A bold step in bank reform

With India's economic growth faltering in the last couple of years, the government has been casting about for ways to galvanise the economy. Last November, **it tried demonetisation**. It was a bold move but its economic benefits will be long in coming while the short-term disruption has been very real and demoralising. This year, it pushed through the goods and services tax (GST). Again, this is hugely positive over the medium term, but is painful in the short run.

The government seems to have realised that a simpler, more effective remedy is at hand: recapitalising public sector banks (PSBs) and enhancing the flow of credit. The proposal to **recapitalise PSBs to the extent of 2.11 trillion** (2.11 lakh crore) is a winner by any reckoning. It is, perhaps, the most effective way to provide a much-needed fiscal stimulus to the economy and revive growth. Small wonder that the markets have given the move a rapturous welcome.

To understand the significance of bank recapitalisation, we need a little primer on bank capital. Regulation requires that banks hold assets only in proportion to the capital they have. 'Capital' is a combination of equity, equity-like instruments and bonds. For a given balance sheet, there is a certain minimum of capital that banks must hold. This is called 'capital adequacy'. The higher the capital is above the regulatory minimum, the greater the freedom banks have to make loans. The closer bank capital is to the minimum, the less inclined banks are to lend. If capital falls below the regulatory minimum, banks cannot lend or face restrictions on lending.

When loans go bad and turn into non-performing assets (NPAs), banks have to make provisions for potential losses. This tends to erode bank capital and put the brakes on loan growth. That is precisely the situation PSBs have been facing since 2012-13.

'Stressed advances' (which represent non-performing loans as well as restructured loans) have risen from a little over 10% in 2012-13 to 15% in 2016-17. This has caused capital adequacy at PSBs to fall. Average capital at PSBs has fallen from over 13% in 2011-12 to 12.2% in 2016-17. The minimum capital required is 10.5%. An estimated 10 out of 20 PSBs have capital of just one percentage point above the minimum or less. Inadequate capital at PSBs has taken its toll on the flow of credit. Growth in credit has fallen below double digits over the last three years. Between 2009-10 and 2014-15, annual credit growth was in the range of 15-20%. In the 'India Shining' period of 2004-09, credit growth had been over 20%.

Some observers ascribe the deceleration in credit growth to poor demand. They say that corporates have excessive debt and are in no position to finance any investment. This may be true of large corporates. However, it is not true of enterprises in general. One study, which covered over 4,000 companies, showed that the debt to equity ratio fell below 0.8 (which is a low level of debt) in 2008-09 and remained low until 2012-13. (J. Dennis Rajakumar, 'Are corporates overleveraged?', *Economic and Political Weekly*, October 31, 2015).

Moreover, demand for investment finance may have decelerated but demand for working capital remains strong. If anything, the introduction of GST has increased small business demand for working capital. Low growth in credit is confined to PSBs. Private banks have seen loan growth of 15% this year.

The government has realised that there is a problem with the supply of credit. It has to do with PSBs' inability to lend for want of adequate capital. The National Democratic Alliance (NDA) government should have recognised the problem when it assumed office in May 2014. At the time, stressed advances were already 10% of the total. The NDA government should have moved swiftly to recapitalise PSBs.

Government to transfer ownership in PSU banks to a new holding company

Instead, it chose to sweep the problem under the carpet. Market estimates had placed the requirement of government capital at a minimum of 2 lakh crore over a four-year period. In 2015, under the Indradhanush Plan, the government chose to commit a mere 70,000 crore over the period.

The dominant view in government at the time seemed to be that PSBs had messed up in a big way, so putting more capital into them was simply 'money down the drain'. Their role needed to be shrunk through consolidation or by selling strategic stakes to private investors.

This is a mistaken view. The bad loan problem at PSBs is not entirely the result of mismanagement. There have certainly been cases of malfeasance and poor appraisal of credit. However, as the Economic Survey of 2016-17 made clear, these are not responsible for the bulk of the NPA problem. The problem is overwhelmingly the result of factors extraneous to management.

PSBs, unlike their private sector counterparts, had lent heavily to infrastructure and other related sectors of the economy. Following the global financial crisis of 2007, sectors to which PSBs were exposed came to be impacted in ways that could not have been entirely foreseen. Blaming PSBs for the outcomes and starving them of capital was not the answer.

The failure to quickly recapitalise PSBs has adversely impacted the economy in many ways. First, it has come in the way of adequate supply of credit. Second, it has hindered the effective resolution of the NPA problem and kept major projects from going through to completion. Resolution requires banks to write-off a portion of their loans in order to render projects viable. They cannot do so if they see that write-offs will cause their capital to fall below the regulatory minimum. Third, corporates are stuck with high levels of debt and are unable to make fresh investments.

The government's move to recapitalise banks changes the picture. Of the 2.11 trillion package, 1.35 trillion will be towards issue of recapitalisation bonds. PSBs will subscribe to these bonds. The government will plough back the funds into banks as equity. Another 180 billion will be provided as budgetary support. The remaining 580 billion will be raised from the market. Analysts believe the package should enable banks to provide adequately for NPAs and support modest loan growth. Once PSBs have enough capital and are in a mood to lend, they can liquidate excess holding of government securities and use the cash to make more loans.

Analysts worry about the fiscal impact of the recapitalisation package. International norms allow borrowings for bank recapitalisation not to be counted towards the fiscal deficit. In the past, India has used this accounting fudge. The proposed recapitalisation bonds are likely to add to the fiscal deficit unless the government resorts to other fudges such as getting the Life Insurance Corporation of India or a separate holding company to issue the bonds. The government should not worry unduly about **missing the fiscal deficit target of 3.2% of GDP**. The markets will understand that the fiscal stimulus is well spent.

Analysts also fret over repeated bailouts of PSBs and the costs to the exchequer. They seem to think that bank bailouts have to do with government ownership and inefficiency and the answer is to privatise some of our PSBs. They couldn't be more wrong.

The overwhelming majority of bank systems worldwide are privately owned. And yet these systems are prone to periodic bouts of bank failures. The International Monetary Fund has documented 140 episodes of banking crises in 115 economies in the world in the period 1970-

2011. The median cost of bank recapitalisation in these crises was 6.8% of GDP. India's cost of recapitalisation over a 20-year period is less than 1% of the average GDP during this period.

The Modi government has shown courage in opting for substantial recapitalisation of banks. This is not something that fits into the 'reform' mantra whereby private is good and public is bad. Reserve Bank of India Governor Urjit Patel has welcomed the move in effusive terms: "The Government of India's decisive package to restore the health of the Indian banking system is in the view of the [RBI] a monumental step forward in safeguarding the country's economic future." Indeed. The government's recapitalisation move promises to do more to quickly usher in 'acche din' than any other single measure it has initiated during its tenure.

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