Mains Practice Question

Q. Recently government has decided capital infusion of banks in order to help them move out of RBI’s Prompt Corrective Action Framework. Examine the impact of such a move along with its long term implications for the economy. (250 words)

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Approach

- Give context while explaining PCA and its objective
- Give the need for current capital infusion
- Discuss concerns of such bailout by the government

Answer

- The government has decided to significantly increase its capital infusion in state-owned banks to help some of the banks navigate their way out of the Reserve Bank of India's prompt corrective action (PCA) framework.
- PCA norms allow the RBI to place certain restrictions such as halting branch expansion and stopping dividend payment. It can even cap a bank’s lending limit to one entity or sector.
- Banks need capital for two reasons: one, to support the credit need of the borrowers, and, two, as they need to set aside money to take care of bad assets.

Positive Impact of Capital Infusion

- The capital infusion will boost the banks' Tier 1 capital, which is a capital measure that was introduced in 2014 as a precautionary means to protect the economy from a financial crisis, will be crucial for a way out of PCA.
- It will also provide much-needed growth capital to strengthen banks that will be merged.
- Capital infusion is required as the impact of 17 banks out of 21 public sector lenders being in PCA would be disastrous for lending. Public sector banks are crucial for giving loans to small businesses and their share is large.

Negative Impact

- The capital infusion will widen the fiscal deficit and will bring the financial crunch in capital investments.
- Capital infusion is not going to result in the recovery of bad loans.

- Banks may not take adequate precautions while lending when they know that the government will step in to help if the loans turn sour which is referred to as moral hazard associated with capital infusion.

Conclusion

- Bank recapitalization announcement offers temporary relief to public sector banks, but it is not a long-term solution.If the ailing banking sector needs to be cured the government must address some of the fundamental issues and infuse the right skills and expertise in these banks. In their absence, capital infusion alone is a band-aid solution to the problems.