PSU Bank Recapitalization Plan – 2017

By,

Dhanyakumar M H

Introduction

The finance minister, Arun Jaitley on Tuesday, 25-Oct-2017, announced a ₹2.11 lakh cr. bank recapitalisation plan for state-owned lenders. PSB's have been weighed down by bad loans in the recent past and were struggling to meet the capital adequacy norms under Basel. Recapitalisation is aimed at stimulating the flow of credit, to spur private investment and increase the ability of banks to lend, by compensating the losses from bad loans.

How does Government plan to achieve it?

Infuse ₹2.11 lakh cr. over a time frame of 2 years. A part of the package will be through budgetary allocations. The government will also buy ₹18,000 cr. worth of shares of Public Sector Banks. Public Sector Banks will need to raise ₹58,000 cr. from the market and for the rest of the amount the government will issue "Bank Recapitalization Bonds" worth ₹135,000 cr. Once the fund is raised through Recapitalization bonds, the Government will buy shares in public banks. If we look at the capital infusion plan, partly the onus is on banks to raise from the market and partly on the government.

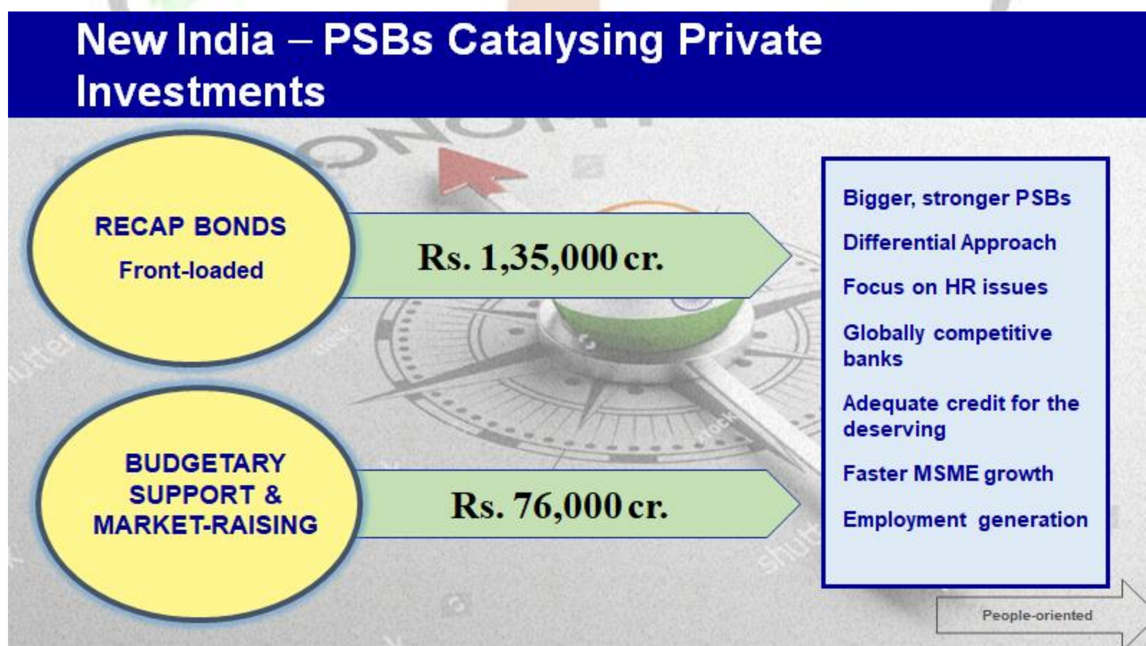

Figure 1. Snippet from Finance Ministry press release – Recapitalisation Plan

Recap Bonds:

Government issued bonds are generally bought by financial institutions, private banks, public banks and FII's. In effect, the banks are buying these bonds and the funds flow to the government; the government uses these funds to further buy shares in the banks, in the form of capital infusion and increase the stake of the government. A closer look at the financial engineering arrangement shows the banks giving money to government to buy shares in exchange for the bonds.

The finance minister has not given any further details on the type of the bonds that will be issued. In the 90s, the government had issued non-tradable, non SLR compliant bonds. In my opinion, the bonds should be allowed to trade in the secondary market, as it will allow the banks to trade and also to move out to buy further bonds. Non-marketable bonds will simply appear on the banks' balance sheets and cannot be utilised even for lending activities.

Post demonetization, banks were flushed with deposits. However, due to low credit demand banks couldn't materialise the use of low cost funds. Recapitalization bonds provide a venue for the banks to invest and earn the income. This whole exercise is a win-win situation for the banks and the government. Government with its brilliant financial engineering, would be earning returns from the equity market by purchasing the bank's stock and if the market forces determined the interest rate on these bonds, it would effectively equal the Gsec bonds. Banks receive a Gsec interest rate on investment and the Government receives equity market return on its investment.

Impact:

Given the NPA crisis and recent RBI initiatives, the government is forcing the banks to take the losses from bad loans! Banks have given the excuse of insufficient capital to absorb losses in the past and were reluctant to lend further because of the capital ratios. Adding to that, the government has given full authority for the banks to approach NCLT under the insolvency and bankruptcy code. Now there is no excuse for the banks. If the borrower defaults, banks can own the companies and can auction off the assets to recover the loans. If the banks do not take bold steps now, it will be just another futile effort by the government.

The Government's idea is to strengthen the banks, in turn, they support private investment which is a catalyst in creating jobs and will help in reviving the growth of the economy.

Direct recapitalization allows the banks to multiply the given money and provide a boost to demand side factors.

Fiscal Deficit:

According to the chief economic adviser to finance ministry, Arvind Subramanian, under IMF accounting practices, recapitalisation is not part of the fiscal deficit. However, according to Indian accounting practices, it is a part of the deficit. India is under a crisis to review the growth story and pulling the string off the fiscal deficit target will not cause much damage if it is not done. Also, the fiscal deficit number is not sacrosanct in nature.

Inflation:

With more liquidity in the market, inflation is bound rise in India. The RBI has been watching inflation and any increase observed will leave room for RBI to increase the interest rates. Contrarily, it may be the end of the low-interest-cycle if there is credit take off and the conditions in the market improve.

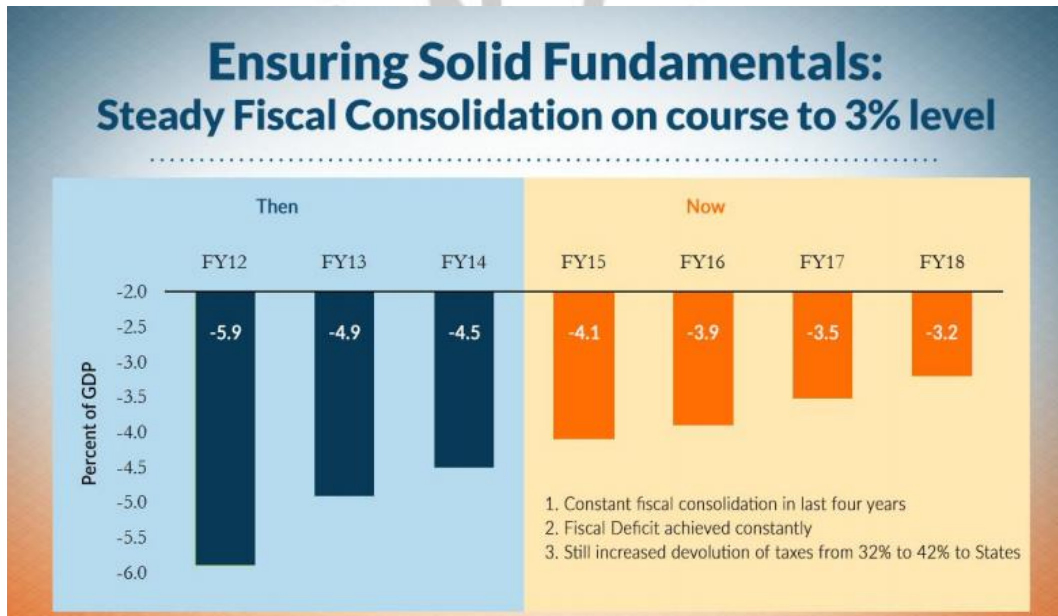

Figure 1. Snippet from Finance Ministry press release – Fiscal Consolidation

Real Issue: Moral Hazard – Change in Repayment behaviour of borrowers

Companies which are struggling to repay loans, now see their competitors getting a semi-write-off on their loan, and then decide they can default too. Bottom line, it could actually increase the NPAs! Banks also have an easy way to write-off and do bad lending again! If the banks can control the asset quality and stop further slippages by effectively monitoring, it would go a long way in the Indian growth story.

Banks are now revitalized; will corporate India rebuild to pave a path for high growth or exploit the opportunity for a select few benefits.

FOSTERING FORTUNES