On Unanticipated "Recapitalization" Announcement:

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On 24th October 2017, Government of India announced a major initiative – by committing for issuance of "recapitalization bonds" worth of Rs 1.35 lakh crores over the current and 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 "twin balance sheet" crisis which has had translated into prolonged and weak growth of 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 the public sector banks (which suppresses credit to private corporate sector and household sector).

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

With the passage of Insolvency and Bankruptcy Code (IBC), India has an enabling regulatory ecosystem to implement the reforms relate 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 24th is a part of ongoing "Indradhanush" strategy introduced in 2015 to revive the public sector banks. The objective of "Indradhanush" is to help the banks to meet their capital adequacy ratio (CAR) and thereby make the banks comply with the Basel III global risk norms.

As per the Basel III norms, banks have to maintain capital adequacy ratio of around 11 per cent by March 2019. The most stressed banks in India have capital adequacy ratio (CAR) much below 10 per cent, as of now and they are in need of capital. With the objective to infuse capital, government has announced in 2015, a package of Rs 70,000 crores (staggered over four years) to banks to meet the capital adequacy requirements. As highlighted by former RBI Governor, Dr Y V Reddy, selective capital infusion to viable banks (keeping capital infusion to unviable banks to minimum)

would help to meet Basel III norms and provide adequate capital for private corporate investment. Quoting Dr Y V Reddy, the Chief Economic Adviser (CEA), Dr Arvind Subramanian, also highlighted the aim must be to shrink or narrow the scope of the unviable banks.

The details of "recap bonds" are still awaited. All what is evident from the announcement is these "recap bonds" will be placed with the public sector banks for which the Government will get an equivalent holding of equity in the banks. The recapitalisation package that Finance Minister announced on October 24th includes banks raising Rs58,000 crore from the market over next two years, in addition to a budget support of Rs18,000 crores and capital infusion of Rs1.35 trillion through bonds.

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

The moot question asked by economists here, is what could be the cost or the fiscal implication of this "recap bonds announcement". Will it increase the fiscal deficit? The CEA FinMin has clarified that recap bonds do not increase fiscal deficits under standard international accounting/IMF accounting practices, as they are "below-the-line" financing. As per the IMF's rules, the estimated fiscal cost of issuing Rs 1.35 lakhs crores recapitalization bonds is only the interest payment of Rs 8000-9000 crores, which is around 0.4 per cent of aggregate public expenditure in India. However he clarified that it would add to fiscal deficit under India's accounting procedures, as it requires bonds to be included in the fiscal deficit. However CEA clarified that as bonds are a capital transaction, the recap bonds do not increase directly demand for goods and services and in turn do not increase inflationary pressures.

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

What are the expected benefits of frontloading "recapitalization bonds"? The stressed and non-performing assets (NPAs) in the banking system together amounts to roughly 10 lakh crores, and there is a progress in reducing the NPAs with the "Quality Asset Review" in place by former RBI Governor Raghuram Rajan. The former RBI Governor Raghuram Rajan in an interview recently has highlighted that "it is important to "recognize" (than "non-recognize") that banks do need capital". Rajan was emphasizing 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 "recapitalization" form a significant prelude to banking "reforms".

The recapitalization move was done to stem the burgeoning “stress assets” and spur “genuine” long term infrastructure lending for upcoming or stalled mega infrastructure projects. This big bang “recap” move is also intended to create employment simultaneously with economic growth revival from the three-year low of 5.7 cent per cent in the Q1 of this FY.

Finally, it may also be acknowledged that such “frontloading” of recap bonds may also create “perverse incentives” and “moral hazards”; and therefore this is not advisable as a “recurring package”.