Basel III and Challenges

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Basel III

The recent GFC has not only triggered a debate on the subject of business model of banking but also redefined the contours and rationale underlying banking regulation.
The major lessons learnt for any regulatory policy are –

- **Health of individual institution does not necessarily guarantee the health of the financial system as a whole** — Need for an exclusive macro-prudential overlay to the micro-prudential regulation.

- Crisis has highlighted the **linkages of main types of risk**, especially credit, market and liquidity risk as also the **criticality of funding liquidity of banks** in determining their resilience – Awareness about the importance of regulating liquidity risk needs to be enhanced.

- **Part of the bank’s risk taking activities were left to others, which were lightly /not regulated** – Need to widen the perimeter of regulation to ensure that all systemically important institutions, markets and products are captured.

- **Build up of excessive on and off-balance sheet leverage**, accompanied by gradual **erosion of the level and quality of capital base** – Required some corrective policy action.
Basel III

Major Regulatory Reforms in Progress – Distilling the lessons of crisis, an international endeavor led to reform in the global financial regulation, known as Basel III.

Objectives -

- Improve banking sector’s ability to absorb shocks
- Reducing risk spillover to the real economy
Basel III

The Basel III reform aims to enhance micro prudential regulation and have a macro prudential focus -

- **Capital Regulation** – Improving the quality, risk coverage, consistency and transparency of the capital base.
- **Leverage Ratio** - A non-risk based ratio as a supplementary measure to Basel II risk capital requirements.
- **Liquidity Regulation** – to elevate resilience of banks to liquidity stresses – LCR and NSFR and some other standards.
- **Countercyclical Measure** – Time Dimension - To absorb the shocks and lower the volatility of the financial and real economy cycle – In form of capital buffers. Also, work is in progress on forward looking provisions - Working closely with IASB towards expected loss approach instead of incurred loss approach.
Basel III

- Cross Sectional Dimension - Too Big Too Fail - SIFIs/SIBs -
  - What can be done – Identification of SIFIs, Reducing the probability and impact of failure via higher prudential and other requirements - Capital and liquidity surcharge on SIBs, Activity restriction/exposure on SIBs., etc.
  - Improving resolution and other measures to ensure that all financial institutions can be resolved safely, quickly and without destabilizing the financial system and exposing the taxpayer to the risk of loss
  - more intensive supervisory oversight for financial institutions which may pose systemic risk
Basel III- Capital

- **Raising the quality of capital** - To ensure banks are better able to absorb losses on both a going concern (Tier I capital) and a gone concern (Tier II capital) basis - A key element of the new definition is the greater focus on common equity, the highest quality component of a bank’s capital.

- Tier 1 capital
  - Going concern capital
  - Common equity Tier I - to be the predominant form and must satisfy 14 criteria
  - Non-common equity – Additional Tier I - must satisfy 14 criteria
  - Innovative features (e.g., step up option) to be phased out

- Tier 2 capital
  - Gone concern capital
  - One set of entry criteria – removing sub-categories like Upper Tier 2 and Lower Tier 2 capital
  - Must satisfy 9 criteria

- Conversion of Non-equity capital instruments to equity at pre-defined trigger and at point of non-viability for additional Tier I and Tier II instruments.
Basel III- Capital

- **Increasing the risk coverage of the capital framework** - In addition to raising the quality 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 exposures, was a key destabilising factor during the crisis.

- In response, in July 2009, there was considerable strengthening of the minimum capital requirements for the trading book and complex securitisations, including for re-securitisation. It also introduced measures to strengthen the capital requirements for counterparty credit exposures arising from banks’ derivatives, repo and securities financing activities.
Basel III- Capital

- **Improving the consistency of capital**- The regulatory deductions / adjustments to capital varied across jurisdictions. With a view to improving the consistency of capital by harmonizing regulatory adjustments / deductions to capital across jurisdictions, a large number of baseline proposals came in December 2009, primarily aiming of harmonised set of regulatory deductions to improve consistency.

- Regulatory capital deductions to be taken from common equity than from Tier I and Tier II capital.
Basel III - Capital

- **Raising the level of the minimum capital requirements** - This includes an increase in the minimum common equity requirement from 2% to 4.5% and a capital conservation buffer of 2.5%, bringing the total common equity requirement to 7%.

- The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments whose inclusion is based on stricter criteria, will increase from 4% to 6% (before factoring in the conservation buffer).

- **Disclosure Requirements** – To Improve Transparency.
Basel III- Capital - Position in India

Capital – Indian banks at the system level are not likely to be significantly impacted by the proposed capital rules, mainly due to already high capital adequacy ratio.
However, for emerging economies like India, the implementation comes at a time when credit demand is expected to pick up given, *inter alia*, the compulsions of robust growth, the investment needs of infrastructure and the demand ushered in by increasing financial inclusion.

Thus, notwithstanding the current position at the aggregate level, the analysis revealed that the capital will need to be augmented in the coming years.

This could prove to be a challenge for the banking system.

Issue of Investors’ sentiments - RoE!

Criticality of capital planning – The capital requirements may be lower in initial years but higher during the later years as per the calendar.
RBI issued final guidelines on Basel III on May 2, 2012, which is based on the Basel III reforms on capital regulation, to the extent applicable to banks operating in India.

<table>
<thead>
<tr>
<th>Proposed Ratios under Basel III</th>
<th>CET 1 Ratio</th>
<th>Tier 1 Ratio</th>
<th>CRAR</th>
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</thead>
<tbody>
<tr>
<td>Minimum requirement</td>
<td>5.5</td>
<td>7</td>
<td>9</td>
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<tr>
<td>Capital conservation buffer</td>
<td>2.5</td>
<td></td>
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<tr>
<td>Minimum requirement + capital conservation buffer</td>
<td>8</td>
<td>9.5</td>
<td>11.5</td>
</tr>
</tbody>
</table>
One of the underlying features of the GFC was the build up of excessive on and off-balance sheet leverage in the banking system, while continued to show strong risk based capital ratios. Issue of risk weight!!

Also, at the peak of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on the asset prices and exacerbating the crisis – i.e. positive feedback loop between losses, decline in bank capital, and contraction in credit availability.

Therefore, non-risk based leverage ratio as a credible supplementary measure to risk based capital requirements was introduced with the intention to constrain the build-up of leveraging and helping avoid destabilizing deleverage process.
Basel III- Leverage Ratio

- Leverage Ratio –
  - Numerator – Tier 1 capital.
  - Denominator – All on and off B/S exposure.
- It is intended to test a minimum Tier I leverage ratio of 3% during parallel run (Jan 1, 2013 to Jan 1, 2017). The disclosure on leverage will start from January 1, 2015.
- Final prescription of Leverage Ratio requirement and further calibration of numerator would be based on the parallel run outcome.
Basel III- Leverage Ratio

- The numerator i.e. Tier 1 capital will be based on the new definition under Basel III; the items that are deducted completely from capital will also be deducted from the measure of exposure.
- The denominator i.e. Exposure should generally follow the accounting measure of exposure.
  - On - B/S items - All items of assets and non derivative exposures (net of provision) as also SFTs (without netting long and short positions with the same counterparty).
  - Derivatives - MTM plus PFE as per the current exposure method and no netting in r/o same counterparty.
  - Off- B/S items – Generally by using CCF of 100%. In case of commitments that are unconditionally cancellable, a CCF of 10% to be used.
Basel III- Leverage - Position in India

- Leverage – Estimates show that the leverage of Indian banking system is quite moderate.

- Indian banks may not have a significant problem in meeting the leverage ratio requirement since the Tier 1 capital of many Indian banks is comfortable (more than 9%) and their derivatives portfolios are also not very large.
Basel III– Capital Conservation Buffer

- **Capital Conservation Buffer (CCB)** – It is designed to ensure that banks build up capital buffer comprising common equity of 2.5% of RWAs during normal time and can be drawn down during a stressed (systemic or idiosyncratic) period.

- It is intended to strengthen the banks’ resilience to adverse conditions, and provide the mechanism for rebuilding capital during the early stages of economic recovery. It thus helps in reducing the pro-cyclicality.

- Under this framework, if capital level breaches the CCB level (i.e. between 8% to regulatory minimum of 5.5%), banks should look to rebuild them through reducing discretionary distribution of earnings (e.g. Dividend payments, share buyback, staff bonus payments, discretionary payments on other Tier I capital instruments, etc.). The distribution constraints imposed on banks increases when their capital levels approach the minimum requirements.

- Banks may also choose to raise capital as an alternative to conserving internally generated capital. But greater thrust should be on retaining earnings for rebuilding CCB.
## Basel III– Capital Conservation Buffer

<table>
<thead>
<tr>
<th>Common Equity Tier 1 Ratio</th>
<th>Minimum Capital Conservation Ratio (expressed as a % age of earnings)</th>
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<tbody>
<tr>
<td>5.5% - 6.125%</td>
<td>100%</td>
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<tr>
<td>&gt;6.125% - 6.75%</td>
<td>80%</td>
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<td>&gt;6.75% - 7.375%</td>
<td>60%</td>
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<td>&gt;7.375% - 8.0%</td>
<td>40%</td>
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<td>&gt;8.0%</td>
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Basel III– Countercyclical Buffer

- **Primary objective**
  - *Protect banking sector from periods of excessive aggregate credit growth often associated with build-up of system-wide risk*

- Aim is for banking sector in aggregate to have capital on hand to help maintain flow of credit during periods of system-wide stress and minimise the downturn impact in the real economy
  - Help contain risk that a disruption in credit flow might undermine performance of real economy that then feeds back as additional losses in banking system
Basel III– Countercyclical Buffer

- Each jurisdiction responsible for calculating countercyclical capital buffer applicable to all credit exposures in its jurisdiction
- Buffer is subject to an upper bound & only in effect when there is evidence of excess credit growth resulting in build up of systemic risk
- On at least a quarterly basis, relevant authorities in each jurisdiction will review whether a buffer should come into effect in their jurisdiction, or whether the buffer currently in effect should be increased or decreased
- Relevant authorities will communicate their decisions to banks in their jurisdiction and other banks that have credit exposures to counterparties in their jurisdiction
Basel III– Countercyclical Buffer

- It is within a range of 0-2.5% of RWAs (common equity) based on national discretion. - will be phased in w.e.f. January 1, 2016.

- This will be implemented according to national circumstances i.e. buffer will be in effect only when there is excessive credit growth that results in system-wide build up of risk.

- No variables can be relied on to mechanistically raise buffer during build-up of systemic risks, or reduce it on a timely basis when credit cycle turns
  - Discretion in framework therefore unavoidable

- Deviations of ratio of aggregate private sector credit to GDP from its long term trend was found serving as good indicator of build-up of systemic risk
Basel III- Counter-Cyclical Measures- Position in India

- Essentially, BCBS buffer guide implicitly assumes that the long-term trend of the credit-to-GDP ratio is a reliable proxy for the optimal credit required for an economy and any positive/negative deviation denotes excess/deficit credit growth.

- This is presumably valid in the case of the advanced economies operating generally at full employment with mature and integrated financial markets.

- However, the BCBS buffer guide of deviation of credit-to-GDP ratio from its long-term trend is not suitable for India for variety of reasons. Unlike in advanced economies where this ratio is stable, in emerging economies such as India, it will likely to go up for structural reasons.

- The long-term trend does not represent optimal credit requirements of the Indian Economy. Factors which predominantly determine the credit-to-GDP ratio in India include financial deepening from a low base, rising efficiency of goods markets, rising efficiency of credit markets and policy initiatives to improve flow of credit to sectors like the agriculture and small scale units.
Basel III- Counter-Cyclical Measures- Position in India

- For an emerging market economy like India, credit demand is expected to go up due to compulsions of robust growth, investment needs of infrastructure and the demand for upscaling financial inclusion.

- Further, subtle behavioural changes underway, typical of a fast developing economy, push up credit and these include, *inter alia*, rising consumption financed through debt as consumers become wealthy i.e. behavioural changes arising out of wealth effect..

- One of the important growth driving factor was so far the services sector. However, in future, it may shift to manufacturing sector which may lead to increase in credit to GDP ratio.

- Hence, there is a need for an alternative buffer guide, which can unambiguously mirror the macro-financial environment in which banks in India presently operate.
Basel III- Counter-Cyclical Measures- Position in India

- In fact, the proposed framework is flexible enough to allow national discretion to suit the country situation in a ‘comply or explain’ framework.

- To effectively deploy countercyclical measures, we also need to improve our capabilities to predict business cycles at the aggregate and sectoral levels, and identify them in real time. This will require better quality of economic and financial data as well as improved analytical capabilities.

- In India, sectoral approaches to countercyclical policies have stood the test in the past and we could continue with such sectoral approaches. Measures used in India to contain procyclicality - Standard Provisioning, Risk Weight, LTV, etc.
Basel III - Liquidity Risk - Standards

- Two standards/ratios proposed
  - Liquidity coverage ratio (LCR) for short term (30 days) liquidity risk management
  - Net Stable Funding Ratio (NSFR) for longer term structural liquidity mismatches
- In addition, some other monitoring tools were also proposed.
Basel III - Liquidity Risk - Standards

Liquidity coverage ratio

Ensuring enough liquid assets to survive an acute stress scenario lasting for 30 days

Defined as stock of high quality liquid assets / Net cash outflow over 30 days > 100%
Basel III - Liquidity Risk - Standards

- Net stable funding ratio
  - To promote medium to long term structural funding of assets and activities
  - Defined as Available amount of stable funding / Required amount of stable funding > 100%
Basel III- Liquidity Risk- Standards

- LCR proposed to be introduced from January 1, 2015.
- NSFR from January 1, 2018.
- Observation period to start from January 1, 2012 for both LCR and NSFR.
Basel III - Liquidity – Position in India

- Liquidity – The major problem is to collect the relevant data accurately and granularly, and to formulate and predict the liquidity stress scenarios with reasonable accuracy and consistent with their own situation.
- Since our financial markets have not experienced the levels of stress scenario is going to be a complex judgment call.
- On the positive side, most of our banks follow a retail business model and do not depend much on short term / overnight wholesale funding and also have a substantial amount of liquid assets which should enable them to meet the new standards.
- Internal QIS is being undertaken to assess the level of LCR and NSFR. There may not be much problem for the system as a whole, though some of the banks, and especially larger banks in private sector, may have problem to achieve the requirements.
- Whether SLR securities will qualify for liquid assets?
## Annex 1: Phase-in arrangements

Shading indicates transition periods - all dates are as of 1 January

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<td><strong>Minimum common equity capital ratio</strong></td>
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<td><strong>Minimum common equity plus capital conservation buffer</strong></td>
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<tr>
<td><strong>Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)</strong></td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
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<td><strong>Minimum total capital plus conservation buffer</strong></td>
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<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.5%</td>
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<tr>
<td><strong>Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital</strong></td>
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<td>Phased out over 10 year horizon beginning 2013</td>
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<td><strong>Liquidity coverage ratio</strong></td>
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<td><strong>Introduce minimum standard</strong></td>
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<td><strong>Net stable funding ratio</strong></td>
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<td>Introduce minimum standard</td>
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**Basel III- Capital - - Transitory Arrangement - Position in India as per our Guidelines**

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<tbody>
<tr>
<td>Minimum Common Equity Tier 1 (CET1)</td>
<td>4.5 (3.5)</td>
<td>5 (4)</td>
<td>5.5 (4.5- Jan 1, 2015- Basel III Proposal)</td>
<td>5.5</td>
<td>5.5</td>
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<tr>
<td>Capital conservation buffer (CCB)</td>
<td>-</td>
<td>-</td>
<td>0.625 (Jan 1, 2016)</td>
<td>1.25</td>
<td>1.875</td>
<td>2.5 (Jan 1, 2019)</td>
</tr>
<tr>
<td>Minimum CET1+ CCB</td>
<td>4.5</td>
<td>5</td>
<td>6.125</td>
<td>6.75</td>
<td>7.375</td>
<td>8</td>
</tr>
<tr>
<td>Minimum Tier 1 capital</td>
<td>6 (4.5)</td>
<td>6.5 (5.5)</td>
<td>7 (6- Jan 1, 2015)</td>
<td>7</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Minimum Total Capital*</td>
<td>9 (8)</td>
<td>9 (8)</td>
<td>9 (8)</td>
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<td>9</td>
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<tr>
<td>Minimum Total Capital +CCB</td>
<td>9</td>
<td>9</td>
<td>9.625</td>
<td>10.25</td>
<td>10.875</td>
<td>11.5</td>
</tr>
<tr>
<td>Phase-in of all deductions from CET1 (in %)</td>
<td>20 (20- from Jan 1, 2014)</td>
<td>40</td>
<td>60</td>
<td>80</td>
<td>100 (Jan 1, 2018)</td>
<td>100</td>
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</table>
Basel III – Challenges

- The issues relating to availability and access to quality capital - India being a developing country with a bank dominated financial system which is expected to grow at relatively higher rate, incremental credit requirements are going to be much larger compared to western countries.

- Higher credit growth would obviously require larger capital requirements.

- Banks hitting the market simultaneously to raise capital: Lack of Liquidity

- These issues are especially challenging at the time of cyclical downturn, uncertain global economic scenario, increasing NPAs which require more capital for the banking sector as a whole.
Basel III – Challenges

- Our financial markets are becoming more sophisticated and derivatives are used for hedging and redistributing risks amongst various players.

- This will necessitate more capital requirements unless we are able to ensure that more and more derivatives are cleared through central clearing.
Basel III – Challenges

- **Leverage** - For calculation of leverage ratio, off-balance sheet exposures in the form of letters of credit for trade finance will be counted at their full value.

- Presently such exposures attract 20 per cent CCF for calculation of risk based capital requirements.

- Since trade finance is expected to assume more importance in future as we are becoming more integrated with the world economy, leverage ratio may work as constraining factor.
Basel III – Challenges

- Operationalising the Loss absorbency at the point non-viability of capital instruments:
  - may make capital instruments difficult to price and thus may lack liquidity;
  - may require banks to rely on common equity only;
  - in any case the cost of capital to go up
Basel III – Challenges

- **Operationalising the countercyclical capital buffer**: based on aggregate credit to GDP ratio deviating from long term trend;
- In developing countries trend difficult to project due to structural transformation of the economy;
- The data related to aggregate credit difficult to get especially long time series;
- Implementation has to be in consonance with sectoral approach being followed by us so far;
- Interaction between aggregate and sectoral may have to specified.
Basel III – Challenges

Requirements of Buffers:

- may effectively increase the minimum requirements,

- may be difficult to release during downturns due to strong risk aversion:

- requirement of effective communication with markets
Basel III – Challenges

- **Requirement of LCR**: difficult to project cash outflows reliably during stress periods,

- lack of adequate amount of liquid assets in many jurisdictions;

- in the case of India due to already high reserve requirements it may depress banks’ earnings.
Basel III –Challenges

- **Requirement of NSFR**: The business model of many banks may be required to change,

- medium and long term funding may not be available in sufficient numbers at all times;

- NSFR may constrain infrastructure funding by banks.
Basel III – Challenges

- **Reorientation of Business Models** – One of the possible outcome of changing regulations – the catalysts are - Limit on Leverage, price transparency, greater supervisory scrutiny of proprietary trading – It will be difficult to translate narrow margins into high equity returns – May need to improve efficiency, cutting less profitable parts of the business, raising prices, focus on business lines that give steady and reliable income streams such as settlement, custodial, retail services, specializes on their expertise in niche areas such as advisory services, facilitating client’s trading activities, etc.

- **Funding Patterns may change** - LCR and NSFR may induce banks to increase their holdings of liquid assets and to align more closely the maturity of their funding with that of their investments. Thus, banks may seek access to low cost, stable funding source, such as building up their deposits base. Increased competition for deposits may also lead to a narrowing in NIM.
Basel III – Impact on Indian Banks

- Indian Banks have high Tier 1 ratio in excess of 10% on average; More than 90% of Tier 1 comprise of Common Equity; Thus sufficient cushion is available for Indian banks
- However, for some individual banks there may be need to raise more common equity
- Step-up clause in capital instruments may make some IPDI ineligible going forward – to be phased out over a period of 10 years
- It would push down the banks’ RoE to an extent, it would be difficult to convince investors in short term
- However, it is expected that by looking at the benefits of implementation of Basel III capital requirements by way of increasing resilience of the banking system, investors will get adjusted to the new reality.
- Although all the safeguards proposed under Basel III are necessary, they will also raise the banks’ funding cost. There is thus a need to improve the efficiency so that the cost of borrowings should not go up significantly.
Basel III – Impact on Indian Banks

- Compared to international standards, their exposure to OTC derivatives lesser
- Hence transition to Basel III to be smooth
- Proportion of liquid assets to increase – on SLR - view to be taken
- In line with other EMEs, impact on credit availability to be examined
Macroeconomic Impact – MAG Study

- It is expensive to find assets with capital than with deposits or wholesale debt.
- Higher capital requirements will lead to increased retained earnings, issuance of equity and reduced RWAs/Assets.
- However, the proportion of these three components will depend on the time given to comply with new requirements.
- In a longer implementation schedule, the proportion of retained earnings will be more, thereby mitigating the impact on cost of credit and credit availability.
- The estimated GDP impact per percentage point of higher capital is 0.17%.
- Main benefits – reduced probability of crisis and associated output losses; reduced amplitude of cycles.
- Hence, NET benefit.
Macro-Economic Impact – IIF Study

- Banks fund themselves at a particular price and lend to the private sector at a spread
- Output loss of 0.7% per annum
THANKS