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IMPLEMENTING BASEL III FOR INDIAN BANKS

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Abstract

In order to effectively manage risks in Indian banking projects, the BASEL framework is essential. It offers a standardised method for assessing and reducing risks related to credit, markets, and operations. Indian banks can guarantee capital adequacy, improve risk management procedures, and comply with regulations by following the BASEL principles. This framework supports the long-term expansion of the banking industry while fostering financial stability and defending the interests of investors and depositors. The paper deals with implementation of BASEL III in banking sector of India.

Keywords: BASEL, Framework, Indian Banks, Financial.

Introduction

A committee of banking supervisory authorities was established by the Group of Ten countries' central bank governors at the close of 1974. This Committee became known as the Basel Committee since it frequently convenes at the Bank of International Settlement (BIS) in Basel, Switzerland. Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdoms, and the United States were among the countries represented on the Committee. A nation's central bank serves as its official representative, as does the body in charge of the prudential regulation of the banking industry in cases when the central bank is not involved.

The Basel Committee was never meant to have legal power behind its recommendations, and it has no formal supranational supervisory authority. Instead, it develops general supervisory guidelines and standards and suggests best practise statements, with the understanding that individual authorities will implement them through specific arrangements-statutory or otherwise-that are most appropriate for their own national systems (NEDfi Databank Quarterly, 2004). In this sense, the Committee promotes convergence towards shared methodologies and standards without aiming to harmonise member nations' supervisory practises in great detail.

The Committee seeks the approval of the Group of Ten central bank governors for its major projects and reports to them. Furthermore, the decision requires the participation of numerous national authorities outside of the central banking community because the Committee include representatives from institutions that are not central banks. A vast array of financial matters is addressed by these decisions.

Closing gaps in global supervisory coverage has been a key goal of the Committee's work in pursuing two fundamental principles: sufficient supervision and no foreign financial establishment should be exempt from oversight. Since 1975, the Committee has released a substantial number of documents in an effort to do this.

Literature Review

The study by Bala Subramaniam C.S (2012) [1] holds significance in light of the recent proposal by the Reserve Bank of India (RBI) to implement Basel III regulations in the banking industry starting from January 2013. The Basel III framework, developed by the Bank for International Settlements (BIS) in collaboration with central banks from various countries, requires participating banks in their respective economies to adhere to sound financial and operational management practises. The paper is structured into four distinct sections. The initial segment initiates a discourse on the notion of Non-Performing Assets (NPA) within the framework of detection and control protocols, as well as the overall influence of NPA on the profitability and financial stability of banks. The subsequent section of the report provides a comprehensive examination of non-performing assets (NPAs), followed by a detailed analysis of the significant amount of borrowings from the banking sector.

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This analysis highlights the emergence of sectoral credit booms, which raises concerns regarding the financial performance and operations of the borrowers. The final section focuses on the implications of banks reorganising their advances based on asset classification. In conclusion, a number of questions and views arise about the functioning of the banking sector and the financial stability of the country.

In their study, Ariefianto et al. (2021) [3] investigated three hypotheses pertaining to the prevailing theories on liquidity risk mitigation in emerging economies. These theories include the concepts of money pooling, signalling, and risk assessment. The study employed the dynamic common correlated effect (DCCE) methodology and an error correction model framework to analyse a significant longitudinal dataset encompassing a 15-year period, focusing on banking institutions. The authors provide clear evidence that the implementation of an error-correcting approach enables effective management of liquidity. On average, the response time to a liquidity shock is estimated to range between 2.5 and 3.5 months. The available empirical evidence provides robust support for the notion of money pooling and signalling, suggesting that the primary motivation for this practise is not risk management, but rather the communication of valuable information.

The study conducted by Gabbi and Levich in 2019 [6] The 11th International Risk Management Conference (Paris Campus) was held in June 2018, co-hosted by the University of Paris-Dauphine and the EMLYON Business School. The conference theme, "1968–2018: From Z-Score to Contemporary Risk Management, 50 Years of Risk Management and Measurement," was selected with the intention of showcasing the evolution and impact of the asset evaluation process on hedge fund management within financial institutions and enterprises. This study examines the impact of minor credit rating discrepancies on the rate of adjustment in business leverage. Additionally, it investigates the use of soft factors to estimate default probability in European firms and proposes a new method for calculating a firm's fundamental risk. Furthermore, it analyses the effectiveness of short sale transactions in mitigating stock price volatility, with consideration given to the application of circuit breaker rules.

In their study conducted in 2020, Hunjra et al. explored the effects of banks' risk on diversification, governance, and financial restrictions within emerging Asian economies. Between the years 2010 and 2018, a set of 116 publicly traded commercial banks in eleven emerging nations in Asia were examined by researchers using the generalised moment's approach. The authors found that bank risk-taking is significantly influenced by factors such as diversification, board composition, CEO duality and independent directors, block holders, and capital constraints.

According to Aneja (2015) [4], In the contemporary dynamic world, it might be argued that the one element that is consistently present is risk. Banking encompasses the management of several hazards, including credit risk, liquidity risk, foreign currency risk, market risk, and interest rate risk, which are inherent to all banks. Effectively managing these risks in a proactive, skilled, and integrated manner is of utmost significance in preserving the financial stability of a banking institution. The primary objective of this empirical study is to evaluate the extent to which Indian banks have effectively achieved their goals of mitigating the adverse impacts of risks on their financial performance and capital. The current imperative is the establishment of an effective risk management framework encompassing the processes of risk identification, quantification, and mitigation. An endeavour has been undertaken to evaluate the financial soundness of the commercial banks in India by an examination of their level of risk and the likelihood of insolvency. This study examines the insolvency risk of 73 banks in India, categorised into 26 public sector banks, 20 private sector banks, and 27 selected foreign banks. The analysis utilises the Z-Index to assess the probability of book value bankruptcy over a nine-year period, specifically from 2005-06 to 2013-14. A comparative analysis is conducted to evaluate the likelihood of book value bankruptcy among public, private, and foreign banks.

Analysis

Overuse, undercapitalization, and inadequate liquidity cushions were some of the major causes of the global financial crisis. Other contributing elements to this situation included deficiencies in risk management, corporate governance, advertising transparency, and supervision style. These have identified the fundamental exclusionary rules in Basel II, which was seen to be a more risk-aware strategy than Basel I, its previous iteration.

Basel III was designed to rectify the last emergency's weaknesses and significantly increase the banking sector's stability and productivity to handle future emergencies. Basel III's major push zone is the alteration of banks' capital structure and amount, together with more sensible oversight, risk management, and exposure standards.

1 Bank-Related Impact

The systemic flaws in Basel II will undoubtedly be fixed by the new standards, although banks will be somewhat impacted. These are the following:
Increased Capital Need: Currently, the majority of Indian banks have a common equity ratio between six and ten percent. Therefore, I believe that banks will be able to meet the Basel III standards' increased capital requirements through at least 2014–2015. This is true even after accounting for the little increase in the capital requirement and without adding any new stock.

In any event, a capital shortage will result from the growth in the base capital ratio combined with advance development exceeding interior capital age in the majority of government banks. Mostly between 2015–16 and 2017–18, due to the introduction of a Capital Conservation Buffer (CCB), this will increase. The purpose of the CCB is to ensure that banks build capital cradles in normal times, which can be dragged down when bad things happen in a targeted timeframe. Significant private sector banks will require less capital due to their greater capital ratios and more firmly established advantages. However, it is likely that some open area banks would fall short of the revised centre capital ampleness requirement and will therefore need government assistance to increase their centre capital. The additional value capital requirements for general population banks, mainly due to Basel III rules over the next five years, amount to around Rs 1,400-1,500 billion.

If the administration maintains its current stake, it will be responsible for paying between Rs 900 and Rs 1,000 billion in recapitalization costs. This will result in an additional government acquisition of up to Rs 1,000 billion. The analysis predicts that the country's financial deficit will increase even more, by around 25 basis points year, as a result of this more administrative receiving. This will widen the gap in resources, cause it to inflate, slow down economic growth, reduce loan demand, and ultimately increase bank profitability.

2 Pressure on Equity Return

In order to comply with the new regulations, a considerable proportion of banks must obtain capital from the market in addition to government support. As a result, the cost of capital will increase and return on equity (RoE) would decrease, pushing up interest rates. Banks may raise lending rates in order to offset the loss of ROE. But this will negatively impact interest income as well as the effective demand for loans. Furthermore, as the effective cost of capital rises, the relative inaction of Indian banks in obtaining new funding is probably going to have a long-term impact on loan offtake. Each of these has an impact on banks' profitability.

3 Pressure on Asset Yield

The increased allocation of assets to flexible resources, which generate almost negative returns, may be putting pressure on banks' resource yields and, consequently, their net income. Encourage better coordination of more resources in a flexible manner to spark successful private sector initiatives and also impact economic growth.

4 Banks Must Take Action

Banks must go beyond regulatory compliance and take proactive measures to address these problems and safeguard their profit margins. These steps should include analysing their business lines, risk profiles, capital efficiency, and funding strategies.

5 Techniques That Must Be Used

5.1 A shift in the business mix

The impact on a larger amount of capital will be smaller in retail banking because it has a nearly lower risk weight than corporate banking (apart from because of consumers who are assessed or more). Furthermore, banks must shift their focus to here-and-now/retail credits in corporate banking because the chances of a default in these advances are typically lower than those in long-term advances.

5.2 Modification of the clientele

To ensure that capital is allocated to segments that yield higher risk-balanced returns, banks must assess how much capital they allot to each client segment and value it based on the profile.

5.3 Low-cost capital

A consistent little effort store base is one of the most important requirements to fulfil the new directions. Since adding branches will increase costs and have an impact on overall revenue, banks should focus more on hiring business journalists and facilitators to attract clients.

5.4 Enhancement of protocols and mechanisms

Banks may be able to lower capital requirements to some degree by optimising their risk-weighted assets through the improvement of systems and procedures, data cleansing, and rating model refinement.

Conclusion

Basel III improves upon Basel II principally in four areas:

(i) raising the amount and calibre of capital;
(ii) enacting liquidity criteria;
(iii) altering provisioning guidelines; and
(iv) introducing the leverage ratio.

These are elaborated as follows

1 Increased Quantity and Quality of Capital

The ultimate goal of Basel III's several requirements are to increase capital quantity and quality, which will enhance the organization's ability to absorb losses in both going concern and liquidation scenarios. The Tier I capital ratio rose to 6% with the equity component set at 4.5%, while maintaining the minimum capital adequacy ratio of 8%. Basel III introduced two new concepts: the countercyclical capital buffer (CCB) and the capital conversion buffer. The capital conversion buffer makes that banks can withstand losses without going over the required minimum capital and can continue to operate during a downturn without taking on more debt.

This is not covered by the basic requirements. Thus, Basel III maintains the 8% minimum capital requirement while adding a 2.5% capital cushion buffer. Having a buffer has the effect of lowering dividend payout and staff bonuses. Therefore, the primary concern facing the banks if they pursue this buffer is how they would compensate their shareholders and retain staff members given that profits are probably going to drop. Due to a legally mandated minimum percentage where profits must be distributed, banks are already subject to restrictions when it comes to paying dividends. How will banks raise additional capital in such a situation? For banks, there is a trade-off between increasing profit and exercising caution.

2 Systemic Environmental Concerns are Sufficiently Addressed under Basel III

To begin with, Basel III is the most significant international financial regulation accord. The first Accord, known as Basel I, was ratified in 1988 with the following two key goals in mind:

i. requiring globally operating banks to retain a minimum amount of capital against their risk-based assets, and

ii. fostering worldwide parity in cross-border banking (Norton 1995). The majority of countries have embraced Basel III and claim to have implemented it, which is impressive considering that Basel III is not legally enforceable under international law.

According to the IMF, nations and banks who can prove they have complied with the Accord's implementation will pay less for capital than nations and banks that haven't (Financial Stability Forum 2000). Certain nations adhere to the criteria of the Accord and carry it out diligently.

The Accord is not required to be followed, though; some nations choose which of its stipulations to abide with, while others have stronger requirements. Although raising the regulatory capital level in the global banking system was Basel I's primary goal, it also included a number of national discretions, loopholes, and incentives for banks to transfer less risky assets off their balance sheets and make riskier short-term loans. A lot of these flaws and inadequacies were addressed in 1999 with the proposal of Basel II. Basel II introduced the concept of the "three pillars" which are as follows:

1) Minimum Capital,
2) Supervisory Review, and
3) Market Discipline.

The three pillars are intended to support one another and provide banks with incentives to improve the way they monitor and manage risk. Banks are permitted to use statistical models, which primarily rely on their own historical default and loss data to evaluate their credit, market, and operational risks, to determine their regulatory capital under Pillar 1 (Minimum Capital). The supervisory review standards outlined in Pillar 2 give regulators the authority to mandate that banks adhere to broad corporate governance principles and implement an internal capital adequacy assessment procedure (ICAAP) that improves risk assessment and management. In order to improve shareholders' and creditors' ability to oversee bank management and safeguard the bank's stability and future prospects, Pillar 3 leverages market discipline to compel banks to provide more information to the market.

The application of risk weightings by banks to gauge the riskiness of their assets was broadened by Basel II. An asset's risk weighting is determined by a number of factors, such as the loan's maturity, the likelihood of default, and the bank's loss and exposure in the event of failure. Generally speaking, capital charges are higher for assets with higher risk weightings than for those with lower risk weightings. When it comes to capital costs, corporate loans with shorter maturities are associated with lower risk weightings, whereas those with longer maturities-seven years or more-are associated with greater risk weightings.

Basel II permitted banks to reduce their risk weightings for specific asset classes by using their own assessments of credit and market concerns. When the global financial crisis struck in August 2007, it became evident that this approach to risk management was significantly inadequate; the risk weightings of the majority of US and European banks were found to be poor indicators of the

financial dangers to which institutions were exposed.

Table 1: Basel III's 3-Pillar Framework

Pillar 1	Pillar 2	Pillar 3
Minimum Capital Requirements	Supervisory Review Process	Market Discipline
Additional/Refined Capital Basis • Liquidity Coverage Ratio (LCR) • Net Stable Funding Ratio (NSFR) • OTC Derivatives Charge • Quality and Level of Capital • Leverage Ratio • Capital Conservation Buffers • Counter cyclical Buffers • Enhanced Loss Absorption Clause (Write-Offer Debt Conversion)	Supervision (Dialogue) - Firm-wide Corporate Governance - Managing Risk Concentrations - Alignment of LT Incentives -Sound Compensation Practices - Supervisory Colleges - Capital(ICAAP) - Firm-wide Risk Management - Valuation Practice, Stress Tests	Additional/Enhanced Disclosure - Risk Management •Market •Credit •Operational - Regulatory Capital components - Detailed Reconciliation of Capital - Regulatory Capital Ratios - Securitization Exposures

1. The Basel Committee on Banking Supervision (BCBS) implemented the Basel III reforms in an effort to decrease the risk of a financial sector spillover into the real economy by strengthening the banking sector's capacity to withstand shocks resulting from financial and economic stress, regardless of their source. The G20 leaders made a commitment in Pittsburgh, September 2009, to fortify the regulatory framework governing banks and other financial institutions, as well as to work together to raise capital requirements, establish stringent international compensation standards to curtail practises that encourage excessive risk-taking, enhance the over-the-counter derivatives market, and develop more potent instruments to hold multinational corporations accountable for the risks they undertake. The leaders imposed stringent deadlines on themselves for all of these measures. This led to the announcement of the Basel III capital requirements, a comprehensive reform package by the Basel Committee on Banking Supervision (BCBS) in December 2010 under the title "Basel III: A global regulatory framework for more resilient banks and banking systems."

2. Basel III regulations bolster microprudential supervision at the bank level, aiming to increase the resilience of individual financial institutions during stressful times. Additionally, the reforms focus on macroprudential issues, addressing systemic risks that might accumulate in the banking industry and their gradual procyclical amplification. In order to ensure that banks are better able to absorb losses on both a going concern and a gone concern basis, these new global regulatory and supervisory standards primarily aim to raise the quality and level of capital, increase the capital framework's risk coverage, introduce leverage ratio as a safety net for the risk-based capital measure, raise the standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3), etc. The capital buffers are essentially where Basel III's macroprudential elements are contained. The goal of both the countercyclical buffer and the capital conservation buffer is to shield the banking industry from times of excessive credit expansion.

3. On May 2, 2012, Reserve Bank released guidelines for capital regulation that, to the degree that they applied to Indian banks, were based on the Basel III reforms. In India, the Basel III capital rule went into effect on April 1, 2013, and as of March 31, 2019, it would be fully implemented.

Conflicts of Interest

The authors declare that there are no significant competing financial, professional, or personal interests that might have influenced the performance or presentation of the work described in this manuscript.

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