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ORIGINAL ARTICLE

BASEL - III AND ITS IMPLICATIONS ON INDIAN BANKS

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Abstract:

The long term health and survival of financial service entity hinges upon its ability to understand, appreciate, quantify and manage the range of risks associated with the line of business. During the pre-Basel era the culture of risk management centered around strengthening the transaction procedures aimed at filtering risk encroachments. The art of balancing the cycle of payments and receipts as a going concern was the major risk management technique. The size of the exposures and the risks they carry were not related to capital. Irrespective of the smallness of capital, exposures could swell in tune with the ability to raise public deposits. Adequacy or otherwise was never explored.

KEYWORDS:

Implications , term health , risk encroachments , management technique.

INTRODUCTION

Risks arising from disproportionate exposures may swallow the profits, penetrate beyond the capital and eat upon the depositor's money. In the year of 1988 the Banking for International Settlement (BIS) committee introduced the Basel-I Accord which spoke for the first time about adequacy of capital and the management of risk rolled on from cautious steps to measured steps1. It prescribed a minimum international acceptable level of bank capital. This frame work was progressively introduced not only member countries but also more than 100 other countries that have active global banks. The reason for its unquestioned acceptance by advanced as well as less developed countries, lays largely in the fact that it arrived on the scene precisely when many countries reforming their financial sector (Nachane 2003). India was no exceptions to this. The Narshimham Committee reports I and II had heavily relied on Basel-I for their entire agenda for the banking sector reform in India.

However, the banking industry world over has undergone a major transformation since Basel-I was implemented in 1988. Two specific changes the expound use of securitization and derivates in secondary market vastly improved risk management systems had significant implications for Basel-I for banks that operate on global scale in virtually all financial market, Basel –I has became out dated.

In recognition of these trends, the Basel committee proposed a new – capital adequacy frame work (Basel-II) in June1999, which recommended more risk sensitive minimum capital requirements for banking organization. The Basel-II introduced "three pillars" model which comprises "Minimum Capital Requirements "- that attempt to consolidate roles established in 1988 Accord, "Supervisory review" and " Market discipline"-"as a lever to strengthen discloser and encourage safe and sound banking practices"2

The promotion of financial stability through more risk sensitive capital requirements constitutes one of Basel II's primary objectives. However some weakness identified with Basel II are attributed to pro cyclicality and to the fact that not all material credit risks in the trading book are adequately accounted for in the current capital requirements. The pro cyclical nature of Basel II has been criticized after 2007-08 global

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financial crises, since "capital requirements for credit risk as a probability of default of an exposure decreases in the economic upswing and increases during the downturn"3 hence resulting in capital requirements which fluctuate over the cycle. Other identified consequential effects include the fact that fluctuations in such capital requirements may result in credit institutions raising their capital during periods when its is costly for them to implement such a rise – which has the potential of inducing banks to cut back on their lending. It is concluded that "risk sensitive capital requirements should have pro cyclical effects principally on under capitalised banks."[4]

. This article gives an overview of the Basel-III norms, the time frame agreed upon for implementation and their implications on Indian banks.

An Overview of Basel-III

According the Basel Committee on Banking Supervision (BCBS) the Basel-III proposals have two main components one is proposed changes in Capital and another is key modification to the Liquidity,

1.Proposed modification to Capital/ Leverage ratio

The leverage ratio consist increase in common equity capital ratio, Introduction of Capital Conservation Buffer, Introduction of countercyclical capital buffer and Introduction of Non Risk Based Leverage Ratio

Increase in common Equity Capital Ratio.

Capital is very significant in its role since it serves to absorb risks and protect deposits. The banks capital comprises an element of Tier one, two and three capital. The Basel-III reform package spokes about the increase of minimum common equity requirement from 2% to 4.5% in by January 2015. The rational behind the increasing the equity capital is that it is considered to be the highest quality component of capital, It is subordinated to all other elements of funding-absorbing losses as and when they occur, having full flexibility of dividend payments, No maturity date and It is the primary form of funding which helps to ensure that banks remain solvent. The distinction between definitions of Tier One and Tier Two capital are highlighted by the Committee as corresponding to capital which absorbs losses on a going concern basis and capital which absorbs losses on a gone concern basis respectively.

Proposed key changes, whilst aimed at "significantly improving the quality and consistency of the common equity of Tier One capital", as well as simplifying Tier Two Capital (to the extent that there would be only one set of entry criteria – and the removal of sub categories pertaining to Tier Two) also include the recommendation that Tier Three capital should be abolished "to ensure that market risks are met with the same quality of capital as credit and operational risks."[5] As a result, the proposed harmonised structure of Tier-I capital will consist of paid up capital + 'reserves & Surplus' + Perpetual debt/ preference capital-deferred tax assets – Investments in subsidiaries or associate (50%) – Intangible / Goodwill –securitization exposure " . The core Tier-I capital will arrive after subtracting preference capital and perpetual debt from the tier-I capital.

Category of Tier 1	Calculation	Notes
Common equity ("core Tier 1")	Common equity – Goodwill (deduction) = Tangible common equity – Other deductions = Common equity net of deductions	• Predominant form must be common shares plus retained earnings and other comprehensive income • No debt-like instruments included in core Tier1 • No "financial innovation" permitted • Net of deductions (goodwill, deferred tax assets, minority interest, investments in own shares, etc) • Deductions are internationally harmonised
Additional going-concern capital[1]	+ Preference shares Preferred stock + Other non-dated, loss-absorbing instruments (only limited debt-like features permitted)	• Instruments must meet strict entry criteria (eg subordinated, no maturity date, fully discretionary non-cumulative dividends, no incentive to redeem) • Only limited debt-like features permitted (preferred dividends) • Grandfathering of capital instruments under consideration (including government rescue package instruments) • Elimination of the use of innovative hybrid debt instruments
	= Tier 1 capital (going-concern capital)[1]	• Enhanced disclosure of all elements of Tier 1 capital, including all regulatory adjustments, main features, explanation of ratios
	Contingent convertible bonds (contingent capital)	• Under review: some debt in banks' capital structure converts to equity when a predefined threshold is reached

Source: "Improving the Quality of Tier One Capital"6

The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the period of 2015. The below table summarises the new capital requirements.The regulatory adjustments will begin at 20% of the required deductions from common equity on 1 January 2014, 40% on 1 January 2015, 60% on 1 January 2016, 80% on 1 January 2017, and reach 100% on 1 January 2018. During this transition period, the remainder not deducted from common equity will continue to be subject to existing national treatments The total capital requirement remains at the existing level of 8.0% and so does not need to be phased in. The 2% difference between the total capital requirement of 8.0% and the Tier-one requirement can be met with Tier-two and higher forms of capital. This can have a significant impact on some Indian banks partly capitalized with some part of subordinated debt

Basel-III Phase – in Arrangements

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Source: See page no7 of BIS press release on 12 September 2010 Higher global minimum capital standard7

On a consolidated basis, the Basel Committee will allow 'some prudent reorganization' of the minority interest of a subsidiary that is a bank. The excess capital above the minimum of the subsidiary will be deducted in proportion to the minority interest share, provided the parent bank or affiliated has not entered in to directly or indirectly fund the minority interest.

INTRODUCTION OF CAPITAL CONSERVATION BUFFER

The Introduction of Capital Conservation Buffer above the regulatory minimum requirement is confirmed and calibrated at 2.5% and is to be met with common equity, after the application of deductions. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during period of financial and economic stress. While banks are allowed to draw on the buffer during such period of stress, the closer their regulatory capital ratio approach the minimum requirement, the greater the constraints on earnings distributions.

The capital conservation buffer will be phased in between 1 January 2016 and year end 2018 becoming fully effective on 1 January 2019. It will begin at 0.625% of Risk Weighted Assets (RWA) on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of RWAs on 1 January 2019. Countries that experience excessive credit growth should consider accelerating the build up of the capital conservation buffer and the countercyclical buffer. National authorities have the discretion to impose shorter transition periods and should do so where appropriate. In sum, capital conservation buffer and total common equity will be 7% in 2019.

INTRODUCTION OF COUNTERCYCLICAL CAPITAL BUFFER

The Basel Committee confirms that a counter cyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. The exact implementation measures are yet to be defined and a consultative document4 is still out of on the subject. The purpose of the counter cycle buffer is to achieve the broader micro prudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is an excess credit growth that is resulting in a system wide build-up of risks. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.

The Basel Committee adds that countries that experience excess credit growth should consider

accelerating the build-up of the said countercyclical buffer. This element of the new rules, whilst agreed in principal, still requires the regulators to develop clear guidelines as to how countercyclical capital buffer may be applied, and how and when they may be released.

INTRODUCTION OF NON RISK BASED LEVERAGE RATIO

The above capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. In July, Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration8.

Classification has been given for off-balance sheet items, as uniform credit conversion factor will be applicable. The only factor concretely specified is for unconditionally cancelable off-balance sheet commitments, which are assigned a factor of 10%. Derivative exposures will be calculated by applying existing Basel-II netting roles in addition to a simple measure of potential future exposure based on the standardized factors of the current exposure method. The leverage ratio will be calculated as an average over a quarter. The current design appears to address significant industry concern expressed during the consultative phase.

EXTRA REQUIREMENTS FOR SYSTEMATICALLY IMPORTANT BANKS

Systemically important banks should have loss absorbing capacity beyond the standards announced today and work continues on this issue in the Financial Stability Board and relevant Basel Committee work streams. The Basel Committee and the FSB are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. Practical implications at Asia and India level are still unclear at this stage, as work on these aspects is first subject to validation by G-20 members.

1.Kay modifications to the liquidity frame work

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR), sometimes known as the "Bear Stearns rule" is one of the main component of Basel III's liquidity regime. The LCR requires banks to maintain a stock of "high-quality liquid assets" that is sufficient to cover net cash outflows for a 30-day period under a stress scenario. The formula is:[9]

$$\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} = 100\%$$

Several modifications are introduced regarding the definition of high quality liquid assets. As a part of narrow definition of assets, it will be allowed to include domestic sovereign debt of non-0% risk weighted sovereigns issued in foreign currency, to the extent that this currency matches the currency needs of the banks operation in that jurisdiction. More significantly, a "level 2" of liquid assets, coped at 40% of the stock of liquid assets, will be introduced including the following assets.

Government and Private Sector Entities (PSEI Assets qualifying 20% risk weight under Basel-II's standardized approach for credit risk, subject to a 15% hair cut.
High-quality non-financial corporate and covered bonds not issued by the bank itself .i.e. rated AA- and above in Basel-II, subject to a 15% haircut
It is pointed out that ratings and additional criteria specified in December proposal will be utilized in determining the eligibility. However, no further details are provided by Basel for the movement.

Net Stable Funding Ratio

The Net Stable Funding Ratio (NSFR) is also one of the component of Basel III liquidity regime. The NSFR is to promote resiliency over longer-term time horizons by creating additional incentives for

banks to fund their activities with more stable sources of funding on an ongoing structural basis. The Ratio has been developed to capture structural issues related to funding choices. It ratio measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations. The standard requires a minimum amount of funding that is expected to be stable over a one year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures. The NSF ratio is intended to promote longer-term structural funding of banks' balance sheets, off-balance sheet exposures and capital markets activities.

The committee reaffirms its commitments to introduce the NSF ratio to the Liquidity Coverage Ratio. However, it is acknowledged that the initial calibrations of the NSFR need to be modified, in particular to account for differences in the business models of different institutions. In addition to potential modifications to a variety of "available stable funding" and "required stable funding" factors assigned to assets and liabilities, respectively, the committee states it will continue to consider farther structural changes to the NFSR.

Implications of Basel-III on Indian Banks

The Reserve Bank of India is confident that the domestic banks in India will not face problem to conform to the Basel-III norms. In his inaugural speech at the bankers' conference, BANCON 2010 Mumbai the RBI governor, Dr. D Subbarao, Said, Indian banks are well capitalised and can comfortably adjust to the latest international regulatory framework Basel II and Our assessment is that at the aggregate level Indian banks will not have any problem in adjusting to the new capital rules both in terms of quality and quantum. Further he pointed out that aggregate capital to risk-weighted assets ratio of Indian banking system stood at 11.7 percent as on June 30, 2010, against the Basel III requirement of 10.5 percent. He expressed that the framework is aimed to prevent any repeat of the international financial crisis. Under the new framework banks are required to hold top-quality capital of at least 7 percent of their risk-wearing assets, up from just two percent required under the current Basel II norms.[10]

The table 3 depicts the position of Capital of Indian Banks as on September 2010. It gives the existing difference between core Tier-I and Tier-I ration of selected banks working in India.

Tier-I Capital of Banks working in India as on 30 September-2010 (Rs crore)

Sl.No	Banks	Tier 1	Risk-Weighted Assets	Tier 1 Ratio	Perpetual Debt	Core – Tier 1 Ratio	Average Core – Tier 1 Ratio
Public Sector Banks							
1	Allahabad bank	6925.29	82378.53	8.41	300.00	8.04	8.04
2	Andra Bank	4429.44	60727.17	7.29	200.00	6.96	8.04
3	Bank Of Baroda	15114.10	185221.81	8.16	--	8.16	8.04
4	Bank of India	14209.27	169967.34	8.36	-	8.36	8.04
5	Bank of Maharastra	2943.25	38174.45	7.71	-	7.71	8.04
6	Canara Bank	13712.73	155473.13	8.82	-	8.82	8.04
7	Central Bank	6427.43	105766.50	6.07	-	6.07	8.04
8	Corporation bank	6461.59	78132.89	8.27	737.50	7.32	8.04
9	Indian bank	6988.28	68647.15	10.18	-	10.18	8.04
10	Indian overseas bank	6788.31	88274.51	7.69	-	7.69	8.04
11	Punjab & Sind Bank	2547.94	31929.07	7.98	-	7.98	8.04
12	Punjab National bank	17364.22	215972.88	8.04	2020.50	7.10	8.04
13	Syndicate Bank	5978.68	73514.33	8.13	-	8.13	8.04
14	United Bank of India	3687.68	43848.751	8.41	-	8.41	8.04
15	Vijaya Bank	3789.61	39270.57	9.65	-	9.65	8.04

State Bank Groups							
16	State Bank Of Bikaner and Jaipur	2595.40	33062.42	7.85	-	7.85	8.68
17	State Bank of Hyderabad	5342.76	55026.25	9.71	-	9.71	8.68
18	State Bank of Patiala	4086.35	48244.98	8.47	-	8.47	8.68
Private Sector Banks in India							
19	Development credit Bank Ltd	530.27	4709.32	11.26	-	11.26	12.05
20	HDFC Bank Ltd	22431.43	177043.64	12.67	-	12.67	12.05
21	ICICI Bank	42297.00	302121.42	14.00	-	14.00	12.05
22	Induslnd Bank	3293.40	27064.42	12.17	-	12.17	12.05
23	Axis bank	15795.63	161674.82	9.77	-	9.77	12.05
Foreign Banks in India							
24	City Union Bank Ltd	916.64	6368.48	12.44	-	12.44	13.04
25	Citi Bank India	12635.50	80276.37	15.74	-	15.74	13.04
26	DBS India	1416.01	14020.80	10.10	-	10.10	13.04
27	Deutsche Bank AG	4281.00	30798.56	13.90	-	13.90	13.04

Source: Basel-II discloser reports as on 30 September 2010, from bank websites11.

This table shows that Indian banks are better positioned to meet the capital norms of Basel-III. The average core Tier-I ratios of Public Sector Banks stood 8.04%, 8.68% in case of State Bank of groups,12.05% incase of Private Sector Banks and 13.04% in case of Foreign Banks working in India as against 8.5% to their risk weighted assets under Basel-III. It is quite clear from the table that after adjusting for the perpetual debt, the core Tier-I ratios of Public Sector Banks are much lower than those of the private and foreign banks working in India, of course with the exception of Indian, Canara and Vijaya banks. The core Tier-I ratios of Andra Bank is 6.96% to their risk weighted assets which is the least ratio among the public sector banks. This is because of very large number of perpetual debt in their Tier-I capital as of September 2010. Amongst the Indian banks, private sector banks are better placed compared to their counterparties in public sector. Public sector banks which would fall short of their revised core capital would look forward to government for their support.

As regards to Introduction of countercyclical capital buffer the RBI governor Dr. D Subbarao said that there exists a concern about the variable used to calibrate the countercyclical buffer. He has indicated that the credit to GDP ratio as suggested by new norms may not be appropriate indicator for calibration in Indian context. The proposed frame work is flexible to allow national discretion to suite the individual country situation12. However, our banks need to improve in mechanism and capabilities to business cycles at the aggregate and sectoral levels.

As regards to the leverage ratio, Indian banks have comfortable and do not seen to have any issues. Most of Indian banks have Tier-I capital of about 10% and their exposure to off-balance sheet items like derivatives are also less in comparison to western counterparties. The leverage of banks in India is moderate[5]

As regards to the new liquidity resume is concerned, most of our banks follow a retail business model and do not rely much on short term or wholesale overnight funding. Further, our banks also have a substantial amount of liquid assets as per the RBI a good portion of resource mobilised is parked in Govt. SLR bonds, which would provide adequate liquidity at the time of requirement. However, there may be some challenge due to the fact that our banks have a limited capacity to collect the required relevant data accurately and more granularly.

CONCLUSION

To conclude, there is no doubt the proposed new Basel-III regulation attempts to improve the financial systems of the banks. The implementation of Basel III on Indian banks may not be as much about scrambling for additional capital as it is about optimally deploying available capital. However, what distinguishes Basel III from previous attempts to improve the financial system is its focus on structurally improving the balance sheets of financial institutions. While increased capital has always been considered as the remedy for all financial crises, the inability of capital alone to absorb shocks during the latest financial crisis has led to a broader approach toward improving the resilience of the financial system. While the approach this time is more holistic, concessions regarding timelines for the implementation of the Basel III proposals.

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