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Revitalising the Indian Economy: Announcement of Public Sector Bank Recapitalisation Measures

The Indian government announced a series of measures on 24 October 2017 designed to kick start the economy and enable public sector banks to improve their lending which has largely remained flat due to a lack of industrial demand, particularly from the manufacturing sector. The recapitalisation bonds, which have been proposed to provide additional equity capital to the public sector banks, have been hailed as a huge catalyst that could stimulate the growth of the green shoots of demand in the country. Also announced are some measures to boost road-building activity which can provide a major fillip to employment generation.

Vinod Rai[1]

On 24 October 2017, the government of India announced a recapitalisation plan for public sector banks. The plan involves a total of ₹2.11 trillion (S$44 billion). Out of this, ₹1.35 trillion (S$28 billion) will be raised through recapitalisation bonds and ₹0.76 trillion (S$16 billion) will be made available through budgetary support and market borrowings. The structure and pricing of these bonds are not clear – whether these will be issued as tradeable

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bonds or deemed as the statutory liquidity ratio (SLR)-holdings and, therefore, issued directly to the banks. This is expected to be made known by the government later.

However, the nature and scope of these bonds will indeed determine the impact that this move might have on the fiscal deficit in the national budget. Traditionally, under the International Monetary Fund accounting practice, such capitalisation is treated as a 'below the line' operation and does not count for the fiscal-deficit computation. Only the relevant interest expense is added to the fiscal deficit, and even this depends on the nature of the bonds. This is so, largely because such a recapitalisation does not trigger additional demand for goods and services, which, in a manner of speaking, is what the fiscal deficit measures. To that extent, it is not an inflationary measure.

Globally, the governments issue bonds in many instances of systemic banking crises to finance bank-restructuring. These are issued for two generic purposes in bank restructuring: to finance the government's purchase of equity in banks or to finance the purchase of distressed assets from banks. The design of the bonds issued for these purposes can be a crucial determinant of the future financial performance of restructured banks and, thus, an important factor in the ultimate success or failure of the restructuring or equity-infusing efforts. Bonds issued or guaranteed by the governments of Indonesia, South Korea and Thailand were the main instruments to finance the governments' contributions to bank restructuring during the Asian financial crisis of the late-1990s. Bonds have been used in Ecuador, Nicaragua, and Turkey as well. In fact, bonds have been the standard tools used by countries across the globe for engineering bank restructuring.

A Financial Force-Multiplier

The capital infusion plan announced by the Indian government will be undertaken over two fiscal years. The transaction begins with the government first issuing the bonds. Banks which are flush with liquidity (parked now with the Reserve Bank of India, the country's central bank) would subscribe to these bonds. At this, the government would use the amount so received by it to enhance the equity capital of the relevant banks. In fact, in the 1990s, too, the government had issued recapitalisation bonds to the public sector banks. Those bonds

were originally issued as non-tradeable instruments and did not qualify for SLR, but they were later either converted into equity or treated as perpetual bonds.

In India now, the proposed injection of recapitalisation bonds into the capital-starved public sector banks will act as a major force-multiplier for stimulating their growth. It will help in accelerating their currently tepid growth, which was constrained due to the lack of adequate capital, and also help arrest their market share loss vis-à-vis the well-capitalised private sector banks and non-banking financial companies. The public sector banks can, as a result, have enough money to take care of their stressed loans as well as to support the current signs of recovery and the green shoots of industrial activity.

Ideally, the government should structure these bonds as zero-coupon instruments with a very long maturity cycle of, say, 15 to 20 years and with a one-time bullet repayment at the end of this maturity period. This could impart to the bonds a characteristic similar to equity capital and provide the banks with much-needed relief from their annual interest payments. However, to ensure that the banks actually perk up their credit growth and begin to clean up their balance sheets, this infusion must strictly be in line with objective performance-improvement criteria.

On a related front, it had also been observed that the troubled assets which were being offered for sale under the Insolvency Code were not able to fetch acceptable prices. By recapitalising, the government will, therefore, enable the banks to hold on to these assets for a more opportune time rather than disposing them now and incurring huge haircuts. In an earlier reported case which had undergone the insolvency process, creditors had taken a 95-per cent hit on the assets of a company. In that context, it was being assessed in policy circles that, in resolving cases of such distressed assets in the immediate future, banks would have had to take at least a 50-per cent haircut. Recapitalisation may, therefore, help the banks get better prices for such assets.

A Thumbs-Up from the Markets

The Indian markets have given a thumbs-up to this bold initiative on the part of the government, and the public sector bank stocks have shot up. In fact, as at the close of trading

on 25 October 2017, the Nifty PSU bank index soared 29.6 per cent. The State Bank of India gained 29.6 per cent and the Punjab National Bank gained 46.2 per cent.[2]

While the markets have welcomed the move by the government, Morgan Stanley has called this India's Troubled Asset Relief Programme (TARP) viz the United States (US) TARP, which was implemented when the financial meltdown hit the US and European markets in the last decade. The case for using public funds to recapitalise and restructure banks is that the costs of such an extraordinary action are less than those resulting from a broad disruption in the real economy that might occur due to the failure of one or more systemically-important banks. The benefits from such expenses are difficult to quantify as they largely relate to avoiding disruptive effects, the magnitude and consequences of which are difficult to estimate. However, in most cases of systemic crisis, governments have generally opted for public expenditure to preserve some portion of a widely-insolvent banking system. In this particular case of public sector banks in India, the objective is to ensure that essential banking services continue to be provided to the real economy. In the past, it was, in fact, the public sector banks which alone had advanced money towards infrastructure projects; this indeed is the reason for the heavy stress that they carry on their balance sheets now.

In addition to the recapitalisation programme, intended to regenerate growth and kick start the economic recovery process, the Indian government announced a massive road-building programme of around ₹7 trillion (S$149 billion) with a target to construct 83,677 kilometres of roads in the next five years. This programme includes the Bharatmala project of around 35,000 kilometres with an investment of ₹5.35 trillion (S$112 billion), which is likely to create 142 million man-days of jobs. The government has also approved the construction of 2,000 kilometres of roads along the eastern and western borders of the country to boost border roads and international connectivity. The infrastructure investments will be focused on building motorable roads in the Northeast and the Naxal (Maoist)-affected regions of the country. To boost all-round connectivity, the government has approved the construction of additional roads of 10,000 kilometres. The expectation is that the revival of road-construction and housing sector will have a cascading effect on other sectors such as steel and cement. The

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[2] "Govt bank stocks on fire after recapitalisation plan", Samie Modak, *Business Standard*, 26 October 2017. http://www.business-standard.com/article/markets/govt-bank-stocks-on-fire-117102600035_1.html. Accessed on 26 October 2017.

government had earlier announced an affordable housing programme, which coupled with the anticipated increased lending from the banks, will serve as a multiplier.

The latest series of measures announced by the Indian government has served to send a very positive signal to investors, as these measures can revive demand and provide banks with the requisite capital to enable them to lend towards newer demand without resorting to distress-sale of the troubled assets through the insolvency process.

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