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BASEL III - IMPLEMENTATION OF CAPITAL FRAMEWORK IN INDIAN BANKS

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ABSTRACT

The purpose of this paper is to describe a theoretical model for banking regulation in relation to Basel accords implementation. As a risk manager practitioner at a financial institution and in-charge of Basel implementation in a Basel accords environment of banking regulation, the author has been intrigued by the theoretical basis of the design of Basel accords. The objective is to provide the Capital requirement, transition stage and guidelines by RBI for Indian Banks.

Keywords: *Basel III, Conceptual Framework, Banking Regulation.*

Introduction

The Basel Committee - initially named the Committee on Banking Regulations and Supervisory Practices - was established by the central bank Governors of the Group of Ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets (notably the failure of Bankhaus Herstatt in West Germany). The Committee, headquartered at the Bank for International Settlements in Basel, was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters. Since its inception, the Basel Committee has expanded its membership from the G10 to 45 institutions from 28 jurisdictions. Starting with the Basel Concordat, first issued in 1975 and revised several times since, the Committee has established a series of international standards for bank regulation, most notably its landmark publications of the accords on capital adequacy which are commonly known as Basel I, Basel II and, most recently, Basel III.

Basel III is the third installment in the regulatory framework designed by the BCBS to strengthen the banking sector. The continuous efforts to reduce the risks associated with the financial sector are further developed from the Basel I and II framework. Hence, the regulatory measures aim is to improve the ability to absorb shocks from the financial and economic stress. This will be accomplished through improving the risk management and governance, as well as by strengthening the banks' transparency and disclosures. The regulatory framework is complex and consists of the same three pillars as Basel II with a few additional requirements and enhancements. Pillar I consists of minimum capital requirements and liquidity requirements, and will again be the focus as they demonstrate the capital strength of the bank. Through these requirements, the Basel III regulation aims to strengthen the banking sector by raising both the quality and quantity of the regulatory capital base, as well as by raising additional adequate capital buffers.

Objectives of Basel III Accord

Basel III is a set of international banking regulations developed by the Bank for International Settlements in order to promote stability in the international financial system. The purpose of Basel III is to reduce the ability of banks to damage the economy by taking on excess risk. With that in mind, banks must hold more capital against their assets, thereby decreasing the size of their balance sheets and their ability to leverage themselves. While these regulations were under discussion prior to the financial crisis, their necessity is magnified as more recent events occur.

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Basel III Accord Capital Adequacy Requirements

As a response to the aftermath of global financial crisis (GFC), with a view to improving the quality and quantity of regulatory capital, RBI has stated that the predominant form of Tier I capital must be common equity; as it is critical that banks' risk exposures are backed by high quality capital base. As a result, under Basel III guidelines, total regulatory capital will consist of the sum of the following categories:

- Tier 1 Capital (going-concern capital)
  - Common Equity Tier 1
  - Additional Tier 1
- Tier 2 Capital (gone-concern capital)

Furthermore, in addition to the minimum Common Equity Tier I capital of 5.5% of RWAs, banks are also required to maintain a capital conservation buffer (CCB) of 2.5% of RWAs in the form of common equity Tier I capital. Consequently, with full implementation of capital ratios[62] and CCB the capital requirements are summarized in table- 1 here below:

Table 1: Regulatory Capital requirements in India as per Basel III

S. No.	Regulatory Capital	As % to RWAs
(i)	Minimum common equity Tier I ratio	5.5
(ii)	Capital conservation buffer (comprised of common equity)	2.5
(iii)	Minimum common equity Tier I ratio plus capital conservation buffer [(i)+(ii)]	8.0
(iv)	Additional Tier 1 capital	1.5
(v)	Minimum Tier 1 capital ratio [(i) +(iv)]	7.0
(vi)	Tier 2 capital	2.0
(vii)	Minimum total capital ratio (MTC) [(v)+(vi)]	9.0
(viii)	Minimum total capital ratio plus capital conservation buffer [(vii)+(ii)]	11.5

Table 2: Regulatory Capital Ratios in the year 2018

(i)	Common Equity Tier 1	7.5% of RWAs
(ii)	Capital conservation buffer	2.5% of RWAs
(iii)	Total CET 1	10% of RWAs
(iv)	PNCPSa/PDIb	3.0% of RWAs
(v)	PNCPS/PDI eligible for Tier 1 capital	2.05% of RWAs {(1.5/5.5) ×
		7.5% of CET 1}
(vi)	PNCPS/PDI not eligible for Tier 1 capital	0.95% of RWAs(3-2.05)
(vii)	Eligible Total Tier 1 capital	9.55% of RWAs
(viii)	Tier 2 issued by the bank	2.5% of RWAs
(viii)	Tier 2 capital eligible for CRAR	2.73% of RWAs
		{(2/5.5) × 7.5 %
		of CET 1}
(ix)	PNCPS/PDI eligible for Tier 2 capital	0.23% of RWAs (2.73 – 0.23)
(x)	PNCPS/PDI not eligible for Tier 2 capital	0.72% of RWAs (0.95 – 0.23)
(xi)	Total available capital	15.50%
(xii)	Total capital	4.78% (12.28%
		+ 2.5%)(CET1–
		10% + AT1–
		2.05% + Tier 2–
		2.73)

Transitional Arrangement

The capital ratios and deductions from common equity will be fully phased-in and implemented as on March 31, 2017. The phase-in arrangements for banks operating in India are indicated in the following Table-3

Table 3: Basel III: Transitional Arrangements - Scheduled Commercial Banks in India (Excluding LABs and RRBs)

(% of RWAs)

Minimum Capital Ratios	**March**	**March**	**March**	**March**	**March**	**March**
	2013	2014	2015	2016	2017	2018
Minimum Common Equity Tier 1(CET1)	4.5	5.0	5.5	5.5	5.5	5.5
Capital conservation buffer (CCB)			0.625	1.25	1.875	2.5
Minimum Capital Ratios	**March**	**March**	**March**	**March**	**March**	**March**
	2013	**2014**	**2015**	**2016**	**2017**	**2018**
Minimum CET1+ CCB	4.5	5.0	6.125	6.75	7.375	8.0
Minimum Tier 1 capital	6.0	6.5	7.0	7.0	7.0	7.0
Minimum Total Capital*	9.0	9.0	9.0	9.0	9.0	9.0
Minimum Total Capital +CCB	9.0	9.0	9.625	10.25	10.875	11.5
Phase-in of all deductions fromCET1 (in %)	20	40	60	80	100	100

Source: RBI Basel III Guidelines

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.

It is clarified that capital instruments, which no longer qualify as non-common equity, Tier I capital or Tier II capital (e.g. Tier 2 debt instruments with step-ups) will be phased out beginning January 1, 2013. Fixing the base at the nominal amount of such instruments outstanding on January 1, 2013, their recognition will be capped at 90% from January 1, 2013, with the cap reducing by 10 %age points in each subsequent year. This cap is applicable to Additional Tier 1 and Tier 2 instruments separately and refers to the total amount of instruments outstanding, which no longer meet the relevant entry criteria. To the extent, an instrument is redeemed, or its recognition in capital is amortised, after January 1, 2013, the nominal amount serving as the base is not reduced. The minimum capital conservation ratios a bank must meet at various levels of the common equity Tier I capital ratios.

Table 4: Minimum capital conservation standards for individual bank

Common Equity Tier I Ratio	**Minimum Capital Conservation Ratios (expressed as a percentage of earnings)**
5.5% - 6.125%	100%
>6.125% - 6.75%	80%
>6.75% - 7.375%	60%
>7.375% - 8.0%	40%
>8.0%	0%

The countercyclical capital buffer is aimed at ensuring that banking sector capital requirements take account of the macro-financial environment in which banks operate. The buffer will be implemented through an extension of the CCB and vary between zero and 2.5% of RWAs, depending on the extent of the build-up of system-wide risks.

Leverage Ratio

The Basel Committee will test a minimum tier 1 leverage ratio of 3% during the parallel run period from 1 January 2013 to 1 January 2017. During the period of parallel run, banks should strive to maintain their existing level of leverage ratio but, in no case the leverage ratio should fall below 4.5% as per RBI guidelines. Final leverage ratio requirement would be prescribed by RBI after the parallel run taking into account the prescriptions given by the Basel Committee.

Liquidity Risk Measurement

Basel 3 has introduced two new liquidity standards to improve the resilience of banks to liquidity shocks. In the short-term, banks will be required to maintain a buffer of highly liquid securities measured by the LCR. The standard requires that the ratio be no lower than 100%. The objective of the NSFR is to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. The standard requires that the ratio be no lower than 100%.

RBI Guidelines: For Indian Banks on Basel III

Reserve Bank of India in response to the comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" of the Basel Committee on Banking Supervision (BCBS) issued guideline for Indian Banks in December 2010.

The major highlights of the draft guidelines are:

Minimum Capital Requirements

- Common Equity Tier 1 (CET1) capital must be at least 5.5% of risk-weighted assets (RWAs);
- Tier 1 capital must be at least 7% of RWAs; and
- Total capital must be at least 9% of RWAs.

Capital Conservation Buffer

- The capital conservation buffer in the form of Common Equity of 2.5% of RWAs.

Transitional Arrangements

- It is proposed that the implementation period of minimum capital requirements and deductions from Common Equity will begin from January 1, 2013 and be fully implemented as on 1 January 2022.
- Capital conservation buffer requirement is proposed to be implemented between March 31, 2014 and March 31, 2019.
- The implementation schedule indicated above will be finalized taking into account the feedback received on these guidelines.
- Instruments which no longer qualify as regulatory capital instruments will be phased-out during the period beginning from January 1, 2013 to March 31, 2022.

Conclusion

An attempt has been made to brief about the conceptual framework of Basel accord and the steps taken by RBI for Indian Banks to implement the Basel norms. However the banks are meeting the minimum capital requirement but still there is lot of challenges for Public and Private Sector Banks in order to infuse the additional capital in the system also, to mitigate the credit, market and operational risk.

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