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EXTRAORDINARY TIMES REQUIRE EXTRAORDINARY MEASURES - CAPITAL CONSERVATION IS THE KEY

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Recently RBI Governor rightfully exhorted the banking system to raise capital so as to remain ahead of the curve. We however believe that while capital raising will be important, capital conservation will be also important as the moratorium ends on August 31 and banks start recognising stress. The problem is given the 1 year freeze in IBC, resolution cannot happen at the same time and it is thus imperative that PSBs are either recapitalised or given the alternative of capital conservation, as it is not certain how much fiscal space the Government might have for recapitalisation. In terms of capital conservation, we have the following suggestions.

Firstly, given the financial stress of financial institutions this year, relaxations in Basel norms as presently adopted by India may be done in a way that ultimate restoration to the currently given norms may be achieved by the end of the FY22. Of course, the RBI would need to sound the BIS of this intention and assure the international investors that this is done as a part of financial stability program. **This could free up Rs 1 lakh crore of capital.**

Secondly, a relaxation of the countercyclical buffer could free upto Rs 1.87 lakh crore of capital for the banking system.

Thirdly, the threshold limit of Rs 5 crore for retail exposure to one counterpart, to qualify as Regulatory Retail Portfolio (RRP), could be increased to Rs 8.5 crore for attracting 75% risk weight. **Banks can save capital of around Rs 5000 crore**.

This implies that the total capital saved under these 3 steps could potentially be close to Rs 3 lakh crore.

Further, we feel extending blanket moratorium further may not resolve the issue and we must evaluate borrower specific requirements for the same and accordingly explore sector specific restructuring options. For example, borrowers whose credit profile was sufficiently adequate in pre COVID era (say December 2019) and who have been significantly impacted by the lockdown must be given a system of regulatory forbearance / one-time restructuring of only for such accounts.

Internationally, Banks across the world are facing negative momentum as a result of the significant effects of the coronavirus pandemic, oil shock, and market volatility **However, the good thing is bank ratings will stay largely resilient for two primary reasons this time: strong capital and unprecedented liquidity support , as opposed to 2008 crisis.**

CAPITAL CONSERVATION IS ALSO THE KEY APART FROM CAPITAL RAISING BY BANKS

- Recently RBI Governor rightfully exhorted the banking system to raise capital so that to remain ahead of the curve. We believe we are in extremely challenging times as even as economies across the world have shown record contraction in Q22020, financial markets have given the best return over several decades during the same time. For example, as per independent reports, the 5 largest US investment banks reported around Rs 3.15 lakh crore of cumulative profit in Q22020.
- In India, the bunch of measures taken by RBI and support by Government has ensured that financial stability continues to improve. As a matter of fact, nearly Rs 75,000 crore of CPs were issued by NBFCs, HFCs and FIs in Q1FY21 and the pace picked up in May and June after the RBI and GoI announcements.
- We, however, believe that while capital raising will be important, capital conservation will be also important as the moratorium ends on August 31 and banks start recognising stress. The problem is given the 1 year freeze in IBC, resolution cannot happen at the same time and it is thus imperative PSBs are either recapitalised or given the alternative of capital conservation, as it is not certain how much fiscal space the Government might have for recapitalisation. The RBI has already moved in this direction in April.
- For example, currently as per the regulatory requirement Banks in India need to have a regulatory capital of 9% (1% addition to the Basel prescription of 8%) of Risk Weighted Assets (RWA) along with additional Capital Conservation Buffer (CCB) of 1.875%, which was slated to increase to 2.5% by Mar'20. Considering the potential stress on account of COVID-19, RBI correctly deferred the implementation of the last tranche of 0.625% of the CCB from March 31, 2020 to September 30, 2020.

Capital Cushion at Dispensation (Rs crore)

Description	March'19	March'20	Capital
Outstanding Credit SCBs	**9613101**	**10217760**	
Risk Weighted Assets (RWA) #	9846768	10000000	
Capital requirement	9%	9%	900000
Additional : CCB	1.875%	1.875%	187500
Total Capital Requirement	**10.875%**	**10.875%**	**1087500**
Deferring CCB of 1.875% could free up capital			187500
Rationalising Capital req. with Basel i.e. 8% could free up			100000
Total capital cushion could be at dispensation			**287500**

Source: RBI; SBI Research; # RWA of March'2020 is estimated rounded off

- Interestingly, the countercyclical capital buffer requires banks to hold capital at times when credit is growing rapidly so that the buffer can be reduced if the financial cycle turns adverse or the economic and financial environment becomes substantially worse. Banks can use the capital buffers they have built up during the growth phase of the financial cycle to cover losses that may arise during periods of stress and to continue supplying credit to the real economy. Extraordinary situations require extraordinary measures, and we feel this is the right time regulator might explore all available dispensation at hand for the banking system to conserve capital.
- Firstly, given the financial stress of financial institutions this year, relaxations in Basle norms as presently adopted by India may be relaxed in a way that ultimate restoration to the currently given norms may be achieved by the end of the FY22. Thus RBI would need to right away relax the norms for the next four/five quarters (quarters ending Sept 2020, Dec 2020, Mar 2021 and June 2021 and possibly Sept 2021) and then begin the restoration of Basle norms in two phases--from the end of September-Dec quarter of 2021 and Jan-March 2022. Of course, the RBI would need to sound the BIS of this intention and assure the international investors that this is done as a part of financial stability program. **This could free up Rs 1 lakh crore of capital.**
- **Secondly, a relaxation of the countercyclical buffer could free upto Rs 1.87 lakh crore of capital for the banking system. Together, these two can free up to Rs 2.87 lakh crore of capital for the banking system.**

REGULATORY RETAIL PORTFOLIO (RRP) - EVERY PENNY COUNTS

- Thirdly, the threshold limit is of Rs 5 crore, for retail exposure to one counterpart, to qualify as Regulatory Retail Portfolio (RRP), which attracts risk weight of 75%. And above Rs 5 crore, under standardised approach, is risk weighted as per the ratings assigned by the rating agencies registered with the SEBI and chosen by the Reserve Bank of India.
- If we increase the said limit to say Rs 8.5 crore from existing Rs 5 crore (in line with the current exchange rate of Euro=~Rs 85) additionally approx. Rs 2 lakh crore can be classified under RRP. As these small borrowers are normally rated BBB and below only, assuming presently 100% risk weight for this amount, Banks can save a capital of around Rs 5000 crore. **This implies that the total capital saved under these 3 steps could potentially be close to Rs 3 lakh crore.**

Outstanding credit of SCBs accordinng to size of credit limit				
Credit Limit	Mar-2019 (Rs Crore)		Mar-2020 (Rs Crore)	
	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstanding
Up to Rs. 50 Lakh	205308584	3478721	245571839	3868164
Above Rs. 50 Lakh and up to Rs. 1 Crore	739941	404920	844464	448899
Above Rs. 1 Crore and up to Rs. 4 Crore	432384	638740	474299	675368
Above Rs. 4 Crore and up to Rs. 6 Crore	59852	217113	63561	220479
Above Rs. 6 Crore and up to Rs. 10 Crore	47494	267482	49875	269917
Above Rs. 10 Crore and up to Rs. 25 Crore	44640	482987	45732	488849
Above Rs. 25 Crore and up to Rs. 100 Crore	30152	999995	30508	992874
Above Rs. 100 Crore	12564	3123144	13091	3253210
Total Credit	**206675611**	**9613101**	**247093369**	**10217760**
Approximate amount covered in RRP with Rs 8.5 crore thershold				**200000**
Capital required before (Rs 200000 x RW 100% x 10.875%) A				**21750**
Capital required after (Rs 200000 x RW 75% x 10.875%) B				**16313**
Capital Saving (A-B)				**5438**
Or Say				**5000**

Source:RBI; SBI Research

ASSET QUALITY, CRAR & MORATORIUM

- RBI has allowed moratorium of three months on payment of instalments in respect of all term loans outstanding as on March 1, 2020 which has been further extended by another three months, i.e., from June 1, 2020 to August 31, 2020. Accordingly, tenor for such loans were shifted across the board by six months.
- Most of the retail loans i.e. Housing, Vehicle, Education etc. are through term loans only which are given for a longer tenor. Say a vehicle loan for 3-5 years, education loan for 4-5 years and a housing loan for 10 to 20 years etc. We believe, once the repayment of moratorium period is shifted to the end of the tenor there may not be any issues for repayment by the borrowers. Further these loans are mostly secured and backed by tangible assets. Interestingly we are currently witnessing significant deleveraging of consumers that could act as a positive drag on the retail portfolio of banks when banks come out of moratorium.
- Overall capital of SCBs, as on March'20 is above regulatory requirement, at 14.80%.
- Banks, however, across the world are facing negative momentum as a result of the significant effects of the coronavirus pandemic, oil shock, and market volatility. However, the good thing is bank ratings will stay largely resilient for two primary reasons this time: strong capital and unprecedented liquidity support. In general banks are adequately capitalised across continents this time in contrast to the 2008 crisis when they had insufficient capital.

Outstanding credit of SCBs (Rs in crore)		
As On End	Mar-2020	
OCCUPATION	No. of Accounts	Amount Outstanding
AGRICULTURE	94812042	1175612
INDUSTRY	9901700	3214436
TRANSPORT OPERATORS	3906158	223123
PROFESSIONAL AND OTHER SERVICES	11207913	807058
PERSONAL LOANS	102417721	2487756
TRADE	17824180	1044471
FINANCE	720888	1006726
ALL OTHERS	6302767	258578
TOTAL CREDIT	**247093369**	**10217760**

Source: RBI; SBI Research

BLANKET MORTARIUM EXTENSION IS UNNECESSARY

- Further, we feel extending blanket moratorium further may not resolve the issue and we must evaluate borrower specific requirements for the same and accordingly explore sector specific restructuring options .
- For example, borrowers whose credit profile was sufficiently adequate in pre COVID era (say December 2019) and who have been significantly impacted by the lockdown may take at least two-three quarters to recover. Thus, it is important to have system of regulatory forbearance/one-time restructuring of only such accounts.
- Interestingly, borrowers with credit limits of up to Rs 50 lakh covers 99.4% of the total borrower accounts when we look into outstanding credit distribution of ASCBs. These 99.4% accounts cover around 38% of the credit outstanding but also possibly majority of individual as well as agricultural loan accounts. In view of the above, we expect central banks to weigh all its available dispensation including capital easing and others instead of a blanket extension of moratorium.

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