Reforms needed to back bank recapitalisation

The Narendra Modi government has done well to commit itself to a bold programme to provide additional capital to public sector banks. The specifics of the plan are not yet completely clear, but it is definitely a step in the right direction. The Rs2.11 trillion recapitalisation plan—Rs0.76 trillion of equity from the government and financial markets and another Rs1.35 trillion through recapitalisation bonds—should be adequate for the next two years. Rating agency CRISIL has estimated that public sector banks will need about Rs1.4-1.7 trillion of additional capital by March 2019 to meet the international Basel III requirements.

There are three important issues that need to be dealt with in the months ahead.

First, the recapitalisation deals with the stock of toxic assets that now fester in the balance sheets of most banks. In other words, it deals with the stock rather than the flow. The challenge will be to ensure that the manic lending spree to influential industrial groups that took place on both sides of the global financial crisis is not repeated. Giving banks extra capital was only one of the seven grand themes of the Indradhanush programme announced in 2015. The reform of the Indian banking sector—and especially the privatization of banks—should be the next step.

Second, every bank recapitalisation of this sort naturally brings in its wake fears of moral hazard. Banks will not take adequate precautions when they are lending when they know that the government will step in to help if the loans turn sour. The government should be selective about which banks get the additional capital on offer. A statement by Reserve Bank of India governor Urjit Patel suggests that the banks which have worked harder to deal with their problem loans will get priority in access to fresh capital. Such market discipline is needed. The weaker banks should be given capital only to maintain their current operations, maybe by asking them to use incremental deposits only for investment in government securities. Meanwhile, the larger borrowers who have defaulted on loans should face the heat of the new insolvency law, rather than be allowed to free ride on the recapitalisation.

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Third, the government needs to decide what proportion of the fresh capital will go for provisions against existing bad loans and how much is to be allocated for new loans. That may not seem a crying matter right now, given the weak demand for loans, but it is possible that companies will seek to borrow after a few quarters if the investment cycle does indeed turn in fiscal year 2019. Brokerage house Motilal Oswal believes that of the Rs2.11 trillion, around Rs1.3 trillion will be used to make provisions while the rest will be used for meeting Basel III norms as well as future loan growth.

Although the exact nature of recapitalisation bonds is not yet clear, it is possible that the government will keep them out of the budget to avoid expansion in the fiscal deficit. Under the International Monetary Fund accounting norms, they are treated below the line and do not change the fiscal deficit. One way to take this forward would be for the government to issue bonds to public sector banks, which will become a part of their investment portfolio, and invest the proceeds back into the banks as equity. Effectively, these transactions would be cash neutral and would not have ill-effects, such as higher consumption and higher inflation, which are normally associated with a higher deficit. At the operational level, the government should be able to complete this process without much difficulty as there is excess liquidity in the banking system. But this could affect demand for bonds from banks and push yields.

However, even if recapitalisation bonds are kept out of the budget, they will still add to the government's debt stock and increase the interest liability. According to estimates, interest payments could go up by about Rs9,000 crore. It is also possible that international investors and

rating agencies will look at deficit numbers after taking these bonds into account.

Although resorting to recapitalisation bonds is not a desired outcome, it is perhaps the best that the government could have done in the given circumstances. It is important to note that India is predominantly a bank-financed economy and would find it difficult to grow at a higher rate without the necessary support from the banking system. Infusion of capital will fast-track the resolution of non-performing assets and will help economic revival with the restoration of flow of credit to small and medium enterprises.

The government should back bank recapitalisation with reforms in the financial sector—and in public sector banks in particular. The fact that recapitalisation bonds can be used for capital infusion should not become an alternative for better governance.

Will recapitalisation of banks help revive economic growth? Tell us at views@livemint.com

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