Basel III Accord and Its Implications on Indian Banking: An Evaluation

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Abstract

The main aim of Basel Committee on Banking Supervision has been to reduce the gaps in international supervisory coverage so that no foreign banks should get away from banking supervision and that supervision should be appropriate. In recent years Basel Committee has focused on the capital adequacy. So far Basel I, Basel II and Basel III Accord have been proposed. Basel III proposed in December 2010 is the current accord, which is third in the series of Basel Accords. This paper discusses the salient features of Basel-III Accord and its expected implications on the Indian banks. This paper depicts that the effective implementation of Basel III will make the Indian banks stronger, financially stable and sound so that it would help in delivering value to the real sectors of the economy. It would also help the Indian banks to manage their capital more efficiently and enhance their profitability.

Keywords: Basel III, Basel Committee, Capital requirements, Indian Banks

Introduction

Basel Committee of Banking Supervision formed by the Governors of the central bank of the G-10 countries in 1974 developed the Basel Banking Norms under the support of Bank of International Settlements, Basel, Switzerland. The Committee devises norms and gives recommendations on banking regulation based on capital risk, market risk and operational risk. The committee was developed in response to disorganized liquidation of Herstatt Bank, based in Cologne, Germany in 1974. The event displayed the existence of settlement risk in international finance.

In 1973 the breakdown of Bretton Woods System led to the development of casualties in 1974 such as withdrawal of Backhaus Herstatt banking license in Germany and in October of the same year close down of Franklin National Bank in New York. In 1975, Central Bank governors of the G-10 countries took the initiative to form a committee on Banking Regulations and Supervisory Practices in response to the interruptions in the financial markets. Later the committee was renamed as Basel Committee on Banking Supervision. The committee acts as a forum where the regular cooperation can take place among its member countries takes place regarding the banking supervisory practices. The committee aims at improving the financial stability of the banks by enhancing supervisory know how and quality of banking supervision globally. At present there are 28 member countries in the committee. These member countries are being represented by their central bank and the authority responsible for the prudential supervision of the banking business. Besides banking regulations and
supervisory practices the committee also aims to reduce gaps in an international supervisory coverage.

The Basel Committee for Banking Supervision introduced Basel capital accord popularly called Basel-I in 1988 to strengthen the risk management practices among the banks across the member countries. It mainly focused on standards for measuring credit risk and mentioned the minimum level of capital as a function of risk weighted assets while at the same time defining the components of regulatory capital.

Due to weaknesses in Basel Committee introduced a risk sensitive framework in June 1999, which came to know as Basel II. The aim of this accord was to foster safety and soundness in the financial sector through its risk sensitive framework, improve competitive equality, develop a complete way to address risk and establish ways to capital adequacy that are sensitive to risk involved in banks activities. But the global banking crisis of 2007 highlighted the weaknesses in Basel II such as excess liquidity, excess leverage, inadequate quality capital, procyclicality, and interconnectedness of systemically important too-big-to-fail financial institutions.

The Third Basel Accord was established in response to weaknesses in financial regulation disclosed by late-2000s financial crisis. It is scheduled to be completely implemented by 2018. It calls for greater strengthening of capital requirements, bank liquidity and bank leverage. The main objective of this accord is to enhance the resilience of the banking institutions to face the periods of financial and economic stress. Basel III aims to raise bank’s capital, to move the banks away from short term funding, enhance risk management and governance as well as improve bank’s transparency and disclosures. It includes micro prudential and macro prudential measures since larger strength at the individual bank level decreases the risk of system wide shocks.

Some critics assert that these revised norms may further affect the stability of the financial system by providing higher financial system to mislead the regulations.

The Indian banking system has remained largely unharmed in the global financial crisis. This is mainly amongst others, on account of the relatively robust capitalization of the Indian banks. The Reserve Bank of India had scheduled the start date for implementation of Basel III norms over a 6-year period from April 2013. The current requirement of infusion of additional equity in view of low economic growth and raising non-performing assets of Indian banks paint a gloomy picture.

**Basel III Accord**

The Basel Committee on Banking Supervision introduced Basel III Accord with the aim to enhance global capital and liquidity standards to promote a resilient banking sector and to enhance the ability to face the financial and economic stress which in turn decrease the risk of overflow from the financial sector to the real economy.

To achieve these aims Basel III proposals have been divided into three parts on the basis of the key areas mentioned below:
• Enhanced quality of capital
• Enhanced quantity of capital
• Reduced Leverage through introduction of backstop leverage ratio
• Enhanced short term liquidity coverage
• Enhanced stable long term balance sheet funding
• Enhanced risk capture notably counters party risk.

Explanation of above significant areas:

I. Better quality of capital:

Basel III pointed on enhancing the quality of capital with the objective to enhance the loss-absorption capital in going-concern and liquidation circumstances.

II. Increased quality of capital:

The minimum capital for common equity:

• Increased from 2% to 4.5%.
• In addition banks have to maintain Capital Conservation Buffer of 2.5% of additional core capital, which brings the aggregate minimum core equity to 7%.
• This will be phased in from 2013 to 2019.

Minimum Total Capital:

• Minimum total capital to risk weighted assets has been raised from 8% to 10.5%.
• It will be phased in from 2013 to 2019.

III. Leverage Ratio:

• Tier 1 leverage ratio is set at 3% of a bank’s total assets (both on and off balance sheet assets are involved).
• It is an easy, transparent and non-risk based ratio. It has supplemented the risk based capital requirements.
• It will be implemented on a gross and un-weighted basis not considering the risks related to the assets.

IV. Enhanced short term liquidity coverage:

1. Liquidity Coverage Ratio aims to promote resilience to anticipated liquidity uncertainties over a 30 day time period. This ratio will insure that global banks have an enough quantity of high quality of liquid resources to compensate the net cash flows it will experience under an intense short-term stress period.
2. The stress scenario is based upon the i) extensive downgrade of organizations public credit rating ii) incomplete loss of deposits iii) loss of unsecured wholesale funding iv) extensive raise in secured funding haircuts v) growth in derivative collateral calls vi) important calls on legal and non-legal off- balance sheet exposures involving committed credit and liquidity facilities.

3. Net Stable Funding Ratio requires a bank to keep minimum amount of stable sources of funding respective to the liquidity profiles of the assets also the prospective for contingent liquidity needs rising from the off- balance sheet commitments over a period of one year.

4. NFSR aims to restrain excessive dependence on short- term wholesale funding during the period of resilient market liquidity and promote proper assessment of liquidity risk across on and off balance sheet items. The purpose of NSFR is to boost resilience over a longer time period by developing additional incentives for banks to fund their activities with steady sources of funding on regular basis.

   The LCR will not be proposed until 1 January 2015. By 1 January 2018 it would move to a minimum standard. Both these ratios will be watched carefully and rechecked during the transition period.

V. Enhanced Counterparty Credit Risk:

1. Alignment of modeling approaches such as Internal Model Methods of Counter party credit risk to the stressed periods.

2. Correlation improved for definite financial institutions in the IRB to show the experience of the current crisis. Credit Valuation Adjustment (CVA) capital charge to defend against the mark-to-market losses related with the decline in the creditworthiness of counterparty.

3. Enhanced management of standards of counterparty credit risk in the fields of stress testing and collateral management.

Basel III Accord & India:

Since the establishment of the Basel Accords, India has been a founder signatory of them. It has been trying to pursue Global Basel norms for banking supervision, regulations and risk management. Basel III is a more resilient framework and presented various reforms based on the weaknesses of previous Accord Basel II. It is in the third Basel Accord.

India has started implementing Basel-III capital norms from April 1,2013 in a phased manner. Banks have been given a long period to prepare and plan themselves and to reduce any unexpected results rising out of higher capital requirements as during this period Basel III guidelines would be implemented. Capital Equity will be completely phased in and implemented on March 31,2018.
Draft guidelines reflecting the proposed implementation of Basel III capital regulations in India has been displayed by RBI on its website.

The important features of draft guidelines issued by RBI are as follows:

I Minimum Capital Requirements:

1. Minimum Common Equity Tier 1 Capital must be at least 5.5% of risk-weighted assets.
2. Additional Tier 1 Capital must be at least 1.5% of risk-weighted assets.
3. Tier 1 Capital Ratio must be at least 7% of risk-weighted assets.
4. Total capital ratio must be at least 9% of risk-weighted assets.

II Capital Conservation Buffer (in form of Common Equity Tier 1 Capital) must be at least 2.5% of risk-weighted assets. Banks have to hold 25% additional capital to face future stress and financial uncertainties.

III Credit Value Adjustments:

Banks are required to calculate additional capital charge for ‘Credit Value Adjustment’s risk which grasp the risk of mark-to-market losses due to downturn in the creditworthiness of counterparty.

IV Leverage Ratio:

Banks are required to maintain a leverage ratio of at least 4.5% (5% in draft Guidelines). This ratio will be tested from April 1, 2013 to January 1, 2017. All assets on balance sheet and off balance sheet items at credit conversion factors will be included in the leverage ratio. It will be calculated on averagely quarterly basis (average of month and end balances).

V Definition of Regulatory Capital:

1. Banks are required to maintain minimum total capital of 9% of total risk weighted assets. Capital Conservation Buffer and Countercyclical capital Buffer are not included in this. Appropriate risk factors and capital adequacy assessment of each bank has to be considered by the Reserve Bank in order to insure that the capital held by the bank is consistent with the overall risk profit of the banks.

2. Banks are expected to operate at a level more than the minimum requirement in terms of requirements of Pillar 2.
3. Common Equity Tier 1 Capital must be at least 5.5% of risk-weighted assets. Capital Conservation Buffer (CCB) of 2.5% of risk-weighted assets have to be maintained by the banks in the form of Common Equity Tier 1 Capital. The complete implementation of capital ratios and Capital Conservation Buffer the capital requirements are compiled below:

<table>
<thead>
<tr>
<th>Regulator Capital</th>
<th>% To RWAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Common Equity Tier 1 Capital Ratios</td>
<td>5.5</td>
</tr>
<tr>
<td>Capital Conservation Buffer (Comprised to Common Equity)</td>
<td>2.5</td>
</tr>
<tr>
<td>Minimum Common Equity Tier 1 Ratio plus Capital</td>
<td>8.0</td>
</tr>
<tr>
<td>Conservation Buffer (I+II)</td>
<td></td>
</tr>
<tr>
<td>Additional Tier 1 Capital</td>
<td>1.5</td>
</tr>
<tr>
<td>Minimum Tier 1 Capital Ratio (I + IV)</td>
<td>7.0</td>
</tr>
<tr>
<td>Tier 2 Capital</td>
<td>2.0</td>
</tr>
<tr>
<td>Minimum Total Capital Ratio (V+ VI)</td>
<td>9.0</td>
</tr>
<tr>
<td>Minimum Total Capital Ratio + Capital Conservation Buffer (VII+VIII)</td>
<td>11.5</td>
</tr>
</tbody>
</table>

**Conclusions and Policy Implications:**

Basel III is the enhancement in the Basel II norms. Comparison of capital requirements under Basel-II and Basel-III is being summarized as below:

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Under Basel-II</th>
<th>Under Basel-III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Ratio of Total Capital to RWAs</td>
<td>8%</td>
<td>10.50%</td>
</tr>
<tr>
<td>Minimum Ratio of Common Equity to RWAs</td>
<td>2%</td>
<td>4.5% to 7%</td>
</tr>
<tr>
<td>Tier 1 Capital to RWAs</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>Capital Conservation Buffer to RWAs</td>
<td>None</td>
<td>2.5%</td>
</tr>
<tr>
<td>Core Tier 1 Capital to RWAs</td>
<td>2%</td>
<td>5%</td>
</tr>
<tr>
<td>Leverage Ratio</td>
<td>None</td>
<td>3%</td>
</tr>
<tr>
<td>Countercyclical Buffer</td>
<td>None</td>
<td>0% to 2.5%</td>
</tr>
<tr>
<td>Minimum Liquidity Coverage Ratio</td>
<td>None</td>
<td>TBD (2015)</td>
</tr>
<tr>
<td>Minimum Net Stable Funding ratio</td>
<td>None</td>
<td>TBD (2018)</td>
</tr>
<tr>
<td>Systemically Improvement Financial Institutions Change</td>
<td>None</td>
<td>TBD (2011)</td>
</tr>
</tbody>
</table>
Implementation of Basel III norms will have a net impact on the capital requirements of the Indian banks. They would require Rs 5 Lakh Crore as an additional capital of which non-equity capital of Rs 3.25 Lakh Crore whereas the equity capital will be 1.75 Lakh Crore. According to the governor of RBI the money that would be raised from the market would depend on the recapitalization burden of the public sector banks the government would meet. The amount market would provide would be in the range of 70000 Crore to 1 Lakh Crore which would depend on how much the government had provided over the last five years. The biggest challenge Indian banks would face is the diminishing quality of assets and reduced profitability. Effective implementation of Basel III is going to make Indian banks stronger and more stable that would deliver value to real sectors of the economy. So far it was required that there should be a complete change in the approaches of the banks to risk management. Before the implementation of Basel III Indian banks were functioning on the standardized approaches of Basel II. As Basel III is implemented globally Indian banks will have no choice but to make themselves prepare to attain this difficult task of capital enhancement. The large-scale banks have to adopt the advanced approaches of risk management. The adoption of these advanced approaches to risk management by the banks would help them to manage their capital more efficiently and enhance their profitability.

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