



# Some Select Issues in Financial Markets

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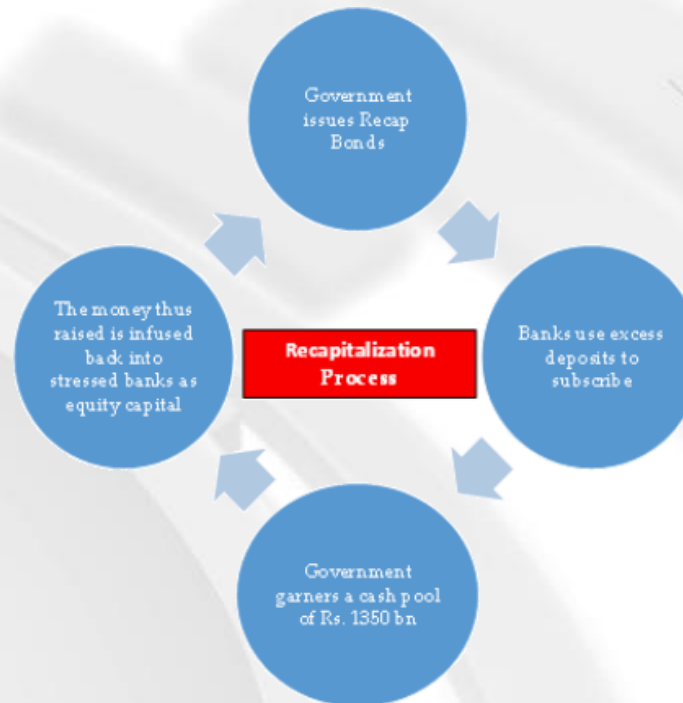


# Recapitalization of PSU Banks

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- A Rs.2.11 trillion bank recapitalization plan for PSUs
- Rs. 1.35 trillion to come from recapitalization bonds, Rs 180 bn from budgetary allocation and 580 bn will be raised by banks from the markets.
- **How will recap bonds work? Likely to happen through financial engineering.**
- It is unclear for now whether these bonds will be tradable or qualify for SLR.
- It is likely that they will involve transfers between the government and banks or between banks - liquidity neutral.

**Intermediate Recapitalization: Banks are essentially giving the promoter (the government) money to buy their own shares**



## Recapitalization to meet capital requirements leaving room for growth

Capital requirements of banks are estimated by different agencies to be between Rs. 1.5 to Rs. 1.8 trillion. This means that the current infusion not only covers the current provisioning requirement but leaves some room aside for growth as well.

Under the BASEL III norms, all banks are expected to meet the minimum required Common Equity Tier I (CET-1) ratio of 8% and capital adequacy ratio of 11.5% by March 2019. Almost half of these banks have their CET Ratio below 8% while the other half have a ratio that is above 8%.

	CET Teir 1 Ratio		CET Teir 1 Ratio
IDBI Bank	5.83	United Bank of India	8.05
Bank of Maharashtra	7.00	Punjab National Bank	8.17
UCO Bank	7.05	Vijaya Bank	8.47
Oriental Bank of Commerce	7.24	Alla habad Bank	8.50
Dena Bank	7.28	Central Bank of India	8.62
Syndicate Bank	7.45	Canara Bank	8.85
Andhra Bank	7.52	Punj and Sind	9.05
Indian Overseas Bank	7.58	Jammu & Kashmir Bank Limited	9.16
Corporation Bank	7.65	Bank of Baroda	9.42
Union Bank of India	7.73	State Bank of India	10.19
Bank of India	7.84	Indian Bank	12.01



## Pros

- Clean balance sheet and revive lending: Banks would be nudged to recognize losses and take haircuts on stressed assets
- Valuation gains for banks which might help when these banks try to raise resources themselves through equity markets



## Cons

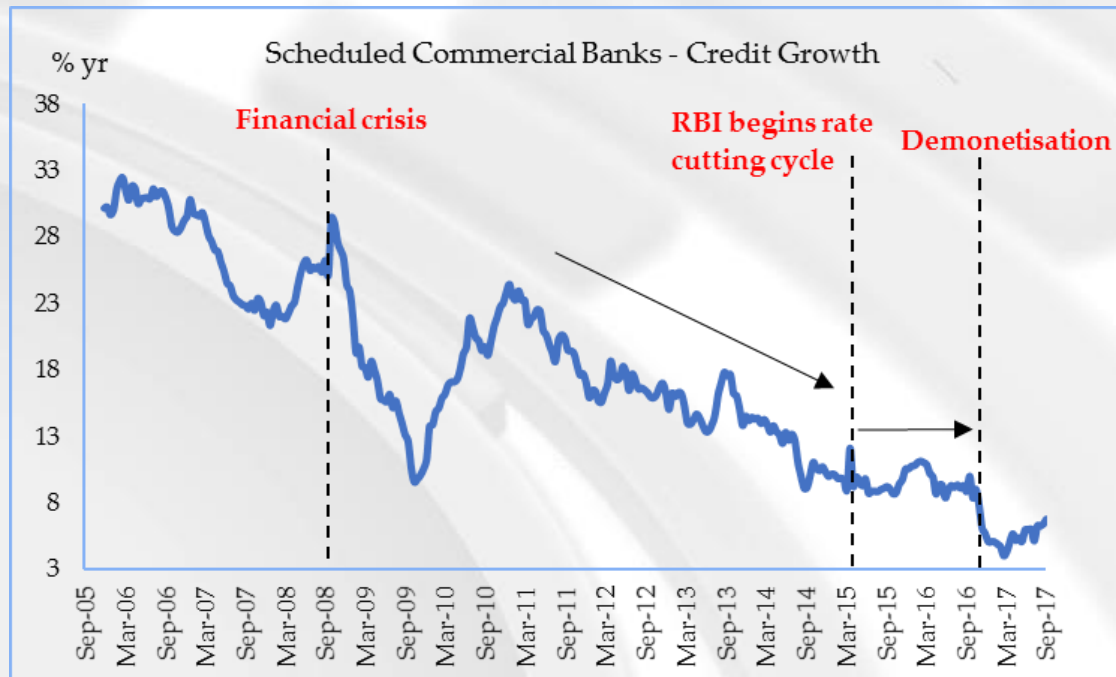
- Pressure on fiscal debt due to recap bonds
- Interest payments on these bonds to raise fiscal deficit over time
- This sort of recapitalization to increase share of gov. holdings in PSUs
- Short term solution as future bad lending behavior of banks not prevented. Need for more structural reforms.



# Credit growth: Issues with demand and supply

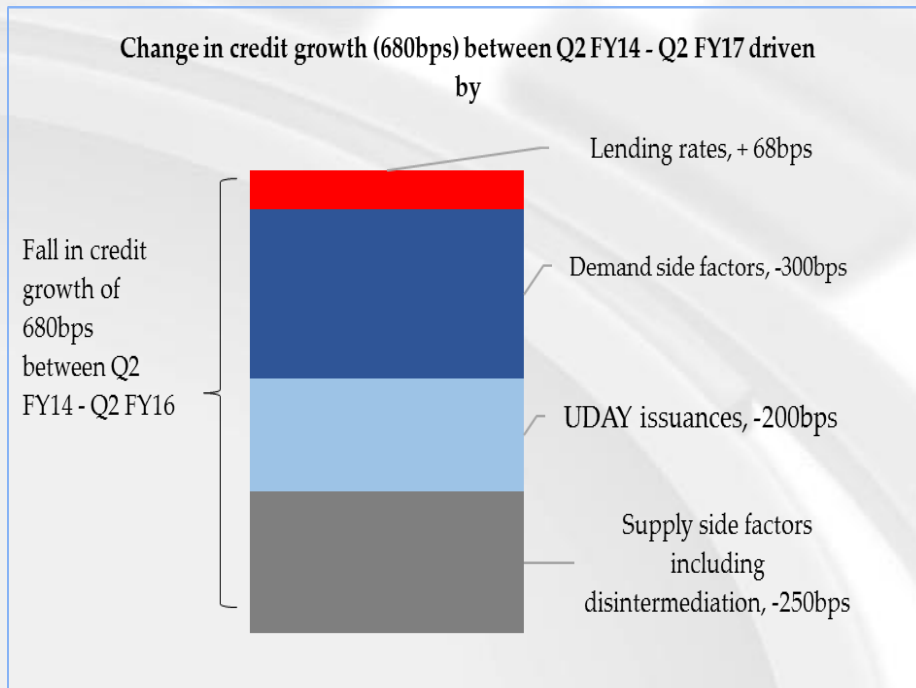
# Credit growth has been falling for last 6 years

- **Credit growth has remained low at 7.7%** (as of October 2017), although picking up slightly from its 60-year lows of sub-5% readings in March 2017.
- During November 2016 and March 2017, credit growth fell by as much as 4 percentage points.
- After the remonetisation process started picking up pace, the improvement in credit growth was limited by the GST effect.
- **Now with the effects of demonetisation and supply disruptions due to GST fading, credit growth has started to pick up, albeit the uptick remains gradual.**
- **The fall in credit growth began before demonetisation: Credit growth has recorded a sustained downward trend for the last six years**



# Segregating demand and supply issues

Correlation with Credit Growth				
Variable	Used as proxy for	Correlation		
		Coefficient	Relation	Lag
Real GDP Non-Agri growth	Sales growth	0.50	Positive	2 quarters
Capacity Utilisation	Room for Fresh Investments	0.65	Positive	4 quarters
Lending rate	Price of credit	0.39	Negative	2 quarters
Corporate bond issuances	Shift to other funding sources	0.66	Negative	1 quarter
Commodity price growth	Reflects input costs and hence need for working capital	0.63	Positive	1quarter



- We segregate the decline in credit growth into supply side, demand side, lending rates and other exogenous factors.
- **Our model suggests that of the 680bps decline in credit growth during this period, conversion of loans to UDAY bonds accounted for a 200bps decline, demand side factors led to 300bps decline and supply side factors including disintermediation were responsible for close to 250bps fall in credit growth.**
- Corporate bonds have become a cheaper alternative for funds. We estimate that the switch to corporate bonds with rising disintermediation has also resulted in a decline in credit growth in FY17. The rise in corporate bonds have in part been driven by issuances by NABARD, NHAI and other public sector financial issuances growing by 20% y-o-y in the past three years.
- On the other hand, the decline in lending rates during this period supported credit growth, pushing it up by 70bps.





# Demonetization and Digitization



## Three key things to know...

Has cash usage declined permanently?

- Conventional definitions could be misleading.

Usage of digital platforms gone up substantially?

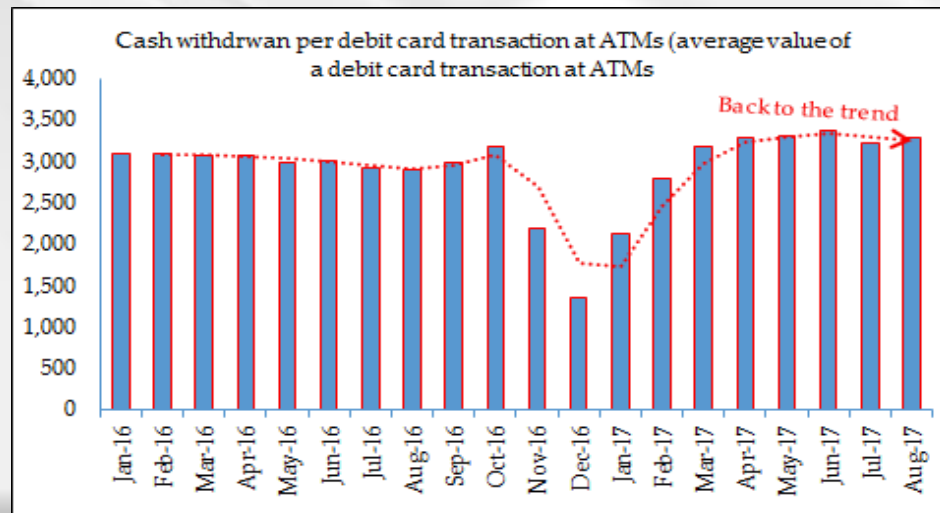
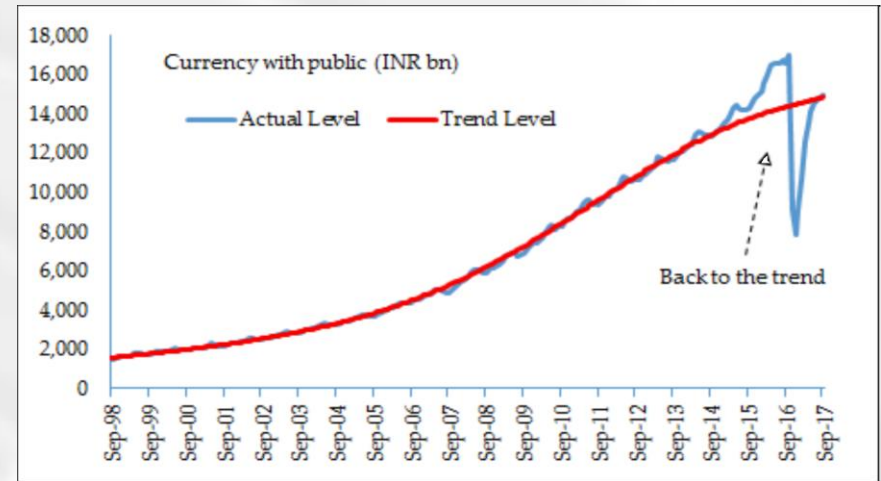
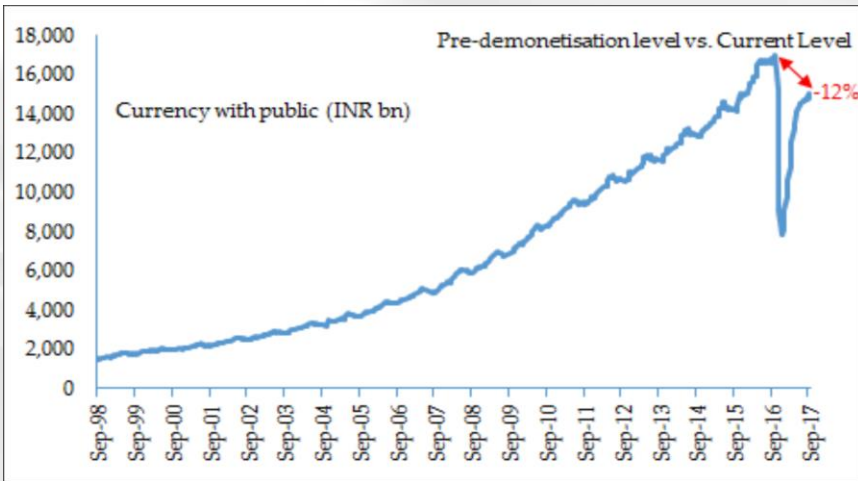
- Some smaller merchants are reverting to cash.

What is the right measure of measuring success?

- Important to focus on B2B Transactions.

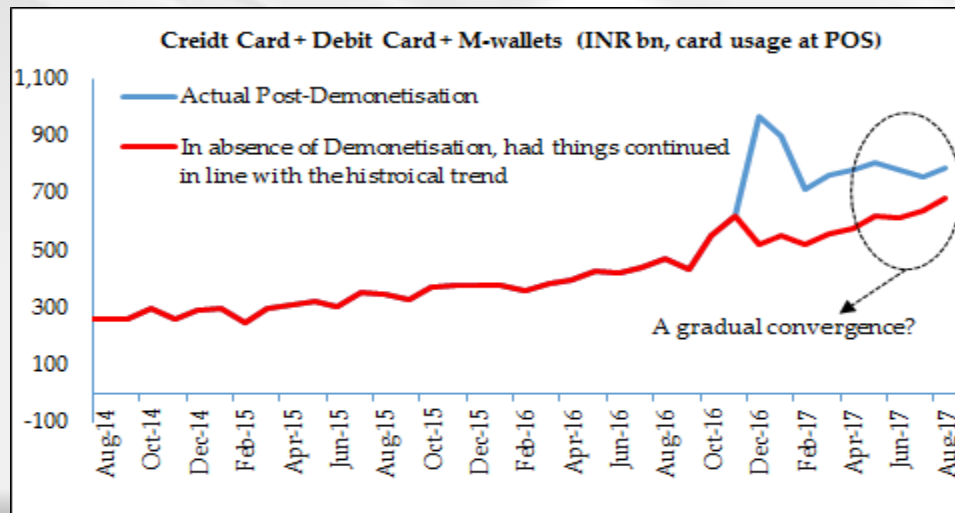
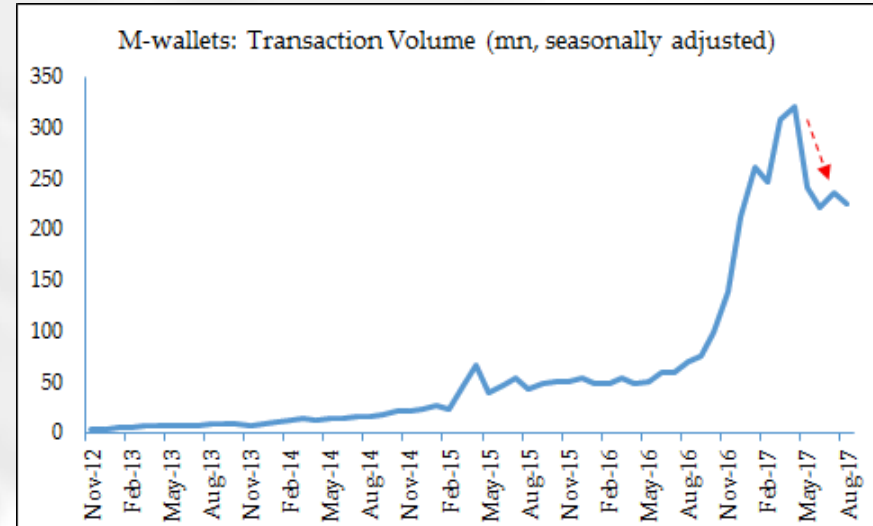
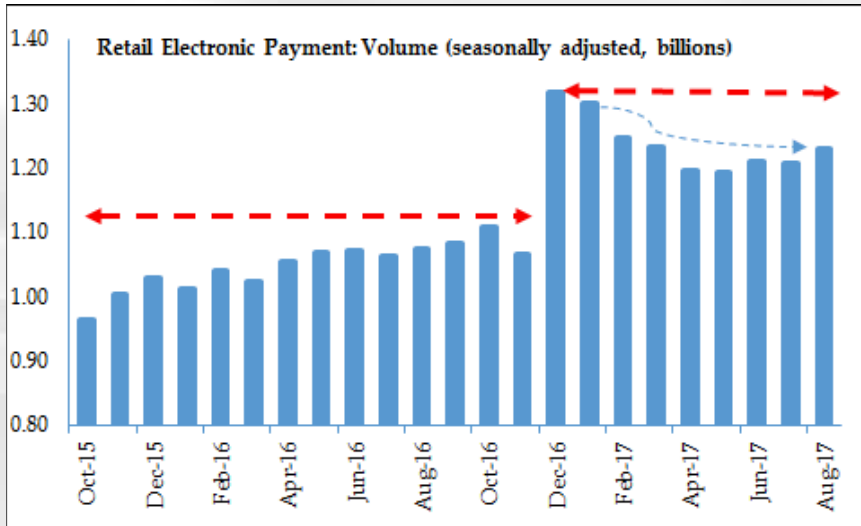
# Has cash usage declined permanently?

A recap of the sudden spike in currency in circulation, which became a big cause of concern in early 2016 is important. Between January and October 2016, currency with public increased at a monthly average rate of 15% YoY compared to average growth of 11% in 2015 and 10% in 2014.



# Has the usage of digital platforms gone up substantially?

With easing of the liquidity crunch, transaction volumes for overall retail electronic payments have seen a marginal dip. For M-wallets too, there has been a gradual tapering after the initial bounce.



# What then is the right measure?

- According to a Ernst and Young report (Accelerating financial inclusion, Jan-2013), there were only 693 machines per million of India's population, compared to 32,995 terminals per million people in Brazil and 4000 terminals per million people in China.
- Thus, before the extensive penetration of digital platforms and change in spending pattern in the country, it is important that digital infrastructure exists in first place. It is in this regard that demonetization has been a success.
- Lastly, distribution and product expansion in the field of B2B Digital transactions is likely to gain more traction than B2C Digital transactions. This is because even as change in basic consumer behavior takes time, the 51 million SMEs in the country (accounting for nearly 40% of GDP) are catching up fast.

