Bank Capital in India: Is it an Elephant in the Room?

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The International Monetary Fund (IMF) has recently published its Financial System Stability Assessment Update of India.[1] While noting that the India commercial banking system is well capitalized and profitable, it examined the amount of equity capital domestic banks would need over the next 8 years ending March 2019 to "support economic growth and to meet Basel III minimum common equity capital requirement of 7.0 percent (minimum common equity of 4.5 percent with capital conservation buffer of 2.5 percent)". Three hypothetical scenarios were considered:

1) **Low Growth**: Annual GDP growth rate of 7 percent with credit growth of 11.5 percent per year.
2) **Medium Growth**: Annual GDP growth rate of 8.5 percent with credit growth of 14 percent per year.
3) **High Growth**: Annual GDP growth rate of 10 percent with credit growth of 17 percent per year.

Basing their analysis on a sample of 30 banks (including public and private banks, and covering over 90 percent of commercial banking system's assets), the report arrived at a startling finding that, "in a mid-growth scenario with average earnings generation, 14 banks are expected to fall short of Basel III minimum common equity requirement with a capital buffer at 7 percent, of which 13 are public banks". As per IMF calculations, on average while in a mid-growth scenario, additional capital needs would amount to around US$19.6 billion, a high growth scenario would bring the capital needs to around US$50.6 billion and 23 banks would need additional capital, of which 20 are public banks. In totality, if the rate of economic growth were to exceed 7 percent, till 2019, between 9 to 20 public banks out of 21 could fall short of Basel III common equity capital requirements with average earnings growth (Table 1).

[1] "India: Financial System Stability Assessment Update", IMF, January 15, 2013 (available at http://www.imf.org/external/pubs/cat/longres.aspx?sk=40231.0).

Table 1: Number of Banks falling short of Basel III Core Tier 1 Capital Requirements of 7%			
	Scenario 1	Scenario 2	Scenario 3
All 30 Banks			
With earnings generation (mean)	10	14	23
With earnings generation (low)	13	17	26
Additional Equity Capital needed (US$ million)	5,200	19,635	50,564
Additional Equity Capital needed (% of GDP)	0.3	1.2	3.1
Of which: 21 Public Sector Banks (81 % of assets in the sample)			
With earnings generation (mean)	9	13	20
With earnings generation (low)	12	14	21
Additional Equity Capital needed with mean earnings (US$ million)	5,134	19,370	49,886
Additional Equity Capital needed (percent of GDP)	0.3	1.2	3.1
Percentage of funds which can be raised From the private sector allowing for govt.'s shareholding to be reduced to 51%	65%	54%	51%
Source: IMF (2013); p. 19.			

While Indian banks as of now is perceived to be well-capitalized, any bondage is as strong as its weakest link. In this context, sometimes there are apprehensions that while on the average Indian banks may be sound in terms of capital, there could be wide variations among different banks. Such apprehensions are not, however, borne from the actual data. Table 2 below reports the Basel II capital adequacy ratio (CRAR) all 46 Indian (public, old private and new private) banks – number of banks whose CRAR is less than 10 percent is one.

Table 2: Frequency Distribution of Capital Adequacy Ratios of Indian Scheduled Commercial Banks: 2012		
CRAR Range	Number of Banks	%
9 % - 10%	1	2.2
10% - 11%	0	0.0
11% - 12%	4	8.7
12% - 13%	12	26.1
13 % - 14%	15	32.6
14% & above	14	30.4
Total	46	100.0
Source: Author’s Calculation from RBI data		

It is not that the Indian authorities are unaware of these needs. Quick estimates released in the *Financial Stability Report* of the RBI (December 2012) placed the additional capital requirement of banks on account of Basel III at Rs 5 trillion, of which non-equity capital will be to the order of Rs. 3.25 trillion while equity capital will be to the order of Rs. 1.75 trillion. These are large numbers. The RBI further noted that, "Additional challenges could be posed by the recent trends in asset quality of banks, regulatory changes in restructuring guidelines and the proposed implementation of dynamic provisioning norms that may increase the provisioning requirements of the banking sector". However, while mentioning that "additional capital requirements of banks" could pose some concerns, the RBI in its *Systemic Risk Survey* of October 2012 classified it as a low risk event.

What has been the action so far? It may be recalled that as early as in 2009, during the heyday of the financial crisis, the World Bank sanctioned a loan to Government of India for providing financial support for implementing the economic stimulus program. An important part of the overall stimulus program is the provision of capital support to public sector banks. India's Banking Sector Support Loan was for a quantum of $3 billion programmatic operation with a first phase of $2 billion and was expected to provide budgetary support to the Government of India.[2] The loan, requested in December 2008, was approved in September 2009 and disbursed in April 2010 but, "it was apparently delayed at the request of the government" (Independent Evaluation Office, World Bank, 2012).[3]

More recently (on December 22, 2012) the Finance Minister, Mr Chidambaram is reported to have said that public sector banks need Rs 1 trillion capital infusion and there are unconfirmed reports that the government has approved the first tranche of Rs 12,000 crore fund infusion in state-owned banks for enhancing their capital base, out of the budgetary provision of Rs 15,000 crore for recapitalisation of public sector banks in the current fiscal.

In recent period (since March 2012) the overall capital adequacy ratio has deteriorated, despite being well above the regulatory minimum. The decline in capital adequacy ratio was more pronounced for the public sector banks. Besides, asset quality of banks has seen considerable deterioration during the half year ended September 2012 (RBI, *Financial Stability Report*, 2012). In view of all these, it is high time that issues regarding bank capital are taken with all seriousness and it is encouraging to see the early indications and actions in this regard.

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[2] The details of the Banking Sector Support Loan to India (Project ID: P116020) is available at http://www.worldbank.org/projects/P116020/banking-sector-support-loan?lang=en

[3] Independent Evaluation Office (World Bank, IFC, MIGA) (2012): *The World Bank Group's Response to the Global Economic Crisis*, available at http://ieg.worldbankgroup.org/content/dam/ieg/crisis/crisis2_full_report.pdf