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Missing The Mark?

Indian banks are behind schedule on selling \$52 billion in Basel-III-compliant notes by 2018 as mandated by RBI

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Anurag Joshi, Bloomberg

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Indian lenders are behind schedule on plans to sell \$52 billion in Basel III-compliant notes by 2018, as a slowing economy and default concerns drive borrowing costs to a seven-year high.

Lenders have raised around \$920 million over the past 12 months, according to data compiled by Bloomberg. That compares with the average \$10.4 billion they must offer annually in the next four years to meet the Reserve Bank of India's (RBI) target. Average yields on top-rated 10-year bonds of Indian banks rose 65 basis points to 9.57 per cent in 2013, the most since 2006.

Failure to meet the RBI's target for compliance with the Basel Committee on Banking Supervision's norms would add to concerns after Fitch Ratings said last month that almost Rs 1 lakh crore in bank loans is at risk of turning bad. Average default risk on dollar securities of Indian lenders rose 58 basis points in 2013 as stressed assets leapt to 10.2 per cent of total lending, the highest in a decade.

"Banks don't want to issue Basel-III securities, which must be long-term, as interest rates are perceived to be high," says Rajesh Mokashi, deputy managing director at CARE Ratings. "Banks will pace the issuance of Basel-III notes based on their capital requirements to fund growth in assets," he adds.

United Bank: Case In Point

The Basel Committee unveiled rules in December 2010 aimed at bolstering the capital of lenders and improving their ability to absorb losses. The changes came after the global financial crisis exposed inadequate buffers in balance sheets. In India, the rules allow the nation's central bank to seek conversion of non-equity Tier-1 and Tier-2 capital into shares, or write off debt, should a lender reach a 'point of non-viability'.

State-owned United Bank of India will need to defer coupon payments on its debt as losses in the last quarter may send the lender's capital ratios below the regulatory minimum of 9 per cent, according to Fitch Ratings.

United Bank reported a loss of Rs 1,240 crore in the three months ended 31 December, according to a 7 February filing.

Tier-1 Challenge

RBI estimates that banks will need to raise Rs 3.25 lakh crore in 'non-equity' capital by March 2018 to meet the norms.

Tier-1 capital comprises common equity and additional securities that have equity-like characteristics such as having no fixed maturity, while Tier-2 includes debt with a minimum maturity of 10 years. Claims of holders of Tier-1 capital such as perpetual securities are lower than Tier-2 debt in the event that a bank is liquidated, according to RBI guidelines.

Financial institutions elsewhere to have issued Basel-III compliant bonds include Barclays, Societe Generale and Banco Bilbao Vizcaya Argentaria. Banco Santander's Mexico unit sold \$1.3 billion in such securities at a yield of 6.12 per cent in December, according to a statement at the time.

In India, there have been only Rs 280 crore of Tier-1 bond sales under Basel-III regulations, compared with Rs 7,250 crore of Tier-2 capital.

Not Prepared

"Investors are still not prepared to invest in Tier-1 capital and until this changes, it will be extremely difficult to meet the regulatory capital needs of the banking industry," says Shameek Ray, Mumbai-based head of Debt Capital Markets at ICICI Securities Primary Dealership. "The market for Basel-III Tier-2 bonds in India has already grown faster and will continue to be much larger than that for Tier-1 bonds as local investor concerns on the equity-like features such as write-down and conversion are far higher for Tier-1 securities."

RBI governor Raghuram Rajan has raised the benchmark repurchase rate 75 basis points to 8 per cent since taking charge in September 2013, to curb mounting consumer costs in Asia's third-biggest economy.

Yields on five-year rupee bonds rated AAA by Crisil, the local unit of Standard & Poor's, rose 53 basis points in 2013, according to data compiled by Bloomberg. Bad loans at Indian banks may rise to 4.6 per cent of total lending by 30 September from 4.2 per cent from a year earlier, RBI said in a December report.

Higher Premiums

Yes Bank, a Mumbai-based private sector lender, sold the nation's first perpetual rupee-denominated Tier-1 Basel-III notes just over a month ago.

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need just over a month ago.

"It will be a challenge for banks to sell Basel-III-compliant Tier-1 notes as investors are yet to understand the complexities of this instrument," says Shashi Kant Rathi, Mumbai-based head of Debt Capital Markets at Axis Bank, the biggest rupee debt arranger in 2013. "Issuers will need to pay coupons 200 basis points more than what they pay on Tier-2 bonds to attract demand for Tier-1 securities."

State-owned IDBI Bank approached holders of its 9.4 per cent rupee-denominated Tier-1 perpetual notes to seek permission to revise terms so they comply with Basel-III requirements, says a person familiar with the matter. IDBI is ready to offer a higher coupon to investors if they agree to the change in terms, he adds.

"Investors will evaluate the banks' cash flows more rigorously to gauge whether the lenders are likely to suffer a problem that may lead to writing off their debt against equity in the balance sheets," says Mahendra Jajoo, executive director at Pramerica Asset Managers, who manages around \$500 million in assets. The bond markets will seek a 'higher premium' to account for risks of conversion of Basel-III debt into equity, he adds.

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