Impact of BASEL III on India

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Abstract.The Basel Committee on Banking Supervision (BCBS) set the first of capital accords in 1988, called the Basel I. Due to the dynamic changes in the world of financial system Basel I gave way to Basel II. Basel II plagued with the problem of pro-cyclicality paved the way for Basel III. India adopted Basel III norms in 2012. The present paper studies the impact of Basel III on India. In the short run, it will lead to a reduction in profitability of banks, curtailed credit to the economy and it is accused of being a needless burden on the Indian banks. But in the longer run, it will keep India integrated with the rest of the world. It will make the Indian financial system stronger, more stable and sound. It boils down to a trade-off between short-term costs and long run growth benefits.

Key Words: Basel I, Basel II, Basel III, impact on India, BCBS

1. Introduction

With the support of the Bank for International Settlements (BIS), Basel, Switzerland, The Basel Committee on Banking Supervision (BCBS) came into force in 1974. The G-10 countries that consisted of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States took this initiative. These countries suffered serious losses in the foreign exchange market after the failure of the Franklin National Bank in New York and Herstatt Bank in Germany. Thus, the Basel Committee has found itself working on improving the bank supervision at an international level since its establishment. The committee regulates the monetary and financial cooperation between central bankers. It has played a pivotal role in developing the capital standards for banks around the world. The Mexican debt crisis of 1982 led to the formation of guidelines for measuring and assessing the capital adequacy of internationally operational banks by the Basel Committee in 1987. Thus an agreement was formed known as Basel I, which settled on 8% risk –weighted value of the assets as the minimum regulatory capital for banks. Basel III norms are a revision of Basel II norms, which are in turn a revision of Basel I norms. In order to understand the relevance of Basel III norms, it is thus essential to understand first the basics of both Basel I & II norms.

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2. What Is Basel I?

Basel I Capital Accord was introduced in 1988. The general agenda for these norms was to strengthen the stability of international banking system. It basically played the role of setting capital adequacy requirements for big financial institutions. Basel I assesses the capital requirements of the banks in order to protect them from credit risk. The Basel Committee identified many other risks as well such as investment risk, interest rate risk, exchange rate risk, concentration risk and country transfer risk. The main focus was on the credit risk. The capital adequacy ratio (or CAR) is defined as "the percentage of a bank's capital to its assets, with assets weighted according to their relative riskiness" (Francis 2006).

The capital was divided in two parts: Tier 1 and Tier 2. Tier 1 capital includes the bank's core capital in shareholders' equity and published or disclosed reserves. Tier 2 capital includes the supplementary capital such as undisclosed reserves, general loan loss reserve, subordinated term debt instruments. The banks total assets must comprise of at least 50% Tier 1 capital. The assets' riskiness was weighed according to 5 weights: 0,10,20,50 and 100%. All the assets were categorized in line with these weights. The Basel 1 Capital Accord, although not legally binding was ratified by countries other than the G-10 as well.

After Basel 1, the world saw an influx of financial innovations. This was majorly due to globalization and financial liberalization. The Basel 1 norms were not entirely able to cope up with the changed scenario. The capital was unregulated and allowed to move freely around the globe. What followed was a series of financial crisis in 1990s. Basel 1's simplistic regulations were unable to cope up with the changing needs of the banking system. Thus, a new set of norms was needed. Basel 1 gave way to Basel II.

3. Transition towards Basel-II Accord

Basel-II Accord paved its way in June 2004. India enforced it in 2006. Its aim was to remove the shortcomings of the Basel I capital accord. The general purpose of these norms was prudential regulations. It followed a more risk sensitive approach and capital requirements capable of meeting up with the advancements of financial instruments. Jaime Caruana, Former Chairman of Basel Committee said "Basel II is not intended simply to ensure compliance with a new set of capital rules. Rather, it is intended to enhance the quality of risk management and

supervision." Basel II stands on 3 pillars namely: minimum capital requirements, supervisory review and market discipline.

Pillar 1 has three major components, which are: credit risk, operational risk and market risk. Different approaches are followed to calculate these. The capital requirement remained constant at 8% of risk-weighted asset. Tier 1 capital was still required to form at least 50% of the banks' total capital. ***Pillar 2*** supervises the response of the banks given the framework of pillar 1. It also provides the necessary tools to deal with various other risks faced by the banks like systemic risk, liquidity risk, legal risk etc. ***Pillar 3*** enhances the risk disclosure to create some discipline in the market. The banks are supposed to make public disclosures; which helps to assess their capital adequacy requirements. It promotes greater transparency.

The shortfall of the Basel II was that is inherently pro-cyclic in nature. The internal ratings-based system that depends on market indicators further magnifies this problem. What this means is that; in good times, there were no additional capital requirements on the banks. But in the bad times, when nobody was interested in investing in the banks, there were significant additional capital requirements according to Basel II. This is the precisely the accused reason of the 2008 financial crisis. Moreover, Basel II neglected the systemic risk (risk to the whole system) in favor of individual financial institutions. The failures of Basel II norms during the crisis led to the introduction of Basel III norms.

4 Basel III- The Way Ahead?

The Basel III norms were introduced in 2010 to fix up the gaps left by the Basel II norms. In India, these norms were adopted in 2012. They were to be implemented from January 1, 2013 to March 31, 2018. Basel III builds up on the framework of Basel II, hence retaining the essence of the latter. The third Basel Accord augments the level and quality of capital, introduces liquidity standards, modifies provisioning norms, makes better and more detailed disclosures. The minimum capital requirement is still an eight per cent of the risk-weighted assets. But over and above the minimum capital requirement, Basel III norms introduce a capital conservation buffer of 2.5% of the risk-weighted assets. This effectively raises the capital requirement to 10.5% from the previous level of 8%. The buffer is put in place so that the banks can take in some of the losses when the market is not good, without violating the minimum capital adequacy requirement. As noticed in the earlier section, one of the biggest problems with Basel II was its

pro-cyclic nature. To remedy this particular shortcoming, Basel III establishes the countercyclical capital buffer which is in the range of 0-2.5% of the risk-weighted assets. Table 1 shows the difference between capital requirements under Basel I and II. The Basel Committee is also suggesting that the banks should move from the 'incurred loss' approach to 'expected loss' approach, in order to make financial reporting useful. Further to make things transparent, the disclosure requirements under Basel III, ask the banks to disclose all the necessary details. Again, this is an improvement over Basel II.

TABLE 1: Capital Requirements under Basel II and III

	As a percentage of risk weighted assets	
	Basel II	**Basel III (as on January 1, 2019)**
Minimum Total Capital	8.0	8.0
Minimum Tier 1 of which: Minimum Common Equity Tier 1 Capital	4.0 2.0	6.0 4.5
Maximum Tier 2 Capital (with Total capital)	4.0	2.0
Capital Conservation Buffer (CCB)	-	2.5
Minimum Common Equity Tier I Capital + CCB	2.0	7.0
Minimum Total Capital + CCB	8.0	10.5

Source: RBI Monthly Bulletin October 2012

Most of the Indian banks already meet with the capital requirements of Basel III. What also needs to be taken into account is that India is a developing country which would anyway require higher additional capital as it moves to greater industrialization. But the question arises how India will be able to raise such a significant amount of capital without selling its stakes to foreign investors. Basel III norms were expected to lower down the profitability of the banks in the short run. The then Governor of Reserve bank of India said in an interview, "Implementation of Basel III is expected to result in a decline in Indian banks' Roe [return on equity] in the short term". The banks will have to face additional cost of capital. Nevertheless, it is also true that the Indian financial system can be expected to reap benefits in the longer run, thanks to the more stable and relatively less risky banking system. It is upon the banks to make themselves more efficient and not let their profitability comedown by much in the medium to long run.

We also need to address the impact of Basel III on Indian economy growth. India would need to invest significantly on infrastructure needs, which require an increased need for credit. We are also moving towards an era of financial inclusion, which will bring together crores of

poor families under the formal financial net. All of this would result in an increase need for credit. This is in contradiction with the Basel III norms that impose higher capital requirements on banks. As a result, there might be an increase in the cost of credit as demand would be significantly higher than supply. Consequently, at a time of increasing credit demand, this would work against the growth objective.

So far we have seen that Basel III will hurt the growth and profitability of banks. Costs seem to be greater than benefits. Critiques of Basel III have pointed out that the third of the capital accords does not make much sense for India. The reason cited is that these norms were made as corrective measures for the big banks of more developed countries, which failed during the time of the crisis. They took advantage of the regulatory gaps, risked too much thinking that they are too big to fail. On the other hand, Indian banks remained financially sound throughout the crisis time. Also, none of the Indian banks are on the list of globally systemically important banks (G-SIBs). Thus, there is no need to adopt the Basel III norms in India and unnecessarily burden the banks.

The proponents argue that the opponents are being too shortsighted. While the former agree that there will be short-run costs, they believe that the in the longer run the benefits will far outweigh these costs. In the era of global harmonization of rules, India can’t isolate itself. If we look from the point of view of global competition, the perception of lower regulations, throws Indian banks into negative light. Moreover, Basel III norms provide strong risk management techniques. Sooner, the Indian financial system adapts to it, the better it is for the overall health of our financial system in the coming time.

5. Conclusion

The Basel Committee on Banking Supervision got its name from the city Basel of Switzerland where this initiative was first developed. The Committee set the first of capital accords in 1988, called the Basel I. Due to the dynamic changes in the world of financial system Basel I gave way to Basel II. Basel II was plagued with the problem of pro-cyclicality. Moreover, Basel II neglected the systemic risk (risk to the whole system) in favor of individual financial institutions. The failures of Basel II norms during the crisis led to the introduction of Basel III norms. India adopted Basel III norms in 2012. There is no doubt that in the short term there are costs associated with the adoption of Basel III in India. It will lead to a reduction in

profitability of banks, curtailed credit to the economy and it is accused of being a needless burden on the Indian banks. But in the longer run, it will keep India integrated with the rest of the world. It will make the Indian financial system stronger, more stable and sound. It boils down to a trade-off between short-term costs and long run growth benefits.

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