Recapitalisation of state owned banks through privatisation

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As with the whole economy, the Covid 19 pandemic dealt a severe blow to India's banking sector, which was already reeling under the huge burden of non-performing assets (NPAs). Stress tests reported in the Financial Stability Report (FSR) indicate that the low ratio of capital to risk adjusted assets (CRAR) is likely to decline further.To revive the economy and resume sustained high growth, bold structural reform will have to be combined strong fiscal and monetary measures.

The big challenge for the latter is the low and declining growth of credit. A credit:GDP ratio of around 51 per cent is not too low compared to other countries at comparable levels of per capita income. However, the worry is that credit growth is declining rapidly. It declined from around 13 per cent, year-on-year, in April 2019 to only 6 per cent in November 2020. This is not attributable to the lockdown because credit growth was already down to 6 per cent in March 2020, when the lockdown had just begun.It is mainly attributable to rising risk aversion among lenders, reflecting the high and rising level of NPAs. Risk aversion certainly spiked during the economic contraction. But the underlying level of banking sector stress has been masked by the regulatory forbearance that RBI mandated, subsequently extended by the Supreme Court, to provide temporary relief for borrowers during the economic contraction. The FSR stress tests now indicate that the gross NPA ratio is likely to go up to as much as 13.5 per cent by September 2021 in the baseline case and 14.8 per cent in the severe stress case.

Within the banking sector, conditions are much worse in public sector banks (PSBs) compared to private banks (PVs) or foreign banks (FBs). Gross NPA is forecast to rise to 16.2 per cent for

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PSBs as compared to 7.9 per cent and 5.4 per cent for PBs and FBs in the baseline case. In the severe stress case gross NPAs could rise to 17.6 per cent, 8.8 per cent and 6.5 per cent respectively for PSBs, PBs and FBs. Clearly, high NPAs are primarily a problem for PSBs which still account for 60 per cent of total bank credit.
Given this background, how can we rapidly grow the banking sector and restore a high level of credit growth to support a strong, sustainable economic recovery?

One approach is to bypass the PSBs and give a big push to private banking by issuing new bank licensces. The recent report on 'Ownership and Corporate Structure for Indian Private Sector Banks' submitted by an RBI internal working group (IWG) espouses this approach. Apart from many recommendations on better prudential regulation, strengthening the supervision capacity of RBI, etc., the IWGs main controversial recomemendation is to enable large corporates and industrial houses to acquire banking licensces.

The proposal has been strongly opposed by former governors and deputy governors of the RBI, several former Chief Economic Advisers, a former Finance Secretary and, most significantly, all save one of one of the many experts the IWG consulted. The key issues which have been intensively discussed, especially in Rakesh Mohan's three part article (Ownership and governance in private sector banks, Business Standard 14, 15, 16 December), are briefly as follows:

i. with an industry CRAR of only 12 per cent, the proposed raising of the promoter share cap to 26 per cent could potentially leverage the promoter's investment by 32 times! The very high risk appetite generated by such leveraging would subject depositers, i.e., individuals, small companies, large corporates and even governments; to a high level of systemic risk, given the limited deposit insurance provided in India.

ii. excessive risk appetite would lead to imprudent lending, especially connected lending to group companies. Conglomerates always find ways around regualtory restrictions against such connecetd lending.
iii. the conglomerate bank would have access to insider information on borrower companies competing with group companies
iv. conglomerate banks would lead to massive concentration of economic power and political influence against not just competing companies but even the regulator.

A safer and cleaner option is to grow the banking sector through simultaneous privatisation and recapitalisation of PSBs. In the last three years, apart merging some weak and strong PSBs, the government has spent some Rs 2.5 trillion on recapitalising PSBs. This has been financed partly by taxpayer money and partly recapitalisation bonds, including the recently introduced discounted zero coupon bonds sold to PSBs that are recapitalised. However, these options do not change the ownership and governance structure of PSBs, which primarily accounts for their poor performance.

A better option is for PSBs to recapitalise themselves by raising fresh equity. There will be no appetite for this unless (a) the banks' balance sheets are first cleaned up and (b) it is announced that the volume of fresh equity being raised is more than the governments holding, i.e, reducing government's ownership to less than 50 per cent. Such a bold reform would mobilise substantial resources from a buoyant capital market. It would recapitalise the banks, empowering them to resume lending, and simultaneously privatise their ownership structure leading to improved performance. It would be more prudent financially and also more acceptable politically to test this approach with one or two small PSBs. But first, government has to bite the bullet