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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

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   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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INDIAN BANKING INDUSTRY – BASICS TO BASEL

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ABSTRACT

The globalisation of the world has dramatically impacted both the dynamics and the pace of global banking business India embarked on a strategy of economic reforms in the wake of a balance-of-payments crisis in 1991. The thrust of these reforms was to promote a diversified, efficient and competitive financial system; with the ultimate objective of improving the allocative efficiency of resources, through operational flexibility, improved financial viability and institutional strengthening. The policy approach to financial sector in India is that the ultimate goal should be to conform to the best international standards and in the process; the emphasis is on gradual harmonisation with the international best practices. Adopting our general approach of gradualism, India implemented the Basel I framework with effect from 1992-93. In this context, this paper makes an attempt to understand the Overview and evolution of BASEL II and BASEL III, India's preparedness and the probable impact of BASEL II.The analysis finds that Implementation of Basel norms is likely to improve the risk management systems of banks as the banks aim for adequate capitalisation to meet the underlying credit risks and strengthen the overall financial system of the country. In India, over the short term, commercial banks may need to augment their regulatory capitalisation levels in order to comply with Basel.However, over the long term, they would derive benefits from improved operational and credit risk management practices.

KEYWORDS
Banking, Balance of Payments, Financial reforms.

INTRODUCTION
The globalisation of the world has dramatically impacted both the dynamics and the pace of global banking business. Mergers, acquisitions, consolidation, expansion, diversification of lines of business, shifting customer orientation and the changing regulatory environment are building up the pressure for banks to explore new possibilities by abandoning the familiar and embracing the unconventional. Competition is compelling banks to be agile and innovate everyday. In this milieu, what really enables banks to build a lasting competitive advantage is the ability to continuously innovate, achieve differentiation and respond quickly to dynamic business challenges.
Against this background of the current thinking in the country and reforms in other sectors, it is important to examine and understand the emerging trends in the banking industry.
The growth of Indian banking after nationalization, both in terms of sectoral coverage as well as geographical expansion, has been unparallel in the world. Yet, this growth has not been without a cost and certain weaknesses have emerged. The banking industry finds itself at the crossroads. India embarked on a strategy of economic reforms in the wake of a balance-of-payments crisis in 1991; a central plank of the reforms was reforms in the financial sector, and with banks being the mainstay of financial intermediation, the banking sector. At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. The thrust of these reforms was to promote a diversified, efficient and competitive financial system; with the ultimate objective of improving the allocative efficiency of resources, through operational flexibility, improved financial viability and institutional strengthening.

BASEL NORMS

Commercial banks in India were expected to start implementing Basel II. Available literature and interaction with the middle level executives of the industry in India by the author indicated that there is a gap exists in terms of Understanding BASEL (I, II, III) norms and practices.

OBJECTIVE OF THE STUDY
In this context, this paper makes an attempt to understand the following aspects on BASEL II
- Overview and evolution of BASEL II and BASEL III
- Views of various stakeholders on the level of preparedness in India.
- Probable impact of BASEL II.
- Background of BASEL III.

METHODOLOGY
The paper is based on the secondary data of various studies and experts views on this topic. Even though Basel norms are the most talked about and written about in the media. Available literature about the progress is not clear; since ther are variying views and risk perception in implementing Basel II.This article attempts to understand these differences which exist across the globe in terms of the views towards the preparedness for implementing Basel II norms.
The article is dived in to three sections. They are as follows:
Section I: Evolution of Basel norms
Section-II: Preparedness in India
Section III: Background of Basel III Norms
Section I: Evolution of Basel norms- This section traces the background and evolution of Basel norms to its present stage. This section also discusses the need for Basel and its percievd impact on the global commitments.
Section-II: Prpearedness in India- This section analyses the level of prepardenss in India. In this section the views of various stakeholders of Indian banking industy on the level of preparedness is being analysed.
Section III: Background of Basel III Norms – An outline of the key elements of the proposed Basel III guidelines are provided.

SECTION I: EVOLUTION OF BASEL NORMS
BACKGROUND
BASEL ACCORD

The Basel Accords) refer to the banking supervision Accords (recommendations on banking laws and regulations), Basel I and Basel II issued by the Basel Committee on Banking Supervision (BCBS).
The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision in the expectation that member authorities and other nation's authorities will take steps to implement them through their own national systems, whether in statutory

form or otherwise. The purpose of the committee is to encourage convergence toward common approaches and standards. The Basel Committee is named after the city of Basel, Switzerland.

The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its 12 member permanent Secretariat is located. The Committee is often referred to as the BIS Committee after its meeting location. However, the BIS and the Basel Committee remain two distinct entities.

The Bank for International Settlements (BIS) is an international organization of central banks which "fosters international monetary and financial cooperation and serves as a bank for central banks." It is not accountable to any national government. The BIS carries out its work through subcommittees, the secretariats it hosts, and through its annual General Meeting of all members. It also provides banking services, but only to central banks, or to international organizations like itself. Based in Basel, Switzerland, the BIS was established by the Hague agreements of 1930.

THE BASEL I ACCORD

On 26th June 1974, a number of banks had released Deutschmarks to Bank Herstatt in Frankfurt in exchange for dollar payments that were to be delivered in New York. Due to differences in time zones, there was a lag in dollar payments to counter-party banks during which Bank Herstatt was liquidated by German regulators, i.e. before the dollar payments could be affected.

BASEL COMMITTEE ON BANKING SUPERVISION (BCBS)

The Herstatt incident prompted the G-10 countries (the G-10 is today 13 countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States) to form, towards the end of 1974, the Basel Committee on Banking Supervision (BCBS), under the auspices of the Bank for International Settlements (BIS), comprising of Central Bank Governors from the participating countries.

BCBS has been instrumental in standardizing bank regulations across jurisdictions with special emphasis on defining the roles of regulators in cross-jurisdictional situations. The committee meets four times a year. It has around 30 technical working groups and task forces that meet regularly.

In 1988, the Basel Committee published a set of minimal capital requirements for banks, known as the 1988 Basel Accord. These were enforced by law in the G-10 countries in 1992, with Japanese banks permitted an extended transition period.

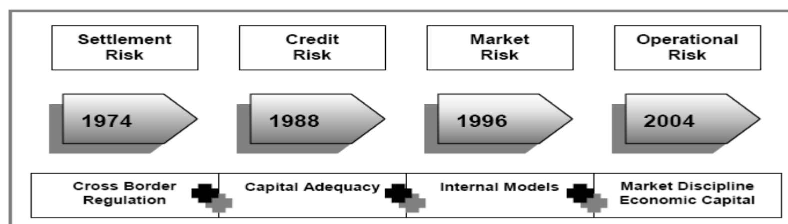
1988 BASEL ACCORD

The 1988 Basel Accord focused primarily on credit risk. Bank assets were classified into five risk buckets i.e. grouped under five categories according to credit risk carrying risk weights of zero, ten, twenty, fifty and one hundred per cent. Assets were to be classified into one of these risk buckets based on the parameters of counter-party (sovereign, banks, public sector enterprises or others), collateral (e.g. mortgages of residential property) and maturity. Generally, government debt was categorised at zero per cent, bank debt at twenty per cent, and other debt at one hundred per cent. 100%. OBS (off-balance sheet) exposure exposures such as performance guarantees and letters of credit were brought into the calculation of risk weighted assets using the mechanism of variable credit conversion factor. Banks were required to hold capital equal to 8% of the risk weighted value of assets. Since 1988, this framework has been progressively introduced not only in member countries but also in almost all other countries having active international banks.

The accord provided a detailed definition of capital. Tier 1 or core capital, which includes equity and disclosed reserves, and Tier 2 or supplementary capital, which could include undisclosed reserves, asset revaluation reserves, general provisions & loan–loss reserves, hybrid (debt/equity) capital instruments and subordinated debt.

In 1996, BCBS published an amendment to the 1988 Basel Accord to provide an explicit capital cushion for the price risks to which banks are exposed, particularly those arising from their trading activities. This amendment was brought into effect in 1998.

FIG.1. EVOLUTION OF BASEL INITIATIVES



INDIA AND BASEL I

The policy approach to financial sector in India is that the ultimate goal should be to conform to the best international standards and in the process; the emphasis is on gradual harmonisation with the international best practices.

Adopting our general approach of gradualism, India implemented the Basel I framework with effect from 1992-93 which was, however, spread over three years – banks with branches abroad were required to comply fully by end March 1994 while the other banks were required to comply by end March 1996. Further, India responded to the 1996 amendment to the Basel I framework, which required banks to maintain capital for market risk exposures, by initially prescribing various surrogate capital charges for these risks between 2000 and 2002. These were replaced with the capital charges as required under the Basel I framework in June 2004, which became effective from March 2005.

INDIA AND BASEL II

Consistent with this approach, for Basel II also, all commercial banks in India are implementing Basel II with effect from March 31, 2007.

BASEL II - BACKGROUND

Close on the heels of the 1996 amendment to the Basel I accord, in June 1999 BCBS issued a proposal for a New Capital Adequacy Framework to replace the 1988 Accord.

AIM OF BASEL II

Basel II aims to encourage the use of modern risk management techniques; and to encourage banks to ensure that their risk management capabilities are commensurate with the risks of their business. Previously, regulators' main focus was on credit risk and market risk. Basel II takes a more sophisticated approach to credit risk, in that it allows banks to make use of internal ratings based Approach -or "IRB Approach" as they have become known -to calculate their capital requirement for credit risk. It also introduces, in addition to the market risk capital charge, an explicit capital charge for operational risk. Together, these three risks -credit, market, and operational risk -are the so-called "Pillar 1" risks.

The proposed capital framework consists of three pillars: minimum capital requirements, which seek to refine the standardised rules set forth in the 1988 Accord; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. The accord has been finalized recently on 11th May 2004 and the final draft is expected by the end of June 2004. For banks adopting advanced approaches for measuring credit and operational risk the deadline has been shifted to 2008, whereas for those opting for basic approaches it is retained at 2006.

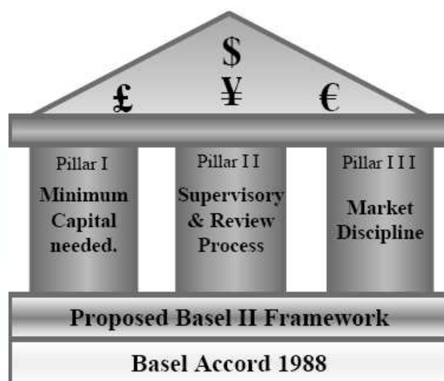
THE NEED FOR BASEL II

The 1988 Basel I Accord has very limited risk sensitivity and lacks risk differentiation (broad brush structure) for measuring credit risk. For example, all corporations carry the same risk weight of 100 per cent. It also gave rise to a significant gap between the regulatory measurement of the risk of a given transaction and its actual economic risk. The most troubling side effect of the gap between regulatory and actual economic risk has been the distortion of financial decision-making, including large amounts of regulatory arbitrage, or investments made on the basis of regulatory constraints rather than genuine economic opportunities. The strict rule based approach of the 1988 accord has also been criticised for its `one size fits all' prescription. In addition, it lacked proper recognition of credit risk mitigants such as credit derivatives, securitisation, and collaterals.

The frequent cases of frauds, acts of terrorism, hacking, have brought into focus the operational risk that the banks and financial institutions are exposed to.

The proposed new accord (Basel II) is claimed by BCBS to be `an improved capital adequacy framework intended to foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk assessment capabilities'. It also seeks to provide a `level playing field' for international competition and attempts to ensure that its implementation maintains the aggregate regulatory capital requirements as obtaining under the current accord. The new framework encouraged incentives for using more advanced and sophisticated approaches for risk measurement and attempts to align the regulatory capital with internal risk measurements of banks subject to supervisory review and market disclosure.

FIG.2. THREE PILLARS OF BASEL II



SUMMARY OF THE THREE PILLARS OF BASEL II

PILLAR I: MINIMUM CAPITAL REQUIREMENTS

- Retains the 8% minimum capital adequacy ratio (CAR) from the 1988 Accord.
- Details more risk sensitive charges for credit risk, details treatments for securitisation exposures and introduces a new charge for operational risk.
- Provides for a range of approaches of increasing sophistication. Banks can adopt the most suitable approach from a range for their respective institutions. As banks become more sophisticated in their measurement systems and practices, they are encouraged to adopt the more risk sensitive approaches for which there are associated (capital reduction) incentives.
- Credit risk: financial institutions are allowed to choose from either the Standardised Approach which uses standardised risk weights and external ratings where available, or the Internal Ratings Based (IRB) Approach which uses data from internal risk management systems. A securitisation framework must be applied for banks involved in traditional and synthetic securitisations or similar structures.
- Market risk: addresses the risk involved in trading book positions and treatment of counterparty credit risk so as to adequately capture event and default risk for trade-debt and equity instruments.
- Operational risk: defined as 'the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.'14 Banks are offered three methods for calculating operational risk capital charges including the Basic Indicator Approach, the Standardised Approach, and the Advanced Measurement Approach (AMA).

PILLAR II SUPERVISORY REVIEW

- Outlines bank management responsibility for establishing internal review processes to monitor and assess capital adequacy based on the risks to which a bank may be exposed.
- Outlines supervisor responsibilities in evaluating capital needs, managing associated risks and intervening when appropriate.
- Encourages active interaction between banks and their supervisors so that action can be taken promptly when issues arise.
- Focuses increased attention on 'home-host' supervisory cooperation within banking groups and the supervision of securities firms and insurers in financial institutions that offer financial products and services.

PILLAR II MARKET DISCIPLINE

- Encourages prudent management and transparency in financial reporting of banks through external market incentives.
- Focuses on effective disclosure of information and specifies the nature and type of information that should be reported to market participants.

TABLE 1: COMPARISON BETWEEN THE 1988 CAPITAL ACCORD AND BASEL II

1988 Capital Accord	Basel II
• Focus on a single risk measure to measure credit and market risk capital adequacy ratio • A 'one size fits all' approach with no material gradation of risk • A less detailed and definitive structure	• Provides a more comprehensive and flexible approach to measuring and managing risk, in the process increasing risk sensitivity • Adds operational risk as a new charge • Promotes banks' internal risk management methodologies • Incorporates supervisory review and market discipline as part of risk assessment

SOURCE: BIS

PERCEIVED IMPACT

1)Apart from banks and regulators, who are directly affected by Basel II, customers, rating agencies, capital markets and other financial companies (outside the scope of Basel II) will also be affected. Banks will have to implement an enterprise-wide risk management framework, which will entail establishing relevant

processes and gathering, integrating and analysing large amount of data. Using quantitative methods to manage risk - and to deploy capital based on risks - requires high quality and high frequency data.
2) Impact on various entities in financial markets.
3) Customers will find that they have to cope with increased demands for timely information from banks that are on IRB approaches. Risk-based pricing of credit products will become the norm as banks begin differentiating customers as per their risk profiles. Riskier borrowers are likely to find their borrowing costs going up and/or credit lines tightened up.
4) Rating agencies may face more competition as the market for them will expand and deepen, which will be a driver for them to be more transparent in their rating process.
5) Good quality rated corporates will prefer capital markets to banks for their funding. Securitisation and credit derivatives will increasingly be used as credit risk hedging tools.
6) Basel II is also likely to impact financial institutions that do not have to comply with it. Non-banking corporations such as credit card companies, leasing companies, auto manufacturers and financiers, or retailers' financing arms may not have to fulfill the potentially extensive disclosure requirements prescribed by Basel II nor make investments in managing operational risk, which will put them at a competitive advantage vis-à-vis banks.

TABLE 2: STRENGTHENED CAPITAL FRAMEWORK: FROM BASEL II TO ENHANCED BASEL II

In percentage of risk-weighted assets	Capital requirements							Additional macro-prudential overlay
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	
1	2	3	4	5	6	7	8	9
Basel II	2			4		8		
Enhanced Basel II definition and calibration	4.5	2.5	7.0	6	8.5	8	10.5	0-2.5

Source: Bank for International Settlements.

The above data indicates a gradual increase inc CRAR and a reduction in the overall operating expenses over a period of time.
The vast majority of countries are adopting the 'better wait' and the gradual approaches, in face of the huge challenges posed by Basel II such as,
1) Capacity to validate models and monitor their use
2) Presence of Foreign Banks
3) Collaboration between home and host supervisors
4) Competitiveness issue
5) Credit portfolio concentration
6) Pro-cyclicality
7) Technical assistance

SECTION II- PREPAREDNESS IN INDIA

Adopting the general approach of gradualism, India implemented the Basel I framework with effect from 1992-93 which was, however, spread over three years – banks with branches abroad were required to comply fully by end March 1994 while the other banks were required to comply by end March 1996. Further, India responded to the 1996 amendment to the Basel I framework, which required banks to maintain capital for market risk exposures, by initially prescribing various surrogate capital charges for these risks between 2000 and 2002. These were replaced with the capital charges as required under the Basel I framework in June 2004, which became effective from March 2005. We have gone a step further than the Basel I requirement and have required the banks in India to maintain capital charge for market risks on their 'Available for Sale' portfolio also with effect from March 2006.
An observation of the Indian banks reveals the following situation

TABLE 3

Select Financial Indicators of Public Sector Banks 1997 to 2002

Period (end March)	CRAR	Other Income	Operating Expense	Net Profit
1997	10.00	1.32	2.88	0.57
1998	11.53	1.33	2.66	0.77
1999	11.20	1.22	2.66	0.42
2000	10.66	1.29	2.53	0.57
2001	11.20	1.22	2.72	0.42
2002	11.80	1.43	2.29	0.72

All the indicators, except CRAR, are ratios to total assets
Source: RBI (2003)

Consistent with this approach, for Basel II also, currently all commercial banks in India have started implementing Basel II with effect from March 31, 2007 – though a marginal stretching beyond this date should not be ruled out in view of the latest indications on the state of preparedness. While considering implementation of Basel II, special attention was given to the differences in degrees of sophistication and development of the banking system and it was decided that they will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some of the banks may be allowed to migrate to the Internal Rating Based (IRB) Approach. As per normal practice in regard to all changes in financial sector, and with a view to ensuring a particularly smooth migration to Basel II, a consultative and participative approach has been adopted for both - designing and implementing Basel II.
A recent RBI report observes that foreign banks operating in India and Indian banks with presence abroad migrated to the Basel II framework with effect from March 31, 2008. All other scheduled commercial banks (except regional rural banks and local area banks) are expected to migrate to the Revised Framework not later than by March 31, 2009.
The official position of the Reserve Bank of India (RBI), as emphasized in its response to BCBS, is as follows, `In its (Basel II) attempt to strive for more accurate measure of risks in banks, the simplicity of the present Capital Accord is proposed to be replaced, with a highly complex methodology which needs the support of highly sophisticated MIS / data processing capabilities. The complexity and sophistication essential for banks for implementing the new capital accord restricts its universal application in the emerging markets.' RBI had also suggested that a common definition of `internationally active banks' be provided by BCBS. Even the United States of America is not adopting the new accord for all of its banks. But, in the same response, RBI has also affirmed that it is `fully committed to implement the best international practices'.

TABLE 4: BASEL PREPAREDNESS PROCESS-INDIA

India	Reserve Bank of India (RBI) plans to, at a minimum, have all banks in India adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk with effect from March 31, 2007	• RBI released guidelines on the CAR framework (Feb 2005) – Under the Standardised Approach, Indian credit rating agencies recognised by the RBI will assign risk ratings. Depending on a bank's rating, a risk weight from 20% to 150% will be assigned to determine the capital requirements – 15% of gross income is to be set aside as provision towards operational risk • To meet Basel II requirements, banks are: – Modernising their financial systems – Preparing to enter the capital market in 2005 to raise funds

TABLE 5: BASEL PREPAREDNESS PROCESS- SELECTED REGIONS

Subject Matter	India	Asia	Africa	Middle East
Basel II implementation: Coverage of banking assets	100% of banking assets in India by 2009 as per Regulatory instructions	70% of banking assets in Asia by 2009	65% of banking assets by 2009	89% of banking assets by 2009

BANKING INDUSTRY VIEW

An analysis of the opinion by top bankers acroos the country point out to the following oppourtunities and challenges

OPPORTUNITITES

- For India, these norms provide massive opportunities in the form of software services, outsourcing and consultancy services.
- It provides an opportunity for global integration and ushering in international best practices.
- Basel II compliance will eventually result in banks acquiring a competitive edge, stating `Banks that move proactively in the broad direction outlined by the Basel Committee will have acquired a definite edge over their competitors when the new accord enters the implementation phase.'
- The new accord provides incentives to banks for improving their credit portfolio through risk management'. The banks will reap the benefits of improved systems and efficiency in the long term'.
- The cost of IT development is almost certainly less in India than elsewhere,' `there may be a faster payback for the more advanced method of internal ratings despite the greater level of investment required as the payback in terms of reduced capital utilisation at least on the credit side may be quicker depending of course on each banks cost of capital.'

REGULATORS VIEW

APPROACH OF THE RESERVE BANK OF INDIA TO BASEL II ACCORD

The Reserve Bank of India (RBI) has asked banks to move in the direction of implementing the Basel II norms, and in the process identify the areas that need strengthening. In implementing Basel II, the RBI is in favour of gradual convergence with the new standards and best practices. The aim is to reach the global best standards in a phased manner, taking a consultative approach rather than a directive one. In anticipation of Basel II, RBI has requested banks to examine the choices available to them and draw a roadmap for migrating to Basel II. The RBI has set up a steering committee to suggest migration methodology to Basel II. Based on recommendations of the Steering Committee, in February 2005, RBI has proposed the "Draft Guidelines for Implementing New Capital Adequacy Framework" covering the capital adequacy guidelines of the Basel II accord. RBI expects banks to adopt the Standardised Approach for the measurement of Credit Risk and the Basic Indicator Approach for the assessment of Operational Risk. RBI has also specified that the migration to Basel II will be effective March 31, 2007 and has suggested that banks should adopt the new capital adequacy guidelines and parallel run effective April 1, 2006. Over time, when adequate risk management skills have developed, some banks may be allowed to migrate to the Internal Ratings Based approach for credit risk measurement.

In the Standardised approach proposed by Basel II Accord, credit risk is measured on the basis of the risk ratings assigned by external credit assessment institutions, primarily international credit rating agencies like Moody's Investors Service This approach is different from the one under Basel I in the sense that the earlier norms had a "one size fits all" approach, i.e. 100% risk weight for all corporate exposures. Thus, the risk weighted corporate assets measured using the standardised approach of Basel II would get lower risk weights as compared with 100% risk weights under Basel I. Basel II gives a free hand to national regulators (in India's case, the RBI) to specify different risk weights for retail exposures, in case they think that to be more appropriate. To facilitate a move towards Basel II, the RBI has also come out with an indicative mapping of domestic corporate long term loans and bond credit ratings against corporate ratings by international agencies like Moody's Investor Services .Going by this mapping, the impact of the lower risk weights assigned to higher rated corporates would not be significant for the loans & advances portfolio of banks, as these portfolios mainly have unrated entities, which under the new draft guidelines continue to have a risk weight of 100%. However, given the investments into higher rated corporates in the bonds and debentures portfolio, the risk weighted corporate assets measured using the standardised approach may get marginally lower risk weights as compared with the 100% risk weights assigned under Basel I. For retail exposures—which banks in India are increasing focusing on for asset growth—RBI has proposed a lower 75% risk weights (in line with the Basel II norms) against the currently applicable risk weights of 125% and 100% for personal/credit card loans, and other retail loans respectively. For mortgage loans secured by residential property and occupied by the borrower, Basel II specifies a risk weight of 35%, which is significantly lower than the RBI's draft prescription of 75% (if margins are 25% or more) and 100% (if margins <25%).

TABLE 6: BANK REGULATORY CAPITAL TO RISK-WEIGHTED ASSETS

(per cent)

Countries	2005	2006	2007	2008	2009
1	2	3	4	5	6
US	12.9	13.0	12.8	12.8	14.3
UK	12.8	12.9	12.6	12.9	14.8
Japan	12.2	13.1	12.3	12.4	15.8
France	11.3	10.9	10.2	10.5	12.4
Germany	12.2	12.5	12.9	13.6	14.8
Portugal	11.3	10.9	10.4	9.4	10.5
Italy	10.6	10.7	10.4	10.8	12.1
Greece	13.2	12.2	11.2	9.4	11.7
Spain	11.0	11.2	10.6	11.3	12.2
Brazil	17.9	18.9	18.7	18.3	18.8
Russia	16.0	14.9	15.5	16.8	20.9
India	12.8	12.3	12.3	13.0	13.2
China	2.5	4.9	8.4	12.0	11.4
Indonesia	19.9	20.6	19.2	17.0	17.6
Malaysia	13.7	13.5	13.2	12.6	15.4
Philippines	17.6	18.1	15.7	15.5	15.8
Thailand	13.2	13.6	14.8	13.9	15.8
Mexico	14.3	16.1	15.9	15.3	15.9

Source: IMF

In the case of India there is a gradual increase in terms of Bank Regulatory Capital to Risk-Weighted Assets.
Kishori J Udeshi, deputy governor, RBI, in her speech at the `World Bank/IMF/US Federal Reserve Board 4th Annual International Seminar on Policy Challenges for the Financial Sector: Basel II' at Washington on June 2, 2004, summed up the Indian response to Basel II.

- Understanding Basel II concepts is one step away from agreeing to it in principle. Implementing Basel II is another long step away from understanding it.
- RBI's approach to the institution of prudential norms has been one of gradual convergence with international standards and best practices with suitable country specific adaptations. Our aim has been to reach global best standards in a deliberately phased manner through a consultative process evolved within the country. RBI had in April 2003 itself accepted in principle to adopt the new capital accord'.
- RBI has announced, in its Annual Policy statement in May 2004 that banks in India should examine in depth the options available under Basel II and draw a road-map by end December 2004 for migration to Basel II and review the progress made thereof at quarterly intervals'.
- At a minimum all banks in India, to begin with, will adopt Standardized Approach for credit risk and Basic Indicator Approach for operational risk. After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to IRB Approach'
- Banks adopting IRB Approach will be much more risk sensitive than the banks on Standardised Approach, (so) the banks on Standardised Approach could be inclined to assume exposures to high risk clients, which were not financed by IRB banks. Due to concentration of higher risks, Standardised Approach banks can become vulnerable at times of economic downturns.
- Keeping in view the cost of compliance for banks and supervisors, the regulatory challenge would be to migrate to Basel II in a non-disruptive manner. We would like to continue the process of interaction with other countries to learn from their experiences.

CHALLENGES

The challenges for the Indian Banking System under BASEL II:

1. Costly Database Creation and Maintenance Process
2. Additional Capital Requirement
3. Risk Management Architecture
4. Rating Requirement
5. Choice of Alternative Approaches
6. Supervisory Framework
7. Disclosure Regime
8. Disadvantage for Smaller Banks

Thus, the full implementation of the Basel II framework, even under the basic/standardized approaches, would remain a major challenge for some time to come, for both the banks and the Reserve Bank.
At the banks' level, the implementation would require, inter alia,

- Upgradation of the bank-wide information system through better branch-connectivity, which would entail cost
- Also raise some IT-security issues.
- The implementation of Basel II also raises several issues relating to development of
- Human resource skills
- Database management.
- Banks would require higher amount of capital under the Basel II framework.
- They would, therefore, need to explore various capital raising options.
- The new norms are a formidable challenge for the regulators and banks to understand and implement.
- These are expected to change the banking landscape and the way banks manage their risks.
- On the customer's side, there will be winners and losers depending on their risk profile.
- Banks in emerging markets would, therefore, face serious implementation challenges due to lack of adequate technical skills, under development of financial markets, structural rigidities and less robust legal systems.
- Besides banks, supervisors would be required to invest considerable resources in upgrading technology systems, and human resources to meet the minimum standards.
- On current indications, implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently.
- The additional capital charge on account of operational risk is considered `harsh' by bankers and software suppliers unanimously. But all of them agree that it will benefit banks in the long term by making them sensitive to operational risk.
- Some experts also feels that Basel II will favour, at least in the short term, the bigger banks who have the technology advantage, but considers this as an opportunity for domestic banks to catch up with the big league in the long term.
- The higher disclosure requirements in the banking sector might lead to a growing tendency towards structural changes in the form of mergers and acquisitions.' As more and more banks move towards the advanced approaches, the gap between the strong and weak banks will increase further, making the weaker banks potential takeover targets'.

TABLE 7: CAPITAL TO RISK WEIGHTED ASSETS RATIO – BANK GROUP-WISE (AS AT END-MARCH)

(Per cent)

	Basel I		Basel II	
Bank group	2009	2010	2009	2010
1	2	3	4	5
Public sector banks	**12.3**	**12.1**	**13.5**	**13.3**
Nationalised banks*	12.1	12.1	13.2	13.2
SBI group	12.7	12.1	14.0	13.5
Private sector banks	**15.0**	**16.7**	**15.2**	**17.4**
Old private sector banks	14.3	13.8	14.8	14.9
New private sector banks	15.1	17.3	15.3	18.0
Foreign banks	**15.0**	**18.1**	**14.3**	**17.3**
Scheduled commercial banks	**13.2**	**13.6**	**14.0**	**14.5**

Source: Report on Trend and Progress of Banking in India 2009-10

The above table shows the gradual increase in the case of India in terms of Capital to Risk-Weighted Assets. The similar trend is evident in terms of the CRAR, capital funds and risk weighted assets.

TABLE 8: COMPONENT-WISE CAPITAL ADEQUACY OF SCHEDULED COMMERCIAL BANKS (AS AT END-MARCH)

(Amount in ₹ crore)

Item	Basel I		Basel II	
	2009	2010	2009	2010
A. Capital funds (i+ii)	4,88,563	5,72,582	4,87,826	5,67,381
i) Tier I capital	3,31,422	3,97,665	3,33,810	3,95,100
ii) Tier II capital	1,57,141	1,74,916	1,54,016	1,72,281
B. Risk-weighted assets	37,04,372	42,16,565	34,88,303	39,01,396
C. CRAR (A as % of B)	13.2	13.6	14.0	14.5
of which: Tier I	9.0	9.4	9.6	10.1
Tier II	4.2	4.1	4.4	4.4

Source: Report on Trend and Progress of Banking in India 2009-10

FICCI SURVEY ON PREPAREDNESS

According to the study, the banking system has a long way to go for providing full market access to foreign players. More than half the respondents felt banks would require two years beyond 2006 to meet the Basel norms and an overwhelming 87 per cent of respondents maintained that the provision for capital changes to address operational risks would put pressure on capital adequacy requirements. Similarly, the provisioning would adversely affect the credit flow to industry, as banks would become more risk averse. The survey covered 216 key decision makers from foreign, private, public sector banks and corporates. The internal rating based on recommendations of Basel II norms would make Indian banks more resilient to risk and help them face competition better, the survey said. On access to foreign players to Indian banking market, the survey said the banking industry would need 2-3 years to gear up to meet challenges of full market access to overseas entities. The FICCI survey said about 56 per cent of respondents favoured lifting restrictions on branch expansion, while 52 per cent sought removal of discriminatory limitations on foreign equity. However, 82 per cent have welcomed the government's move to hike foreign direct investment limit in private sector banks, helping to consolidate the industry, it said.

A recent research paper draws attention to the possible pitfalls in way of the implementation of the Basel norms in India's banking industry. According to this study, while it is a bit early to pass judgment on the success of these new prudential regulations in terms of the long-term stability and growth of the country's banking sector in the context of the newly opened up financial sector, one can duly have some reservations regarding the possible contractionary effects with changing composition of the priority credit itself. The result has often been a drop in the proportion of bank credit reaching out to small and medium enterprises, which have potentials for repayment capacity as well as growth. Supplementary finance, as available from outlets like the SIDBI, cooperative banks or even the fiscal measures do not fill in the void as is left in terms of the unfulfilled demand for finance on the part of the SMEs. As for the poor, meeting the minimum target by banks may not deliver what is needed by those who are not even considered 'bankable' by banks themselves!

According to some studies, the progress of Basel II implementation varies among the regions reflecting mainly differences in their financial and technological readiniess. Various studies done recently indicate that the ownership and structure of the banks do affect their performance. With increasing financial sector liberalization and emergence of financial conglomerates, financial sector stability has emerged as a key objective of the Central Bank in India.

ADVANTAGES

Adoption of Basel II has also improved the Indian banking system on various risk parameters, on the non performing assets and making adequate provisions on bad advances. Basel II implementation allows transparency, growth, strengthening the financial stability of the banks and improves the government standards. Also, the profitability of the banks would increase and stabilize over the years which will help the bank to consolidate itself so that the banks can go global. The Pillar 3 of Basel II enforces market discipline through stricter disclosure requirement. Such disclosure will be useful for supervisory authorities and rating agencies.

SECTION III: BACKGROUND OF BASEL III NORMS

The proposed Basel III guidelines seek to improve the ability of banks to withstand periods of economic and financial stress by prescribing more stringent capital and liquidity requirements for them.

The key elements of the proposed Basel III guidelines include the following:

1. Definition of capital made more stringent, capital buffers introduced and Loss absorptive capacity of
Tier 1 and Tier 2 Capital instrument of Internationally active banks proposed to be enhanced
2. Forward looking provisioning prescribed
3. Modifications made in counterparty credit risk weights
4. New parameter of leverage ratio introduced
5. Global liquidity standard prescribed

The Basel committee is finalization process started the Basel III guidelines by December 2010, following which a six year phase-in period beginning 2013 is likely to be prescribed. This note seeks to assess the impact of the proposed Basel III guidelines on Indian banks capitalisation profile and their liquidity position till 2018. The impact of the suggested norms relating to forward looking provisioning and counterparty risk weights are not captured in this note, since for that more granular data would be required and these are not available currently in the public domain.

The proposed Basel III guidelines seek to enhance the minimum core capital (after stringent deductions), introduce a capital conservation buffer (with defined triggers), and prescribe a countercyclical buffer (to be built up in times of excessive credit growth at the national level). The proposed Basel III guidelines suggest changes in the deductions made for the computation of the capital adequacy percentages.

The key features of the buffer include the following:

Credit-GDP gap could be used as a reference point
Buffer to be set at the national level every year
Buffer to be calculated at the same frequency as the normal capital requirement
Banks could be given one year to comply with the additional capital requirement
Reduction in buffer could take effect immediately
Banks not meeting the norm could be restrained from distributing the earnings (in the same manner as in the case of the capital conservation buffer)

TABLE 9: REGULATORY CAPITAL ADEQUACY LEVELS—PROPOSED VS. EXISTING RBI NORM

	Proposed Basel III Norm	Existing RBI Norm
Common equity (after deductions)	4.5%	3.6% (9.2%)
Conservation buffer	2.5%	Nil
Countercyclical buffer	0-2.5%	Nil
Common equity + Conservation buffer + Countercyclical buffer	7-9.5%	3.6% (9.2%)
Tier I(including the buffer)	8.5-11%	6% (10%)
Total capital (including the buffers)	10.5-13%	9% (14.5%)

Source: ICRA

TABLE 10: THE CAPITAL AND LIQUIDITY REFORM PACKAGE, JULY 2010 – MAJOR FEATURES

(1) *Definition of Capital*

(i) Prudent recognition of the minority interest

(ii) Elimination of counterparty credit restriction on hedging of financial institutions investments.

(iii) Limited recognition of investments in the common shares, mortgage servicing rights, and deferred tax assets for calculating common equity component of Tier I capital.

(2) *Counterparty Credit Risk*

(i) Modification of bond equivalent approach to address hedging.

(ii) Elimination of excessive calibration of credit valuation adjustment.

(iii) To subject banks' mark to market and collateral exposures to central counterparties (CCPs) to modest risk weights in the range of 1-3 per cent.

(3) *Leverage Ratio*

(i) Uniform credit conversion factors (CCF) for off-balance sheet exposures.

(ii) Basel II netting plus a simple measure of potential future exposure based on the standardised factors of the current exposure method.

(iii) Testing the proposal of minimum Tier I leverage ratio of 3 per cent during the parallel run.

(4) *Regulatory Buffers, Cyclicality of the Minimum and Provisioning*

(i) Capital conservation and countercyclical buffers to be finalised by end 2010.

(ii) Findings on cyclicality of the minimum requirement to be dovetailed with those from quantitative impact study to develop a set of supervisory tools to assess the adequacy of banks' capital buffers.

(iii) Dialogue with International Accounting Standards Board (IASB) to develop expected loss approach to provisioning.

(5) *Global Liquidity Standard*

(i) Revision of definition of liquid assets so that they remain liquid in periods of stress.

(ii) Introduction of 25.0 per cent outflow bucket for custody of clearing and settlement activities, as well as selected cash management activities.

(iii) Treatment of all sovereigns, central banks and PSEs on par with corporates with 100 per cent roll-off rate for unsecured funding.

Source: Basel Committee on Banking Supervision.

TABLE 11: PHASE-IN ARRANGEMENTS (FIGURES IN BOLD INDICATE TRANSITION PERIODS)
(ALL DATES ARE AS OF 1 JANUARY)

	2011	2012	2013	2014	2015	2016	2017	2018	As on 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
1	2	3	4	5	6	7	8	9	10
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 years horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Source: BIS

CONCLUSION

From the above discussions, the following conclusions emerge,

Adapting to Basel norms has been demanding for some institutions than for others, based on factors including current risk management practices, business size, geographical spread, risk types, specific business, portfolio, and market conditions.

Banks' risk management functions need to look at a much wider range of risks than this -interest rate risk in the banking book, foreign exchange risk, liquidity risk, business cycle risk, reputation risk, strategic risk. The risk management role of helping identify, evaluate, monitor, man age and control or mitigate these risks has become a crucial role in modern-day banking. Indeed, it is probably not exaggerating the importance of this to say that the quality of a bank's risk management has become one of the key determinants of a success of a bank.

Implementation of Basel norms is likely to improve the risk management systems of banks as the banks aim for adequate capitalisation to meet the underlying credit risks and strengthen the overall financial system of the country. In India, over the short term, commercial banks may need to augment their regulatory capitalisation levels in order to comply with Basel. However, over the long term, they would derive benefits from improved operational and credit risk management practices. The suggested capital requirement as a positive for banks as it raises the minimum core capital stipulation, introduces countercyclical measures, and enhances banks ability to conserve core capital in the event of stress through a conservation of capital buffer. The prescribed liquidity requirements, on the other hand, are aimed at bringing in uniformity in the liquidity standards followed by banks globally. This would help banks better manage pressures on liquidity in a stress scenario.

Undoubtedly the discipline of risk management has significantly altered the ethos of the banking as an economic activity. Banks should view the opportunities opened up by these complex financial instruments in the perspective of larger systemic interest.

Today internationally, when market discipline is being considered an integral part of the regulatory framework, it is imperative for banks to realize that they are equal partners in ensuring financial stability; and this involves helping build up a risk management culture across all stakeholders. Any distortions brought about by misalignment of risk needs and the product being offered to address the risk can only harm and arrest the development of a healthy market.

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