Raghuram Rajan eases Basel III rules as bad loans jump

Rules eased on sales of bonds that count toward a bank's capital and cushion against losses as bad loans surge

India has eased rules on sales of notes that count toward a bank's capital and cushion against losses as soured loans surge in the country.

Reserve Bank of India (RBI) governor Raghuram Rajan made Basel III-compliant bonds more attractive on 1 September by letting individual investors buy, shortening the minimum maturity to five years and reducing potential for losses. Moody's Investors Service said the changes are credit positive. That may make it easier to achieve the RBI's target for some $45 billion of such debt by 2019.

Indian banks have sold the equivalent of $574 million of Basel III notes since 1 April, lagging both the targeted pace and the $26.3 billion in similar securities sold by banks in China this fiscal year, according to data compiled by Bloomberg. Bad debt in India soared to an eight-year high at 4.2% of overall loans in 2013, highlighting the risk of defaults in an economy growing near the slowest pace in a decade.

"The regulatory changes are welcome because they better align India with international jurisdictions," N.S. Venkatesh, the Mumbai-based head of treasury at IDBI Bank Ltd., said in a telephone interview on Thursday. "They'll also increase investor appetite for Basel III bonds and that may reduce the cost of funding for banks by 75 basis points to 100 basis points."

Borrowing costs

Rajan's policies have helped stabilize India's financial markets following last year's plunge in the rupee. The average yield on AAA 10-year Indian bank bonds has fallen to 9.2% from as high as 10.4% in August 2013. It was as low as 7.5% in May last year. That compares with 2.3% for financial debt globally, Bank of America Merrill Lynch indexes show.

The rupee declined 0.1% to 60.9775 per dollar today, having rallied from a record low of 68.845 on 28 August last year. The average cost of insuring the bonds of five Indian banks against non-payment for five years has dropped 138 basis points this year to 175 basis points on Thursday, CMA data show. The yield on 8.4% government notes due July 2024 was little changed at 8.51% on Friday.

Rajan told lenders to corral bad loans or face penalties in January. He's also raised borrowing costs three times to battle Asia's fastest inflation, and aims to curb consumer-price gains to 6% by January 2016 from 7.96% in July.

Less stringent

This is the second time in a year the RBI has tweaked Basel III capital regulations. It said in March that the deteriorating asset quality of lenders had forced it to extend the transition period in which to comply with more stringent capital norms by a year to 31 March 2019.

Non-performing debt as a proportion of total advances fell to 4% as of 31 March from 4.2% on 30 September 2013, which was the highest since the year ended 31 March 2006, RBI data show. India's economy will grow as much as 5.9% in the fiscal year ending March 2015, from 4.7% the previous period, the government predicted last month.

"The ability to raise debt capital significantly improved" after the dilution of the guidelines, analysts including M.B. Mahesh at Kotak Institutional Equities, wrote in a 2 September note. "It appears the move to get retail investors may be a successful one."

The Basel Committee on Banking Supervision unveiled rules in December 2010 aimed at boosting the capital of lenders and improving their ability to absorb losses. The changes came after the 2008 global financial crisis exposed inadequate buffers to balance sheets.

Basel III

Investors in India and around the world have been put off the debt by clauses that allow regulators to impose losses on bond holders should they rule a bank has reached a "point of non-viability." The RBI's 1 September notification allows lenders to take steps to avoid non-payment of Basel III debt, including temporary writedowns.

The RBI also relaxed restrictions on Basel III bond coupon payments by allowing lenders to pay interest out of past reserves as well as current-year profits. The rules also now allow lenders to sell Tier 2 debt with a minimum maturity of five years compared with 10 years beforehand. For Tier 1 perpetual notes with no fixed maturity, banks will have the right to repay the debt after five years instead of 10 originally.

Minimum ratio

The RBI is targeting a minimum ratio of Tier 1 capital to risk-weighted assets of 7% by the end of March 2019, and a ratio of 9% including Tier 2 capital. Tier 1 capital consists of common stock as well as securities with equity-like characteristics, such as perpetual notes, while Tier 2 includes debt with a minimum maturity of five years.

State-owned Bank of India sold Rs.2,500 crore of Tier 1 notes in August, while Punjab National Bank raised Rs.500 crore selling 10-year Tier 2 securities this week, according to data compiled by Bloomberg.

“At a time when public-sector banks are finding it difficult to raise equity capital from the public markets, this provides a way for banks to bolster their Tier 1 ratio,” Srikanth Vadlamani, a Singapore-based senior analyst at Moody’s Investors Service wrote in a 8 September note.

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