The Future of Public Banking*

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At the end of July, Finance Minister Arun Jaitely placed a supplementary demand for grants in Parliament, which included Rs. 12,010 crore year to recapitalise public sector banks by enhancing their equity capital. This demand for recapitalisation funds was to part finance a larger four-year plan under which the public sector banks (PSBs) would be provided Rs. 70,000 crore, with Rs.25,000 crore being disbursed this financial year and the next, and Rs. 10,000 crore in each of the two subsequent years.

This does point to a revitalisation of the recapitalisation exercise. PSB recapitalisation has been a long-term project. Between 2000-01 and 2014-15, budgetary allocations for recapitalisation of banks totalled Rs. 81,200 crore. Much of this was provided for in recent years, with as much as Rs. 58,600 crore (or around 72 per cent of the total) announced during just four consecutive years ending 2013-14. However, the government seemed to have lost the appetite for such recapitalisation. In 2014-15, while Rs. 11,200 crore was allocated for the purpose in the budget, actual capital infusion into public sector banks was just Rs. 6,990 crore. Budget 2015-16 had reduced even the budgeted allocation to Rs. 7,940 crore, which the Reserve Bank of India had deemed inadequate. So the recent demand clearly reflects a revival.

Moreover, in 2014-15, the government had decided to be selective in providing recapitalisation help, with the Rs. 6,990 crore it disbursed going to just 9 of the 27 state-run banks, based on performance as reflected in the returns they earned on equity and assets. That policy is being given up. In its revived version, the recapitalisation programme would divert 40 per cent of the Rs. 25,000 crore, or Rs. 10,000 crore, to the top six lenders (State Bank of India, Bank of Baroda, Bank of India, Punjab National Bank, Canara Bank and IDBI Bank), and provide another 40 per cent to weak banks. Only the remaining 20 per cent is to be allocated according to performance. Thus, the new recapitalisation push seems to be broad-based and less discriminatory on the grounds of performance.

However, there seems to be much confusion regarding the objective of the exercise. One motivation, routinely cited, is India's decision to adhere to periodically revised capital adequacy norms put out by the Basel Committee on Banking Supervision (BCBS). Those norms recommend how much regulatory capital in general, and equity capital in particular, banks must hold relative to the size of their risk-weighted assets. After the 2007-08 crisis the BCBS tightened norms under Basel III, to meet which, it is argued, banks need additional equity capital.

However, Basel norms are not binding, since they are not part of any agreed treaty. And banks in many countries have raised concerns about the impact Basel III norms would have. So, India has the choice of not implementing or at least delaying the implementation of Basel III. The government has chosen not to do so. Moreover, even the Basel III imperative is not immediate, as the stipulated increase in capital requirements has been staggered over time till 2019. Hence, both the government and the Reserve Bank of India (RBI) have said that India's public sector banks are adequately capitalised as of now even based on Basel norms. Recapitalisation, it is argued, is needed only to maintain a safety buffer above that required by Basel, and to meet future capital adequacy requirements when they are to be met.

This raises the question as to how much additional capital would the PSBs need and at which points in time. There are widely varying answers to the question. The rating agency Moody's has argued that if growth is moderate and non-performing assets with banks decline (keeping credit growth respectable), the 11 Indian PSBs it rates (which account for 62 per cent of net bank lending) would have to raise Rs. 1.5 and 2.2 lakh crore between financial year 2015 and financial year 2019, by when Basel III is to be implemented in full.

But such estimates are questionable because they require assumptions on what would be the risk-weighted asset profile of banks over time, and on the degree to which extant equity capital would be eroded because of the need to provide for non-performing assets from the past. The latter, in particular, is a problem afflicting the Indian public banking system at present. Gross non-performing assets of the public sector banks rose from Rs. 59,926 crore in 2009-10 to Rs. 1,64,462 crore by 2012-13. Moreover, these banks were sitting on a pile of stressed but "restructured assets" that had been classified as standard, and much of that is likely to turn non-performing soon. As a result, the non-performing assets of the PSBs are expected to balloon. Since the provisions that have to be made against those NPAs would hit bank balance sheets, the result would be a substantial increase in regulatory capital requirements of the banks. This is bound to inflate the recapitalisation requirement.

The accumulation of open and concealed non-performing assets was partly the result of the changes in the lending strategy of the PSBs after financial liberalisation. There were two components to that shift. One was relatively "autonomous", with banks, endowed with greater flexibility and having to compete to attract deposits with higher interest rates, choosing to increase the share of higher-yielding retail credit assets— housing loans, loans for automobile purchases, educational loans, credit card receivables and a host of other personal loans— and loans to sensitive sectors like stock, real estate and commodity markets in their total assets. Rising defaults in these areas is one cause of rising NPAs.

The other was the result of enforced compliance, with the government pressurising the PSBs to bankroll its infrastructure push. With development banks having been dismantled, the corporate bond market inadequately active, and the government committed to reducing expenditures (in the context of a combination of tax forbearance and fiscal consolidation), projects in the infrastructural sector had to be taken up by the private sector or in PPP mode. With private players unwilling to expose too much of their own capital in these areas, PSBs became a useful lever to push the government's strategy, by facilitating private investment with credit support. The share of infrastructural lending in commercial bank lending to industry increased from around 2 per cent in 1998 to 32 per cent in 2012. Infrastructural projects that were financed varied from power generation and distribution, through roads and ports, to civil aviation and tourism infrastructure such as hotels. These were huge loans extended by consortia of banks to selected private players. Many of these projects are finding it difficult to meet their interest and amortisation payment commitments.

In fact, much of the non-performing assets of the public sector banks relate to loans in this area. The share of Mining, Iron & steel, Infrastructure and Aviation in total advances of the public sector banks stood at 25.1 per cent in December 2014. On the other hand, their share in the stressed assets held by the PSBs was a much higher 43.6 per cent. Since there was a strong probability of default on these loans, provisioning seems unavoidable, resulting in losses that erode the capital base of banks.

One way to deal with this would be to rethink liberalisation and address the increasing exposure of bank- and bank-type agencies to sectors that seem prone to default on credit payments. The other is to infuse additional capital and restructure the banks. It is the latter that is now being pursued in practice. This partly explains the huge estimates of additional regulatory capital requirements for the public sector banks. But those estimates are also partly explained by the fact that large capital requirements suit those who advocate creeping privatisation of public banks. They argue that the government cannot provide the required capital itself, and needs to allow banks to mobilise capital through sale of additional equity in the market. They have been partially successful, with the government issuing guidelines in December 2014 allowing PSBs to mobilise equity capital to meet Basel III capital adequacy norms, subject to the requirement that the government’s holding must be kept at a minimum of 52 per cent. That threshold is likely to be revised given the inclinations of the NDA government. It seems a short route from restructuring the PSBs to privatising them.

According to the finance ministry's estimates, public sector banks will require Rs. 1,80,000 crore of additional capital in the four financial years ending 2018-19. This estimate reportedly takes into account projected internal profit generation and "is based on credit growth rates of 12 per cent for the current year and 12-15 per cent for the next three years, depending on the size of the bank," according to a statement from the ministry. In its view, while at present all state-run banks are adequately capitalised and meet Basel III and Reserve Bank of India norms, with the Rs. 70,000 crore support provided in the new recapitalisation plan, they will be able to raise the remainder of Rs 1,10,000 crore through the market because of improved valuations. That improvement is expected due to: (i) far-reaching governance reforms; (ii) tight NPA management and risk controls; (iii) significant operating improvements; and (iv) capital allocation from the government.

The import of the last of these is obvious. If privatisation is a route the government is likely to take using Basel III as justification, the objective underlying the revival of the recapitalisation exercise becomes clear. Even successful disinvestment at prices that appear reasonable requires that bank balance sheets have to be repaired. If profits are already low because of provisioning against bad loans, and if further such provisioning is expected given the high proportion of stressed assets, capital infusion is unavoidable. The RBI estimates that stressed assets on the books of the PSBs is a high 13.5 per cent of total advances, as compared with just 4.6 per cent in the case of private banks. This does suggest that provisioning will rise over time.

Allocating funds to help write off assets that are likely to go bad and promising to put in more in the coming years are therefore part of a strategy of making public sector bank equity more palatable for potential private investors. The end-targets then are not the banks, but those investors. The attempt is to sweeten the deal before inviting the private sector to take on a larger share in equity. The final goal is privatisation.

That leaves one final question. Since the development banks have been closed down and the experiment of using the PSBs to finance infrastructural investment has gone awry, how will the government finance its ambitious infrastructure investment programme? The Finance Ministry has an answer imbued with much optimism. It assumes that “the emphasis on Public Sector Bank’s financing will reduce over the years by development of a vibrant corporate debt market and by greater participation of Private Sector Banks.” Experience shows that is nothing more than wishful thinking.

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