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Public Sector Banks: A Capital Question

The Government of India's (GoI) plan to help public sector banks (PSB) make a fresh start is well intentioned. Replenishing lost capital is necessary, but it comes with several constraints. For one, GoI's insistence on maintaining a 50% equity in PSBs from raising capital from the market. On the other hand, SEBI's requirement of GoI reducing its stake in PSBs to 75% of less by August 2017 also constrains further GoI infusion for several weak PSBs. But, providing for bad loans is not enough. Why will raising the required capital – assuming they do, stem future loan losses? Given the changing landscape, GoI must ask itself, will PSBs remain relevant in the banking sector in future?

Banks were nationalized in 1969 with a view that the banking sector needs to reach the poor sections of society, and that farmers in India will get access to financial services. More specifically, loans. Sure enough, over the years, RBI has set priority sector lending targets that even private sector banks have to follow. Banks were used as a tool to drive national policy and, in some cases, political agendas – with the explicit expectation that GoI would infuse capital regularly to support any loan losses.

But, perspectives are changing now. While the GoI continues to promise capital infusion, it also requires banks to raise money from the market. The GoI's new-found thinking of letting PSBs raise their own capital, and thereby compelling them operate under market challenges, is directionally correct.

According to the *Indradhanush* scheme, banks need Rs.1.80 trillion in the next four years to become well-capitalized, of which the budgetary allocation for support is only Rs.700 bn – banks will need to raise the remaining Rs.1.10 trillion from the market by FY2019. Of the promised Rs.700 bn, the GoI had already infused Rs.200 bn into PSB by 31 December 2015 – therefore, GoI will infuse only an incremental Rs.500 bn in PSBs will FY2019.

Capital infusion: More than what meets the eye

In the past, GoI capital infusion, to an extent has been circular flow of money - the GoI has been increasing its stake in PSBs, by reinvesting dividends received. Over the past six years, GoI has infused Rs.678.3 bn in PSBs (Table 1). Almost half of that was funded by the PSBs themselves – through dividend (to the extent of GoI's shareholding) and dividend distribution tax (Table 2). If PSBs are to grow they may either consider stemming dividends, or raising more capital.

While GoI and RBI are saying the right things, that only banks that perform will get capital, Life Insurance Corporation of India (LIC) continues to be a surrogate, which possibly creates a contagion risk. LIC has invested in quite a few preferential allotments made by PSBs and is usually the underwriter of first choice for PSBs' fund raise. Take the recent case of IDBI Bank. Even as the Finance Minister in his 2016 budget speech announced that GoI may reduce its stake to below 50%, IDBI Bank was mailing its resolution to raise Rs.15 bn from LIC in a preferential allotment. IiAS estimates that LIC has infused over Rs.120 bn in financial support to PSBs in just the past three years, and is expected to infuse more capital in the current year.

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Box 1: GoI increased control in PSBs after their listing

The GoI has increased its control over public sector banks over the past five years. The median GoI stake in PSBs increased to 69.24% on 31 December 2015 from 59.42% in 31 March 2010. In fact, GoI has also used LIC as a secondary tool for capital support. LIC's median equity stake in PSBs increased to 11.18% on 31 December 2015 from 8.69% on 31 March 2010. In effect, GoI's control (GoI + LIC) over PSB has increased (in every PSB except Punjab National Bank) to a median 80% on 31 December 2015, which defeats the purpose of listing PSBs.

Moreover, minority shareholders will never be able to assert their rights in PSBs: shareholders' (other than GoI) voting rights are capped at 10%. Further, LIC, which holds a median 34% of minority shareholding (Table 3), will likely vote with the GoI, making it virtually impossible for non-promoter shareholders (non-GoI, non-LIC) to have any say.

Can PSBs raise the required capital?

Capital raising for PSBs poses self-imposed challenges: GoI needs to ensure that its stake does not increase beyond 75% post the capital infusion and if banks raise capital from the market, GoI's share cannot get diluted below 50%.

Regulations require GoI to reduce its stake in listed banks to 75% or less by August 2017. This results in seven PSBs being automatically excluded[1] from the incremental Rs.500 bn GoI infusion, and another three where the infusion will have to be limited[2] - unless these banks are able to dilute the GoI shareholding by raising a large amount of capital from the market. Therefore, the proposed capital infusion under *Indhradhanush* scheme will directly benefit only 11 of the 21 listed PSBs[3].

Another opposing constraint comes for the possible dilution of GoI stake to less than 51%, should banks raise the required Rs.1.10 trillion from the market in the next four years. On March 2, 2016, the market cap of PSBs aggregated Rs. 2.85 trillion (Chart 1), but the free float market cap was only Rs.0.99 trillion (Chart 2). Of this, the SBI group accounts for more than half. How realistic is it to expect banks to raise this Rs.1.10 trillion in equity capital from the market? Even if the public sector banks raised the capital from the market, it would significantly dilute GoI's stake (to below 51% in some cases), unless valuations improve substantially. And, for valuations to improve substantially, PSBs will first need to demonstrate performance, and improved risk management practices that will temper future deterioration in asset quality.

The RBI recently eased the Tier 1 capital regulations for banks – most notable amongst those, allowed banks to include revaluation reserves linked to their property holdings. This is expected to add another Rs.350 bn to Tier 1 capital – from a purely accounting standpoint. This will only allow banks to trade on the realizable value of property to increase lending, and will give them some breathing space – it will reduce the urgency or the immediacy of capital raising. But, this notional addition is not growth capital – PSBs will still need to raise Rs.1.10 trillion from the market.

Will the capital infusion stem future loan losses?

Let's take the argument a step further. Even if the banks were to raise the capital needed, would it stem loan losses in future? For that, PSBs will need to improve

[1] *GoI stake in these banks was greater than 75% on 31 December 2015*
[2] *Bank of India, UCO Bank and Vijaya Bank, where GoI stake was in between 70% and 75% on 31 December 2015*
[3] *Not including SBI subsidiaries*

the fundamental quality of their governance. Setting up the Bank Board Bureau is just the first of a series of steps needed. Other recommendations listed out in the 'Report of The Committee to Review Governance of Boards of Banks in India' (the P J Nayak Committee Report) must also be followed through.

PSBs must also focus on improving the quality of their lending decisions by strengthening their internal controls and credit assessment processes. The slow slackening of underwriting requirements to ease lending, has led to several power plants being funded without having either power purchase agreements or fuel supply agreements in place, resulting in stalled projects is one example. Funding over-capacity, and therefore the current spate of defaults, in the steel industry is also, at some level, a function of the ease of funding support from banks. While banks are focussed on the much-needed strengthening of internal processes, they also need to have a macro perspective on their impact on industry dynamics. RBI Governor Raghuram Rajan advocates setting rules of monetary policy for central bankers so that they are encouraged to set policies, within the given constraints, that benefit the world in the long run, rather than pass on a set of their home country's problem to another part of the world. Surely, Indian banks can coordinate to ensure that lending practices have a long term positive impact on the industry – since, eventually, the industry excesses will come back to bite the banks.

Banks need a strong bankruptcy law to empower loan recoveries and an equally strong support from the judiciary to make the law effective. Average loan recovery rates have dipped to 18.4% in 2014-15 from 21.9% in 2012-13 (Table 4). The SARFAESI Act[4] brought fillip to loan recoveries, and it continues to report the highest recovery rates compared to Debt Recovery Tribunals (DRT) and Lok Adalats. Nevertheless, the overall recovery rates are low, a likely outcome of the slow process of winding up that eventually withers any remaining value of producing assets. India ranks 136th on Resolving Insolvency in World Bank's Doing Business Report 2016[5]. A bankruptcy law, hopefully, will allow speedy closure of businesses, enabling better recovery rates and faster release of funds. But, the judicial system also needs to step up its efforts at helping banks either collect on the loan collaterals or enforce bankruptcy. India ranked 178th on Enforcing Contracts in World Bank's Doing Business 2016 report[5].

Will PSBs remain relevant?

Even after all of this, it may be too late for PSBs (other than SBI) to remain relevant. Private sector banks have outpaced PSBs' growth rates in the past. That the market cap of private sector banks was 2.5x those of PSBs (including SBI) on 2 March 2016 is a telling sign (Chart 1). In 2012-15, banks made 12 public issuances for equity, of which 7 were made by private sector banks (Table 5). But, unlike PSBs, private sector banks have raised about half the amount of capital that PSBs have in the past three years (Table 6) – largely because private sector banks are better capitalized and have been careful about conserving capital. Unlike PSBs, private sector banks never had a ready tap that spits out endless amounts of capital.

The banking sector is structurally changing. With the start of small banks and other differentiated banks, rural penetration levels will increase, and rural India will have access to several more banking products. If the goal of nationalizing

[4] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
[5] No change over 2015 levels

banks in 1969 was financial inclusion, then small banks and other differentiated banks will serve that agenda. What then will remain the role of PSBs? If PSBs continue to fight the private sector banks in the lending space, they need more than an *Indradhanush* to get out of their '*Chakravyuh*'. They must be allowed to operate freely, with a focus on shareholder return. Only the PSBs that can survive market forces must prevail, others must be strategically merged into better run banks - public or private.

Private sector banks are like David – they are steadily beating down the behemoth and may just win the battle against Goliath of the banking sector. The March 2014 PJ Nayak Committee report optimistically predicted that PSB's market share would decline to 63.2% by 2025 from their 73% share in 2013. We believe that, given all that has transpired since the report, perhaps the market share of PSBs will be closer to 50% by 2025. This is because the GoI, in pressing to hold a 50% equity, is itself constraining PSBs ability to raise capital and grow.

Table 1: Bank-wise capital infusion by the GoI *Rs. Bn.*

S.N	Banks Name	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
1	Allahabad bank	-	6.7	-	-	4.0	3.2
2	Andhra Bank	-	11.7	-	-	2.0	1.2
3	Bank of Baroda	-	24.6	-	8.5	5.5	12.6
4	Bank of India	-	10.1	-	8.1	10.0	-
5	Bank of Maharashtra	-	9.4	4.7	4.1	8.0	-
6	Canara Bank	-	-	-	-	5.0	5.7
7	Central Bank of India	4.5	22.5	6.8	24.1	18.0	-
8	Corporation Bank	-	3.1	-	2.0	4.5	-
9	Dena Bank	-	5.4	-	-	7.0	1.4
10	Indian bank	-	-	-	-	-	2.8
11	Indian Overseas Bank	-	10.5	14.4	10.0	12.0	-
12	Oriental Bank of Commerce	-	17.4	-	-	1.5	-
13	Punjab National Bank	-	1.8	6.6	12.5	5.0	8.7
14	Punjab & Sind Bank	-	-	-	1.4	1.0	-
15	Syndicate Bank	-	6.3	-	-	2.0	4.6
16	State Bank of India	-	-	79.0	30.0	20.0	29.7
17	UCO Bank	4.5	16.1	0.5	6.8	2.0	-
18	Union Bank of India	-	7.9	-	11.1	5.0	-
19	United Bank of India	3.0	5.6	-	1.0	7.0	-
20	Vijaya Bank	-	10.7	-	-	2.5	-
21	Bhartiya Mahila Bank	-	-	-	-	10.0	-
22	IDBI Bank	-	31.2	8.1	5.6	18.0	-
23	State Bank of Bikaner & Jaipur	-	-	-	-	-	-
24	State Bank of Patiala	-	-	-	-	-	-
25	State Bank of Hyderabad	-	-	-	-	-	-
26	State Bank of Mysore	-	-	-	-	-	-
27	State Bank of Travancore	-	-	-	-	-	-
	Total	**12.0**	**201.2**	**120.0**	**125.2**	**150.0**	**69.9**

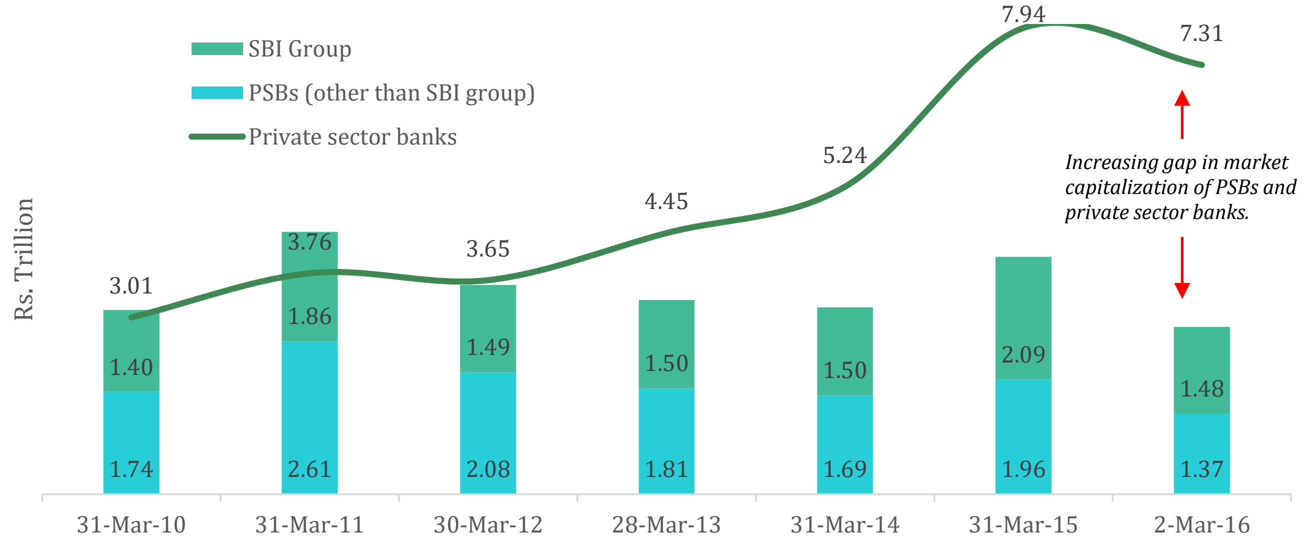
Source: www.data.gov.in

Table 2: Dividend and dividend tax from PSBs financed almost half the capital infusion in the recent past

(Rs. Bn.)	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Capital infusion by the GoI (Table 1)	12.0	201.2	120.0	125.2	150.0	69.9	678.3
Total dividend (incl div tax) declared by listed PSBs	75.9	89.3	97.9	115.6	81.7	81.9	542.4
GoI's share of equity dividends	39.5	47.8	52.4	62.7	44.6	43.2	290.1
Dividend tax paid by listed PSBs	10.6	12.8	13.8	16.7	10.8	13.2	78.0

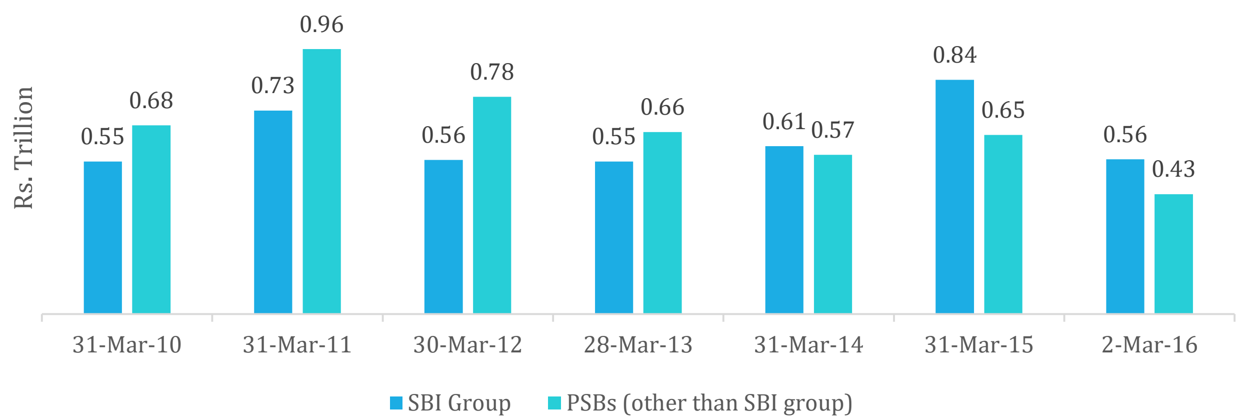
Source: ACE Equity, IiAS Research

Chart 1: Market capitalization of Indian banks – private sector banks outpace PSBs



Source: ACE Equity, IiAS Research

Chart 2: Free-float market capitalization of public sector banks



Note: Free-float market capitalization = total market capitalization x (1-GoI stake)
Source: ACE Equity, IiAS Research

Table 3: GoI's and LIC's stake in PSBs has increased over the past five years

	31-Mar-10			31-Dec-15				Increasing GoI's control
	GoI	LIC	GoI + LIC	GoI	LIC	GoI + LIC	LIC's share of minority interest	
(All numbers in %)	A	B	C=A+B	D	E	F=D+E	G=E/(100-D)	H=F-C
Allahabad Bank	55.23	10.64	65.87	62.73	12.61	75.34	33.84	9.47
Andhra Bank	51.55	10.69	62.24	63.97	7.66	71.63	21.26	9.39
Bank Of Baroda	53.81	8.41	62.22	59.24	10.92	70.16	26.79	7.94
Bank Of India	64.47	8.56	73.03	70.13	12.54	82.67	41.98	9.64
Bank Of Maharashtra	76.77	8.69	85.46	81.61	12.72	94.33	69.18	8.87
Canara Bank	73.17	6.03	79.20	66.30	13.75	80.04	40.79	0.84
Central Bank Of India	80.20	6.76	86.96	81.46	12.88	94.34	69.47	7.38
Corporation Bank	57.17	26.32	83.49	67.20	21.22	88.42	64.69	4.93
Dena Bank	51.19	6.78	57.97	65.00	11.63	76.63	33.23	18.66
IDBI Bank Ltd.	52.67	11.15	63.82	80.16	7.25	87.41	36.55	23.59
Indian Bank	80.00	0.00	80.00	82.10	3.14	85.24	17.54	5.24
Indian Overseas Bank	61.23	10.43	71.66	81.19	10.21	91.40	54.29	19.74
Oriental Bank Of Commerce	51.09	13.45	64.54	59.13	7.88	67.01	19.28	2.47
Punjab & Sind Bank	57.80	0.00	57.80	79.62	10.49	90.12	51.50	32.32
Punjab National Bank	75.00	9.83	84.83	62.08	11.18	73.26	29.49	(11.57)
State Bank Of India	59.42	11.83	71.25	61.37	11.50	72.87	29.77	1.62
Syndicate Bank	66.47	11.06	77.53	69.24	9.16	78.40	29.78	0.87
UCO Bank	63.59	8.40	71.99	72.83	14.36	87.19	52.85	15.20
Union Bank Of India	55.43	5.25	60.68	63.44	10.24	73.68	28.01	13.00
United Bank of India	84.20	0.00	84.20	82.00	12.12	94.12	67.33	9.92
Vijaya Bank	53.87	9.02	62.89	74.06	5.80	79.86	22.36	16.97
Median %	**59.42**	**8.69**	**71.66**	**69.24**	**11.18**	**80.04**	**33.84**	

Source: BSE, ACE Equity, bank websites, IiAS Research

Table 4: NPAs of scheduled commercial banks

Year	Sr No.	Recovery Channel	Lok Adalats	Debt Recovery Tribunals	SARFAESI Act	Total
2012-13	1	No. of cases referred	8,40,691	13,408	1,90,537	10,44,636
	2	Amount involved (Rs. Bn)	66	310	681	1,057
	3	Amount recovered (Rs. Bn)	4	44	185	233
	4	% recovered	6.1	14.1	27.1	21.9
2013-14	1	No. of cases referred	16,36,957	28,258	194,707#	18,59,922
	2	Amount involved (Rs. Bn)	232	553	953	1,738
	3	Amount recovered (Rs. Bn)	14	53	253	320
	4	% recovered	6.2	9.5	26.6	18.4
2014-15	1	No. of cases referred	91,31,199	1,71,113	12,41,086	1,05,43,398
	2	Amount involved (Rs. Bn)	887	3,789	4,705	9,381
	3	Amount recovered (Rs. Bn)	43	531	1,152	1,726
	4	% recovered	4.8	14	24.5	18.4

Notes:
1. *Amount recovered during the given year could be with reference to cases referred during the given year as well as during the earlier years.*
2. *# : Number of Notices issued*

Source: www.rbi.gov.org

Table 5: Public issues by banks

Year	Public Sector Banks		Private Sector Banks		Total		Grand Total (Equity + Debt)
	Equity	Debt	Equity	Debt	Equity	Debt	
2012-13	-	-	3	-	3	-	**3**
2013-14	-	-	-	-	-	-	**-**
2014-15	5	-	4	-	9	-	**9**

Note : Data for 2014-15 are provisional.
Source : RBI, SEBI, Merchant Bankers and Financial Institutions

Table 6: Private placements by banks

	2012-13		2013-14		2014-15	
	No.	Rs. Bn.	No.	Rs. Bn.	No.	Rs. Bn.
Public sector banks	12	91	28	415	30	282
Private sector banks	22	171	1	3	17	224
Total	**34**	**262**	**29**	**418**	**47**	**506**
Capital raised in 2012-15						
Public sector banks						788
Private sector banks						398

Note: Data for 2014-15 are provisional.
Source: RBI, SEBI, Merchant Bankers and Financial Institutions, IiAS Research

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