# Basel-III in Indian Banks and Capital Concerns

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**Abstract**

India's banking sector is now a days in a need to raise money in capital markets or some capital inflows through government due to the asset quality concerns and capital problems faced by them. Basel III capital ratios in April 2013 and 2014 showed that there will be a need of funds from either government or capital markets that will be required by banks to meet their liquidity requirements. Again, due to the increasing non-performing loans( NPLs) , Indian banks are in a need of a large amount of capital for maintaining the growth rate of economy and also for generating profits that are now a days insufficient for internal capital generation to fund loan growth. Average gross NPL ratio of public sector banks increased to 4.3% (of total loans), an increase of 3.4% from December 2013 to March 2013. At the end of December gross non-performing assets (NPAs) of Indian banks increased to Rs. 2.4 trillion, an increase of about 36% from last year. But if look from the other point of view, not only for investments, Indian banks need the funds for various other reasons too. One among them is to combat asset concerns. The purpose of this paper is to discuss all these issues in detail.

**Keywords**

Indian Banking Sector, Capital Concerns, BASEL-III Norms, Asset Quality Concerns, Non Performing Loans.

## Introduction

Oil and petrol price are decreasing; Most of the company's Q1 profits are blasting beyond the reach; People are enjoying the economic condition, but what about the investments? Have they increased? Is it a right time for making the investments? If so where is the fund available?

On 26th May, India faced a tremendous change by the formation of new government. That is the time when things started changing in Indian economy. This incident almost smashed every nook and corner in India. As a result of the economic boom, the above stated things became favorable for everyone. Now the biggest trouble is the investments. The reason is that, finding the source for the fund is becoming more tedious.

Are the banks in India having the sufficient cash for funding these investments?

Global rating agency Moody's Investors Services warned that Indian banks will require more capital than what the government has allocated interim budget, especially in the context of higher capital requirements under the Basel III norms and increasing bad loans that would require banks to set aside more money to cover such loans. India's government unveiled its interim budget for the fiscal year starting in April, allocating Rs.11,200 crore ($1.8 billion) for capital injections into public sector banks. The allocation is credit negative for public sector banks because it is much smaller than the Rs.25,000-36,000 crore ($4.1-$5.8 billion), estimated that the banks needed to meet a minimum tier 1 ratio of 8% in the fiscal year ending March 2015. Without sufficient government capital infusions, public sector banks will be challenged to maintain minimum tier 1 ratios of 8%.

A huge amount of capital is required to combat the sharp rise in bad loans of Indian banks. According to the current norms banks need to maintain capital to cover these bad loans for maintaining their profitability. As per the estimates, banks have to make provisions for at least 70% coverage ratio to maintain asset quality. The bad loans are expected to rise at Indian banks in fiscal year ending 2015.

Due to the increasing non-performing loans( NPLs) , Indian public sector banks are in a need of a large amount of capital for maintaining the growth rate of economy and also for generating profits that are now a days insufficient for internal capital generation to fund loan growth. Average gross NPL ratio of public sector banks increased to 4.3% (of total loans), an increase of 3.4% from December 2013 to March 2013. At the end of December gross non-performing assets (NPAs) of Indian banks increased to Rs. 2.4 trillion, an increase of about 36% from last year. But if look from the other point of view, not only for investments, Indian banks need the funds for various other reasons too. One among them is to combat asset concerns.

**Combat Asset and Capital Concerns**

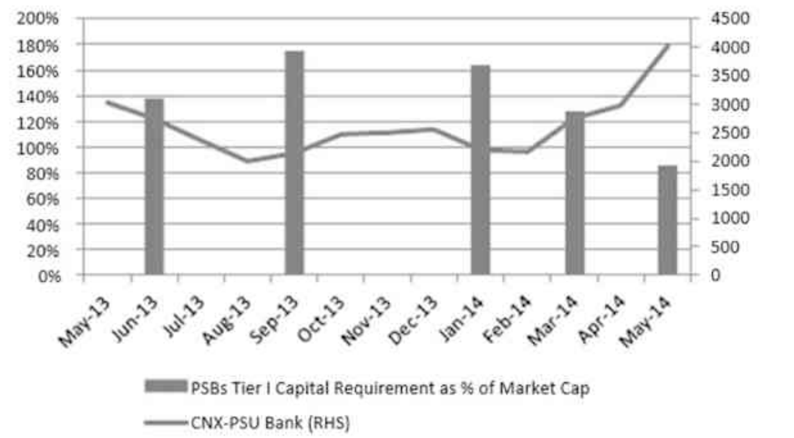
India's banking sector is now a days in a need to raise money in capital markets or some capital inflows through government due to the asset quality concerns and capital problems faced by them. As it will take economy and domestic industry to recover slowly and the financial leverage to decline among corporates, this weakness in bank's asset quality is expected to remain for next 12 months.

Moody's investors have also given a negative outlook for the Indian economy, increasing inflation levels and the increasing asset quality concerns faced by the public sector banks.

The same was also reported by Fitch Ratings in its last report published in December 2013. The pressure on standalone credit worthiness of the government banks is continue to exist, and therefore the viability ratings are also under pressure.

Basel III capital ratios in April 2013 showed that there will be a need of funds from either government or capital markets that will be required by banks to meet their liquidity requirements. The full effect impact of the past [economic] slowdown still has to take place. We also need to see how the government can fulfill capital requirements. The credit rating agencies are unlikely to change the Indian bank ratings despite of a partial slowdown in the near future. The subordinated and junior subordinated ratings of 11 banks was decreased by one or two notches to 'Ba2' or 'Ba3' by Moody's in September 2013.

Chart 1: Movement in CNX-PSU Bank Index and PSBs' Tier I Capital Requirement




*Source: Bloomberg, NSE, ICRA Research*

Further reductions could take place in the medium term, depending on the outlook for the country as a whole. Apart from the policies adopted by the new government, agencies predicted that there were various other macroeconomic factors that could affect the country's sovereign and banking industry ratings.

As for the banking industry ratings, stresses are from sovereign ratings – given that rating agencies do not rate banks higher than the country's sovereign rating, asset quality and capitalization. This is a continuing challenge and implies a bank-specific evaluation.

The analysts agree, however, that the likelihood of major policy changes being implemented within the next year is uncertain at best.

This leads us with the doubt that whether the Basel 3 norms has any impact for the capital concerns for the banking sector.

**Basel 3 Implementation and Effects on the Capital**

Due to the stringent RBI guidelines about Basel 3, Indian banks have to plan their capital requirements in advance. If government carries out its responsibilities towards public sector banks properly then they will be able to meet their high capital requirements and will also be able to strengthen their competitive position among international banks.

The Bank for International Settlements (BIS) has set the deadline for full implementation as 2019 whereas RBI has more demanding schedule which is 2017.

According to RBI, the total regulatory requirement of total capital (tier 1 and tier 2) is 9% higher than BIS norm of 8%. There are two important changes that happened under Basel 3 :

- There is high quality of 9% capital required. Presently, bank capital is equally split between tier 1 and tier 2 but under Basel 3, tier 1 capital will constitute 7% out of total 9%.
- Second is that the banks will now need to maintain a capital conservation buffer which will comprise common equity of 2.5% which leads to total capital requirement of 11.5%. Also, between 2013 and 2017, banks will be expected to operate at a minimum tier 1 leverage ratio of 5

To maintain total capital requirement of 11.5% , banks have to operate with capital in the range of 15-17% instead of 13% under Basel 1. This leads to capital concerns in banks. Whether Indian banks will be able to achieve these targets? There are few reasons which drive a sign of optimism.

- First is that the investor confidence is increasing due to the returns provided by Indian banking stocks.
- Second, by investing money in banks, investors are looking forward for an economic growth rate of 8-9% and increase in credit growth of 20%.
- Third, Indian banking is able to overcome the subprime crisis which is reflected in the return on asset ratios of Indian banks which is highest in the world today i.e., above 1% every year since crisis.

There are two main concerns imposed by western bankers about the high capital requirements by Basel 3:

- One, it will lead to a decrease in bank's profitability.
- Two, due to passing of higher cost of capital to borrowers, there will be a decrease in economic growth rate.

Till now there had been only a small effect on bank's net interest income due to high capital and in the coming years also it is expected to be small due to the presence of numerous high yielding products with banks like SMEs, vehicle loans, personal loans, credit cards, etc.

The increasing return on assets due to increasing fee income will continue to make Indian banks attractive to investors in India and abroad. For example, HDFC Bank with huge surpluses requires less amount of capital.

There can be constraints from the following two factors:

- First, is the low price of stocks in the Indian market: banks may not find it attractive to issue capital at current price. A possible answer is to raise small sums through rights issues in such periods and approach the broader market when things look up.
- Second, a major constraint is the government's shareholding in PSBs.

Government may not be willing to reduce its shareholding below 51%.

Basel 3 will impact Indian and western banks differently. In India, banks are raising capital to finance their growth whereas western banks are raising capital by shrinking their balance sheets.

Basel 3 will be able to overcome the fear of increased competitive advantage by international banks by using some advanced risk management models with its enhanced capital requirements as compared to Basel 2.

**Sources for Capital**

For the increasing need of capital, Indian banks are moving towards overseas market for tier 1 capital. Bank of India is the first one with a Basel III compliant Tier 1 US dollar bond as early as January. The other banks in the process of awarding mandates for their own proposed offerings are IDBI Bank, RBS, etc.

According to Reserve Bank of India, to meet the new bank capital guidelines, Indian banks need to raise Rs 5trn (US $

81.2bn) on or before March 2018. The RBI expects nearly Rs1.75trn of that total to come from equity capital, Rs1.9trn in additional Tier 1 securities and the rest in Tier 2 bonds. The US dollar market will play a major role in meeting those requirements.

Since India introduced Basel III rules in April, the rupee market has seen only five bank capital deals, and all have been Tier 2 issue. State-owned Life Insurance Corp of India is the only big onshore investor that can buy Tier 1 Basel III deals

Bank of India is unclear about its capital requirements but it hopes to lock-in funds to avoid the rush of such capital bonds in the coming years.

Tier 1 offerings from Bank of India and others are expected to be unrated, since rating agencies score Basel III bonds at least three notches below a bank's senior credit rating to reflect the risk to investors, putting the securities deep into high-yield territory in the case of Indian banks. Basel III bonds must be written down to zero if a regulator declares the issuing bank is no longer viable.

So in that case will the debt and equity market be the option for raising funds for meeting the capital requirements?

**Equity and Debt Markets**

According to ICRA's estimates, to meet the stringent Basel 3 norms, the total Tier I capital requirement of public sector banks (PSBs) during FY2015-FY2019 has reduced from 150-170% (of market capitalization) as in January 2014 to 80-90% at present. This has led to a decrease in their stock prices since the beginning of February 2014.

The improvement in the equity valuation of the PSBs also reduces dilution concerns, which is a positive. At present, five PSBs which together require around 40% of PSBs total Tier I capital are trading above their book values, which could increase their ability to raise higher amounts of capital from non-government sources.

Indian banks (PSBs and private banks) are expected to issue non-equity capital bonds of Rs. 2.5- trillion over the next three years (FY2015-FY2017). Of this, around two-third would be by the PSBs, and the rest by private banks. Of the total non-equity capital bonds, around 40% would be Tier II capital bonds and balance 60% Additional Tier I capital bonds.

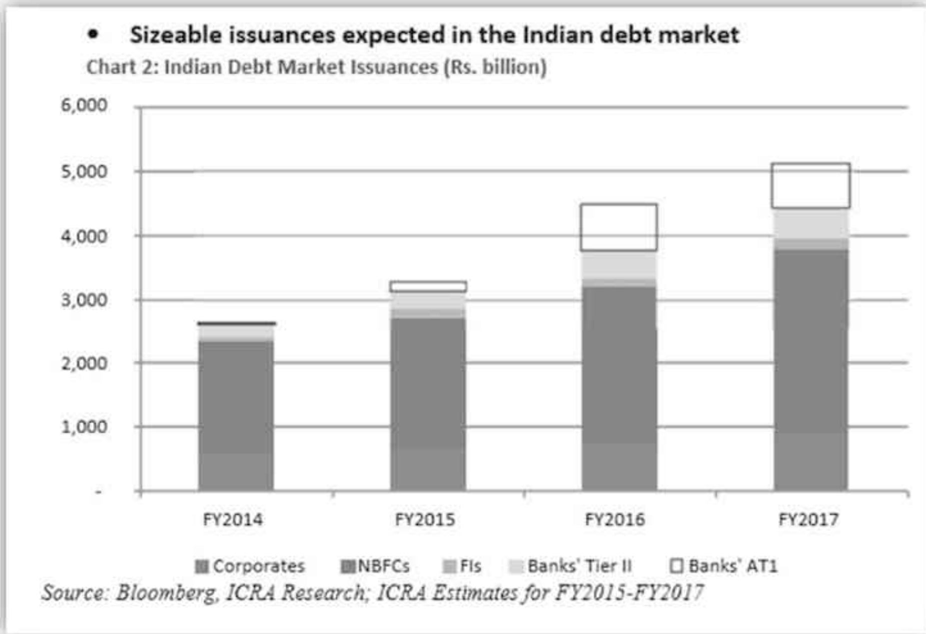
The investor confidence for Additional Tier 1 is less due to its riskiness. If common equity falls below 8%, Additional Tier I investors could incur a loss on the coupon , and even the principal could be at risk if common equity Tier I drops below 5.5%.

Out of the Total Tier 1 capital requirement of 80-90%, 60-70% of the PSBs market capitalization can be raised from non-government sources assuming the Government of India maintains 51% equity stake in all of them. This is possible if investor confidence for PSBs equity is sustained/ improves. Additionally, out of the PSBs' total Tier I capital requirement of Rs. 3.9-4.2 trillion, around one-third would be required in the form of Additional Tier I capital (AT1). In the best case scenario, the equity capital required from external sources would reduce to 40-50% of their market capitalization as on May 23, 2014, if the PSBs could raise Rs. 1.4-1.5 trillion through AT1 and the GoI brings in its share of Rs. 0.8-0.9 trillion.

To replace the existing Tier II and meet the incremental Tier II capital requirement, the PSBs would also need to raise Basel III compliant Tier II capital of Rs. 1.4-1.6 trillion over the same time horizon of FY2015-FY2019. Further, private banks would have to raise Tier II capital of Rs. 0.7-0.8 trillion over the same period of FY2015-FY2019.

The requirement of AT1 capital remains large as banks have negligible levels of AT1 as of March 2014 vis-à-vis the required 1.5%. The capital requirement for Tier II arises primarily from the need to replace Basel II compliant Tier II with Basel III compliant instruments. It is assumed that the banks would maintain Tier II at around 2.5% of their risk weighted assets (RWA) on an ongoing basis; in case banks opt for a higher level of Tier II capital, the issuances could be higher.

Indian banks (PSBs and private banks) require a total of Rs. 4.2-4.7 trillion as hybrid capital during FY2015-2019, which is a very large sum in relation to both the non-equity capital raised by them during FY2014 and the issuances in the Indian debt market that year. This large requirement has led to a rise in debt issuances over next five years provided there is adequate investor confidence for these hybrids. So far, Basel III compliant Tier II bonds are subscribed primarily by Government-owned insurance company, while there has been no issuance of AT1 instruments by the PSBs. If there are no takers for the AT1 bonds, banks may have to bridge the gap by raising higher Core Tier I capital (equity capital).




Apart from getting the funds from the debt market, more number of banks in India are focusing to get their capital from the public.

**Levitation of Capital from Public**

- The sudden rush in banking stocks has motivated several public sector banks to turn their attention to the public markets for raising capital to fund growth.
- Several top-notch public sector banks including Bank of India, Canara Bank and Vijaya Bank are in the process of securing shareholders' approval for this purpose.
- This year, with public sector bank share prices seeing some re-rating, the banks are looking to the public markets for capital. Also, the Government this year is not in a position to pour capital in excess of Rs.11,200 crore provided in the interim Budget.
- The Benchmark BSE Sensex has moved up by 13 per cent and the banking index BSE Bankex that consists of both private and public sector bank stocks, gained about 17 per cent over the past three months.

**Budgeted Figure for the Requirement of Capital**

In order to provide greater autonomy to public sector banks, Finance Minister Arun Jaitley said that the lenders would require Rs 2.40 lakh crore capital by 2018 to meet global Basel III norms and for this there is a need to raise additional resources. A large part of this fund would be raised through public offers made to retail customers, he said.

"While preserving the public ownership, the capital of these banks would be raised by increasing the shareholding of capital in the phased manner through sale of shares largely through retail common citizen in the country," he said.

"Thus, while the government would continue to hold majority shareholding, the citizen of India will also get direct shareholding in the bank which they currently hold indirectly," he added.

Besides, he said government would look into the issue of providing greater autonomy to the boards of banks. "We will also examine the proposal to give greater autonomy to banks while making them accountable," he said.

To enhance the capital into the current financial year , the interim budget had announced infusion of Rs 11,200 crore in public sector banks. At present, there are 27 public sector banks including SBI and its subsidiaries.

**Conclusion & Recommendations**

It is clear that the Indian banking sector needs more capital, but what about the existing capital? Has it been utilized properly? If so why the NPA's are still rising? These are the most important questions that have to be answered.

In accordance with the annexures, it is visible that banks aren't using the existing funds efficiently. So at first and foremost, they should try to rectify the glitches and make the efficient use of the funds.

According to rating agency ICRA Ltd, in which Moody's Investors Service own a significant stake, bad loans of Indian banks will rise further hit by a slowdown in business and the slow pace of economic recovery. The gross non-performing assets (NPAs) of banks could rise to 4.2-4.4% by March, from 4.1% as on December. By March, the gross NPAs of state-run banks could rise to 4.8-5% of total loans in the banking system. "Considering the current business slowdown, the stretched working capital cycles of corporates and the slow pace of economic recovery, ICRA is of the view that the gross NPA percentage of the public sector banks (PSBs) would be at 4.8-5% as on March 31, 2014," ICRA said. There was a rise of about 36% from last year in gross bad loans of 40 listed Indian banks to Rs.2.43 trillion at the end of December.

The rise in bad loans prompted the Reserve Bank of India to come out with a road map to contain sticky assets in the economy through early recognition of stress in the system. Secondly, give license to new banks may increase the competition in the market, but it is doubtful that it will lead to an efficient use of the funds. Though it may give rise to capital in an overall perspective, it won't be enough for meeting the demand in the market.

**IDFC's Capital Structure**

IDFC, the parent and a listed entity, would be at the top of the heap, with a non-operating financial holding company (NOHFC) a step below under the proposed structure. This NOHFC will hold four subsidiaries — for banking, investment banking, asset management and alternate assets class businesses.

The bank will commence activity of home loans under a separate subsidiary by working on building blocks for the bank in the first 18 months. Later, this housing loan portfolio could be transferred to the bank. IDFC has already applied for a licence for the home finance business.

About the capital structure of the bank, existing IDFC shareholders would get shares of the bank on a proportionate basis—the details of which are being worked upon. IDFC Bank will be listed from the outset. Every shareholder of IDFC will own the bank directly as well as indirectly (through IDFC).

To bring down the stake of foreign institutional investors (FIIs) within the regulatory limit (49 per cent), it will also be issuing shares in the parent company (IDFC) on a preferential basis to domestic investors. At end-December 2013, FIIs held a little over 51 per cent in IDFC.

About building a team for the banking entity, the bank would hire at least 10-15 senior management people first, apart from the few already hired. The bank already has 600 employees currently and that could grow to 1,500-2,000 over the next two years. However, the bank will be led by a person from within IDFC. Vikram Limaye will remain at IDFC and will not lead the bank.

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## ANNEXURE

**Annexure 1**
**Bank Wise And Bank Group-wise Gross Non-performing Assets,**
**Gross Advances And Gross Npa Ratio Of Scheduled Commercial Banks – 2013**

| As on March 31, 2013(Amount in ` Million) | | | |
|---|---|---|---|
| Banks | Gross NPAs | Gross Advances | Gross NPAs to Gross Advances Ratio (%) |
| **Public Sector Banks** | | | |
| | | | |
| State Bank of India | 511894 | 10785571 | 4.75 |
| State Bank of Bikaner and Jaipur | 21195 | 584737 | 3.62 |
| State Bank of Hyderabad | 31860 | 920231 | 3.46 |
| State Bank of Mysore | 20806 | 459805 | 4.52 |
| State Bank of Patiala | 24530 | 754598 | 3.25 |
| State Bank of Travancore | 17499 | 683885 | 2.56 |
| **SBI and its Associates** | **627784** | **14188827** | **4.42** |
| Allahabad Bank | 51370 | 1309363 | 3.92 |
| Andhra Bank | 37145 | 1001378 | 3.71 |
| Bank of Baroda | 79826 | 3328113 | 2.4 |
| Bank of India | 87653 | 2929679 | 2.99 |
| Bank of Maharashtra | 11376 | 763972 | 1.49 |
| Canara Bank | 62602 | 2439358 | 2.57 |
| Central Bank of India | 84562 | 1762337 | 4.8 |
| Corporation Bank | 20482 | 1193540 | 1.72 |
| Dena Bank | 14525 | 664569 | 2.19 |
| IDBI Bank Limited | 64500 | 2001347 | 3.22 |
| Indian Bank | 35655 | 1071559 | 3.33 |
| Indian Overseas Bank | 66080 | 1643665 | 4.02 |
| Oriental Bank of Commerce | 41840 | 1301862 | 3.21 |
| Punjab and Sind Bank | 15369 | 518434 | 2.96 |
| Punjab National Bank | 134658 | 3152440 | 4.27 |
| Syndicate Bank | 29785 | 1494227 | 1.99 |
| UCO Bank | 71301 | 1315691 | 5.42 |
| Union Bank of India | 63138 | 2119111 | 2.98 |
| United Bank of India | 29638 | 697081 | 4.25 |
| Vijaya Bank | 15329 | 705135 | 2.17 |
| **Nationalised Banks $** | **1016834** | **31412861** | **3.24** |
| **Public Sector Banks** | **1644618** | **45601688** | **3.61** |

**Annexure 2**
**Bank Wise And Bank Group-wise Gross Non-performing Assets,**
**Gross Advances And Gross Npa Ratio Of Scheduled Commercial Banks - 2013**

| As on March 31, 2013(Amount in ` Million) | | | |
|---|---|---|---|
| Banks | Gross NPAs | Gross Advances | Gross NPAs to Gross |
| **Private Sector Banks** | | | Advances Ratio (%) |
| Catholic Syrian Bank | 2109 | 89760 | 2.35 |
| City Union Bank | 1731 | 153429 | 1.13 |
| Dhanalakshmi Bank | 3803 | 78963 | 4.82 |
| Federal Bank | 15540 | 451946 | 3.44 |
| ING Vysya Bank | 1214 | 318916 | 0.38 |
| Jammu & Kashmir Bank | 6438 | 398537 | 1.62 |
| Karnataka Bank | 6389 | 254165 | 2.51 |
| Karur Vysya Bank | 2859 | 297059 | 0.96 |
| Lakshmi Vilas Bank | 4599 | 118923 | 3.87 |
| Nainital Bank | 673 | 21746 | 3.09 |
| Ratnakar Bank | 259 | 63952 | 0.4 |
| South Indian Bank | 4339 | 320140 | 1.36 |
| Tamilnad Mercantile Bank | 2145 | 163661 | 1.31 |
| | **52098** | **2731197** | |
| **Old Private Sector Banks** | 23714 | 1989007 | **1.91** |
| Axis Bank | 2150 | 67530 | 1.19 |
| Development Credit Bank | 20481 | 2413061 | 3.18 |
| HDFC Bank | 96078 | 2984164 | 0.85 |
| ICICI Bank | 4578 | 446416 | 3.22 |
| Indusind Bank | 7581 | 489186 | 1.03 |
| Kotak Mahindra Bank | 943 | 470869 | 1.55 |
| **New Private Sector Banks** | **207623** | **11591430** | **1.76** |