Migration to Basel III: A scalable peak for Indian Banks

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The Basel Committee on Banking Supervision has come out with the third of the Basel accords, Basel III, in 2010-11, as a response to the deficiencies in financial regulation exposed by the global financial crisis of the late 2000s. Basel III sets standards for bank capital adequacy, stress testing, and market liquidity risk.

In India, the guidelines, prescribed by the Reserve Bank of India (RBI) for implementation between 2013 and 2018, are more stringent than the one proposed by the Basel Committee on Banking Supervision. The requirement of common equity capital is higher, the leverage ratios are stricter, and the period for implementation shorter, in RBI's guidelines.

India's banks have maintained their equity and overall capital adequacy ratios well in excess of the minimum levels prescribed by the regulator. The leverage ratios are currently adequate, and are expected to be in line with the prescribed regulatory requirements. CRISIL, therefore, believes that India's banks will be ready to migrate to the new guidelines by January 2013. However, the banks may face challenges in raising additional capital to maintain growth on an ongoing basis through the implementation period.

The following sections of this article highlight the five key measures of the Basel III guidelines prescribed by RBI and the impact in terms of compliance requirement.

Measure 1: Quality of capital to enhance significantly

The capital adequacy ratio (CAR) has been increased to 11.5 per cent of risk-weighted assets from 9 per cent. Table 1 indicates the minimum requirements for each component of capital, and the timelines for transition to the new standards.

Table 1: Minimum requirements in capital

[In per cent]	Basel II	Basel III	Basel II India	Basel III India	Timeline for Basel III India
Equity capital					
A) Minimum equity capital	2.0	4.5	3.6	5.5	January 1, 2013 to March 31, 2015
B) Capital conservation buffer	-	2.5	-	2.5	March 31, 2015 to March 31, 2018
C) Total Equity Capital (A + B)	**2.0**	**7.0**	**3.6**	**8.0**	January 1, 2013 to March 31, 2018
D) Non-equity Tier-I capital	2.0	1.5	2.4	1.5	
E) Tier-I capital (C+D)	**4.0**	**8.5**	**6.0**	**9.5**	January 1, 2013 to March 31, 2018
F) Tier-II Capital	4.0	2.0	3.0	2.0	
G) Total Capital (E + F)	**8.0**	**10.5**	**9.0**	**11.5**	January 1, 2013 to March 31, 2018

Implementation of Basel III guidelines will enhance the proportion of equity capital—which has the highest loss absorption capacity—to 8.0 per cent from 3.6 per cent required earlier. The capital conservation buffer of 2.5 per cent in excess of the minimum equity capital will help absorb potential losses in financial exigencies. If a bank's equity capital ratio dips below 8.0 per cent, or below the stipulated minimum during the implementation phase, the bank may face regulatory constraints in distributing earnings (as in paying dividend, for instance).

RBI can also prescribe an additional capital requirement of up to 2.5 per cent as a counter-cyclical buffer, which may increase the total capital requirement to 13 per cent. The objective of this buffer, set aside during times of excessive credit growth, is to create a cushion for periods of stress. The buffer will be created in the form of either equity capital or non-equity Tier-I capital instruments with loss-absorption capacity.

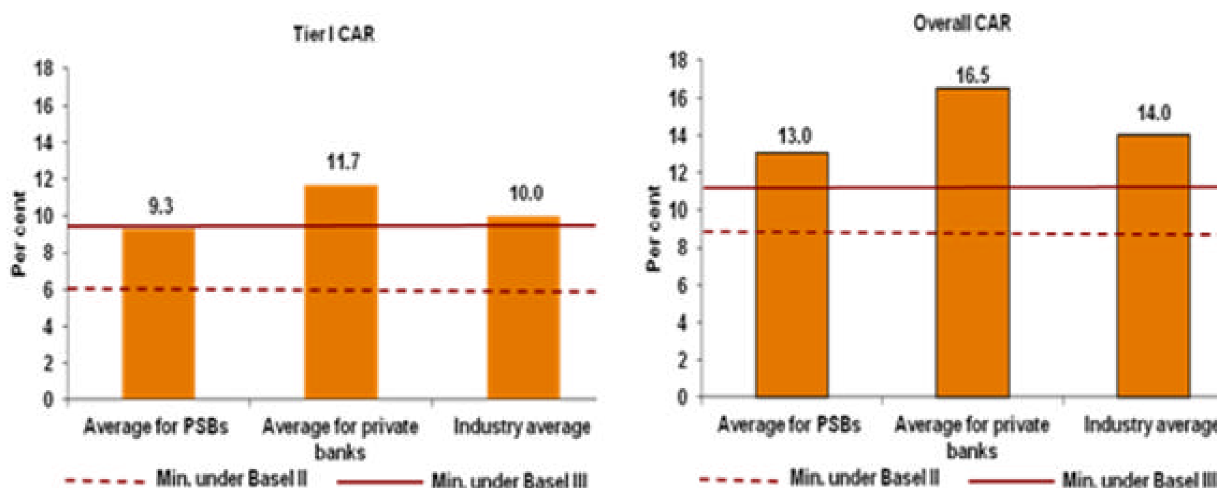
Impact: Indian banks comfortably placed to migrate to Basel III; capital requirement for growth to remain high

- India's banks have largely maintained a higher equity capital ratio than the guidelines stipulate. The industry's Tier-I capital ratio and overall CAR are comfortable—estimated at around 10.0 per cent and 14.0 per cent, respectively, as on March 31, 2012.
- CRISIL believes that Indian banks are well placed to migrate to the Basel III requirement by January 2013, and to comply with the minimum equity capital requirement of 5.5 per cent, as all banks currently have a common equity capital ratio which is above this requirement. However, the minimum common equity requirement will

increase significantly—to 8.0 per cent by March 2018—resulting in banks having to raise substantial capital to meet this requirement.

- CRISIL reckons that banks will need to raise equity capital of Rs.1.4 trillion till March 2018 to meet growth requirements, while they comply with equity capital requirements. The requirement may increase by another Rs.1.3 trillion if investor appetite for non-equity Tier-I capital instruments is low. Public sector banks, given their relatively lower capital ratios and moderate internal accruals, will account for the bulk of this requirement and will, therefore, need regular infusions from the GoI to meet the equity capital requirement.

Chart 1: Comparison of Basel II, Basel III and estimated position as on March 31, 2012



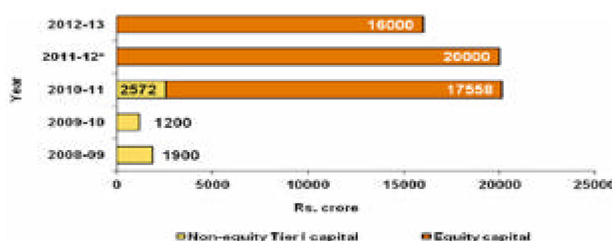
<u>Measure 2:</u> Non-equity Tier-I capital instruments to carry higher loss absorption capability

RBI's Basel III guidelines prescribe that fresh non-equity Tier-I capital instruments carry a write-off clause to qualify as capital. This clause will enhance the instruments' loss absorption capacity. The clause will be triggered by events such as infusion of public funds, or the banks' inability to remain viable unless the instrument is written-off, upon which such instruments will either be written-off or converted into equity capital. The existing non-equity Tier-I capital instruments in the banks' balance sheet without the 'write-off' clause will need to be phased out over the decade beginning January 1, 2013.

<u>Impact:</u> Lower investor appetite may lead to higher need for equity capital

- The banks' non-equity Tier-I capital instruments, such as perpetual non-cumulative preference shares (PNCPS) and innovative perpetual debt instruments (IPDI) currently do not have write-off clauses. These instruments will, therefore, not qualify as capital under the new guidelines. The banks will need to phase out these securities over the decade beginning January 1, 2013, and replace them with eligible securities. Introduction of this clause may also lead to reduced investor appetite, and increased costs of raising new forms of non-equity Tier-I capital instruments.
- The requirement for an increased proportion of equity capital, and the introduction of the write-off clause for non-equity Tier-I capital instruments, is driving incremental capital infusions in PSBs, mainly as equity capital by GoI. Alternatively, the terms and conditions of instruments such as PNCPS and IPDI must be modified to introduce the write-off clause, or they must be converted to equity. Accordingly, the capital infusions by GoI in PSBs since 2009-10 have been primarily in the form of equity, unlike in previous years, when capital infused was as non-equity Tier-I capital.

Chart 2: Trend in GoI capital infusion in PSBs



<u>Measure 3:</u> Tighter deduction norms to reflect true capital

RBI's Basel III guidelines recommend that deductions from capital be made from equity capital, so that the availability of true capital may be determined in calculating risk-based measures. This is unlike the previous guidelines that permitted deduction of 50 per cent each from Tier-I and -II capital for most deductibles (except intangibles and deferred tax assets, which are deducted from Tier-I capital).

The guidelines prescribe that any shortfall in the defined benefit pension fund be fully deducted from equity capital. Furthermore, under Basel III, all unamortised pension liabilities (including the second pension option and enhanced gratuity liabilities) are to be recognised on the balance sheet. Accordingly, from January 1, 2013, banks must deduct the entire amount of unamortised expenditure from equity capital.

The guidelines limit banks' investments, in the equity share capital of unconsolidated financial subsidiaries/associates, to 10 per cent of the paid-up capital and reserves. Investments in excess of 10 per cent will be deducted from the equity capital of the investing bank.

<u>Impact:</u> in Could result in decline banks' equity capital ratios

- While deduction of unamortised second pension option and enhanced gratuity libialities from capital will result in a 40-to-50-basis-point reduction in equity capital ratio, the limit on investment in unconsolidated subsidiaries is unlikely to have a significant impact.

<u>Measure 4:</u> Introduction of leverage ratio to contain build-up of excess leverage

$$\frac{\text{Tier-I capital}}{\text{Bank's on-balance sheet and off-balance sheet exposures}}$$

The highly leveraged balance sheets of international banks were the main causes of the global economic crisis of 2008. The leverage ratio, therefore, seeks to contain the banks' off-balance sheet and on-balance sheet leverage, and to complement their risk-based capital measures.

The simple, non-risk-based measure for leverage is aimed at containing build-up of excessive leverage. Banks will need to maintain minimum levels of leverage ratio (likely to be 4.5 per cent), after the supervisory monitoring period which commenced on January 1, 2011. Off-balance sheet items shall be included with appropriate credit conversion factors. After a supervisory monitoring period, a parallel run will be conducted between January 1, 2013 and January 1, 2017. The leverage ratio will be finalised based on the results of the parallel run, and shall be effective January 1, 2018.

<u>Impact:</u> Indian banks unlikely to face problems in adhering to leverage ratio

- Given the Indian banks' limited range of derivative products and international exposure, their current off-balance sheet exposures are generally small. A few Indian private sector and foreign banks, however, do have sizeable off-balance sheet exposures (including derivatives and securitisation). CRISIL believes that these banks will, nevertheless, meet the minimum leverage ratio requirements given their current large capital bases and the long implementation period.

<u>Measure 5:</u> Introduction of liquidity and funding ratios to ensure banks maintain adequate liquidity

The RBI guidelines on liquidity risk management prescribing the liquidity and funding ratios are currently in the draft stage and based on the Basel III recommendations.

Liquidity coverage ratio (LCR):

$$\frac{\text{Stock of high quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100$$

Maintenance of a minimum LCR will ensure that banks maintain sufficient high-quality liquid resources to survive stress scenarios lasting a month. Banks must maintain adequate unencumbered, high-quality, assets that can be used to meet liquidity needs over a 30-day horizon, under an acute stressed-liquidity scenario. The liquid assets include cash, including reserves in excess of CRR requirements, government securities in excess of SLR requirements, SLR securities as allowed by RBI, marketable securities of foreign sovereigns, and corporate bonds and certain securities issued by public sector entities or multilateral development banks with some 'haircut'. While the LCR is currently subject to an observation period, banks will have to submit an LCR statement to RBI from June 2012, though the guidelines will be effective from January 1, 2015.

Net stable funding ratio (NSFR):

$$\frac{\text{Available amount of stable funding (ASF)}}{\text{Required amount of stable funding (RSF)}} \geq 100$$

This measure complements LCR, and establishes a minimum acceptable amount of stable funding over a one-year horizon. The ASF for banks includes capital, liabilities with effective maturity of more than a year, and the portion of stable term deposits (with maturities of less than a year) and demand deposits that is expected to remain with the bank during periods of financial stress. The ASF should be adequate to cover the RSF, which include the bank's assets and off-balance sheet activities that are less liquid, over a one-year time horizon. An RSF factor is applied to each asset to arrive at the RSF; assets that are more liquid and readily available to act as sources of liquidity in an extended stress environment receive a lower RSF factor than assets that are less liquid. The NSFR is currently subject to an observation period, banks will need to submit an NSFR statement to RBI from June 2012, while the guidelines will be effective January 1, 2018.

Impact: Banks well placed to comply with the new liquidity and funding ratio requirements, if the same are implemented in the current form

- The current RBI provisions allow cumulative mismatches of up to 5 per cent, 10 per cent, 15 per cent, and20 per cent of the cumulative outflows in the first four maturity buckets—next day, 2 to 7 days, 8 to 14 days, and 15 to 28 days, respectively. The LCR provision effectively means that banks cannot have negative mismatches in short-term maturity buckets, and must maintain higher liquidity. Analyses of maturities of select assets and liabilities of banks in the past three years indicate that cumulative mismatches up to 28 days have been well within the current RBI guidelines. CRISIL, therefore, believes that India's banks are comfortably placed to comply with the new LCR requirements.
- LCR, together with NSFR, will, however, force banks to focus on long-term stable funding sources such as retail deposits, stable savings accounts, as opposed to short-term bulk deposits and certificates of deposits (CDs). On an overall basis, these provisions will strengthen the banks' liquidity. However, they may reduce interest spreads to some extent.

In conclusion, migration to Basel III will strengthen banks as the guidelines aim to significantly enhance the quality of banks' capital by augmenting the equity capital (equity and reserves) requirement, and increase the loss-absorption capacity of non-equity Tier-I instruments. Introduction of the 'write-off' clause in non-equity Tier-I instruments may increase their pricing, and adversely impact investor preference for such instruments over the long term. Fresh capital infusion by the Government of India (GoI) in public sector banks (PSBs) is, therefore, expected to be primarily in the form of equity capital, rather than non-equity Tier-I instruments.

The guidelines for liquidity risk management1 will require banks to maintain greater liquidity, and improve their ability to withstand liquidity stress. CRISIL believes that Indian banks will adapt to the new liquidity requirements fairly well, given that the banks maintain an aggregate cash reserve ratio (CRR) and statutory liquidity ratio (SLR) level of around 30 per cent of their deposit base. The banks have also maintained limited funding mismatches in shorter-term maturity buckets. CRISIL believes that India's banks are better placed than their counterparts in the West, to meet guidelines stipulating a stable funding mix; this is because India's banks have higher current and savings account and retail term deposits. Nevertheless, stringent funding and liquidity requirements, and increased costs of raising capital may constrain banks' profitability.

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[1] *While the draft guidelines on liquidity risk management have been issued, the final guidelines are still awaited.*