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# BASEL III: A TOOL OF RISK MANAGEMENT IN BANKING SECTOR

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## ABSTRACT
*In response to the dynamic and extremely risky global environment, the present paper attempts to analyze the need of third generation banking sector reforms i.e. Basel III norms. Indian banks are not likely to be impacted much by the new capital rules, the aggregate capital to risk-weighted assets ratio of Indian banking system stood at 13.4 per cent as at the end of June 30, 2010 of which Tier-I capital constituted 9.3 per cent. Therefore, Indian banking system need not to be significantly stretched in meeting the proposed new capital rules, both in terms of capital requirement and the quantity of capital. But there may be some negative impact arising from shifting of some of deductions from Tier-I and Tier-II capital to common equity. However, increasing level of NPAs in public sector banks means higher capital requirement. Given that Indian banks are better managed than their counterparts in US/UK, there would be little concern, but still a worry to raise capital cheap. As the Basel III is a comprehensive set of reforms measures, therefore it will strengthen the regulation, supervision and risk management, and governance of the Indian banking sector, which in turn will improve the banking sector's ability to absorb shocks arising from financial and economic stress.*

## KEYWORDS
Basel III, Tier-I and Tier-II capital, third generation reforms, risk-weighted assets ratio, financial and economic stress.

## INTRODUCTION
In the pre-reforms period, the Government ownership of the public sector banks, commanding about 90 percent of the banking business, was considered adequate for maintaining public confidence. The level of international banking business was also limited and there was little pressure to conform to the international norms. More importantly, with low level of profits, the banks could not plough back adequate resources to shore up their net worth. Therefore, the question of building up adequate level of capital and resources in PSBs did not receive enough attention in the past. As far back as 1961, the RBI had advised the banks to aim at a ratio of 6 percent of paid-up capital and reserves to total deposits, because banks had been increasing their assets without a corresponding augmentation of their capital base. The ratio had declined from 9 percent in 1950 to 4 percent in 1960 and further to 1.5 percent by 1978 (for PSBs). Since income was recognized on accrual basis rather than on actual recovery of cash and banks were not required to make sufficient provisions for non-performing loans (the system of classifying advances as per health code was itself subjective), the actually deteriorating financial health of banks did not get reflected in banks' balance-sheets. It was only after the introduction of prudential and accounting norms in 1992-93 following the Ghosh Committee recommendations, the losses were shown clearly on banks' balance sheets. By 1992-93, 20 nationalized banks (now 19 after the merger of NEWBK with PNB in 1993-94) reported combined losses of Rs.3648.92 crore with equity nearly being wiped out or becoming negative in case of several banks. Against this, the Government accepted the Narasimham Committee recommendations for adoption of the BIS norms on capital adequacy to improve the financial health of the banks and enable them to compete both at home and abroad. The RBI introduced the norms in a phased manner from April 1992, covering all banks (PSBs, PSIBs and FBs) by March 1996.
In the present study, an attempt is made to analyse the achievement of Indian banking sector during the post reforms period regarding the capital adequacy requirements i.e. under the regime of Basel I & II and the effectiveness of the provisions of Basel III as a tool of risk measurement and their likely impact on Indian banking.

## BASEL COMMITTEE – ORIGION
The Basel Committee has played a leading role in standardizing bank regulations across jurisdictions. Its origins can be traced to 1974. Bank Herstatt, a German bank was liquidated in 1974. On the day of liquidation, some banks had released payment of DM to this Bank in Frankfurt, in exchange for US Dollars. However, due to difference in time-zone, Bank Herstatt received payments but it ceased its operations before the counterparty banks could receive their USD payments. The cross-jurisdictional problems, led the G-10 countries (at present G-10 consists of eleven countries, namely Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) and Luxembourg to form a Standing Committee under the auspices of the Bank for International Settlements (BIS). This Committee is called the "Basle Committee on Banking Supervision", The Committee comprises of representatives from Central Banks and Regulatory Authorities of different countries. During the last few decades, the major focus of the committee has been to define roles of regulators in cross-jurisdictional situations; ensure that international banks and bank holding companies are under comprehensive supervision by a "home" regulatory authority; and promote uniform capital requirements so as to ensure that banks from different countries compete with one another on a "level playing field".

## BASEL - I ACCORD
In 1988, the Basle Committee published a set of minimal capital requirements for banks. These became law in G-10 countries in 1992, with Japanese banks permitted an extended transition period. The requirements have come to be known as the 1988 Basle Accord. The 1988 Basle Accord mainly focused on the core banking in the sense of deposit taking and lending and its focus remained on credit risk. Bank assets were assigned "risk weights" e.g. Government debts were assigned 0 per cent risk weight and bank debts were assigned 20% risk weight, and other debt were assigned 100 per cent weights. Banks were asked to hold capital at least equal to 8% of the risk weighted value of assets. Additional rules applied to contingent obligations, such as letter of credits and derivatives. Slowly it was felt that Banks have become more aggressive and are taking higher risk. Thus, the Basle Committee decided to update the 1988 accord to include bank capital requirements for market risk.
The objective was to have common norms for all the banks, which would strengthen the capital resources of international banks in order to improve the stability of the international banking system and to reduce the competitive inequalities arising from the differences in capital requirements across nations. This forced the banks of G-10 countries to implement a credit risk measurement framework. For the first time, restrictions were placed on the exposures that a commercial bank could hold in relation to its capital base. The Basel-I provided for the implementation of a credit risk measurement framework with a Minimum Regulatory Capital (MRC) of 8 percent by end of 1992.
The Basle Committee has defined the capital in two tiers: Tier-I and Tier-II. Tier-I capital, otherwise known as Core capital, provides the most permanent and rapidly available support to a bank against unexpected losses, whereas Tier-II capital contains elements that are less permanent in nature or less rapidly available. The RBI identifying Tier-I and Tier-II capital for Indian and foreign banks has established Norms. Tier-I capital means (i) Paid-up capital, (ii) Statutory reserves and (iii) Other free reserves, if any. Capital reserves representing surplus arising out of sale proceeds of assets will also be reckoned for this purpose. Equity investments in subsidiaries, intangible assets and losses in current period and those brought forward from the previous periods will be deducted from

Tier-I capital. Tier-II capital consists of (i) Undisclosed Reserves and Cumulative Perpetual Preference Shares, (ii) Revaluation Reserves, (iii) General Provisions and Loss Reserves, (iv) Hybrid Debt Capital Instruments and (v) Subordinated Debt.

In order to strengthen the capital base of Indian banks, RBI introduced in April 1992, a system of assigning risk weights for different kinds of assets and relating capital strength to Risk Weighted Assets (RWA) of commercial banks. It was stipulated that all the Indian banks with international presence should the achieve Capital Adequacy Ratio (CAR) of 8 percent by 31st March, 1994 (later on extended to 31st March, 1995), foreign banks by 31st March 1993, other banks to achieve 4 percent by 31st March, 1993 and 8 percent by 31st March, 1996. Capital Adequacy Ratio is defined as ratio of Capital Funds to Risk Weighted Assets. The RBI increased Capital Adequacy Ratio to the level of 9 percent from the year ending on 31st March, 2000.

In April 1993, the Basle Committee released a package of proposed amendments to the 1988 accord. This included a document proposing minimum capital requirements for banks' market risk. Banks were also required to identify Trading Book and hold capital for trading book market risks and organization-wide foreign exchange exposures. VaR (Value at Risk) was to be used for capital charges for the trading book. However, these proposals received certain adverse comments. Thus, in April 1995, the Basle Committee released revised proposals. Under these proposals, a number of changes including the extension of market risk capital requirements to cover organization-wide commodities exposures were proposed. Another important provision allowed banks to use either a regulatory building-block VaR measure or their own proprietary VaR measure for computing capital requirements. The Basel Committee's new proposal was adopted in 1996 as an amendment to the 1988 accord, which went into effect in 1998.

## BASEL-II ACCORD

The banking industry has changed in many ways since the implementation of Basel-I in 1988. Two specific changes - the expanded use of securitization and derivatives in secondary markets, and vastly improved risk-management systems had significant implications for Basel-I. It has been criticized to be a "one size fits all" model, lacking in sophisticated measurement and management of risks. The capital regime recommended by Basel-I could not keep pace with either due to the complex nature of the operations of the large banks or the substantial changes in both the concepts and technology of risk management. It has also been criticized as being inflexible due to its focus on primarily credit risk, ignoring market risk and operational risk and treating all types of borrowers under one risk category regardless of credit worthiness.

The Basel Committee on Banking Supervision (BCBS) released the Third Consultative Paper (CP3) on the New Basel Capital Accord (Basel-II) in July 2003, applicable to all member countries from January 1, 2007 and India is no exception. The framework of Basel II can be viewed from a three-pillar format. The fist pillar is compatible with the credit risk, market risk and operational risk. The minimum regulatory capital (MRC) will be focused on these three risks. The second pillar gives the bank responsibility to exercise best ways to manage the risk specific to that bank. The third pillar on market discipline for greater transparency, disclosure and encouraging best international practices.

The Minimum Regulatory Capital (MRC) is set by the Capital Ratio which is defined as "(Total Capital -Tier-I + Tier-II + Tier-III)/(Credit Risk + Market Risk + Operational Risk)". Basel-I provided for only a credit risk charge. A market risk charge was implemented in 1996. The Committee has proposed operational risk capital of 12 per cent of minimum regulatory capital is provided i.e., MRC will be 9 per cent + 12 per cent of 9 per cent i.e. 10.08 per cent. In this ratio, the denominator represents the bank's assets weighted according to the following three separate types of risk i.e. credit risk, market risk and operational risk.

The ratio of capital to risk weighted assets registered a rising trend and increased from 11.5 per cent (1997-98) to 13.6 per cent (2009-10) which is above the internationally accepted standards. But this ratio is higher in new private sector Indian banks (PSIBs) and foreign banks (FBs) than the public sector banks (PSBs) and old private sector Indian banks (Old PSIBs). In view of the financial crisis at the international level, the issues still exists, i.e. having achieved the capital adequacy ratio, will the PSBs, especially the nationalized banks, be able to sustain in the new regime? Should all the banks hold the same level of capital or should the weaker banks be asked to hold more?

## BASEL III ACCORD

The Basel Committee's reform programme includes the measures finalized by the Committee dealing with stronger trading book capital standards along with higher requirements for complex securitsations and exposures to off-balance-sheet vehicles. In addition, fundamental strengthening of the Basel II framework and introduce for the first time minimum global standards for liquidity risk. These reforms are designed to respond to key pre-crisis shortcomings, which became painfully evident during the crisis. The banking sector entered the crisis with too much leverage and inadequate liquidity buffers. These were accompanied by poor governance and risk management as well as inappropriate incentive structures, especially related to compensation. The combination of these factors was manifest in poor underwriting, the mispricing of credit and liquidity risk and excess credit growth. When the crisis hit, these shortcomings and weaknesses in the banking sector amplified and deepened the downturn. The outcome was huge, rapid deleveraging; big losses by banks; a deep recession; and massive direct support from the public sector in the form of capital injections, guarantees and liquidity. Now, in the face of this experience, minimum standards for capital and liquidity need to be raised substantially so that the banking sector can withstand future periods of stress, thus enhancing financial stability and promoting more sustainable growth. The banking sector must serve as a stabilizing force and not as an amplifier of shocks.

At present, the minimum standard for the highest quality capital is just 2 per cent of common equity to risk weighted assets - it is even less when you factor in necessary deductions from capital. And with respect to liquidity, no global minimum standard currently exists. Leading up to the crisis, liquidity buffers were inadequate and excessive reliance was placed on short-dated wholesale money to fund long term illiquid assets. Banks have made progress to strengthen capital levels and liquidity buffers but more needs to be done. In addition, when competitive pressures reassert themselves, there is the risk of a renewed race to the bottom to the unacceptable pre-crisis status quo. Moreover, public sector finances have been stretched and must be consolidated. There is no public sector appetite to engage in the types of banking sector support measures of the past three years. Banks therefore must use their return to profitability - which is due in part to public sector support - to boost capital and liquidity buffers. Significant risks remain in the economy and the financial system, and it would be unacceptable if banks did not use this opportunity to bolster their resilience to future shocks. Finalizing the Basel Committee capital and liquidity, reforms will raise resilience and provide greater certainty and stability in the markets as to the new standards towards which the sector must move.

Basel III is comprised of the following building blocks, which were agreed and issued by the Committee and its governing body between July 2009 and September 2010:

- higher quality of capital, with a focus on common equity, and higher levels of capital to ensure banks can better absorb the types of losses like those associated with this past crisis;
- better coverage of risk, especially for capital market activities;
- an internationally harmonized leverage ratio to constrain excessive risk taking and to serve as a backstop to the risk-based capital measure;
- capital buffers, which should be built up in good times so that they can be drawn down in periods of stress;
- minimum global liquidity standards to improve banks' resilience to acute short term stress and to improve long-term funding; and
- stronger standards for supervision, public disclosures and risk management.

Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, improve risk management and governance and strengthen banks' transparency and disclosures. The reforms target bank-level, or micro prudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress and macro prudential i.e. system wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time. These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system wide shocks.

## ELEMENTS OF THE REFORM PROGRAMME

***(1) Capturing all the Risks***

The first objective is to capture all significant risks in the capital framework. During the initial phase of the financial crisis, the majority of losses and the build up of leverage occurred in the trading book. At the same time, the trading book rules did not adequately capture all of the key risks to which banks were exposed. As a consequence, capital for trading book exposures was distressingly inadequate. The crisis also exposed weaknesses in banks' risk management and measurement of securitization and off-balance-sheet exposures. This shortcoming resulted in large, unexpected losses. The Committee's July 2009 enhancements included new rules to strengthen the treatment for certain securitizations in Pillar-1 by introducing higher risk weights for resecuritisation exposures. Counterparty credit risk is another key risk for which the regulatory capital improvement is needed. The enhancements proposed by the Committee are meant to strengthen the resilience of individual banking institutions and reduce the risk that shocks are transmitted from one institution to the next through the derivatives and financing channel.

***(2) Raising the Quality of the Capital Base***

The Committee's efforts to improve risk coverage are a crucial element of the capital adequacy equation but this is only half the story. The other half relates to the quality of the capital base backing banks' risk exposures. The Committee has proposed a series of measures that would overhaul the definition of capital. This is the second objective of the reform programme and it is set out broadly along two lines. First, the level and the share of the highest quality capital in Tier-1, namely, common equity and retained earnings, will rise substantially. During the crisis, losses came directly out of retained earnings but because of other forms of financial instruments in the capital base, some banks maintained deceptively high Tier-1 capital ratios. Moreover, in the case of many banks, non-common Tier-1 capital instruments ultimately had to be converted into common equity before confidence was restored. Second, the proposal introduces a rigorous set of deductions and exclusions from common equity to arrive at a more transparent, meaningful definition of capital and to restore the credibility of the Tier-1 capital base. Basel III is a micro prudential and firm-specific approach, which considers the three elements of the capital equation: the numerator of the new solvency ratios, i.e. capital, the denominator, i.e. risk-weighted assets, and finally the capital ratio itself.

***(A) The Numerator: A Strict Definition of Capital***

Regarding the numerator, the Basel III framework substantially raises the quality of capital. Basically, in the old definition of capital, a bank could report an apparently strong Tier 1 capital ratio while at the same time having a weak tangible common equity ratio. Prior to the crisis, the amount of tangible common equity of many banks, when measured against risk-weighted assets, was as low as 1 to 3 per cent, net of regulatory deductions. That's a risk-based leverage of between 33 to 1 and 100 to 1. Global banks further increased their leverage by infesting the Tier- 1 part of their capital structure with hybrid "innovative" instruments with debt-like features. In the old definition, capital comprised various elements with a complex set of minimums and maximums for each element, i.e. Tier-1 capital, innovative Tier-1, upper and lower Tier-2, Tier-3 capital, each with their own limits which was sometimes a function of other capital elements. The complexity in the definition of capital made it difficult to determine what capital would be available when losses arise. This combination of weaknesses permitted tangible common equity capital, the best form of capital, to be as low as 1 per cent of risk-weighted assets. In addition to complicated rules around what qualifies as capital, there was a lack of harmonization of the various deductions and filters that are applied to the regulatory capital calculation. And finally, there was a complete lack of transparency and disclosure on banks' structure of capital, making it impossible to compare the capital adequacy of global banks. During the crisis, credit losses and write downs come directly out of retained earnings and therefore common equity. It is thus critical that banks' risk exposures are backed by a high-quality capital base. This is why the new definition of capital properly focuses on common equity capital.

The concept of Tier-1 capital will continue to exist and will include common equity and other instruments that have a loss-absorbing capacity on a "going concern" basis. Innovative capital instruments which were permitted in limited amount as part of Tier-1 capital will no longer be permitted and those currently in existence will be phased out. Tier-2 capital will continue to provide loss absorption on a "gone concern" basis and will typically consist of subordinated debt. Tier 3 capital, which was used to cover a portion of a bank's market risk capital charge, will be eliminated and deductions from capital will be harmonized. With respect to transparency, banks will be required to provide full disclosure and reconciliation of all capital elements. With respect to the numerator of the capital equation, the focus is on tangible common equity, the highest-quality component of a bank's capital base and therefore the component with the greatest loss-absorbing capacity.

***(B) The Denominator: Enhanced Risk Coverage***

Regarding the denominator, Basel III substantially improves the coverage of the risks, especially those related to capital market activities: trading book, securitization products, counterparty credit risk on OTC derivatives and repos. In the period leading up to the crisis, when banks were focusing their business activities on these areas, a significant increase in total assets was observed. Yet under the Basel II rules, risk-weighted assets showed only a modest increase. This phenomenon was more pronounced for some countries and regions than for others. For global banks, the enhanced risk coverage under Basel III is expected to cause risk-weighted assets to increase substantially. This, combined with a tougher definition and level of capital, may tempt banks to understate their risk-weighted assets. The relationship between risk-weighted assets and total assets with a view to promoting a consistent implementation of the global capital standards across jurisdictions should be monitored very closely.

***Risk Weighting Challenges***

Many asset classes may appear to be low-risk when seen from a firm-specific perspective. But it is seen that the system-wide build-up of seemingly low-risk exposures can pose substantial threats to broader financial stability. Before the recent crisis, the list of apparently low-risk assets included highly rated sovereigns, tranches of AAA structured products, collateralized repos and derivative exposures etc. The basic approach of the Basel capital standards has always been to attach higher risk weights to riskier assets. The risk weights them and the methodology was significantly enhanced as we moved from Basel I to Basel II and they have now been further refined under Basel III. Nonetheless, as the crisis has made clear, what is not so risky in normal times may suddenly become very risky during a systemic crisis. Something that looks risk-free may turn out to have rather large tail risk.

***Trading Books and Securitizations***

Basel II focused primarily on the banking book, where traditional assets such as loans are held. But the major losses during the 2007-09 financial crisis came from the trading book, especially the complex securitization exposures such as collateralized debt obligations. The revised framework now requires the introduction of a 12-month stressed VaR capital charge; incremental risk capital charge applied to the measurement of specific risk in credit sensitive positions when using VaR; similar treatment for trading and banking book securitizations; higher risk weights for re-securitizations (20 per cent instead of 7 per cent for AAA-rated tranches); higher credit conversion factors for short-term liquidity facilities to off-balance sheet conduits and SIVs (the shadow banking system); and more rigorous own credit analyses of externally rated securitization exposures with less reliance on external ratings. Eradication the trading book loophole, i.e. eliminate the possibility of regulatory arbitrage between the banking and trading books.

***Counterparty Credit Risk on Derivatives and Repos***

The Basel Committee is also strengthening the capital requirements for counterparty credit risk on OTC derivatives and repos by requiring that these exposures be measured using stressed inputs. Banks also must hold capital for mark to market losses (credit valuation adjustments – CVA) associated with the deterioration of a counterparty's credit quality. The Basel II framework addressed counterparty credit risk only in terms of defaults and credit migrations. But during the crisis, mark to market losses due to CVA (which actually represented two thirds of the losses from counterparty credit risk, only one third being due to actual defaults) were not directly capitalized.

***(C). Capital Ratios: Calibration of the New Requirements***

With a capital base whose quality has been enhanced, and an expanded coverage of risks both on- and off-balance sheet, the Basel Committee has made great strides in strengthening capital standards. But in addition to the quality of capital and risk coverage, it also calibrated the capital ratio such that it will now be able to absorb losses not only in normal times, but also during times of economic stress. To this end, banks will now be required to hold a minimum of 4.5 per cent of risk-weighted assets in tangible common equity against 2 per cent under Basel II. In addition, the Basel Committee is requiring a capital conservation

buffer of 2.5 per cent. Taken together, this means that banks will need to maintain a 7 per cent common equity ratio. When one considers the tighter definition of capital and enhanced risk coverage, this translates into roughly a sevenfold increase in the common equity requirement for internationally active banks.

***(D). Capital Conservation***

It is prudent for banks to build capital buffers during times of economic growth. Then, as the economy begins to contract, banks may be forced to use these buffers to absorb losses. But to offset the contraction of the buffer, banks could have the ability to restrict discretionary payments such as dividends and bonuses to shareholders, employees and other capital providers. Of course they could also raise additional capital in the market. In fact, what is witnessed during the crisis was a practice by banks to continue making these payments even as their financial condition and capital levels deteriorated. This practice, in effect, puts the interest of the recipients of these payments above those of depositors, which is not acceptable. To address the need to maintain a buffer to absorb losses and restrict the ability of banks to make inappropriate distributions as their capital strength declines, the Basel III will now require banks to maintain a buffer of 2.5 per cent of risk-weighted assets. This buffer must be held in tangible common equity capital. As a bank's capital ratio declines and it uses the conservation buffer to absorb losses, the framework will require banks to retain an increasingly higher percentage of their earnings and will impose restrictions on distributable items such as dividends, share buybacks and discretionary bonuses. Supervisors now have the power to enforce capital conservation discipline. This is a fundamental change. Banks will no longer be able to pursue distribution policies that are inconsistent with sound capital conservation principle.

The above discussion outlined that the implementation of Basel III will reduce the probability and severity of financial crisis and thus promote higher grow over the long term. With regard to the long term implications, it is observed that there are clear economic benefits from increasing the minimum capital and liquidity requirements from their current levels. The benefits of higher capital and liquidity requirements accrue from reducing the probability of financial crisis and the output losses associated with such crisis. The evidence suggests that there is a substantial room to strengthen capital and liquidity standards in a way that does not jeopardize near term growth, but enhances long term stability and economic output. In such circumstances, Indian banking system cannot afford to continue to operate with such thin minimum regulatory capital and liquidity requirements as the system does not have the capacity for another round of bail outs, nor does the public have the tolerance for it. However the impact of the Basel III norms on the Indian banking system is expected to the marginal. Most of the Indian banks compiled (as on 31st March, 2011) with Tier I capital ratio of 6 per cent, which banks have to achieve in 2015 (based on Basel III). Also, Indian banks will go through less pain than the counterparts in western economies. However, there will be areas where the banks may have to review its liquidity guidelines. For instance, after an observation period beginning in 2011, the liquidity coverage ratio (LCR) will be introduced on 2015. The revised net stable funding ratio will move to a minimum standard by 2018. These new rules will force the banks to hold more capital to prevent another financial crisis. To ease the burden arising out of Basel III, the regulators have given the banks transition periods to comply. These periods, extending in some cases to January 2019 or later, are longer than many analysts had expected. Global banks have liked the news that they have been given an extended period and there is no immediate need to go to market to raise capital. Government also has earmarked Rs.150 billion for recapitalization of state-owned banks in 2010-11 to shore up their Tier-I capital to at least 8 per cent.

## CONCLUSION

Basel III will not only enhance the micro prudential framework for capital, but it also adds a macro prudential approach that is system-wide and systemic. The nine regulatory breakthroughs will reduce the probability and severity of future financial crises and thus, promote higher growth over the long-term. Raising capital and liquidity standards will reduce the probability and impact of crises and bring with it large benefits. Basel III is a comprehensive set of reforms measures, which will improve the Indian banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance and strengthen banks' transparency and disclosures.

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