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Progress of Indian Banks towards Compliance of Regulatory Capital Standards under Basel III Framework

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Abstract: It is incredibly significant that banks remain financially healthy as they are mainstay of every country's economy. Otherwise, a financial crisis can hit a country leading to recession like the United States (US) in 2008. *Banks are functioning in the process of financial intermediation and dealing with various kinds of financial and non-financial risks. Economic crisis in the last decade have sturdily influenced the banks to concentrate on their business risk management. Banks have been moving towards the use of sophisticated models for measuring and managing risks.* The Basel III structure, whose main objective is to augment the banking sector's safety and stability and signifies the need to improve the quality and quantity of capital components, leverage ratio, and liquidity standards. Reserve Bank of India (RBI) had issued guidelines for Indian banks based on Basel III framework developed by Basel Committee on Banking Supervision (BCBS). The RBI has stipulated that Indian banks should reach the regulatory capital standard as mentioned in Basel III accords by the end of March 2019. In this context the present paper is an endeavor to study the Basel III regime in India, its impact and progress of compliance of Indian banks towards Basel III guidelines issued by RBI.

Keywords: Indian banking, Banking Risks, Regulatory capital, Basel III norms.

1. Introduction:

Banking business primarily a treaty of pooling public money in the form of deposits and employ the same to meet the credit needs of business world. In banking process banking assets are created as a practice of intermediation by accepting deposits and sanctioning loans. The basic function of intermediation itself is a source of credit and liquidity risks for any banking institution. These risks expose banks to incur both expected and unexpected losses, putting depositors' money at risk. Expected losses may be mitigated by a combination of product pricing and accounting loss provisions, while capital funds are likely to meet unexpected losses. Thus the primary role of capital in a banking institution is to meet the unexpected losses arising out of portfolio choice of banks and to protect the depositor's money. Risk management is a significant function of today banks' management. Global banking crisis in the recent years has strongly prejudiced, and the risk management is given increased importance in the total banking management. Credit risk is most dominant risk in the banks worldwide. Liquidity, market, operational and other risks are also prevailing more in today's banking. Similar circumstances are upsetting the banking sector in India banks, regulatory bodies and other involved institutions are meticulously functioning to resolve all these issues. Strategy for the risk management is gaining noteworthy changes and progress in the recent years.

Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision (BCBS) in response to the global financial crisis of 2007-09. BCBS has released the Basel III framework entitled "Basel III: A Global Regulatory Framework for more Resilient Banks and Banking systems" in December 2010. According to the BCBS, the Basel III framework have introduced with two main objectives such as

- To strengthen the global capital and liquidity regulations with the goal of promoting more resilient banking sector.
- To improve the banking sector's ability to absorb shocks arising from financial and economic stress.

Basel III regime is not a revolution but it is an evolution of former Basel I and Basel II standards, to tackle with the mounting risks in recent years in the banking sector and also to ensure banks are better able to absorb losses on both a going concern and a gone concern basis. Basel III framework is designed to strengthen the regulation, supervision and risk management of banks. Also aimed to Increase the risk coverage of the capital, introduction of leverage ratio to serve as a backstop to the risk-based capital measure, raise the standards for the supervisory review process and public disclosures etc. The Basel III framework is based three main standards viz. 1. Minimum Capital and Liquidity Requirements (Pillar 1) 2. Supervisory Review Process for Risk Management and Capital Planning (Pillar 2) 3. Risk Disclosure and Market Discipline (Pillar 3).

2. Objectives of the study:

- To study the RBI guidelines based on Basel III structure for risk management in banking.
- To examine the impact of Basel III norms on Indian Banking.
- To assess the progress of compliance of Indian banks towards Basel III guidelines issued by RBI.

3. Research Methodology:

The present paper is based on the extensive research for which the secondary source of information has gathered. The sources include online publications of RBI, Indian Banks and other financial agencies, various committees' reports, journals and websites etc.

4. Basel III in India

Reserve Bank of India (RBI) has issued guidelines based on the Basel III accords on banks' capital regulation on May 2, 2012, to the scope applicable to all banks working in India. The Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it will be fully implemented by March 31, 2019. In order to ensure smooth migration to Basel III norms without any stress on banks RBI has made transitional arrangements. Ensuring the banking sector's safety and stability and strengthening capital regulation of banks is the prime thrust of Basel III guidelines. The four significant facets addressed by Basel III are:

- Augmentation in the level and quality of regulatory capital
- Introduction of liquidity standards
- Modifications in provisioning norms and
- Introduction of leverage ratios

For the purpose of improving the quality and quantity of regulatory capital and to ensure the Indian banks more resilient to absorb the shocks of financial crisis, RBI had stipulated that the major form of Tier 1 capital must be Common equity which is significant that banks' risk exposures are backed by high quality capital base. As per Basel III guidelines, total regulatory capital shall consist of the sum of the following categories (figure 1).

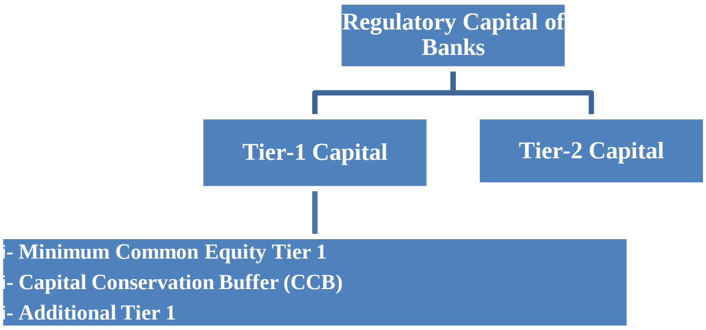

Figure 1: Composition of Regulatory capital of Banks as per Basel III framework

According to RBI and with full implementation of capital ratios and Capital Conservation Buffer (CCB) the regulatory capital requirements are summarized in the following table.

Basel III Regulatory Capital Requirements

Sl.No	Regulatory Capital	As % to Risk Weighted Assets (RWA)
1	Minimum common equity Tier 1 Ratio	5.5
2	Capital conservation buffer (comprised of common equity)	2.5
3	Minimum common equity Tier 1 Ratio plus Capital conservation buffer (1+2)	8.0
4	Additional Tier 1 Capital	1.5
5	Minimum Tier 1 capital ratio (1+4)	7.0
6	Tier 2 Capital	2.0
7	Minimum Total Capital (MTC) ratio (5+6)	9.0
8	Minimum total capital plus capital conservation buffer (7+2)	**11.5**

(Source: Basel III guidelines issued by RBI.)

The Common Equity component of Tier1 capital shall comprise of paid-up equity capital, share premium, statutory reserves, other free reserves and surplus of previous year if any, subject to the regulatory adjustments or deductions.

- The Additional Tier 1 capital shall consists of perpetual non-cumulative preference shares and its share premium, debt capital instruments and any other instruments as prescribed by RBI for inclusion in this Additional Tier 1 capital, subject to the regulatory adjustments or deductions.
- The Tier 2 capital shall comprises of general provisions and loss reserves, debt capital instruments, preference share capital and its share premium, any other instruments notified by RBI and subject to regulatory adjustments or deductions.
- The regulatory adjustments or deductions shall includes Goodwill and other intangible assets, Deferred tax assets, cash flow hedge reserves, shortfall of provisions to expected losses, investments in own shares, investment in capital of banking or insurance entities.
- According to Basel III, banks have to follow Disclosure Requirements to improve transparency of regulating capital reporting. They have to disclose (a) reconciliation of all regulatory capital elements back to the audited balance sheet (b) separate disclosure of all regulatory adjustments (c) description of all limits and minima identifying positive and negative elements of capital (d) description of the main features of capital instruments issued.
- RBI stipulates every bank to have a sound process for identifying, measuring and mitigating liquidity risk. Banks have been advised to maintain some regulatory limits in order to satisfy the liquidity standards under Basel III framework.
  - i) Inter Bank Liability limit is extended up to 300% of the net worth (earlier it was 200%) for the bank whose Capital to Risk-weighted Assets Ratio (CRAR) is at least 25% as on March 31st of the previous year.
  - ii) Call Money Borrowing limit is enhanced up to 125% of their capital funds on any day, during a fortnight. However, banks are allowed to lend Call Money up to 50% of their capital funds on any day, during a fortnight.
- RBI has introduced the two minimum standards for funding liquidity in accordance with Basel Committee 1. Liquidity Coverage Ratio (LCR) for short term resilience of banks 2.Net Stable Funding Ratio (NSFR) for long term resilience of banks.
- RBI has stated that a bank should have sufficient collateral, it is expected that every bank should have proper systems and procedures to calculate all of its collateral positions in a timely manner.
- A bank should develop and adopt an intraday liquidity strategy concerned with monitoring and measuring expected daily gross liquidity inflows and outflows, for making arrangements for sufficient intraday funds.
- Under Basel III, a simple, transparent, non-risk based leverage ratio has been introduced. The leverage ratio is calibrated to act as a credible supplementary measure to the risk based capital requirements. The numerator of the leverage ratio consists of high quality capital; the denominator includes both on-balance sheet and off-balance sheet assets. The Basel III leverage ratio framework follows the same scope of regulatory consolidation as used for the risk-based capital framework. RBI has stipulated 4.5 % as leverage ratio to be followed by banks in India.

5. Impact of Basel III framework on Indian Banking

The Basel III capital standards may have positive impact on Indian banks as they results in maintenance of regulatory capital requirements and augment banks' ability to core capital in the incident of financial stress conservation capital buffer. On the other hand stipulated liquidity requirements help the banks to maintain uniform liquidity standards and manage the liquidity crisis effectively. Nevertheless implementation of most cost-effective model of Basel III may be throbbing issue for Indian Banks.

5.1 Impact on Financial System

Under the Basel III regime banks have to comply with the regulatory capital, liquidity buffers, inter banks liability limits and other stipulations, this will results in reduction of systemic risks and effective management of risks emanating due to counter party defaults, liquidity stress, contagion risks among banks during the times of financial crisis. Undeniably, implementation of Basel III would strengthen the Indian Banking sector's capacity to absorb shock arising from financial and economic crisis, and reduce the risk of spillovers from the financial sector to the real economy.

5.2 Increased regulations

RBI and other regulatory bodies have the closer observations on banks regarding the compliance of Basel III norms and there would be increased supervisory wakeups on the banking operations in terms of capital standards, liquidity ratios, liquidity coverage ratios, net stable funding ratios and others.

5.3 Reorganization of Banks

As a result of increased focus of the regulatory bodies on the organizational structure, capital structure and capability of banks; weaker banks would opt for reorganize their legal identity by means of mergers, acquisitions, disposal of portfolios and entities wherever possible.

5.4 Stress on weaker banks

Compliance of Basel III standards is very challenging to weaker banks; it is very difficult to raise required capital and funds in the presence of competition from large financial institutions.

5.5 International arbitrage

In the case of inconsistent implementation of Basel III structure among various countries across the globe, results in international arbitrages and global financial stability might disrupt.

5.6 Impact on capital requirements

RBI has proposed the overall capital adequacy ratio at 11.5 %, also leverage ratio has been introduced at 4.5 % under Basel III framework. The Government of India estimated that extra capital required for the period 2016-19 is Rs. 180000 crore. The Government of India proposed to make available Rs. 70000 crore out of budgetary allocations during the above period, remaining Rs.110000 crore is proposed to be raised from market.

5.7 Impact on profitability

Basel III adversely affects the Return on Equity (RoE) due to increase in the capital base, however shareholders' value does not effect. The leverage ratio limits the banks to grow their business on the basis of external debt. Higher leverage ratio leads to decrease in profitability of the banks as it can do less profitable lending operations, but it results in increase of financial stability.

5.8 Operational issues

The public sector banks are required to improve their risk management system and supervision to comply with Basel III norms. The improved efficiencies of public sector banks will also increase their value which will enable them to raise equity from capital markets.

6. Progress of Basel III Compliance in India

The implementation of Basel III regime given by RBI in India have made in phases, by the end of 31st March, 2019 all Indian banks are required to comply with the standards in terms of maintenance of regulatory capital, liquidity and leverage ratios. In this context the progress of compliance of Basel III guidelines by Indian banks regarding regulatory capital requirements is assessed and presented in the following table.

Regulatory Capital of Indian Banks as per Basel III guidelines issued by RBI

(Rs. In Millions)

S. No	Name of the Bank	Total Risk Weighted Assets (RWAs)	Regulatory Capital as % to RWAs	Regulatory Capital
Select Public Sector Banks				
1	SBI Group	13452259.64	12.71	1709782.20
2	Allahabad Bank	1289063.36	10.89	140379.00
3	Bank of Maharashtra*	765080.47	10.14	77586.81
4	Andhra Bank*	1393123.82	11.04	153800.87
5	Bank of India*	2498154.26	12.09	302026.85
6	Canara Bank*	3601692.37	13.10	471821.70

7	Central Bank of India*	1804521.74	8.05	145264.00
8	Punjab National	3409796.18	10.21	348140.19
9	Corporation Bank	1286345.11	11.04	142012.50
10	IDBI*	2134779.61	8.18	174646.32
11	Indian Bank*	1198207.54	13.00	155766.98
12	Indian Overseas	138766.67	7.98	11073.58
13	Oriental Bank of	150688.60	10.35	15596.27
14	Syndicate Bank*	1569459.38	11.84	185823.99
Select Private Sector Banks				
1	Axis Bank	3233374.54	16.18	523160.00
2	HDFC	6139391.02	16.93	1039398.90
3	ICICI	4748671.92	17.13	813447.50
4	Indus Ind Bank*	1222969.19	14.28	174640.00
5	Kotak Mahindra Bank	1426084.66	17.60	250990.90
6	Yes Bank	1968158.28	16.30	320809.80
7	Citi Union Bank	280133.69	15.11	42328.20
8	Dhanalakshmi Bank	40484.46	14.16	5732.60
9	Federal Bank	619008.56	13.43	83132.85

(Source: Compiled from Basel III disclosures of select Indian Banks)

(Regulatory capital as on 30th September 2018, remaining data as on 31st December2018)*

- RBI has envisaged full implementation of Basel III capital regulations in India by March 31, 2019.Maintenance of regulatory capital requirements under the Basel III regime has been a challenging task for the Public Sector Banks (PSBs), only five banks have crossed the target percentage of 11.5 and the other banks have failed to build their capital requirements.
- Government of India announced in October 2017 recapitalization of PSBs 2,11,000 crore over the coming financial years comprising of capital infusion by the Government of Rs. 1,53,139 crore and the balance through raising of capital by PSBs.
- Indian Bank is far better and has buildup regulatory capital Rs. 155766.98 millions which is 13 percent of total Risk Weighted Assets (RWAs) of Rs. 1198207.54millions.
- Indian Overseas Bank is far away from maintenance of regulatory capital as stipulated by RBI, its regulatory capital stood at Rs. 11073.58 millions at 7.98 per cent of total RWAs Rs. 138766.67 millions.
- All Indian private sector banks have accomplished the Basel III regulatory capital targets well in advance to the time limit. Kotak Mahindra Bank has buildup regulatory capital of Rs. 250990.9 millions at 17.6 per cent of total RWAs of Rs.1426084.66 millions, superior than all other private sector banks.
- Among private sector banks, Federal Banks has buildup regulatory capital of Rs. 83132.85 millions at 13.43 per cent of total RWAs Rs. 619008.56 millions, last in the list of private sector banks India.
- As a backstop to the risk-based capital measure, the RBI had introduced the leverage ratio prescribing a benchmark of 4.5 per cent. Private sector banks are maintaining prescribed leverage ratio but majority of public sector banks are failed to maintain targeted leverage ratio.
- As per the RBI report (June 2018) on Financial Institutions' soundness and resilience, Using their High Quality Liquid Assets (HQLAs) required for meeting day-to-day liquidity requirements, 78% of banks will remain resilient in a scenario of assumed sudden and unexpected withdrawals of around 12 per cent of their deposits along with the utilization of 75 per cent of their committed credit lines.

7. Conclusion

Basel III framework aimed to construct robust capital base for banks and ensure sound liquidity and leverage ratios to ride out any banking crises in future and thereby guarantee the financial stability. Almost all public sector banks had fall short in compliance of Basel III guidelines issued by RBI even the stipulated transitional period will close in few months, the Government of India have injected fresh capital in to some public sector banks but they are struggling to comply with guidelines due to mounting NPAs in the recent two years. While private sector banks are better in compliance of Basel III guidelines and they remain resilient. RBI suggested that banks have to review and evaluates the various components of the banks' liquidity risk management process. These reviews should assess the extent to which the bank's liquidity risk management complies with the regulatory or supervisory instructions as well as its own policy, so that necessary improvements can be made to the present risk management process of banks.

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