Basel III and Its Impact on the Banking System in India

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The Basel III framework represents an effort of BCBS (Basel Committee on Banking Supervision) to fix the gaps and lacunae in Basel II that has came into the light during the 2008 crisis. Its aimed to improve the banking sector's ability to absorb the shocks arising from financial and economic stress, risk management and governance and strengthen bank's transparency and disclosures. This article deals with the banking sector reforms in India and the techniques designed to handle the risks, related with the vast banking sector. An assessment of Basel norms and their impact on the economic growth of the country has been done. The development of Basel III and its impact on the banking system in India has been examined, since economic reforms of 1991, most of

the practices, procedures and methods of banking have changed significantly.

Key Words: *Banking Sector, Basel norms, framework, Reforms*

Introduction

Indian banking sector has faced many changes and reforms during economic liberalization. Though it was a part of overall economic reforms. Thus, it has changed the working of Indian banks. These reforms have not only affected the productivity and performance of the Indian banks but also left a never-ending mark on the working of the Indian banking sector. The efficient and effective banking sector plays a crucial role in increasing the rate of economic growth in any economy. Economic and financial sector reforms were introduced by the Government of India in 1991 and banking sector reforms were part of financial sector reforms. They were introduced in 1991 to make the Indian banking sector effective, efficient and dynamic. In India PSBs are still dominating the commercial banking system as almost 80% of the businesses are still controlled by them. The RBI has given licenses to new private sector banks and has also been providing licenses to industrial houses as a part of liberalization process. Many banks are successfully operating in the retail and consumer segments but they have to still provide services to industrial finance, retail trade, small business and agricultural finance.

About Basel Norms:

The Basel Committee on banking supervision provides a forum for regular co-operation on banking supervisory matters. Its purpose is to increase the understanding of important supervisory issues and enhance the quality of banking supervision globally. It pursues to do so by exchanging information on key supervisory issues, approaches and techniques with a purpose to build up common understanding. The committee's secretariat is situated at the bank for International Settlements in Switzerland. This committee formulated its first document to introduce minimum amount of capital that banks should hold globally. This minimum amount of capital is a percentage amount of the total capital of the bank which is also known as minimum risk based capital adequacy.

Basel-I:

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. The guidelines of Basel I were adopted by India in 1999. Basel I was the first global instrument evaluating the significance of risk in relation to capital and confirmed to be an achievement in the finance and banking world. The acceptance of Basel 1 Accord was seen by large investment banks as a sign of regulatory strength and financial stability in emerging markets. Some weaknesses were identified in Basel I such as no importance was given to risk related with credit, risk related with various currencies and macroeconomic risk.

Basel-II:

Due to weaknesses in Basel II 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, 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%). India faced difficulties while implementing Basel –II as there was a requirement of enhanced risk

management and measurement. It aimed to provide catalyst to use internal rating system by global banks. And secondly there was a need to arrange risk capital by the banks. But the recent global financial crisis of 2008-2009 has reflected weaknesses in whole approach to risk management developed through Basel II process.

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. Its purpose is to enhance the ability of banks to absorb shocks arising from financial and economic stress, supervision and risk management of banking sector. It is also created to strengthen the resolution of [illegible] important cross border banks. Implementation of Basel III will be a challenging task [illegible] Indian banks but also for the government of India. It is predicted that Indian banks need to raise Rs 6, 00,000 crores in external capital by 2020.

It covers Mainly the Following Aspects:

Basel III intends to propose stringent definition of capital. Improved quality capital means the greater loss absorption capacity. This will make the banks stronger and efficient enough to face any crisis.

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.

The Counter cyclical buffer has been proposed with the aim to enhance capital requirements in good times and decline in bad times. The buffer will range from 0% to 2.5% which will consist of common equity and loss absorbing capital.

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.

Under Basel III liquidity standards have been introduced which includes liquidity coverage ratio and net stable funding ratio which will be proposed in 2015 and 2018 respectively.

Study of Basel III in Indian Context:

Currently bank's capital consist of Tier 1 and Tier 2 capital but Tier 2 capital will not be more than 100% of Tier 1 capital. In Tier 1 capital new instruments are restricted to 15% of Tier 1 capital. Subordinated debt is restricted to 50% of Tier 1 capital in Tier 2 capital. To enhance the quality of capital the Tier 1 capital will include common equity under Basel III. Currently the regulatory alteration to capital is different across various jurisdictions. To enhance the quality of common equity and also flexibility of regulatory alterations across jurisdictions, most of the alterations under Basel III will be made from Common Equity. The norm for instruments to be involved in Additional Tier 1 capital and Tier 2 Capital will be enhanced. This way the market discipline under Pillar 3 of Basel II accord will become better.

Capital Ratio of Basel III Vs Basel II

	Basel III	Basel II
Tier 1 Capital Ratio	2013=4.5% 2014=5.5% 2015=6%	4%
Core Tier 1	2013=2% 2014=3.5% 2015=4.5%	2%
Capital Conservation Buffer	2016=0.625% 2017=1.25% 2018=1.875% 2019=2.5%	None

Source: Business Mathematics and Informatics Internship Report.

Few months back RBI Governor, D. Subbarao announced that implementation of Basel III will impact on the Return on Equity of Indian banks. Return on Equity of banks may decline in the short term. As per Basel III guidelines banks have to keep good quality capital equal to 7 percent of their risk weighted assets. Its purpose is to enhance the financial stability and make the banks stronger and efficient enough to face any crisis in the future. As Basel III demand higher capital requirements from the banks it will impact on the lending rates of the banks and extensive economic development across the world.

Conclusion

While implementing Basel III guidelines capital of banks will decline by 60% because of discharge of certain elements of capital from Tier 1. Also the risk weightings are predicted to rise by 200%. The effect of these will decline the Return on equity and profitability of banks. The move from short term to long term liquidity will raise the cost of funds in the banking sector. Bank's profit margins will also be affected. One of the common principle of careful banking is to borrow long and lend short. There should be a proper balance between duration of assets and duration of liabilities. The leverage ratio of Indian banks is balanced so it is not a major issue. Still with capital dilution, expanded risk weightings and restrictions on derivative trading the enhanced leverage ratio will affect the capacity of Indian banks. Systemic stability should be there but it should not affect the larger objectives of removal of poverty, generation of employment, priority sector lending and equitable regional growth. Thus it is concluded that new guidelines of Basel III will bring stability in the banking sector across the world and will make the banks stronger and efficient enough to face any crisis.

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