The Banking Influence on Capital Markets

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The year 2014 saw a resurgence of the stock markets after the Indian voter delivered an unequivocal mandate in favour of the present Government. The primary markets also woke up from a comatose state and corporate India was able to raise nearly ? 400 bn in a short period of time. There was widespread expectation that the injection of much needed capital would result in a multiplier effect on the economy and generate jobs and growth.

After nearly 15 months since then, while the markets have remained at the elevated levels the much needed multiplier effect on investments and jobs is still to run its course. The valuation benchmark for stocks has been rolled over from FY 16 to FY 17 multiples and after 2 quarters of corporate underperformance the gap between expectations and reality is further away today than it was a year back.

All this has happened at a time when the Indian retail investment in equities through the mutual funds is at a record high. What is more confounding is that while availability of foreign and domestic equity capital to industry remains high the net investment in the economy is still lagging.

The primary reason for this is that the other critical element for new project starts viz. debt capital is sorely missing or at the very least is in short supply. The fresh lending by the Indian banking sector is sluggish and this is more so in the case of public sector banks.

The public sector banks in India find themselves in an unenviable situation where the NPA situation has now turned alarming. As per a recent report, a single borrower that has been downgraded to default and that has not been recognized as a bad loan by the banking system constitutes nearly 0.5% of the total banking exposure. With a capital adequacy of ~10.5%, this would mean that it would take just about two dozen companies in a similar state to bring down the system. The banking system is deeply in need of capital and while the private sector banks have been able to raise this capital, through follow on issuances including QIPs, the capital markets have not been so benevolent on the public sector banks. The infusion of capital in these banks by the Government though welcome is woefully inadequate.

This has created a vicious cycle whereby the reluctance of investors to fund banks at valuations that are at a significant discount to their book values and perhaps even adjusted book values has impacted the ability of banks to provide the much needed debt capital for industry. This in turn has resulted in underinvestment in the economy and not provided the necessary vigor to the anticipated growth in the economy. This has also impacted consumer demand which in turn has depressed corporate earnings.

While the Government is taking all efforts to spur investment in the economy through Government spending on projects, it finds itself a bit constrained on this front on account of the need to rein in fiscal deficit and on account of supply bottlenecks in terms of land acquisition, environment clearances etc. The recent allocation of coal blocks in a seamless way through auctions has helped in easing one bottleneck. However the other bottlenecks cannot just be wished away.

Against this backdrop it is imperative that the banking sector quickly finds its feet and gets out of the abyss it finds itself in. But how does one do that?

While the task at hand is formidable, the quickest solution lies in falling back on that one underrated instrument of policy – Interest Rate.

The Reserve Bank has so far and rightly so been following a cautious policy in terms of easing interest rates lest it spur inflation. However the call is now for aggressive action on this front. In the last 9 months or so we have seen a situation of negative WPI inflation and against this the monetary easing has been relatively slow. We need to see a faster drop in interest rates from now on.

The immediate relevance of this to the banking system is that banks would then be able to realize gains on their treasury portfolios which can be used to aggressively recognize and write down bad assets. This would restore confidence amongst investors and enable banks to raise fresh equity from markets. This would set in motion a virtuous cycle of investment, employment and growth. The thaw that has set in, in corporate credit, has to be broken. It is said that stagnant water accumulates moss while a running river is considered clean. The stagnation that we are now witnessing in availability of credit for growth has to be reversed, and reversed soon, before any long term damage is caused. The river of credit has to keep flowing.

The other impact of the drop in interest rates will be that the Indian Rupee which has so far been resilient against the dollar will weaken and this in turn will help exports. While the current account deficit is comfortable at the moment on account of low commodity prices especially crude oil, export growth has been anemic. A lower rupee will help in providing the right impetus to the Make in India program

We are thus at a situation where business confidence is high, equity inflows from the retail segment and from foreigners is high and yet growth is eluding us.

Interest rate cuts seem the best way forward.

Coming back to the capital markets, we are now seeing a potential resurgence in the primary markets after a long hiatus of nearly 7 years. The current pattern of filings show that companies from different and relatively new sectors in the economy are raising capital and this bodes well for investors who so far had to largely contend with more of the same type earlier. Also almost all companies raising money have been through the Private equity test before. These offerings are largely a mix of offers for sale combined with fresh capital raise.

Considering that the companies would have gone through diligence before, the quality of these companies are expected to be better. However since not all the money raised is by the company, the effect on investment and growth would not be directly proportional to the size of the offering. A part of the money would go back to the private equity investors. However over the medium term such exits are helpful in bringing in more capital into the country as they demonstrate successful exits for Private equity funds.

Also some of the companies raising money represent the new age economy. These companies have no baggage of the past and successful deployment of the capital so raised could result in growth and employment taking new shapes and forms. This is because an unprecedented amount of private investment has been made in the Internet and Digital space and if these companies really grow in the manner envisaged, the rules of business could potentially change over the years and rules for raising capital from the public will also need to be relooked at then.

In the interim, the new rules expected for IPOs, which eliminate physical applications and replace them with electronic bids as is the case with current Offers for sale are a step in the right direction and would significantly reduce the cost of raising capital for companies. These need to be introduced at the earliest.

Amidst all this and which is really heartening is that the retail investors have made a comeback into equities which is evident in the mutual fund collections. The returns from real estate have dwindled and gold seems to have lost its sheen. This seems to have caused a shift of savings into equities. The above normal returns by funds on the back of a rising market have also meant that these investments have yielded good returns to the retail investors and their confidence in the funds has been reaffirmed. For the first time we have seen that mutual fund and insurance companies are leading investments in IPOs and QIPs as against FIIs.

The basic elements for a long and sustained rally in equity markets, both primary and secondary, are all in place. The only joker in the pack that could disrupt this is the rising legacy of Non Performing Assets of the Banks. This issue has to be addressed swiftly and firmly literally taking the bull by the horns. That will enable the bulls in the markets to smile for a long time to come.