



The effect of bank recapitalization on the Indian economy

Vipul R. Patel

Asst. Professor,

C.C. Sheth College of Commerce,

Navgujarat Campus, Usmanpura,

Ashram Road, Ahmedabad,

Gujarat-380014.

Email: vipulrpatel@yahoo.com

Mob. No:- 9998850256/8160848977

Abstract

India's government on 23rd Oct, 2017 announced a massive bank recapitalization plan worth tens of billions of dollars a possible "game changer" for the country's bad loans problem. The plan could not only provide cheer for investors worried about Indian banks' worsening balance sheets, but it may also have far-reaching implications for the country's economic prospects. The announcement has been awaited for a long time. India's growing mountain of bad loans has created weak bank balance sheets, crippling the lending ability of financial institutions and hindering the country's growth. That, in turn, makes debtors less able to pay off loans creating a vicious cycle. A significant capital injection from the government, however, could be a "game-changer" in breaking the cycle. The article explained about effect of bank recapitalization.

Key words: recapitalization, game changer, capital injection.

Introduction:-

Recapitalisation involves a major change in the way a bank is funded. This could come about through issuing new shares or loan from a government. Essentially recapitalisation involves providing the bank with new capital, e.g. government agree to buy new shares. This improves the banks' bank balance and prevents them from going bust.

Since the Government is the majority shareholder in the public sector banks, it has to provide equity capital, if the banks are struggling. This injection of capital is also known as the recapitalisation of banks.

Difference between Loans and recapitalisation:-

If you give a bank a loan, it can help improve liquidity, but it doesn't improve their balance sheet, because they still owe the extra money received. i.e. the money shows up as an asset, but also as liability because you have to pay it back. Recapitalisation would inject money without creating a liability.

Why has Recapitalisation of the Banks Occurred?

Since the credit crunch, the banks have lost money. This means that their liabilities are greater than their assets. Therefore they technically owe more to other people than assets they own. Banks lost money because: People defaulted on loans and mortgages, Banks lent money (bought CDOs) to sub-prime mortgage companies in America who lost money, Falling house prices means that banks assets decline further and if they repossess homes it's harder to get value of the original loan back, Recession led to more defaults and losses.

Recapitalisation revolution:-

The Non-Performing Assets (NPAs) in the banking sector have been rising. As of June 2017, the NPAs of the banking system were as high as 10.2 % of the loans advanced by the banks. This high NPA has limited the capacity of banks to lend. The bank credit growth in the year 2016-17 was 5.1 %, which is the lowest since 1951. Hence, a massive recapitalisation was deemed as necessary to clean up the balance sheet of the banks.

The recapitalisation of banks worth 2.11 lakh crores has been proposed to be done in three ways: Budgetary allocations Rs.18000 crore, Raised from the market through the issue of equity shares by banks 58000 crore, Issue of Recapitalisation bonds by the Government 1.35 lakh crore.

(a) Budgetary allocations-

In this year's budget, the Government had already allocated Rs.70000 crore for recapitalisation until 2019. Out of this, Rs.50000 crore has been provided to the banks. In his budget speech, the finance minister, Arun Jaitley had stated – “additional allocations will be provided as may be required”.As per the recent announcement, Rs.18000 crore will be released out of the present allocations.

(b) Issue of equity shares by banks-

Banks were already expected to raise Rs. 1.1 lakh crore from the market through the issue of equity shares, under the Indradhanush scheme. But, banks have raised only 21000 crores till now. As per the recent announcement, additional 58000 crores will be raised from the market. Some analysts have questioned the ability of the banks to raise funds from the market, given the fact that they have raised only a fraction of the amount expected by the existing Indradhanush scheme.

(c) Recapitalisation bond-

The Government will issue recapitalisation bonds worth Rs.1.35 lakh crores. The structure of the bonds has not been worked out by the finance ministry yet. But, it is expected that the bonds will be bought by the banks themselves. After

demonetisation, the banking sector is flush with liquidity. It will use this excess liquidity to buy recapitalisation bonds from the Government. The Government will then use the money raised through issue of bonds, to buy equity shares in the banks. In effect, the recapitalisation bonds will be exchanged for equity shares. This is not the first time that the bank recapitalisation bond will be issued in India. According to the data by Bloomberg, in the year 1994, India had sold about 48 billion rupees of 12year recapitalisation bonds at a coupon rate of 10 %.

Some commentators are worried about the impact of recapitalisation on fiscal deficit of India. However, under standard international accounting practices, recapitalisation bonds are classified as 'below the line' financing and not included in the fiscal deficit. Hence, it will not increase fiscal deficit. But, under the accounting practices used by India, recapitalisation bonds are added to the fiscal deficit calculations. However, when recapitalisation bonds were issued in the 1990s, they were not included in fiscal deficit calculations. The Government had classified them as off-balance sheet items. Either way, the yearly interest payments on the bonds issued will be included in the fiscal deficit. But, its impact will be marginal. The chief economic advisor of India, Arvind Subramaniam, estimates the interest payments to be around 8000 to 9000 crore per year.

The massive recapitalisation will strengthen the capital base of the banks. It will help banks to write-off its bad loans and subsequently increase its lending capacity. According to Goldman Sachs, it could boost credit growth by up to 10 %. An important caveat is, there should be a demand for credit too, for an increase in credit growth to take place. The stock markets reacted positively to the news. The day after the announcement, 25th Oct 2017, was a historic day for the markets as the SENSEX closed beyond 33,000 for the first time ever. An index of Public Sector Banks surged 30 % on the day.

All said and done, recapitalisation is only a first step to address the rot in the banking sector. The Government should follow it up with structural reforms to reduce its role in the public sector banks and move towards privatisation. This will bring in efficiency and accountability. The capital infusion will address the problem of stock of NPAs by cleaning up the balance sheet. It is equally important to ensure that the cycle of piling up of NPAs is not repeated. To conclude, the capital will help the banks to comply with Basel 3 norms that will come into force in 2018. Some analysts have estimated that banks need an even larger infusion to comply with BASEL 3.

Effect of bank recapitalisation:-

1. Maintain a capital-adequacy ratio for the uninitiated:-

A bond is an instrument issued to borrow money. Hence, a yearly interest has to be paid on the face value of the bond and the face value is itself repaid after the maturity of the bond. In this particular case, the Government is the issuer (borrower) and the bank is the buyer (lender). BASEL-3 norms are the international banking regulations that have to be followed by the banks in all countries. According to it, the banks

have to maintain a capital-adequacy ratio of at least 8 %. The capital-adequacy ratio is the ratio of capital to the risk-weighted assets (loans etc) . Hence, more capital is required to be able to give more loans.

2. Fall in Inter Bank Lending:-

Before the credit crunch, many banks relied on inter-bank loans to improve their balance sheets. For example, a bank would lend a long term 30 year mortgage and finance this loan by borrowing on short term money markets. However, the credit crunch meant that banks were no longer willing to lend to each other. This means that they had a shortfall in their balance sheets and were left with losses. If consumers asked to withdrawal all their savings, then the bank would not be able to meet the demand to withdraw deposits. So, recapitalisation created that banks had enough money to pay back depositors who have savings in their bank.

3. Recapitalisation and Confidence:-

One issue with recapitalisation is to restore confidence. If people have confidence deposits are secure, they won't want to withdraw them. But, if they feel bank may go bankrupt then they will want to withdraw money. A recapitalisation can assure depositors their savings are safe – preventing a bank run.

4. Impact on fiscal deficit:-

The government's plan will have little impact on its target to shrink the shortfall to 3.2% of GDP in the year through March 2018 because the IMF's rules classify such debt as "below-the-line" financing. Only interest expense will be added to the fiscal deficit, and this is estimated at about Rs90 billion each year or 0.4% of total budgeted spending. Technically, however, India's accounting rules require the bonds to be included in the budget deficit, so the government will probably reclassify them later as off-balance sheet items—just as it did when similar notes were issued in the 1990s—according to Kotak Mahindra Bank Ltd.

5. Stressed loans:-

Not immediately. Any pick-up is likely only after banks' balance sheets have been materially strengthened, which would include cleaning up some \$191 billion of stressed assets. Moreover private demand which has been subdued over the past few years has to recover for loan growth to revive from two-decade lows. Crisil Ltd. expects the capex cycle to revive in the year starting 1 April 2018, and CLSA says the government's plan should help satisfy more than 70% of lenders' needs for lending to increase, absorbing "haircuts" on stressed loans.

6. Monetary policy:-

The government is yet to disclose details on the structure and pricing of the bonds, as well as how it will raise the rest of the cash. These will determine if there's a liquidity squeeze. If the measures do revive credit growth, inflation may accelerate as well, limiting scope to lower the policy rate, said Indranil Pan, chief economist at

IDFC Bank Ltd. The government's plan will front-load capital injections while staggering the attendant fiscal implications over a period of time, Reserve Bank of India governor Urjit Patel said in a statement.

7. Buyers of bonds:-

If one goes by history, banks themselves flush with deposits following Modi's cash ban will be buyers of the debt. "Banks can cleverly invest these funds in the recap bonds which will ultimately be routed back as equity in the system,". This step will also ensure that bond market will not be impacted by such a large issuance for the private sector issuers. In 1994, India had sold about Rs. 4,800 crore of 12year recapitalisation bonds at a coupon rate of 10%, according to data compiled by Bloomberg.

8. Aggressive recovery mode:-

Nothing happens to them even if they pretended and extended these NPAs too long. The promoters should not. In effect the banks should take over the defaulting companies. Recognise full losses. Sell all the assets in a mega auction. Do not allow the promoters or relatives to bid for these assets or own them for five years later. And with what they recover, it comes back as capital because you recognized a full loss and later recovered something back. Marking down the loss of a loan doesn't mean the promoters get away. The recovery is still pursued and whatever is recovered becomes a profit.

9. Inflation:-

For bond market player, yields change. The ten-year bond hasn't yet reacted but it will tomorrow. An additional 1,35,000 crore of bonds will be a pain. But what if it's not marketable? That means buying banks can't sell them, so there's no additional supply. Non-marketable bonds are a bad idea. We've learnt that in the past. They just sit on bank books and hurt lending anyhow. So might as well make them marketable. Some yield pressure will come but eventually we have to recover. Just recognize the problem already. But yields may go up because of inflation that will come. India doesn't have the problem of low demand for credit. There is demand but banks have lousy capital ratios so they won't lend. And capex demand has dried up somewhat, but that will recover over time. If banks start lending again, it's impact that a big expansion in money supply. Liquidity, in India, with credit supply, means inflation in the future. The RBI's been good at watching this recently. So they will raise rates accordingly. This could really be the end of the low interest rate cycle if there is an actual recovery in public sector bank credit now.

10. Reviving demand:-

At present banks have funds but are unable to find credit-worthy borrowers. Reviving demand is also essential. The big infrastructure push announced would aid this, and help crowd in private investment. The fiscal support will not be much but the push will mop up under-utilized funds lying with the financial sector, as savings are shifting from physical to financial assets, and private investment is low. Revival of

global growth should help export growth. Domestic consumption is recovering after policy shocks. Since there is not much fiscal space, it is vital that the Monetary Policy Committee supports the effort. Inflation has been below the RBI's 4 percent target since October 2016, real rates are very high and there is space to reduce. Since Indian macroeconomic policy is now constrained by rules, there is no need to fear large slippages they cannot happen. Minor slippages are validated by and required to counter the growth and employment slowdown. Monetary and fiscal policy should coordinate towards appropriately stabilizing the domestic cycle.

Conclusion:-

The summaries of effect of bank recapitalisation are as below-

- Despite the anticipated benefits to investors and to the economy at large, the move does not come without risks.
- For one, interest payment on the bond will come at a budgetary cost, which could push up government expenditure and the fiscal deficit.
- Already, India faces a challenging fiscal position, having spent 96 percent of its full-year deficit target in the first five months of its fiscal year. The squeeze limits the government's ability spends and boosts growth.
- Economic expansion had slowed to a three-year low of 5.7 percent in the April-to-June period, which many said was caused by the introduction of the new Goods and Services Tax and a recent ban on high-value notes.
- The country's central bank, the Reserve Bank of India, is also more likely to hike rates sooner than markets currently expect. That would prove bearish for short-term interest rates, although the impact on rates in the longer term remains uncertain, the Goldman note added.
- Furthermore, the move could "sustain the risk of more public sector bank loans turning sour, swelling the country's bad loan ratio.

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