

CAFRAL Seminar

India Ratings
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Basel III Instruments: Key Rating Factors

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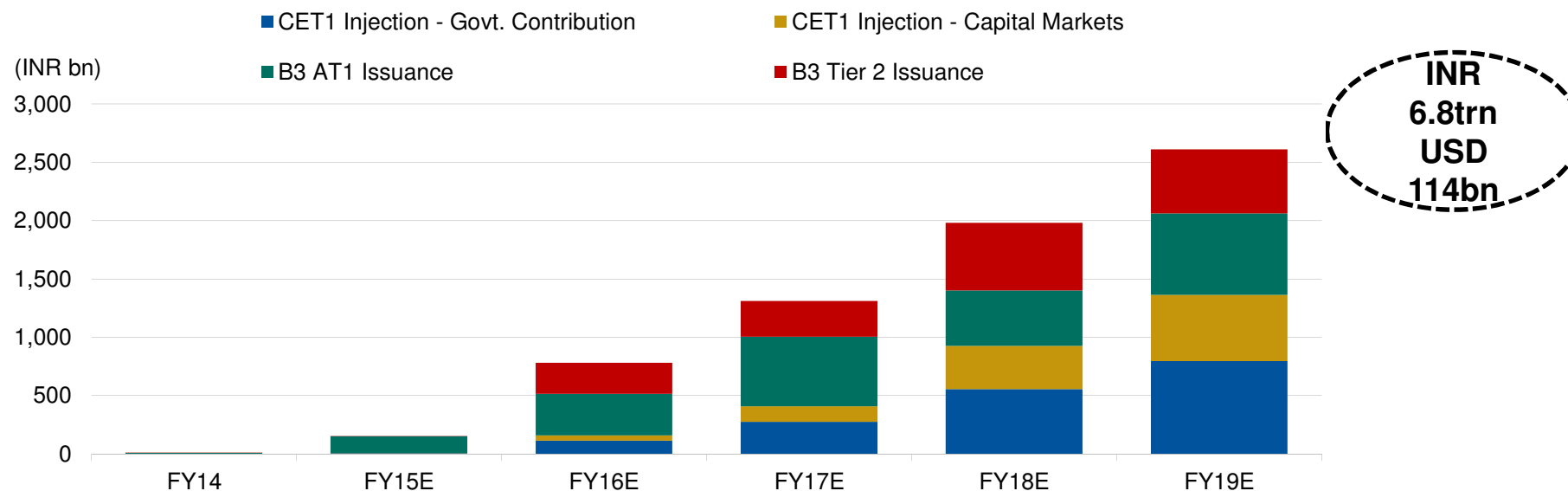
Basel III is Credit Positive for Banks

- ❑ Focus on higher quality capital
- ❑ Higher Tier 1 capital requirement
- ❑ Indian banks start with a good CET1 base > 7%
- ❑ Incremental CET1 is mostly growth capital
- ❑ Need to build strong base of AT1 investors

Capital Planning Key to Managing Basel III Transition

- Over 85% of incremental requirements to be met in FY17-FY19
- Front-ending capital raising critical to avoid crowding out later
- Sustained pressure on profitability could increase requirements further

Indian Banks: Capital Projections for Basel III Transition



CET1
INR 2.8
trn

AT1
INR 2.3
trn

Tier 2
INR 1.7
trn

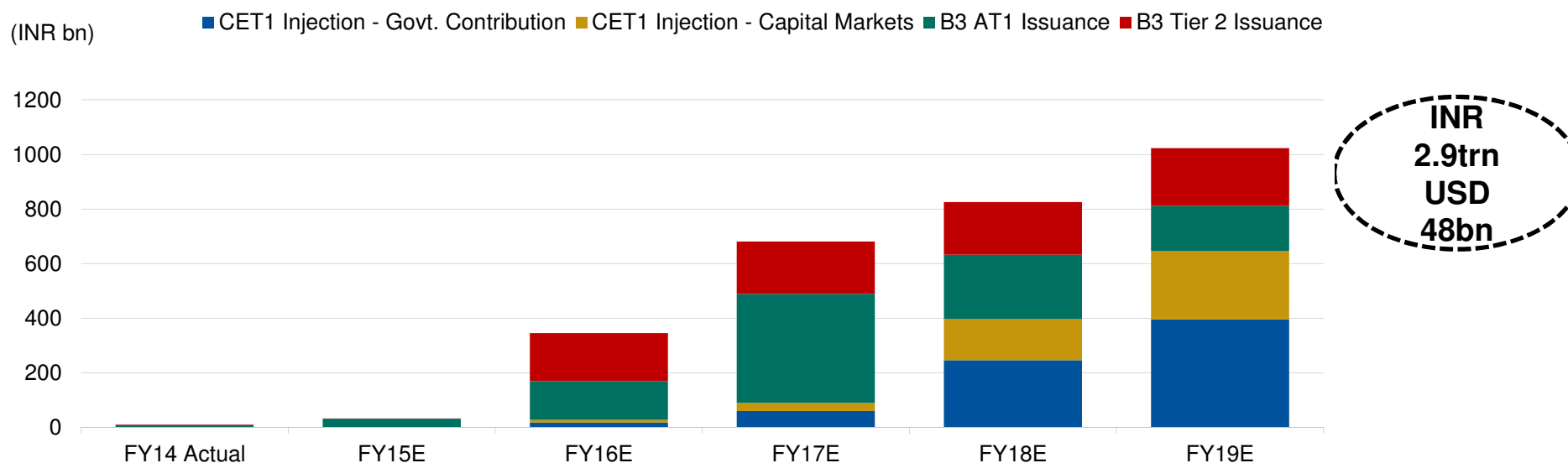
Govt. Equity Contr.
INR 1.7trn
USD 29bn

Large PSU Banks ~ 40% of system assets

- Strong AT1 requirements

PSU Banks (SBI Consolidated, PNB ,BOB, Canara, BOI)

Capital Projections for Basel III Transition



Source: India Ratings Estimates.

CET1
INR 1.2
trn

AT1
INR
0.97 trn

Tier 2
INR 0.8
trn

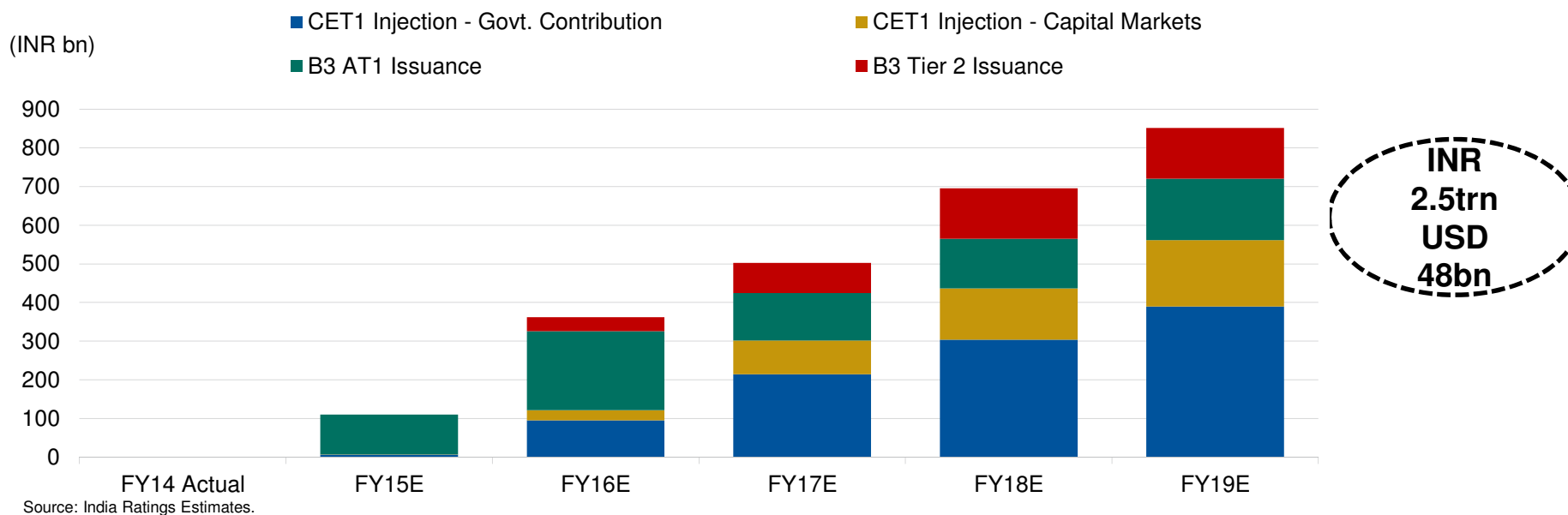
Govt. Equity Cont.
INR 0.7trn
USD 12bn

Other 16 PSU Banks ~ 31% of system assets

- Requirements are disproportionately high: weaker profitability, lower initial T1

Other PSU Banks

Capital Projections for Basel III Transition



CET1
INR 1.4
trn

AT1
INR 0.7
trn

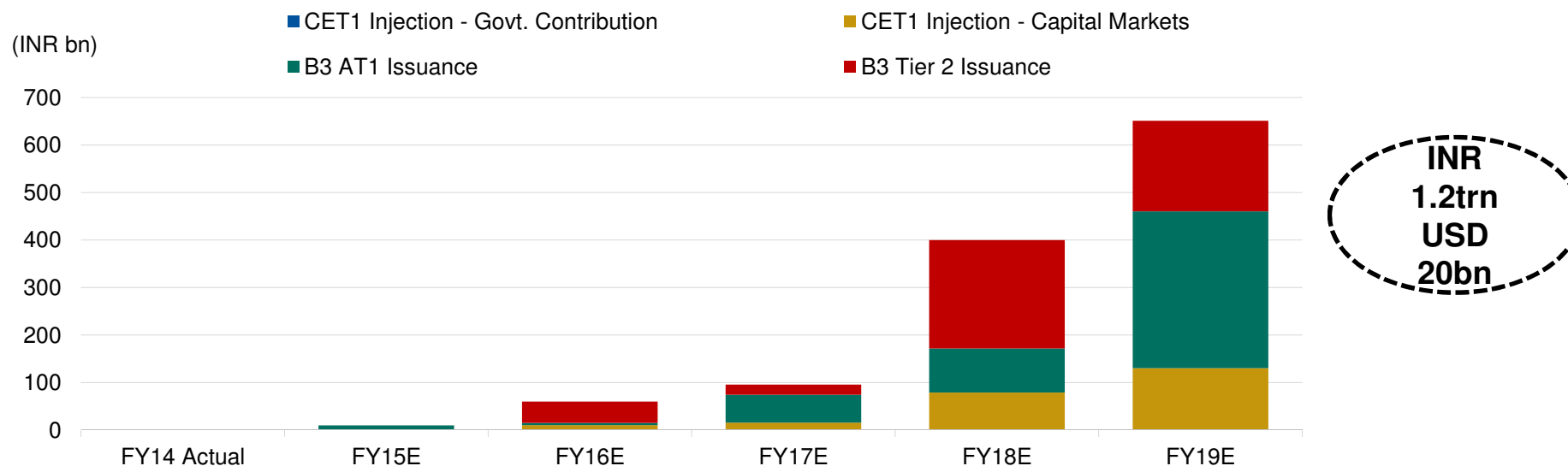
Tier 2
INR 0.4
trn

Govt. Equity Cont.
INR 1.0trn
USD 17bn

New Private Banks are Well Placed

New Private Bank

Capital Projections for Basel III Transition



Source: India Ratings Estimates.

CET1
INR 0.2
trn

AT1
INR 0.5
trn

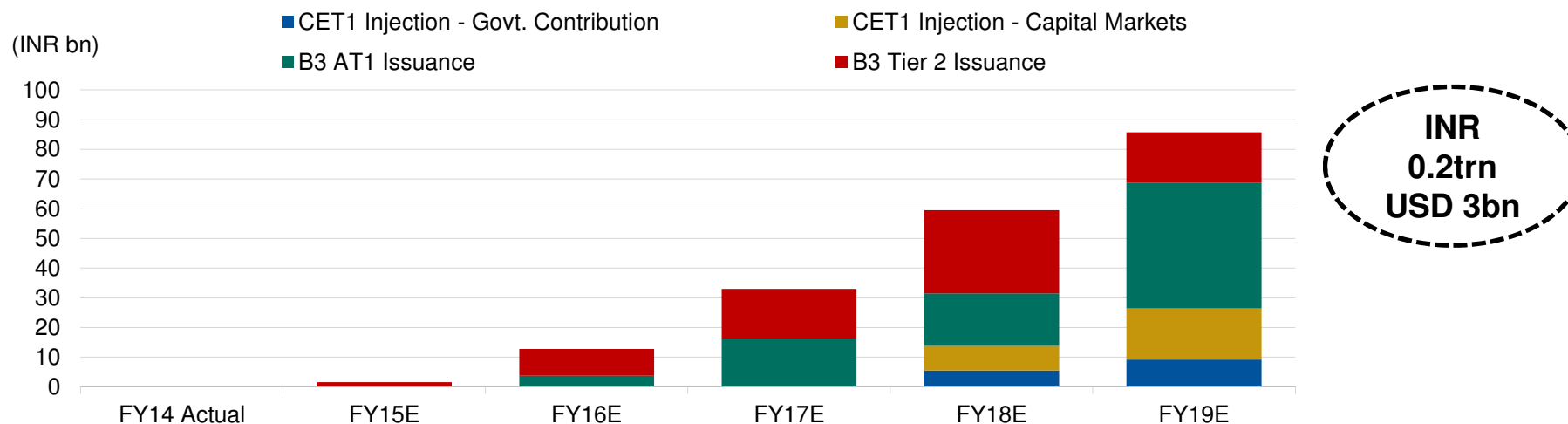
Tier 2
INR 0.5
trn

“Old” Private Banks

- 93% of incremental requirements to be met in FY17-FY19

Old Private Bank

Capital Projections for Basel III Transition



Source: India Ratings Estimates.

CET1
INR 40
bn

AT1
INR 80
bn

Tier 2
INR 72
bn

Govt. Equity Cont.
INR 14.6bn
USD 0.2bn

Basel III Hybrids - Key Difference is Loss Absorption

- ❑ All capital instruments must have a provision that requires them, **at the option of the RBI**, to either be written off or converted into common equity upon the occurrence of a Point of Non-Viability (PONV) trigger.
- ❑ For Tier 1 instruments - **pre-specified loss trigger at CET1 of 6.125%**
- either principal write-down or conversion to equity mandatory

Important considerations ...

WHAT WILL TRIGGER PONV – IMPORTANT RATING CONSIDERATION FOR ALL BASEL III INSTRUMENTS

- a. Decision that **equity conversion or temporary/permanent write-off** - without which the firm would become non-viable - is necessary, as determined by the RBI.
- b. Decision to make a **public sector injection of funds**, without which the bank would have become non-viable, as determined by RBI.

WHAT IS THE RISK OF NON-PERFORMANCE & ASSOCIATED LOSSES – IMPORTANT RATING CONSIDERATION FOR TIER I INSTRUMENTS

Can Capital be the Only Determinant of PONV?

- ❑ In the past, **banks have become non-viable in spite of maintaining capital adequacy**
 - e.g. Lehman Brothers, RBS, Washington Mutual

- ❑ Factors important from an Indian perspective:
 - **Support driven ratings appropriate for Government banks**
 - ✓ Explicit statement of support in Union Budget 2012-13:
 - ✓ Cabinet note specifying need-based recapitalization during Basel III implementation
 - Long term rating (LTR) measures probability of default by a bank, factoring in support, but **distance to PONV is linked to unsupported credit profile (UCP)**
 - **As UCP declines, the PDs on senior debt (linked to LTR) and subordinated instruments (linked to UCP) diverge**

- ❑ Higher risk of non-performance for banks with lower UCP – therefore notching appropriate

Examples of bank failure



- 6th largest US bank in mid-2008 Key Ratios: 30 Jun 2008
 - Tier 1: 7.8%
 - Total CRAR: 13.9%
 - Assets: \$314bn
- Faced a bank run in mid-2008 & customers withdrew \$16.7bn deposits in 9 days



- Lehman Brothers
- Tier 1 ratio of 7.3% in end-2007
- RoE of 18.6% in end-2007
- 4th Largest investment bank in USA when it collapsed in 2008

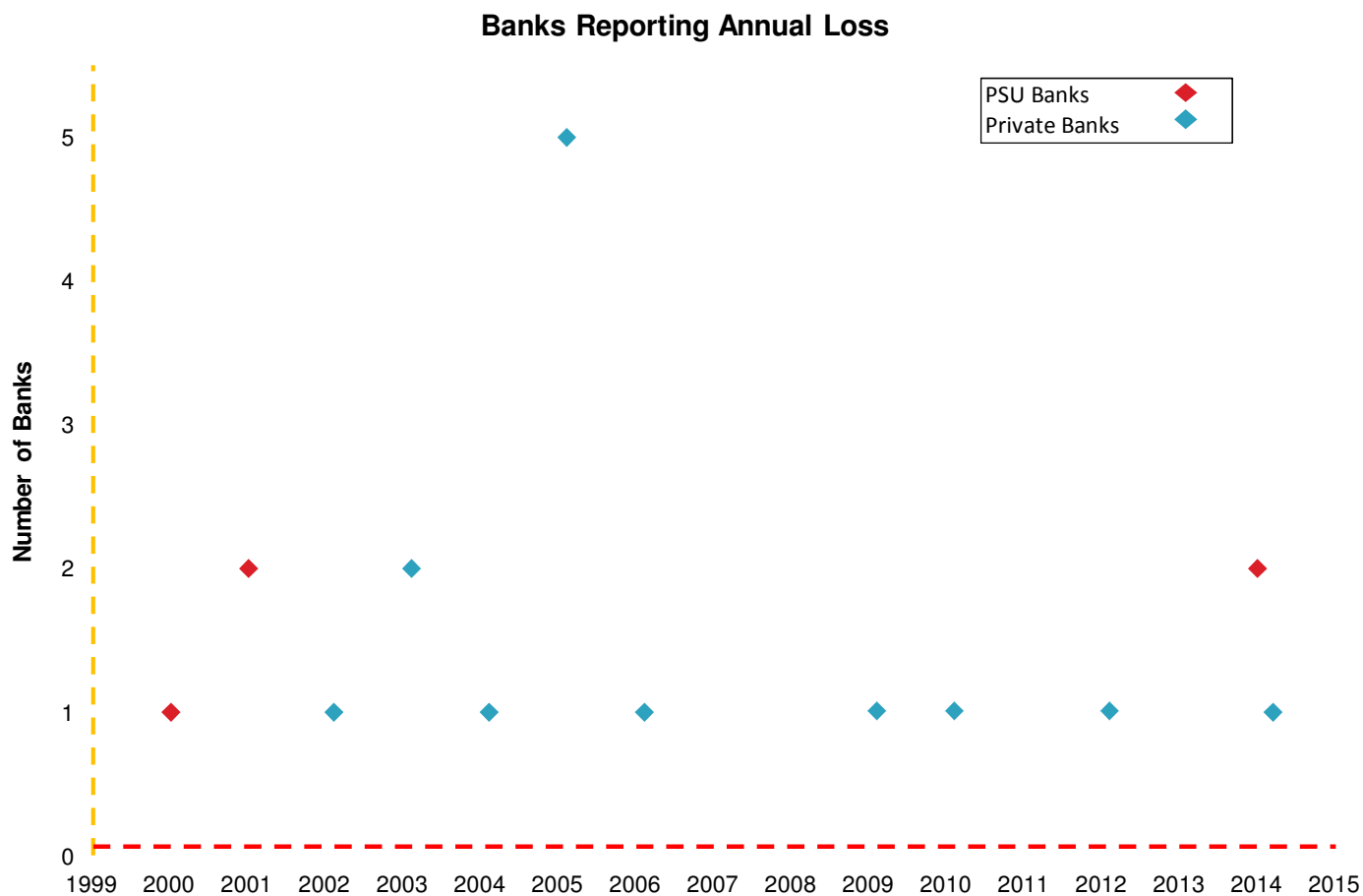


- Tier 1 ratio of 8.6% as on 30 Jun 2008
- One of the world's largest FI with total assets of \$3.8tn in 2008
- Bank failed in October 2008 - bail-out of GBP45bn required

More than capital adequacy, factors like investor confidence and liquidity crucial in determining PONV

India's Experience

Prompt regulatory action has prevented loss to creditors



Tier 1 instruments - What is the Risk of Non-Performance?

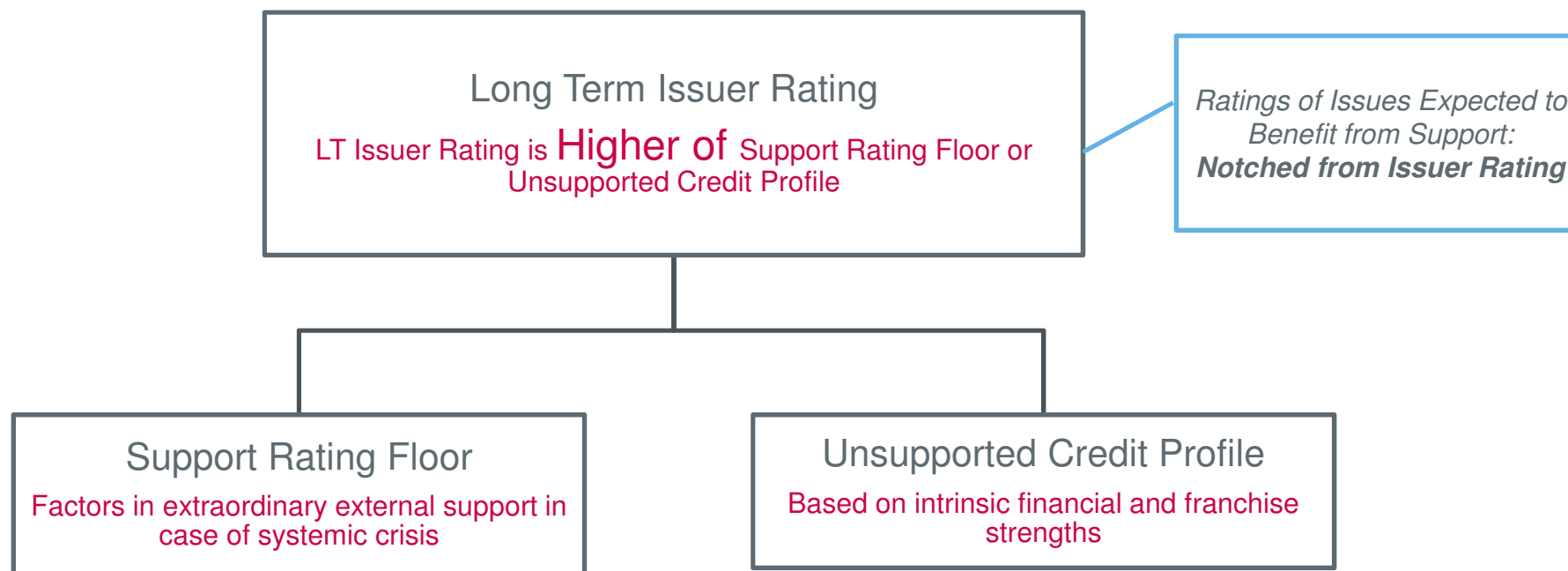
- ❑ Adjustments to CET1 - **Timeliness of Capital Support?**
 - Deduction from capital in respect of shortfall in provisions to expected losses under IRB approach for computing capital for credit risk
 - Cumulative unrealized gains or losses due to change in own credit risk on fair valued financial liabilities, if recognized, to be reduced
 - Unamortized defined benefit liabilities to be deducted

- ❑ Capital cushion may be breached and coupon deferral triggered while government infusion awaited
 - **Therefore, notching to be done from unsupported credit profile (UCP)**

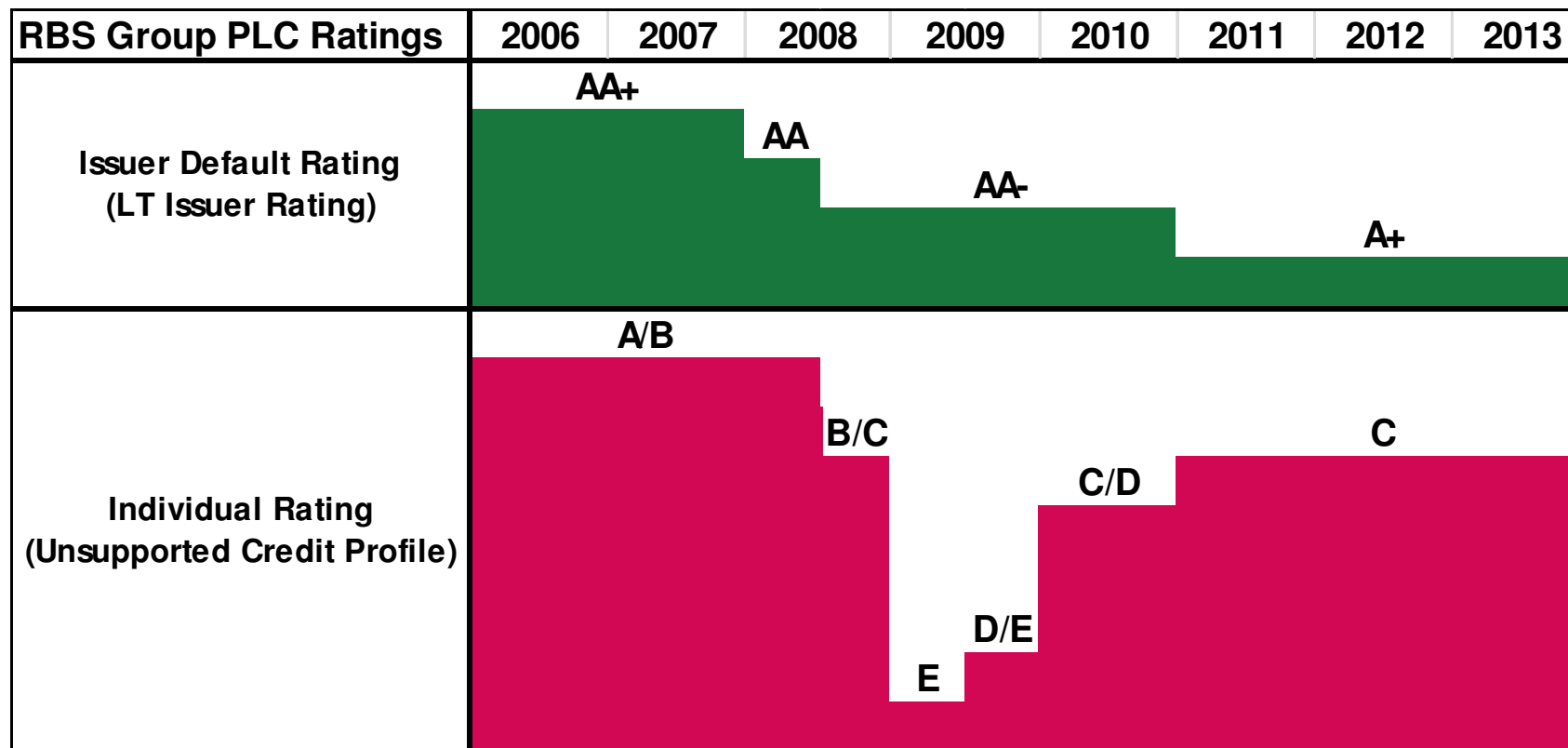
- ❑ Possibility of **coupon non-payment** even for highly rated banks

- ❑ However, loss severity expected to be restricted to coupon deferral for government banks

India Ratings: Transparent Bank Rating Methodology



Fitch's Issuer Rating of Distressed RBS was Resilient



India Ratings - Framework for rating Basel III Hybrids

TIER I INSTRUMENTS

- A** Perpetual, non-cumulative, permanent write down
- B** Perpetual, non-cumulative, equity conversion

- **Notched from unsupported credit profile (UCP)**

TIER II INSTRUMENTS

- C** Conversion to equity/ write down

- **Notched from long-term rating (LTR)**

Facilitating Investor Awareness

- Transparent and matured rating approach
- Easy to understand risk measurement
- Rating adequately differentiates between senior debt and hybrids
- Possible to price in risk on hybrids
- Some flexibility may be needed in investment criteria

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