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Theme 193
BASEL -II AND THE BANKS' PREPAREDNESS

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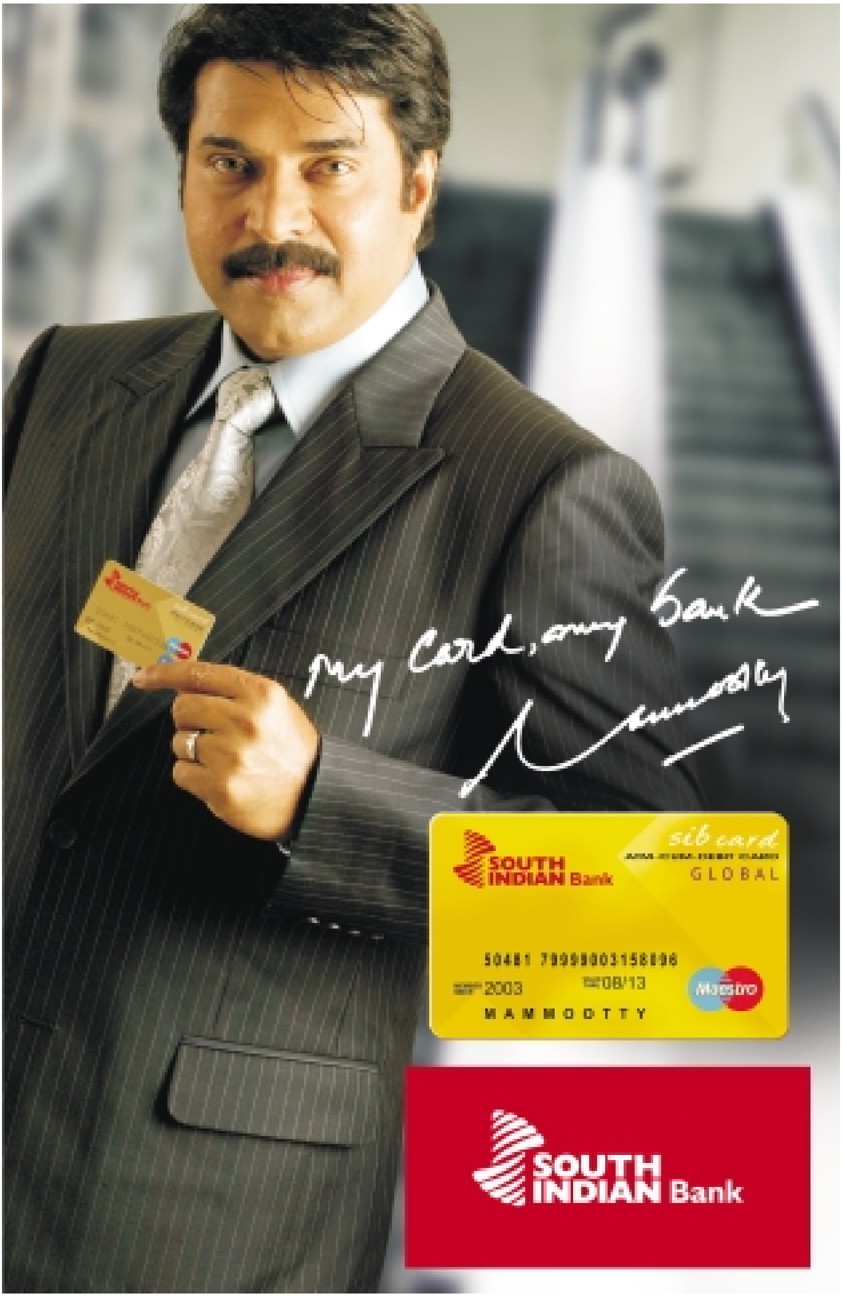
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DECEMBER 2007

Theme No. 193 : BASEL-II AND THE BANKS' PREPAREDNESS

Introduction

The first step towards an organized Risk Management arose through Basel initiatives. The advent of Basel-II has certainly brought to focus the pressure on capital through different risk weights. The attempt at harmonizing the capital adequacy standards internationally date back to 1988, when the "Basle committee on Banking Regulations and supervisory practices", released a capital adequacy framework, now known as Basel-I. This norm was widely adopted in over 100 countries.

What are the risks covered under Basel-I?

The accord, in its original form, addressed only the credit risks in the bank's operations. This meant that a bank with a higher risk profile would have to maintain a higher quantum of regulatory capital. The framework also stipulated, for the first time, a regulatory capital charge for the off-balance sheet business of the banks, so as to capture their risk exposures more comprehensively. Pursuant to the recommendations of the Committee on the Financial System (the first Narasimham Committee, 1991), this framework was implemented in India in 1992 in a phased manner. It was only in 1996 that an amendment was made to cover the market risks also.

What are the limitations of Basel-I which paved the way to Basel-II?

First, the Accord had a broad-brush approach under which the entire exposures of banks were categorized into three broad risk buckets viz., sovereign, banks and corporates, with each category attracting a risk weight of zero, 20 and 100 per cent, respectively. Such a risk weighting scheme did not provide for sufficient calibration of the counterparty risk since, for instance, a corporate with "AAA" rating and one with "C" rating would attract identical risk weight of 100 per cent and require the same regulatory capital charge. This, in turn, provided an incentive for the banks to acquire higher-risk customers in pursuit of higher returns, without necessitating a higher capital charge.

Second, the Accord addressed only the credit risk and market risk in the banks' operations, ignoring several other types of risks inherent in banking activity. For instance, the operational risk, that is, the risk of human error or failure of systems leading to financial loss, was not at all addressed-as were the liquidity risk, credit concentration risk, interest rate risk in the banking book, etc.

Third, since 1988, the emergence of innovative financial products had transformed the contours of the banking industry and its business model. The credit-risk transfer products, such as securitization and credit derivatives, enabled removal of on-balance sheet exposures from the books of the banks, when they perceived that the regulatory capital requirement for such exposures was too high and hiving off such exposures would be a better strategy. The Basel-I framework did not accommodate such innovations and was, thus, outpaced by the market developments.

The birth of Basel-II framework.

In order to take care of the limitations of Basel-I as discussed above, Basel Committee on Banking Supervision (BCBS), after a world-wide consultative process and several impact assessment studies, evolved a new capital regulation framework, widely known as Basel-II framework ("International Convergence of Capital Measurement and Capital Standards: A Revised Framework"). The objectives of the revised framework, which was released in June 2004, are to broadly maintain the aggregate level of minimum capital requirements, while providing incentives to adopt more advanced risk-sensitive approaches as envisaged in the revised framework.

What are the stipulations of the three Pillars under Basel-II?

The Pillar 1 stipulates the minimum capital adequacy ratio and requires allocation of regulatory capital not only for credit risk and market risk but additionally, for operational risk as well, which was not covered in the previous accord. The Pillar 2 of the framework deals with the 'Supervisory Review Process' (SRP), and it requires the banks to develop an Internal Capital Adequacy Assessment Process (ICAAP) which should encompass their whole risk universe – by addressing all those risks which are either not fully captured or not at all captured under pillar 1 and assign an appropriate amount of capital internally. Under the Supervisory Review, the supervisors would conduct a detailed examination of the ICAAP of the banks, and if warranted, could prescribe a higher capital requirement, over and above the minimum capital adequacy ratio envisaged in Pillar 1.

The Pillar 3 of the framework, Market Discipline, focuses on the effective public disclosures to be made by the banks, and is a critical complement to the other two Pillars. It is based on the basic principle that the markets would be quite responsive to the disclosures made and the banks would be duly rewarded or penalized by the market forces. It recognizes the fact that the discipline exerted by the markets can be as powerful as the sanctions imposed by the regulator.

What are the preparatory measures adopted by RBI for Basel-II implementation?

In August 2004, soon after the new framework was released by the BCBS, the banks were advised to conduct a self-assessment of their risk management systems and to initiate remedial measures, as needed, keeping in view the requirements of the Basel-II framework. A Steering Committee was constituted in October 2004, comprising senior officials from 14 select banks (a mix of public sector, private sector and foreign banks). In February, 2005, based on the inputs received from this committee, the RBI issued the draft guidelines, for public comments, on implementation of Pillar 1 and Pillar 3 requirements of the Basel-II framework. In the light of the feedback received from a wide spectrum of banks and other stake holders, the draft guidelines were revised and the final guidelines were issued on April 27, 2007. As regards the Pillar 2, the banks have been asked to put in place the requisite internal Capital Adequacy Assessment Process (ICAAP) with the approval of their Boards. The minimum capital adequacy ratio prescribed under Basel-II norms continues to be nine per cent.

What is the present level of preparedness of Indian Banks for implementation of Basel-II?

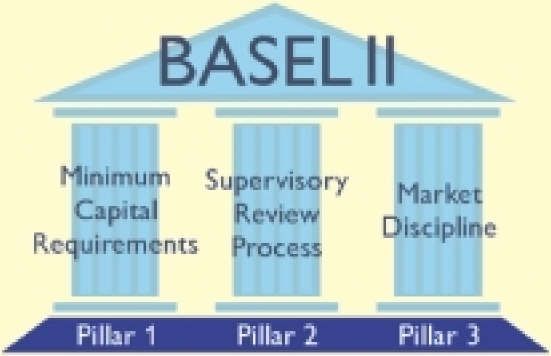
Even before the final guidelines were issued, the RBI had asked the banks in May 2006 to begin conducting parallel runs, as per the draft guidelines, so as to familiarize them with the requirements of the new framework. During the period of parallel run, the banks are required to compute, on an on going basis, their capital adequacy ratio – both under Basel-I norms, currently applicable, as well as the Basel-II guidelines to be applicable in future. This analysis, along with several other prescribed assessments, is to be placed before the Boards of the respective banks every quarter and is also transmitted to the RBI.

What are the RBI guidelines for the implementation of Basel-II?

The foreign banks operating in India and the Indian banks having operational presence outside India are required to migrate to the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk with effect from March 31, 2008. All other Scheduled commercial banks are encouraged to migrate to these approaches under Basel-II, not later than March 31, 2009. It has been a conscious decision to begin with the simpler approaches available under the framework. As regards the market risk, the banks will continue to follow the Standardised-Duration Method, already adopted under the Basel-I framework, under Basel-II also.

What are the challenges ahead from the adoption of Basel-II?

First, the new norms might, in some cases, lead to an increase in the overall regulatory capital requirements for the banks, if the additional capital required for the operational risk is not offset by the capital relief available for the credit risk. Second, the Standardised Approach for credit risk leans heavily on the external credit ratings. While the RBI has accredited four rating agencies operating in India, the rating penetration in India is rather low and it is confined to rating of the instruments and not of the issuing entities as a whole. Third, the risk weighting scheme under Standardised Approach also creates some incentive for some of the bank clients with loan amount less than Rs.10 crores to remain unrated, since such entities receive a lower risk weight of 100 per cent against 150 per cent risk weight for a lowest rated client. Fourth, the new framework could also intensify the competition for the best clients with high credit ratings, which attract lower capital charge, but will put pressure on the net interest margins of the bank. Finally, implementing the ICAAP under the Pillar 2 of the framework would perhaps be the biggest challenge for the banks in India as it requires a comprehensive risk modelling infrastructure to capture all the known and unknown risks that are not covered under the other two Pillars of the framework. Though the implementation of Basel-II would be a challenge for the Indian banks, it provides an opportunity to leverage capital base, improve the risk management practices and enhance the bottom-line by moving from capital adequacy to capital efficiency.



Fact sheet - Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was originally established by the central bank Governors of the G-10 countries in 1975. This Group of Ten is made up of eleven industrialized countries - Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. With the subsequent inclusion of Luxembourg and Spain, Basel committee has the representation of 24 financial regulators / institutions from 13 countries. Basel committee meets four times a year, usually at Basel. Basel seats the Bank for International Settlements (BIS) and it is the third largest city of Switzerland. The BIS was established in the context of the Young Plan (1930), which dealt with the issue of the reparation payments imposed on Germany by the Treaty of Versailles following the First World War. Reparation (cost of repairing) is the payment in money or materials by a nation defeated in war.

The present Chairman of the Basel Committee is Mr. Nout Wellink, President of the Netherlands Bank. On 1st July 2006, Mr Wellink succeeded Mr Jaime Caruana who relinquished the Basel Committee chairmanship upon conclusion of his term of office as Governor of the Bank of Spain. It was Mr. Caruana , who during his three-year term as Chairman of the Basel Committee, brought many important projects to a successful conclusion, including the revised Capital Adequacy Framework-Basel II. Mr Stefan Walter is the Secretary General of the Basel Committee and the secretariat is run mainly by professionals on deputation from member institutions. Basel committee has four main subgroups: The Accord Implementation Group, The Policy Development Group, The Accounting Task Force and The International Liaison Group .

For further details visit : www.bis.org

2008

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WISH YOU A HAPPY AND PROSPEROUS NEW YEAR

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