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Economics

BASEL-3 AND ITS IMPACT ON INDIAN BANKING SECTOR

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ABSTRACT

Indian banking industry is considered as a blooming and sustainable sector in the global financial system. This paper deals with the banking sector reforms in India and the ways designed to manage the risks associated with huge banking sector. An evaluation of Basel Norms and their impact on economic growth of the country has been done pursuant to the globalization of the industry. The emergence of BASEl-3 and its impact on banking in India have been explored. Since economic reforms of 1991, most of the traditional and outdated concepts, practices, procedures and methods of banking have significantly changed. The competition among financial intermediaries has gradually helped the interest rates to decline significantly. Deregulation has been achieved. The real interest rate has been effectively maintained at moderate rate. The borrowers did not pay high price while depositors had incentives to save. Such conditions are atypical of bank failure, if not properly managed. The banks had to formulate strategies to manage their risk by proper provisioning. The introduction of Basel- Norms is one of the various initiatives towards that objective. Reforms in the financial and the banking sectors have enabled better financial products. This has allowed financial viability of the banks and helped to boost economic growth.

***Keywords**:* Banking Sector, Reforms, Economy, Inflation, Growth, BASEL, Risk-weighted assets, common equity, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

Introduction- Indian banking sector has undergone major changes and reforms during economic reforms. Though it was a part of overall economic reforms, it has changed the very functioning of Indian banks. This reform has not only influenced the productivity and efficiency of many of the Indian Banks, but has left everlasting footprints on the working of the banking sector in India. The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. The Government of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic. Almost 80% of the business are still controlled by Public Sector Banks (PSBs). PSBs are still dominating the commercial banking system. Shares of the leading PSBs are listed on the stock exchanges. The RBI has given licenses to new private sector banks as part of the liberalisation process. The RBI has also been granting licenses to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance

The PSBs will play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches. Hence, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines. This chapter focuses on India's banking sector, which has been attracting increasing attention since 1991 when a financial reform programme was launched. It assesses whether the reform programme has been successful so far in restructuring public-sector banks.

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Role of BASEL-The objective of the Basel Committee's reform package is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy. 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. Moreover, banks provide critical services to consumers, small and medium-sized enterprises, large corporate firms and governments who rely on them to conduct their daily business, both at a domestic and international level. To address the market failures revealed by the crisis, the BASEL Committee is introducing a number of 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 during periods of stress. The reforms also have a macro prudential focus, addressing system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time. Clearly these two micro and macroprudential approaches to supervision are interrelated, as greater resilience at the individual bank level reduces the risk of system wide shocks.

About BASEL Norms - The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland. The committee drafted a first document to set up an international 'minimum' amount of capital that banks should hold. This minimum is a percentage of the total capital of a bank, which is also called the minimum risk-based capital adequacy. In 1988, the Basel I Capital Accord (agreement) was created. In 1988, BCBS(*Basel committee for Banking Supervision)* introduced capital measurement system called Basel capital accord, also called as Basel 1. Basel I define capital based on two tiers:

Tier 1 (Core Capital): Tier 1 capital includes stock issues (or share holders equity) and declared reserves, such as loan loss reserves set aside to cushion future losses or for smoothing out income variations. It focused almost entirely on credit risk.

Tier 2 (Supplementary Capital): Tier 2 capital includes all other capital such as gains on investment assets, long-term debt with maturity greater than five years and hidden reserves (i.e. excess allowance for losses on loans and leases). However, short-term unsecured debts (or debts without guarantees), are not included in the definition of capital.

BASEL-1, defined capital and structure of risk weights for banks. The minimum capital requirement was fixed at 8% of risk weighted assets (RWA). RWA means assets with different risk profiles. A portfolio approach was taken to the measure of risk, with assets classified into four buckets (0%, 20%, 50% and 100%) according to the debtor category. For example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral. India adopted Basel 1 guidelines in the year 1999.

BASEL-1was the first international instrument assessing the importance of risk in relation to capital and proved to be a milestone in the finance and banking history. Some loopholes continued to prey upon the risk-sensitive sector. Fixation of 8% capital ratio to protect banks from credit risk was recommended. But, no recognition was given to risk associated with maturity of credit, risk associated with different currencies and macroeconomics risk. Due to these limitations BASEL Committee decided to propose a more risk-sensitive framework in June, 1999 which was signed as BASEL-II accord.

BASEL-II- The objective of BASEl-II was to "*promote safety and soundness in the financial system; enhance competitive equality; constitute a more comprehensive approach to addressing risks; and to develop approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a banks' positions and activities".* The Basel II capital accord is a three-pillared framework consisting of Minimum Capital Requirement, Supervisory Review Process and Market Discipline. Minimum Capital Requirement is based upon certain calculations at which minimum capital requirement has to be maintained. Under the Supervisory Review Process, the Central Bank (RBI in India) of the concerned country has to ensure that each bank has an adequate capital to adopt better management techniques. The Market Discipline mandates strict disclosure on risk management practices with transparency.

Basel II provides three approaches of increasing sophistication to the calculation of credit risk capital:- the Standardised Approach (SA), the Foundation Internal Ratings Based Approach(FIRBA) and the Advanced Internal Ratings Based Approach (AIRB). Basel II also introduced capital requirements for operational risk (OR) for the first time.

Implementation in India- The process of implementing Basel II norms in India was planned to be carried out in phases. Phase I was for foreign banks operating in India and Indian banks having operational presence outside India with effect from March 31,2008. In phase II, all other scheduled commercial banks (except Local Area Banks and RRBs) were to adhere to Basel II guidelines by March 31, 2009. With the deadline of March 31, 2009 for full implementation of Basel II norms fast approaching, banks are looking to maintain a cushion in their respective capital reserves. The minimum capital to risk-weighted asset ratio (CRAR) in India was placed at 9%, one percentage point above the Basel II requirement. All the banks have their Capital to Risk Weighted Assets Ratio (CRAR) above the stipulated requirement of Basel guidelines (8%) and RBI guidelines (9%). As per Basel II norms, Indian banks should maintain tier I capital of at least 6%.

The hurdles which were faced by India for implementation of BASEL-II were that first of all, there is a need for improved risk management and measurement. It aims to give impetus to the use of internal rating system by the international banks. Second requirement is to arrange risk capital requirement by the banks. Also, Basel II gives some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to ratings of issuers. Encouraging ratings of issuers would be a challenge.

But, the accelerating financial globalization made it necessary to evolve new strategies to reduce financial risks associated with the banking sectors.

BASEL-III- Basel III released in December, 2010 is the third in the series of Basel Accords. Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. Its aim is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance, strengthen banks' transparency and disclosures.

The Basel III which is to be implemented by banks in India as per the guidelines issued by RBI from time to time, will be challenging task not only for the banks but also for GOI. It is estimated that Indian banks will be required to raise Rs 6,00,000 crores in external capital in next nine years or so i.e. by 2020. Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision to strengthen the "regulation, supervision and risk management of the banking sector". These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source improve risk management and governance strengthen banks' transparency and disclosures.

Features of BASL-III The features of BASEL-III, which make it more stringent than BASEL-I and II are as follows.

1. Basel III aims to introduce much stricter definition of capital. Better quality capital means the higher loss-absorbing capacity. This in turn will mean that banks will be stronger, allowing them to better withstand periods of stress.
2. By introduction of Basel III ,banks will be required to hold a capital conservation buffer of 2.5%. The aim of asking to build conservation buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.
3. The countercyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e. in bad times. The buffer will range from 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital.
4. The minimum requirement for common equity, the highest form of loss-absorbing capital, has been raised under Basel III from 2% to 4.5% of total risk-weighted assets. The overall Tier 1 capital requirement, consisting of not only common equity but also other qualifying financial instruments, will also increase from the current minimum of 4% to 6%. Although the minimum total capital requirement will remain at the current 8% level, yet the required total capital will increase to 10.5% when combined with the conservation buffer.
5. Under Basel III, a framework for liquidity risk management will be created. A new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are to be introduced in 2015 and 2018, respectively.

Comparison of Basel-II and Basel-III

Requirements	*Under Basel II*	*Under Basel III*
Minimum Ratio of Total Capital To RWAs	*8%*	*10.50%*
Minimum Ratio of Common Equity to RWAs	*2%*	*4.50% to 7.00%*
Tier I capital to RWAs	*4%*	*6.00%*
Core Tier I capital to RWAs	*2%*	*5.00%*
Capital Conservation Buffers to RWAs	*None*	*2.50%*
Leverage Ratio	*None*	*3.00%*
Countercyclical Buffer	*None*	*0% to 2.50%*
Minimum Liquidity Coverage Ratio	*None*	*TBD[1] (2015)*
Minimum Net Stable Funding Ratio	*None*	*TBD[1] (2018)*
Systemically important Financial Institutions Charge	*None*	*TBD[1] (2011)*

(TBD-To be Determined)[1]

Literature Review- Several previous studies describe the reform effort and the inefficiency of the banks. IMF (2004 and 2005) provides an overview of the most recent reforms and Barnett (2004) reviews the structure and recent developments in the banking sector. For a review of previous banking system reforms, since the mid-1990s, (*Karacadag ,2003*). Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an

important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks (*Beck, Levin and Loayza 1999; King and Levin 1993; Rajan and Zingales 1998; Demirgüç-Kunt, Asli and Maksimovic 1998; Jayaratne and Strahan 1996).* Many countries including India adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. It has been argued by a number of economists that a well-developed financial system enables smooth flow of savings and investments and hence, supports economic growth (*King and Levine, 1993, Goldsmith, 1969).* A healthy financial system can help achieve efficient allocation of resources across time and space by reducing inefficiencies arising out of market frictions and other socio-economic factors.

Analysis of BASEL-III in Indian Context- Presently, a bank's capital comprises Tier 1 and Tier 2 capital with a restriction that Tier 2 capital cannot be more than 100% of Tier 1 capital. Within Tier 1 capital, innovative instruments are limited to 15% of Tier 1 capital. Further, Perpetual Non-Cumulative Preference Shares along with Innovative Tier 1 instruments should not exceed 40% of total Tier 1 capital at any point of time. Within Tier 2 capital, subordinated debt is limited to a maximum of 50% of Tier 1 capital. However, under Basel III, with a view to improving the quality of capital, the Tier 1 capital will predominantly consist of Common Equity. At present, the regulatory adjustments (i.e. deductions and prudential filters) to capital vary across jurisdictions. A revised version of this document was issued in June 2011, generally applied to total Tier 1 capital or to a combination of Tier 1 and Tier 2 capital. They are not generally applied to the Common Equity component of Tier 1 capital. With a view to improving the quality of Common Equity and also consistency of regulatory adjustments across jurisdictions, most of the adjustments under Basel III will be made from Common Equity. The qualifying criteria for instruments to be included in Additional Tier 1 capital outside the Common Equity element as well as Tier 2 capital will be strengthened**.** This requirement will improve the market discipline under Pillar 3 of the Basel II framework. The minimum Common Equity, Tier 1 and Total Capital requirements will be phased-in between January 1, 2013 and January 1, 2015, as indicated below:

As a percentage of risk weighted assets(RWA)	January 1,2013	January 1,2014	January 1,2015
Minimum Common equity Tier-1 Capital	3.5%	4%	4.5%
Minimum Tier-1 Capital	4.5%	5.5%	6%
Minimum total Tier-1 Capital	8%	8%	8%

Recently RBI Governor, D. Subbarao declared that *"Implementation of Basel III is expected to result in a decline in Indian banks' ROE [return on equity] in the short term,"* .The global Basel III requirements, which require all banks to hold top quality capital equal to 7 per cent of their assets, adjusted for risk, are aimed at improving financial stability and avoiding a repeat of the American crisis of 2008. But the sharply higher capital requirements have drawn warnings from analysts and financiers about their impact on banking lending rates and wider economic growth across the developing world.

Conclusion- By implementation of the Basel III norms, the capital of many banks will reduce by around 60% because of the phased removal of certain components of capital from Tier 1. In addition, the risk weightings are expected to grow by nearly 200%. The twin impact of these two stipulations will greatly reduce the ROE and the profitability of banks. The proposed shift from short-term to long-term liquidity will increase the cost of funds for the banking system. This will further squeeze the banks' profit margins. One of the basic tenets of prudent banking is to borrow long and lend short. There must be a match between the duration of

liabilities and the duration of assets, which is at the heart of asset-liability management. Long duration assets were acquired with short duration funding. However, it is a known fact that illiquid banks will soon become insolvent.

The leverage ratio of Indian banks is moderate, and hence, not a cause for concern. However, with capital dilution, increased risk weightings and ceilings on derivative trading, the new leverage ratio will impact the lending capability of the banks. As India is a developing economy, the shrinkage of bank credit can set in recessionary trends. Further, the developmental agenda of the Indian banks will take a backseat in such a situation. While systemic stability is welcome, it cannot be at the cost of the larger economic goals of poverty alleviation, employment generation, priority sector lending and balanced regional growth.

Therefore, it is opined that the new regime of prudential regulations will result in greater stability of the banking industry in various countries. Exercising controls on the capital, liquidity and leveraging of banks will ensure that they have the ability to withstand crises.

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