the RBI showed great regulatory forbearance in allowing lenders to work out remedies for genuine cases which faced a business cycle downturn. Various options were made available, including extending duration of loans, debt restructuring, swapping equity for debt and so on. But it does not seem to have made any significant difference. The NPA recovery process has since got a boost due to the new insolvency and bankruptcy law. The government too announced the Indradhanush scheme focused on banking reforms and recapitalisation of NPA-burdened banks. Two instalments of infusion in the past two years proved woefully inadequate as the NPA ratio continued to mount.

The fifth reason for worsening NPA is an omnibus called “malfeasance”. This includes cosy relationships between banker and borrower, crony capitalism, political interference in lending decisions (a legacy of the past), a less than vigorous attempt to recover past dues, careless due diligence, etc.

There may be other reasons as well. The fact is that 10% of all loans have gone bad. No wonder that after provisioning, for many public-sector banks their net worth would be completely eroded. Hence the days of piecemeal and feeble remedies are gone.

In the light of this background, the decision to inject 2.11 lakh crore of capital into public sector banks is a welcome boost. This was also evident from the reaction of the stock market as some bank stocks soared by as much as 35%. It is somewhat a moot point that this injection could have been done at least one year ago.

The injection is clever because it has been done without busting the promised fiscal deficit target. It has been financed by the sale of recapitalisation bonds. Banks are currently flush with cash which was deposited after demonetisation. Much of that same cash will be used to buy those bonds. The proceeds of the sale of these bonds will be put back into the bank as fresh equity by the government. It’s a neat roundtrip of depositors’ cash coming back as capital. To that extent it is taxpayers who are funding this equity injection. More details are awaited. For instance, since banks are listed entities, should not other shareholders apart from the government also be asked to make a matching equity infusion? What about the windfall gains that arose as a result of this equity infusion? How will the bonds be repaid by the government? What will be their duration? Will they be traded? Would they instead be converted into perpetual bonds, never to be repaid, as was done to the 1992-93 bonds?

Suffice to say that this capital infusion provides banks with the much-needed room to make fresh loans. In the coming days of Basel-3 where much capital is needed for risk provisioning, the NPAs are a millstone which prevent fresh lending.

With this big bang recap effort, we can expect the growth pipes to be unclogged. Of course, the recapitalisation effort is useless without accompanying reforms which can prevent a recurrence. Those reforms are mostly about governance, meaning granting genuine autonomy to banks in their functioning, including all aspects such as lending, recovery, and recruitment decisions. Banks have to be accountable to shareholders, including the government, through their respective boards. That’s the fourth crucial “R” that was part of this recap package – recognition, recapitalisation, resolution and reform. Without reform of credit functioning, culture, treatment of delinquencies and even ownership structure in banking, this recap effort will only be stopgap. Assuming reform is coming (witness the huge increase in India’s global rank in ease of doing business), let’s raise a toast to the bank recap.

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