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# Banks' state debt pile at stake as India braces for Basel battle

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The Reserve Bank of India is bracing for a fight on proposed changes to the global regulatory framework that would hit the country's lenders with higher capital charges for the mountain of government debt on their books.

Tighter rules would bite India's banks, already struggling with surging bad loans and higher provisions. With nearly 30 per cent of their assets in state debt, India's lenders would take a hit if the Basel Committee on Banking Supervision raised capital requirements on sovereign bonds.

"There is a proposal to impose capital requirements on sovereign assets that banks hold," RBI Governor Raghuram Rajan, who steps down in September, said last month. "We are opposing that tooth and nail at Basel."

The Basel Committee, which brings together regulators from about 30 nations including the RBI, the U.S. Federal Reserve and the Bank of England, began reviewing the regulatory treatment of banks' government bond holdings last year. The regulator plans to publish a proposal around year-end, and deliberations could continue for several years.

Most countries currently treat state debt as if it were risk-free, meaning banks don't need capital to protect against default. Sovereign debt is also exempt from rules that limit a bank's exposure to any single creditor.

## 'No Longer Tenable'

The current system is "no longer tenable," but any changes to reflect the "risky nature of public debt" would need to factor in the "special role" it plays in the financial system as a "source of liquidity and a potential buffer for the macroeconomy," according to the Bank for International Settlements.

The Basel Committee is considering four main options: revisions to the risk-weighted and large-exposure rules, beefing up supervisory powers to tackle sovereign risk and requiring lenders to enhance disclosure.

European Basel Committee members such as Germany are among advocates for changing the rules, driven by their experience of the "doom loop" between banks and sovereigns that forced countries such as Greece and Spain into painful public bailouts during the euro area's debt crisis.

Rajan said deliberations at the Basel Committee are sometimes dominated by advanced economies. India's task is to identify regulations that "we're uncomfortable with, that are more suited to their banks and not to ours," he said. "What we accept are things that we think are reasonable for the safety and stability of our economy."

## Financial Stability

India is joined in opposition by countries such as Italy, which has warned that changes could destabilize the financial system.

This split is reflected in the data. Domestic government debt accounted for 27.7 percent of Indian banks' total assets in 2015, BIS data show. Mexico was at 23 percent and Brazil at 20 percent. Some advanced economies aren't far behind. Italy comes in at 17.2 percent and Japan at 16.5 percent.

In Germany, by contrast, domestic government debt makes up 7.5 percent of banks' total assets. In the U.S., the figure is 8.5 percent.

Part of the reason for the special regulatory treatment is that government bonds differ from other debt, according to the BIS. In some emerging markets, it's the only high-grade domestic security, leading inevitably to higher exposures. Some central banks also define eligible collateral for monetary policy market operations such that only state debt qualifies.

## Liquid Instruments

The RBI requires commercial lenders to invest a portion of deposits in liquid instruments, which in practice means government bonds. The so-called statutory liquidity ratio is currently 21 percent of deposits, and many lenders exceed this level in the absence of comparable alternatives.

Maintaining excess SLR securities helped banks to weather the impact of "the slow phase of the economic cycle on their balance sheets and earnings," the RBI said in its annual report last year.

The SLR is scheduled to drop to 20.5 percent in January, and eventually to zero, though no deadline has been set. One reason is that the Indian government relies heavily on banks to fund its budget deficit.

Imposing a higher risk weight to sovereign bonds would hit Indian banks already scrambling to meet capital requirements that phase in over the next few years, according to Krishnan Sitaraman, a senior director at CRISIL Ratings.

## Capital Burden

Indian banks had about Rs 26 trillion (\$387 billion) of securities issued by the central and state governments on their books as of March, Sitaraman said. AAA rated corporates carry a 20 percent risk weight. Applying a requirement half as stringent to state debt would add about 300 billion rupees to banks' capital burden, he said, citing CRISIL estimates.

If the Basel Committee opts for exposure limits, Indian banks could face foreign-exchange risks arising from holding foreign sovereign paper.

In addition, weaning banks off Indian sovereign bonds could also drive up the government's borrowing costs. Banks hold about 45 percent of state debt, so any exposure limit below the level of current holdings would force the government to seek out alternative investors, Sitaraman said.

India does have clout when it comes to global regulation, Rajan said, pointing to the total loss-absorbing capacity requirement adopted by the Group of 20 nations last year in a bid to tackle the problem of too-big-to-fail banks.

## Loss-Absorbing Capacity

TLAC, designed by the Financial Stability Board, requires the world's most systemically important banks from 2019 to have loss-absorbing capacity equivalent to at least 16 percent of risk-weighted assets -- the low end of the proposed range.

India opposed TLAC "significantly and got it written down," Rajan said. "We were one of the leading emerging markets to actually bring that down."

A predecessor at the RBI took a more conciliatory stance on global standards, including those for sovereign bonds.

"If you don't accept an international rule which is adopted by all countries, then obviously you don't have the same facilities in foreign borrowing or lending and in terms of your banking institutional structure being respected equally abroad," said Bimal Jalan, RBI governor from 1997 to 2003.

"They will adopt a rule by consensus and then we will follow that rule," Jalan said.

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