INTERNATIONAL JOURNAL OF MANAGEMENT (IJM)

ISSN 0976-6502 (Print)
ISSN 0976-6510 (Online)
Volume 6, Issue 5, May (2015), pp. 18-24
© IAEME: http://www.iaeme.com/IJM.asp
Journal Impact Factor (2015): 7.9270 (Calculated by GISI)
www.jifactor.com

IJM

© I A E M E

BASEL III AND ITS IMPLEMENTATION

Dr. Manisha

Assistant.Prof. Department of Management Studies,
DeenbandhuChottuRam University of Science &Technology, Murthal
Sonipat, Haryana

Mrs. Kaveri Hans*

*Research Scholar, Department of Management Studies,
DeenbandhuChottuRam University of Science &Technology, Murthal
Sonipat, Haryana

ABSTRACT

For any business, profits are the important element but for banking business, safety and being solvent are foremost. Since banking is that business which deals with depositor's money, so the protection of depositor's money is important. To safeguard their interest, capital regulation came into picture. Basel accords are those guidelines which instruct banks to back up their risk with capital. Adequate capital adds cushion to bank's failure and ensures depositors safety of their money. Basel III is the third accord and provides stricter approach towards managing risk and capital. RBI has also implemented these norms for Indian banks. This paper examines the new elements of Basel III accord and its implementation stages with special reference to India. By focusing on strict capital regulation Basel III has introduced higher capital ratios, new buffers and leverage ratio framework which enhances risk management practices and make banking sector robust and shock absorbent.

Keywords: Banks, Capital Regulation, Basel Norms, Risk.

INTRODUCTION

In 1969 a revolutionary step was undertaken in Indian banking industry, to nationalised 14 largest banks which constitute more than 85% of bank deposits in the country. The main motive behind this step was to facilitate the development of Indian economy and to generate public confidence in banking. Another milestone in banking was in 1990 when policy of liberalisation came into existence and various small bankers got licence to work as banking entity. Prior to liberalisation need of capital regulation was not felt so desperately. As the banking sector grows and various foreign banks came into scenario, complying with international norms became important. Moreover,

after liberalization various banks reported losses as there were no specified rules regarding capital and risk taken. Thus, Narasimham committee gives recommendations on banking reforms in 1991. On the basis of which Reserve bank of India introduced a risk asset ratio system similar to Basel norms covering all banks and enabling a secure and reliable banking environment. By March 1996, most banks had attained required CRAR of 8%.

Capital to risk weighted asset ratio (CRAR) is that amount of bank's capital which they need to keep aside in relation to risk taken by them. Adequate capital adds cushion to bank's failure and ensures depositors safety of their money. Capital adequacy ratio are intended to ensure that banks maintain a minimum amount of own funds in relation to the risks they face so that banks are able to absorb unexpected losses (RBI, 2008). Basel norms are those regulations which provide guidelines to banks as to how much capital they should keep to ensure smooth functioning. Basel II and Basel III are improved version of Basel 1988 popularly known as Basel I. The main objective of the present study is to analyse Basel III norms and to examine the implementation stages of Basel III issued by Reserve Bank of India.

BASEL NORMS

Basel 1

In 1970s breakdown of Bretton Woods's system led to the failure of various banks globally. Closure of BankhausHerstatt's of Germany and the Franklin National Bank of New York made the regulators think about the adverse scenario of financial sector. In order to regulate this situation Basel Committee on Banking Supervision (BCBS) under the auspices of Bank for International Settlement (BIS) introduced Basel accord popularly known as Basel 1 in 1988. The central bankers of the G10 countries established this committee. Its aim was and is to enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide (BIS, 2013). This committee has no legal enforcement; rather it issues guidelines and standards whose implementation provides a level playing field and consistency in member countries supervisory approaches. Initially, this committee was supposed to draft guidelines for G10 countries only but because of its efficient and effective principles, non G10 countries also showed interest for its implementation in their individual countries. Thus, this committee expanded its membership in 2009 and now included 27 jurisdictions (BIS, 2013). Not only G10 countries member implemented this accord but all other countries with active international banks also actively participated in this. Later on various amendments were done in this accord to make it more reliable and dependable.

Under these standards banks were instructed to keep capital aside on the basis of risk they are undertaking. Basel I set this ratio as 8% of the value of the risk weighted assets whereas RBI set this limit as 9% for Indian banks.

$$\text{CRAR} = \frac{\text{Capital}}{\text{Risk Weighted Assets}} \geq 8\%$$

Capital as in numerator includes Tier 1 capital and Tier2 capital. Tier1 capital includes paid up capital, statutory reserves, capital reserves and other undisclosed free reserves and it is primarily used to cover unexpected losses. Tier2 capital includes revaluation reserves, subordinated debt, general provisions and loss reserves and it is used to mainly at the time of winding up. Tier2 capital cannot exceed more than 50% of Tier 1 capital. Risk weighted assets as in denominator are calculated by summing up credit risk weighted assets, market risk weighted assets and operational risk weighted assets.

In 1992, the committee felt the need to make changes in 1988 accord because Basel I was not as adequate as it was earlier due to the changing scenario of financial sector. In spite of having

significant impact on international banking Basel I failed to address some important issue such as it was dependent only on credit risk and excluded other risks in calculating capital adequacy. It also fails to discriminate between different borrowers, their repaying capabilities, their credit rating and risk involved. Also, inadequate assessment of risks involved in the use of financial instruments like derivatives and securitization led to introduction of Basel II Accord.

Basel II

Thus, the committee issued "Revised Capital Framework" in 2004 generally known as Basel II (BIS, 2013). Basel II accord was initiated in 1999 and needed to be implemented by 2009. After 6 years of preparation the accord was presented to banks in June 2004. Keeping the objective of financial stability and capital adequacy as same, the Basel II aims to make capital structure more risk sensitive as well as to promote risk management practices or to improve risk management structure of banks. The second Basel accord, Basel II supplemented the original Basel accord by introducing three pillars : First pillar is minimum capital requirement based on risk profiling which deals with definition of capital requirements and extended definition of risk which included credit risks, market risks and operational risks : Second pillar is supervisory review which requires the supervisory authorities to subject all banks to an evaluation process and to impose any necessary supervisory measures based on the evaluations (Prakash, 2008): Market discipline forms third pillar which enhances the bank's working framework by ensuring adequate disclosure and clarity in public reporting. Following this proposal various guidelines were issued for the successful implementation of the accord which was mainly related to focus on trading book, consistent implementation, market risk amendment and supervisor's role. Basel II framework was a successful successor of 1988 accord and enhanced form of 1988 accord. But the global financial crisis of 2008 and the collapse of Lehman Brother highlighted the defects of Basel II. The committee felt a need to strengthen this framework and time came to introduce the third accord i.e. Basel III. Basel II accord failed because of problems like portfolio invariant, procyclicality, securitization, biasness related to inputs etc.

Basel III

In order to make international banking sector more resilient and more stable, the committee introduced new proposed standards 'Basel III' in mid-December 2010. The main objective of Basel III framework is to improve the banking system's ability to efficiently absorb shocks arising from financial and economic stress and to reduce the risk of spill-over from the financial sector to real economy (BCBS, 2010). The focus of Basel III is an even greater risk management at micro and macro level, the introduction of leverage and liquidity ratios, counter cyclical and conservation buffers as well as the calibration of further buffers for systemically important banks (Dzato, 2012). The foundation of Basel III is the three pillars same as of Basel II but now the committee focuses on strengthening regulatory capital framework by introducing some key features such as raising the quality and quantity of capital base, enhancing risk coverage, introducing leverage ratio, reducing procyclicality and promoting counter cyclical buffers and by introducing a global liquidity standards such as liquidity coverage ratio and net stable funding ratio. Key features of Basel III capital standards are discussed below:

1) Pillar 1 Minimum capital requirement: while drafting Basel III guidelines emphasis was made to make capital base stronger. Three things that need to do to achieve this objective are; to cover all risks, to enhance quality of capital and to raise quantity of capital base. Basel III covers almost all types of risks included trading and banking book securitization, on and off balance sheet activities, counterparty credit risk on OTC derivatives and repos etc. To enhance quality of capital, definition of capital has change. Earlier, total regulatory capital was constituted of Tier1 and Tier2 capital with more emphasis on Tier1 capital ratio and less emphasis on common equity ratio. Also, the complexity lie with the components of capital. New definition properly focuses on common

equity Tier1 capital as it has more shock absorbing ability. Tier II capital will also be there as gone concern capital and Tier III capital which at one time was used for market risk capital charge, will be eliminated. The focus of Basel III was also on raising quantity of capital base by raising requirement of capital ratios as under

Table 1: Summary of capital ratios

Ratio	Calculation	Under Basel II	Under Basel III Decided by BCBS	Under Basel III Decided by RBI
Common Equity Tier1 capital ratio	Common equity tier 1 capital / Credit risk RWA+ Market risk RWA+ Operational risk RWA	2%	4.5%	5.5%
Tier 1 capital ratio	Eligible tier 1 capital / Credit risk RWA+ Market risk RWA+ Operational risk RWA	4%	6%	7%
Total capital ratio CRAR	Eligible total capital / Credit risk RWA+ Market risk RWA+ Operational risk RWA	8%	8%	9%
Capital conservation buffer		--	2.5%	
Countercyclical buffer		--	0 to 2.5%	
Leverage ratio		--	At least 3%	

Source: created by author

2) Pillar 2 Supervisory review and evaluation process: supervisors need to evaluate bank's strategies and should intervene if any bank fails to maintain minimum capital requirements. Supervisors should ensure that banks are maintaining adequate capital and handling risk efficiently.

3) Pillar 3 Market discipline: regulators have made disclosures more strict and transparent. Banks need to make disclosures under Basel III in its published financial results or at a minimum on its websites under regulatory disclosure section. These disclosures should be made by banks as on 30.9.2013 onwards.

4) Introduction of new capital buffers: in order to make banks more shock absorbent, capital conservation buffer (CCB) and countercyclical capital buffers were introduced. CCB is an additional reserve that banks need to maintain in the form of common equity tier 1 capital, at least 2.5% of RWAs. This buffer is introduced to ensure that banks have sufficient capital buffer (above minimum requirement) which can be used in stressed times. Also, countercyclical capital buffer can be imposed by regulators on banks to raise capital. It can range from 0% to 2.5%. It helps in slowing down economy if credit expands enormously and encourage lending when economy slowdown.

5) Introduction of leverage ratio framework: since higher leverage was one of the causes of financial crisis, Basel III introduced leverage ratio requirement. The goal of the leverage ratio is to potentially capture the risk that may not be captured in the risk weights for capital requirement measures and to be a compliment to this measurement (BCBS 2010). At least 3% leverage ratio is to be maintained by Indian banks and its disclosure will begin by January 1, 2015.

6) Introduction of Liquidity risk measurement framework: under this two new ratios are introduced. Liquidity coverage ratio (LCR) to maintain adequate level of liquidity in short span of

time of 30 days and Net funding sable ratio (NFSR) which is designed to have enough liquidity for a period of 1 year. On the full implementation of Basel III these ratios should not be less than 100%. These ratios are to be decided yet and will be implemented in 2015 and2018 respectively.

IMPLEMENTATION STAGES OF BASEL III

Basel III capital norms were introduced by BCBS in December 2010 and is to be implemented by all banks (Indian or International) with effect from April 2013. For its implementation, banks need to make necessary changes in their capital planning by taking various considerations such as changing macro-economic conditions and outcomes of periodic stress tests. Basel III implementation is phased- in over years to ensure smooth migration which in turn may pose higher burden of capital requirement in later years and lesser burden in earlier years of its implementation. According to RBI, capital ratios and deductions from common equity will be fully implemented by March 31, 2018 (See table 3). Of late, industry wide concerns have been expressed about the potential stresses on the asset quality and consequential impact on the performance/profitability of the banks (RBI, 2014).

Thus banks required some more time to raise capital to fully implement Basel III. The deadline for its implementation in India is extended up to March 31, 2019 which is also internationally agreed timeline, instead of March 31, 2018 (See table 2 & 4). The main amendments while revising the timeline was made in the implementation of capital conservation buffer (CCB). It has been decided that the implementation of CCB will begin as on March 31, 2016 (RBI, 2014). Thus, Basel III will be fully implemented by March 2019. Consequently, minimum capital conservation standards for individual bank were also revised (See table 5 & 6).

CONCLUSION

Although, Basel III may seems difficult to implement at start because of higher capital requirement but at the end it will be beneficial for whole banking system. It is a precautionary approach which will help banks to be prepared for any upcoming crisis and make banks strong enough to face any downfall without harming depositor's money, RBI has always taken conservative approach and set capital ratio standard higher than prescribed internationally. The phase-in implementation will impose lower capital burden in early years and higher capital burden in later years. Also, the extended deadline of its full implementation will provide banks some extra time to raise capital and to be Basel III compliant.

REFERENCES

1. BCBS 2010.Basel committee on banking supervision; Basel III: a global regulatory framework for more resilient banks and banking system; available at http://www.bis.org/publ/bcbs189.pdf
2. BIS, 2013.A brief history of the Basel committee available at www.bis.org accessed on 2 December 2014
3. Dzato, Robert (2012). Ghana goes Basel II- Key Challenges and Opportunities, Retrieved from http://www.fepinternational.org/Ghana%20Goes%20Basel%20II-Article.pdf on 12.5.2013
4. Prakash, Anupam (2008). Evolution of the Basel framework on Bank capital Regulation, Reserve bank of India occasional papers, Vol. 29 No.2 Monsoon 2008
5. RBI (2008). Reserve Bank of India, Managing capital and risk; available at http://rbi.org.in/scripts/publicationsview.aspx?id=10489

6. RBI (2014). Reserve Bank of India, Master Circular Implementation of Basel III capital regulations in India—capital planning Available at www.rbi.org Dated March 27, 2014
7. R.Shenbagavalli, S.Senthilkumar and Dr.T.Ramachandran, "A Strategy To Manage The NPAS of Public Sector Banks" International Journal of Management (IJM), Volume 4, Issue 3, 2013, pp. 1 - 7, ISSN Print: 0976-6502, ISSN Online: 0976-6510, Published by IAEME.

ANNEXURE

Table 2: Basel III phase-in arrangements issued by Bank for International Settlement

Phases		2013	2014	2015	2016	2017	2018	2019
CAPITAL	Leverage Ratio		Parallel run 1 Jan 2013-1 Jan 2017 Disclosures starts 1 Jan 2015				Migration to Pillar 1	
	Minimum Common Equity Capital ratio (MCET)	3.5%	4.0%	4.5%				4.5%
	Capital Conservation Buffer (CCB)				0.625%	1.25%	1.875%	2.5%
	MCET + CCB	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
	Phase in of deduction from CET		20%	40%	60%	80%	100%	100%
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%
	Minimum Total Capital		8.0%					8.0%
	Minimum Total capital + Conservation Buffer		8.0%		8.625%	9.25%	9.875%	10.5%
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013					
LIQUIDITY	Liquidity Coverage ratio			60%	70%	80%	90%	100%
	Net Stable Funding Ratio						Introduce minimum standard	

Source: www.bis.org

Table 3: Transitional Arrangements for Scheduled Commercial Banks in India

(% of RWAs***)

Minimum Capital Ratios	April 1, 2013	March 31, 2014	March 31, 2015	March 31, 2016	March 31, 2017	March 31, 2018
CET 1*	4.50	5.00	5.50	5.50	5.50	5.50
CCB**	--	--	.625	1.25	1.875	2.50
Minimum CET 1+ CCB	4.50	5.50	6.125	6.75	7.375	8.00
Minimum Tier 1 capital	6.00	6.50	7.00	7.00	7.00	7.00
Minimum Total Capital #	9.00	9.00	9.00	9.00	9.00	9.00
Minimum Total Capital + CCB	9.00	9.00	9.625	10.25	10.875	11.50
Phase-in of all deductions from CET 1 (in %)	20	40	60	80	100	100

Source: RBI, Master Circular Dated July 1, 2013
*CET 1: Common equity Tier 1 capital
**CCB: Capital conservation buffer
***RWAs: Risk weighted assets
#the difference between the minimum total capital requirement of 9% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.

Table 4: Revised Transitional Arrangements for Scheduled Commercial Banks in India

(% of RWAs***)

Minimum Capital Ratios	**April 1, 2013**	**March 31, 2014**	**March 31, 2015**	**March 31, 2016**	**March 31, 2017**	**March 31, 2018**	**March 31, 2019**
CET 1*	4.50	5.00	5.50	5.50	5.50	5.50	5.50
CCB**	--	--	--	0.625	1.25	1.875	2.50
Minimum CET 1+ CCB	4.50	5.50	5.50	6.125	6.75	7.375	8.00
Minimum Tier 1 capital	6.00	6.50	7.00	7.00	7.00	7.00	7.00
Minimum Total Capital #	9.00	9.00	9.00	9.00	9.00	9.00	9.00
Minimum Total Capital + CCB	9.00	9.00	9.00	9.625	10.25	10.875	11.50
Phase-in of all deductions from CET 1 (in %)	20	40	60	80	100	100	100

Source: RBI, Master Circular Dated March 27, 2014

*CET 1: Common equity Tier 1 capital

**CCB: Capital conservation buffer

***RWAs: Risk weighted assets

#the difference between the minimum total capital requirement of 9% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital

Table 5: Minimum capital conservation standards for individual bank

Common Equity Tier 1 Ratio after including the current periods retained earnings			Minimum Capital Conservation Ratios (expressed as % of earnings)
As on March 31, 2015	As on March 31, 2016	As on March 31, 2017	
5.5% - 5.65625%	5.5% - 5.8125%	5.5% - 5.96875%	100%
>5.65625% - 5.8125%	>5.8125% - 6.125%	>5.96875% - 6.4375%	80%
>5.8125% - 5.96875%	>6.125% - 6.4375%	>6.4375% - 6.90625%	60%
>5.96875% - 6.125%	>6.4375% - 6.75%	>6.90625% - 7.375%	40%
>6.125%	>6.75%	>7.375%	0

Source: RBI, Master Circular Dated July 1, 2013

Table 8: Revised minimum capital conservation standards for individual bank

Common Equity Tier 1 Ratio after including the current periods retained earnings			Minimum Capital Conservation Ratios (expressed as % of earnings)
As on March 31, 2016	As on March 31, 2017	As on March 31, 2018	
5.5% - 5.65625%	5.5% - 5.8125%	5.5% - 5.96875%	100%
>5.65625% - 5.8125%	>5.8125% - 6.125%	>5.96875% - 6.4375%	80%
>5.8125% - 5.96875%	>6.125% - 6.4375%	>6.4375% - 6.90625%	60%
>5.96875% - 6.125%	>6.4375% - 6.75%	>6.90625% - 7.375%	40%
>6.125%	>6.75%	>7.375%	0

Source: RBI, Master Circular Dated March 27, 2014