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Matthews Asia Perspective

What's Behind India's Massive Bank Recapitalization?

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The Indian government announced a massive bank recapitalization in late 2017 of about US$32 billion over the next two years for large Public Sector Banks (PSBs). Part of this amount would be raised by the government using bank recapitalization bonds that banks could subscribe to using excess liquidity parked with the central bank. The remaining could be raised by banks through the capital markets, once the banks are rerated after this balance-sheet repair. As long-term investors in India, we wonder if this exercise in financial engineering will enable banks to make a fresh start to become stronger and profitable, or if it might create a moral hazard issue, delaying painful but necessary decisions that could otherwise be made now.

Current State of Banking in India

The current state of affairs is not good, except that the problems are not as dire as they were in the United States during the financial crisis of 2008. The problems are concentrated among PSBs, which account for three-quarters of the total outstanding bank credit, and a few private sector banks that are focused on corporate lending. Ineffective corporate governance at PSBs stemming from political interference and widespread corruption has been the root cause. The dual regulation by the Reserve Bank of India and the Finance Ministry has led to indecisiveness and incentives for making evergreen loans among bank officials, who avoid timely recognition of bad loans for fear of a vigilance inquiry and create perverse incentives for borrowers. The consequence has been a ballooning number of stressed loans at PSBs to the tune of 15% to 20% of total loan assets, classified under different labels (e.g., nonperforming assets, restructured loans, 5:25 schemes, etc.), with an effective coverage of around 30%.[1] A brief perspective on how PSBs entered into this mess may help to clarify the situation for investors.

Evolution of Banking and the Context Leading Up to the Current Bailout

Indian banking has a long history of over 300 years. During this period, it has undergone several structural changes. Private banking was introduced around the mid-19th century and was predominant until the country's independence in 1947. Commercial banks were largely in private hands and were generally profitable. They were perceived to be businessman-friendly, however, and lacked the tenacity to serve poorer sections of society, including agriculture and related activities that formed the backbone of the Indian economy in those days.

Decades later, the noble objective of financial inclusion was addressed by the nationalization of large banks in India, first in 1969 and later in 1980, which may not be surprising if one considers the influence of socialism and the Soviet Union on India during those years. Growth and the redistribution of credit took precedence over profits. Matters grew worse in the past decade with a policy push to build infrastructure and the government asking PSBs to shoulder the funding responsibility. Many corporations took advantage of loopholes in the system and were able to borrow without much equity contribution. Now, with many projects stalled amid a slowdown and a lack of investment reforms, and with many large borrowers having little skin in the game, almost one-fifth of banking assets runs the risk of getting wiped out.

The tragedy is that despite putting PSBs through this pain, financial inclusion remains elusive even after four decades of bank nationalization, with almost half of the population not having functional bank accounts and the bulk of credit disbursal still benefiting large corporations.

The only silver living has been recent advancements in technology, regulations and processes that have enabled microlending and the servicing of smaller accounts in a cost-effective manner. The country has also witnessed a surge in biometrics-based identification for a majority of the population that links to various services including banking and the direct transfer of subsidies to the beneficiaries. Regulations also have kept pace, allowing the Banking Correspondent (BC) model to service low-end banking transactions. The government has been able to open 300 million accounts linked with biometrics-based debit cards with zero balance requirements to include the poorest segments of society. The country is realizing that in a digitized world, financial

inclusion can be profitable. Technology has made nationalization irrelevant to meet financial inclusion.

The recent decision to demonetize a majority of India's currency and the implementation of a unified Goods and Services Tax (GST) regime has been a blessing in disguise for the ailing PSBs, which have been flush with liquidity, otherwise stashed in unaccounted-for gold and real estate. Unfortunately, this money cannot be used to lend unless there is enough equity or Tier 1 capital in the banking system. With the recapitalization move, the government is able to use part of these deposits toward injecting equity into these banks to meet the provision requirements as well as to grow the loan book.

With the upcoming national elections in early 2019, the timing of this move cannot be better politically, as it would be hard for the government to create jobs without the support of banks. As an instance, the government's ambitious Bharatmala project to build 84,000 kilometers of roads and create 142 million man-days of jobs over the next five years has an outlay of 7 trillion Indian rupee (over US$100 billion), which would not be possible if PSBs were unable to fund it. A combination of economic and political compulsions has forced the government to capitalize banks in this manner, which is not as unprecedented as one might think.

Experience of Bailouts in Other Countries

Bank recapitalization or large bailouts have been tried in many countries with mixed success. It has been done several times in China, for example, beginning in the 1990s, before which the banks operated primarily as an extension of the state to meet its policy agenda. After the first recap, significant banking reforms led banks to lend on commercial terms to some extent, with the exception of some directed lending from time to time. There have been more recaps after the first one, which suggests that it is not a one-time process and depending upon the cycle, such situations would keep recurring. But after the recap, the government did make efforts to professionalize the banks and improve their governance (e.g., by listing them on the Hong Kong stock exchange).

The Troubled Asset Relief Program (TARP) in the United States in 2008, which involved government purchases of troubled companies' assets and equity, was another kind of bailout but with a similar spirit, i.e., to stabilize the country's financial system, restore economic growth and prevent a financial crisis. Eventually, the value of these assets increased over time, and the government profited on its investments in troubled assets. So, in that sense, the bailout saved the system from collapsing without a financial loss and could therefore be considered a success. But does it mean there would be no such bailout in the future? Not necessarily. The recent noise around regulations being too tight to survive might pave the way for high risk-taking in the distant future, leading to another bailout-like situation.

The experience of the Nordic bank resolution during the early 1990s suggests that societywide benefits could accrue if the fire-sale disposal of assets can be avoided and public confidence in the financial system can be sustained.

Is It a Long-Term Solution?

India's bank capitalization was perhaps necessary to keep the public sector banks functional. The other option of selling a government stake to raise equity capital for the banks at current valuations was neither pragmatic, given a depressed outlook, nor legal unless the Parliament repeals the Bank Nationalization Act of 1969. That said, this move can give only a short-term lease on life to PSBs, and would actually be counterproductive unless it is followed by a host of governance reforms. In our opinion, the long-term solution to repair governance is for the government to reduce its stake to levels such that it retains overall control but low enough that the boards regain their independence, as well as powers to enforce accountability. This would require more political capital than what the present government can afford to spare at the moment, but is worth pursuing at the right time.

In addition, the government has the ability to convert many impaired loans from nonperforming to standard if only it could make a few policy changes. Among impaired loans, 60% come from steel, power, telecom, infrastructure and textiles.[2] A significant part of this is on account of policy missteps and could be revived with some political will. Many power projects are commissioned but not operational, for example, due to a lack of demand from the state utilities that buy this power, even though the end consumer with an ability to pay is facing power cuts. If the "open access" is enforced in letter and spirit, the end consumer could buy power directly from power producers, bypassing the corrupt and inefficiently run state utilities, and these power plant assets would no longer remain stressed. Another issue in the power sector is power theft. A 2012 study by NDTV news found that 40% of electricity in India was unpaid at the time, with the bulk of that amount representing theft.[3] Once this issue is addressed, say, by the laying of underground cables, many debt-ridden state power utilities could also turn profitable.

Similarly, telecom assets are stressed primarily because of very expensive spectrum charges, as they are auctioned by the government to the highest bidders, and very low telecom tariffs, since the government has been promoting competition to unreasonable levels amid allegations of favoritism. All is not lost in the sector as data usage has been growing exponentially and the rising consolidation should clear things up if only the government is more rational in its future policy actions.

Conclusion

There is a genuine fear that, like in the past, this lifeline might be used by the government to buy time and delay painful but necessary reforms. Usually, the window to make difficult reforms is only two to three years after an electoral victory before the next election cycle starts. The GST reform, for example, was made within this window and now the populist agenda is back in the cards to woo voters during the 2019 elections. Amid such a persistent conflict, breakthrough reforms happen only under emergency situations such as the Balance of Payment crisis in 1991, which led to economic liberalization reforms even though the country was led by a minority government.

That said, one cannot deny the necessity of this move given the state of PSBs and the fact that making painful decisions by a government with the full support of its voters is always preferred over decisions made amid extreme circumstances. There is also a chance that this could actually increase the value of loan assets as more time is given to banks to resolve them instead of letting them fail right now, and policy efforts are made to revive these assets. The experiences of bailouts in various countries suggest that this is not a new phenomenon and every country goes through cycles that would require measures of this kind at some point. Even though this could lead to a moral hazard, this imperfect solution is probably necessary and perhaps better than letting India's whole financial system collapse.

1 Source: Reserve Bank of India, "Financial Stability Report: Issue 16," December 2017
2 Source: zeebiz.com "Top Five Sectors with Most Exposure to Banks NPAs." June 2017
3 Source: NDTV.com "How India's power sector is losing Rs. 55,000 crore per year." August 2012

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