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BASEL III AND PREPAREDNESS OF PUBLIC SECTOR BANKS IN INDIA

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Abstract

Basel III is a comprehensive set of reforms, developed by the Basel Committee on Banking Supervision which seeks to improve the ability of the banking sector to deal with financial and economic stress, improve risk management and strengthen the bank's transparency and disclosures. In India, the Reserve Bank of India had followed this up by issuing draft guidelines and this process commenced in January 2013 and will culminate in 2017. This paper analyses the preparedness of Indian Public Sector Banks for Pillar 1- Minimum Regulatory Capital Requirements based on Risk Weighted Assets (RWAs): Maintaining capital calculated through credit, market and operational risk areas of Basel III, based on capital adequacy of Tier 1 capital and capacity to face credit risk, market risk and operation risk. The secondary data for the study were collected through published annual reports of banks, RBI reports, journals and websites. The data were analysed through percentage, ratios and comparative statements.

Keywords*: Basel III, Capital Adequacy, Credit Risk, Market Risk, Operation Risk, Public Sector Banks*

JEL CODE: G21, G32, E58

1. Introduction

The Banking Sector has been undergoing drastic metamorphosis where the need for a stable,efficient,resilient and vibrant banking system has come to occupy the centre stage **(Swamy, 2007)**. The banking sector reforms are aimed at enhancing productivity, efficiency and competitiveness of the banking industry. However, deregulation has created intense competition, accompanied by high risk. The RBI also implemented the guidelines on capital measures and capital standards, as given by the Committee on banking regulations and supervisory practices[Basel Committee], with effect from April, 1992.These focused on credit risk to strengthen the soundness and stability of the banking system**(Ahmed,2009)**. The Narasimhan Committee endorsed the internationally accepted norms for capital adequacy standards, developed by the Basel Committee on Banking Supervision (BCBS)in 1991. The Basel III banking norms, intended to make the global banking industry safer and protect economies from financial meltdowns, has been finally agreed to by central banks and banking regulators from 27maj or countries. The

culmination of the two-year long process, undertaken by the Basel Committee on Banking Supervision, comes after intense debate between those demanding tougher reserve requirements and their opponents, arguing that such norms would adversely affect banks' profitability and stifle financial innovation. Basel III is a comprehensive set of reforms, developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector. Basel III seeks to improve the banking sector ability to deal with financial and economic stress, improve risk management and strengthern the bank's transperancy. It is the continuation of the efforts initiated to enhance the banking regulatory framework under Basel I and Basel II. At the G20 Summit in November 2010 held at Seoul, the member countries approved the Basel III framework for the international banking system. In India, the Reserve Bank of India had followed this up by issuing draft guidelines spelling out the roadmap for the implementation of the Basel III norms. This process commenced in Jan 2013 and will culminate in 2017.The Basel III measures aim to

- Improve the Banking Sector' s ability to absorb shocks arising from financial and economic stress
- Improve risk management and governance
- Strengthen bank's transparency and disclosures.

The basic structure of Basel III remains unchanged, with three mutually reinforcing pillars.

Pillar 1: Minimum Regulatory Capital Requirements, based on Risk Weighted Assets (RWAs): Maintaining capital calculated through credit, market and operational risk areas.

Pillar 2: Supervisory Review Process: Regulating tools and frameworks for dealing with peripheral risks that banks face.

Pillar 3: Market D iscipline: Increasing the disclosures that banks must provide to increase the transparency of banks.

Capital Adequacy Ratio indicates a bank's risk-taking ability. The RBI uses **Capital to Risk Weighted Assets Ratio (CRAR)** to track whether a bank is meeting its statutory capital requirements and is capable of absorbing a reasonable amount of loss. Table-1 depicts the capital requirement for banks under Basil II and Basel III norms.

CRAR = (Tier I capital + Tier II capital)/ Risk-Weighted Assets.

Capital funds are broadly classified into Tier 1 and Tier 2 capital. Tier one capital absorbs losses without a bank being required to cease trading and Tier two capital absorbs losses in the event of winding-up and so provides a lesser degree of protection to depositors.

Tier I capital (core capital) is the most reliable form of capital. The major components of Tier I capital are paid up equity share capital and disclosed reserves viz statutory reserves, general reserves, capital reserves (other than revaluation reserves) and any other type of instrument notified by the RBI as and when for inclusion in Tier I capital. Examples of Tier 1 capital are common stock, preferred stock that is irredeemable and non-cumulative and retained earnings.

Tier II capital (supplementary capital) is a measure of a bank's financial strength to provide protection against unexpected losses and is less permanent in nature.It consists mainly of undisclosed reserves, revaluation reserves, general provisions, subordinated debt and hybrid instruments. Major recommendations of Basel

III are enhanced quantity and quality of capital, leverage ratio to ensure that banks do not lend more than their capacity and short term and long term liquidity funding and rigorous credit risk management.

2. Literature Review

According to Cem Karacadag and Michael W. Taylor(2000), compared with the existing Capital Accord, the proposals represent a shift across two intersecting dimensions-regulatory versus economic capital and rules-based versus process-oriented regulation. On minimum capital standards, the case for using external ratings may be stronger than has been recognized, given the divergences in the purpose and design of internal ratings. On supervisory review, ensuring comparability among supervisors and building supervisory capacity and on enhancing market discipline, incentives for markets to exercise discipline will be required. Nag and Das (2002) and Ghosh and Nachane (2003) assert that for India in the post reform period, public sector banks have shifted their portfolio to reduce capital requirements. The adoption of stricter risk management practices and minimum capital requirements have had a dampening effect on overall credit supply. Their findings resonate with that of Laeven and Majnoni (2004). Athanasoglou (2005) who examined the effect of bank specific, industry specific and macroeconomic determinants of bank profitability. The coefficient of capital variable was positive and highly significant, reflecting the sound financial condition of Greek banks. Ngo (2006) investigated the relationship between bank capital and profitability. The results showed no significant relationship between capital and profitability. Sarma and Nikaldo (2007) established that Indian banking system performed reasonably well during the Basel I regime, maintaining an average CAR of about 12 per cent which was higher than the internationally accepted level of 8 per cent and the RBI's minimum requirement of 9 per cent. Manmeet Singh(2009) points out that the CRAR of the new private sector banks and foreign banks declined on account of higher growth of risk weighted assets as they have relatively larger exposure to the sensitive sectors to which higher risk weights are applied The Indian Banking System enjoys better CRAR than China and Bangladesh. Compared to emerging markets, performance in CRAR by Indian banks matches with Korea, South Africa and Malaysia and in developed countries, with Australia and Canada. Sreejata Banerjee (2012) identified financial parameters that influence banks in India in complying with Basel I. The private sector and foreign banks are affected by credit risk weighted assets and they are guided by the risk in their loan portfolio. The public sector banks are influenced by credit deposit ratio, capital and return on asset. Basel II shows that business per employee and profit per employee influence CRAR of banks belonging to different ownerships in India.

3. Statement of the Problem

Capital Adequacy is an indicator of the financial health of the banking system. It is measured by the Capital to Risk-weighted Asset Ratio (CRAR). Financial Regulators generally impose a capital adequacy norm on their banking and financial systems in order to provide for a buffer to absorb unforeseen losses due to risky investments. A well adhered to capital adequacy regime does play an important role in minimizing the cascading effects of banking and financial sector crises. Tier 1 capital is the core measure of a bank's financial strength from a Regulator's point of view. In

addition to raising the quality and level of the capital base, there is a need to ensure that all material risks are captured in the capital framework. Failure to capture major on- and off-balance sheet risks as well as derivative related exposures, was a key factor that amplified the crisis. In this paper, the focus is on one particular prudential regulation, i.e. capital adequacy requirement in the banking sector in India and on the preparedness of public sector banks to comply with the Basel III norms intended to be employed. Its readiness is measured through capital adequacy and capacity to face credit risk,market risk and operation risk.

4. Objectives of the study

The objectives of the study are

- To study the compliance of Indian public sector banks with Basel II Tier I capital norm and the proposed Basel III Tier I capital norm
- To measure the cushion enjoyed by Indian public sector banks which have CRAR above the Basel III norm of 10.5%
- To identify the capital requirement for credit risk,market risk and operation risk and asset quality.

5. Methodology

The study was based on secondary data. Data for the study were obtained mainly from the annual reports of the Public Sector Banks in India. The banks were selected based on the availability of information to compute Capital to Risk-weighted Weight Assets Ratio (CRAR), that is, value of Tier I capital, Tier II capital and Risk-Weighted Assets. The data needed for the study were made available in the financial reports of 21 Public Sector Banks, namely, Allahabad Bank, Andra Bank, Bank of Baroda, Bank of India, Bank of Maharastra, Canara Bank, Central Bank of India, Corporation Bank, Dena Bank, Indian Bank, Indian Overseas Bank, Oriental Bank of Commerce, Punjab and Sind Bank, Punjab National Bank, Syndicate Bank, UCOBank, Union Bank of India, United Bank of India, Vijaya Bank, State Bank of India and Industrial Development Bank of India for the year 2011-2012. The secondary data were also collected through RBI reports, journals and websites. The data were analysed through percentage, ratios and comparative statements. The data used for the study covered a period of one year from 2011-2012. Descriptive Statistics was used to analyse the data. The cushion in capital adequacy of banks is the difference between the percentage of CACR and the Tier 1 capital. The spread is the net interest margin and is the difference between interest yield on earning assets and interest rates paid on borrowed funds. Borrowing and lending rates are expressed as percentage of asset.The study limits its scope to Pillar 1 of Basel III, that is, Minimum Regulatory Capital Requirements based on Risk Weighted Assets (RWAs).

6. Analysis and Discussion

I. Capital Adequacy

The bank carries out regular assessment of its capital requirement from time to time to maintain the Capital to Risk-weighted Assets Ratio (CRAR) at the desired level **(Bishnoi2009)**. The capital plan is reviewed on an annual basis to take care of business growth and CRAR. Based on the Tier I capital as on 31 March 2012, estimates were made for readiness of public sector banks to meet with Basel III recommended Tier I capital of 10.5% of CRAR. Capital Adequacy signals the banks' ability to maintain capital commensurate with the nature and extent of all types of risk and the

ability of management to identify, measure, monitor and control these risks. It also explains the ability of bank to absorb a reasonable amount of loss and still complies with statutory capital requirements. Currently, the Reserve Bank of India (RBI) prescribes banks to maintain Capital Adequacy Ratio (CAR) of 9% with regard to credit risk, market risk and operational risk on an ongoing basis, as against 8% prescribed in BASEL II framework. BASEL III framework raised it to 10.5% of the Tier I capital required by the banks to match with BASEL III. The results are shown in **Table 2 and Figure 1.** It indicates the insufficiency of capital in most of the public sector banks. It has been understood that few banks have excess capital position above the prescribed norm, namely, Bank of Baroda(0.33) and Indian Bank (0.78) whereas the other banks need to infuse further capital to meet with the prescribed minimum standard. More than two percent of deficits were found with State Bank of India, Industrial Development Bank of India, Corporation Bank, Bank of Maharashtra, Indian Overseas Bank and Central Bank of India.

II Credit Risk and Asset Quality

As advised by the RBI, the public sector banks have adopted the comprehensive approach relating to credit risk mitigation and collateral management under the Standardised Approach which allows fuller offset of eligible securities against exposures, by effectively reducing the exposure amount by the value ascribed to the securities. Asset Quality reflects the amount of existing credit risk associated with the loan and investment portfolio and be judged by the Non-Performing Assets (NPA) ratio **(Rajshekar 2005)**. Based on the results of **Table 3**, the credit deposit ratio indicates the effective use of funds for lending out of the deposits collected. A prudent leveraging will provide a cushion for credit expansion through capital adequacy.Investment to deposit ratio indicates the utilization of their assets effectively for generating further income and also revealed by the spread computed. The asset quality of banks can be judged by the Non-Performing Assets (NPA) ratio. Non-Performing Assets (NPA) are assets which fail to make either interest or principal payments for more than 90 days. RBI has set guidelines to classify NPA into different categories like sub-standard, doubtful or loss assets. There are two effects of NPA on bank financial statements:

1) Loss incurred due to non-payment of principal and interest by borrowers
2) Reduction of capital base due to its allocation to provision for doubtful assets.

It is mandatory for all banks to have their asset base well diversified so that risk can be mitigated (**Uppal 2009)**. The level of NPAs in the Indian banking industry is a great conern and thus urgent cleaning up of banks balance sheet has become a crucial issue **(Vashisht 2004).** The public sector banks have higher NPAs in the Service Sector. NPAs in other sectors like Agriculture, Industry and Personal Loans are almost similar for these banks. The asset quality of a bank directly affects its credit rating. An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.The major causes for occurrence of NPAs were lack of proper planning,wrong selection of the customers by the banks and the recessionary trend **(Jappanjyot, 2011)**. **Table 4** and **Figure 2** show that majority of the public sector banks have NPAs, more than one percent of net advances. Due to stringent collection mechanism, banks are trying to bring down their NPA levels. Allahabad Bank, Andhra Bank, Bank of Maharashtra Corporation Bank and Syndicate Bank recorded less than one percent

of NPA on net assets. There has been decrease in the quantum of doubtful assets.

7. Suggestions of the Study

- **Capital Infusion** : The Indian Public Sector Banks need to infuse additional capital in order to adopt Basel III capital accord over the next five years,by taking into account the imminent capital dilution in the existing capital of PSU banks. Additional capital will also be required to address the enhanced counter party default, especially in OTC derivatives.Different estimates of additional capital infusion have been announced by various international credit ratings agencies.
- **Profitability**: Subsequent to the Basel III norms, the capital of many banks will be reduced by around 60% because of the phased removal of certain components of capital from Tier 1. In addition, the risk weightings are expected to grow by nearly 200%. The twin impact of these two stipulations will greatly reduce the ROE and the profitability of banks. The proposed shift from short-term to long-term liquidity will increase the cost of funds for the banking system. This will further squeeze the banks' profit margins.
- **Liquidity**: The prudent banking is to borrow long and lend short. There must be a match between the duration of liabilities and the duration of assets. Short-term liquidity coverage for 30 days has been recommended by the Basel III. Under this norm, high quality liquid assets are compared to the expected cash outflows over a period of 30 days. Cash outflows need to be met with adequate liquid assets. This ratio is termed as the Liquidity Coverage Ratio (LCR). Another ratio concept introduced is the Net Stable Funding Ratio (NSFR). This ratio is intended to reduce the dependence of banks on short-term wholesale funding and increase their dependence on long-term funding.

8. Scope of Future Research

- A comparative analysis of capital adequacy requirements of Public Sector Banks, Private Sector Banks and Foreign Banks in India
- Capital Adequacy, Supervisory Process and Market Discipline of Public Sector Banks in India
- Credit Risk and Asset Quality of Public Sector Banks, Private Sector Banks and Foreign Banks in India

9. Conclusion

Prudential regulations will result in greater stability of the banking industry. Public sector banks in India need to exercise controls over the capital, liquidity and leveraging of banks to ensure that they have the ability to withstand crises. Basel III will set off a process of churning in the Indian banking industry. It is expected that there will be a process of consolidation in the Indian banking industry through a process of mergers and acquisitions which will culminate in the bigger banks acquiring the smaller ones. Basel III incorporates stability in the banking system where micro-prudential regulations ensure the viability and risk compliance of individual banks while macro-prudential guidelines target the stability of the banking system as a whole.

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Table-1: Comparison of Capital Requirements under Basel II and Basel III

Requirements	Under Basel II	Under Basel III
Minimum Ratio of Total Capital To RWAs	8%	10.50%
Minimum Ratio of Common Equity to RWAs	2%	4.50% to 7.00%
Tier I capital to RWAs	4%	6.00%
Core Tier I capital to RWAs	2%	5.00%
Capital Conservation Buffers to RWAs	None	2.50%
Leverage Ratio	None	3.00%
Countercyclical Buffer	None	0% to 2.50%
Minimum Liquidity Coverage Ratio	None	TBD (2015)
Minimum Net Stable Funding Ratio	None	TBD (2018)
Systemically important Financial Institutions Charge	None	TBD (2011)

Source: Secondary data

Table-2: ***Capital Adequacy for Basel III based on Tier I Capital of Public Sector Banks in India from 2011 to 2012***

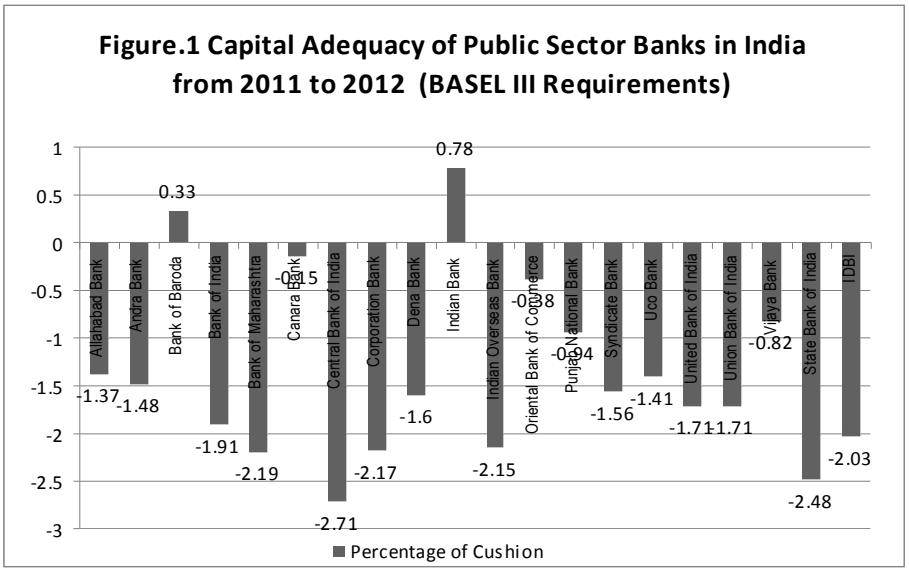
Name of the Bank	Total Eligible capital (₹. in Crores)	Total Tier I Capital (₹. in Crores)	CACR (%)	Tier I Capital (%)	Cushion* (%)
Allahabad Bank	13935.22	9912.20	12.83	9.13	-1.37
Andhra	11156.34	7638.53	13.18	9.02	-1.48
Bank of Baroda	37229.07	27497.91	14.67	10.83	0.33
Bank of India	28508.49	20592.12	12.03	8.59	-1.91
Bank of Maharashtra	6498.99	4705.87	12.43	8.31	-2.19
Canara Bank	29007.77	21828.93	13.76	10.35	-0.15
Central Bank of India	17464.04	10978.41	12.40	7.79	-2.71
Corporation Bank	13767.09	8819.96	13	8.33	-2.17
Dena Bank	7106	5183	13.1	8.9	-1.6
Indian Bank	11649.59	9687.21	13.56	11.28	0.78
Indian Overseas Bank	17603.57	11042.2	13.32	8.35	-2.15
Oriental Bank of Commerce	14917.67	11901	12.69	10.12	-0.38
Punjab National Bank	36852.59	27079.97	13.12	9.56	-0.94
Syndicate Bank	11976.02	8750.64	12.24	8.94	-1.56
Uco Bank	12,042	7,891	12.35	8.09	-1.41
United Bank of India	7114.57	4929.37	12.69	8.79	-1.71
Union Bank of India	7114.57	4929.37	12.69	8.79	-1.71
Vijaya Bank	6707.79	4974.69	13.06	9.68	-0.82
State Bank of India	129801.00	84939	12.26	8.02	-2.48
IDBI	31591.93	18207.97	14.70	8.47	-2.03

Source: Computed from Annual Reports of Banks 2011-2012

Table-3: Credit, Investment to Deposit Ratios of Public Sector Banks in India from 2011- 2012

Banks	Credit Deposit Ratio	Investment Deposit Ratio	Spread as % of Assets
Allahabad Bank	69.64	34.01	2.82
Andhra Bank	79.02	27.99	3.01
Bank of Baroda	74.67	21.62	2.31
Bank of India	78.20	27.26	2.16
Bank of Maharashtra	73.25	29.94	2.86
Canara Bank	71.09	31.21	2.06
Central Bank of India	75.20	30.20	2.25
Corporation Bank	73.80	34.87	1.92
Dena Bank	73.47	29.84	2.40
Indian Bank	74.77	31.44	3.12
Indian Overseas Bank	78.87	31.14	2.28
Oriental Bank of Commerce	71.80	33.41	2.37
Punjab & Sind Bank	73.11	31.79	2.06
Punjab National Bank	77.39	32.31	2.93
Syndicate Bank	78.27	25.84	2.79
UCO Bank	75.02	29.72	2.16
Union Bank of India	79.81	27.98	2.63
United Bank of India	70.74	32.61	2.43
Vijaya Bank	69.72	34.49	1.99
State Bank of India	83.13	29.91	3.24
IDBI Ltd.	86.06	39.51	1.56

Source: Computed from Annual Reports of Banks 2011-2012



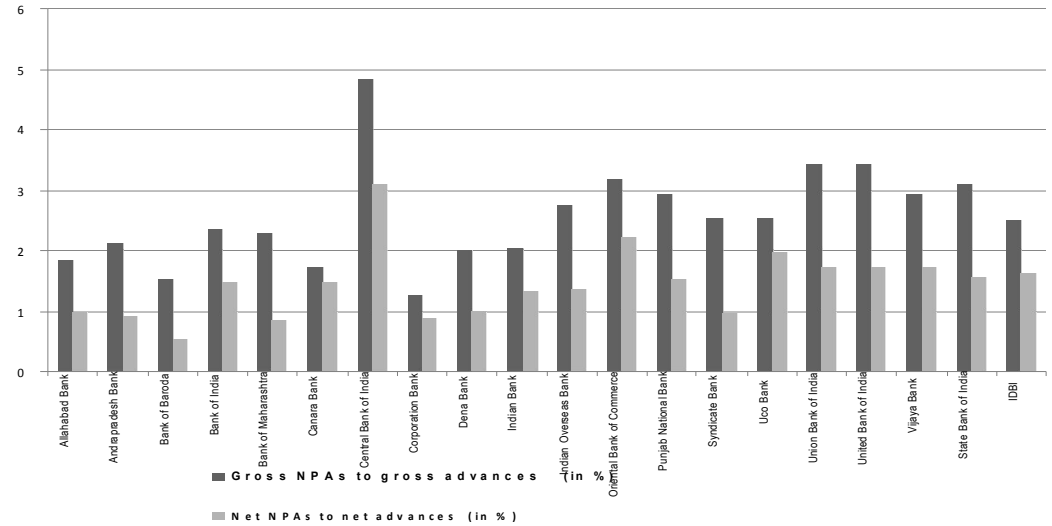
Source: Computed from Annual Reports of Banks 2011-2012

Table-4: Non Performing Assets of Public Sector Banks in India from 2011 to 2012

Name of the Bank	Net NPA (₹. in crores)	Gross NPAs to gross advances (in %)	Net NPAs to net advances (in %)
Allahabad Bank	1091.70	1.83	0.98
Andrapradesh Bank	755.85	2 .12	0.91
Bank of Baroda	1543.64	1.53	0.54
Bank of India	3666.18	2.34	1.47
Bank of Maharashtra	469.57	2.28	0.84
Canara Bank	3386.31	1.73	1.46
Central Bank of India	4556.77	4.83	3.09
Corporation Bank	869.38	1.26	0.87
Dena Bank	964.23	2.0	1.0
Indian Bank	1196.83	2.03	1.33
Indian Overseas Bank	1907.44	2.74	1.35
Oriental Bank of Commerce	2459.03	3.17	2.21
Punjab National Bank	4454.23	2.93	1.52
Syndicate Bank	1185.43	2.53	0.96
Uco Bank	793.90	2.52	1.96
Union Bank of India	1075.55	3.41	1.72
United Bank of India	1075.55	3.41	1.72
Vijaya Bank	998.01	2.93	1.72
State Bank of India	15733.98	3.09	1.56
IDBI	2910.93	2.49	1.61

Source:Compiled from Annual Reports of Banks 2011-2012

Figure 2
Non-Performing Assets of Public Sector Banks in India



Source: Computed from Annual Reports of Banks 2011-2012