Implementation of Basel III Capital Regulation in India

The Basel Committee on Banking Supervision (BCBS) had issued comprehensive reform packages entitled "Basel III- A global regulatory framework for more resilient banks and banking systems" in December 2010. The objective of the Basel III was to improve banking sector resilience by strengthening global capital and liquidity regulations, respectively. Reserve Bank of India (RBI), being a member of the BCBS, is fully committed to the objective of Basel III reform package and, therefore, intends to implement these proposals for banks operating in India. Accordingly guidelines have been drafted based on Basel III reforms on capital regulation, to the extent applicable to banks operating in India. The final guidelines on Basel III capital regulations have been issued by the RBI vide circular DBOD.No.BP. BC.98/21.06.201/2011-12 dated 2nd May, 2012. The article discusses implementation of Basel III Capital Regulation in India. Read on…

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The final guidelines on Basel III capital regulations issued by the RBI vide circular DBOD.No.BP. BC.98/21.06.201/2011-12, dated 2nd May, 2012, would become effective from 1st January, 2013, in a phased manner. The Basel III capital ratios will be fully implemented as on 31st March, 2018. The RBI has laid out a six year road map to make Indian banks safer and avoid recurrence of the 2008 crisis, but it will need an estimated ₹1.5 lakh crore in capital at a time when it is scarce. According to the rating agencies, banks in India have to raise about ₹2.7 lakh crore between January 2013 to March 2017 to meet the new capital adequacy norms. Of these, banks will need to raise ₹1.4 lakh crore in the form of equity capital.

Extract of Paragraph 90 of the Monetary Policy Statement 2012-13

Implementation of Basel III Capital Regulations

As indicated in the SQR of October 2011, the Reserve Bank prepared the draft guidelines on Basel III, which was placed on its website in December 2011, for comments/suggestions from various stakeholders. The draft guidelines provide for a roadmap for smooth implementation of Basel III capital regulations in

terms of the transitional arrangements (phase-in) of capital ratios and grandfathering (phase-out) of ineligible capital instruments. The Reserve Bank is also in the process of estimating, on the basis of data collected from banks, the likely impact of the proposed Basel III norms on banks' capital position and leverage. The estimation exercise, as also the comments/suggestions from various stakeholders, will form the basis for finalising the guidelines on capital regulations. It is proposed: to issue the final guidelines on the implementation of Basel III capital regulations by end April 2012.

Major Changes Proposed in Basel III over Earlier Accords, i.e. Basel I and Basel II

(i) **Better Capital Quality:** One of the key elements of Basel III is the introduction of much stricter definition of capital. Better quality capital means the higher loss absorbing capacity. This in turn will mean that banks will be stronger, allowing them to better withstand periods of stress.

(ii) **Capital Conservation Buffer:** Another key feature of Basel III is that now banks will be required to hold a capital conservation buffer of 2.5%. The aim of asking to build conservation buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.

(iii) **Countercyclical Buffer:** This is also one of the key elements of Basel III. The countercyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e. in bad times. The buffer will range from 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital.

(iv) **Minimum Common Equity and Tier 1 Capital Requirements:** The minimum requirement for common equity, the highest form of loss-absorbing capital, has been raised under Basel III from 2% to 4.5% of total risk-weighted assets. The overall Tier 1 capital requirement, consisting of not only common equity but also other qualifying financial instruments, will also increase from the current minimum of 4% to 6%. Although the minimum total capital requirement will remain at the current 8% level, yet the required total capital will increase to 10.5% when combined with the conservation buffer.

(v) **Leverage Ratio:** A review of the financial crisis of 2008 has indicted that the value of many assets fell quicker than assumed from historical experience. Thus, now Basel III rules include a leverage ratio to serve as a safety net. A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis. 3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018.

(vi) **Liquidity Ratios:** Under Basel III, a framework for liquidity risk management will be created. A new liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) are to be introduced in 2015 and 2018, respectively.

Guidelines by RBI for Implementation of Basel III Capital Regulation in India

The final guidelines issued by the RBI are as below. These guidelines would become effective from 1st January, 2013 in a phased manner. The Basel III capital ratios will be fully implemented as on 31st March, 2018.

A. Summary of Basel III Capital Requirements

1. Improving the Quality, Consistency and Transparency of the Capital Base:

Presently, a bank's capital comprises Tier 1 and Tier 2 capital with a restriction that Tier 2 capital cannot be more than 100% of Tier 1 capital. Within Tier 1 capital, innovative instruments are limited to 15% of Tier 1 capital. Further, Perpetual non-cumulative preference shares along with innovative Tier 1 instruments should not exceed 40% of total Tier 1 capital at any point of time. Within Tier 2 capital, subordinated debt is limited to a maximum of 50% of Tier 1 capital. However, under Basel III, with a view to improving the quality of capital, the Tier 1 capital will predominantly consist of common equity. The qualifying criteria for instruments to be included in additional Tier 1 capital outside the common equity element as well as Tier 2 capital will be strengthened.

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At present, the regulatory adjustments (i.e. deductions and prudential filters) to capital vary across jurisdictions. These adjustments are generally applied to total Tier 1 capital or to a combination of Tier 1 and Tier 2 capital. They are not generally applied to the common equity component of Tier 1 capital. With a view to improving the quality of common equity and also consistency of regulatory adjustments across jurisdictions, most of the adjustments under Basel III will be made from common equity. The important modifications include the following:

(i) Deduction from capital in respect of shortfall in provisions to expected losses under internal ratings based (IRB) approach for computing capital for credit risk should be made from common equity component of Tier 1 capital;

(ii) Cumulative unrealised gains or losses due to change in own credit risk on fair valued financial liabilities, if recognised, should be filtered out from common equity;

(iii) Shortfall in defined benefit pension fund should be deducted from common equity;

(iv) Certain regulatory adjustments which are currently required to be deducted 50% from Tier 1 and 50% from Tier 2 capital, instead will receive 1250% risk weight; and

(v) Limited recognition has been granted with regard to minority interest in banking subsidiaries and investments in capital of certain other financial entities.

The transparency of capital base has been improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the published accounts. This requirement will improve the market discipline under Pillar 3 of the Basel II framework.

2. Enhancing Risk Coverage

At present, the counterparty credit risk in the trading book covers only the risk of default of the counterparty. The reform package includes an additional capital charge for credit value adjustment (CVA) risk which captures risk of mark-to-market losses due to deterioration in the credit worthiness of a counterparty. The risk of interconnectedness among larger financial firms (defined as having total assets greater than or equal to $100 billion) will be better captured through a prescription of 25% adjustment to the asset value correlation (AVC) under IRB approaches to credit risk. In addition, the guidelines on counterparty credit risk management with regard to collateral, margin period of risk and central counterparties and counterparty credit risk management requirements have been strengthened.

3. Enhancing the Total Capital Requirement and Phase-in Period

The minimum Common Equity, Tier 1 and Total Capital requirements will be phased-in between 1st January, 2013 and 1st January, 2015, as indicated below:

As a %age to Risk Weighted Assets (RWAs)	1st January, 2013	1st January, 2014	1st January, 2015
Minimum Common Equity Tier 1 capital	3.5%	4.0%	4.5%
Minimum Tier 1 capital	4.5%	5.5%	6.0%
Minimum Total capital	8.0%	8.0%	8.0%

(i) *Capital Conservation Buffer*

The capital conservation buffer (CCB) is designed to ensure that banks build up capital buffers during normal times (i.e. outside periods of stress) which can be drawn down as losses are incurred during a stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements. Therefore, in addition to the minimum total of 8% as indicated in paragraph 2.3.1 above, banks will be required to hold a capital conservation buffer of 2.5% of RWAs in the form of common equity to withstand future periods of stress bringing the total common equity requirement of 7% of RWAs and total capital to RWAs to 10.5%. The capital conservation buffer in the form of common equity will be phased-in over a period of four years in a uniform manner of 0.625% per year, commencing from 1st January, 2016.

(ii) *Countercyclical Capital Buffer*

Further, a countercyclical capital buffer within a range of 0 – 2.5% of RWAs in form of common equity or other fully loss absorbing capital will be implemented according to national circumstances. Purpose of countercyclical capital buffer is to achieve the broader macro-prudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that results in a system-wide build-up of risk. The countercyclical capital buffer, when in

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effect, would be introduced as an extension of the capital conservation buffer range.

(iii) *Supplementing Risk-based Capital Requirement with a Leverage Ratio*

One of the underlying features of the crisis was the build-up of excessive on-and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios. Subsequently, the banking sector was forced to reduce its leverage in a manner that not only amplified downward pressure on asset prices, but also exacerbated the positive feedback loop between losses, declines in bank capital and contraction in credit availability. Therefore, under Basel III, a simple, transparent, non-risk based regulatory leverage ratio has been introduced.

Thus, the capital requirements will be supplemented by a non-risk based leverage ratio which is proposed to be calibrated with a Tier 1 leverage ratio of 3% (the Basel Committee will further explore to track a leverage ratio using total capital and tangible common equity). The ratio will be captured with all assets and off balance sheet (OBS) items at their credit conversion factors and derivatives with Basel II netting rules and a simple measure of potential future exposure (using current exposure method under Basel II framework) ensuring that all derivatives are converted in a consistent manner to a "loan equivalent" amount. The ratio will be calculated as an average over the quarter.

B. Additional Aspects Covered in Basel III

The guideline issued by the RBI also contains the following additional aspects covered in Basel III reform package:

1. Capital conservation buffer and
2. Leverage ratio.

All other instructions contained in remaining paragraphs of the Master Circular DBOD.No.BP.BC. 11/21.06.001/2011-12, dated 1st July, 2011 on 'Prudential Guidelines on Capital Adequacy and Market Discipline – New Capital Adequacy Framework (NCAF)' will remain unchanged under Basel III framework.

Calculation of Admissible Excess Additional Tier 1(AT1) and Tier 2 Capital for the purpose of reporting and disclosing minimum total Capital Ratios

Capital Ratios in the year 2018	
Common Equity Tier 1	7.5% of RWAs
CCB	2.5% of RWAs
Total CET1	10% of RWAs
PNCPS/PDI	3.0% of RWAs
PNCPS/PDI eligible for Tier 1 capital	2.05% of RWAs {(1.5/5.5)*7.5% of CET1}
PNCPS/PDI ineligible for Tier 1 capital	0.95% of RWAs (3-2.05)
Eligible Total Tier 1 capital	**9.55% of RWAs**
Tier 2 issued by the bank	2.5% of RWAs
Tier 2 capital eligible for CRAR	2.73% of RWAs {(2/5.5)*7.5% of CET1}
PNCPS/PDI eligible for Tier 2 capital	0.23% of RWAs (2.73-2.5)
PNCPS/PDI not eligible Tier 2 capital	**0.72% of RWAs (0.95-0.23)**
Total available capital	**15.50%**
Total Capital	**14.78% (12.28% + 2.5%) (CET1 -10%+AT1-2.05% +Tier 2-2.73)**

Time Frame for Implementation of the Guidelines

The implementation of the capital adequacy guidelines based on the Basel III capital regulations will begin as on 1st January, 2013. This means that as at the close of business on 1st January, 2013, banks must be able to declare/disclose capital ratios computed under the amended guidelines. However, as on 31st December, 2012, banks should calculate the capital adequacy according to existing Basel II framework. Banks should get the capital adequacy computation as on 1st January, 2013, verified by their external auditors and keep the verification report on record. The Basel III capital ratios will be fully implemented as on 31st March, 2018. ■