

Paper 41**CHANGES IN BASEL NORMS AND ITS IMPACT ON INDIAN BANKS****Mr. Amith Donald Menezes**Assistant Professor, Dept.of Mgt. & Commerce, Srinivas University, Pandeshwar , Mangalore
& Research Scholar at VTUE-mail- amith.menezes@yahoo.co.in**Abstract:**

Basel III norms are guidelines framed by a committee of central banks that is based in Basel, Switzerland. The Reserve Bank of India is also a member of this committee. The norms aim to toughen up the banking system in every country to withstand financial shock. They focus on the risks that banks are vulnerable to, particularly after the crisis in the banking sector, which was triggered by the problem in the US sub-prime mortgage market. Basel III aims to plug the gaps in the existing Basel II guidelines. The new norms will be made effective in a phased manner from January 1, 2013 and implemented fully from March 31, 2019. The guidelines will ensure that banks are well capitalized to manage all kinds of risks. The existing norms stipulate that banks should maintain Tier-I capital, or core capital, and Tier-II capital that comprise instruments with debt-like features. The proposed Basel III norms are going to have a significant impact on the Indian financial sector. While it is in a comfortable position to meet some of the proposed Basel III norms, the implementation of some of the other norms will be a challenge.

This paper tries to find out the impact of Basel III norms on the Indian banking industry.

Keywords: Banking, Basel-III, Equity, Buffers, Capital-Adequacy-Ratio, Tier-I, Tier-II**1. INTRODUCTION**

The breakdown of the Bretton Woods system of managed exchange rates in 1973 soon led to casualties. On 26 June 1974, West Germany's Federal Banking Supervisory Office withdrew Bankhaus Herstatt's banking license after finding that the bank's foreign exchange exposures amounted to three times its capital. Banks outside Germany took heavy losses on their unsettled trades with Herstatt, adding an international dimension to the debacle.

In October the same year, the Franklin National Bank of New York also closed its doors after racking up huge foreign exchange losses. Three months later, in response to these and other disruptions in the international financial markets, the central bank governors of the G10 countries established a Committee on Banking Regulations and Supervisory Practices.

Later renamed as the Basel Committee on Banking Supervision, the Committee was designed as a forum for regular cooperation between its member countries on banking supervisory matters. Its aim was and is to enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide.

The Committee seeks to achieve its aims by setting minimum supervisory standards; by improving the effectiveness of techniques for supervising international banking business; and by exchanging information on national supervisory arrangements. And, to engage with the

challenges presented by diversified financial conglomerates, the Committee also works with other standard-setting bodies, including those of the securities and insurance industries.

Since the first meeting in February 1975, meetings have been held regularly three or four times a year. After starting life as a G10 body, the Committee expanded its membership in 2009 and now includes 27 jurisdictions. The Committee now reports to an oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), which comprises central bank governors and (non-central bank) heads of supervision from member countries. This committee has taken various measures to strengthen the banking structure, to enable the banks to face the financial crisis, and to survive in the period of stress. Namely, this committee has given following three accords:

1. BASEL I
2. BASEL II
3. BASEL III

The first concrete evidence of global coordination in banking regulation were felt towards the end of 1974, when the G-10 countries (now its G-20 group of nations) took the initiative to form the Basel Committee on Banking Supervision (BCBS) under the auspices of Bank for International Settlements (BIS) comprising of central bank governors of participating countries.

2. OBJECTIVES OF THE STUDY:

- To understand the Basel Accords and more particularly Basel-III in detail.
- To know/understand the need of Basel Accords.
- To understand the RBI guidelines regarding Basel-III.
- To estimate the additional capital requirements of PSB's and Pvt. Sector.
- To examine the impact of Latest Basel Accord on Indian banking.

3. METHODOLOGY:

To fulfil the objectives of the study, we have taken both primary & secondary data into consideration.

Primary data: Primary data has been collected through personal interview by direct contact method. Personal interview and discussion was made with the manager and other personnel in the organization for this purpose.

Secondary data:

The secondary data is collected from the Magazines, Annual reports, Internet and Text books.

Basel I Accord:

The Accord called for a minimum capital ratio of capital to risk-weighted assets of 8% to be implemented by the end of 1992. Ultimately, this framework was introduced not only in member countries but also in virtually all other countries with active international banks. In September 1993, a statement was issued confirming that all the banks in the G10 countries with material international banking business were meeting the minimum requirements set out in the 1988 Accord.

Limitations of Basel I

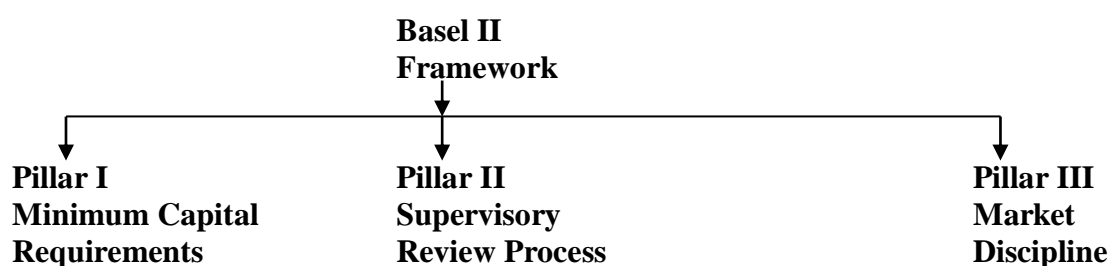
However, Basel I comprised of some rigidities, as it did not discriminate between different levels of risks. As a result, a loan to an established corporate borrower was considered as

risky as a loan to a new business. .So all loans given to corporate borrowers were subject to the same capital requirements, without taking into account the ability of the counterparties to repay. It also did not take cognizance of the credit rating, credit history and corporate governance structure of all corporate borrowers

Basel II Accord: Banking has changed dramatically since the Basel I document of 1988. Advances in risk management and the increasing complexity of financial activities / instruments (like options, hybrid securities etc.) prompted international supervisors to review the appropriateness of regulatory capital standards under Basel I. To meet this requirement, the Basel I accord was amended and refined, which came out as the Basel II accord.

The new proposal is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face and realign regulatory capital more closely with underlying risks.

Figure 1 : Basel II framework



LIMITATIONS OF BASEL II:

1. Lack of sufficient public knowledge
2. Lack of precise knowledge
3. Lack of consistency

BASEL III

A strong and resilient banking system is the foundation for sustainable economic growth, as banks are at the centre of the credit intermediation process between savers and investors. And provide critical services to consumers, small and medium-sized Business, large corporate firms and governments who rely on them to conduct their daily business, both at a domestic and international level. One of the main reasons the economic and financial crisis of 2007 became so severe was that the banking sectors of many countries had built up excessive on and off-balance sheet leverage.

The approach to capital regulation – based on so-called “Basel I” and “Basel II” – was identified by many regulators and commentators as one of the key factors contributing to the financial crisis. Moreover, Basel I and II focused on capital only, with no internationally agreed quantitative standards for liquidity. This is often perceived to have been a serious shortcoming when the financial crisis unfolded in 2007 and liquidity evaporated in the key funding markets used by many banks and bank-sponsored vehicles.

To address the market failures revealed by the crisis, the Basel Committee on Banking Supervision (BCBS) introduced Basel III as fundamental reforms to the international regulatory framework. The reforms strengthen bank-level, or micro prudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress.

Under Basel III, the quality and composition of capital are expected to be increased in a phased manner spanning up to year 2019. While Tier-1 capital has to be increased from 4.5% in 2013 to 6% by 2019, the overall capital, including capital conservation buffers and counter-cyclical buffers, is required to be increased from 8% in 2013 to 10.5% in 2019. Liquidity ratios are envisaged to be initiated in a phased manner beginning with an observation period that commenced in 2011. The introduction of minimum standards for liquidity ratios are expected to be between 2014 and 2018. The most discussed leverage ratio is monitored from 2011. Below table captures the key elements of Basel-III framework and the timeline for their full compliance as per BCBS.

Features of the Basel III

- 1.) Enhanced Capital Requirement:
- 2.) Tier 1 Capital requirements
- 3.) Introduction of a Capital Conservation Buffer
- 4.) Introduction of Countercyclical Buffer
- 5.) Leverage Ratio (Ratio of Tier 1 Capital to Total Assets)
- 6.) Liquidity Risk Measurement

BASEL III OBJECTIVES

According to the BCBS, the Basel III proposals has two main objectives:

- 1.) To strengthen global capital and liquidity regulation with the goal of promoting a more resilient banking sector.
- 2.) To improve the banking sector’s ability to absorb shocks arising from financial and economic stress, which, in turn, would reduce the risk of a spillover from the financial sector to the real economy.

Figure 2 Comparison of Basel II to Basel III

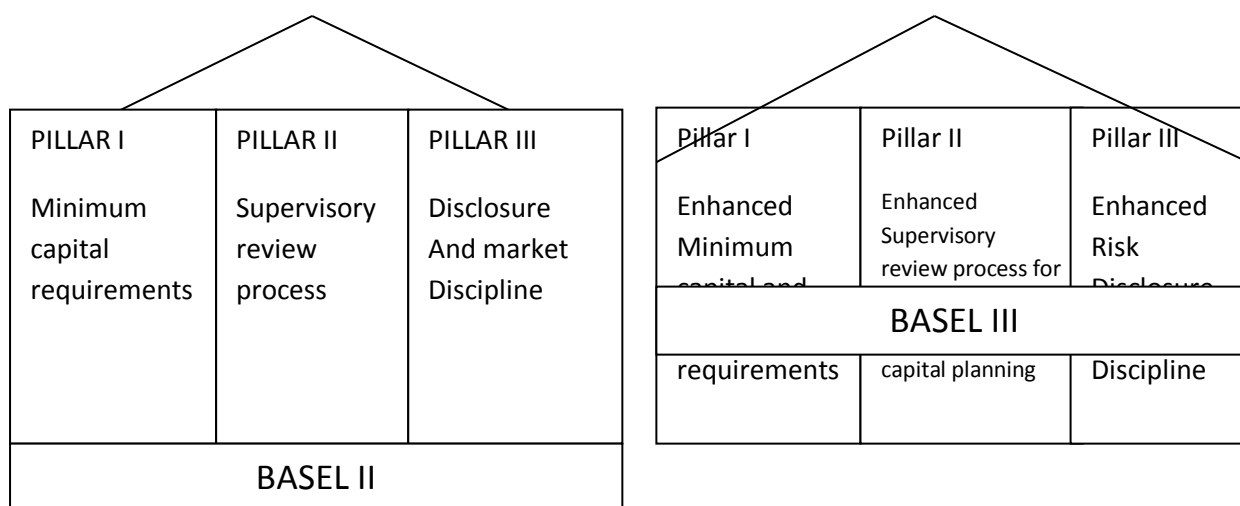


Table. 1. Comparison of capital requirements under Basel II and Basel III

Requirements	Under Basel II	Under Basel III
Minimum Ratio of Total capital to RWAs	8%	10.5%
Minimum Ratio of common Equity to RWAs	2%	4.5% to 7%
Tier 1 capital to RWAs	4%	6%
Core Tier 1 capital to RWAs	2%	5%
capital conservation Buffers to RWAs	None	2.5%
Leverage Ratio	None	3%
Countercyclical Buffer	None	0% to 2.5%
Minimum liquidity coverage Ratio	None	From 2015
Minimum Net stable Funding Ratio	None	From 2018
Systemically important Financial Institutions Charge	None	From 2011

Significance of Basel III for Indian banking:

Basel III guidelines attempt to enhance the ability of banks to withstand periods of economic and financial stress by prescribing more stringent capital and liquidity requirements for them. The new Basel III capital requirement would be a positive impact for banks as it raises the minimum core capital stipulation, introduces counter-cyclical measures, and enhance banks' ability to conserve core capital in the event of stress through a conservation capital buffer. The prescribed liquidity requirements, on the other hand, would bring in uniformity in the liquidity standards followed by the banks globally. This liquidity standard requirement, would benefit the Indian banks manage pressure on liquidity in a stress scenario more effectively.

Although implementing Basel III will only be an evolutionary step, the impact of Basel III on banking sector cannot be underestimated, as it will drive significant challenges that need to be understood and addressed. Working out the most cost-effective model for implementation of Basel III will be a critical issue for Indian banking.

1. Impact on the financial system:

Basel III framework implementation would lead to reduced risk of systematic banking crisis as the enhanced capital and liquidity buffers together lead to better management of probable risks emanating due to counterparty defaults and or liquidity stress circumstances.

2. Higher Capital Requirement

Presently, in India, most banks' common equity ratio falls in the range of about 6-10 per cent. Hence, in my opinion, banks may able to comply with the higher capital requirement as per Basel III norms at least till 2014/15. This, without infusing any fresh equity, even while taking into account the marginal increase in capital requirement.

3. Pressure on Return on Equity:

To meet the new norms, apart from government support a significant number of banks have to raise capital from the market. This will push the interest rate up, and in turn, cost of capital will rise while return on equity (RoE) will come down.

4. Pressure on Yield on Assets:

On account of higher deployment of funds in liquid assets that give comparatively lower returns, banks' yield on assets, and thereby their profit margins, may be under pressure.

5. On weaker banks:

Further, there would be a drastic impact on the weaker banks leading to their crowding out. As is well established, as conditions deteriorate and the regulatory position gets even more intensive, the weaker banks would definitely find it very challenging to raise the required capital and funding.

6. Increased supervisory vigil:

Banking operations might experience a reduced pace as there would be an increased supervisory vigil on the activities of the banks in terms of ensuring the capital standards, liquidity ratios-LCR and NSFR and others.

7. Reorganization of institutions:

The increased focus of the regulatory authorities on the organizational structure and capital structure ability of the financial firms (mainly banks) would lead the banks to reorganize their legal identity by resorting to mergers and disposals of portfolios, entities, or parts of entities wherever possible.

8. International Arbitrage:

In case of inconsistent implementation of Basel III framework among different countries would lead to international arbitrage thereby resulting in disruption of global financial stability.

Action Required from Banks

In this regard the following strategies need to be adopted:

1. Change in Business Mix:

Since retail banking has a comparatively lower risk weight compared to corporate banking (except in the case of clients who are A rated and above), the impact on higher allocation of capital will be less on retail banking

2. Change in Customer Mix:

Banks need to review their capital allocation to each client segment and price it in line with the profile to ensure that capital is allocated to segments that generate higher risk-adjusted returns.

3. Low-Cost Funding:

One of the most important factors to meet the new regulations is to have a stable low-cost deposit base. For this, banks need to focus more on having business correspondents/facilitators to reach customers as adding branches will increase costs and have an impact on the profit margin.

4. Improvement in systems and procedures:

Refining the rating model/data cleaning/ modernization of systems and procedures may help banks economize their risk-weighted assets, which will help reduce capital requirements to some extent.

5. Additional capital:

In order to fully compliment with the Basel III capital requirements banks require additional capital, banks need to frame out the proper strategy regarding procurement of needed funds.

Are Indian banks ready to implement Basel III?

Most of the private sector and foreign banks are in a comfortable position since they have a core capital in excess of 9% whereas this is not the case with the public sector banks. According to an ICRA report, public and private sector banks would require an additional capital of 600000 crore, assuming a 20% growth in risk-weighted assets, which is “achievable so long as banks can find investors for the riskier additional tier I capital,” says ICRA.

Out of the total requirement 75-80% will be required by the public sector banks. Thus the burden will fall on the cash-stripped government which will need to infuse massive amount of capital to maintain its shareholding of 58%. This looks difficult to achieve seeing the current state of the government financials with high fiscal deficit of 5.9% in 2011-12 and massive subsidy burden. The government is not in a position to provide the capital nor will it allow other investors to do so because it would reduce the government’s grip on public sector banks.

The leverage ratio of 3% will not affect the Indian banks much because this is meant for banks with large trading book and exposure to off balance sheet derivatives and Indian banks don’t have much exposure to the derivatives market. Liquidity coverage Ratio (LCR) requires banks to hold enough liquid assets to cover cash outflows during a 30 day stress period. Indian banks are fairly comfortable on this front as well as they hold 24% in government securities in form of SLR(Statutory Liquidity Ratio) and 4.75% in cash in form of CRR(Cash Reserve Ratio) with the RBI.

However the ultimate LCR burden would depend on how much CRR and SLR can be offset against LCR. Basel III will also force banks to put a large part of their profit back in the balance sheet as retained earnings rather than distributing dividends. Although there is no significant improvement in capital requirement under Basel3 as compared to Basel 2 but the problem is change in way that some of the capital market instruments will be treated. Perpetual debt which is now treated as Tier 1 capital will be excluded under Basel3, putting more pressure in the requirement of core capital.

Findings

The new capital requirements under Basel III would have a positive impact for banks as they raise the minimum core capital, introduces counter-cyclical measures, and enhance bank’s ability to conserve core capital in the event of stress through a conservation capital buffer. The liquidity standards requirements would benefit the Indian banks in managing the pressures on liquidity in a stress scenario more effectively. However, in case of inconsistent implementation of a new framework among different countries would lead to international arbitrage thereby resulting in disruption of global financial stability.

Basel III framework’s impact on the financial system would be significant, as its implementation would lead to reduced risk of systemic banking crises as the enhanced capital and liquidity buffers together lead to an improved management of probable risk emanating due to counter party defaults and or liquidity stress circumstances. The stricter norms on inter-bank liability limits would reduce the interdependence of the banks and the reduced

interconnectivity among the banks would save the banks from contagion risk during the times of crisis.

There would be a strong impact on the weaker banks leading to their crowding out. As the conditions deteriorate and the regulatory position gets even more intensive, the weaker banks would definitely find it very challenging to raise the required capital and funding. Further, this would affect their business models apart from titling the banking business in favour of large financial institutions and thereby titling the competition in the light of increased regulatory oversight on the organisational structure and capital structure of the financial firms (mainly banks), there would be scenarios where the banks may look towards reorganizing their legal identity by resorting to mergers and acquisitions and disposal of portfolios, entities, or parts of entities wherever possible.

Summary of Basel III implications

1) **Increased quality of capital**

Basel III contains various measures aimed at improving the quality of capital, with the ultimate aim to improve loss-absorption capacity in both going concern and liquidation scenarios.

2) **Increased quantity of capital**

Basel III contains various measures aimed at increasing the level of capital held by institutions, as well as providing counter-cyclical mechanisms

3) **Reduced leverage**

Leverage ratio acts as non-risk sensitive backstop measure to reduce the risk of build up of excessive leverage in the institution and in the financial system as a whole.

4) **Increase short term liquidity coverage**

The regulatory response to the financial crisis has seen a long overdue rebalancing towards the importance of the liquidity risk management and to complement its “principles for sound liquidity risk management and supervision”, the Basel committee has further strengthened its liquidity frameworks by developing two minimum standards for funding liquidity: have a negative impact on probability.

5) **Increased stable long term balance sheet funding**

The Net Stable Funding Ratios (NSFR) is designed to encourage and incentivize the banks to use stable source to fund their activities to reduce the dependency on short-term funding.

6) **Strengthen risk capture, notably counterparty risk**

The BCBs seek to ensure full coverage of risks in the Pillar 1 framework increasing the capital requirements against risks not adequately captured in the Basel II framework.

4. RECOMENDATIONS :

Actions to consider in respect of capital management

- Carry out appropriate scenario planning and impact assessments to ensure the development of a successful capital strategy.
- Identify which businesses have most attractive fundamentals under Basel III and which businesses in the firm’s portfolio should be considered for exiting, growing, or diverting.
- Ensure managers have adequate incentive to optimize use of capital.
- Apply consistent, quantified capital objectives throughout the group.

- Identify the changes needed to fine-tune/lower capital consumption.
- Ensure the firm is geared up to deliver measurement and management and requirements on a sufficiently timely basis.
- Consider how to address the pricing implications arising from changes in the capital requirements for certain products.
- Review whether the same business models can continue under a different structure, minimizing capital penalties (e.g. branch versus subsidiary).
- Prepare to be able to meet accelerated implementation time scales if required.

Actions to consider in respect of liquidity Management

- Ensure an understanding of current liquidity position in sufficient detail and possession of knowledge of where the stress points are.
- Ensure management has adequate incentive to optimize use of capital.
- Consider the impact of new liquidity rules on profitability and whether it has been factored into key business process and pricing.
- Check that liquidity planning, governance, and modelling are in line with leading industry practice.
- Determine an appropriate series of liquidity stress test and how these will change overtime.
- Gain awareness of the likely implementation timetable for different elements of the global and national framework being proposed.
- Assess the firm's strategy in light of the existing legal and regulatory structure of the organization and identity whether the system, data, and management reporting are adequate to meet the requirements.

Actions to consider in respect of general capital planning:

- Ensure that business is correctly charged for the capital costs of the business that they are doing.
- Ensure that Basel III capital implications are taken into account for new business and consider how existing long-dated business can be revisited.
- Consider the introduction of external capital into specialist structure models to mitigate the capital impacts arising.
- Focus on Basel III implementation as well as Basel III given that Basel III amplifies any increase in RWAs arising from Basel II.
- Examine the performance of existing assessment methodologies (e.g. IRB Models)
- Review existing data quality—Are the benefits from collateral information or improved re-rating of obligors due to inappropriate process missing?

5. CONCLUSION

It needs to be clearly understood that Basel III is an evolution rather than a revolution for many banks. It is an improvement over the existing Basel II framework. The most significant differences for banks are the introduction of liquidity and leverage ratios and enhanced minimum capital requirements. Basel III provides for a timeline of implementation which is quite acceptable in the case of Indian context, as it is observed that Indian banks are relatively well positioned for smoother implementation of the new standards.

While the effective implementation of Basel III will demonstrate to the stakeholders that the bank is quite well positioned, a speedy implementation would contribute to bank's competitiveness by delivering better management insight into the business, enabling it to take strategic advantage of future opportunities.

One of the main significant challenges posed by Basel III apart from the increased capital standards is that of creating a new risk management culture with a greater rigor and accountability. In effect, Basel III is changing the way the banks look at their risk management functions and might imply them to go for a robust risk management framework to ensure a true enterprise risk management. From the regulator's angle, it requires RBI to be proactive and stricter in terms of regulatory supervision surveillance.

The major challenge the Indian banks face is the deteriorating quality of assets and reduced profitability. Dr. D. Subha Rao, Former Governor of R.B.I. has rightly opined that effective implementation of Basel –III is going to make Indian banks stronger, more stable and sound so that they could deliver value to the real sectors of the economy. By far, the most important reform is that there should be a radical change in banks approach to risk management. Banks in India are currently operating on the standardized approaches of Basel – II. Since Basel III is a Universal compulsion, Indian Banks have no choice but to prepare themselves for achieving this herculean task of capital augmentation. The large scale banks need to migrate to the advanced approaches, especially as they expand their overseas presence. The adoption of advanced approaches to risk management would enable banks to manage their capital more efficiently and improve their profitability.

As Basel III aims at providing a solid foundation for financially sound banking, it is both a challenge and an opportunity for Indian banks. The opportunity comes in the form of acquiring new quality capital, selection of technology architecture and redesigning of the risk management as well as risk reporting. The challenge is for the bank management and the regulator in successfully implementing the new standards as per the suggested timeline and win over the stakeholders.

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