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The Journey from Basel I to Basel III and Implications for Indian Banks

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During the last two decades there have been various developments at the international and national level which have affected the operating environment of banks. Liberalization, globalization, development of new financial products and services and immense changes in technology and communication have brought important changes in working of the banks. The banking sector is going through significant changes in products, in customer base and in channels of delivery.

Banks are at the centre of credit intermediation process of every economy – through their role as lenders, market makers, providers of liquidity and payment services. A crisis in the banking sector is thus bound to have great effects on the economy in the form of financial and economic downturns and all efforts must be made to avoid their occurrence.

With financial risks growing in size and probability, proactive, efficient and integrated risk management practices are called for to enhance banks and protect the interest of stakeholders such as depositors, shareholders and employees. To set global standards for risk management in banks, the Bank for International Settlements set up the committee on Banking Supervision (BCBS). The Committee has introduced three sets of recommendations for banks popularly known as Basel I, Basel II and Basel III norms.

This paper highlights the important provisions of all three forms of Basel norms and explains the implications of Basel III for Indian banks.

Basel I- Basel I was very simple in its approach. 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. It was agreed that the banks would maintain a minimum capital of 8% of risk weighted assets. Different risk weights were charged for specified categories of exposure.

Basel I introduced common global standards and allocated capital to the quantum of risks borne by a bank. The major contribution of Basel I was that it laid the groundwork of international convergence on measuring banking risks and defining capital standards.

The major weakness of Basel I was its 'one size fits all approach'. It imposed a single rate of capital adequacy for credit risk regardless of the degree of risk

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within that category. It focused completely on credit risk, ignoring other types of risks such as liquidity risks, market risk and operational risk.

Basel II- Due to weaknesses in Basel I a risk sensitive framework was introduced by Basel Committee 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. Basel II norms were fully implemented in India in 2009. As per RBI banks in India had to maintain minimum capital to risk weighted asset ratio (CRAR) at 9% which was more than the specified requirement of Basel norms (8%). It was thought that the implementation of Basel II would require higher capital requirement for Indian banks but most banks fulfilled the prescribed CRAR prescribed under Basel II. The problems which came across while implementing Basel II are the high cost of up gradation, cost of training staff, lack of number of rating agencies and the reliability of complete rating process. But the global banking crisis of 2007 highlighted the weaknesses in Basel II such as excess liquidity , excess leverage, inadequate quality capital, procyclicality, interconnectedness of systemically important too-big-to-fail financial institutions.

Basel III- The Third Basel Accord was established in response to weaknesses in financial regulation disclosed by late-2000s financial crisis. The Basel III framework on improving the risk management, transparency and disclosures of the banking sector was developed by Basel Committee on Banking Supervision in December 2010. The main objective of this accord is to enhance the ability of the banks to absorb shocks arising from 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.

Basel III includes micro prudential and macro prudential measures since larger strength at the individual bank level decreases the risk of system wide shocks.

It covers mainly the following aspects:

1. Basel III intends to propose stringent definition of capital. Improved quality capital means the greater loss absorption capacity. The quality, consistency and transparency of capital base have been raised. This will make the banks stronger and efficient enough to withstand future shocks.
2. By development of Basel III banks will need to hold Capital Conservation Buffer of 2.5%. . The purpose to build Capital Conservation buffer is to make assure that banks keep a limited amount of capital which will help to absorb losses during financial and economic stress.
3. There are measures to increase capital levels in good times which can be drawn down during a downturn to decrease procyclicality. The Counter cyclical buffer has been proposed with the aim to protect the system against excess credit growth. The buffer will range from 0% to 2.5% which will consist of common equity and loss absorbing capital.
4. The minimum requirement for common equity has been increased from 2% to 4.5% of risk weighted assets under Basel III. The Tier 1 capital not only includes common equity but also other financial instruments will rise from 4% to 6%. Even though the minimum total capital requirement will be fixed at 8% level but the total capital requirement will rise to 10.5% which includes conservation buffer.
5. Under Basel III global liquidity standards have been introduced for internationally. active banks that include a 30-day Liquidity Coverage Ratio which is made compulsory by January 2018 and Net Stable Funding Ratio will be proposed in 2015. It will protect the banks against the periods of stressed liquidity.
6. Globally systemically important banks (considered to be too-big-to-fail) will be required to have additional loss absorbency capacity beyond the Basel III requirements.

Basel III and Indian Banks- Under Basel III the requirement of capital will definitely be higher. Banks will require more equity capital since Tier I capital has been increased and new capital norms have been proposed for trading in derivatives and other securities. Banks in India have to raise fresh capital to meet the growing credit needs and to

meet the provisioning requirements. Public sector banks in India have to approach the capital market for fresh equity as the government would not be in a position to provide additional equity to them.

Banks in India are well-capitalized and are already maintaining a higher equity capital ratio than specified in the proposed Basel III guidelines. For banks that fall short, the favorable environment of economic growth will permit them to enhance their capital bases through issue of fresh equity. Another major issue is that the traditional performance metric- Return on Equity (ROE) will take a hike due to combination higher core equity, leverage ratio and phasing of inadmissible instruments. Banks will need to seriously evaluate costs and other aspects of their performance if they wish to maintain the high levels of ROE.

There is also the factor of dynamic provisioning i.e. greater provisioning during a downturn which means that the banks would be required to maintain more capital during difficult times and in turn it will put pressure on the banks profitability.

There will be some other challenges for the banks which includes challenge of enhancing risk management systems. Risk management systems must be enhanced to account for environmental risk factors. Another major issue for banks would arise from the treatment of their pension liabilities. For focusing upon the quality of capital after the financial crisis RBI has introduced full recognition of liabilities from defined benefit pension funds in calculation of Tier 1 capital which will help the banks to absorb the losses and protect the depositors and creditors.

Public sector banks will face more difficulties than the private sector banks while implementing Basel III for various reasons such as banks have collected more NPAs than the private sector banks, financial strength of public sector banks.

The RBI is planning to look into shadow banking activities and tighten norms here also. Shadow banking refers to financial sector services beyond the regulatory purview of central banks.

Eventually all banks will face the challenge of meeting the credit needs of a growing economy and the needs of socially responsible banking while adjusting to a more strict regulatory regime.

Conclusion-

Banks are in the business of risk and they face an infinite number of risks in their daily operations. These risks have increased recently due to certain factors such as globalization, financial innovations, increasing complexity of financial products etc. The Basel norms proposed by the BIS with the objective of developing global standards for measuring, managing and protecting against these risks.

The journey from Basel I to Basel III has been a significant one and the Basel norms shows the lessons learned. Each set of norms has been distinguished by greater sophistication and more inclusive coverage then the preceding set.

This paper has highlighted the major provisions of all three sets of Basel norms and looked at the major implications of Basel III for Indian banks.

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