Recapitalising India's Public Sector Banks*

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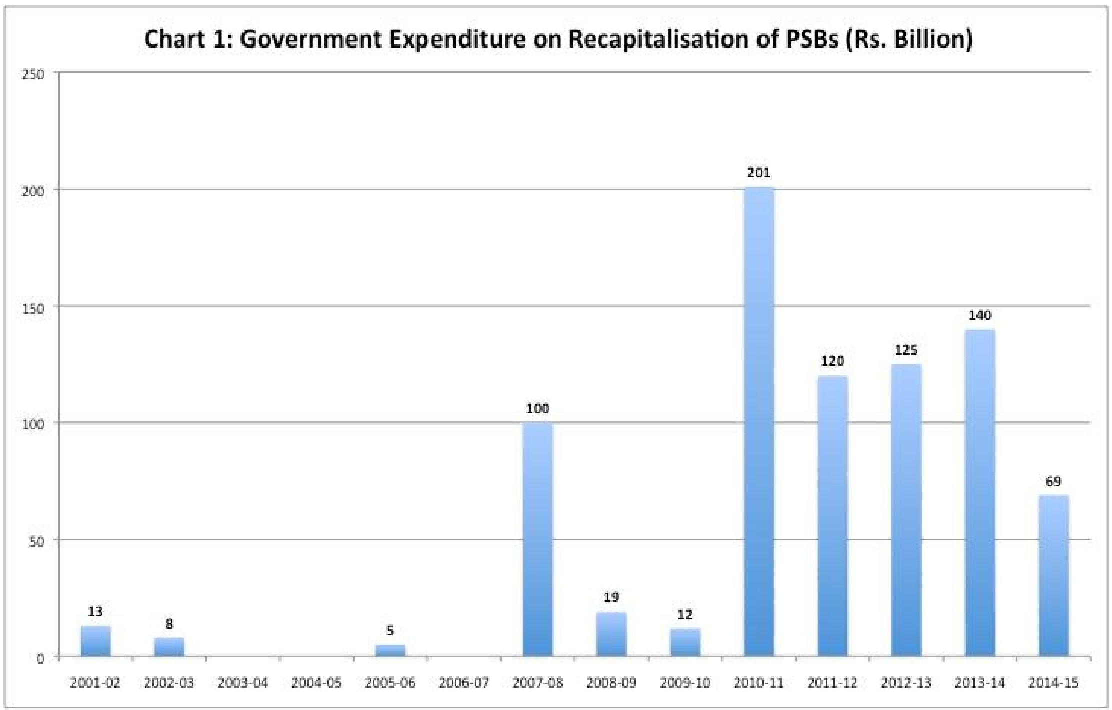
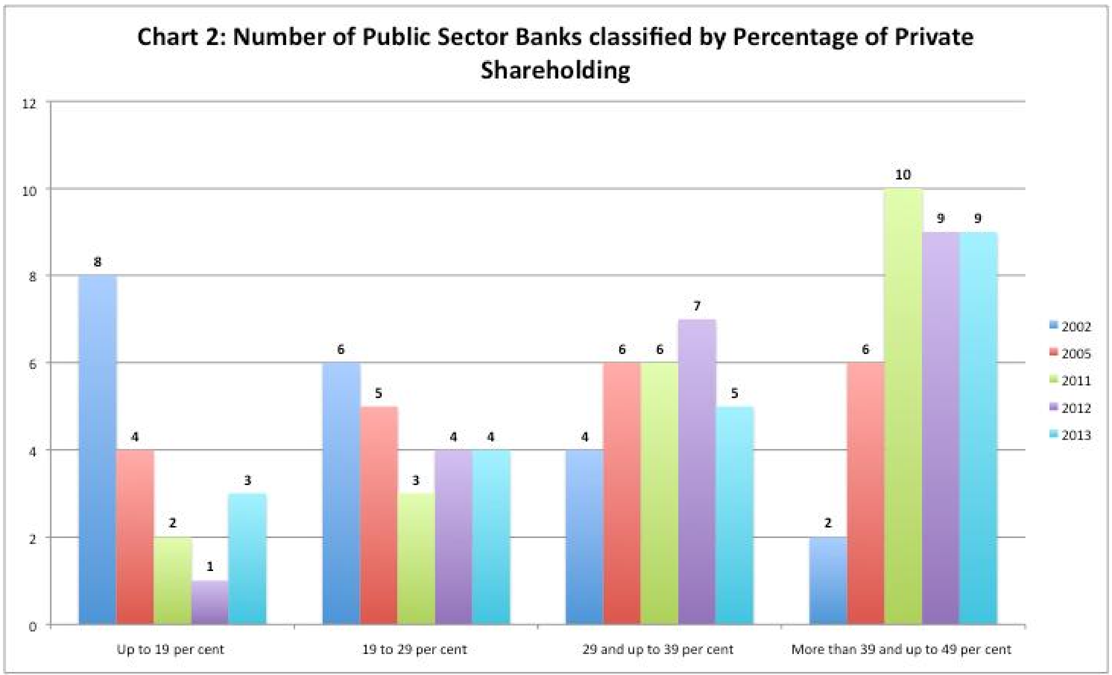
There are reports that the government has granted 7 public sector banks permission to raise capital through equity issue in the market to meet their capital requirements. This follows the December 2014 guideline permitting public sector banks to mobilise equity capital to meet Basel III capital adequacy norms, subject to the requirement that the government's holding must be kept at a minimum of 52 per cent.

Thus far, while equity dilution was occasionally resorted to, recapitalisation of public sector banks (PSBs) was largely financed through allocations from the budget that raised the government's stake. Between 2000-01 and 2014-15 budgetary expenditure on recapitalisation of banks totalled Rs. 81,200 crore (Chart 1). Much of this expenditure is recent. As much as Rs. 58,600 crore (or around 72 per cent of the total) was expenditure undertaken during just four consecutive years ending 2013-14. However, the government now seems 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. 6,900 crore. Budget 2015-16 has reduced even the budgeted allocation to Rs. 7,940 crore.



The message being sent out is that, because of its "limited fiscal space", the government is not in a position to provide more funding to the banks, and that PSBs must prepare "capital augmentation plans through innovative financial instruments" to meet their capital requirements. There can be innovative ways in which the central bank can help with recapitalisation, even if the argument that the budget cannot be burdened with the exercise is accepted. But that is not our concern here. In practice it is expected that, if the government refuses to provide funds for recapitalisation as part of its fiscal consolidation exercise, banks would be required to raise money in capital markets by issuing new equity.

The December 2014 decision allowing dilution of equity in PSBs, subject to a government shareholding floor of 52 per cent, was a signal that this is the direction the government would like the PSBs to take. Clearly, this 52 per cent boundary is flexible, since how far PSBs would have to go in diluting the government's equity stake would depend on how much funding they need to strengthen their capital base. Estimates vary widely. One estimate, for example, places the capital requirement of PSBs to meet Basel III norms at Rs. 2,40,000 crore by 2018.



This would require going further than 52 per cent if equity dilution is the principal means of ensuring capital adequacy. As Chart 2 shows, the process of diluting public ownership in the PSBs has already gone far, with a significant proportion of PSBs in the 40-50 per cent and 30-40 per cent public shareholding range. If additional large sums are to be mobilised from equity dilution, the principle of majority government ownership will have to be given up.

When assessing estimates of capital requirements it is necessary to understand how these figures are arrived at. The estimation involves projecting by how much the public sector banks would "have to" grow their business. The faster the growth of deposits received and loans provided by the PSBs, the larger their risk weighted assets. Since under different versions of Basel the regulatory "uncommitted" capital required is prescribed as a percentage of the banks' risk weighted assets, capital requirements would increase.

Thus 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. ICRA, the Indian associate of Moody's, had estimated in 2010 that Indian banks (both public and private) would have to raise Rs. 6 lakh crore over the nine-year period ending 2019.

These additional capital requirement numbers are quite surprising given the fact that prior to the formulation of the Basel III norms, India not only had stricter capital adequacy requirements than the international norm but the actual capital adequacy of its banking system was even better than those domestic norms. Thus, for example, as against the 2% Common Equity Tier 1 capital requirement set under Basel II, the Indian requirement was 3.6 per cent. And while the total capital requirement was 9 per cent for India (8 per cent under Basel II), the actual achievement in 2010 of banks accounting for 95 per cent of banking assets was as much as 14.5 per cent.

If despite these advantageous initial conditions, estimates of capital required to be infused or mobilised are huge, it is for three reasons. First, it is being assumed that India is likely to see a huge expansion in the banking business. This assessment is partly driven by the post-2003-04 experience, when the ratio of scheduled bank credit to GDP in India, which had averaged 20-22 per cent through the 1990s, rose sharply to more than 55 per cent. It is obviously being assumed that this credit boom is normal and would continue. Secondly, it is being taken for granted that India would implement the stricter Basel III norms (including setting aside capital as Conservation and Countercyclical buffers) and keep to the deadline of 2019. And, third, the estimate takes account of the fact that non-performing assets in India have risen significantly in recent years (touching 5.6 per cent in December 2014) and would rise even further. This would mean that internal generation of surplus funds would be limited or even negative for some, necessitating large external infusions to cover for the first two trends.

There can, however, be differences in perspective on these matters. For example, the credit boom of the 2000s was the result of the easy liquidity situation that a surge in capital inflows created. Combined with banking policy liberalisation, this triggered a credit spiral that was based on an expansion of the universe of borrowers that brought in clients who were more prone to default. A consequence was the rise in defaults and non-performing assets, which enhance the need for external funding that the credit expansion creates in the first place. So the over-rapid expansion of the banking business in India was not all positive and there is no need to provide for a similar pace of expansion in the immediate future.

Moreover, Basel III was formulated to address the problems of banks that were responsible for the financial crisis. These norms are not binding and in fact there is still lack of clarity on whether regulators and banks in the developed countries would implement Basel III in its entirety as per the prescribed timeline. So India can easily buy time and even chose to implement a modified version. Taking the more stringent capital requirements of Basel III as an unavoidable given is without substance.

All this is important also because this may not be the best time for PSBs to try and mobilise capital from the markets. With their non-performing assets high and balance sheets stressed, the price they would get for their equity if they can sell enough at all would be low. That would require even larger dilution to achieve a given capitalisation target. The result would be privatisation at bargain basement prices of a magnitude that destroys public banking. Moreover, if such large scale privatisation is to occur, foreign banks have to be attracted and given a role in acquisition of PSB equity. Recapitalisation then would actually be a project pushing for privatisation of public banking and the expansion of foreign presence in the Indian banking space.

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