Recapitalising PSBs - II

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What is the issue?

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Union government recently announced recapitalization plan for PSBs, the success of this plan depends on future reforms.

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How recapitalization actually works?

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- In the Economic Survey of 2014-15, the Twin Balance Sheet (TBS) challenge afflicting the Indian economy was identified.
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- TBS clogs the economy, depriving it of demand and the lubrication that oils and feeds that demand.
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- Resolving the TBS challenge comprehensively requires 4 R's -
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1. **Recognition** - Banks must value their assets as far as possible close to true value, as RBI has been emphasising.
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2. **Recapitalisation-** Their capital position must be safeguarded via infusions of equity (recapitalisation) as the banks have been demanding.
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3. **Resolution** - The underlying stressed assets in the corporate sector must be sold or rehabilitated as the government has been desiring
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4. **Reform** - Future incentives for the private sector and corporates must be set right (reform) to avoid a repetition of the problem.
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How recently announced recapitalization is planned?

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- It is expected that the exercise will be modelled on the lines of a similar bailout in the nineties.
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- That is the Centre issues recapitalisation bonds to PSBs, and re-routes the sums so raised as equity capital.
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- The package envisages an infusion of Rs.1.35 lakh crore through recapitalisation bonds and market funding of Rs.58, 000 crore, aside from Rs.18, 000 crore from the Budget.
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- These bonds after taking into account the existing provisioning and the recoverable value of the underlying loans will ensure a healthy capital base for the PSBs.
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- It is likely that the recap bonds will be placed with the banks for which the government will get an equivalent holding of equity in the banks.
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- This will be a capital transaction because it not only increases the government's liability but also increases its assets.
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- The overall or net financial position of the government remains unchanged.
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- The issuing agency of the recap bonds, borrowing costs and the identity of the banks who receive infusion will all be keenly watched.
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What are the difficulties in recent recapitalization plan?

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- With capital requirements for the balance sheet repairs pegged at a mammoth Rs.2.4 lakh crore, finding the money has been difficult amid fiscal constraints.
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- The large capital infusion that the Centre is now willing to make is against the spirit of the original Indradhanush scheme which had tied PSB infusions to performance metrics.

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- As PSBs supply the funds needed, the Centre avoids roiling the bond market with new borrowings or hiking taxes for the overburdened taxpayer.
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- Also it is unclear whether global rating agencies will be willing to ignore the higher debt-to-GDP ratio while assigning their India ratings.
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- Market participants have pointed out that the resolution procedures are still in their infancy, untried even for small cases.
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- Governance reforms at PSBs, particularly those related to the distancing of bank boards from government interference, have made snail-paced progress in recent years.
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- The big-ticket bailout will actually raise the Centre's equity holdings in the PSBs, making them even more vulnerable to undue interference.
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- There is also the moral hazard of allowing PSBs to dip into the exchequer frequently to cash for their bad or corrupt lending practices.
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What needs to be done?

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- The new measures are aimed at bringing resolution in banks to concentrate on the longer-term strategic approach by focusing on their NPAs than on new lending.
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- Banks must be provided with the money to clean up their balance-sheets so that they have the financial ability and managerial attention span and incentive to refocus on their core activity of lending.
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- Recapitalisation must be selective and incentive-based, directing it to those banks where the "bank for the buck" in terms of new credit creation will be maximum.
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- The recapitalisation strategy by taking off stressed loans from banks will clean the balance-sheet, and private sector will be willing to become owners or equity-holders.
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- Public-to-private lending model has proved toxic, It may be better to have more private-to-private lending and even private-to-public lending.

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- India needs to have both large public sector and private sector banks, competing domestically and being competitive internationally.
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- Excessive caution, inertia in decision-making must be followed and variety of constraints imposed by referee institutions must be addressed.
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Way forward

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- The recapitalisation will raise the moral hazard question on a bailout of the bad lending and borrowing decisions of the past to some extent, moral hazard is unavoidable.
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- In one view achieving this would require allowing majority private ownership, such ownership is not a cure-all, nor will it ensure that imprudent lending and moral hazard will not arise.
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- While the recap bond idea offers an expedient solution to PSB capital woes, there can be significant negative repercussions in the long run which the Centre would do well to recognise.
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Source: Financial Express, Business Line

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