A monumental bailout

Reform must be the most abused word in the Indian lexicon. A bunch of incompetent and inefficient state-owned banks tot up lakhs of crores of bad loans, the government writes a fat cheque to bail them out and all of us hail it as a great piece of reform, some even calling it a "monumental" reform step. Without accompanying structural changes, this is just another bailout, albeit a bigger one. But then we live in an age of bailouts, where governments and central banks across the world not only condone, but reward financial institutions for their excesses and follies.

It can be no one's case that recapitalisation wasn't necessary. In another industry, these entities may have become bankrupt and perished or been taken over. But banks cannot be allowed to fail as they are systemically important and therefore capital had to be given. The new capital was also required to enable these sick banks to take large haircuts on their bad loans and settle them, so that the system could move on. This bit is fine. However, the general view is that this will dramatically boost economic growth, revive the flagging capex cycle and galvanise public sector banks to become the tigers of our financial system again. These expectations need to be examined.

Let's take growth first. The premise is that PSU banks did not have capital, therefore they couldn't lend; this was holding back credit growth and in turn economic growth. If that was the case, surely the best and biggest PSU banks, which had no dearth of capital, should have been recording healthy credit growth, right? Wrong. They had the money to lend, but there were no takers. SBI and BoB, despite ample capital adequacy, registered average credit growth of 4-5 per cent in the first nine months of 2017. Their loan growth to industry was closer to zero. The problem is demand for loans, not supply. Supply only creates an enabling condition to lend, the demand comes from underlying economic conditions which remain unchanged. It is a case of laying out a variety of dishes in front of an ailing man, a temptation unlikely to be accepted. Recapitalisation is not necessarily growth positive.

How about a capex revival? If the country's top 500 companies were asked today why they were not announcing new projects, not one would say it is because they were unable to get loans from a PSU bank. There is ample credit on tap from private sector banks and non-banking financial companies (NBFCs). The problem is that low capacity utilisation and sluggish economic conditions prevent large companies from investing. Visions of smoke billowing out of new factory chimneys, because the UCO bank suddenly sanctioned a loan after a long lull, is plain wishful thinking.

This brings us to the dream of a new dawn in public sector banking. It's not clear who will get how much yet, but fair to assume that the more beleaguered banks will get a significant share. First, they will need to provide for their enormous pile of accumulated bad loans and take some substantial hits to settle the big accounts. With whatever is left over they will go for the low-hanging fruit - consumer loans. While loan growth to industry has been negligible, consumer loans have been growing at a healthy clip of 15 per cent. Private banks and NBFCs have had a free ride in this segment and PSU banks, with the new capital, will certainly aim to cannibalise some of their growth. This may lead to market share changes within the banking sector, not necessarily higher overall growth. Yet, smaller PSU banks need many changes to be able to compete effectively with their private competitors. Finally, they will turn to the parched SME sector for working capital loans and agriculture, and the government will want them to, given upcoming electoral considerations. One can only hope that such loans are not directed as it will only give birth to another bad asset issue down the line. Thus, while recapitalisation does provide some oxygen to these choked banks, rumours of a grand resurgence are vastly exaggerated.

The government's unexpectedly large dole out is at best a bold first step. It has to now carefully chart out how to distribute this capital. Structural changes like better boards, new managements, better compensation and hiring plans have to accompany handouts to the weaker banks. Else, nothing would have changed, fundamentally. The government has an opportunity to use this bail out as the starting point of a comprehensive overhaul of public sector banking culture. If it stops short of that, we should call this a bailout, not reform and be aware that a decade down the line, some government will again have to take an equally "monumental" step forward.

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