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PROSPECTS OF BASEL III NORMS FOR INDIAN BANKING SECTOR: A CASE STUDY OF SBI

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ABSTRACT

Basel Norms were first introduced in 1988 in order to strengthen the stability of international banking system by ensuring an adequate level of capital in this system. The purpose was to set up a fair and a consistent international banking system in order to decrease competitive inequality among international banks and thus provide a "level playing field" so that banks could no longer build business volume without adequate capital backing. Basel I norms were introduced in response to in response to the messy liquidation of Cologne-based Herstatt Bank in 1973. Then Basel II norms were introduced with three pillars focusing on aspects like supervision and market discipline apart from the capital requirements. But inspite of these norms the subprime mortgage crisis followed by global recession prompted the G-20 countries to further strengthen the regulatory system for banks and other financial firms. Thus Basel III norms came into being in 2009. The present paper is devoted to the study of Indian Banking Experience with Basel norms as well as the possible impact of upcoming Basel III norms on Indian Banking System. Camel test has been used to analyze the impact of Basel II norms on State Bank of India's Performance and inferences have been drawn thereof to ascertain the possible impact of Basel III norms on India's Banking System.

KEYWORDS

Basel III, Basel II, Camel Analysis.

INTRODUCTION

In response to the messy liquidation of Cologne-based Herstatt Bank in 1973, Basel Committee on Banking Supervision was formed in the late 1974 under the auspices of the Bank for International Settlements (BIS) located in Basel, Switzerland.On 26 June 1974, a number of banks had released Deutschmarks (the German currency) to the Herstatt Bank in exchange for dollar payments deliverable in New York. Due to differences in the time zones, there was a lag in the dollar payment to the counterparty banks; during this lag period, before the dollar payments could be effected in New York, the Herstatt Bank was liquidated by German regulators.This incident prompted the G-10 nations to form the Basel Committee on Banking Supervision and hence **Basel I** came into being.Basel I is the round of deliberations by central bankers from around the world.

BASEL I

In 1988, the Basel Committee on Banking Supervision (BCBS) in Basel, Switzerland, published a set of minimum capital requirements for the banks which is also known as "the 1988 Basel Accord"and it was enforced by law in the Group of Ten (G-10) countries in 1992. The Basel Capital Accord in 1988 proposed by Basel Committee of Bank Supervision of BIS focused on credit risk prescribing a minimum capital risk adjusted ratio (CRAR) of 8 percent of the risk weighted assets. Although it was originally meant for banks in G-10 countries more than 190 countries claimed to adhere to it and India began implementing the Basel I in April 1992.

Assets of banks are classified and grouped into five categories (0%,20%,50% and 100%) according to credit risk, carrying risk weights of 0% (for example cash, bullion, home country debt like Treasuries), 20% (securitisations such as mortgage-backed securities (MBS) with the highest AAA rating) 50%, 100% (for example, most corporate debt), and some assets given No rating. Banks with an international presence are required to hold capital equal to 8% of their risk-weighted assets (RWA).Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes, capital is split into two categories: Tier I and Tier II. These categories represent different instrument's quality as capital.

The tier 1 capital ratio = tier 1 capital / all RWA

The total capital ratio = (tier 1 + tier 2 + tier 3 capital) / all RWA

Leverage ratio = total capital/average total assets

INDIA'S BANKING EXPERIENCE WITH BASEL I

As far as, Capital Adequacy requirements were concerned, RBI raised the Capital Adequacy Norms for Indian Banks. Banks were required to maintain a minimumcapital risk adjusted ratio(CRAR) of 9 percent on an ongoing basis, as opposed to the Basel Committee on Banking Supervision's Basel I norm of 8 percent CRAR Basel I had positive as well as negative aspects. There was worldwide adoption of Basel I owing to its relatively simple structure. Post Basel I, there was substantial increase in capital adequacy ratios of internationally active banks, increased competitive equality among internationally active bank, and greater discipline in managing capital.It provided a benchmark for assessment by market participants.

In spite of these advantages and positive effects, weaknesses of Basel I standards eventually became evident.

WEAKNESSES OF BASEL I STANDARDS

- Capital adequacy depends on credit risk, while other risks (e.g. market and operational) are excluded from the analysis;
- In credit risk assessment there is no difference between debtors of different credit quality and rating;
- Emphasis is on book values and not market values;
- Inadequate assessment of risks and effects of the use of new financial instruments, as well as risk mitigation techniques.

Then came Basel II. Basel I primary focus was on two types of risks which a bank face namely credit risk and market risk out of which initial focus was on credit risk. But in Basel II operational risk was also considered in addition to credit risk and market risk.

BASEL II

On 26th June, 2004, The Basel Committee on Banking Supervision released "International Convergence of Capital Measurement and Capital Standards: A Revised Framework", which was known as Basel II Accord.

Basel II Accord focuses on three pillars:

(1) Minimum Capital Requirements (addressing risk)

(2) Supervisory Review

(3) Market Discipline

INDIA'S BANKING EXPERIENCE WITH BASEL II

Initially RBI set the target for implementation ofBasel II for March 2007 but later on postponed it. Finally Basel IInorms were implemented on 31 March 2009. This shows that RBI chose a slow and steady approach for implementing Basel II's standardized norms and moved to internal ratings in credit and Advanced Measurement Approach norms for operational risks in banks.

According to the draft guidelines published by RBI the capital ratios are set to become: Common Equity as 5% + 2.5% (Capital Conservation Buffer) + 0–2.5% (Counter Cyclical Buffer), 7% of Tier 1 capital and minimum capital adequacy ratio (excluding Capital Conservation Buffer) of 9% of Risk Weighted Assets. Thus the actual capital requirement is between 11 and 13.5% (including Capital Conservation Buffer and Counter Cyclical Buffer).

BASEL III

Basel III reforms are the response of Basel Committee on Banking Supervision (BCBS) to improve banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spillover from the financial sector to real economy. During Pittsburg summit in September 2009, G-20 leaders committed to strengthen the regulatory system for banks and other financial firms and also act together to raise capital standards, to implement strong compensation standards aimed at ending practices that led to excessive risk taking, to improve the over the counter derivatives market and to create more powerful tools to hold large global firms to account for the risk they take. Consequently,the Basel Committee on Banking Supervision (BCBS) released comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" (known as Basel III capital regulations) in December 2010. Basically, Basel III norms were introduced due to the financial crisis of 2008. Initially, Basel III was scheduled to be introduced from 2013 until 2015; however, changes from 1stApril 2013 extended implementation until 31stMarch 2018 and again extended to 31 March 2019.

Basel III (or the Third Basel Accord) is a global, voluntary regulatory standard on bank capital adequacy, stress testing and market liquidity risk.

RBI issued guidelines based on Basel III reforms on capital regulation on 2nd May 2012 to extent applicable to banks operating in India. The Basel III capital regulation has been implemented from 1st April 2013 in India in phasesand it will be fully implemented as on 31st March 2018.

OBJECTIVES OF THE STUDY

The present research paper tries to understand and focus on the following issues and objectives:

- To study the framework of Basel Norms as proposed by Basel Committee on Banking Supervision as well as to study India's experience with Basel II norms by analyzing a public sector bank's performance through Camel Test.
- To study the possible impact of Basel III norms on Indian Banking Sector and ascertaining its relevance in context of Indian Economy.

The present paper studies the impact of Basel III on Indian Banking Sector with reference to CAMEL Analysis of State Bank of India (SBI) for a period of year 2006 to year 2010. The CAMEL analysis as presented in the paper assesses SBI Bank's performance (India's largest Public Sector Bank) prior to and post Basel II. On the basis of results concluded there from, the paper studies the possible impact of Basel III norms on Indian Banking Sector.

RESEARCH METHODOLOGY AND DATA ANALYSIS

In the present paper, CAMEL Rating System has been used to assess and evaluate the performance of India's largest public sector bank SBI (State Bank of India) for a period of year 2006 to year 2010. The study is based on secondary data collected from various websites and sources. The data that has been used here for calculating the ratios is taken from the consolidated financial statements of SBI.

In India Basel II was fully implemented on 31st March 2009. Therefore, the ratios & data has been analyzed prior to and post 2009 in order to evaluate the impact of Basel II on SBI's performance post Basel II.

CAMELS rating system is designed to take into account and reflect all the significant financial and operational factors in assessing and evaluating an institution's performance. Institutions are rated using a combination of specific financial ratios and examiners qualitative judgments.

The components of a bank's condition that are assessed:

- **(C)**apital adequacy
- **(A)**ssets
- **(M)**anagement Capability
- **(E)**arnings
- **(L)**iquidity (also called asset liability management)
- **(S)**ensitivity (sensitivity to market risk, especially interest rate risk)

Here we have studied the performance of a public sector bank in order to know the impact of Basel II on Indian Banking Sector so as to predict the possible consequences and impact of Basel III on the Indian Banking Sector.

ANALYSIS OF STATE BANK OF INDIA FROM YEAR 2006 TO 2010

1. C-TO ASSESS CAPITAL ADEQUACY

❖ **CAPITAL ADEQUACY RATIOS (CAR)**

Year	CAR
2006	11.88
2007	12.34
2008	13.54
2009	14.25
2010	13.39

(Ratios calculated from SBI's consolidated data)

Interpretation

Capital Adequacy Ratio (CAR), also known as Capital to Risk Weighted Assets Ratio (CRAR), is the measure of a bank's capital and is expressed as a percentage of a bank's risk weighted credit exposures. Capital adequacy ratio is the ratio which determines the bank's capacity to meet the time liabilities and other risks such as credit risk, market risk, operational risk etc. In the simplest formulation, a bank's capital is the "cushion" for potential losses, and protects the bank's depositors and other lenders. SBI's Capital Adequacy Ratio shows that prior to implementation of Basel II that is in year 2006 and 2007 and 2008; the CAR of SBI is way higher than the statutory minimum of 8 % of CAR as proposed under Basel I Accord. Post Basel II the statutory requirement was raised to 9% by RBI and still SBI continue to maintain CAR of 14.25 % and 13.39% in year 2009 and 2010 respectively. This shows that the bank is "well-capitalized" and can absorb any present or anticipated losses with ease.

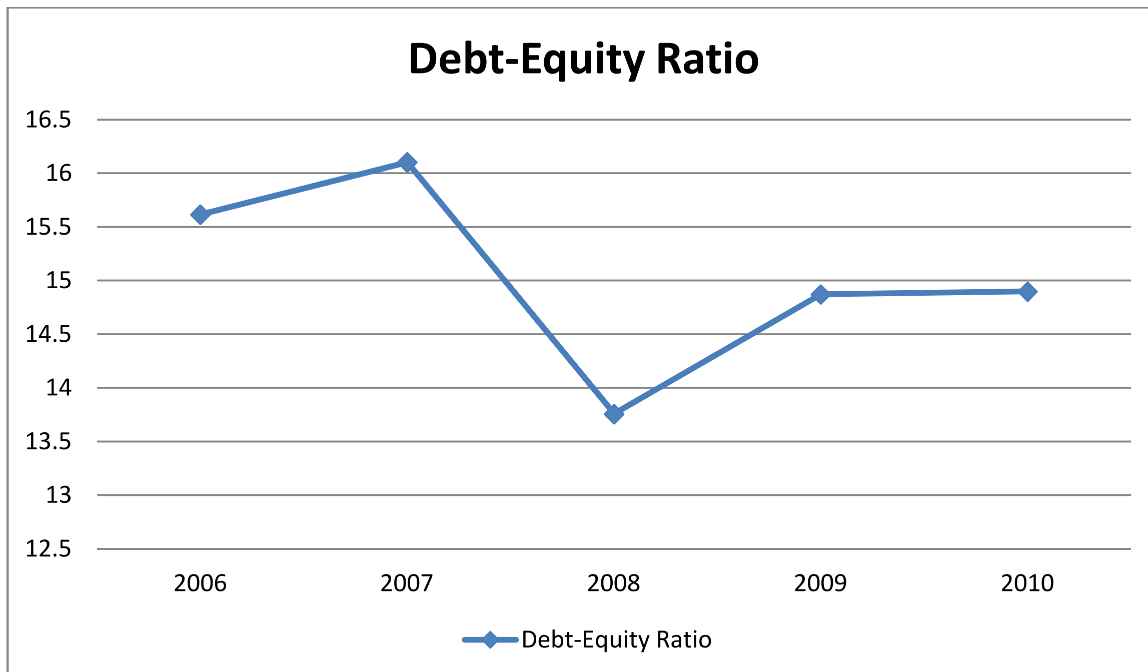
❖ **DEBT-EQUITY RATIO**

(Rs. In Crore)

Year (12 Months)	2006 March	2007 March	2008 March	2009 March	2010 March
Total Debts	580,999.17	684,934.71	842,439.69	1076,579.97	1238,539.13
Net Worth	37,206.71	42,535.65	61,236.38	72,390.39	83,135.58
Debt-Equity Ratio	**15.6154**	**16.1026**	**13.7572**	**14.8719**	**14.8978**

Interpretation

The Debt-Equity Ratio is a financial ratio indicating the relative proportion of shareholder's equity and debt used to finance a company's assets. Closely related to leveraging, the ratio is also known as Risk, Gearing or Leverage. It indicates the proportion of company's assets that are being financed through debt. As shown above, SBI's Debt-Equity Ratio has decreased from 16.1026 in financial year 2006-07 to 13.7572 in financial year 2007-08 but increased to 14.8719 in financial year 2008-09 and continued to increase in financial year 2009-10 as well. The Debt-Equity Ratio of SBI shows the following trend in the given graphical presentation.



As can be seen from the above given trend, the Debt-Equity Ratio has shown an increasing trend post Basel II which can be owing to the fact that in order to maintain capital adequacy ratio as per Basel norms, the bank had to infuse more and more capital in order to finance its growth. Increasing trend shows soundness of long-term financial policies but at the same time, it can be a dangerous trend as investors and lenders prefer low debt-equity ratio because in that case their interests are better protected.

2. A-TO ASSESS ASSET QUALITY

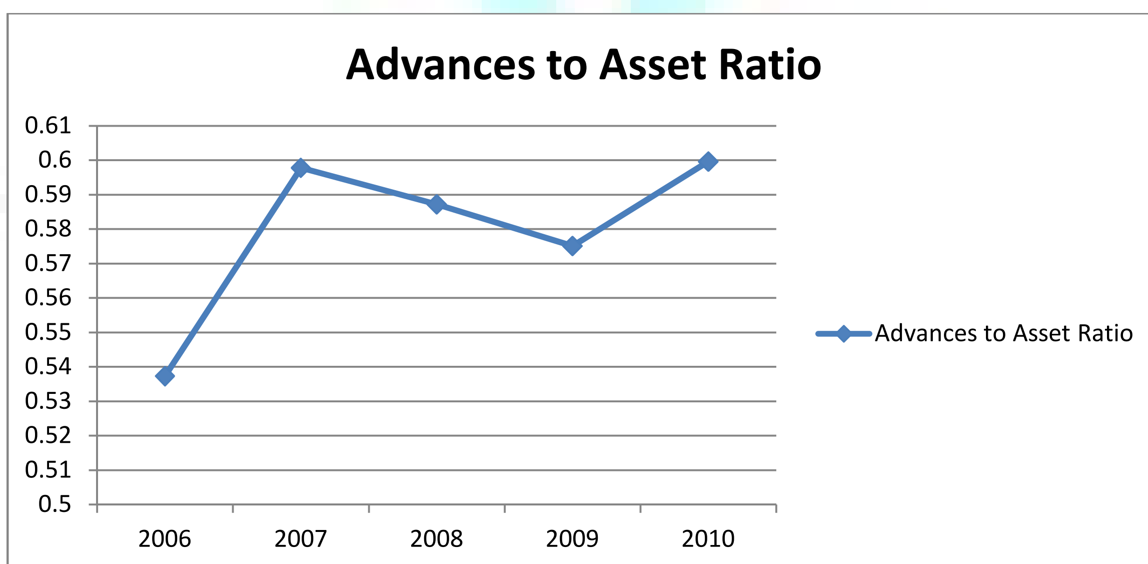
❖ **ADVANCES TO ASSETS RATIO**

(In Rs. Crore)

Year (12 Months)	2006 March	2007 March	2008 March	2009 March	2010 March
Loans & Advances	374,476.24	487,285.96	603,221.94	750,362.38	869,501.64
Total Assets	696,991.83	815,174.41	1027,269.52	1304,825.74	1450,143.96
Advances to Assets Ratio	**0.5373**	**0.5978**	**0.5872**	**0.5751**	**0.5996**

Interpretation

Advance to Assets Ratio shows a bank's risk-taking abilities and position in lending funds. Here SBI's advance to assets ratio is showing a positive trend as increase in advances is more than increase in assets that shows growth in investments. The bank has been able to maintain high advance to assets ratio post Basel II also which is a favourable position for long-term. The Advance to Assets Ratio shows the following trend in the given graphical presentation.



❖ **TOTAL INVESTMENTS TO TOTAL ASSETS RATIO**

(In Rs. Crore)

Year	2006 March	2007 March	2008 March	2009 March	2010 March
Total Investments (TI)	227,931.05	216,521.05	273,841.72	372,231.45	402,754.13
Total Assets (TA)	696,991.83	815,174.41	1027,269.52	1304,825.74	1450,143.96
TI/TA	**0.3270**	**0.2656**	**0.2666**	**0.2853**	**0.2777**

Interpretation

Total Investments to Total Assets Ratio shows how well the investments are backed up by bank's assets. Asset backing is good for a bank's credit rating and profitability because assets provide creditworthiness to a bank. In case of SBI the ratio picks up after 2007 and continues to increase but falls in 2010.

3. M-TO ASSESS MANAGEMENT QUALITY

Management Ratios

❖ **TOTAL ADVANCES TO TOTAL DEPOSITS RATIO**

(In Rs. Crore)

Year	2006 March	2007 March	2008 March	2009 March	2010 March
Total Advances	374,476.24	487,285.96	603,221.94	750,362.38	869,501.64
Total Deposits	544,024.27	636,272.88	537,403.94	1011,988.33	1116,464.56
Total Advances to Total Deposits Ratio (TA/TD)	**0.6883**	**0.7658**	**1.1224**	**0.7415**	**0.7788**

Interpretation

Management is the most forward-looking indicator of condition and a key determinant of whether a bank possesses the ability to correctly diagnose and respond to financial stress. Total Advances to Total Deposits Ratio shows the efficiency of management in converting the deposits available with the bank into advances that is how easily a bank is able to convert its deposits into operations. SBI's TA/TD ratio shows an increasing trend till 2007-08 after which it decreases by 34% and then again picks up which is a positive sign for the bank because a higher TA/TD ratio puts a bank on the better side of interest income which are earned from bank's advances.

4. E-TO ASSESS EARNING RATIOS

❖ **RETURN ON NET WORTH**

(In Rs. Crore)

Year	2006	2007	2008	2009	2010
Profit(Net Profit)	5,679.38	6,633.08	9,212.83	11,178.90	12,020.54
Net Worth	37,206.71	42,535.65	61,236.38	72,390.39	83,135.58
Return on Net Worth	**0.1526**	**0.1559**	**0.1504**	**0.1544**	**0.1446**

Interpretation

The continued viability of a Bank depends on its ability to earn an appropriate return on its assets which enables it to fund expansion, remain competitive, and replenish and/or increase capital. Profit is the lifeline of a business. It is as important for the enterprise as is blood for the human body. Therefore assessing the earnings capacity of a bank is one of the critical aspects of CAMEL Analysis. Return on Net worth Ratio links profitability of a bank to its capital structure. SBI has maintained this ratio with minor fluctuations. It shows that the bank is earning decent profits with the money that has been invested by the shareholders in the bank.

5. L-LIQUIDITY RATIOS

❖ **G-Securitiesto Total Assets Ratio** (In Percentage)

	2004-05	2005-06	2006-07	2007-08	2008-09
G-Sec/ Total Assets	37.39	27.25	20.77	19.51	23.56

Interpretation

Liquidity is one of the important aspects of Camel Ratio. Liquidity is the ability to convert an asset into cash readily. It is also known as "marketability." Government-Securities to Total Assets measure the proportion of Government Securities in Total Assets of the Bank.G-sec to Total Investment ratio shows Bank's aggressiveness in improving its credit deposits ratio keeping the investments lower. Banks invest in Government Securities in order to meet the SLR (Statutory Liquidity Ratio) requirements. SBI's data shows that the ratio has shown a downward trend prior until financial year 2007-08 after which it started to pick up.

❖ **Liquid Assets to Total Assets** (In Percentage)

	2004-05	2005-06	2006-07	2007-08	2008-09
Liquid Assets/Total Assets	8.55	6.14	6.46	1.66	8.33

Interpretation

Maintaining correct amount of liquidity is important for any Bank. There should be a perfect balance between liquidity and profitability which ensures growth and earnings for a bank. SBI's Liquid Assets to Total Assets Ratio shows fluctuations as can be seen that the ratio decreased to 1.66 % in financial year 2007-08 as Basel II norms started to become prevalent in that year but then there was a sharp increase in the ratio in year 2008-09.

RESULT AND DISCUSSION

The main reason for introducing Basel III was the financial crisis of 2008. There was a need to further strengthen the Banking system by emphasizing on four important banking aspects i.e. Capital, Leverage, Funding and Liquidity.

Here the possible impact of Basel III on Indian Banking System is being focused with reference to the study of impact of Basel II on a Public Sector Bank's performance. Camel Analysis shows that the performance of SBI has shown positive result on almost all the aspects of Camel analysis. Firstly, SBI has been able to maintain a higher Capital Adequacy Ratio even more than the statutory minimum.

Debt-Equity Ratio has shown positive trend which explains the fact that in order to maintain the minimum Capital Adequacy Ratio the bank has gone for borrowed funds so as to add more capital base to the organization. But this also means that bank has to bear the risk of having more borrowed funds in proportion to the owner's funds. So such a position although points towards the long-term growth plans of the bank but also it makes the bank profile a risky proposition from investment point of view as lenders and investors would prefer a low debt-equity ratio as compared to a higher one.

Then the other aspects like assets quality, management capability and earnings have also shown positive signs. However on liquidity parameter the Bank has shown many fluctuations. So, on the basis of Camel analysis it can be inferred that SBI bank's performance have improved and shown positive signs post Basel II. The implementation of BASEL II has been positive for India's largest public sector bank's performance.

Basel III will bring about the much needed change to the risk management approach which is being adopted by Indian banks.The adoption of advanced approaches to risk management would enable the banks to manage their capital more efficiently and improve their profitability. The purpose of these norms is

increasing the capacity of the banks so as to absorb shock during financial crisis and at the same time, decrease such crisis probabilities. If a bank is well capitalized it can shield against any financial crisis situation and can provide buffer against any shock arising there from.

CONCLUSION AND RECOMMENDATIONS

Basel III implementation is the need of the hour for Indian Banking System but it should be done in a phased manner keeping in view the problems and conditions of Indian Banking System and in the context of Indian Economy. Basel III has certain pros as well ascons for the Indian banking system.

Firstly, Basel III norms will make Indian Banks strong and stable enough to guard against any financial shut down.

Secondly, adopting advance approaches to manage risk will help Indian Banks in efficiently managing their capital thereby improving their profitability.

Thirdly, Banks with expanding overseas operations, normally the larger banks will gain from the implementation of these norms as they will be able to better manage their capital and also be able to become sound and stable enough to bear global shocks arising from financial crisis.

Lastly, Basel-III Norms will enable the Indian Banks to grab better financial opportunities not just in India but also abroad.

However, there are some negative sides of Basel III implementation also which needs to be taken care of. Indian Economy is growing at a fast pace therefore the demand for credit will go up in future but due to higher capital norms of Basel III, Banks will be required to maintain higher CAR norms and consequently this will reduce their lending capacity and demand for credit will not be fully met. Increasing credit demand and inability of banks to lend money will increase the borrowing rates pushing the country towards more economic slowdown.

Despite of the above drawback, Basel III is still required for Indian Economy especially for Banks having international presence. India has opened up the gates for trade and business in 1991 through LPG (Liberalisation, globalisation and privatization). Therefore, spillover effects of the international scenarios will be much prevalent in our Economy like the subprime crisis accompanied with worldwide recession showed its effect on the Indian Economy also. Therefore, to provide buffer against such spillover effects on the Indian Banking Sector in future and for integrating the Indian Economy with that of the world's economy, Basel III should be implemented in a phased manner.

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