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BASEL III IMPLEMENTATION IN THE INDIAN BANKING SYSTEM

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ABSTRACT

The capital requirements for credit risk, market risk and operational risk are laid down by Basel III which is the international capital adequacy structure for banks. Basel III is the third of the Basel Accords suggested on banking laws and regulations issued by Basel Committee on Banking Supervision in order to augment the banking regulatory framework over Basel II. Criticism has been faced by the Basel I Accord due to its focus on principally credit risk. A New Capital Adequacy Framework (popularly referred to as Basel II) has been proposed by Basel Committee incorporating three major elements: (a) minimum capital requirements, (b) supervisory review and (c) market discipline. A further modification in 'Basel III' was initiated in 2010 in response to a number of failings in Basel II, which came to light during the crisis in since 2008. The Basel III is to be implemented by banks in India as per the guidelines issued by RBI from time to time. This paper briefly describes the implications and issues of Basel III Norms in Indian banking sector. This study is based on the secondary data which has been collected from annuals reports of RBI, journals and various websites.

KEYWORDS
Basel 3, Basel 2, Risk management, CRAR, profitability, India.

INTRODUCTION

Basel III is created in order to ensure that the impact of future crises not becomes as severe as the previous one. The Basel Committee on Banking Supervision (BCBS) introduced a broad restructuring enclosure entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" in December 2010, with the aim to advance the banking sector's ability to soak up shocks happening from economic stress. The reform package relating to capital regulation, together with the enhancements to Basel II framework and amendments to market risk framework issued by BCBS in July 2009, will amend certain provisions of the existing Basel II framework, in addition to introducing some new concepts and requirements.

Thereafter Basel-III is a wide-ranging set of reform measures to toughen the regulation, supervision and risk management of the banking sector. This present research paper would make an effort to analyze likely implications and issues of Basel III for Indian Banking sector. Therefore, Basel III will have some micro-prudential elements so that risk is contained in each individual institution; and a macro-prudential cover that will "lean against the wind" to take care of issues relating to the systemic risk (see figure 1).

Reserve Bank of India issued Guidelines based on the Basel III reforms on capital regulation on May 2012, to the extent applicable to banks operating in India. The Basel III capital regulation has been implemented from April 01, 2013 in India in phases and it will be fully implemented as on March 31, 2018 (RBI, 2012). (See table 1)

TABLE - 1

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Minimum common equity	2.0%	2.0%	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Minimum Tier 1 capital	4.0%	4.0%	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%	8.0%	8.0%
Capital conservation buffer						0.625%	1.25%	1.875%	2.50%
Countercyclical buffer						≤ 0.625%	≤ 1.25	≤ 1.875	≤ 2.50%
Leverage ratio	Supervisory monitoring		Initially set at 3% during observation period from 1 January 2013 to 1 January 2017; any final adjustments in first half of 2017					The plan is to migrate to Pillar 1 treatment on 1 January 2018	
Capital instruments that no longer qualify as common equity			Either excluded from 1 January 2013 or, if they meet certain criteria, phased out over 10 years starting with 2013						
Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital			Phased out over 10 years starting with 2013 (though existing public sector capital injections will be grandfathered until 1 January 2018)						
Phase in of regulatory adjustments				20%	40%	60%	80%	100%	100%
Liquidity coverage ratio (LCR)	Observation period				Minimum standard applies				
Net stable funding ratio (NFR)	Observation period							Minimum standard applies	

Source: http://www.allbankingsolutions.com/Banking-Tutor/Basel-iii-implementation-guidelines-RBI.htm

IMPLICATIONS OF BASEL III FOR THE INDIAN BANKING SYSTEM

Although the Basel III framework focuses mainly on international active banks, its underlying principles are intended suitable for application to banks of varying levels of intricacy and difficulty. It is, therefore, advantageous to discuss likely implications of Basel III for the Indian banking system. The implications are high-lighted below *(see figures 1, 2, 3):*

- **Higher capital requirement both in terms of quantity and quality**
  - **Introduction of capital conservation buffer** of 2.5% of Risk Weighted Assets (RWA) over and above the minimum capital requirement of 8% under Basel II which increased the total capital requirement to 10.5%. The key rationale of the buffer is to enhance the loss absorbing ability of the bank and permit to carry on its business even in recession devoid of deleveraging.
  - **Introduction of countercyclical capital buffer** of 0 – 2.5% of RWA with the object to get better capital requirements in good times and decrease the same in bad times and as a result, eliminates the procyclical capital needs of Basel II.
  - **Intensification of counterparty credit risk framework** under market risk instruments. Counterparty credit risk capital requirement is assessed based on stressed input parameters.
  - **Introduction of leverage ratio as a backstop to the risk based capital requirement.** A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to 20 put a cap on distend of leverage in the banking sector on a global basis.
  - **Provision for higher capital surcharge for Systematically Important Financial Institutions (SIFIs)** is made as macroprudential framework. SIFIs will be expected to have loss-absorbing capability beyond the Basel III requirements. Available options include capital surcharges, contingent capital and bail-in-debt.
  - **Provision for Credit Valuation Adjustment (CVA) risk capital charge** for OTC derivatives is made to protect banks against the risk of decline in the credit quality of the counterparty.
- **Introduction of Liquidity and Solvency Standards**

Basel III addresses both short term liquidity risk management and longer term solvency risk management. Under Liquidity Coverage Ratio (LCR), banks are required to maintain sufficient high quality unencumbered liquid assets to overcome any stressed funding situation over a 30-day period. On the other hand, to mitigate the longer term liquidity mismatches, banks are to maintain Net Stable Funding Ratio (NSFR). It encourages banks to avail stable source of funding relative to the liquidity profile of assets including off-balance sheet commitments.

- **Amendments in Provisioning Norm**

Basel III proposed the 'expected loss approach' as against current 'incurred loss approach' of making provision on the ground that it will arrest more accurately the actual losses and hence less pro-cyclical in nature. In this context, it is to be mentioned that the RBI has already issued an approach paper on the suitable provisioning framework in line with the Dynamic Provisioning (Jayadev, 2013).

- **Improved Disclosures Requirements**

Basel III needs banks to disclose all pertinent information as regards to their risk exposures, regulatory capital and regulatory adjustments thereto so as to make easy more informed decision making for the market participants.

FIG. 1

FIG. 2

FIG. 3

Chart 3: Implementation: from Basel II to Basel III

As a percentage of risk-weighted assets	Capital requirements							Additional macroprudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer	Additional loss-absorbing capacity for SIFIs
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	2			4		8			
Memo:	Equivalent to around 1% for an average international bank under the new definition			Equivalent to around 2% for an average international bank under the new definition					
Basel III New definition and calibration	4.5	2.5	7.0	6	8.5	8	10.5	0–2.5	1–2.5%
								10.5% — 15.5%	

Source: http://www.allbankingsolutions.com/Banking-Tutor/Basel-iii-implementation-guidelines-RBI.htm

ISSUES WITH BASEL III ACCORD

In Basel III there are some major issues that should not be ignored by the RBI when implementing the Accord in India. These issues are highlighted below.

- **Additional capital requirement**

As banks go on increasing the risk weighted asset portfolio to meet the growing economy's credit requirements, they would need additional common equity funds for meeting Basel III accord. Therefore, it is presuming that all Indian banks need to maintain the higher capital requirement of Basel III at a time when credit demand is going to expand very quickly (Jayadev, 2013).

- **Profitability**

Basel- III implementation will trim down return on equity for the average bank by about 4% points in Europe and about 3% in the US provided other factors remain the same (Sharma 2014). It is expected that similar impact on the profitability of Indian banking system is also happen since Basel III requires higher and better quality capital which will raise the cost of equity and non-equity regulatory capital; because raising additional capital from market will raise interest rate and in turn the cost of capital will ascend. In this process the return on common equity capital will dropped. Therefore, the profitability level would be decreased automatically (Mahapatra, 2012).

- **Risk Management system**

In current years many banks in India are making efforts in the direction of moving towards implementation of advanced approaches. The bigger banks need to move smoothly to the advanced approaches, particularly as they expand their overseas presence. Implementation of advanced approaches requires steady and broader based capability in risk management; and also requires adequate and good quality data at the right time. Other banks also need to strengthen their risk management and control system so as to allocate risk capital efficiently and improve profitability and shareholder's return (Jayadev,2013).

- **Liquidity requirement issues relating to SLR and LCR**

Indian banks are statutorily requisite to hold minimum reserves of high-quality liquid assets. Presently, such reserves (Statutory Liquidity Ratio – SLR) are required to be maintained at a minimum of 24% of net demand and time liabilities. As these reserves are part of the minimum statutory requirement, RBI faces a problem whether and how much of these reserves can be permitted to be considered to the LCR. If these reserves are not considered towards the LCR and banks are to meet the whole LCR with additional liquid assets, the proportion of liquid assets in total assets of banks will raise considerably, thereby lowering their income drastically. RBI is examining to what level the SLR requirements could be considered towards the liquidity requirement under Basel III (Mahapatra, 2012).

CONCLUSION

Basel – III is advancement rather than a mutiny for the banking system all over the world. The basic objective of the accord is to provide a rock hard base for economically sound banking internationally. A timeline of implementation of Basel III is practically satisfactory in the Indian perspective as it is found that Indian banks are comparatively sound placed for smother attainment of the standards; however, meeting Basel III format is both a challenge and an opportunity for Indian banks. The opportunity appears in the form of acquiring new equity capital, choice of suitable technology architecture and redesigning of risk management framework for efficient risk management and risk reporting. The challenges are successful implementation of the new standards as per recommended guidelines, timeframe and also negotiation with the stakeholders. Various fundamentals still, stay in progress and yet the final implementation date looks a long way. Though, banks should ensure they are engage with Basel III as soon as possible to position themselves competitively in the new post crisis financial risk and regulatory landscape. Therefore, RBI roadmap for the implementation of Basel III accord will give adequate time both for the banking sector and for the regulators in India to plan suitable and influential policy for successful mitigation of the challenges emergence from the acceptance of Basel III. The purpose of the Basel III capital and liquidity standards is to build banks more hard-wearing. Though, Basel III also compels costs on banks, reducing the returns that they can earn on their assets and increasing their cost of capital. It is to be estimated that banks will seek to pass these costs on to their customers to the extent possible.

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