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BASEL- III CAPITAL REGULATION IN INDIA- A STUDY

Dr. S. ANITHA DEVI
Head Department of Business Administration, T.J.P.S. College, Guntur (Dt), A.P.

SADHIK SAYYED
UGC MAN-Fellow (JR), Full-Time PhD Research scholar,
Department of Commerce & Business Administration,
Acharya Nagarjuna University, Guntur (Dt), A.P.

ABSTRACT

Banking occupies one of the most important positions in the modern economic world. It is necessary for trade and industry. Hence it is one of the great agencies of commerce. Although banking in one form or another has been in existence from very early times, modern banking is of recent origin. It is one of the results of the Industrial Revolution and the child of economic necessity. So the Basel giving to a framework of banking sector's safety and stability emphasizes the need to improve the quality and quantity of capital components, leverage ratio, liquidity standards and enhanced disclosures. The present article examines the growth and structure of Indian Commercial Banks and Basel III issue for Indian banking.

Key words: Banking in India, Basel III; Capital regulation and Risk.

INTRODUCTION

A commercial bank is a profit-seeking business firm, dealing in money and credit. It is a financial institution dealing in money in sense that it accepts deposits of money from the public to keep them in its custody for safety. So also, it deals in credit, i.e., it creates credit by making advance out of the funds received as deposit to needy people. It thus, functions as a mobiliser of saving in the economy. A bank therefore like a reservoir into which flow the savings, the idle surplus money of households and from which loans are given on interest to businessmen and other who need them for investment or productive uses.

Indian banking in the modern sense originated in the last decades of the 18th century. The among the first banks were Bank of Hindustan, which established in 1770 and liquidated in 1826-32; and General Bank of India, established 1786 but failed in 1791. The largest bank, and the oldest still in existence, is the State Bank of India. It originated as the Bank of Calcutta in June 1806. In 1809, it was renamed as the Bank of Bengal. This was one of the three banks funded by a presidency government; the other two were the Bank of Bombay and the Bank of Madras. The three banks were merged in 1921 to from the imperial Bank of India, which upon India's independence, became the State Bank of India in 1955. For many years the presidency banks had acted as quasi-central banks, as did their successors, until the

Reserve Bank of India was established in 1935, under the Reserve Bank of India Act, 1934.

In 1960, the State Bank of India was given control of eight state-associated banks under the State Bank of India (Subsidiary Banks) Act, 1959. These are now called its associate banks. In 1969 the Indian government nationalized 14 major private banks. In 1980, another 6 more private banks were nationalized. These nationalized banks are the majority of lenders in the Indian economy. They dominate the banking sector because of their large size and widespread networks.

In Indian banking sector is broadly classified into schedule banks and non-scheduled banks. The scheduled banks are those which are defined under the 2nd schedule of the Reserve Bank of India Act, 1934. The scheduled banks are further classified into: Nationalized banks; State Bank of India and its associates; Regional Rural Banks (RRBs); foreign banks; and other Indian private sector banks. The term commercial bank refers to both scheduled and non-scheduled commercial banks which are regulated under the Banking Regulation Act, 1949.

Generally banking in India was fairly mature in terms of supply, product range and reach-even though reach in rural India and to the poor still remains a challenge. The government has developed initiatives to address this through the State Bank of India expending its branch network and through the National Bank for Agriculture and Rural Development has developed initiatives to address this through the State Bank of India expanding its branch network and through the National Bank for Agriculture and Rural Development with thing like microfinance.

Objective of the study:

- **i.** To identify the RBI capital regulation for implementation of Basel-III in Indian scenario.
- **ii.** Key features of the New Capital Standards under Basel III, and
- **iii.** Risk coverage of capital framework.

Review of Literature:

Review of literature has vital relevance with any research work. Due to literature review the possibility of repetition of study can be eliminated and another dimension can be selected for the study.

1. **Rao & Ghosh 2008, - "Risk parameters of banking sectors in India"** Rightly pointed out that India banking sector is still in its preparatory stage in implementing a sound operational risk management due to lack of qualification.

2. **Raghuvir Mukherji 2008, “Basel III-The BCBS Response to Financial Crisis and its implementation in India”** in his article, he observe that taking lessons from the financial crisis of 2008-09, the BCBS tweaked the term of the term of the existing Basel II Capital Accord again to equip financial firms to cope better with similar crisis in the future called Basel III. It has increased these minimum capital requirements in a phased manner, it will increase CRAR to 10.5%, Tier I capital to 8.5% and equity (equity capital and retained earnings) to 7% of risk weighted assets (RWA).
3. **Dr.Sankarshan Bsau in his paper “Risk Management in Banks and Financial Institutions”** risk management techniques need to be in tune with the kind of business that a firm undertaken- in other words both have to be on the curve and, if anything, the risk function should be ahead of the curve for an effective risk management process. Risk management as process should essential be a way of life for Banks and Financial Institutions.
4. **Arindam Banerjee “Risk Management in Banking Sector: An Overview”** in this Cover Article begins with an introduction to the commercial banking in Indian Scenario and further tries to locate the risk management areas in Banking Sector. The article further highlights the increasing the role of Cost And Management Accountants in commercial banks in India so to contribute towards risk management functions to increase its efficiency and growth.
5. Suresh Kumar Agarwal in his work the topic **“Implementation of Basel III Capital Regulation in India” (2012)-** He discussed that Implementation of Basel III Capital Regulation in India, one of the key elements of Basel III is the introduction of much sector definition of capital. Better quality means the higher loss absorbing capacity. This in turn will means that banks will be stronger, allowing them to better withstand periods of stress.
6. **Alamelu and Chidambaram emphasized the profiti1bility aspect in commercial banks.** In this paper, the scholar analyzed and compared the performance of public and private sector bank on profitability angle. It was found that all the private sector banks have been registered both high profits and high rate of growth. Better customer service, technology, innovative products, good marketing strategies, proper monitoring of advances, risk over coming, regional orientation are some of factors responsible for the success of private sector banks in India.

Basel – How it come into picture

In banking entity assets are created as a process of intermediation by accepting deposit; the basic function of intermediation itself is a source of credit and liquidity risks for any banking institution. Further, banks are exposed to various market and non-market risks in performing their functions. These risk expose banks to events, both expected and unexpected, with the potential to cause losses, putting depositor's money at risk. So banks and the regulator all over the world have been concerned about these risks, and the formal framework for bank's capital structure was evolved in 1988 with the introduction of the 'International Convergence of Capital measurement and Capital Standard; popularly known as Basel I, issued by the Basel committee on Banking supervision (BCBS).

Basel is a city in Switzerland which is also the headquarters of Bureau of International Settlement (BIS). BIS foster co-operation among central banks with a common goal of financial stability and common standards of banking regulations. Currently there are 27 member nations in the committee. Basel guidelines refer to broad supervisory standards formulated by this group of central banks-called the Basel Committee on Banking Supervisory (BCBS).

On 26 June 1974, a number of banks had released payment of Deutsche Marks (DEM-German Currency at that time) to Herstatt (Based out of Cologne, Germany) in Frankfurt in exchange for US Dollars(USD) that was to be delivered in New York. Because of time-zone differences, Herstatt ceased operations between the times of the respective payments. Germany regulators forced the troubled Bank Harstatt into liquidation. The counter party banks did not receive their USE payments. Responding to the cross-jurisdictional implications of the Herstatt debacle, the G-10 Countries, Spain and Luxembourg formed a standing committee in 1974 under the auspices of the Bank for International Settlements (BIS),

The set of agreement by the BCBS, which mainly focuses on risk to banks and the financial system are called Basel accord. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. India has accepted Basel accords for the banking system.

According to Walter Leaf "A bank is a person or corporation which holds itself out to receive form the public, deposits payable on demand by cheque." Likewise the banking system is to collection of the deposit in various field and payable in demand draft or cheque and it would be creating in the credit for the account holders, but banks have need a particular supervision for supporting to get profit.

Basel-I

In 1988, BCBS introduced capital measurement system called Basel capital accord, also called as Basel I. it focused almost entirely on credit risk. It 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. For example, an asset backed by collateral would carry lesser risks as compared to personal leans, which have no collateral. India adopted Basel I guidelines in 1999. Under these norms: assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of 0%(Cash, Bullion, Home Country Debt like Treasuries), 10%, 20%, 50%, and 100% and no rating. However, there are major problems with definition of Capital and Differential Risk Weights to Assets across countries, like Basel standards are computed on the basis of book-value accounting measures of capital, not market values. Accounting practices vary significantly across the G-10 countries and often produce results that differ markedly form market assessments.

Other problem was that the risk weights do not attempt to take account of risk other than credit risk, viz., market risk, liquidity risk and operational risk that may be important sources of insolvency exposure for banks.

Basel- II

In 2004, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord. The guidelines were based on three parameters. Banks should maintain a minimum capital adequacy requirement of 8% of risk assets, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that is credit and increased disclosure requirements. Banks need to mandatorily disclose their risk exposure, etc to the central bank. Basel II norms in India and overseas are yet to be fully implemented. Disclosure requirements allow market participants assess the capital adequacy of t he institution based on information on the scope of application, capital, risk exposures, risk assessment processes, etc.

Basel III

In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008. A need was felt to further strengthen the system as banks in the developed economies were under- capitalized, over-leveraged and had a teater reliance on short-term funding. Also the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk. Basel III norms aim at making most banking activities such as their trading book activities more capital-intensive. The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameter viz. capital, leverage, funding and liquidity. Requirements for common equity and Tier1 capital will be 4.85% and 56% respectively. The liquidity coverage ratio (LCR) will require banks to hold a buffer of high quality liquid assets sufficient to deal with the cash outflows encountered in an acute short tem stress scenario as specified by supervisors. The minimum LCR requirement will be to reach 100% on 1 January 2019.

BCBS, through Basel III, put forward norms aimed at strengthening both sides of balance sheet of banks viz**. a)** Enhancing the quantum of common equity;

b) Improving the quality of capital base;
c) Creation of capital buffers to absorb shock;
d) Improving liquidity of assets;
e) Optimizing the leverage through Leverage Ration;

f) Creating more space for banking supervision by regulators under Pillar II and
g) Bring further transparency and market discipline under Pillar III.

Thus, Basel III norms were release by BCBS and individual central banks were asked to implement these in a phased manner. RBI (Central bank of India) too issued draft guidelines in the initial stage and then came up with the final guidelines.

Some of the RBI Guidelines for Implementation of Basel III guidelines an over View-

The final guidelines have been issued by Reserve Bank of India for implementation of Basel III guidelines on 2nd May, 2012. Major features of these guidelines are:

1. These guidelines would become effective from January 1st, 2013 in a phased manner. This means that as at close of business on January 1st, 2013, banks must be able to declare or disclose capital ratios computed under the amended guidelines. The Basel III capital ratios will be fully implemented as on March 31st, 2018.
2. The capital requirements for the implementation of Basel III guidelines may be lower during the initial periods and higher during the later years. Banks needs to keep this in view while capital planning.
3. Guidelines on operational aspects of implementation of the countercyclical capital Buffer. Guidance to banks on this will be issued in due course as RBI Is still working on these.
4. For the financial year ending March 31st ,2013, banks will have to disclose the capital ratios computed under the existing guidelines (Basel II) on capital adequacy as well as those computed under the Basel III capital adequacy framework.
5. The guidelines require banks to maintain a Minimum Total Capital (MTC) of 9% against 8% (international) prescribed by the Basel Committee of Total Risk weighted assets. This has been deciding by Indian regulator as a matter of prudence. Thus, it requirement in this regard remained at the same level.
6. Of the above, Common Equity Tier 1 (CET1) Capital must be at least 5.5% of RWAs;
7. In addition to the Minimum Common Equity Tier 1 capital of 5.5% of RWAs, (international standards require these to be only at 4.5%) banks are also required to maintain a Capital Conservation Buffer(CCB) of 2.5% of RWA s in the form of Common Equity Tier 1 capital. CCB is designed to ensure that banks build up capital buffers during normal times (i.e. outside

periods of stress) which can be drawn down as losses are incurred during a stressed period. In case such buffers have drawn, the banks have to rebuild them through reduced discretionary distribution of earnings. This could include reducing dividend payments, share buybacks and staff bonus.

8. Indian banks under Basel II are required to maintain Tier 1 Capital of 6%, which has been raised to 7% under Basel III. Moreover, certain instruments, including some with the characteristics of debts, will not be now included for arriving at Tier 1 Capital;
9. The new norms do not allow banks to use the consolidated capital of any insurance or non financial subsidiaries for calculating capital adequacy.
10. Leverage Ratio: under the new set of guidelines, RBI has set the leverage ratio at 4.5% (3% under Basel III). Leverage ratio has been introduced in Basel III to regulate banks which have huge trading book and off balance sheet derivative positions. However, in India most of banks do not have large derivative activities so as to arrange enhanced cover for counterparty credit risk. Hence, the pressure on banks should be minimal on this count.
11. Liquidity norms: The Liquidity Coverage Ratio (LCR) under Basel III requires banks to hold enough unencumbered liquid assets to cover expected net outflows during a 30- day stress period. In India, the burden from LCR stipulation will depend on how much of CRR and SLR can be offset against LCR. Under present guidelines, Indian banks already follow the norms set by RBI for the statutory liquidity ratio (SLR) - and cash reserve ratio (CRR), which are liquidity buffers. The SLR is mainly government securities while the CRR is mainly cash. Thus, for this aspect also Indian banks are better placed over may of their overseas counterparts. Countercyclical Buffer: Economic activity moves in cycles and banking system is inherently pro-cyclic. During upswings, carried away by the boom, banks end up in excessive lending and unchecked risk build-up which carry the seeds of a disastrous downturn. The regulation to create additional capital buffers to lend further would act as a break on unbridled bank-lending. The detailed guidelines for these are likely to be issued only at a later stage.

Key features of the New Capital Standards under Basel III:

1. Considerably increase the quality of bank's capital;
2. Significantly increase the required level of their capital;
3. Reduce systemic risk; and
4. Allow sufficient time for a smooth transition to the new regime.

Of the above additional features, some prescriptions on leverage have been added. RBI may await further work pertaining to liquidity standards and the counter-cyclical buffer. While as one of the 27 members of the Basel Committee, India is committed to implement Basel III, two conservative deviations in the RBI guidelines are worth noting. First, the time schedule is tighter, compressing the implementation period by two years from 2019 to 2017. Secondly, the overall requirement of capital is more stringent at least by one percentage point.

Regulatory Capital requirements in India as per Basel III

Sl.	Regulatory Capital	As % to RWAs
(*i*)	Minimum common equity Tier I ratio[63]	5.5
(*ii*)	Capital conservation buffer (comprised of common equity)	2.5
(*iii*)	Minimum common equity Tier I ratio plus capital conservation buffer [(i)+(ii)]	8.0
(*iv*)	Additional Tier 1 capital	1.5
(*v*)	Minimum Tier 1 capital ratio [(i) +(iv)]	7.0
(*vi*)	Tier 2 capital	2.0
(*vii*)	Minimum total capital ratio (MTC[64]) [(v)+(vi)]	9.0
(*viii*)	Minimum total capital ratio plus capital conservation buffer [(vii)+(ii)]	11.5

Source: Basel III guidelines issued by RBI

Risk coverage of the Capital framework:

All organizations deal with risk, though the nature and magnitude may differ for each type of organizations; like in Bank sectors are to be effect in their nature of mobilizing money. Risk is in most cases, we observe there is deviation in what we achieve from what we had planned or what we had expected. We may define Risk as uncertainty resulting in adverse outcome, adverse in relation to planned objectives or expectations. The possible unfavorable impact is the Risk of the Bank. The etymology of the word Risk can be traced to the Latin word "Rescum" meaning Risk at sea or that which cuts. Risk is associated with uncertainty and reflected by way of charge on the fundamental basic i.e. in the case of business it is the capital, which is the cushion that protects the liability holders of an institution. These risks are inter-dependent and events affecting one area of risk can have ramifications and penetrations for a range of other categories of risks.

The extent of calculating that need to be performed to understand the impact of each such risk on the transactions of the bank makes it nearly impossible to continuously update the risk calculations. Hence, providing real time risk information is one of the key challenges of risk management exercise. Risk Management system is the pro-active action in the present for the future. The objective of risk management is not to prohibit or prevent risk taking activity, but to ensure that the risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated. It also presents an institution to fail or materially damage its competitive position. Function of risk management should actually be bank specific dictated by the size and quality of balance sheet, complexity of functions technical/professional manpower and the struts of MIS in place in that bank.

The risk coverage of the capital framework will be strengthened.

1. Promote more integrated management of market and counterparty credit risk.
2. Add the credit valuation adjustment risk due to deterioration in counterparty's credit rating.
3. Strengthen the capital requirements for counterparty credit exposures arising form banks derivatives, repo and securities financing transactions
4. Reduce procyclicality
5. Raise the capital buffers backing these exposures
6. Provide additional incentives to move OTC derivative contracts to qualifying central counterparties (probably clearing houses). Currently, the BCBS has stated derivatives cleared with a QCCP will be risk-weighted at 2% (The rule is still yet to be finalized in the U.S.)
7. Provide incentives to strengthen the risk management of counterparty credit exposures.
8. Raise counterparty credit risk management standards by including wrong-way risk.

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 among the differences for banks are the introduction of liquidity and leverage ratios, and enhanced minimum capital requirements.

Basel III provides for a timeline of implementation that 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 will lead to 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 more proactive, and stricter in terms of regulatory supervision surveillance.

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