e-Resources Module-VIII

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BASEL-III FRAMEWORK FOR BANK CAPITAL REGULATION

Despite the existence of Basel Committee on Banking Supervision at the international level and Basel-I followed by Basel-II norms on bank capital regulation prescribed by it, the North Atlantic Financial crisis or U.S. sub-prime lending crisis had erupted in 2008. Learning from the shortfalls of Basel-II norms, the Basel-III standards emerged at the global level largely as an improvement rather than negation of Basel-II. These improvements pertained to bringing in even more stringent capital requirements, introducing liquidity standards, modifying provisioning norms and mandating more comprehensive disclosures on the part of commercial banks. In order to incorporate Indian fiscal year and in the interest of financial prudence, the Reserve Bank of India preponed the implementation schedule of Basel-III in India and tried to bring in even more stringent norms of capital regulation for Indian banks vis-à-vis global standards. On closer examination we find that the potential benefits of Basel-III far outweigh its expected costs in the case of Indian economy and Basel-III could be instrumental in effectively integrating Indian financial markets with global financial markets.

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Despite the existence of Basel Committee on Banking Supervision at the international level and Basel-I followed by Basel-II norms on bank capital regulation prescribed by it, the North Atlantic Financial crisis or U.S. sub-prime lending crisis had erupted in 2008. In view of the experience of U.S. sub-prime lending crisis and alleged shortcomings of Basel-II, it became imperative to lay emphasis on somehow strengthening the safety and stability of banking sector in the post-crisis era. It was against this backdrop that Basel-III Committee was constituted as an *enhancement rather than negation* of Basel-II. That is to say, improving upon and bridging the gaps of Basel-II was the topmost agenda of policy reforms suggested by the Basel-III Committee on bank capital regulation.

At the International level, the Basel-III guidelines were to be implemented between January 1, 2013 to December 31, 2018. But in the case of Indian economy, the Reserve Bank of India (RBI) issued guidelines whereby the Basel-III guidelines were to be implemented in India between the period January 1, 2013 to March 31, 2018. This preponement of the end date was largely governed by the Indian fiscal year that ends on 31st March every year and instead of postponing the end date to March 31, 2019, it was found preferable to prepone it otherwise it would have gone beyond the prescribed schedule of Basel-III thereby attracting negative attention.

It must further be pointed out that in comparison to global norms set by the Basel-III, the RBI has stipulated more stringent norms for capital regulation of Indian Banks. This is well in line with its past practice during Basel-I & Basel-II regimes as it tends to offset the shortfalls in meeting international norms on account of *judgemental errors* thereby contributing to financial prudence.

The main areas of advancement in Basel-III over Basel-II pertain to not only the level of *capital*, but also *leverage*, *liquidity standards* as well as *provisioning and disclosure norms*. More specifically, as per Basel-III norms, over and above the basic minimum capital requirement of 8% of Risk Weighted Assets (RWA), the banks have to maintain a “Capital Conservation Buffer” of 2.5% of RWA. This provision is aimed at ensuring that banks carry on their business smoothly even in the face of a downturn. As the Reserve Bank of India has prescribed a more stringent basic minimum capital of 9% of RWA for Indian Banks, it directly follows that banks in India are required to maintain a total capital requirement of 9%+2.5% or 11.5% of RWA.

Further, Basel-III prescribes that during periods of excess credit growth, an additional capital buffer in the form of “Countercyclical Capital Buffer” in the range of 0 to 2.5% of RWA can also be imposed on banks. This is required for the *safety and soundness* of banking as the higher level of capital built during good times could eventually be fruitfully utilised in the face of economic downturns.

In addition, as per the provisions of Basel-III, there is a higher *capital surcharge* in the case of Systemically Important Banks. The latter refer to banks that acquire “systemic importance” owing to their large scale of operation. In case, the systemic importance of a bank in an economy is confined to the domestic level alone, it is called a Domestic-Systemically Important Bank or D-SIB. If, however, the bank under consideration is big enough to acquire systemic importance at the Global level, then it is referred to as a Global-Systemically Important Bank or simply G-SIB. It has been empirically observed that quite a few such G-SIBs are prone to indulging in risky behaviour under the misplaced belief that they are “too-big-to-fail”. Evidently, with a view to avoiding this type of “moral hazard” on the part of G-SIBs, it was absolutely essential to prescribe more stringent norms of capital requirement for such institutions.

As far as mitigating the risk of excessive “*leverage*” being built by banks is concerned, the Basel-III instituted a leverage ratio of 3 per cent *i.e.*, 33.3 times. The Reserve Bank of India (RBI) went a step further by prescribing an even higher leverage ratio of 4.5 per cent or 22.22 times for Indian Banks.

Likewise, with a view to mitigating *liquidity risk*, Basel-III mandated that banks shall maintain Liquidity Coverage Ratio (LCR) in the short-term and Net Stable Funding Ratio (NSFR) in the long-term.

As regards *provisioning*, Basel-III has advocated norms based on “expected loss” rather than “incurred loss” since provisioning based on expected loss is relatively less procyclical and hence can be reasonably expected to be more useful for all the stakeholders concerned. Moreover, Basel-III has prescribed more stringent norms for the banks on their *disclosures* relating to risky exposures and regulatory capital.

There is no denying the fact that the imposition of Basel-III norms on Indian banks as modified and made more stringent by the Reserve Bank of India (RBI) will impose some costs in the short-term. But D. Subbarao, the former Governor of RBI, is of the firm view that all these costs will be far outweighed by the potential benefits of Basel-III in India as reflected by a far *stronger*, *stable*, *sound* and *profitable* banking system emerging from it that could in turn deliver true value to the real sector of the Indian economy.

Given that the implementation of Basel-III framework for bank capital regulation at the international level involves a review by “peer group” whose findings will be made public, the strict adherence to Basel-III norms or even more stringent standards on the part of Indian banks as prescribed by RBI is likely to put Indian banks at an “advantage” in global competition and can be reasonably expected to go a long way in effectively integrating Indian financial markets with global financial markets.