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Implementation of Basel-II Accord in India

Implications for Banking Governance

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ABSTRACT

Basel II is the recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, in June 2004, is to create an international standard that banking regulators about how much capital banks need to put aside to guard against the types of financial and operational risks. Advocates of Basel II believe that such an international standard can help protect the international financial system from problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to setting up rigorous risk and capital management system. This requires the banker, to establish the mechanism to capital reserves, bank risk exposes, lending and investment practices. Generally speaking, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability. India is also not exempted from this risk because it agreed to implement the Basel-II by 2008. With this background the present study is an attempt to provide a prelude to the implementation norms of Basel Accord-II in India and its implication for the concomitant corporate governance policies of banking sector.

1. INTRODUCTION

During early 21st century, India witnessed an unprecedented economic growth phase. Since 1993-94, the country has not just managed to restore the higher growth that it had achieved in the 1980s but has sharply reduced the volatility in its GDP growth. This was made possible by the steady improvement in Indian economy. A steady improvement in macro economic performance of India and the strength of its banking system were not uncorrelated events. Banks in India have played a leading role in mobilizing savings, allocating capital, overseeing the investment decisions of firms, besides providing risk management vehicles. Bank credit has always been a dynamic instrument for the growth of India even during the post-economic liberalization. The process of providing banking services has changed rapidly from the traditional style of banking. The rapid pace of technological advancement and internationalization of banking services have opened many new frontiers for banks.

To fulfill the financial needs of a growing economy like India, banks have been undertaking increasingly complex financial operations (both in credit and trading), which are exposing them to several risks. In recognition of this trend, the RBI has been highlighting the importance of improved risk management practices since 1999. While liberalization has brought opportunities for banks to expand their business activities, it has also introduced new uncertainties and risks in their business operations. The measures like imposition of prudential norms, strengthening of supervisory system, liberalization of interest rate, new competitive environment etc, have brought significant changes in banks' attitude towards profitability, productivity and risk. Because of the changing competitive environment, the importance of improved efficiency has assumed a critical significance for the survival and sustained viability of commercial banks in India. In this changed global banking scenario, to get the competitive edge, Indian banks had to work hard to improve their efficiency at all levels of banking operations. Under these circumstances, implementation of Basel Accord in India is inevitable to strengthen the Indian banking industry at global level. Basel bound rules were framed in the Swiss town cased Basel-I in 1988 by

the Bank for International Settlements. It was adopted by the member countries by the end of 1992. An attempt is made in this article to illuminate the various aspects of Basel-I and Basel-II accord related issues in Indian context.

2. BASEL-I ACCORD (1988)

As stated earlier in 1988, the Basel Committee decided to introduce a capital measurement system. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with the active support of international banks. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by the end of 1992. Weightages were assigned by the committed for different categories of exposure of banks so that risky assets like unsecured commercial loans had a risk weight of 100% whereas risk free investment in sovereign paper carried zero percent risk weight.

3. NEED FOR IMPLEMENTING THE BASEL-I ACCORD

1. To make the capital requirement of banks more sensitive to their risk profiles.
2. To minimize disincentives to hold liquid and low risk assets.
3. To achieve greater consistency in bank capital adequacy throughout the world.

Capital was categorized as Tier-I representing equity and Tier-II consisting of supplementary capital such as sub-ordinate debt. This Basel-I framework was relatively simple to understand and implement. This is useful to maintain banking Institutions worldwide. Adopted the minimum capital adequacy standards improved their capitalization ratios. Our banking regulator RBI mandated a higher CRAR (capital risk weighted asset ratio) of 9% as against 8% suggested by Basel-I framework. Basel-I adopted a policy that does not distinguish between the differing risk profiles and risk management standards across banks. An effort has been on for nearly six years to rectify this drawback and come out with a new version. On June 26, 2004, the efforts fructified with the committee coming out with a final version of the revised accord, titled the "International convergence of capital measurement and capital standards". A revised framework is more popularly known as the new Basel Capital Accord /Basel- II.

4. BASEL-II ACCORD (2004)

Basel-II accord was introduced with the aim of correcting most of the deficiencies in Basel-I. The first version of Basel-II came out in 1999, followed by two other versions on 2001 and 2003. A revised framework was issued by the Basel Committee on banking supervision in June 2004. The revised framework has been designed to provide options for banks and banking system, for determining the capital requirement for credit risk and operational risk. It enables banks/supervisors to select approaches that are most appropriate for their operations and financial markets. The framework is expected to promote adoption of stronger risk management practices in banks.

The overarching goal for the Basel-II framework is to promote adequate capitalization of banks and to encourage improvements in risk management, thereby strengthening the stability of the financial system. This goal is accomplished through the introduction of "three pillars" that reinforce each other and that create incentives for banks to enhance the quality of their control processes. The first pillar represents a significant strengthening of the minimum requirements set out in the 1988 accord, while the second and third pillars represent innovative additions to capital supervision.

5. NEED FOR BASEL-II

Over the past 20 years, there have been several examples of banking crises that have threatened wider systemic damage. i.e.

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instance of Mexico, Latin American debt crises, East Asia's debt problems etc. The weaknesses of banking sector can result in huge economic losses involving sometimes massive costs of banking sector restructuring.

6. REGULATORY INITIATIVES TAKEN BY RBI

The following are regulatory initiatives taken by RBI in line with Basel-II

- Ensuring that banks have a suitable risk management framework oriented towards their requirement by the size and complexity of their business, risk philosophy, market perceptions and expected level of capital.
- Introduction of Risk Based Supervision (RBS) in 23 banks on a pilot basis.
- Encouraging banks to formalize their Capital Adequacy Assessment Program (CAAP) in alignment with their business plan and performance budgeting system.
- Enhancing the area of disclosure, so as to have greater transparency of the financial position and risk profile of the banks.
- Improving the level of corporate governance standards in banks
- Building capacity for ensuring the regulators' ability to identify and permit eligible banks for IRB (Integrated Risk Based/Advanced Measurement Approaches)

7. CHALLENGES TO IMPLEMENTING BASEL-II NORMS IN INDIA:

The following challenges are envisaged in the implementation of Basel-II norms in India:

- Implementation of the Basel-II Accord, especially the IRB approach, will be a major challenge, as banks will have to substantially upgrade their information systems, risk management systems as well as the technical skills of the staff.
- In terms of operational risk, the banks will have to prioritize risk control among different business lines. Given the complexities and data requirements, many banks will be compelled to use the Standardized Approach, which means that the capital charge for operational risk will only be an add-on to the overall capital.
- The issue of credit ratings has to be streamlined. Though there are few players in the credit rating arena in India, the credit ratings methodology used by these agencies need to be strengthened and applied universally.
- Basel-II allows the supervisor to prescribe higher minimum capital levels for bank interest rate in the banking book and concentration of risk exposures. RBI has already initiated action to identify these issues in banks.
- Issues of cross-border capital have to be sorted out and this will particularly affect foreign banks (currently foreign banks are statutorily required to maintain local capital)

8. SOME CRITICISM ON BASEL-II ACCORD

- There is a general criticism that the tightened norms may go against the interests of developing countries, small enterprises and infrastructure projects.
- Analysts feel that it may be too expensive for troubled Asian countries to recapitalize their banks to international standards.
- Theoretically higher capital adequacy will no doubt make banks sounder, but experience has shown that when trouble comes, 8 % or 10% or 12% can be absurdly low. The South East Asian banks, which suffered in the recent turmoil, were mostly well capitalized with CARs well above the required levels.

9. BASEL ACCORD AND INDIAN BANKS

Pillar-I is designed to ensure that banks shall maintain sufficient capital to cover their risks based on their systematic measurement. With the objective of giving

due consideration to the improvement and strengthening of a bank's risk management systems, should be logically reduced its capital requirement. The Basel-II Framework prescribed three principal approaches for estimating capital as given below: 1. Standard approach, 2. Foundation Internal Rating Based Approach (Foundation IRB), 3. Advanced Internal Rating Based Approach (Advanced IRB).

It is estimated that when Basel-II rules come into force by March 2007, Indian banks might have to raise their capital by as much as Rs 15000 crore to Rs 16000 crore. In the first week of March 2005, the RBI announced detailed draft guidelines on how banks have to implement the new rules, which determine how much capital banks have to set aside as a cushion against default on loans. The new rules come into effect only on 31 March 2004 but the effects are already being felt. According to RBI report (2004) that 14 banks are likely to hit the capital market to raise around Rs 4,390 crore in equity during 2004. A major reason for the rush is to comply with Basel-II. The Rating Agencies (ICRA) have estimated that the current capital requirement of Indian Banks stands at around Rs 11,922 crore to implement the Basel-II capital adequacy norms.

Table-I clearly shows the additional capital required by Indian banks to implement Basel-II capital adequacy norms. It is understood from the Table that SBI and its associate banks require Rs.3359.83 crores as additional capital to implement the Basel-II capital adequacy norms. It is equal to13.4% of their current capital adequacy ratio. In the case of nationalized banks, they require Rs.5041 crores as additional capital to implement these norms and it is nearly 13.1% of their current capital adequacy ratio. This is followed by private banks and foreign banks which require the amount of Rs.1645 crores and Rs.1043 crores respectively. Their CCA ratios are 13.7% and 15%. When comparing all scheduled commercial banks, they require huge additional capital to implement the Basel-II capital adequacy norms. In total, the amount comes to Rs.11088.83 crores as additional capital required by all scheduled and commercial banks to implement this capital adequacy norm which is 12.9%. With reference to CAR, the fall in CAR (in percentage) of SBI and its associates was 1.47, which is very high than all other group of banks. This is followed by nationalized banks (1.19), all scheduled commercial banks (1.14), foreign banks (1.09) and private banks (0.74).

Table-II depicts the capital to be raised by the 14 banks in equity to comply with Basel-II norms and IPO by the end of 2005. In overall comparison of all banks, Bank of Baroda raised the capital (Rs 1500 crores) through Initial Public Offering (IPO) followed by HDFC Bank (Rs 900 crores), Punjab National Bank (Rs 400 crores), Central Bank of India (Rs 400 crores), Central Bank of India (Rs 400 crores) and Indian Bank (Rs 300 crores) and Andhra Bank (Rs 140 crores). The bank which raised lowest amount (Rs 100 crores) through IPO is Bank of India. With reference to CAR, Bharath Overseas earned the highest ratio of (16.25) followed by Punjab National Bank (13.10), Bank of India (13.01), Indian Bank (12.82), Allahabad Bank (12.52), Central Bank of India (12.43), HDFC Bank (11.66), Syndicate Bank (11.49), Punjab & Sind Bank (11.06) and Dena Bank (9.48).

10. PREPAREDNESS OF INDIAN BANKS

In India different banks are at different stages of implementation vis-à-vis the accord. Big banks like ICICI, HDFC, IDBI, UTI have the necessary IT Infrastructure, however, most of the banks including some of the big banks in India find gaps in data management. Indian banks have got some breathing space with RBI

Table-1

Additional Capital Requirements by Indian Banks to implement Basel-II Capital Adequacy Norms

S. No.	Name of the Banks	Additional capital required under Basel-II (Rs in crore)*	Current capital adequacy ratio (%)	Fall in CAR (%)
1	SBI and its associates	3,359.83	13.4	1.47
2	Nationalized banks	5041.00	13.1	1.19
3	Private banks	1645.00	13.7	0.74
4	Foreign banks	1043.00	15.0	1.09
5	All scheduled commercial banks	11088.33	12.9	1.14

* Operational risk only **Source:** Capital and CAR data from RBI

extending the deadline to adopt international capital norms. In mid term review of monetary policy 2006, the deadline date for implementation for the new framework has been stretched by two years in view of the preparedness of Indian banks. A recent survey conducted jointly by IBA and Aptiva Consulting provides insights into the Indian Banks' readiness for implementation of Basel II. Major outcome of the survey is summarized below:

- Basel II compliance requires segregation of credit portfolio into various segments i.e. corporate exposure, Retail Exposures, Bank exposures, Sovereign Exposure Equity exposures.
- 63% banks have indicated their ability to segregate the portfolio entirely. Remaining 37% are not clear on equity exposures and retail exposures
- 58% of the banks are not able to classify corporate portfolio under Multilateral Development exposure & Public Sector Enterprise exposure.
- Only 58% of the respondents are able to segregate Retail portfolio and identify Mortgage & Commercial Real estate upfront.
- 58% of banks are not geared for segregation of Corporate Portfolio at the Standardized Approach (SA) level.
- 42% are not geared for segregation of retail portfolio at Standardized Approach level.
- 12% banks use all the risk mitigation techniques possible and presumably do use credit derivatives

Table-2

The Capital to be raised by 14 banks in equity to comply with Basel-II Norms

S.No	Name of the Bank	CAR	IPO Size Rs (Crore)
1	Dena Bank	9.48	200
2	Punjab & Sind Bank	11.06	150
3	Syndicate Bank	11.49	200
4	HDFC Bank	11.66	900
5	Central Bank of India	12.43	400
6	Allahabad Bank	12.52	100
7	Indian Bank	12.82	300
8	Bank of India	13.01	100
9	Punjab National Bank	13.10	400
10	Andhra Bank	13.71	140
11	Bank of Baroda	13.91	1500
12	DCB	14.26	N.A
13	Bharath Overseas	16.25	N.A
14	YES Bank	-----	-----

Source: Prime Database

Note: 1. Data for YES Bank not available, 2. CAR: Capital adequacy Ratio, 3. IPO: Initial Public Offering

- 88% do not currently use all risk mitigation technique and none of these use credit derivatives.
- For generation of data relating to PD,LGD and EAD rating methodologies should be clear. It is found that 57% banks are equipped to provide PD estimates,17% banks with LGD and EAD estimates, 26% could provide maturity data.
- 65% of the banks have gone into implementation mode of operational risk management without a preceding planning exercise.
- 47% of the banks are finding difficulty in assessing and reporting operational risk

loss data, 39% are finding difficulty in accessing operational risk expertise and 33% are finding difficulty in modeling of operational risk.

- 70% of the banks lack understanding of correct technique for identification, assessment, monitoring and control of operational risk.
- 43% of the banks see the lack of operational risk governance structure.
- With regard to the responsibility of implementation of the Accord it is found that in 43% banks the risk management department holds primary and sole responsibility of implementation, in 29% banks RMD holds responsibility but has a dedicated project team for Basel II and in only one bank there is there is BU level team for Basel implementation.
- 73% of the banks see business gap analysis as a bottleneck for implementation of the accord, 50% of the banks have identified data requirement for PD analysis as a significant obstacle, 40% of the banks see cost of compliance and 25 % banks inadequate IT infrastructure as obstacle for implementation
- It is observed that there is a complete absence of budgeting process in planning this implementation across banks. This leaves question of measuring timeliness and cost effectiveness of implementation.

Thus overall findings of the survey show that many of the level of detail issues have not been completely grasped. Their needs to be awareness of complexity of issues relating to collateral, regulatory retail portfolio, SME. The lack of proper understanding directs to midstream course corrections and system redesign that could be expensive and time-consuming process.

11. CONCLUSION

Basel-II norms provide a timely opportunity for Indian banks to raise their standards of banking practice to international level. However, in order to lesser the burden on the system, Reserve Bank of India would do well to adopt a gradual approach. Basel-II races towards its deadline and member countries including India, cannot hope to adopt the new norms unless they are able to "hunch and bend" their banking systems to suit the norms. Policy makers need to negotiate strongly for the interest of emerging economies in every possible international forum on regulation. We cannot afford to forget the basic fact that Basel-II can be effectively implemented only if our economy and markets have strong fundamentals.

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