



## **Bank recapitalization in Indian context**

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### **Abstract**

The recent issue of recapitalisation bonds by the government is a step in the right direction. Recapitalisation is a tried and tested tactic and has been successfully replicated in many countries, including India, in the past. This paper tries to analyse the result of previous recapitalization policies and to explore the repercussions of recent recapitalization policy.

**Keywords:** recapitalization, NPA, PSU's

### **Introduction**

The recapitalization of public sector banks has been rightly welcomed by India. The Narendra Modi government has decided to spend big money to clean up the banks it owns, despite the obvious risks of moral hazard that bank bailouts across the world have inevitably faced. The next step should be a clear roadmap for future financial policy, before India stumbles into its next banking mess.

Three important policy documents laid the groundwork for banking reforms since the 1991 reforms: The report of the first Narasimham committee set up in 1991, the report of the second Narasimham committee set up in 1998 and the report of the Raghuram Rajan committee that was released in 2009. Not all their ideas were implemented, but they did set the ball rolling for a structural transformation of Indian banking. It is now time for a fourth comprehensive look at the issue, as a new set of challenges emerge. Yet, despite this undoubted progress away from the days of financial repression, this is the third banking mess India has had to deal with over the past three decades. Compare this instability with what has happened in the equity markets over the same period of time.

### **Objectives**

- To analyses the bank recapitalization plan.
- To understand how it will impact various economic variables.

### **Method of data collection**

The data is collected from secondary sources like newspaper, bank periodicals, magazines, and websites.

### **Some of the important banking policy issues that the government needs to deal with in the coming years**

First, the need for public sector bank autonomy has been recognized for long. It is time to recognize the harsh truth that such autonomy is impossible given the political interests involved, to clear the way for dodgy loans to favoured industrial groups. India needs to now shift the needle from autonomy towards privatization. Banking is the only important sector of the economy in which the private sector is

dwarfed by the public sector. The share of public sector companies has fallen sharply in most sectors such as airlines. Banking is an exception-and it is time this changes.

Second, the first Narasimham committee had said that India should move towards a three-tier banking structure. Four large lenders were to be developed as global banks, 10 banks were to become nationwide universal banks and local banks would concentrate on specific regions. It is not necessary to chart the future out in such granular detail, but the underlying issue of banking structure is an important one. The ongoing debates about bank consolidation and differentiated licensing require a framework rather than the current ad hoc statements.

Third, the weakest banks cannot be shut down at once because of the disruption such a move would cause. However, there is a strong case to convert at least some of them into narrow banks that use all their deposit money to buy government bonds. They could in effect become large payments banks rather than the more traditional financial intermediaries. Narrow banking is an idea that needs serious attention.

Fourth, India needs to move towards a financial structure in which large companies get mostly funded by the bond markets while smaller firms depend more heavily on banks for their finance. We have already seen some of this happening as companies have raised money from the bond markets when bank lending stagnated. The problem is that the corporate bond market is still illiquid, with most bonds held to maturity by a narrow set of investors. Deepening the corporate bond market is critical.

One of the grand lessons of the global financing crisis is that no country has figured out how to maintain financial stability. Credit booms have inevitably left bad loans in their wake. Bank-led financial systems such as Japan have been in trouble. And so have financial systems such as the US where the bond markets are more important.

The unstable financial systems hurt economic growth and job creation in the long run. The fiscal costs of bailouts can also be staggering.

### **This isn't the first time**

The first tranche of recapitalisation bonds was issued by the

Indian government in 1994. In the 1993-94 Union Budget, the then finance minister Manmohan Singh announced “provision for a large capital contribution of Rs 5,700 crore to the nationalized banks” to protect “the viability and financial health of the Indian banking system”.

In the same budget, Singh announced the government’s decision to allow State Bank of India and other nationalized banks to access the capital markets for raising fresh equity, even as the government would “continue to retain majority ownership, and therefore effective control” in these banks. The next budget (1994-95) provided another Rs 5,600 crore as additional capital contribution for these banks in the form of government bonds. On both occasions, there was no immediate fiscal burden but the government bore the interest cost.

After the 2008 global financial crisis, the first signs of stress in Indian banks were seen in 2010 and since then, the government has pumped in Rs 67,734 crore capital to keep the public sector banks running, apart from the Rs 70,000 crore fund infusion plan under the so-called Indradhanush plan, over a period of four years between 2016 and 2019.

Of this, Rs 52,000 crore has already been infused. The remaining Rs 18,000 crore has been included in the latest package. The Indradhanush plan (announced in August 2015), also outlined Rs1.1 trillion being raised by the banks from the market. Of this, the banks till now have raised a little over Rs 21,000 crore. The government expects them to raise Rs 58,000 crore in next two years. If the enthusiasm of the investors is anything to go by, none would dare to dub it as too ambitious a target.

While announcing the first bank recapitalisation plan in the 1994 budget, Singh had said: “While undertaking such a large injection of capital into the banks, specific commitments will be required from each bank to ensure that their future management practices ensure a high level of portfolio quality so that the earlier problem does not recur.” Had the government stuck to this, we would not have seen recurring bailouts of Indian banks.

### **Action plan for Recapitalization & Reaction**

The lack of liquid funds at a time when non-performing assets remain at high levels has incapacitated the banks’ ability to lend and spur investments - the two major challenges confronting India, according to Finance Minister Arun Jaitley. Most analysts are gung-ho on India’s plan to pump so much money-more than one-third of the core or tier I capital (equity and reserves)-into state-owned banks. Investors too have sent a strong signal of their approval.

Reacting to the Rs 2.11 trillion bank recapitalisation over a period of two years, the market value of state-owned banks zoomed Rs1.2 trillion in one day.

There are three components in the bank recapitalisation package that roughly accounts for 1.3% of India’s GDP-the government will directly pay banks Rs18,000 crore by buying their shares; another Rs 58,000 crore will be raised from the market; and Rs1.35 trillion (equivalent to 0.9% of GDP) is expected to come from recapitalisation bonds.

The question remains who will issue the recapitalisation bonds (the government or a special purpose vehicle that can be floated for this purpose), the maturity of such bonds and the

coupon. Whether they will add to the fiscal deficit or not will depend on who is issuing the bonds, and what kind of instrument it is. However, the interest outgo on the bonds is likely to add to the deficit, since the government will pay that. At current market rates, the annual interest cost for the government would be about Rs 9,000 crore-less than 0.1% of the GDP.

Under International Monetary Fund norms, recapitalisation bonds are not added to the accounting of the fiscal deficit as they are squared off by buying shares in banks. In India, however, such bonds in the past were taken into account since the government pays interest and eventually redeems them. If they are issued by quasi-government institutions, such bonds will be treated as contingent liabilities of the government.

### **Current scenario**

Highlighting the plight of the Indian economy grappling with its twin balance sheet problem-over-leveraged companies and bad-loan-laden banks-the Economic Survey 2016-17 has mentioned that more than four-fifths of the NPAs are in the public sector banks, where the NPA ratio had reached almost 12% of loans in January 2017. This is higher than any other major emerging markets, with the exception of Russia. Since then, the pile of bad loans has risen further.

The stressed loans of the banking system-including NPAs and restructured loans but excluding written-off loans-are now at least Rs9.5 trillion or 12.6% of the overall credit portfolio of Indian banks (all banks have not announced their September quarter earnings as yet).

Even though roughly one-third of the bad assets have already been provided for, banks are expected to use much of the recapitalisation money to clean up their balance sheets. The package will encourage them to aggressively set aside money and take deep haircuts for resolving the bad loan problems. Besides, the capital will also be used to meet the international Basel III norms that will kick in by April 2019.

Indeed, rising bad loans have created a fear psychosis among public sector bankers and they aren’t too willing to lend but the bank recapitalisation package is unlikely to revive growth overnight, as the lack of demand for credit is a far bigger problem than banks’ ability to lend at this point.

The capital infusion will, of course, help the government-owned banks fight it out with private banks and non-banking financial companies for their share of loans. Also, even though the large corporations do not have big investment plans, the micro, small and medium enterprises are looking for money and the government-owned banks will be able to support their credit demand.

### **Conclusion**

There is no doubt that the massive recapitalisation plan will help banks clean up their balance sheets, but will it fuel credit offtake and lift the sagging growth in Asia’s third largest economy? Even if the answers to both these questions are in the affirmative, is this the last of the bailouts for Indian banks? In other words, besides taking care of the stock of toxic assets, will it stem the flow of such assets in Indian banking in future?

"Like most banking systems in Asia, India is also seen as possessing strong government support but this view has

recently come under some uncertainty. The government will continue to support the public sector banks and its reluctance to recapitalize them to stronger levels in part reflects a desire to impose more discipline on the banks."

Analysts estimated that Indian banks need an additional \$40 billion to \$65 billion to clean up bad loans on their balance sheets and meet the stricter capital requirements set forth in an international regulatory framework called Basel III.

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