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Basel III Compliance: The Present Scenario in India

Aliza Haider

Research Scholar, Department of Commerce,
Aligarh Muslim University
E-mail: ahalizahaider@gmail.com

Abstract—*In the era of globalization, there is more exposure to risk as banks are expanding and opening their branches abroad. Banks vulnerability to risk has lead to the need of efforts towards bringing stability and strength in banking industry. At the international level, Basel Committee on Banking Supervision (BCBS) lays down guidelines to protect banks operating worldwide from failure. After Basel I and Basel II, the committee introduced Basel III in December, 2010 as a measure to protect financial sector from turmoil. The main constituents of the framework include better quality of capital, high liquidity standards, leverage ratio, capital buffers, improved supervision and risk management. Indian banking industry has followed the earlier norms and now it is progressing to fulfil the latest Basel III requirements. The transition from Basel II to Basel III in India started in April 1, 2013 and banks are directed to comply with full standards by March 31, 2019. The present study highlights the progress in Basel III implementation and the challenges for Indian banks. It also aims to assess the Capital to Risk-Weighted Assets Ratio (CRAR) maintained by Scheduled Commercial Banks (SCBs) in India under compliance to Basel III framework and founds that all bank groups are maintaining CRAR and Tier I ratios above the required level.*

Keywords*: Basel III, CRAR, Indian Banks, Compliance Process.*

1. INTRODUCTION

The financial sector reforms of 1991 focused on competition, prudential regulations and brought a thorough change in the Indian banking industry. Banks in India and abroad are having better technology and resources but at the same time they are exposed to higher risks, this has aroused the need for stabilizing and strengthening the banking system. Basel Committee on Banking Supervision (BCBS) established towards the end of 1974 took the step towards framing guidelines and laying international standards to protect the banks operating worldwide from failure. The first initiative in this direction was Basel I Accord which presented a framework of capital requirements and tried establishing uniformity in capital standards across countries but failed to discriminate among different types of risks. In order to cater to the need, BCBS designed a more detailed and flexible framework that is, Basel II. It rests on three pillars namely, minimum capital requirement, supervisory review process and market discipline [1]. The financial crisis of 2008 which started with the collapse of Lehman brothers brought to notice the drawbacks in Basel II framework and in order to deal with this issue, the requirement of a stronger reform package aroused. Basel III alleviates risks by enhancing the robustness and efficiency of the banking industry.

2. OBJECTIVES OF THE STUDY

- To know the concept of Basel III and its implementation status in India.
- The Capital to Risk-Weighted Assets Ratio (CRAR) maintained under Basel III by Scheduled Commercial Banks (SCBs).

3. REVIEW OF LITERATURE

Jain (n.d.) studied Basel III implementation in Public Sector Banks (PSBs) in India and found that banks have enough time for smooth transition towards the new framework but the compliance with the standard would make credit expensive and reduce profitability of banks. Sarmah & Bharadwaz (2017) studied the literature related to Basel III implementation in India. It summed up that Indian banks are having high CRAR and Private Sector Banks (PVBs) are in a better position than PSBs. Banks should pay attention to risk management and implementation of the framework should be moderate so as not to interrupt with the banking system. Santhi (2014) analysed the readiness of PSBs in India to maintain the minimum capital requirements based on risk weighted assets. It is concluded that PSBs should keep a check on their capital, liquidity and leverage to ensure smooth performance. Mallya (2012) elaborated about all set of Basel norms and the implications of Basel III in Indian banking sector. The study concluded that while adopting the Basel III framework, banks will find it difficult to meet the growing credit needs of the economy.

4. NEED FOR BASEL III

After the global crisis of 2008, it was realized that there is need to further strengthen the financial system. Basel III guidelines proposed in December 2010 aims at building up the ability of banks to absorb shocks arising from economic and financial stress and thus, reducing the spillover effect from the financial sector to the real economy [3]. Before Basel III came into existence the banks in developed countries were overleveraged, undercapitalized and dependent on short term funding. The capital under Basel II was also not enough to handle additional risks and this gave way to Basel III which lays emphasis on capital, leverage, funding and liquidity [7]. Indian banks operate abroad and foreign banks also conduct their business in India. In such a scenario non-compliance or incomplete adherence with the global regulatory standards will bring problems to the banks [2]. The underlying principle behind adoption of Basel III is that our economy is open and banks operating worldwide are vulnerable to unfavourable conditions. Though, Indian financial system is not prone to crisis but Basel III will give banks the resilience they need.

Basel III aims at increasing the resilience of banks in times of stress and seeks to increase the level of capital to make banks absorb losses, increase risk coverage, bring in leverage ratio and lift the standards for supervisory review process and market disclosures. Basel III introduces capital conservation buffer and countercyclical buffer to save banks in times of excessive credit growth [5].

5. IMPLEMENTATION OF BASEL III

The three pillars in Basel II namely, minimum capital requirements, supervisory review process, and market discipline continue to be a part of Basel III regulations as well with some modifications. The approaches used for calculating capital for credit risk are Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. For calculating capital for operational risk the approaches are Basic Indicator Approach, The Standardised Approach and Advanced Measurement Approach. These approaches depend upon risk sensitivity and banks choose the option that fits best into its state of development. To have uniformity with the international standards it was put forward in 2007 that banks in India should follow Standardised Approach for credit risk, Basic Indicator Approach for operational risk and Standardised Duration Approach for market risk [5].

Banks were advised to make an internal assessment to find out whether they are equipped to move towards advanced approaches or not and after the Boards approval the approach is applied accordingly. Banks can adopt advanced approaches in the risk category they are prepared for with prior approval of Reserve Bank of India (RBI) and can carry with simpler approaches in other categories for which they are not prepared [5]. Liquidity Coverage Ratio (LCR) was introduced in India from January 1, 2015and will be fully effective by January 1, 2019. The central bank has also issued guidelines on implementation of Net Stable Funding Ratio (NSFR) [11].

5.1. Transition to Basel III

Basel III is an improved version with better risk management system and disclosure requirements. Minimum Tier 1 Capital with major composition of shares should be 7 percent and Total capital should be maintained at 9 percent of the risk weighted assets. Capital Conservation Buffer requirement of 2.5 percent further adds to the total capital ratio, making it 11.5 percent [10]. Proper transitional arrangements are designed to ascertain a smooth shift towards the Basel III norms. Banks started implementing the norms from April 1, 2013 and full implementation is scheduled by March 31, 2019 [5]. This is adjacent to the BCBS suggested date for full implementation that is, January 1, 2019 [6].

Table 1: Transitional Arrangements in Scheduled Commercial Banks

(% 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

Source: RBI (2015). Master Circular- Basel III Capital Regulations

6. CAPITAL ADEQUACY

As a step to sustain financial stability and bring competence in all economies, Basel III guidelines require banks operating worldwide to maintain a minimum Capital to Risk Weighted Assets Ratio of 8 percent.

CRAR= (Tier I capital +Tier II capital) ÷Risk Weighted Assets

Tier I capital is the going concern capital or core capital which is made up of equity capital and disclosed reserves. It absorbs losses even when the bank is operating. On the other side, Tier II capital is the gone concern capital which only soaks losses during bankruptcy [4].

Table 1shows that capital adequacy requirement in banks as per RBI guidelines is 9 percent. By the end of March 2018, minimum total capital requirement after adding the countercyclical buffer is 10.875 percent which has to be increased to 11.5 percent towards the end of Basel III implementation in 2019. The banks create capital buffers at normal times to be used in times of stress.

Table 2: Component-wise CRAR of SCBs (As at end March)

(Amount in Rs. billion)

		PSBs		PVBs		FBs		SCBs	
		2016	**2017**	**2016**	**2017**	**2016**	**2017**	**2016**	**2017**
1	Capital Funds	6,647	7,047	3,705	4,239	1,296	1,184	11,647	12,470
	(i) Tier I Capital	5,138	5,480	3,109	3,643	1,208	1,110	9,455	10,233
	(ii) Tier II Capital	1,509	1,567	596	596	88	74	2,192	2,237
2	Risk Weighted Assets	56,260	58,053	23,622	27,289	7,584	6,328	87,466	91,671
3	CRAR (1 as % of 2)	11.8	12.1	15.7	15.5	17.1	18.7	13.3	13.6
	Of which: Tier I	9.1	9.4	13.2	13.3	15.9	17.5	10.8	11.2
	Tier II	2.7	2.7	2.5	2.2	1.2	1.2	2.5	2.4

Source: Report on Trend and Progress of Banking in India (2016-17)

Table 2 shows that all groups in SCBs have been successful in maintaining CRAR above the minimum level. The CRAR of SCBs increased from 13.3 percent in 2016 to 13.6 percent in 2017. Table 1 shows that the Tier I capital requirement was increased to 7 percent in 2015 and the same will continue till the end of Basel III implementation. Table 2 proves that Bank groups have maintained Tier I ratios well above the required level. It can also be observed that among the SCBs; Foreign banks (FBs) have maintained the highest CRAR followed by PVBs. Though PSBs too have maintained CRAR higher than the required level but they have the least ratio in the group. A positive change is that the CRAR of PSBs in 2017 is 12.1 percent which is slightly higher than that maintained in 2016.

7. CHALLENGES IN BASEL III COMPLIANCE

It is seen that Indian banks are performing better with an average capital ratio of 13.6 percent for 2017. But some PSBs in India may face difficulties in meeting the Basel III criteria within the stipulated period. The main reasons can be summed up into the following points:

- Poor asset quality, decreased credit growth and lower amount of profit are the new feature of Indian banking sector. Stressed asset pile of 10 trillion, in which Gross Non-Performing Assets (GNPAs) consist of 7.7 trillion; affects the banks negatively [10].
- Changes in the external environment may also delay the process of complying with the regulatory norms. Demonetisation, Goods and Services Tax (GST) and the Real Estate (Regulation and development) Act (RERA) are possibly affecting the implementation of Basel III [10].
- PSBs need to raise capital to meet the Basel III criteria. This seems to be an enormous task in a situation when Non Performing Assets (NPAs) are on the rise. The need of the hour is better risk management, controls and checks at all levels in banks. Capital infusion by government will also act as a stimulant in PSBs [10].
- Besides core capital, Basel III requires Indian banks to raise high quality capital. The weaker banks will find it tough to raise additional capital and in the process will get merged with stronger banks. Thus, only the strong banks will survive and make it to the end of Basel III compliance [10].
- Banks have to keep up to the Basel III requirement as well as need to work on meeting the expectations of customers and stakeholders. They have to hold on technologies like Big Data and Artificial Intelligence along with the adoption of Basel III norms [10].

8. CONCLUSION

Basel III is all set to transform the global banking sector. Indian banks too are working towards its full implementation as per the guidelines issued by RBI from time to time. Undoubtedly, Basel III compliance will act as a shield to protect our banks from financial strains making them survive in the long run with enhanced strength and efficiency. In the present scenario, Indian banking industry is moving well with Basel III implementation. The positive effects are noticed as SCBs are keeping the prescribed capital requirements. The Basel framework has changed the business model in banking sector but meeting the norms within the deadline may be difficult. It is evident that banks require management of NPAs, capital infusion, stability in external environment, enhanced risk management and control to fulfil the Basel III criteria by 2019.

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