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# Reserve Bank of India and Basel Norms

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ABSTRACT

*The Reserve Bank's approach to the institution of prudential norms has been one of gradual convergence with international standards and best practices with suitable country specific adaptations. The aim has been to reach global best standards in a deliberately phased manner through a consultative process evolved within the country. This has also been the guiding principle in the approach to the New Basel Accord. Implementation of Basel II has been described as a long journey rather than a destination by itself. Undoubtedly, it would require commitment of substantial capital and human resources on the part of both banks and the supervisors. As envisaged by the Basel Committee, the accounting profession too, will make a positive contribution in this respect to make Indian banking system stronger. Basel III is a countercyclical capital requirement which can lead to an additional increase in the capital ratios under a declaration of "excessive credit growth."*

Keywords : RBI, BASEL NORMS, CAPITAL ADEQUACY and CPWG

The Reserve Bank's approach to the institution of prudential norms has been one of gradual convergence with international standards and best practices with suitable country specific adaptations. The aim has been to reach global best standards in a deliberately phased manner through a consultative process evolved within the country. This has also been the guiding principle in the approach to the New Basel Accord e.g. while the minimum capital adequacy requirement under the Basel standard is 8% in India, but it is stipulated and achieved a minimum capital of 9%. On the other hand, banks in India are still in the process of implementing capital charge for market risk prescribed in the Basel document.

Soon after the creation of the Basel Committee, its eleven member states (known as the G-10) began to discuss a formal standard to ensure the proper capitalization of internationally active banks. During the 1970s and 80s, some international banks were able to "skirt" regulatory authorities by exploiting the inherent geographical limits of national banking legislation. Moreover, internationally active banks also encouraged a regulatory "race to the bottom," where they would relocate to countries with less strict regulations. With the end of the petrodollar boom and the ensuing banking crises of the early 1980s, this desire for a common banking capitalization standard came to the forefront of the agendas of the Basel Committee's member states. Six years of deliberations followed; in July of 1988, the G-10 (plus Spain) came to a final agreement: The International Convergence of Capital Measurements and Capital Standards, known informally as "Basel I."

RBI's association with the Basel Committee on Banking Supervision dates back to 1997 as India was among the 16 non-member countries that were consulted in the drafting of the Basel Core Principles. Reserve Bank of India became a member of the Core Principles Liaison Group in 1998 and subsequently became a member of the Core Principles Working Group on Capital. Within the CPWG, RBI has been actively participating in the deliberations on the Accord and had the privilege to lead a group of 6 major non G -10 supervisors which presented a proposal on a simplified approach for Basel II to the Committee.

**BASEL I**

The Basel I Accord divides itself into four "pillars." The first, known as The Constituents of Capital, defines both what types of on-hand capital are counted as a bank's reserves and how much of each type of reserve capital a bank can hold. The accord divides capital reserves into two tiers. Capital in the first tier, known as "Tier 1 Capital," consists of only two types of funds—disclosed cash reserves and other capital paid for by the sale of bank equity, i.e. stock and preferred shares. Tier 2 Capital is a bit more ambiguously defined. This capital can include reserves created to cover potential loan losses, holdings of subordinated debt, hybrid debt/equity instrument holdings, and potential gains from the sale of assets purchased through the sale of bank stock. To follow the Basel Accord, banks must hold the same quantity (in dollar terms) of Tier 1 and Tier 2 capital. The second "pillar" of the Basel I Accord, Risk Weighting, creates a comprehensive system to risk weight a bank's assets, or in other words, its loan book. Five risk categories encompass all assets on a bank's balance sheet. The first category weights assets at 0%, effectively characterizing these assets as "riskless." Such "riskless" assets are defined by Basel I as cash held by a bank, sovereign debt held and funded in domestic currency, all OECD debt, and other claims on OECD central governments. The second risk category weights assets at 20%, showing that instruments in this category are of low risk. Securities in this category include multilateral development bank debt, bank debt created by banks incorporated in the OECD, non-OECD bank debt with a maturity of less than one year, cash items in collection, and loans guaranteed by OECD public sector entities. The third, "moderate risk" category only includes one type of asset—residential mortgages—and weights these assets at 50%. The fourth, "high risk" category is weighted at 100% of an asset's value, and includes a bank's claims on the private sector, non-OECD bank debt with a maturity of more than one year, claims on non-OECD dollar-denominated debt or Eurobonds, equity assets held by the bank, and all other assets. The fifth, "variable" category encompasses claims on domestic public sector entities, which can be valued at 0, 10, 20, or 50% depending on the central bank's discretion. The third "pillar," A Target Standard Ratio, unites the first and second pillars of the Basel I Accord. It sets a universal standard whereby 8% of a bank's risk-weighted assets must be covered by Tier 1 and Tier 2 capital reserves. Moreover, Tier 1 capital must cover 4% of a bank's risk-weighted assets. This ratio is seen as "minimally adequate" to protect against credit risk in deposit insurance-backed international banks in all Basel Committee member states. The fourth "pillar," Transitional and Implementing Agreements, sets the stage for the implementation of the Basel Accords. Each country's central bank is requested to create strong surveillance and enforcement mechanisms to ensure the Basel Accords are followed, and "transition weights" are given so that Basel Committee banks can adapt over a four-year period to the standards of the accord.

**BASEL II**

In response to the banking crises of the 1990s and the aforementioned criticisms of Basel I, the Basel Committee decided in 1999 to propose a new, more comprehensive capital adequacy accord. This accord, known formally as A Revised Framework on International Convergence of Capital Measurement and Capital Standards and informally as "Basel II" greatly expands the scope, technicality, and depth of the original Basel Accord. While maintaining the "pillar" framework of Basel I, each pillar is greatly expanded in Basel II to cover new approaches to credit risk, adapt to the securitization of bank assets, cover market, operational, and interest rate risk, and incorporate market based surveillance and regulation.

**Pillar I**

The first "pillar," known again as Minimum Capital Requirements, shows the greatest amount of expansion since Basel I. In response to Basel I's critics, Basel II creates a more sensitive measurement of a bank's risk-weighted assets and tries to eliminate the loopholes in Basel I that allow banks to take on additional risk while cosmetically assuaging to minimum capital adequacy requirements. Its first mandate is to broaden the scope of regulation to include assets of the holding company of an internationally active bank. This is done to avoid the risk that a bank will "hide" risk-taking by transferring its assets to other subsidiaries and also to incorporate the financial health of the entire firm in the calculation of capital requirements for its subsidiary bank.

**Pillars II and III**

Pillars II and III are much less complex and lengthy than Pillar I—they only occupy 40 of the 350 pages of the Basel II Accord. Pillar II primarily addresses regulator-bank interaction, extending the rights of the regulator in bank supervision and dissolution. Regulators are given the power to oversee the internal risk evaluation regimes proposed in Pillar I and change them to the simpler, more conservative "bucket-based" approaches if they deem a bank unable to manage its credit, market, and operational risks independently. Regulators can also review a bank's capital assessment policy when they see fit, and are given the mandate to hold senior management responsible if a bank misrepresents its risk positioning. Moreover, banks are charged with drafting their own risk profiles, and if this reporting is not done, authorities have the right to penalize the at-fault bank. Two additional mandates also widen the breath of regulator power in Basel II. Firstly, regulators are allowed to create a "buffer" capital requirement in addition to the minimum capital requirements as calculated in Pillar I if banks are seen to be "skirting" around the capital adequacy goals of the accord. Secondly, to avoid a repeat of the financial crises in countries like Korea and China, banking supervisors are urged to mandate early action if capital reserves fall below minimum levels and are given significant authority by way of Basel II's recommendations to prescribe rapid remedial action for banks in such a situation. Pillar III, looks to increase market discipline within a country's banking sector. In sum, disclosures of a bank's capital and risk-taking positions that were once only available to regulators are recommended to be released to the general public in the Basel II Accord. Statistics such as the aggregate amounts of surplus capital (both Tier 1 and Tier 2) held by a bank, risk-weighted capital adequacy ratios, reserve requirements for credit, market, and operational risk, and a full description (with assumptions) of the risk mitigation approaches of a bank are recommended for quarterly release to the general public under Basel II's standards. With this action, Basel II hopes to empower shareholders to enforce discipline in the risk-taking and reserve-holding methods of banks, where banks seen to hold too few reserves and take on too much risk are punished by their own shareholders for doing so.

**BASEL III**

The key elements of the proposed Basel III guidelines include the following:

1. Definition of capital made more stringent, capital buffers introduced and Loss absorptive capacity of Tier 1 and Tier 2 Capital instrument of Internationally active banks proposed to be enhanced
2. Forward looking provisioning prescribed
3. Modifications made in counterparty credit risk weights
4. New parameter of leverage ratio introduced
5. Global liquidity standard prescribed

The Basel committee is expected to finalise the Basel III guidelines by December 2010, following which a six year phase-in period beginning 2013 is likely to be prescribed. This note seeks to assess the impact of the proposed Basel III guidelines on Indian banks" capitalisation profile and their liquidity position till 2018. The impact of the suggested norms relating to forward looking provisioning and counterparty risk weights are not captured in this note, since for that more granular data would be required and these are not available currently in the public domain. The norms on "leverage ratio" and "net stable funding ratio" are also not discussed in this note as they are likely to be implemented not before 2019.

The Basel III guidelines aim to improve banking sector's ability to endure long periods of economic and financial stress by laying down more rigorous and stringent capital and liquidity requirements for them. These regulations have been framed to enhance the quality, consistency and transparency of the capital base and strengthening the risk coverage of the capital framework. The Reserve Bank expects all commercial banks in India to strengthen their existing risk management systems to adopt more advanced approaches of risk management being followed by developed countries. These norms aim to improve the banking sector's ability to induce long periods of economic and financial stress by laying down more rigorous and stringent capital and liquidity requirements for them. The new guidelines are aimed at enhancing the quality, consistency and transparency of the capital base and strengthening the risk coverage of the capital framework. We may conclude that the commercial banks in India are moving in the right direction under the watchful eyes of Reserve Bank of India for implementation of Basel III norms.

**Regulatory Capital Adequacy Levels—Proposed vs. Existing RBI Norm**

| | Proposed Basel III Norm | Existing RBI Norm |
|---|---|---|
| Common equity (after deductions) | 4.5% | 3.6% (9.2%) |
| Conservation buffer | 2.5% | Nil |
| Countercyclical buffer | 0-2.5% | Nil |
| Common equity + Conservation buffer + Countercyclical buffer | 7-9.5% | 3.6% (9.2%) |
| Tier I(including the buffer) | 8.5-11% | 6% (10%) |
| Total capital (including the buffers) | 10.5-13% | 9% (14.5%) |

Source: Basel committee documents, RBI, Basel II disclosure of various banks; Figures in parenthesis pertain to aggregated capital adequacy of banks covering over 95% of the total banking assets as on March 31, 2010.

**RBI Guidelines for Implementation of Basel III: An overview**

(a) Base III guidelines would become effective from January 1, 2013(now Postponed) in a phased manner. This means that as at the close of business on January 1, 2013(postponed), 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 31, 2018.

(b) 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;

(c) 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. Moreover, some other proposals viz. 'Definition of Capital Disclosure Requirements', 'Capitalisation of Bank Exposures to Central Counterparties' etc., are also engaging the attention of the Basel Committee at present. Therefore, the final proposals of the Basel Committee on these aspects will be considered for implementation, to the extent applicable, in future.

(d) For the financial year ending March 31, 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.

(e) 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 decided by Indian regulator as a matter of prudence. Thus, it requirement in this regard remained at the same level. However, banks will need to raise more money than under Basel II as several items are excluded under the new definition.

(f) of the above, Common Equity Tier 1 (CET 1) capital must be at least 5.5% of RWAs;

(g) 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 RWAs 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 been drawn down, the banks have to rebuild them through reduced discretionary distribution of earnings. This could include reducing dividend payments, share buybacks and staff bonus.

(h) 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;

(i) The new norms do not allow banks to use the consolidated capital of any insurance or non financial subsidiaries for calculating capital adequacy.

(j) 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 3 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.

(k) 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 many of their overseas counterparts.

(l) 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 by RBI only at a later stage.

**Major Changes Proposed in Basel III over earlier Accords (Basel I and Basel II)**

The following are the major changes proposed in Basel III Accords:

**(a) Better Capital Quality:** One of the key elements of Basel 3 is the introduction of 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.

**(b) Capital Conservation Buffer:** Another key feature of Basel III is that now 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.

**(c) Countercyclical Buffer:** This is also one of the key elements of Basel III. 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.

**(d) Minimum Common Equity and Tier 1 Capital Requirements:** 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.

**(e) Leverage Ratio:** A review of the financial crisis of 2008 has indicted that the value of many assets fell quicker than assumed from historical experience. Thus, now Basel III rules include a leverage ratio to serve as a safety net. A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis. 3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018.

**(f) Liquidity Ratios:** 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.

**(g) Systemically Important Financial Institutions (SIFI):** As part of the macro-prudential framework, systemically important banks will be expected to have loss-absorbing capability beyond the Basel III requirements. Options for implementation include capital surcharges, contingent capital and bail-in-debt.

**Conclusion:**

Implementation of Basel II has been described as a long journey rather than a destination by itself. Undoubtedly, it would require commitment of substantial capital and human resources on the part of both banks and the supervisors. RBI has followed a consultative process while implementing Basel II norms and move in a gradual, sequential and co-ordinated manner. As envisaged by the Basel Committee, the account-

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ing profession too, will make a positive contribution in this respect to make Indian banking system stronger. Basel III is a countercyclical capital requirement which can lead to an additional increase in the capital ratios under a declaration of "excessive credit growth." This could have a significant countercyclical impact on the developed countries' economies. This suggests that such a declaration should be closely coordinated with monetary policy decision-making.

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