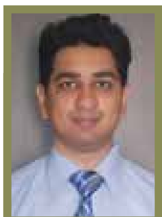
# Roadmap to Basel III Accord

*The banking sector's role is unquestionably crucial in the financial intermediation process and thus achieves sustainable improvement and faster economic growth. Round about 40 % of the gross national savings are deployed in the bank deposits, thus making the banking system's role very important for the credit source. Though, with the rise in the capital market and deregulation of the interest rates, the bank's market risk assets' exposure has tremendously gone up. The lack of sufficient capital to take up the market risk is visible through instability in the assets of the market and therefore can more highlight the issues faced by the banking sector. The present global financial crisis found its grounds in the constant overlooking of risk along with weakening of the equity capital. The author in this article maps the roadmap to Basel III Accord, which is both opportunity as well as challenge for the banks in India. Read on...*

Basel III Accord has been proposed by the Basel Committee on Banking Supervision (BCBS) and the policy makers in order to strengthen the firmness of the financial system and also to make certain that the financial institution upholds the adequate capital buffers and protect the economy from any negative impact in the future.

Basel 3 or Basel III comes third in the chain of Basel Accords. The task of these accords is to handle the risk management characteristic for the banking sector/industry. Basel III can be rightly said as the global regulatory standard, *i.e.* it has been agreed by the BCBS on the matter of liquidity risk, stress testing and bank capital adequacy. As compared to Basel III, Basel I and Basel II which were the previous version of the same are less stringent.

Basel III as per the BCBS is a complete set of development measures that has been developed by the BCBS in order to toughen the risk management, supervision and regulation of the banking sector. In the year 2008, when the whole world was under the dilemma of financial crisis, Basel III was specifically designed in order to deal with the weaknesses that were cropping up that time. During that period, the BCBS was seen putting more efforts in preparing the banking sector for any economic decline in future. This structure



**CA. Gautam Gupta**

(The author is a a member of the Institute, who may be contacted at gautamguptagg@yahoo.co.in).

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improves measures related to bank and also take into consideration the macro-prudential regulations, in order to create a more constant and established banking sector.

In short, it can be rightly said that the Basel III is just the continuous efforts initiated by the BCBS in order to improve the framework of the banking regulatory under the previous accords, *i.e.* Basel I and Basel II. This most up-to-date Accord, *i.e.* Basel III, now works on improving the ability of the banking sector in order to improve risk management, building up the transparency of the bank and also to deal with the economic and financial stress.

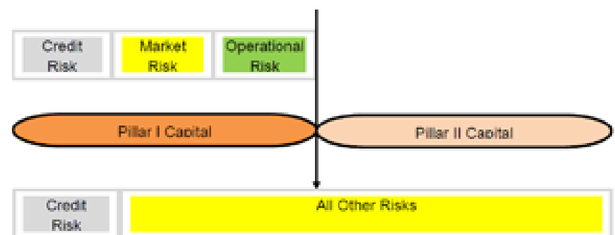
## Paradigm Move from Basel I to Basel II and Eventually to Basel III

Paradigm move from Basel I to Basel II was; Basel I use to work on 'one-size-fits-all' approach whereas Basel II put more focus on risk sensitive capital regulation. The second series of the Basel Accord, *i.e.* Basel II, was proposed to build international standards for the banking regulators to organise or manage how much capital or funds should banks kept aside so that they can safeguard themselves and the economy from any type of operational and financial risks. At the same time, the Basel II also focuses on the ways to keep up the adequate stability or constancy of regulations so that the above said does not happen to be a cause of competitive disparity or inequality amongst the banks those are internationally active. Advocates or the believers of Basel II have a belief that these high international standards could, up to a great extent, protect or guard the international financial system from many different sorts of problems that may arise if any major or a series of banks gets collapsed. The approach that was used by Basel II was "three pillars" approach and those three pillars are: *minimum regulatory capital requirements* (Addressing Risk), *supervisory review and market discipline.*

## Three Pillar Approach

### First Pillar

The first pillar, *i.e. minimum regulatory capital requirements,* is based on risk weighted assets (RWAs) that deals with the upholding of regulatory capital that is computed for three key components of risk that has to be faced by the banks and those three components are: *market risk, operational risk* and credit risk. All these three risks are computed with the help of the approach, which are sufficient and appropriate for the individual banks, is illustrated:




For the calculation of the requirement of the capital for the credit risk, Basel II has initiated three possible potential approaches. These three approaches are:

1) Foundation Internal Rating Based
2) Standardised Approach (Externally Set)risk weights
3) Advanced Internal Rating Based

In *Foundation Internal Ratings- Based Approach,* the banks developed their own experimental model to estimate the probability of default (PD) for either group of clients or individual clients. Only after the approval or authorisation from the local regulators, banks can use this particular approach. Under F-IRB, the banks are requisite to make use of regulator's approved LGD (loss given default) and other factors that are required for computing the RWA (risk weighted assets). It is only then that the overall required capital is computed as a fixed percentage of the estimated RWA.

In the *Standardised Approach,* the banks are required to use ratings from external credit rating agencies to compute requisite capital for credit risk. In many of the countries standardised approach is the only approach that the regulators have planned to give consent in the preliminary phase of implementation of Basel II.

In Advanced *Internal Ratings-Based Approach,* in order to calculate or compute the PD, LGD, EAD (exposure at default) and other factors that are used by the banks to compute their RWA; banks use

their own quantitative model. Only after all this the required capital is computed as a fixed percentage of the estimated RWA.

**Second Pillar**
The second pillar, *i.e. supervisory review process,* necessitates the banks to have measures or the procedures for the assurance and evaluation of an ample and sufficient capitalisation in relation to the risk profile along with the strategy relating to the maintenance of the level of own resources or funds which is also known as Internal Capital Adequacy Assessment Process (ICAAP).

**Third Pillar**
The third pillar *i.e. market discipline,* intends to complement or harmonise the first pillar and the second pillar *i.e.* the minimum capital requirements and supervisory review process respectively by developing or making a set of disclosure necessities or requirements which will give the go ahead to the participants in the market to estimate the institution's capital adequacy. Enhanced or the better disclosures on the components detail of the regulatory capital and also their settlement or reconciliation are required as they include the complete or the comprehensive clarification of how does a bank computes all their regulatory capital ratios.

The financial world, in spite of the successful implementation or execution of Basel I and Basel II guidelines, saw one of the worst crises in the year 2008 because of which the whole financial markets fall down tremendously. Out of the major falls, the fall of Lehman Brothers was the most devastating of them all. There was one interesting comment on the Lehman Brothers' balance sheet: *Whatever was on the left-hand side (liabilities) was not right and whatever was on the right-hand side (assets) was not left.* Therefore, it became all the more mandatory to have a look on the Basel II again and search for the hidden loopholes and also to make Basel norms much more severe, stringent, stern and wider in scope.

## Key Changes Projected in Basel III over Basel I and Basel II

**(a)** ***Better Capital Quality:*** In Basel III, altogether a new and a stricter capital definition is defined. By better capital quality, they mean it will have high capacity of loss-absorbing. All this will make the banks quite stronger and also help them to survive in the worst environment.

**(b)** ***Capital Conservation Buffer:*** Another feature that was projected in Basel III is that the banks can now hold up to 2.5% of capital conservation buffer. The reason for holding up this much percentage of buffers is to make sure that the banks can put a cushion against themselves in order to absorb or take up the losses during the time of economic and financial stress.

**(c)** ***Countercyclical Buffer:*** Countercyclical Buffer is also one of the important components of Basel III. This component was introduced with the intention to boost the requirement of the capital during the good times and slow down the same during the bad times. Buffer helps in slowing down the activities of the bank when it started overheating and encourage lending in tough times. The countercyclical Buffer range from 0% to 2.5% and consists of either loss absorbing capital or common equity.

**(d)** ***Tier 1 Capital Requirement and Minimum Common Equity:*** The least prerequisite for common equity also known as the uppermost type of loss-absorbing capital has been gone up under the Basel III accord from somewhere around 2% to 4% of total RWA, *i.e.* risk-weighted assets. The whole of Tier 1 capital requirement consist of not only the common equity but also includes many other financial instruments which also will go up from 4% to 6%. Even though the least total capital requirement will still stay at 8% only, however the required total capital will raised to 10.5% when it will be pooled with the Conservation Buffer.

**(e)** ***Leverage Ratio:*** Basel III also projected the minimum Leverage Ratio. This ratio can be computed by dividing the capital of the Tier 1 by the average total consolidated assets of the Banks. Leverage ratio in surplus of 3% has to be maintained by the banks.

**Leverage Ratio**

$$\frac{\text{Tier 1 Capital}}{\text{Exposure}} \geq 3\%$$

**(f)** ***Liquidity Coverage Ratios:*** This Ratio makes it mandatory for banks to hold enough high-quality liquid assets in order to cover up their net cash outflows over the period of 30 days.

$$\text{Liquidity Coverage Ratio} = \frac{\text{Stock of High Quality Liquid Assets}}{\text{Net Cash Outflows over the next 30 calendar days}} \geq 100\%$$

(Institutions or banks have to make sure that they should be having enough high quality liquid assets with them in order to survive or stay alive during the sensitive stress situation that last for 30 days).

The net stable funding ratio (NSFR) was to necessitate the accessible amount of constant funding to surpass the requisite amount of constant funding over a period of one year of the total extended stress.

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

The NSFR is designed to give confidence and incentivise the banks to make use of constant sources in order to finance their activities. At the time of better market liquidity, the NFSR reduces the reliance on short term funding and at the same time promotes the better liquidity risk' assessment across the balance sheet items. The NSFR needs a least amount of constant fund source at a bank that is relative to the liquidity profiles of the banks' assets along with the possible contingent liquidity needs that arises from commitments from off-balance sheet over a period of one year.

The new LCR (liquidity coverage ratio) and the NSFR are to be commenced in the year 2015 and in the year 2018 respectively.

(g) ***Systemically Important Financial Institutions (SIFI):*** As a component of the macro-prudential framework or the structure, systemically key banks will be projected to have loss-absorbing ability beyond the requirement of the Basel III. Options for the execution include bail-in-debt, contingent capital and capital surcharges.

**Basel III Transitional Arrangements**

The Basel III Capital Regulations that is issued by the RBI (Reserve Bank of India), the CCB (capital conservation buffer) is scheduled to be put into practice from 31st March, 2015 in parts and will be completely executed by 31st March, 2018. It has been determined that the execution of CCB will be commenced on 31st March, 2016. Therefore, the Basel III Capital Regulations will be completely executed by 31st March, 2019. The transitional or the halfway arrangements as shown in the Paragraph 4.5 of Master Circular (Ref. Circular DBOD. No. BP.BC.102/21.06.201/2013-14 dated 27th March, 2014—Implementation of Basel III Capital Regulations in India—Capital Planning) is illustrated:

**Transitional Arrangements-Scheduled Commercial Banks (excluding LABs and RRBs)**

(% of RWAs)

| Minimum capital ratios | April 1, 2013 | March 31, 2014 | March 31, 2015 | March 31, 2016 | March 31, 2017 | March 31, 2018 | March 31,2019 |
|---|---|---|---|---|---|---|---|
| Minimum Common Equity Tier 1 (CET1) | 4.5 | 5 | 5.5 | 5.5 | 5.5 | 5.5 | 5.5 |
| Capital conservation buffer (CCB) | - | - | - | 0.625 | 1.25 | 1.875 | 2.5 |
| Minimum CET1+ CCB | 4.5 | 5 | 5.5 | 6.125 | 6.75 | 7.375 | 8 |
| Minimum Tier 1 capital | 6 | 6.5 | 7 | 7 | 7 | 7 | 7 |
| Minimum Total Capital' | 9 | 9 | 9 | 9 | 9 | 9 | 9 |
| Minimum Total Capital +CCB | 9 | 9 | 9 | 9.625 | 10.25 | 10.875 | 11.5 |
| | | | | | | | |
| Phase-in of all deductions from CET1(in %) | 20 | 40 | 60 | 80 | 100 | 100 | 100 |

The difference between the minimum total capital requirement of 9% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital;
# The same transition approach will apply to deductions from Additional Tier 1 and Tier 2 capital.

### How Basel III Requirements will Affect Indian Banks?

It will be the challenging or the difficult task not just for the banks but along with that also for the Government of India to implement the Basel III in accordance to the guidelines or course of action directed by the RBI. Capital expansion to this level will have an influence on the Bank's equity returns mainly the public sector banks. According to the Finance Ministry Budget 2014, PSU banks will be required to raise ₹2.40 lakh crore capital by 2018 to meet the Basel III norms.

In order to meet the new norms or customs, only the Government support is not enough instead support from many other banks are required in order to raise the requisite capital from the market. All this will boost the interest rate and as a result of which cost of capital will increase and the RoE (return on equity) will decrease. To compensate or to pay off this RoE loss, banks may end up pushing up their lending charges. Nevertheless, all this will have a direct unfavorable influence on the demand for loan and on the interest income as well. Additionally, with effectual capital rising cost, the relative stillness shown by the banks in India in relation to lift up the fresh capital is also assume to have directly affected the credit offtake in the years to come. The above said things have a great impact on the bank's profitability. However, only support for Indian banks is the reality or fact that in the past they have preserved their overall capital and foundation very well in surplus of the regulatory minimum.

**Comparison of Capital Requirements under Basel II and Basel III :**

| | Basel II | Basel III |
|---|---|---|
| Minimum Ratio of Total Capital To RWAs | 8% | 10.5% |
| Minimum Ratio of Common Equity to RWAs | 2% | 4.5% |
| Tier I capital to RWAs | 4% | 6% |
| Core Tier I capital to RWAs | 2% | 5% |
| Capital Conservation Buffers to RWAs | None | 2.50% |
| Leverage Ratio (Tier 1 capital to Exposure) | None | 3.00% |
| Countercyclical Buffer | None | 0% to 2.50% |
| Minimum Liquidity Coverage Ratio (HQLA to net cash outflows over 30 days horizon) | None | 100% |
| Minimum Net Stable Funding Ratio (Available to Required Stable funding) | None | 100% |

### Conclusion

For the banks, it has to be undoubtedly clear that the Basel III is the evolution or growth for them rather than the revolution. Basel III is the enhancement of Basel II framework as Basel III has introduced leverage and liquidity ratios for the banks and also enhanced minimum capital requirements. Basel III helps in providing a justifiable timeline for the implementation and that is very much acceptable in the Indian scenario as it has been seen that the banks of India are quite well positioned for the smoother and proper implementation of new and better standards.

Although the successful execution of Basel III will reveal to the stakeholders that the Indian banks are quite well placed or positioned, a speedy execution will lead to add to the competitiveness of the bank by conveying improved management insight into the industry, facilitating it to take strategic and competitive advantage of the possible future opportunities.

Apart from the raised capital standards, one of the major considerable challenges faced by Basel III is of generating a new or fresh risk management culture with a better firmness, accountability and responsibility. As a result, Basel III has changed the way the banks look at their functions of risk management and may imply them to go for a vigorous risk management framework to make sure a true venture risk management. From the regulator's point of view, it requires Reserve Bank of India to be more practical, and stringent in terms of regulatory supervision scrutiny.

So as to attain improved risk management and to fulfill with the revised regulatory reporting necessities, the risk management individuals would need quick and immediate access to value data that is spotless and precise. All this would need data flow management systems in tune with the growing practices of risk management. Successful systems of data management are not going to be economical as they involve major costs in their maintenance, upgradation and acquisition,

Basel III proves to be both the opportunity as well as the challenge for the banks in India as it provides a solid base or foundation for financially sound banking. The opportunity or prospects comes in the shape of redesigning of the risk management framework, choice of technology architecture and attaining new capital for efficient risk reporting as well as risk management. The major challenge is for the regulator and the bank management to successfully implement the new and fresh standards as per the recommended timelines and also to win over the stakeholders. ■