A CRITICAL REVIEW OF BASEL-III NORMS FOR INDIAN PSU BANKS

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ABSTRACT

Basel III norms are guidelines framed by a committee of central banks that is based in Basel, Switzerland. The Reserve Bank of India is also a member of this committee. The norms aim to toughen up the banking system in every country to withstand financial shock. They focus on the risks that banks are vulnerable to, particularly after the crisis in the banking sector, which was triggered by the problem in the US sub-prime mortgage market.

Base III aims to plug the gaps in the existing Basel II guidelines. The new norms will be made effective in a phased manner from January 1, 2013 and implemented fully from March 31, 2018. The guidelines will ensure that banks are well capitalized to manage all kinds of risks. The existing norms stipulate that banks should maintain Tier-I capital, or core capital, and Tier-II capital that comprise instruments with debt-like features.

Keywords: Banking, Basel-III, Equity, Debt, Capital-Adequacy-Ratio, Tier-I, Tier-II

Introduction

The Basel Committee on Banking Supervision (BCBS) issued a comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" in December 2010, with the objective to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill-over from the financial sector to the real economy. The reform package relating to capital regulation, together with the enhancements to Basel II framework and amendments to market risk framework issued by BCBS in July 2009, will amend certain provisions of the existing Basel II framework, in addition to introducing some new concepts and requirements. Thereafter, these norms were notified for Indian banks by RBI vide its notification dated 2nd May'2012.

Basel-III is a comprehensive set of reform measures to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- Improve risk management and governance
- Strengthen banks' transparency and disclosures

The reforms target:

o Bank-level, or micro-prudential regulation, which will help raise the resilience of individual banking institutions to periods of stress

o Macro-prudential, system wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time

These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system-wide shocks. The Committee's package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. This reinforces the stronger definition of capital and the higher capital requirements for trading, derivative and securitization activities to be introduced at the end of 2012.

Aim of the Research Paper

This research paper would make an attempt to critically analyze the impact of Basel III on Indian Banks, specifically PSU (Public Sector Undertaking) Banks. On one hand, Basel III has introduced many elements of capital, such as a clearly defined common capital that measures core equity capital in relation to its total risk-weighted assets and hence, assesses the bank's financial strength and capital conservation buffers at various levels. On the other hand, the new norms will push up the capital needs of Indian banks by $20 billion to $30 billion (1 lakh crore to 1.5 lakh crore). Since banks will now need additional capital for doing the same level of business, they may see a sharp drop in their returns on assets (ROA).

The global Basel-III requirements, which require all banks to hold top-quality capital equal to 7% of their assets, adjusted for risk, are aimed at improving financial stability. But the sharply higher capital requirements have drawn warnings from analysts and financiers about their impact on banking lending rates and wider economic growth across the developing world. This research paper aims to study these viewpoints in the right perspective of Indian PSU banks.

Main requirements under Basel-III

1) Banks to maintain a minimum 5.5% in common equity (as against 3.6% now) by March 31, 2015.
2) Banks must create a capital conservation buffer (consisting of common equity) of 2.5% by March 31, 2018.
3) Banks should maintain a minimum overall capital adequacy ratio of 11.5% (against the current 9%) by March 31, 2018.

Three tiers of capital have been defined:

■ Tier 1 Capital includes only permanent shareholders' equity (issued and fully paid ordinary shares and perpetual non-cumulative preference shares) and disclosed reserves (share premium, retained earnings, general reserves, legal reserves)

■ Tier 2 Capital includes undisclosed reserves, revaluation reserves, general provisions and loan-loss reserves, hybrid (debt / equity) capital instruments and subordinated term debt. A limit of 50% of

Tier 1 is applicable for subordinated term debt.

- Tier 3 Capital is represented by short-term subordinated debt covering market risk. This is limited to 250% of Tier 1 capital that is required to support market risk.

New Capital requirements

As per existing norms, the total minimum capital ratio is 9%, comprising Tier-I and Tier-II capital. Basel-III regulatory capital matrix is percentage to Risk weighted assets (RWA's):

i) Minimum common equity Tier-I ratio: 5.5%

ii) Capital conservation buffer (comprising common equity): 2.5%

iii) Minimum common equity Tier-I ratio plus capital conservation buffer [(i) + (ii)]: 8%

iv) Additional Tier-I capital: 1.5%

v) Minimum Tier-I capital ratio [(i) + (iv)]: 7%

vi) Tier-II capital: 2%

vii) Minimum total capital ratio (MTC) [(v) + (vi)]: 9%

viii) Minimum total capital ratio plus capital conservation buffer [(vii) + (ii)]: 11.5%

Impact on Indian Banks

Reserve Bank of India (RBI) notified the new Basel-III norms in May'2012, which will be effective from January'2013 in a phased manner and fully implemented by March 2018. Basel III has introduced many elements of capital, such as a clearly defined common capital that measures core equity capital in relation to its total risk-weighted assets and hence, assesses the bank's financial strength and capital conservation buffers at various levels. Besides, risk-based capital ratios will have to be supplemented with leverage ratio during a parallel run. Basel III rules propose to bring in more clarity and eliminate grey areas in the current rules by clearly defining different kinds of capital.

As per the research report of Credit Suisse, the new norms will push up the capital needs of Indian banks by $20 billion to $30 billion (1 lakh crore to 1.5 lakh crore). Since banks will now need additional capital for doing the same level of business, they may see a sharp drop in their returns on assets (ROA). Further, the incremental equity requirement in the Indian banking system may go to as high as Rs. 3.2 to 4 trillion over the next six years. According to ratings firm ICRA, the government's share in this could be Rs. 1.2 to 1.7 trillion. When banks with low core Tier-I shore up their capital to around 9% (required 8% and 1% cushion), their return on equity (ROE) could drop by 1% to 4%, which they could seek to compensate by raising their lending yields, increasing fee income, or rationalizing costs.

As per Credit Suisse research report, about $15 billion was needed for Indian banks to support 18% growth, of which around $11-12 billion was needed by the PSU (Public sector Undertakings) banks. After these norms requiring re-capitalization, banks may need another $5 billion in the next 1 year, in addition to $3 billion needed by private banks. Further, the transition to Basel III is likely to result in a moderation in the return on equity of banks by 200-300 basis points for PSU banks and around 100 basis points for private banks. Additionally, banks would be required to maintain liquidity coverage ratio and net stable funding ratio of above 100%.

The Basel-III norms come at a time when banks are under pressure to set aside funds for a potential increase in bad loans. For every 1% increase in gross NPA's (Non-performing-assets), the banking system may require additional Rs.25000 crore.

Movement of Capital requirement and triggers under various scenarios

- o Core Capital: Equity component of a bank's capital (5.5% in all scenarios)
- o Capital conservation buffer: Capital set aside for off balance-sheet transactions (2.5% in all scenarios)
- o Counter cyclical buffer: Extra capital to cushion shocks (1% in 'High Credit Growth Scenario'; 2.5% in 'Higher Credit Growth Scenario'; 1.5% in 'Stress Situation, Higher credit Growth Continues Scenario')

Regulatory Capital = Core Capital + Capital conservation buffer + Counter cyclical buffer (when activated)

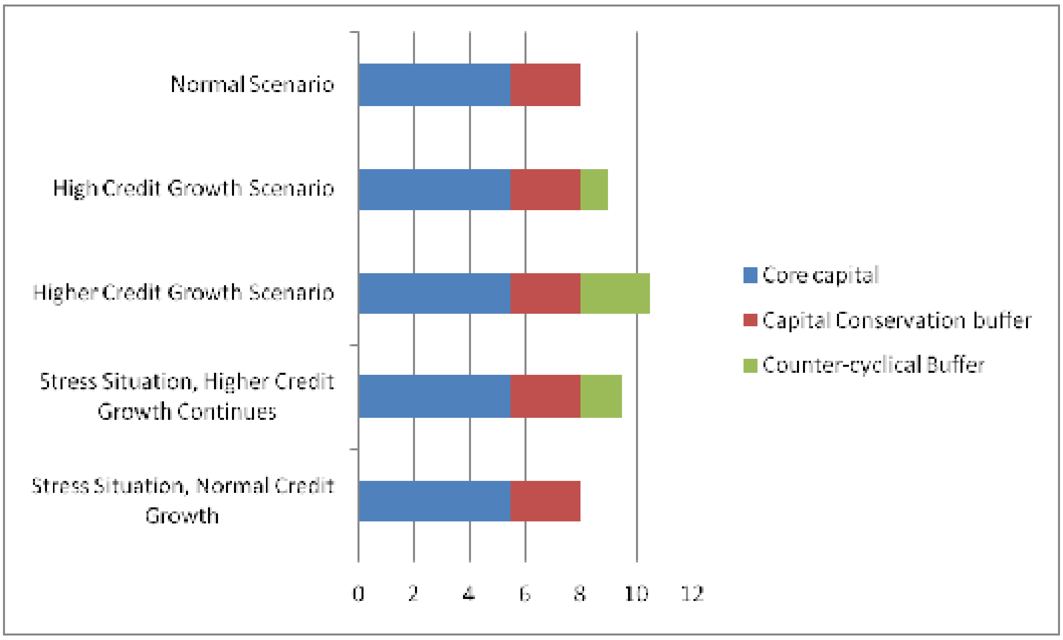

Fig.: Bar chart representing minimum regulatory requirement (All figures in %)

o Actual Regulatory Core capital:

- 9% in 'Normal Scenario'
- 9% in 'High Credit Growth Scenario'-Introduction of countercyclical buffer (1%)---No restriction on earning distribution
- 9.5% in 'Higher Credit Growth Scenario'-Higher level of countercyclical buffer (2.5%)-Restriction on earning distribution kicks in
- 9% in 'Stress Situation, Higher credit Growth Continues Scenario'-Part release of countercyclical buffer (1.5%)-Restriction on earning distribution becomes lower
- 7% in 'Stress Situation, Normal Credit Growth Scenario'-Complete release of countercyclical buffer (0%)-Restriction on earning distribution become higher

Difficulties with implementing Basel-III norms

There are worries among certain bankers that the implementation of Basel-III proposals will have an adverse impact on the return on equity and financial ratios. There are concerns that public sector banks may not be able to grow their loans since government-dependent lenders would not have adequate capital. Critics of Basel-III norms feel that just because banks would have more capital, it does not mean that a bank will not get into trouble. The crises may at best be postponed. Walter Bagehot, the former editor of 'The Economist', had famously said, "No capital is required for a well-run bank and no amount of capital can save a badly-run bank!"

A taskforce of leading bankers warned in June'2012 that the Basel III rules were too focused on problems that occurred in Europe and the US. They argued the standards unfairly penalise trade finance and project finance, two forms of credit that are particularly important in developing nations. This school of thought believes that the Indian banking system has proved robust due to constant monitoring by the RBI. As per past instance, Indian Banks had carried a huge negative net-worth for three years without any problem. As per this argument, Public Sector banks do not need more capital.

Since Basel-III is an international norm, therefore, Indian banks, including PSB's (Public Sector Banks) with international presence, would find it an obstacle if they are non-compliant. One of the solution proposed by policymakers is to go slow on imposing new capital adequacy norms for PSB's as all of them do not have a foreign presence.

However, the difficulty in increasing the capital of PSB's is not because of their inability to attract investors. If investors are given confidence, banks would be able to raise sufficient capital. But the government would have to dilute its holding in the PSB's. It seems difficult because the government may be unwilling to let go its majority stake in these banks. If fresh equity is to be raised without diluting the government's share, huge budget allocations are required. As per estimates, about Rs.60000-75000 crore demands for capital from banks could be there in the next six years. Again, it may not be easy for the government, considering its fiscal deficit.

The government may have to work on two options. One is to ask PSB's to keep their loan portfolios at current levels or even shrink them. But it would be a retrograde step and will affect the funds available to industry adversely. The other is to accept a dilution of its stake, may be up to 26%.

After declaring in the Parliament that every company -private or government, should have a minimum of 25% float, the proposal was diluted when the investment banking circles said it would be impossible for the government to meet its disinvestment target. The implementation of capital norms are seen as unwelcome move not only in India but are opposed by most bankers across the world.

While capital is just one of the focus items, the bigger worry for Indian banks could come from the treatment of their pension liabilities. This liability is still to an extent not been quantified. With its focus on the quality of the capital after the financial crises, RBI has proposed full recognition of liabilities from defined benefit pension funds in the calculation of Common Equity Tier-I to ensure it is able to absorb losses. This also eliminates the risk of this being used to protect depositors and other creditors.

As per Credit Suisse analysts, this could be more harmful to their share prices than capital, as these would be reflected on the profit and loss statement of banks. The simultaneous implementation of Basel-III and the so-called 'dynamic provisioning' requirements (2.4 to 3% of loans in balance-sheet) may enlarge the difficulties that banks could face amid the approx. Rs.2 lakh crores of loans that would have to be restructured by this fiscal end. Banks with high credit costs may find it tough to meet the additional burden.

Merits of Basel-III norms

As per some of the research reports relating to Banking industry, there is enough evidence that the most serious economic crisis are associated with banking sector adversities and high public sector interventions. The Basel Committee's long-term impact study of crisis shows that banking crisis generally result in losses in economic output equal to about 60% of pre-crises GDP. Moreover, there is a significant spill-over of risk between the banking sector and governments.

The recent experience of industrialized nations shows that to save the banking sector, governments of these nations had to increase their debts to such an extent that their debt-to-GDP ratios have risen by 10-25% points. Therefore, people who are concerned that tighter norms under Basel-III would impose a heavy burden on Indian government in terms of infusion of capital in Public sector banks (PSB's), should also take into consideration the fact that the costs associated with the failure of PSB's will be much higher in dimension and their subsequent impact. Hence, the economic benefits of making banks more resilient to shocks are huge.

There is a concern that a higher capital requirement under Basel-III would reduce the profitability of PSB's and make loans more expensive. As per RBI's estimates, there could be a marginal drop in GDP growth in the short-term. But given that the banking sector stability is a precondition of sustainable economic growth, a short-term sacrifice of growth has to be tolerated in the interest of long-term sustainable growth. This is a typical perplexity that an emerging economy faces.

The features of Basel-III such as higher risk coverage, thrust on loss-absorbing capital in periods of stress, improving liquidity standards, creation of capital buffers in good times and prevention of excess build-up of debt during boom times would help create a resilient banking system.

Conclusion

Given the current environment, the RBI has extended the final date for Basel-III to 2018. This is positive as PSB's will get more time for preparation. Moreover, capital deduction now starts at 20% against 40% stipulated earlier. This move is encouraging and should ensure smoother migration to the new framework.

The RBI wants to implement the recommendations of the 'Basel Committee on Banking Supervision' to make the financial system safe. It is aimed at protecting the depositors and to prevent a 2008-like crises. Moreover, the 'perception' of a lower standard regulatory regime will put Indian banks at a disadvantage in global competition.

RBI is currently working on operational aspects of implementation of the Countercyclical Capital Buffer. Besides, certain other proposals viz. 'Definition of Capital Disclosure Requirements', 'Capitalisation of Bank Exposures to Central Counterparties' etc., are also engaging the attention of the Basel Committee at present. Therefore, as per RBI, the final proposals of the Basel Committee on these aspects will be considered for implementation, to the extent applicable, in future. Further, for the financial year ending March 31, 2013, banks will have to disclose the capital ratios computed under the existing guidelines (Basel II) on capital adequacy as well as those computed under the Basel III capital adequacy framework.

India's struggling banking sector will face a period of lower profitability as it seeks to raise at least Rs. 5000 billion in extra capital to meet the new Basel-III international banking standards. The government could consider reducing its majority stakes in a variety of state-owned banks, as it attempts to cut the Rs. 900 billion in recapitalization, needed to maintain present shareholding levels.

Indian government has so far rejected suggestions that it might reduce its shareholding in more than two dozen public sector banks, including a stake of approximately 60% in the State Bank of India, the nation's largest lender by market share. The RBI governor had in the recent past suggested that the Indian government could save Rs. 200 billion in recapitalization costs if it reduced its stakes in all state-owned banks to just 51 per cent.

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