Basel III for Indian Banks: The Capital Conundrum

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Executive Summary

CRISIL recently rated India's first Basel-III compliant Tier-II bond issue of Rs.5 billion by an Indian bank. CRISIL has also released its rating criteria on banks' Basel-III capital instruments. These set in motion the expected capital raising of around Rs.4.7 trillion under Basel III by Indian banks over the next five years, and is a critical step towards tapping bond markets for banks' capital requirements.

The Reserve Bank of India (RBI) has implemented Basel-III capital regulations for India's banks with effect from April 1, 2013. CRISIL believes that the guidelines will structurally strengthen India's banking sector by enhancing both the quantity and quality of banks' capital. Moreover, with the introduction of a capital conservation buffer, banks will be better positioned to absorb potential losses during financial exigencies.

CRISIL estimates that India's banks will need to raise around Rs.2.7 trillion and Rs.2 trillion as Tier-I and -II capital, respectively, by March 2018 to comply with the Basel-III norms. The main challenge for banks will be in raising the non-equity Tier I capital given that they now carry higher risk attributes; this means that ratings on these instruments will be a few notches lower than under Basel II. This will also mean that the market appetite for the instruments will be limited. It is, therefore, critical that the bond markets be developed for Basel-III-compliant non-equity Tier I capital instruments, and that India's banks adopt strong measures to conserve capital and improve accruals. Tier-II capital, however, should not be a challenge for India's banks to raise. The ratings on Tier-II capital instruments will be the same, or close to the Basel-II lower Tier-II ratings, given that the rating adequately factors in the risks inherent in these instruments.

CRISIL believes that the six-year period till March 2018 that RBI has provided for banks to migrate fully to Basel-III regulations is sufficient for them to raise the required capital. The challenges in raising non-equity Tier-I capital, notwithstanding, Basel III will structurally strengthen the banking sector. In addition, RBI's strong regulatory supervision will ensure that the banks are cushioned against potential shocks, and that systemic risks are reduced.

Basel III: The challenges for Indian banks

The phased transition to Basel-III (*refer to Table 1*) capital regulations reduces the challenges that India's banks will face during the migration. Between April 2013 and March 2018, India's banks will need to raise Rs.2.7 trillion as Tier-I capital—of which around Rs.1.3 trillion will need to be equity capital, while the remainder may be raised as non-equity capital (*refer to Table 2*).

Table 1: The phased transition to Basel-III capital regulations

(As a % of RWA)	1-Apr-2013	31-Mar-2014	31-Mar-2015	31-Mar-2016	31-Mar-2017	31-Mar-2018
Common Equity Tier 1(CET1) [A]	4.50%	5%	5.50%	5.50%	5.50%	5.50%
Min Capital conservation buffer (CCB) [B]	-	-	0.625%	1.25%	1.88%	2.50%
Min CET 1 + CCB [A+B]	**4.50%**	**5.0%**	**6.125%**	**6.75%**	**7.375%**	**8.0%**
Non-equity Tier I [C]	1.50%	1.50%	1.50%	1.50%	1.50%	1.50%
Min Tier 1 [A+C = D]	**6.0%**	**6.5%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**
Max Tier 2 [E]	**3%**	**2.50%**	**2%**	**2%**	**2%**	**2%**
Min Total Capital [D+E = F]	**9%**	**9%**	**9%**	**9%**	**9%**	**9%**
Min Total Capital + CCB [F+B]	**9%**	**9%**	**9.625%**	**10.25%**	**10.875%**	**11.50%**

- *Table 2: The equity and non-equity component in the capital requirement*

Tier I capital requirement (Rs. trillion)	Total equity capital	Non-equity Tier I
Public sector banks	0.9	1.2
Private sector banks	0.4	0.2
Total	**1.3**	**1.4**
** Over 5 years upto March 2018; net of internal accruals and adjusted for phase-out of existing instruments under Basel II*		
Key assumptions	**Total equity capital ratio as on March 2018**	**Non-equity Tier I as on March 2018**
Public sector banks	8.00%	1.50%
Private sector banks	10.00%	0.50%

Given the capital support that the Government of India continues to extend to the public sector banks, and the proven capital-raising ability of private sector banks, raising Rs.1.3 trillion as equity capital by March 2018 should not pose challenges for these banks.

The key challenge, however, will be for banks to raise Rs.1.4 trillion as non-equity Tier-I capital over the next five years.

Raising the non-equity Tier-I component

The Basel III guidelines stipulate that non-equity Tier-I capital instruments have the following equity-like features:

- Availability of full discretion on coupon payment at all points of time,
- High capital threshold for potential coupon non-payment, and,
- Introduction of principal loss at a pre-specified trigger.

The stipulations for full coupon discretion and principal loss absorption were not part of the Basel-II norms for non-equity Tier-I capital. CRISIL believes that their inclusion in Basel III will significantly increase the instruments' risk attributes, and reduce their acceptability among investors.

Although the availability of full coupon discretion to banks represents potential risks for investors, the banks are unlikely to exercise this discretion in the normal course of business. However, if the total equity capital of a bank falls below the threshold set by the regulator, the likelihood of coupon non-payment will increase.

The guidelines also mandate that banks conserve capital by not distributing the distributable surplus entirely. The restriction becomes applicable to a bank if its total equity capital ratio slips below 8 per cent. A higher proportion of distributable surplus will need to be conserved if the equity capital declines further to lower levels (*refer to Table 3*). Payment of coupons on non-equity Tier-I instruments is through distributable surplus from earnings; it is, therefore, likely that these coupons will not be paid in full if the equity capital level reduces to less than 8 per cent. Given that the average equity capital level for the banking system was around 9 per cent as on March 31, 2013, the difference with the regulator-specified minimum capital level is low. This substantially increases the risk of non-payment of coupon on these instruments in a stress scenario.

Table 3: Capital conservation ratio as a proportion of earnings

Total Equity Capital ratio	Minimum capital conservation ratios (as a per cent of distributable surlus)
5.5 per cent - 6.125 per cent	100 per cent
> 6.125 per cent - 6.75 per cent	80 per cent
>6.75 per cent - 7.375 per cent	60 per cent
>7.375 per cent - 8.0 per cent	40 per cent
>8.0 per cent	0 per cent

For non-equity capital instruments issued by India's banks, it is for the first time that a principal loss absorption feature has been introduced. The main objective of the feature is to ensure that non-equity Tier-I instruments are available to banks in stress situations to absorb losses. As per the guidelines, if the bank's equity capital breaches the pre-specified trigger of 6.125 per cent, the principal component of the non-equity Tier-I capital will be either written down or converted into equity. Loss of principal, due to write-down or conversion of instruments into equity on breach of the trigger, can lead to significant losses to investors.

Factoring the increase in risk attributes of Tier-I instruments under Basel III, CRISIL's rating on these instruments could be a few notches lower than under Basel II.

Investor appetite expected to be limited

Investor appetite for non-equity Tier-I capital instruments may be limited, given the significant increase in risk attributes on these instruments, and the lower ratings. Moreover, the pricing differential between Tier-I and -II instruments under Basel III will be high at between 100 and 150 basis points, and may reduce the attractiveness for issuer banks. This could result in a major deficit in the minimum non-equity Tier I capital requirement of Indian banks' and might have to be met through equity capital raising resulting in a huge challenge for banks. Nevertheless, raising capital through non-equity Tier-I capital instruments may continue to be cheaper than raising equity capital.

Enablers for banks to meet the Tier-I capital requirement

Development of bond markets

To help banks tide over the challenges in raising capital, it is imperative that the corporate bond markets be developed. The range and depth of investors in such instruments may be expanded through a structured bond market development plan. This could include:

- Realignment of investment policies of long-term investors, to make them eligible for investing.
- Innovative solutions by the government, such as introduction of a holding company concept for public sector banks. The holding company can look at investing in these capital instruments and build market confidence in them.
- Exploring the overseas investor market to raise non-equity Tier-I capital.

Focus on capital conservation and improving accruals

Government and regulator interventions alone will not suffice to help banks raise capital, unless the banks themselves adopt measures, such as the following:

- Capital conservation through offloading of large exposures, where the risk-weighted capital allocation is high. For instance, public sector banks have large infrastructure exposures that may be refinanced by infrastructure debt funds (IDF) or entities such as India Infrastructure Finance Company Ltd.
- Focus on improving profitability and internal accruals—this is important for public sector banks given their modest internal accruals and large exposures to assets with sizeable risk-weighted capital allocations. Even an improvement by 10 basis points in return on average assets will reduce the capital requirement by around Rs.80 billion annually for the banking sector.

Raising the Tier-II component

CRISIL estimates that India's banks will need to raise around Rs.2.0 trillion by March 2018 as the Tier-II component in the capital requirements under Basel III. However, this will not be a challenge for India's banks.

The RBI guidelines on Basel III do not restrict banks from servicing the coupon or dividend on Tier-II instruments. However, they require banks to write off or convert Tier-II instruments into equity upon occurrence of the trigger, called the Point of Non-Viability (PONV).

The PONV trigger for loss of principal on Tier-II instruments is a new feature introduced through Basel-III guidelines. CRISIL, however, believes that the PONV trigger is a remote possibility in the Indian context. The robust regulatory and supervisory framework and systemic importance of the banking sector will ensure adequate and timely intervention by RBI to avoid a bank becoming non-viable. Due to the strong supervision by RBI none of the scheduled commercial banks have gone into liquidation in India. The inherent risk associated with the PONV feature is adequately factored into the rating of banks. The rating on Basel-III compliant Tier-II capital instruments may, therefore, be the same, or close to the rating of lower Tier-II instruments under Basel II.