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UNANTICIPATED RECAPITALISATION ANNOUNCEMENT

A big boost to the economy

The recapitalisation aims to stem the burgeoning stressed assets and spur genuine long-term infrastructure lending for upcoming or stalled mega-infrastructure projects

ON OCTOBER 24, the government announced a major initiative—by committing for issuance of "recapitalisation bonds" worth ₹1.35 lakh crore over the current and the next fiscal year to strengthen the capital base of public sector banks and, in turn, to boost "non-food credit" flow to the economy to trigger growth and employment.

This announcement came against the backdrop of the "twin balance sheet" crisis, which has had translated into prolonged and weak growth of the Indian economy. The twin balance sheet crisis, as noted in the Economic Survey 2017, refers to the simultaneous occurrence of over-indebtedness in the corporate sector (which suppress demand for credit) and stressed balance sheets in public sector banks (which suppress credit to private corporate sector and household sector).

IBC provides regulatory ecosystem for "recap" move to meet Basel III norms

With the passage of the Insolvency and Bankruptcy Code (IBC), India has an enabling regulatory ecosystem to implement reforms related to the "cleansing process" of bank balance sheets and to correct for "weak core capitalisation" image of India's banking sector by the credit agencies. The proposed capital infusion will provide a "risk buffer" and tighter capital-reserve ratio to boost credit flow for the revival of stalled private corporate investment.

This "front-loading" of recap bonds announced on October 24 is a part of the ongoing Indradhanush strategy introduced in 2015 to revive public sector banks. The objective of Mission Indradhanush is to help banks meet their capital adequacy ratio and thereby make banks comply with Basel III global risk norms.

As per Basel III norms, banks have to maintain the capital adequacy ratio of around 11% by March 2019. The most stressed banks in India have the capital adequacy ratio much below 10%, as of now, and they are in need of capital. With the objective to infuse capital, the government had announced, in 2015, a package of ₹70,000 crore (staggered over four years) to banks to meet their capital adequacy requirements.

As highlighted by former RBI Governor YV Reddy, selective capital infusion to viable banks (keeping capital infusion to unviable banks at a minimum) would help meet Basel III norms and provide adequate capital for private corporate investment. Quoting YV Reddy, the Chief Economic Adviser (CEA) Arvind Subramanian also highlighted that the aim must be to shrink or narrow the scope of unviable banks.

> **This big bang recapitalisation move is intended to create employment simultaneously with economic growth revival, from the three-year low of 5.7% in the Q1 of the current financial year**

The details of recapitalisation bonds are still awaited. All what is evident from the announcement is that these recapitalisation bonds will be placed with public sector banks for which the government will get an equivalent holding of equity in banks. The recapitalisation package that the finance minister announced on October 24 includes banks raising ₹58,000 crore from the market over the next two years, in addition to a budget support of ₹18,000 crore and capital infusion of ₹1.35 trillion through bonds.

No impact on fiscal deficit as recap bonds is "below-the-line" financing as per IMF rules

The moot question asked by economists here is what could be the cost or the fiscal implication of this recapitalisation bonds announcement? Will it increase the fiscal deficit? The CEA has clarified that recapitalisation bonds do not increase fiscal deficits under the standard international accounting or IMF accounting practices, as they are "below-the-line" financing. As per IMF's rules, the estimated fiscal cost of issuing ₹1.35 lakh crore recapitalisation bonds is only the interest payment of ₹8,000-9,000 crore, which is around 0.4% of the aggregate public expenditure in India. However, the CEA has also clarified that it would add to fiscal deficit under India's accounting procedures, as it requires bonds to be included in the fiscal deficit. At the same time, the CEA has noted that since bonds are a capital transaction, the recapitalisation bonds do not directly increase demand for goods and services and, in turn, do not increase inflationary pressures.

Recognition rather than "non-recognition" of weak core capitalisation of Indian banks is a bold move

So, what are the expected benefits of front-loading recapitalisation bonds? The stressed and non-performing assets (NPAs) in the banking system together amount to roughly ₹10 lakh crore, and there is a progress in reducing NPAs with the Asset Quality Review in place by former RBI Governor Raghuram Rajan. In fact, Rajan, in a recent interview, had highlighted that "it is important to 'recognise' (than 'non-recognise') that banks do need capital." Rajan was emphasising on the need for a cleansing process of bank balance sheets and capital support, along with a revival of stalled private sector investment to trigger economic growth. This "recognition" and "recapitalisation" form a significant prelude to banking reforms.

The recapitalisation move was done to stem the burgeoning stressed assets and spur genuine long-term infrastructure lending for the upcoming or stalled mega-infrastructure projects. This big bang recapitalisation move is also intended to create employment simultaneously with economic growth revival, from the three-year low of 5.7% in the Q1 of this financial year.

Finally, it may also be acknowledged that such front-loading of recapitalisation bonds may also create "perverse incentives" and "moral hazards", and therefore this is not advisable as a "recurring package".

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