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Theme 243

BASEL III: RBI's DRAFT GUIDELINES AND BANKS' PREPAREDNESS

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SIB STUDENTS' ECONOMIC FORUM

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Theme No. 243 : BASEL III : RBI's DRAFT GUIDELINES AND BANKS' PREPAREDNESS

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". Basel Committee on Banking Supervision is a committee of bank supervisors as a forum for discussion on the handling of specific supervisory problems. The G-20 nations' 2009 summit in Pittsburgh called for arriving at a new capital accord to develop a more resilient banking sector. We discuss on the RBI draft guidelines and banks' preparedness to adopt the new capital accord.

What do you know about the Basel Standards?

The Bank for International Settlements (BIS), Basel, Switzerland formed the "Basel committee" to undertake a study on the banking system and suggest standards for ensuring safety, liquidity, soundness and solvency in the system. The committee has issued comprehensive reform packages entitled "BASEL III" – a global regulatory framework for more resilient Banks and Banking systems and "BASEL –III International Frame work" for liquidity risk measurement, standard and monitoring.

What is the rationale behind introduction of a new capital accord?

The International Banking system has been passing through an era of financial turmoil after the sub- prime crisis resulting in government bail outs. The Basel Committee endorsed the suggestions by the G-20 summit that Basel I and Basel II had failed to shield the banking system against the tremors of the post crisis period. The foundations of an alternative finance system need to be established urgently to allow the real economy to survive the next global crisis. The committee is of the view that the existing regulatory standards need a review and more stringent norms have to be put in place to provide adequate protection to the international banking system. The new accord- Basel III- has been termed as a new set of standards to equip the international banks to overcome the crisis in a troubled market condition by infusing extra capital and reserves during good times. Reserve Bank of India, a member of BCBS, is fully committed to the objectives of the reform package and therefore intends to implement these proposals for banks operating in India. RBI has released the draft guidelines outlining the proposed implementation of the new regulation in India.

What was the role played by G-20 nations in setting up the new standards?

The G-20 summit in Pittsburgh expressed serious concern over the inherent weakness of the International Banks to withstand the after effects of the sub- prime bubble. The summit endorsed a suggestion to the Basel committee to undertake a study on the possible reforms

in the existing standards and submit the same for approval in the ensuing G-20 nations' 2010 summit at Seoul. The Basel III accord with a new set of standards and practices is now ready for implementation fromJanuary 1, 2013.

What do you know about the Basel Committee?

The Basel committee is a group within the BIS (Bank for International Settlement) for prescribing standards in the capital frame work of banks to ensure efficiency and resilience in the system. The major objective of the Committee is to enhance understanding of key supervisory issues and improve the quality of banking supervision. Basel I, the original Capital accord by Basel in 1988, was designed as a regulatory frame work on capital requirements for international banks. The efficacy of the standards was subjected to serious debates in terms of the freedom enjoyed by banks in coining the regulation as a cushion to overcome the risks in aggressive lending. In reality the Basel 1 accord paved the way for regulatory arbitrage in the system. Basel II, originally known as "International Convergence of Capital Measurement and Capital Standards; A Revised Framework" was introduced in 2004 as a substitute for Basel I. The revised accord mainly addressed the issues related to management of risks in lending and the deficiencies in capital frame work in Basel 1. The concept of corporate governance was highlighted and various capital structures were designed taking into account the credit rating mechanism.

Which are the major areas covered in the new accord?

Basel III addresses the shortcomings in the revised frame work of Basel II visible in major areas such as Capital Adequacy Ratio, Rating Models, Liquidity Constraints and so on in the system. The new accord suggests infusion of additional capital in the form of common equity and inclusion of a capital conservation buffer of 2.5 % of their risk weighted assets. The committee is optimistic that, the micro –prudential proposals will take care of the financial health of banks and the macro level prudential proposals can address the systemic risks and pro-cyclical amplification of the risks over a period of time.

Compare the capital structure in Basel II and Basel III?

As of now the capital adequacy ratio is 8% of which equity content is only 2%, whereas under Basel III, though Capital Adequacy Ratio remains at 8%, the equity component would go up to 4.5%

Accord	Tier I Capital Ratio	Core Tier I Capital Ratio	Remarks
Basel II	4 %	2 %	8% can be met with Tier –II
Basel III	6 %	4.5%	-do-

Core Tier-1 Capital means the net capital raised through common equity after deductions.

What is the time schedule in Basel III to achieve the Core Tier 1 capital Ratio?

Year	Core Tier I Capital Ratio
December 31, 2012	2%
January 1, 2013	3.5%
January 1, 2014	4%
January 1, 2015	4.5%

What is the new recommendation on Capital Conservation Buffers in Basel III?

Buffer means savings in good times to be utilised in bad times. The concept of Capital

buffer has found its place for the first time in the Committee's proposal in the form of provisioning to address the expected loss. The Committee envisages adoption of new methods for assessment of risk weights and credit provisioning through periodical supervisory reviews. The new recommendation aims at a revised counter cyclical outlook instead of a pro-cyclical outlook to effectively withstand the risks associated with credit growth in the system. Banks are required to keep a buffer of 2.5% over and above the statutory Core Tier I ratio of 4.5%. As such the capital adequacy ratio, under Core Tier I (common equity) alone stands revised upward at 7%.

Year	Core Tier I Ratio
December 31, 2015	Nil
January 1, 2016	0.625%
January 1, 2017	1.25%
January 1, 2018	1.875%
January 1,2019	2.5%

How does the new recommendation on global standards affect Banks?

The existing accord is silent on the size of short term and long term assets to cover liquidity crunch and funding capability. But Basel III addresses both the issues by prescribing global minimum standards in the form of short term and long term assets coverage ratios. As such the new capital accord imposes not only higher capital requirements but also stringent global standards in maintenance of coverage ratios. The liquidity coverage norms would definitely increase the cost of acquisition of long term assets adversely affecting the return on equity. Indian Banks would find it difficult to maintain more liquid assets over and above SLR (currently 24% of Net demand and Time Liabilities) as it would put them in a completely disadvantageous position. The new capital and funding norms may strain the investment activities especially the insurance business. In case the equity invested in insurance subsidiaries exceeds 10% of common equity, such investments will not be reckoned in calculation of capital adequacy ratio under Basel III. The new accord specifically mentions about the additional loss absorbing norms for SIFs(Systemically Important Financial institutions) over and above the prescribed standards. There are strict requirements proposed for maintenance of capital for portfolios such as counter party risks on derivatives, re purchase options, and security financing. Basel III is more specific on measurement of operational risk and its supervision. The new capital accord hints about introduction of a leverage ratio to check the accumulation of abnormal leverage in the system to be experimented over a period of parallel run. The move is intended to safeguard against model risk and measurement error.

What are the impacts foreseen in Indian Banking Sector, if RBI favours implementation of the new rules under Basel III?

- Capital Requirements will be higher for all Banks.
- Funding rules may adversely affect the bottom line.
- Banks may have to exit from/review some of the subsidiary activities like insurance business.

RBI allays fears of any larger impacts of the new proposal in the Indian Banking System. The Capital to Risk weighted Assets Ratio of Indian Banks is between 13 and 14%. The

new adequacy norms under Basel III may not put any additional burden on our banks in view of the high CRAR (Capital to Risk weighted Assets Ratio) maintained as of now. RBI says that all the capital ratios of our banks are at about the minimum requirement of Basel III and as such the transition to Basel III would not be much of an issue for our banks. Moreover capital requirement on increased covering of risks would not be applicable to our banks, as either those activities are not allowed or the magnitude is quite small. But the Basel Committee is not agreeable to the stand taken by India that the SLR (Statutory Liquidity Ratio) portfolio may be excluded from the leverage. RBI admits that shifting some deductions from Tier I and Tier II to common equity and the changes in counter party credit risk assessment in the new proposals may have an adverse impact on certain banks.

In a recent statement, RBI said Indian banks will have to incur additional costs to build capital buffers to comply with Basel III rules. Even though the industry is seen comfortably placed to implant the Basel III regulations, a few individual banks may fall short and might need additional capital. Basel III demands building capital and liquidity buffers, in phases from 2013 and its implementation may lead to an increased cost of borrowing for Indian companies both in domestic as well as overseas markets. Banks have to achieve a double digit growth in business by trimming the interest rates on advances and hiking those on deposits. The demand for credit will go up posing a challenge to banks to increase their deposit rates to attract more deposits. RBI views implementation of liquidity standards as a major challenge due to inadequacy and inaccuracy in data compilation. The stress point for our banks would be to adjust the amortised portion of pensions and gratuity liabilities in the opening balance sheet on April 1, 2013 while transitioning to the International Financial Reporting Standards (IFRS).

What are the major highlights of the draft guidelines issued by RBI?

Bank’s capital comprises Tier 1 and Tier 2, where Tier 2 cannot be more than 100% of Tier 1, innovative instruments within Tier 1 cannot be more than 15% of Tier 1 and perpetual non- cumulative preference shares along with innovative Tier 1 instruments cannot be more than 40% of Tier 1 at any point of time. Within Tier 2, subordinated debt is limited to 50% (maximum) of Tier 1.

1. Common Equity Tier 1 (CET 1) should be minimum 5.5% of RWAs(Risk weighted Assets)
2. Tier 1 capital must be at least 7% of RWAs
3. Total capital must be at least 9% of RWAs.
4. Capital Conservation Buffer in the form of common equity must be 2.5% of RWAs.
5. The implementation will be completed on March 31, 2017, beginning from January 1, 2013.
6. Capital conservation buffer requirement is to be implemented between 2014 and 2017.
7. The implementation schedule will be finalised based on feed backs on these guidelines
8. Instruments, not qualified as regulatory capital, will be phased out from January 1, 2013.
9. For OTC derivatives, in addition to counter party default risk, banks will be required to compute an additional credit value adjustments risk capital charge.
10. The parallel run for leverage ratio will start from January 1, 2013 to January 1, 2017 with banks operating at a minimum Tier 1 leverage ratio of 5% subject to the final BCBS proposal.

BASEL III : CAPITAL FRAME WORK :

	Basel II	Basel III
Capital to Risk weighted Assets Ratio	8%	8%

Basel III : Core Tier 1 Capital Ratio:

Year	Core Tier 1 capital Ratio
December 31, 2012	2 %
January 1, 2013	3.5%
January 1, 2014	4 %
January 1, 2015	4.5 %

Basel III : Capital Conservation Buffer

Year	Core Tier 1 Capital Ratio
December 31, 2015	Nil
January 1, 2016	0.625%
January 1, 2017	1.25%
January 1, 2018	1.875%
January 1, 2019	2.5%

RBI DRAFT GUIDELINES: QUALITY : CONSISTENCY: TRANSPARENCY:

Minimum Capital Requirements:

- CET 1 - Minimum 5.5% of RWAs
- Tier 1 – Minimum 7 % of RWAs
- Total Capital - Minimum 9 % of RWAs

Capital Conservation Buffer:

- Common equity - Minimum 2.5% of RWAs

Leverage ratio:

- Tier 1 Leverage - Minimum 5% during parallel run

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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