What bank recapitalisation means

The past couple of days have brought cheer to public sector banks. The promised recapitalisation of Rs2.1 trillion takes care of not only the provisioning requirements of public sector banks, but also provides them with growth capital. All requirements of public sector banks have been addressed at one stroke.

Bank recapitalisation via special recapitalisation bonds is an approach the government used in the 1980-1990s. Between financial years (FY) 1985-1999, the government infused Rs204 billion into public sector banks via recapitalisation bonds. The operational details of the bonds will likely be similar to the bonds of the 1990s.

Assuming that the Rs1.35 trillion infusion is equity capital, it could be highly dilutive but positive for the FY19 adjusted books. The Rs1.5–1.6 trillion infusion will lead to 0-200% dilution of public sector banks. At first glance, the quantum of this dilution will look high for minority investors, but in most public sector banks the current stock price is higher than the adjusted book value of FY17, so raising at current prices or higher will have a positive impact on the FY19 adjusted book value.

The Common Equity Tier 1 (CET 1) requirement determines if a bank can stand the test of crisis. Our estimates suggest that the CET1 requirement of all public sector banks is Rs1.5-1.6 trillion. The balance recapitalisation fund can be directed towards growing their business-growth capital. Recapitalisation, therefore, takes care of dry powder requirements for stressed assets and future capital for growth, assuming CET 1 of 9.5%, 60% provisioning on all stress and 7% compound annual growth rate (CAGR) in risk weighted assets (RWAs) over FY18–19.

We expect bank recapitalisation to benefit the economy through five main channels. First, assuming Rs700-750 billion is available to banks as growth capital and a leverage ratio (loan-to-equity) for banks of eight-nine times, the available growth capital should enable banks to extend additional loans worth Rs5.8-6.5 trillion (7.3-8.3% of outstanding credit).

Second, the capex cycle recovery has been stuck because of the excess leverage sitting in many companies. While banks have recognized the bulk of these assets as non-performing assets (NPAs), resolution of these assets has been long-pending. Resolution in most of these cases requires a right-sizing of the debt of these leveraged companies, which was only possible with capital in the public sector banks. Now, with adequate capital, this resolution process will move forward more quickly, which should set the stage for a capex cycle recovery in the medium term.

Third, capital shortage in the face of rising NPAs had resulted in a wider gap between the public sector banks' weighted average lending and deposit rates; so recapitalisation should enable more effective transmission. Fourth, recapitalisation should improve risk appetite, easing credit conditions at the margin for needy borrowers; and finally, higher share prices should enable public sector banks to directly raise more capital from markets.

Overall, the bank recap is a growth positive. Given that capex weakness is due to excess leverage (which the recapitalisation addresses), private investment should pick up over time as capacity utilization improves. In any case, a cyclical recovery is already under way and we expect gross domestic product (GDP) growth to rise from an average of 5.9% in H1 2017 to 6.7% in H2 and to 7.5% in 2018.

The recapitalisation commitment to banks does have fiscal implications. For now, the fiscal impact of the recapitalisation bonds is likely to be limited to the additional interest payments, which are estimated at Rs80-90 billion per year (0.05% of GDP). At the same time, the government should also benefit from a rise in PSB market caps due to increased dividends and a sell-down of equity.

However, the recapitalisation bonds will increase the government’s debt liability by 0.8% of GDP (47.5% in FY17) either directly (if the bonds are issued by the government) or indirectly via higher contingent liabilities (if the bonds are issued by a government agency). Despite the adverse impact on debt, this should not have any adverse impact on India’s sovereign credit rating because recapitalisation will also improve India’s medium-term growth prospects.

With no extra government borrowing, the likelihood of inflationary impact from recapitalisation is less. Recapitalisation should also be neutral for monetary policy as it improves growth prospects and monetary transmission, which is often cited by the Reserve Bank of India (RBI) as one reason why the positive growth effects from monetary policy have been limited.

The quantum of recapitalisation is a positive surprise and matches estimates of capital requirements for public sector banks for both NPA provisioning and some growth. With a very clear solution in place for the NPA problem, growth recovery will be less susceptible to periodic slowdowns and will be more structural than cyclical. While the current measures will take time to show effect, the medium and long term will be a showcase of the positive impact of these announcements. The government now needs to follow through with reforms aimed at public sector banks. Since 2014, the policy choices made by both the government and the RBI have resulted in a stability not afforded to many emerging markets. The big bank recap is another step in that direction.

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