Basel III norms and banks: global trends and Indian experience

[1]Aneesh Kumar G S and [2]Dr G S Gireesh Kumar
[1]Department of Commerce, SVR NSS College, Vazhoor
[2]Associate Professor, Department of Commerce, Nirmala College, Muvattupuzha

Abstract

The pronounced new Basel III guidelines intend 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 capital requirement as proposed by the proposed Basel III guidelines would necessitate Indian banks1 raising Rs. 600000 crore in external capital over next 9 years, besides lowering their leveraging capacity. It is the Public Sector Banks that would require most of this capital, since they dominate the Indian banking sector. Further, a higher level of core capital could dilute the return on equity for banks. However, Indian banks may still find it easier to make the transition to a stricter capital requirement regime than some of their international counterparts since the regulatory norms on Capital Adequacy in India are already more stringent, and also because most Indian banks have historically maintained their core and overall capital well in excess of the mandatory level. This paper attempts to have a glimpse into the international trends and Indian experience in Basel III reforms.

Key Words: *BIS, BCBS, Tier I, Tier II, Capital conservation buffer, Counter Cyclical Buffer*

INTRODUCTION

The modern banking industry is rapidly developing with a clear trend towards globalization. Accordingly, international community has been working hard collectively to seek the best practice of banking regulation. Several major FIs failed, were bailed-out by governments, or merged (voluntarily or otherwise) during the crisis. While the specific circumstances varied, in general the decline in the value of mortgaged backed securities held by these companies resulted in either their insolvency; the bank runs as investors pulled funds from them, or inability to secure new funding in the credit markets. These institutions had typically borrowed and invested large sums of money relative to their cash or equity capital, meaning they

were highly leveraged and vulnerable to unanticipated credit market disruptions. The five largest U.S. investment banks, with combined liabilities or debts of $4 trillion, either went bankrupt Lehman Brothers, were taken over by other companies (Bear Stearns and Merrill Lynch), or were bailed-out by the U.S government (Goldman Sachs and Morgan Stanley) during 2008. Government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac either directly owed or guaranteed nearly $5 trillion in mortgage obligations, with a similarly weak capital base, when they were placed into Receivership in September 2008. For scale, this $9 trillion in obligations concentrated in seven highly leveraged institutions can be compared to the $14 trillion size of the U.S. economy (GDP) or to the total national debt of $10 trillion in September 2008.

As a result of the financial crisis in 2008, twenty five U.S. banks became insolvent and were taken over by the Federal Deposit Insurance Corporation (FDIC). As of August 14, 2009, an additional 77 banks became insolvent. This seven month tally surpasses the 50 banks that were seized in all of 1993, but is still much smaller than the number of failed banking institutions in 1992, 1991, and 1990. The United States has lost over 6 million jobs since the recession began in December 2007. City Bank, Bank of China , Banco De Oro of Philippines, Bangkok Bank , Bank Of Nova Scotia of Singapore all these Asian banks failed during crisis. Years of unrestrained spending, cheap lending and failure to implement financial reforms left Greece badly exposed when the global economic downturn struck. National debt, put at €300 billion ($413.6 billion), is bigger than the country's economy, reached 120 percent of gross domestic product in 2010.

Many countries have indeed had their shares of banking crisis, requiring major reforms to address weak banking supervision and inadequate capital. It has therefore been established that in addition to Deposit Insurance, official capital adequacy regulations play a crucial role in stabilizing the banking system and by extension, the economy as a whole. It then becomes imperative to realize that capital adequacy regime is one of the most important sets of rules and proposals in both International and domestic banking laws. If capital adequacy regulation would constitute an effective legal regime in banking, then stakeholders believed that it needed to be really International in scope, since banking itself has become international. . In reaction to this, the Basel Committee on Banking Supervision (BCBS) promulgated the Basel Accord in 1988.

Upon the promulgation of Basel Accord of 1988 (Basel I) the face and scope of international banking regulation changed forever. Today, the accords consist of Basel I, II and III. All three of them primarily pertain to minimal capital requirements every bank needs to hold in reserves, with Basel I starting out in 1988 with a basic focus on credit risk. Basel II first published in June 2004 (and later revised in 2006) aims at helping banks separate operational risk from credit risk, as well as quantifying both, and ensuring that capital allocation is

more risk-sensitive. Basel III, published in 2010, introduces a more distinct definition of common equity, a framework for counter-cyclical capital buffers and different measures to limit counter party credit risks. The new norms are based on renewed focus of central bankers on macro-prudential stability. The global financial crisis following the crisis in the US sub-prime market has prompted this change in approach. The previous set of guidelines, popularly known as Basel II focused on macro-prudential regulation. In other words, global regulators are now focusing on financial stability of the system as a whole rather than micro regulation of any individual bank. Most legal scholars would classify the Basel Committee as an *"International Financial Regulatory Organization (IFRO)"*.

BASEL ACCORDS: A GLIMPSE

Basel Accords refer to the banking supervision accords, are a series of recommendations on banking and financial regulations, set forth by the Basel Committee on Banking Supervision. The Basel Accords are Basel I , Basel II and Basel III. They are called the Basel Accords as the BCBS maintains its secretariat at the Bank for International Settlements in Basel, and the Committee usually meets there.

BASEL I

The Basel Capital Accord 1988 was the concern of the Governors of the G10 central banks that the capital of the world's major banks had become dangerously low after persistent erosion through competition. Capital is necessary for banks as a cushion against losses and it guarantees an incentive for the owners of the business to manage it in a prudent manner. The Basel I requires internationally active banks in the G10 countries to hold capital equal to at least 8% of a basket of assets measured in different ways according to their riskiness. It emphasized the importance of adequate capital by categorizing it into two Tiers: Tier 1, or core capital (the sum of shareholders equity, retained earnings, capital surplus and capital reserves); Tier 2 or supplementary Capital (consisted of loan loss allowances, preferred stock with maturity greater than 20 years, subordinated debt, unclosed capital reserves and hybrid capital instruments.). The bank has to hold at least half of its measured capital in Tier 1 form. A portfolio approach is taken to the measure of risk, with assets classified into four buckets (0%, 20%, 50% and 100%) according to the debtor category. This means that some assets (essentially bank holdings of government assets such as Treasury Bills and bonds) have no capital requirement, while claims on banks have a 20% weight, which translates into a capital charge of 1.6% of the value of the claim. However, virtually all claims on the non-bank private sector receive the standard 8% capital requirement.

The two principal purposes of the Basel I were to ensure an adequate level of capital in the international banking system and to create a "more level playing field" in competitive terms so that banks could no longer build business volume without adequate capital backing. These two objectives have been achieved. The merits

of the Accord were widely recognized and during the 1990s the Accord became an accepted world standard, with well over 100 countries applying the Basel framework to their banking system.

The shortcomings of Basel I

Basel I Capital Accord has been criticized on several grounds. The main criticisms include the following:

- **Limited differentiation of credit risk**
  There are four broad risk weightings (0%, 20%, 50% and 100%), based on an 8% minimum capital ratio.
- **Static nature of default risk.**

  The assumption that a minimum 8% capital ratio is sufficient to protect banks from failure does not take into account the changing nature of default risk.
- **No recognition of term structure of credit risk.**

  The capital charges are set at the same level regardless of the maturity of a credit exposure.
- **Simplified calculation of potential future counter party risk.**

  The current capital requirements ignore the different level of risks associated with different currencies and macro-economic risk. In other words, it assumes a common market to all actors, which is not true in reality.
- **Lack of recognition of portfolio diversification effects.**

  In reality, the sum of individual risk exposures is not the same as the risk reduction through portfolio diversification. Therefore, summing all risks might provide incorrect judgment of risk.

BASEL II

Basel II is the revised capital accord of Basel I. Basel II accord defines the minimum regulatory capital which is to be allocated by each bank based on its risk profile of assets. Banks have to maintain the capital adequacy ratio (CAR) of minimum 8 % under Basel II but for RBI it is 9%. As per RBI, banks which are getting more than 20% of their businesses from abroad have to implement Basel II. Basel II Framework was brought out with the intention of revising and setting right the inadequacies of the 1988 Basel I Accord.

The **BCBS** released the "International Convergence of Capital Measurement and Capital Standards : A Revised Framework" in 2004 with the fundamental objective being " to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks".

Pillars of Basel II

Pillar 1: Minimum Capital Requirement: This imposes minimum capital requirements on credit, market and operational risks to reduce impact of losses on exposure.

Pillar 2: Supervisory Review Process: This imposes specific bank supervision to promote better risk management.

Pillar 3: Market Discipline: It promotes market discipline through greater public disclosure.

The RBI has set a revised target of March 31st 2008 for the implementation of the Basel II Framework for foreign banks in India and Indian banks with foreign operations ; and a deadline of March 31st 2009 for migration to Basel II approaches by all other scheduled commercial banks ,and a target of achieving the Tier I capital ratio of not later on March 31st 2010 both on solo and consolidated basis.

The devastating impact of the financial crisis and the ensuing global recession prompted the authorities to reconsider the international framework regulating the banking system, known as Basel II. These accords, developed by the Basel Committee on Banking Supervision, deal with the whole spectrum of regulatory and supervisory issues, including liquidity standards, credit, operational and market risk management and accounting standards. However, the main feature of these regulations is that banks have to comply with a minimum Tier 1 capital requirement ratio to their risk-weighted assets of 4.0% (Tier 1 capital is core capital, consisting of equity, retained earnings and other instruments); the risk weighting is calculated by using a standardized or internal-ratings based approach. The goal of this capital requirement is for the bank to be able to absorb unexpected losses, such as those that occurred during the latest financial crisis.

The Shortcomings of Basel II

The financial crisis highlighted a series of shortcomings in the Basel II accords:

• The capital requirement ratio of 4% was inadequate to withstand the huge losses that were incurred.

• Responsibility for the assessment of counterparty risk (essential to the risk-weighting of banks' assets and therefore in assessing the capital requirement) is assigned to the ratings agencies, which proved to be vulnerable to potential conflicts of interest.

• The capital requirement is 'pro-cyclical:' if the global economy expands and asset prices rise, the country and counterparty risks associated with a borrower tend to decrease and thus the capital requirement is lower; however, in the event of a recession, the reverse is also true, thus raising the capital requirement for banks and further restraining lending.

• Basel II incentivizes the process of 'securitisation', as financial institutions that repackage their loans into asset-backed securities are then able to move them off their balance sheets and thus reduce the assets' risk-weighting. As a result, this process enabled many banks to reduce their

capital requirement, take on growing risks and increase their leverage.

Basel III

The Basel Committee on Banking Supervision (BCBS)-Central bank governors and heads of supervision from 27 countries meet in the Swiss town of Basel on December 2010, Sunday to agree to tougher bank capital and liquidity standards. The Group of 20 leading countries (G20) called for the Basel III reform to apply lessons from the financial crisis 2007 2008, had exposed shortcomings in the Basel II framework of 2004, so that states are less likely to have to rescue banks again in the next crisis. . The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.

The Basel Committee proposed the Basel III guidelines by December 2010, following which a six year phase-in period beginning 2013 is likely to be prescribed. The impact of the suggested norms relating to forward looking approach 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 norms on “leverage ratio” and “net stable funding ratio” are also not discussed in this note as they are likely to be implemented not before 2019.

Objectives of Basel III Reforms

The following are the various objectives of Basel III:

1. The document ***Basel III: International framework for liquidity, risk measurement, standards and monitoring***, strengthen global capital and liquidity rules with the goal of developing more stable banking sector. The objective of the reforms is to improve the banking sector’s ability to absorb shocks arising from financial and economic stress.

2 .To improve risk management and governance as well as strengthen banks’ transparency and disclosures of systemically significant cross-border banks.

3. To maintain a strong and resilient banking system for sustainable economic growth.

4. To improve confidence in the solvency and liquidity of many banking institutions.

5. To improve global liquidity, cross-border credit availability and demand for exports.

6. To introduce a number of fundamental reforms to the international regulatory framework. The reforms strengthen bank-level, or micro prudential, regulation, which will help raise the strength of individual banking institutions to periods of stress.

Components of Basel III Framework

The key components of the proposed Basel III guidelines are:

1. Constituents of capital

2. Capital Conservation Buffer
3. Counter Cyclical Buffer
4. Leverage Ratio
5. Liquidity
6. Risk Coverage

1. **Constituents of Capital**

The common equity component of Tier 1 will be comprised of ordinary share capital and retained profits. Non-common equity Tier 1 ("Additional Tier 1") will be principally made up of perpetual non-cumulative preference shares and other qualifying instruments. Tier 2 capital will no longer be divided into lower Tier 2 (principally, dated term preference shares and subordinated debt) and upper Tier 2 (including certain perpetual preferred instruments and subordinated debt). All Tier 2 instruments will be required to be either convertible into common equity or written down in the event of the institution becoming non-viable without a bail-out. Tier 3 capital will be abolished. Generally speaking, Tier 3 capital was unsecured subordinated debt that is fully paid up, cannot be repaid before maturity without prior regulatory approval and with an original maturity of at least two years. Deductions from capital (or regulatory adjustments) will be applied to the common equity Tier 1 component and not to overall capital.

Changes in Standard Deduction

The proposed Basel III guidelines suggest changes in the deductions made for the computation of the capital adequacy percentages. The key changes for Indian banks include the following:

Table 1: Deductions from Capital—Proposed vs. Existing RBI Norm

	Proposed Basel III Guideline	**Existing RBI Norm**	**Impact**
Limit on deductions	Deductions to be made only if deductibles exceed 15% of core capital at an aggregate level, or 10% at the individual item level	All deductibles to be deducted	Positive

Deductions from Tier I or Tier II	All deductions from core capital	50% of the deductions from Tier I and 50% from Tier II (except DTA and intangible assets wherein 100% deduction is done from Tier capital)	Negative
Treatment of significant investments in common shares of unconsolidated financial institutions	Any investment exceeding 10% of issued share capital to be counted as significant and therefore deducted	For investments up to:(i) 30%: 125% risk weight or risk weight as warranted by external rating (ii)30-50%: 50% deduction from Tier I and 50% from Tier II	Negative

Source: Basel Committee Documents

2. Capital conservation buffer

Basel III introduces an extra buffer of 2.5% of common equity above the minimum requirement for Tier 1 common equity for the top-tier holding company of the banking group. It is intended to ensure that financial institutions have a cushion during times of financial and economic stress. The constraints on distributions will increase as the capital conservation buffer decreases further below the required amount. The capital conservation buffer requirement will apply as of January 1, 2016 at 0.625%, moving to 1.25% as of January 1, 2017, then 1.875% as of January 1, 2018 and will rise to the full 2.5% level by January 1, 2019 (at which point the total Tier 1 common equity target would effectively be 7%, i.e., a 4.5% minimum and a 2.5% conservation buffer). Under Basel III, institutions that meet the minimum ratio requirement but remain below 7% Tier 1 common equity target (i.e., the minimum plus a conservation buffer) would be expected to maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible. The Basel Committee has suggested that a quicker implementation may be appropriate in countries that are experiencing excessive credit growth

Table 2: Illustration on distributable Earnings in Various Scenarios

Actual conservation capital as percentage of required conservation capital	Maximum Permissible earnings that can be distributed in the subsequent financial year
<25%	0
25 %-50%	20 %
50 %-75 %	40 %
75 %-100 %	60 %
>100 %	

Source :Basel Committee Documents

3.Counter Cyclical Buffer

The Basel committee has suggested that the counter cyclical buffer, consisting of equity or fully loss absorbing capital, could be fixed by the national authorities concerned once a year and that the buffer could range from 0% to 2.5% of risk weighted assets, depending on changes in the credit-to-GDP ratio.

The primary objective of having a countercyclical buffer is to protect the banking sector from system-wide risks arising out of excessive aggregate credit growth. Typically, excessive credit growth would lead to the requirement for building up higher countercyclical buffer; however, the requirement could reduce during periods of stress, thereby releasing capital for the absorption of losses or for protection of banks against the impact of potential problems

Comparison on Capital Requirement

Overall, with the Basel III being implemented, the regulatory capital requirement for Indian banks could go up substantially in the long run (refer Table 3). Moreover, capital requirements could undergo a change in various scenarios, thereby putting restriction on banks ability to distribute earnings.

Table 3: Regulatory Capital Adequacy Levels

	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: Basel committee documents

Table: 4 Capital Requirements

Date	Milestone: Capital Requirements
2013	**Minimum capital requirements:** Start of the gradual phasing-in of the higher minimum capital requirements.
2015	**Minimum capital requirements:** Higher minimum capital requirements are fully implemented.
2016	**Conservation buffer:** Start of the gradual phasing-in of the conservation buffer.
2019	**Conservation buffer:** The conservation buffer is fully implemented.

Source: Basel Committee Documents

- **Leverage**

This aims to put a cap on build-up of leverage in the banking sector on a global basis for the first time. It will help to lessen the risk that eventual deleveraging could destabilize the sector, and introduce extra safeguards. The leverage ratio will be calculated in a comparable manner across jurisdictions, adjusting for any remaining differences in accounting standards. A trial leverage ratio of 3 per cent of Tier 1, or balance sheets cannot exceed 33 times Tier 1 capital, is to be trialed before a mandatory leverage ratio is introduced in January 2018.

Table: 5 Leverage Ratio

Date	Milestone: Leverage Ratio
2011	**Supervisory monitoring:** Developing templates to track the leverage ratio and the underlying components.
2013	**Parallel run I:** The leverage ratio and its components will be tracked by supervisors but not disclosed and not mandatory.
2015	**Parallel run II:** The leverage ratio and its components will be tracked and disclosed but not mandatory.
2017	**Final adjustments:** Based on the results of the parallel run period, any final adjustments to the leverage ratio.
2018	**Mandatory requirement:** The leverage ratio will become a mandatory part of Basel III requirements.

Source: Basel Committee Documents

5. Liquidity

The world's first set of common liquidity requirements aims to ensure banks have enough liquid or cash-like assets to tide them through a very severe short-term shock and for less severe conditions in the medium to longer term. The short-term liquidity buffer is to be mostly sovereign debt but include high-quality corporate debt. A one-year horizon liquidity buffer, known as a net stable funding ratio, will be trialed and become mandatory in January 2018 .

Table: 6 Liquidity Ratio

	Proposed Basel III	**Existing RBI Norm**				
Liquidity Ratios	Liquidity Coverage Ratio = Stock of high quality liquid assets/Net cash outflows over a 30-day time period >= 100%	Number of days	***1***	***2-7***	***8-14***	***15-28***
		Maximum Permissible gap (as % of outflows)	***5%***	***10%***	***15%***	***20%***
	Net Stable Funding Ratio (NSFR) = Available amount of stable funding/Required amount of stable funding > =100 %	No such norm				

Source: Basel Committee Documents

Table: 7 Liquidity Requirements

Date	**Milestone: Liquidity Requirements**
2011	**Observation period:** Developing templates and supervisory monitoring of the liquidity ratios.
2015	**Introduction of the LCR:** Introduction of the Liquidity Coverage Ratio (LCR).
2018	**Introduction of the NSFR:** Introduction of the Net Stable Funding Ratio (NSFR).

Source: Basel Committee Documents

6.Risk Coverage

These proposals aim to strengthen capital requirements for counterparty credit exposures arising from banks' derivatives, repo and securities financing activities .There will be a risk weighting of one to three per cent on banks' mark to-market and collateral exposures to a central counterparty. The weighting on non-centrally cleared contracts will be higher.

BASEL III NORMS ON BANKS: GLOBAL IMPACTS

The introduction of Basel III, which changes the way banks approach liquidity management and data reporting, will have a marked impact on banks' profitability and overall business models. Basel III is the first attempt to globally harmonize regulation and provide a platform for each country to standardize its liquidity guidelines. These new standards will require an increase in liquid assets held by banks and also will require that these assets be of higher quality. As a result, banks' costs and profitability will be affected. The top 35 US banks will be short of between $100bn and $150bn in equity capital after the new Basel III global bank regulations are imposed, with 90 per cent of the shortfall concentrated in the biggest six banks, according to Barclays Capital. The 8 per cent core tier one capital ratio, a key measure of bank strength, provides a one point cushion against falling below the effective global minimum of 7 per cent set in September by the Basel Committee on Banking Supervision. The Basel III reforms will hit banks in two ways – by gradually tightening the definition of what counts as tier one capital; and by forcing banks to increase the risk adjustment for big swathes of their businesses. Banks can respond by increasing their capital through retained earnings or equity issuance or they can cut their risk-weighted assets through sell-offs and by cutting back on risky business lines. So far most analysts believe the big US banks will not be forced to raise capital just for regulatory purposes. But some people worry sharp cuts in assets could force banks to curb lending to the real economy or raise borrowing costs. The French banking association offered calculations that suggested a 6% hit to the French economy.

The Basel Committee proposals are being considered at the same time that the accounting setting bodies are considering significant changes to accounting standards that will affect banks' financial statements. Additionally, the current and proposed guidance under US GAAP and IFRS differs significantly and consequently will impact institutions implementing the Basel III requirements in different ways. Without coordination, the accounting changes could result in unintended consequences to the regulatory capital levels and capital ratios of banks. The most efficient approach would be for banks to address both regulatory and accounting changes through a single process. Ideally, the Basel Committee and accounting standard-setters would coordinate the timing of the mandatory adoption of their standards. In addition, they would eliminate or minimize the effect of any inconsistencies in their guidance except where necessary to reflect different objectives and audiences (for example, approaches to valuations and provisions). However, whether this coordination will occur is uncertain given that the views of standard setters differ regarding what role US GAAP or IFRS should play in the prudential regulation of banking entities.

No assessment of the impact of Basel III would be complete without a review of the effect on profitability of individual

businesses and the bank as a whole. Three types of impact must be considered:

- **Balance-sheet-specific impact at the corporate level** that cannot be attributed to individual businesses. Examples include those capital deductions that will affect each bank's balance sheet differently, depending on its assets, but will not have a particular effect on businesses.
- **Universal impact across all banks and businesses.** The new capital and leverage ratios are the best examples of rules that affect all businesses proportionally. The impact would be more pressing on marginally profitable businesses, but all businesses would suffer unless the cost rise could be passed on to customers.
- **Business-specific impact.** This category includes rules on risk-weighted assets (RWAs), liquidity, and long- term funding, which were designed specifically to address the risks that were visible during the crisis, for example, in trading and securitization.

The disclosure requirements proposed under Basel III force banks to be more transparent about their business activities and the way they make provisions for capital to compensate the underlying risks. In implementing these new disclosures, banks should consider the following:

- Perform a rationalization that what is currently disclosed in the financial statements
- Determine the incremental processes and controls necessary to comply with the enhanced disclosures.
- Consider developing flexible processes and infrastructures that may be amended as new reporting requirements arise.

BASEL III NORMS: IMPACT ON INDIAN BANKS

According to RBI Governor D Subbarao , Indian banks are not likely to be impacted by the new capital rules. At the end of June 30, 2010, the aggregate capital to risk-weighted assets ratio of the Indian banking system stood at 13.4%, of which Tier-I capital constituted 9.3%. As such, RBI does not expect our banking system to be significantly stretched in meeting the proposed new capital rules, both in terms of the overall capital requirement and the quality of capital. There may be some negative impact arising from shifting some deductions from Tier-I and Tier-II capital to common equity. Indian banking system is moderately leveraged and PSU banks may not face problem in building buffer capital. The governor also says that PSU banks, Public Sector Banks should not be so much worried about meeting the capital requirements under the Basel III norms because the governor says that the government will have to contribute to help public sector banks meet their capital

requirements and also maintain their 51% ownership.

Anand Sinha , Deputy Governor ,RBI has said that the Central Bank has already finalized certain portion of Basel III norms. As an impact of the previous crisis, two things have emerged ,including counter-cyclical capital and counter –cyclical provisioning .Our banks have already done it in the past.

The adoption of Basel III norms significantly increases the regulatory capital requirement of Indian banks. Furthermore, within capital, the proportion of the more expensive core capital could increase. According to the proposed norms, the minimum core capital requirement is set to be raised to 4.5%. In addition, the introduction of the conservation and countercyclical buffer means that the capital requirement would increase to between 7% and 9.5%. Indian banks, as per the current norms are required to maintain Tier I capital of at least 6%. However, since innovative perpetual debt and perpetual non-cumulative preference shares cannot exceed 40% of the 6% Tier I capital, the minimum core capital is 3.6% (i.e., 60% of 6%).

Given that most Indian banks are capitalized well beyond the stipulated norms, they may not need substantial capital to meet the new stricter norms. However, there are differences among various banks. While core capital in most of the private sector banks and foreign banks exceeds 9%, there are some public sector banks that fall short of this benchmark. These public sector banks, which account for more than 70% of the assets in the banking sector and are a major source of funding for the productive sectors, are likely to face some constraints due to the implementation of the Basel III norms. These banks are also unable to freely raise capital from the market as the government has a policy of maintaining at least 51% stake in these banks. Currently, there are only six banks where the government stake is higher than 70%. The other option is for the government to infuse capital to these banks to augment their core capital.

Moreover, a rise in risk-weighted assets as well as the proposed disqualification of some non-common Tier I and Tier II capital instruments for inclusion under regulatory capital would increase the requirement of additional capital. According to ICRA (2010), if risk-weighted assets were to grow at an annualized rate of 20%, there would be a requirement of additional capital by the banking sector (excluding foreign banks) of about Rs 6000 billion as a whole over the next nine years, ending on 31 March 2019. Of this, public sector banks would require about 75–80% of this additional capital and private Indian banks accounting for the rest.

While the concept of a countercyclical buffer is intuitively appealing, operationalizing it has many challenges. These include defining a business cycle in a global setting although business cycles are not globally synchronized, identifying an inflection point in the business cycle to indicate when to initiate building up the buffer, choosing the appropriate indicator that identifies both

good and bad times, determining the right size of the buffer, etc. Given the different stages of financial sector development in different countries there will be a need to allow national discretion in applying the framework. In India there is also a concern about the variable (most likely the credit-to-GDP ratio) will be used to calibrate the countercyclical buffer. However, this may not be the most appropriate variable candidate for India (Subbarao 2010). Unlike in advanced countries, in India and other developing economies, the credit-to-GDP ratio is a volatile variable and is likely to go up for structural reasons like enhanced financial intermediation owing to high growth or efforts of deeper financial inclusion. Moreover, while credit growth can be a good indicator of the build up phase, credit contraction tends to be a lagging indicator of emerging pressures in the system.

The primary challenge for India will be to develop the capability to collect accurate and relevant data granularly. Given that Indian financial markets were not subject to the same stress level as markets in advanced countries, predicting the appropriate stress scenario will be a tough call. However, at the same time, most Indian banks follow a retail business model whereby there is limited dependence on short-term or overnight funding. Furthermore, Indian banks possess a large amount of liquid assets that will enable them to meet new standards. From the Indian point of view, a key issue is the extent to which SLR holdings should be considered in the estimation of the liquidity ratios. On the one hand, while there is a case for these to be excluded as they are expected to be maintained on a regular basis; however, it would also be reasonable to treat at least a part of the SLR holdings in calculating the liquidity ratio under stressed conditions, especially since these are government bonds against which the RBI provides liquidity.

In India, more than 70% of the banking sector is dominated by public sector banks, where compensation is determined by the government with the variable component limited. Furthermore, private and foreign banks are statutorily required to obtain the RBI's regulatory approval for remuneration of their whole-time directors and chief executive officers. Recently, in a move to join the global initiative on compensation structures and align Indian compensation structures to Financial Stability Board (FSB) guidelines, RBI issued draft guidelines on compensation of high-level executives. These guidelines attempt to ensure effective governance of compensation, align compensation with prudent risk taking, and improve supervisory oversight of compensation. However, the Indian banking system is currently facing a different predicament. With the majority of the banking sector also a part of the public sector, ideally one would like to attract the best talent into this sector. However, there is a disparity between the compensation packages of public and private sector bank executives, the former receiving significantly less valuable packages. This disparity should be rectified as it is leading to a loss of talent from the public sector to private sector.

The outgoing deputy governor of the Reserve Bank of India, Shyamala Gopinath, is confident that Indian banks have the necessary capital cushion to absorb the additional requirements of Basel III. Fast-forwarding to current developments, banks in India are well placed to cope with new banking regulation sweeping the global financial services industry, such as Basel III. “Banks in India are adequately capitalised and common equity of banks in India stood at 8.38% as of December 2010 and if we take tier 1 capital, it was 8.60%,”. To maintain the financial system, the RBI has thrusted foreign banks to set up subsidiaries in India if they want to do substantial business in the country. To encourage banks to operate as subsidiaries the RBI has offered a “less restrictive branch expansion policy”.

CONCLUSION

Basel III is an opportunity as well as a challenge for banks. It can provide a solid foundation for the next developments in the banking sector, and it can ensure that past pitfalls are avoided. The primary objectives of the Basel reforms are to ensure the reduction of incidence, severity, and costs of financial crises and the associated output loss. As per the March 2010 dataset, the average common equity tier I capital of Public Sector Bank is 7.27 % and average CRAR is 13.21 %. The maximum and minimum of the core capital are 10.50 and 4.37 %.The CRAR of all the public sector bank is above 10.5 %. The average Common Equity Tier I Capital of Private Banks is 12.67 % and average CRAR is 14.91 %.The private banks are well cushioned above the Basel III defined Core (common equity tier I) are 17.31 % and 9.62 %. The CRAR of all the private banks is above 10.5 %. The average Common Equity Tier I Capital of Foreign Banks is 13.78 % and average CRAR is 16.39 %.The Foreign Banks are well cushioned above the Basel III defined Core (common equity tier I) capital. The maximum and minimum of the core capital are 17.29 % and 6.72 %.The CRAR of all the foreign banks is above 10.5 %. Where banks have strengthened their capital over the last few years through retained earnings and capital raisings, the implementation of Basel III is likely to have less of an impact on the global economy. To the extent that banks try to comply more quickly with Basel III’s capital and leverage requirements, this may lead to an increase in loan spreads, the tightening of loan terms or a cut-back in lending volumes.

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