BASEL NORMS IMPLEMENTATION WITH RESPECT TO INDIAN BANKS: A CRITICAL REVIEW

DR. SOUGATA CHAKRABARTI*; DR. DEBDAS RAKSHIT**

*PHD, CAlIB, MBA, BE,
WORKING IN A COOPERATIVE BANK IN THE RANK OF ASST. GENERAL MANAGER,
LAKSHMIPUR MATH, COLLEGE MORE, BURDWAN.

**PH.D, FCMA, MCOM,
PROFESSOR, DEPTT. OF COMMERCE, THE UNIVERSITY OF BURDWAN,
THE UNIVERSITY OF BURDWAN,
DEPTT. OF COMMERCE, GOLAPBAG,
BURDWAN.

ABSTRACT
The failure to prevent financial crises in the twenty first century raises concerns. There is a wide body of evidence that the most severe economic crises are associated with banking sector distress and banking crises result in losses in economic output. The objective of the Basel III reforms is to reduce the probability and severity of future crises. This will involve some costs arising from stronger regulatory capital and liquidity requirements and more intense and intrusive supervision. But our analysis and that of many others has found the benefits to society well exceed the costs to individual institutions. Basel III is fundamentally different from Basel I and Basel II. One central focus is strengthening global capital and liquidity rules (Basel III) with the goal of improving the banking sector’s ability to absorb shocks arising from financial and economic stress. Basel III emphasizes the need for transparent and comparable accounting rules and for improvements in corporate governance, imposition of a group leverage ratio and proposes a Non-Operating Holding Company Structure reforms that are essential to deal with contagion and counterparty risk that are so integral to the ‘too big to fail’ issue. This study aims to study these viewpoints in the perspective of Indian scenario.

KEY WORDS: Basel norms implementation, Basel III reforms, perspective of Indian scenario.

Introduction

In the backdrop of Herstatt Bank debacle, G-10 countries and Luxembourg formed a standing committee under the auspices of the Bank for International Settlements (BIS) called the Basel Committee on Banking Supervision. It plays a leading role in standardizing bank regulations across jurisdictions. The committee has been focusing on defining roles of regulators in cross-jurisdictional situations and to promote uniform capital requirements so banks from different countries may compete with one another on a “level playing field.” In Basel I (1988) the committee set minimum capital requirements for banks’ credit risk and added capital charges for market risk in an amendment on 1996. The Basel Committee developed Basel II which is an overhaul of Basel I in the year 2000. When Implementation of Basel II was nearing in completion a financial crisis hit and shows the inadequacy of Basel Accords. The failure to prevent financial crises in the twenty first century raises concerns. The obvious questioned raised whether Basel Committee is fine tuning an approach that may be
fundamentally inadequate? The Basel Committee responded with a longer-term overhaul of bank capital requirements, which is called Basel III (2010). Reserve Bank of India responded by releasing a series of guidelines on the implementation of BASEL III Capital Regulations on May 2, 2012 with an intention of implementing it in phased manner commencing from January 1, 2013 to March 31, 2018 for Indian Scheduled Commercial Banks.

**Literature Review**

Most of the literature on the subject is focused on the implementation issue of Basel. The primary objectives of the Basel reforms are to ensure the reduction of incidence, severity, and costs of financial crises and the associated output loss. However, the proposals enshrined in the reform package will be associated with some macroeconomic costs. These include a rise in lending rates as well as a drop in the overall quantum of lending. According to BCBS (2010), a one percentage point increase in the capital ratio raises loan spreads by 13 basis points, and a median 0.09% decline in output (Sengupta, 2011). It has been observed that developing countries ‘assets are subject to more volatility and procyclicality than developed countries (Stijn Claessens et al., 2008). New generation private sector banks are better equipped to face challenges of the Basel III guidelines in comparison to PSU banks because of their high capital adequacy ratios, enhanced proportion of common equity, better IT and other modern financial skills of the personnel (Balasubramaniam,). State run banks of India have shifted their portfolio to reduce capital requirements in the post reform period which have had a dampening effect on overall credit supply (Nag & Das, 2002), (Ghosh & Nachane, 2003). Sarma and Nikaldo (2007) find that Indian banking system performed reasonably well during the Basel I regime, maintaining an average CAR of about 12 per cent, which is higher than the internationally accepted level of 8 per cent and the RBI’s minimum requirement of 9 per cent. Post Lehman Brothers crisis moved banks to become more cautious by maintaining buffer capital, over and above the minimum level required by the Basel II. The main hallmarks of the crisis can be identified as ‘Too-big-to-fail’ institutions that took on too much risk – a large part of these risks being driven by new innovations that took advantage of regulatory and tax arbitrage with no effective constraints on leverage (previous studies of OECD). One of the regulatory lessons of the crisis is that it is critical that all countries and regions now follow the global implementation process. The banking sector’s shock absorbing capacity must be much stronger than it has been in the past, and the implementation standards must be more globally consistent and robust (Walter, 2011). India’s struggling banking sector will face a period of lower profitability as it seeks to raise at least Rs. 5000 billion in extra capital to meet the new Basel-III international banking standards (Jain, 2012). The main cause for systemic failure in the last global crisis were seen liked with banks working within the broad global regulatory framework but failed to restrain excessive leverage and risk taking (Blundell-Wignall, Wehinger and Slovik).

**Objective of the Study**

This work would make an attempt to relook Basel norms and study the impact of Basel III in Indian context. Basel III has introduced common capital that measures core equity capital in relation to its total risk-weighted assets for assessing the bank’s financial strength and capital conservation buffers at various levels. The new norms will push up the capital needs of Indian banks. There is a need of additional capital for doing the same level of business for Indian banks which may see a sharp drop in their returns on assets. The global Basel-III requirements are aimed at improving financial stability. But higher capital requirements may
have drawn impact on banking lending rates and wider economic growth of India. This study aims to study these viewpoints in the perspective of Indian scenario.

Basel I & II at a glance

Basel I accord is a set of minimum capital requirements for banks published in 1988. Basel I came into effect in December 1992 with an objective to maintain enough capital to absorb losses without causing systemic problems, and to maintain a level the playing field globally. A minimum ratio of 4% for Tier 1 capital (which should mainly be equity less goodwill) to risk-weighted assets (RWA) and 8% for Tier 1 and Tier 2 capital (certain subordinated debt etc). The First Narasimham Committee Report recommended the introduction of a capital to risk-weighted assets system for banks in India since April 1992. RBI stipulated that foreign banks operating in India should achieve a CRAR of 8 per cent by March 1993 while Indian banks with branches abroad should comply with the norm by March 1995. All other banks were to achieve a capital adequacy norm of 4 per cent by March 1993 and the 8 per cent norm by March 1996. In 1998, the RBI raised the minimum regulatory CRAR requirement to 9 per cent, and banks were advised to attain this level by March 31, 2009. Basel I was a simple ―broad-brush‖ approach and gave banks the ability to control the amount of capital they required by shifting between on-balance sheet assets with different weights by securitising assets and shifting them off balance sheet – a form of disintermediation. Banks quickly accumulated capital well in excess of the regulatory minimum and capital requirements, which, in effect, had no constraining impact on bank risk taking. An Amendment to Basel I was made on 1996 to incorporate capital charge for market risk. One strand of thought criticizes the capital adequacy ratio of Basel I for being too simple and risk insensitive. One of the major issues with Basel I was rampant regulatory arbitrage and as a result a ‘revised framework’ known as Basel II was released (Jackson, 1999).

Financial Institutions Regulated by RBI

Basel II was released in June 2004 (Basel Committee on Banking Supervision, 2004). Basel II uses a “three pillars” concept. The three pillars are minimum capital requirements (addressing risk) i.e. Pillar 1, supervisory review i.e. Pillar 2 and market discipline (Disclosure requirements) i.e. Pillar 3. Pillar 1 consists of Credit Risk, Market Risk and Operational Risk. Supervisory review is a guiding principle for banking supervision. Basel I is arguably the most successful of all recent financial standards’ (Powell 2002). The extensive use of Information Technology in the banking sector coupled with rapid transformation in risk management techniques in the 1990s outpaced the straightforward approach of Basel I. Banks remained compliant with the Accord after shifting their higher-risk loan portfolio to
off-balance sheet accounts. Eventually in 2004, the more sophisticated Basel II replaced the risk insensitive Basel I. Substantial debate arose after the introduction of the Accord with two distinct opinions about this milestone in banking regulation. One group criticizes Basel II on the grounds of it being procyclical, and, therefore implying that Basel II is counter productive as a policy tool in the hands of central banks. However, those who are associated with the Basel Committee on Banking Supervision (BCBS) refute this criticism. They contend that the solutions are inbuilt into the regulation and hence it is not procyclical. These discussions centered on the macroeconomic perspective, and little attention has been given to the micro level issues, such as how banks adjust their operations in response to the regulatory capital mandate.

**Basel II implementation in India**

The RBI announced the implementation of Basel II norms in India for internationally active banks from March 2008 and for the domestic commercial banks from March 2009. RBI issued the first draft guidelines on Basel II implementations in the year 2005 in which an initial target date for Basel II compliance was set for March 2007 for all commercial banks, excluding Local Area Banks (LAB) and Regional Rural Banks (RRB). In India implementation of Basel II was a challenge because some banks are internationally active others not and it was a mix of small and big banks. In India some banks are strong but others are not so strong and adoption of technology also different. The different levels of human resource capabilities, diverse patterns of ownership, extensive branch network, lack a robust credit rating framework and insufficiently developed legal Framework Relating to Enforcement of Collateral are also issues of major concern. India adopts a three track approach for Basel roll out. It was decided that Commercial Banks to adopt Basel II framework from March 2007 but Cooperative Banks to adopt Basel I and Regional Rural Banks to adhere to minimum capital requirement. RBI followed a consultative approach by forming a Steering Committee and a Sub-groups of Steering Committee to address specific issues relating to national discretion, mapping of ratings, retail exposures, credit risk mitigation, Pillar 3 aspects, issues relating to ICAAP (Internal Capital Adequacy Assessment Process) of banks, issues relating to operational risk management. The deadline was extended to March 2008 for internationally active banks and March 2009 for domestic commercial banks. Due to complexity and intense data processing requirement RBI advised Indian banks to adopt Standardized Approach for credit risk and Basic Indicator Approach for operational risk in the initial years. As per RBI guidelines, Indian banks were required to maintain a minimum CRAR of 9 per cent on an ongoing basis and were encouraged to achieve a tier I CRAR of at least 6 per cent by March 2010. The major issues at bank level were higher capital requirements, capacity building, improved IT architecture / MIS, improvements in governance standards and oversight, data issues and validating economic capital and at regulator level major issues were capacity building, rating penetration, issue vs issuer, refine & upgrade financial information monitoring, data warehousing.

**Comparison and critical review of Basel I & II**

The Basel I accord dealt with only parts of each of Basel II pillars. For example: with respect to the first Basel II pillar, only one risk, credit risk, was dealt with in a simple manner while market risk was an afterthought; operational risk was not dealt with at all. Pillar 1 of the Basel II system defines minimum capital to buffer unexpected losses. Total Risk-weighted
asset (RWA) are based on a complex system of risk weighting that applies to ‘credit’, ‘market’ (MR) and ‘operational’ risk (OR), which are calculated separately and then added:

\[ RWA = \{12.5(OR+MR) + 1.06*\text{SUM}[w_ia_i]\} \]

where: \( w_i \) is the risk weight for asset \( i \); and \( a_i \) is asset \( i \); OR and MR are directly measured and grossed up by 12.5 for 8% equivalence; and credit risk is the sum of the various asset classes, each weighted by its appropriate risk weight. A scaling factor applied to this latter term, estimated to be 1.06 on the basis of Quantitative Impact Study (QIS3) data (but subject to change).The Basel II accord has also failed to enhance competitive equality amongst banks. Large financial institutions are making significant gains on smaller institutions in terms of capital obligations. Finally, the accord cannot be seen to constitute a more ‘comprehensive’ approach to addressing risks. Provisions for risks associated with the trading book are conspicuously absent, despite the Committee’s awareness that the size of banks’ trading books had mushroomed as a result of Basel I. Basel II is criticised for being “the wrong kind of regulation”. It failed to address liquidity and leverage risks, and was unable to foresee or prevent the financial crisis. The Basel II of 2004 copied and pasted the capital charge for market risk of Basel I amendment of 1996.“Under Basel II, Pillar I was the ‘star’ of the show. It was the main focus for firms and regulators, while Pillar II was essentially complementary to it.” Pillar II in Basel II played the role of checking and backing up the sufficiency and robustness of the capital requirements, and was used to cover shortfalls (if any) and put more responsibility on firms. Banks made the common mistake of thinking that the data required for modeling (under Pillar I) was sufficient for all the reporting (all three pillars). As the centerpiece for capital regulation to avoid crises the Basel approach has failed in its first and second formulations and the world is still dealing with the after effects of the greatest financial crisis since the Great Depression. Basel I and II fail to stop global crisis
Basel III have a macro prudential focus and addressed system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time. The key elements of ‘Basel III’ proposals for reform are to raise the quality, consistency and transparency of the capital base, enhancing risk coverage, supplementing the risk-based capital requirement with a leverage ratio and reduction of Pro-cyclicality.

Most of the adjustments under Basel III will be made from Common Equity and banks’ risk exposures are backed by a high quality capital base. Tier 1 capital must be common shares and retained earnings and be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither maturity dates nor an incentive to redeem. Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses will be phased out. In Basel III, shortfall in provisions to expected losses under Internal Ratings Based (IRB) approach and shortfall in defined benefit pension fund should be made from Common Equity component of Tier 1 capital. Cumulative unrealized gains or losses if any due to change in own credit risk on fair valued financial liabilities should be filtered out from Common Equity. Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated. All elements of capital required with detailed reconciliation to be disclosed to the published accounts to improve the market discipline. The committee stresses that equity can be used to write off losses. Goodwill, income of the 3rd party minorities, deferred tax assets, bank investments in its own shares, bank investments in other banks, financial institutions and insurance companies – all cross-share holdings and investments in sister companies are not to be included in common equity. In Basel III shortfall in provisions to expected losses under Internal Ratings Based (IRB) approach and defined benefit pension fund will be made from Common Equity component of Tier 1 capital. Basel III proposed that cumulative unrealized gains or losses should be filtered out from Common Equity if it is due to change in own credit risk on fair valued financial liabilities and all elements of capital required for reconciliation will be disclosed to the published accounts to improve the market discipline. Total Capital Requirement will be enhanced in phases and the minimum Common Equity, Tier 1 and Total Capital requirements will be phased-in between January 1, 2013 and January 1, 2015, as indicated below:
### Time frame

<table>
<thead>
<tr>
<th>Time frame</th>
<th>Minimum Common Equity Tier 1 capital as a % age to Risk Weighted Assets (RWAs)</th>
<th>Minimum Tier 1 capital as a % age</th>
<th>Minimum Total capital as a % age</th>
</tr>
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<td>4.5</td>
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<tr>
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<td>4.0</td>
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</tr>
<tr>
<td>January 1, 2015</td>
<td>4.5</td>
<td>6</td>
<td>8.0</td>
</tr>
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**Enhancing risk coverage**

In Basel III additional capital charge for Credit Value Adjustment (CVA) risk is introduced to capture risk of mark-to-market losses due to deterioration in the credit worthiness of counterparty. 25% adjustment to the asset value correlation (AVC) under IRB approaches is prescribed to capture risk of interconnectedness among larger financial firms (defined as having total assets greater than or equal to $100 billion). The Committee has introduced higher capital requirements for re-securitisations in both the banking and the trading book and raise the standards of the Pillar 2 supervisory review process and strengthen Pillar 3 disclosures. To address systemic risk within the financial sector, the Committee has raised the risk weights on exposures to financial institutions relative to the non-financial corporate sector, as financial exposures are more highly correlated than non-financial ones. The committee introduced liquidity requirements to penalise excessive reliance on short term, interbank funding for supporting longer dated assets.

**Supplementing the risk-based capital requirement with a leverage ratio**

The Committee introduced a leverage ratio requirement with an intention of mitigating the risk of the destabilising deleveraging processes which can damage the financial system and the economy and additional safeguards against model risk and measurement error by supplementing the risk-based measure. The leverage ratio is calculated in a comparable manner across jurisdictions, adjusting for any differences in accounting standards. Under Basel III, a non-risk based regulatory leverage ratio of 3% of Tier 1 leverage ratio has been introduced. The ratio will be captured with all assets and off balance sheet items at their credit conversion factors and derivatives with Basel II netting rules and ratio will be calculated as an average over the quarter.

**Reducing procyclicality and promoting countercyclical buffers**

In Base III a countercyclical capital buffer within a range of 0 – 2.5% of Risk-weighted assets in form of Common Equity or other fully loss absorbing capital is to be implemented to reduce pro-cyclicality. An additional capital conservation buffer of 2.5% of RWAs in the form of Common Equity is introduced to withstand future periods of stress bringing the total Common Equity requirement of 7% of RWAs and total capital to RWAs to 10.5%. It will be phased-in over a period of four years in a uniform manner of 0.625% per year, commencing from January 1, 2016. Banks should maintain a minimum overall capital adequacy ratio of 11.5% (against the current 9%) by March 31, 2018.
Banks should not issue Additional Tier 1 capital instruments to the retail investors. From January 1, 2013 banks should deduct the entire amount of unamortized expenditure from common equity Tier 1 capital for the purpose of capital adequacy ratios. This is to achieve the broader macro-prudential goal of protecting the banking sector from periods of excess aggregate credit growth and reducing pro-cyclicality. These set of measures raise the resilience of the banking sector in good times with an intention of dampening any excess cyclicity of the minimum capital requirement, conserve capital to build buffers at individual banks and the banking sector that can be used in stress.

The Basel Committee introduced Liquidity Coverage Ratio to ensure sufficient unencumbered, high quality liquid assets to offset the net cash outflows it could encounter under an acute short term stress scenario. The Basel Committee introduced minimum liquidity standards to promote an international level playing field. The Basel Committee is proposing a Liquidity Coverage Ratio (LCR) which is \( \text{High Quality Assets} / (\text{30 Day Net cash Outflows}) \geq 100\% \).
The effective implementation of Basel III will make Indian banks stronger, more stable and sound. It would help them in delivering value to the real sectors of the economy. At present, Banks in India are operating on the Standardised Approaches of Basel II but they have to adopt advanced approaches to risk management which would enable Indian banks in managing their capital more efficiently and improve their profitability. A change in perception to seeing the capital framework as pre-requisite instead of compliance function for keeping banks sound, stable and profitable is important. It provides deeper and more broad-based capacity in risk management and ensures adequate and good quality data. As per the estimates of RBI, Indian banks need an additional capital requirement of Rs.5 lakh crore, of which, non-equity capital will be of the order of Rs.3.25 lakh crore while equity capital will be Rs.1.75 lakh crore. The amount the market would have to provide would depend on how much of the recapitalisation burden of public sector banks the government would meet (Dr. Rao Subba, ex. Governor RBI).

**Challenges Indian Banks Have To Face**

Stricter regulations of Basel III will undoubtedly hit Indian banks hard. Apart from just attaining compliance with the new regulations, Indian banks will have to go beyond compliance and take measures to restore profitability. The stricter capital definition lowers banks’ available capital and risk weighted assets (RWA) are significantly increased due to securitizations, trading book positions and certain counterparty credit risk exposures.
The objective of the Basel III reforms is to reduce the probability and severity of future crises. This will involve some costs arising from stronger regulatory capital and liquidity requirements and more intense and intrusive supervision. There is a concern that a higher capital requirement under Basel-III would reduce the profitability of Indian banks and make loans more expensive. As per RBI's estimates, there could be a marginal drop in GDP growth in the short-term due to it but the benefits to society well exceed the costs to individual institutions. Researchers have found the costs are more than offset by the long-term gain because a country can maintain sustainable growth on the foundation of a strong banking system. Banks are highly leveraged institutions and are at the centre of the credit intermediation process in any country and banking crisis is very damaging for any country. The Basel Committee’s long-term economic impact study found that the central estimate in the economics literature is that banking crises result in losses in economic output equal to about 60% of pre-crisis GDP. A destabilised banking system affects the provision of credit and liquidity to the broader economy and ultimately leads to lost economic output and ultimate spillover of risk between the banking sector and sovereigns. In recent past a number of industrialised nations had increased their debts to such an extent that their debt-to-GDP ratios have risen by 10-25% points to save the banking sector. The Reserve Bank of India (RBI) plans to introduce increased capital requirements by 2016 for banks regarded as too big to fail, and make them subject to greater regulatory oversight. It would require banks to build reserves during periods of stability in order to weather more difficult times. Banks classified as systemically important will be required to hold additional capital in the range of 0.2 percent to 1 percent of their risk weighted assets, according to the central bank proposals. The higher capital requirement will begin from April 2016 and would be implemented in phases until 2019. The list of domestic systemically important banks will be disclosed in August every year, starting in 2015 and will be subjected to more intense supervision in the form of higher frequency and higher intensity of off- and on-site monitoring as per RBI.
Indian banking scenario is dominated by State run banks. State run banks are at the centre of the credit intermediation process particularly in rural lending. A destabilised banking system affects the broader economy and ultimately leads to lost economic output and any crisis there has also been significant spillover of risk between the banking sector and sovereigns. Capital infusion in public sector banks of India to comply Basel III is a challenging one but considering the fact that the costs associated with the failure of bank's will be much higher in dimension and their subsequent impact. Central banks across the globe set Basel standards for banks and India has been implementing Basel standards gradually without disrupting the banking system. Indian banks will face the challenge of raising fund from the capital market in present economic scenario of the country. Private sector banks are in better placed in comparison public sector banks because of high capital adequacy ratios, enhanced proportion of common equity and better IT and other modern financial skills of the personnel. Small public sector banks, cooperative banks and RRBs may found difficulties in facing challenges in following the Basel III guidelines. Too much leverage, too little capital, and inadequate liquidity buffers were major causes of global financial crisis. Shortcomings in risk management, corporate governance, market transparency and quality of supervision were also the other causes of crisis. Adoption of Basel III will improve quantity and quality of capital of Indian banks, with stronger supervision, risk management and disclosure standards. The Basel III capital proposals have some very useful elements particularly leverage ratio, a capital buffer and the proposal to deal with pro-cyclicality through dynamic provisioning based on expected losses but has no reference in regulation of shadow banking system.

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