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BASEL NORMS COMPLIANCE IN INDIA: ISSUES AND CONCERNS

A Paper Presented

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Abstract

The recurrence of financial crises in the world prompted Group of 10 countries (G – 10) to form the Basel Committee on Banking Supervision (BCBS) of Bank of International Standards. The BCBS proposed a Basel accord in 1988 which was adopted in April 1994 in India. Gradually, India implemented Basel – II and Basel – III norms in 2009 and 2013 respectively. The global financial crisis necessitated the need for strengthening banks all over the world by creating an extensive regulatory framework for computing Credit to Risk weighted Asset Ratio (CRAR) taking into consideration credit market and operational risks. Indian Banks have been following Basel – III norms since 2013 and full compliance will be achieved by 31st March, 2019. The stringent capital adequacy requirements have posed various challenges for the Indian Banks. Full compliance of these new norms will increase Indian banks' capital needs by $20 billion to $30 billion. Various studies on implementation of Basel norms have revealed that these standards have been formulated taking into account Organisation for Economic Cooperation and Development countries than developing countries. The banks especially in developing countries may face a sharp decline in their return on capital (ROA) due to these new norms. India is finding itself at crossroads, balancing to achieve social objectives of financial inclusion and creating a resilient financial system to absorb financial shocks. The objective of this paper is to study the implementation of Basel standards from 1994 onwards in phases from Basel – I to Basel – III and the challenges faced in the process.

Keywords: Banking, Financial Services, Regulation, Basel Norms, Capital Adequacy

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1. Introduction

The international financial system has undergone a considerable change since the crash of the IMF system of determining exchange rates. All countries in the world have their own exchange rate determination mechanisms. In such a scenario the trading partners have to rely on a robust financial infrastructure, domestic as well as international, to facilitate international transactions. The Basel Committee on Banking Supervision (BCBS) of Bank of International Standards (BIS) developed a mechanism in 1988 known as Basel Standards for developing a robust and resilient banking system for smooth settlement of international transactions.

Recurrent financial crises in various parts of the world necessitated innovation of strategies which could bolster their financial systems to avoid them. In 1974, Bank of Herstatt in Germany was liquidated over delay in payments in New York due to difference in time zones. This incident exhorted G-10 countries to form BCBS under the BIS. In 1988, BCBS introduced risk-based capital adequacy norms through Basel – I accord. The accord focussed mainly on credit risk and classified a bank's assets into five groups on the basis of risk weight assigned to each asset. The Government held debts (Government securities) were assigned zero risk while other assets of banks such as borrowings by banks were given 20% risk. Loans and advances to others by banks were apportioned 50% risk. The banks were advised to hold capital equal to 8% of risk weighted assets. This paper attempts to study the intricacies of Basel standards for the banking system, its implementation and impact on capital requirements, liquidity and profitability of India banks.

2. Objectives

The main objectives of this study are:

i. To study the evolution of Basel standards for banking system
ii. To elucidate the transition of Indian banks in embracing Basel – I to Basel – III standards
iii. To examine the impact of Basel norms on the banking system in India

3. Research Methodology

This study is based on secondary sources of data such as research reports, working papers of scholars from prestigious institutions, books and journal articles. An attempt has been made to

study the intricacies of Basel standards developed by the BCBS of BIS and implemented by various countries all over the world, including India. A summarised analysis of these studies has been presented in this paper in a lucid and comprehensive manner.

4. Literature Review

Griffith Jones (2002) has shown empirically that Basel – II standards may overestimate the risk of lending to developing countries. Thus implementing these standards may be detrimental to the development of their banking system.

Griffith Jones (2003) and Kings et al (2003) and Kraussl (2003) have argued that Basel – I norms lack representation by developing countries. The risk weights for credit risks of international lending are in favour of Organisation for Economic Cooperation and Development (OECD) countries.

Bordoloi (2003) asserts that Basel standards necessitate the need to upgrade risk management skills of their staff and undertake massive investments.

Allen et al (2012) believe that the real challenge in implementing Basel – III standards lies in "ensuring a coordinated adoption" across the breadth of financial entities.

Jayadev (2013) has drawn attention to the fact that banks need to change their perceptions about risk management functions from mere compliance to building a robust financial institution.

Shah (2013) has also raised concerns about a fall in ROE while implementing Basel – III norms.

These studies point out various concerns about implementing Basel standards such as raising capital, risk management, upgradation of skills of staff in banks, decline in returns on equity and assets etc. but with appropriate safeguards set in place Basel norms can strengthen financial system all over the world.

5. Basel – I Norms in India

Basel – I standards were adopted in India in April, 1994. To determine CRAR banks' capital is divided into two categories – core capital (Tier – I) and supplementary (TIER – II) capital. Tier – I capital comprises equity capital and undisclosed reserves. Tier – II capital includes undisclosed reserves, revaluation reserves, general provisions/general loan-loss reserves, hybrid debt capital instruments and subordinated term debt. Basel – I stipulates that at least 50% of banks' capital should be core capital.

In 1996, in addition to 'credit risk' 'market risk' was added with an amendment to Basel – I accord to calculate CRAR. To measure market risk banks were given two options. One, they could choose a standardised approach using building block methodology, and two, they could adopt an 'in-house' approach which allows banks to develop their own propriety models to calculate capital charge for market risk by using the notion of value-at-risk. These methodologies calculate capital charges for market risk and not for risk weighted assets. To compute credit risk, risk weighted assets have to be multiplied with 12.5 (reciprocal of 8%, the minimum capital adequacy norm) and then added to the risk weighted assets to arrive at credit risk. To compute CRAR, the numerator will be the sum of the bank's tier I and tier II capital (tier II capital should be limited to a maximum of 100% of tier I capital), plus a tier III capital introduced in the 1996 amendment to support market risk.

6. Basel – II Norms

Basel – II was conceived after the banking crisis in 1990 and due to criticism of Basel – I on many counts. In 1991 the Basel Committee proposed a new accord known as a 'Revised Framework on International Convergence of Capital Measurement and Capital Standards known as Basel – II. The new framework was designed to improve regulatory capital requirements and signal the underlying risks posed by the financial innovations. Basel – II accord was published in June 2004. A survey conducted in 2007 by Financial Stability Institute of BIS reveals that 82 countries intended to adopt Basel – II norms by 2015. India adopted Basel – II norms in 2009. Basel–II accord is a comprehensive framework of banking supervision incorporating supervisory review and market discipline. It is based on three pillars – Pillar 1 refers to minimum regulatory requirement. It is an extensive regulatory framework for computing CRAR taking into consideration credit market and operational risks.

Pillar 2 relates to supervisory review that provides key principles of supervisory review. It encompasses risk management guidance and supervisory transparency and accountability. Computation of the Risk Weighted Assets (RWA) of a bank involves three methodologies – the Standardised Approach (SA) and two Internal Rating Based (IRB) approaches. The SA requires banks to use credit ratings from external agencies to compute capital adequacy requirement commensurate with the level of risk. The two IRB approaches are – the Foundation IRB (FIRB) and Advanced IRB (AIRB). The FIRB allows banks to ascertain risk weights of their assets as per their internal models (Shenoy et al 2013). However, the regulator provides model assumptions for loss given default (LGD) and exposure at default (EAD) and effective maturity (M). Advanced IRB is the same as FIRB except that a bank is free to set assumptions of LGD,

EAD and M in the model. IRB is a self-regulatory mechanism which benefits both, the regulators and banks.

Pillar 3 is represented by market discipline. This pillar encourages market discipline by developing a set of disclosure requirements that will allow market participants to assess key pieces of information on risk exposure, risk assessment process and capital adequacy of a bank.

The financial crisis of 2007-08 exposed the inadequacy of Basel – II to check financial irregularities. Hence in 2009 amendments were made in Basel – II to make it more robust with the following revisions:

a) Augmenting the value-at-risk based trading book framework with an additional charge for risk capital, including mitigation risk and default risk.
b) Addition of stressed value-at-risk condition. This condition takes into account probability of significant losses over a period of one year.

The implementation date was set at 31st December, 2010. However these revisions were included in Basel – III later by the BCBS in 2012.

It is true that Basel norms have been designed to strengthen capital base of banks and improve the supervisory regime but critics are of the opinion that these norms lack representation of developing countries (Griffith-Jones 2003; King et al 2003; Kraussl 2003). These norms are biased in favour of Organisation for Economic Cooperation and Development (OECD) countries. Basel – II norms have done away with the distinction between OECD and non-OECD countries and the risk weights are based on risk assessment of the country. Countries can decide between risk assessment rating given by the private sector risk assessors such as Standard and Poor, Moody's and Fitch, or using the country risk scores given by the export credit agencies recognised by the national supervisor of the country.

The removal of distinction between OECD and non-OECD countries is a welcome move but risk assessment of a country by a credit rating agency may inhibit a developing country's chances of accessing capital from abroad. Also, risk assessment of a country by a credit rating agency is pro-cyclical and a developing country may suffer a poor rating at turbulent times when raising capital to overcome a difficult economic situation is imperative (Ferri et al 1999; Monfort and Mulder 2000). An empirical study by Griffith and Jones et al (2002) has revealed that Basel – II have significantly overestimated the risk of international lending to developing countries. During the East Asian crisis of 1997-98, capital flow to East Asian countries – Indonesia, South Korea

and Thailand declined sharply due to down gradation of sovereign ratings by Moody's and worsened the crisis (Ferri et al, 2000).

7. Basel – III Norms and Indian Banks

Basel – III accord was introduced in response to the global financial crisis in 2007. The revisions incorporated in Basel – II in 2009 led to an increase in the minimum common equity requirement from 2% to 4.5%. In addition, the banks are required to hold a capital conservation buffer of 2.5% to withstand future periods of stress leading to 7% minimum equity requirement. There are valid fears among bankers that Basel – III norms may affect Indian banks adversely. Critics are of the opinion that Basel – III norms were chalked out for G-10 countries. For developing countries the norms are too stringent and would affect achievement of their social objectives such as escalation of financial inclusion.

The implementation of Basel – III norms in India commenced from 1st April, 2013 and full compliance is expected to be achieved by 31st March, 2019. It would be beneficial for Indian banks as they would be able to compete globally by becoming Basel – III compliant. However, additional capital requirements would pose various problems for banks already struggling to manage a high amount of NPAs.

Total minimum capital requirements by the Indian banks as per Basel – III norms would be 11.5% (minimum total capital ratio of 9% plus capital conservation buffer of 2.5%). These new norms increase Indian banks' capital needs by $20 billion to $30 billion. The banks may face a sharp decline in their return on capital (ROA) due to these new norms.

Table 1: Calibration of Capital Requirements of Basel – III

Capital requirement/Buffer	Common Equity Tier 1 (%)	Tier 1 Capital (%)	Total Capital (%)
Minimum	4.5	6.0	8.0
Conservation Buffer	2.5	-	-
Minimum plus Conservation Buffer	7.0	8.5	10.5
Counter cyclical Buffer Range	0 – 2.5	-	-

Source: Basel – III Accord, 2011 Revision

For the Indian banks, meeting the stringent capital requirements of Basel – III norms is a huge challenge. Many of the public sector banks are having a large amount of distress assets and raising capital from the market would be very difficult for them. A research report by Credit

Suisse reveals that Basel – III compliance would push up capital needs of Indian banks by $20 billion to $30 billion (one lakh crore to 1.5 lakh crores). It will be difficult for banks to remain profitable as increased capital requirement to do the same amount of business would reduce their return on assets (ROA). The incremental equity requirements of banks would increase by Rs.3.2 to 4 trillion in the forthcoming six years. Basel – III norms compliance in a period when many of the public sector banks are having a large amount of NPAs would further put pressure on them to provide for bad loans. For every 1% increase in gross NPAs the banking system would require Rs.25000 crores (Jain, Mukul 2013).

In spite of these concerns, Basel – III compliance would make Indian banks resilient and globally competent. Features like wider risk coverage, counter cyclical capital requirement, enhanced liquidity, creation of buffer at good times and prevention of bad debts would strengthen Indian banks and place them on International pedestal.

8. Conclusion

Introduction of uniform banking standards by BCBS for banks all over the world facilitates international monetary transactions. The gradual transition from Basel – I to Basel – II and further to Basel – III standards in banking has posed various difficulties for Indian banks which are at present stressed with high NPAs and finding it difficult to remain liquid as well as profitable. Nevertheless, compliance to these norms would lead to a resilient banking system which is required at a time when the countries in the world are so closely inter-connected with each other that the news of distress in one economy spreads to other parts of the world with lightning speed due to advancement of technology. The Indian banks may find it difficult to meet stringent capital requirements of Basel – III but proactive steps taken by them to reduce their NPAs and streamlining of their operative costs would definitely enable them to meet the international banking standards.

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