

# Impact of BASEL-III Implementations for Indian Banking System: A Review

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## ABSTRACT

Widespread calls for reforms of regulation and supervision had come from all over the world whenever the financial crisis sparked and exposed significant weaknesses in the financial, regulatory and supervisory framework of the nations. Best practices in supervision and regulation have been embodied in BASEL Core Principles (BCPs). These principles were issued by the Basel Committee on Bank Supervision, comprising representatives from bank supervisory agencies from advanced countries. Following which, many countries have started to adopt and comply with the BCPs; India too is looking forward to adopting it. But before we actually adopted it in its true form, the readiness of India needs to be studied in the light of capital adequacy and liquidity position, only then can we hope to achieve the target of stability with growth.

**Keywords:** Financial crisis, Basel core principles, Basel Committee, Capital adequacy, Liquidity position

### 1. Introduction

Financial crisis all over the world has attracted attention towards the reforms of regulation and supervision of financial institutions and markets. It has also raised the question on the functioning of banks as number of these financial institutions in the world collapsed. Situation was the same, whether the country practiced regulated or unregulated system. For example, unregulated hedge funds could not sustain the crisis and as a result collapsed and quietly disappeared. Similarly, regulated banks in the United States and Europe ( eg-American Eagle Savings Bank, The First State Bank, Central Florida State Bank, etc) which have operated with too much leverage, poured too much money into bad assets, also collapsed. As far as everything was running smooth, no problems were found of significant effect but the recent crisis (running since 2007) exposed significant weaknesses in the regulatory and supervisory framework worldwide, and has given birth to a growing debate about the role these weaknesses may have played in causing and propagating the crisis. Consequently, policy makers are focusing their attention towards reforms of regulation and supervision of their respective financial systems and at the same time, they are focusing on the up gradation of their frameworks. For this to happen, many countries have started adopting the recommendations of BASEL III for the functioning of their banks.

### Evolution of the BASEL Framework

Emergence of the need of BASEL framework took place with the growing scenario of internationally active banks in United States which were facing the problem of lending to sovereign borrowers that threatened their solvency in the late 1980's. Whereas countries like Japan were strengthening their capital base which posed competition to banks of other countries. In order to correct the imbalance of internationally competitive banks across the globe, BASEL framework was established in 1974 at the Bank for International Settlements (BIS), a meeting place for central bankers created after the First World War. It required banks to hold a reasonable amount of capital to serve as a buffer in the event of losses and also to stay competitive. A minimum ratio of 4% for Tier-1 capital (i.e. - Equity less Goodwill) to risk-weighted assets (RWA) and 8% for Tier 1 and Tier 2 capital (certain subordinated debt etc) was prescribed.

The framework contained "three pillars" as follows:

- (i) Rules to define minimum capital requirements;
- (ii) Supervisory oversight, which includes authority to insist on supplementary capital beyond Pillar 1 requirements; and
- (iii) Market discipline.

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Pillar 1 is the core of the framework which classifies bank assets into different “risk categories,” to determine a parameter, called a “risk weight.” This parameter is used to calculate a capital charge equal to 8 percent of each asset's risk-weighted value. Under BASEL I, this parameter was fixed at 0, 20, 50, or 100 percent.

A 'revised framework' known as BASEL -II was released in June 2004 (BCBS, 2004) as many issues had crept in with Basel-I, most notably that regulatory arbitrage was rampant (Jackson, 1999). Every official 'Quantitative Impact Study' (QIS) conducted by the Basel Committee forecasted large capital reductions relative to BASEL I levels for banks employing the internal rating base approach. Therefore, now the aim was to make it more “risk sensitive” and involved extensive refinement of the rules for determining the risk weights under BASEL II. Credit ratings were used to introduce an empirical basis for some risk weights. A system of complicated calculations on the basis of internationally agreed formulae was defined.

Pillar 1 of the BASEL-II system defined minimum capital to buffer unexpected losses. Total risk-weighted assets (RWA) are based on a complex system of risk weighting that applies to 'credit', 'market risk' (MR) and 'operational' risk (OR), which are calculated separately and then added:

$$RWA = \{12.5(OR+MR) + 1.06 \cdot \sum [w(i) A(i)]\}$$

(where: w(i) is the risk weight for asset i; and A(i) is asset i; OR and MR are directly measured and grossed up by 12.5 for 8% equivalence; and credit risk is the sum of the various asset classes, each weighted by its appropriate risk weight. A scaling factor applied to this latter term, estimated to be 1.06 on the basis of QIS-3 data.)

Banks were able to choose between: first, a simplified approach (for smaller institutions without the capacity to model their business in risk terms) by using the fixed weights shown in column two of Table 1; second, an approach based on external ratings (shown in the column three in Table 1); and third, an internal ratings-based (IRB) approach for sophisticated banks, driven by their own internal rating models (see the right side of Table 1).

TABLE 1. Basel I and Basel II risk weights and commentary

Security	Risk Weights Under BASEL I and BASEL II (Pillar I)%					
	BASEL I	BASEL II Simplified Standardised	BASEL II Standardised based on External Ratings	BASEL II Advanced : Internal Ratings Based (IRB) 2004-05 QIS 4 Avg % chg in portf. MRC	BASEL II Advanced : Internal Ratings Based (IRB) 2004-05 QIS 4 Median % Chg in portf. MRC	
Most Government/ Central Bank	0	0		0	0	Comes close to letting banks set their own Pillar 1 capital, with supervisory oversight. Risk weights depend on internal estimates of a loan's probability of default; loss-given default; exposure to loss. These are based on the banks' own complex risk models, relying on subjective inputs and often on unobservable (e.g. OTC illiquid securities) prices.
AAA to AA-			0			
A- to A-			20			Pillar 2 provides for supervisory oversight. With stress testing, and guidance from supervisors, banks can be made to hold capital for risks not adequately captured under Pillar 1.
BBB+ to BBB-			50			
BB+ to B- (& unrated)			100			
Below B-			150			
Other public (supervisors discretion)	0-50	0		0	0	Pillar 3 is disclosure and market discipline which relies on some notion of market efficiency. Rational markets punish poor risk managers.
Claims on MDBs	20	0		-21.9	-29.7	
Most OECD Banks & Securities firms	20	20	<90days	other	-2.19	-29.7
AAA to AA-			20	20		Pillar 3 is disclosure and market discipline which relies on some notion of market efficiency. Rational markets punish poor risk managers.
A+ To A-			20	50		
BBB+ to BBB-(unrated)			20	50		
BB+ to B-			50	100		
Below B- Residential	50	35	35		-61.4	-72.7
Mortgages-fully secured						Pillar 3 is disclosure and market discipline which relies on some notion of market efficiency. Rational markets punish poor risk managers.
Retail Lending (consumer)	100	75	75		(-6.5 to -74.3)	
Corporate & Commercial RE	100	100			(-21.9 to 41.4)	(-29.7 to 52.5)
AAA to AA-			20			Pillar 3 is disclosure and market discipline which relies on some notion of market efficiency. Rational markets punish poor risk managers.
A+ to A-			50			
BBB+ to BB-(& unrated)			100			
Below BB-			150			

Sources: BIS (1988) and BIS (final version June 2006); FDIC (2005).

Despite the fact that the above principles were put into practice by the eminent bankers of the world, BASEL II also collapsed due to its failure to create a more comprehensive approach to risk management which stemmed from its lenient treatment of asset securitization.

## 2. Advent of BASEL-III

BASEL-III norms are rules written by the Bank of International Settlement's Committee on Banking Supervision (BCBS) whose mandate is to define the reform agenda for the global banking community as a whole. BASEL-III aims to address the problem of excess leverage and poor liquidity management. It retains the core feature of the BASEL framework, i.e., the capital charge system with multiple risk weights. The main focus is on the identification of numerous problems that contributed to or emerged during the crisis and proposes new and often more detailed rules in the hope that these will avoid recurrence of such problems. However, while trying to constructively address some problems, it has made the process much complex.

The new rule prescribes method to assess risks, and the amount of capital to set aside for banks according to their risk profile. Going by the new rules, the predominant component of capital is common equity and retained earnings with restriction on inclusion of items such as deferred tax assets, mortgage-servicing rights and investments in financial institutions to not more than 15% of the common equity component. While the key capital ratio has been raised to 7% of risky assets, according to the new norms, Tier-I capital that includes common equity and perpetual preferred stock will be raised from 2-4.5% starting in phases from January 2013 to be completed by January 2015. In addition, banks will have to set aside another 2.5% as a contingency for future stress. Banks that fail to meet the buffer would be unable to pay dividends, though they will not be forced to raise cash. While BASEL II focused on macro prudential regulation but due to the global financial crisis in the US Subprime market, there has been a change in approach, i.e., the focus has now shifted at micro level in BASEL III.

### Major provisions of BASEL III.

- (i) More stringent definition of capital and Loss absorptive capacity of Tier 1 and Tier 2 Capital instrument of internationally active banks.
- (ii) Prescription of forward looking provisioning.
- (iii) Modifications made in counterparty credit risk weights
- (iv) Introduction of new parameter of leverage ratio.
- (v) Prescription of Global liquidity standards.

## 3. Objectives of the Study

Following are the objectives of the study-

- (i) To study the implications that the implementation of BASEL-III is going to have on existing Indian banking system.
- (ii) To assess the readiness of India for BASEL III.
- (iii) To point out the requirements for the implementation of BASEL III in India.

## 4. Literature Review

A lot of research has been done recently to study the implications of BASEL norms on the soundness of the banks and the results have been contradictory. The very first compilation and analysis on banking sector laws and regulations was done by **Barth, Caprio, and Levine (2001, 2004, and 2006)**. They used various surveys of regulators around the world to study the relationship between alternative regulatory strategies and reached at the conclusion that private sector monitoring of banks (such as disclosure of reliable, comprehensive and timely information) improves bank performance and stability. They interpret their findings as a challenge to the BASEL Committee's influential approach to bank regulation which heavily emphasizes capital and official supervision. IMF and the World Bank financial sector assessments have often found implementation to be lacking in the above type of surveys, particularly in low income countries, so that cross-country comparisons of what is on the books may hide substantial variation in the quality of supervision and regulation. Base Core Principles (BCP) assessments overcome the above problem. For these assessments standardized methodology by experienced international assessors is executed. On the basis of **Barth, Caprio and Levine's (2001, 2004, and 2006)** 1 survey data and BCP assessments, **Cihak and Tieman (2008)** analyzed the quality of financial sector regulation and supervision and found out that quality of supervision and regulation is higher in high income countries than in lower income countries. Correlation between survey data and BCP data was found to be as low as 20-30 percent range, which suggested that S&P's sovereign implementation of BASEL III norms makes a lot of difference.

Yet another major study was undertaken by **Sundararajan, Marston, and Basu (2001)** who took a sample of 25 countries to study bank regulation and performance. By examining the relationship between an overall index of BCP compliance and two indicators of bank soundness: nonperforming loans (NPLs) and loan spreads it was found out that BCP compliance was not a significant determinant of these measures of soundness. **Podpiera (2004)** extends the set of countries and finds that better BCP compliance lowers NPLs. **Das et al. (2005)** relates soundness of banks to a broader concept

of regulatory governance, which encompasses compliance with the BCPs as well as compliance with standards and codes for monetary and financial policies.

**Demirgüç-Kunt and Detragiache** established in 1998 that Bank soundness is affected by the macroeconomic outlook, as factors such as slow output growth, high and volatile inflation; rapid exchange rate depreciation, high real interest rates, and rapid credit expansion have been found to be associated with instability of banks. These macroeconomic variables were combined in alternative specifications to test volatility. Ratings by world renowned

rating agencies were also a comprehensive indicator of the quality of macroeconomic policies and institutions affecting the stability of banks in a country. These Macroeconomic variables are taken from the IMF's International Financial Statistics.

A mention may also be made of the research done by **Demirgüç-Kunt, Detragiache and Tressel**, in 2008 in which it was understood that banks receive more favorable financial strength ratings from Moody's in countries with better compliance with BCPs related to information provision, while compliance with other principles does not affect ratings significantly.

The findings of these studies can be summarized as:

Researchers	Study	Findings
Barth, Caprio, and Levine (2001, 2004, and 2006)	The relationship between alternative regulatory strategies	Private sector monitoring of banks improves bank performance and stability.
Cihak and Tieman (2008)	Analysis of financial sector regulation and supervision	Quality of supervision and regulation is higher in high income countries than in lower income countries.
Sundararajan, Marston, and Basu (2001) Podpiera (2004)	The relationship between an overall index of BCP compliance and two indicators of bank soundness: nonperforming loans (NPLs) and loan spreads (sample of 25 countries)	BCP compliance was not a significant determinant of these measures of soundness. BCP compliance lowers NPLs
Das et al. (2005)	Same study as Sundarajan, Martson and Basu but extended to include more countries	Compliance with the BCPs as well as standards and codes for monetary and financial policies leads to bank soundness
Demirgüç-Kunt and Detragiache established (1998)	Relationship between bank soundness and regulatory governance	Quality of macroeconomic policies and institutions affects the stability of banks in a country.
Demirgüç-Kunt, Detragiache and Tressel (2008)	Macroeconomic variables (from IMF's International Financial Statistics) outlook on bank soundness Study of Moody's rating across countries	High credit rating for BCP complaint countries.

Source: ICRA rating services 2010

After a thorough study of the above table, it becomes clear that different countries had different experiences as far as the effectiveness of BASEL proposals for the smooth functioning of their financial systems is concerned. Some researchers have shown that BCP compliance leads to bank soundness (**Cihak and Tieman (2008), Podpiera (2004), Das et al. (2005), Demirgüç-Kunt and Detragiache established (1998), Demirgüç-Kunt, Detragiache and Tressel (2008)**). At the same time, there are examples where BCPs have been unsuccessful in generating any positive results **Barth, Caprio, and Levine (2001, 2004, and 2006) and Sundararajan,**

**Marston, and Basu (2001)**. But in most cases, the results have been positive and, therefore, we are quite hopeful that BCPs will help India address issue of financial problems.

## 5. Methodology Used

This exploratory study is based on secondary data including analysis of previous research articles, reports and websites. The authors have gone for secondary sources to collect information because it is always wise to begin any research activity with a review of the secondary data (**Novak, 1996**). Besides it, secondary data are also

helpful in designing subsequent primary research and, as well, can provide a baseline with which to compare primary data collection results of the researcher.

## 6. Significance of the Study

This study is highly significant as it will benefit every bank whether public sector or private sector as it tries to bring out focal points which need attention. It will also benefit policy makers and administrators of financial institutions in framing their upcoming policies in line with the BASEL III guidelines.

## 7. Stipulations of BASEL III

The Basel committee finalized the BASEL III guidelines in December 2010, following which a six year phase-in period

beginning 2013 was prescribed. BASEL III norms are scheduled to be implemented from January 1, 2013, and have to be completed by January 1, 2019. The definition of regulatory capital has been revised in the sense that it is much wider in terms of risk coverage clauses and encompasses measures to address systemic risks. The RBI observed that implementation of Basel III has thrown up significant challenges for both banks and banking supervisors alike. Availability of an adequate amount of capital, both in terms of quality and quantity, "provides significant comfort to begin implementation of the new framework" as per the time schedule fixed by the BCBS. To study the impact of BASEL III norms on Indian banks, capitalization of top Indian banks should be known (refer Table 2)

**Table 2: Capitalization profile of top Indian banks as on March 31, 2010.**

Public Sector Banks (Amount in Rs. crore)	Core Tier-1 (net of deductions)	Core Tier-1 (net of deductions) %	Tier-1 (net of deductions) %	Tier-2 (net of deductions)%	CRAR %	GOI shareholding
Allahabad Bank	5,876	7.72%	8.12%	5.51%	13.62%	55.23%
Andhra Bank	4,221	7.81%	8.18%	5.75	13.93%	51.55%
Bank of Baroda	13,157	8.43%	9.20%	5.16%	14.36%	53.81%
Bank of India (Consolidated)	12,230	7.15%	8.57%	4.43%	13.0%	64.47%
Bank of Maharashtra	2,069	5.61%	6.41%	6.37%	12.78%	76.77%
Canara Bank	12,030	7.99%	8.54%	4.89%	13.43%	73.17%
Central Bank of India	4,341	4.71%	6.83%	5.40%	12.23%	80.20%
Corporation Bank	5,724	8.169/5	9.25%	6.12%	15.37%	57.17%
Dena Bank	2,202	7.33%	8.16%	4.61%	12.77%	51.19%
IDBI Bank	7,952	4.37%	6.35%	5.13%	11.48%	52.67%
Indian Bank	6,605	10.50%	11.13%	1.6%	12.71%	80.00%
Indian Overseas Bank	6,095	7.68%	8.67%	6.11%	14.78%	61.23%
Oriental bank of Commerce	7,297	8.63%	9.28%	3.25%	12.54%	51.09%
Punjab National Bank	15,207	8.04%	9.11%	5.04%	14.16%	57.80%
Punjab & Sind Bank	2,127	7.14%	7.68%	5.41%	13.10%	100.0%
State Bank of India - Group	75,295	8.60%	9.28%	3.25%	12.54%	51.09%
State Bank of Bikaner & Jaipur	2,343	7.70%	8.35%	4.95%	13.30%	
State Bank of Hyderabad	3,748	7.079%	8.64%	6.26%	14.90%	
State Bank of Mysore	1,965	6.70%	7.59%	4.84%	12.42%	
State Bank of Patiala	3,505	7.52%	8.16%	5.10%	13.26%	
State Bank of Travancore	2,658	8.31%	9.24%	4.50%	13.74%	
Syndicate Bank	5,206	7.17%	8.24%	4.46%	12.70%	66.475%
UCO Bank	3,482	4.90%	7.06%	6.16%	13.21%	63.59%
Union Bank	8,657	7.06%	7.91%	4.60%	12.51%	55.43%
United Bank	2,871	6.85%	8.16%	4.64%	12.80%	84.20%
Vijaya Bank	2,478	6.40%	7.69%	4.81%	12.50%	53.84%
<b>Total - Public Sector Banks</b>	<b>205,119</b>	<b>7.66%</b>	<b>8.60%</b>	<b>4.75%</b>	<b>13.35%</b>	

Source: ICRA Rating Services 2010

After studying the above profile, one is in a better position to understand the new requirements as stipulated by BASEL

III and the amount of variations required in different parameters, amongst which the major ones have been listed below:

**(i) Capital requirements:**

The Indian Banks would be necessitated to raise Rs. 6, 00,000 crore over the next 9 years and also lower their leverage capacity. As compared to their international counterparts, Indian banks may find it easy to make the transition to a stricter capital requirement regime as India is already following stringent regulatory norms on capital adequacy. India has also shown a regular track record of maintaining capital in excess of regulatory minimum. The proposed BASEL III guidelines seek to enhance the **minimum core capital** (after stringent deductions), introduce a **capital conservation buffer** (with defined triggers), and prescribe a countercyclical buffer (to be built up in times of excessive credit growth at the national level). Proposed and existing RBI norms have been shown as under:

**Table 3: Regulatory Capital Adequacy Levels Proposed vs. Existing RBI NormA)**

	Proposed BASEL III Norm	Existing RBI Norm
Common equity (after deduction)	4.5%	3.6%b(9.2%)
Conservation buffer	2.5%	Nil
Countercyclical buffer	0-2.5%	Nil
Common equity + Conservation after + Countercyclical buffer	7-9.5%	3.6%b(9.2%)
Tier (Including the buffers)	8.5-11%	6% (10%)
Total capital (Including the buffers)	10.5-13	9%5%)

Source: Basel committee documents, RBI, Basel II disclosure of various banks; figures in parenthesis pertain to aggregated capital adequacy of banks covering over 95% of the total banking assets as on March 31, 2010.

**Table 4: Deductions from Capital: Proposed vs. Existing RBI Norms**

	Proposed BASEL III Guideline	Existing RBI Norm	Impact
Limit on deduction	Deductions to be made only if deductibles exceed 15% of core capital at an aggregate level, or 10% at the individual item level	All deductions to be deducted	Positive
Deductions from Tier I or Tier II	All deductions from core capital	50% of the deduction from Tier I and 50% from Tier II (except) DTA and intangible assets wherein 100% deduction is done from Tier I capital)	Negative
Treatment of significant investments in common shares of unconsolidated financial institutions	Any investment exceeding 10% of issued share capital to be counted as significant and therefore deducted.	For investment u to: (i) 30-125% risk weight or risk weight as warranted by external rating (ii) 30-50%: 50% deduction from Tier I and 50% from Tier II.	Negative

Source: Basel committee documents, RBI, Basel II disclosure of various banks; figures in parenthesis pertain to aggregated capital adequacy of banks covering over 95% of the total banking assets as on March 31, 2010.

**A) Changes in standard deductions-** The proposed BASEL III guidelines suggest changes in the deductions made for the computation of the capital adequacy percentages. The key changes for Indian banks are given in Table 4.

Table 4: Deductions from Capital: Proposed vs. Existing RBI Norms

**B) Capital conservation buffer-** The BASEL committee suggests that a new buffer of 2.5% of risk weighted assets (over the minimum core capital requirement of 4.5%) be

**(ii) Liquidity requirements****Table 5: Liquidity Ratio Proposed vs. Existing RBI Norms**

Liquidity Ratios	Proposed BASEL III	Existing RBI Norm			
		1	2-7	8-14	15-28
Liquidity Coverage Ratios Stock of high quality liquid assets/ Net cash outflows over a 30-day time period 100%	Number of days	50%	10%	15%	20%
		Maximum Permissible gap (as %) of outflows			
	No such norm				
	Net Stable Funding Ratio (NSFR) = Available amount of stable funding/Required amount of stable funding > 100%				

Source: ICRA Rating Services 2010

created by banks, 7% is likely to become the new minimum capital requirement.

The proposed capital buffer has two-fold objective:

1. In times of need, it can be dipped into in order to meet the minimum regulatory requirement on core capital.
2. Once accessed, certain triggers would get activated, conserving the internally generated capital. This would happen as in this scenario, the bank would be restrained in using its earnings.

It is evident from Table 5 that RBI has stipulated variable norms for liquidity ratios depending upon the number of days, liquidity ratio is increasing continuously whereas under BASEL III liquidity ratio has been fixed at 100% for 30 day period which is much higher in comparison to RBI norms. It implies that lesser funds should be blocked in fixed assets. Again, NSFR has been fixed at a minimum 100% which guarantees amount of stable funding available, whereas, RBI is silent about NSFR.

## 8. How will BASEL III Norms Impact Indian Banks?

According to RBI Governor Subbarao "Indian banks are unlikely to be affected but may face some negative impact due to shifting some deductions from Tier-I & Tier-II capital to common equity".

There exists a debate on whether BASEL III would have positive or negative implications on Indian Financial system in particular and the Indian Economy as a whole. The points discussed below provide glimpse about the implications of BASEL-III,

- (i) While the proposal to make deductions "only if such deductibles exceed 15% of core capital" would provide some relief to Indian banks (since all such deductibles are currently reduced from the core capital), the stricter definition of "significant interest" and the suggested 100% deduction from the core capital (instead of 50% from Tier I and 50% from Tier II) could have a negative impact on the core capital of some banks. **(Batra, 2010)**
- (ii) Another challenge that Indian Banks are likely to face in the nine years ending March 31, 2019, are the requirement of additional capital Rs 600000 crore (over internal capital generation). Of this, the public sector banks would require 75-80% and private banks 20-25%. **(Batra, 2010)**
- (iii) If non-common Tier I and Tier II capital instruments get disqualified for inclusion under regulatory capital, the requirement would further go up in the near future and in turn pose a challenge to find the investors, with higher risk appetite, to subscribe to the capital requirement of Indian banks.
- (iv) The leveraging capacity of banks and at the same time Return on Equity would be affected with the increase in the minimum core Tier I capital requirement to 7-9.5% (9.5% including countercyclical buffer at the maximum level) and the overall Tier I capital to 8.5-11% (depending on the countercyclical capital buffer level). For instance, a bank generating 18% ROE on a core capital of 6% would generate around 15% ROE (3 percentage points lower) in case it were to raise its core capital to 8%. **(Batra, 2010)**

- (v) It would be noted from Table 2 that, in India, most of the private sector banks and foreign banks are well capitalized; therefore, their earnings may not get affected with the implementation of BASEL III. Whereas, negative impact will be seen on those public sector banks whose Core Tier I is less than 7%.
- (vi) RBI will annually set counter cyclical buffer which will lead to a variation in lending rates and/or the ROE of banks.

## 9. Requirements for Implementation of BASEL III in India

- (i) The macro-prudential framework that Basel III has laid is still untested and would need continuous research, monitoring, and experience sharing among the regulators to ensure its effectiveness. In India, since public sector dominates the Indian banking sector, most of the capital would be required by this sector. Therefore, RBI's focus on public sector banks is much desired.
- (ii) There are chances that return on equity for banks could get diluted as they would be required to maintain higher level of core capital. Therefore, a proper balance needs to be maintained keeping in mind the two divergent aspects of capital and liquidity.
- (iii) At present, Government of India (GOI) supports non-core Tier I capital but, in times to come, it will have to support certain private sector banks which may fall short of revised core capital adequacy requirement to augment their core capital.
- (iv) Banks will also be required to mobilize additional capital in order to meet expected growth of 20% in the risk weighted assets and stringent capital adequacy norms.
- (v) BASEL III implementation is expected to result into GDP growth of 0.05 to 0.15 percentage point per annum. An increase in bank lending spreads affects economic outputs. To meet the capital requirements effective in 2015 (4.5% for the common equity ratio, 6% for the Tier 1 capital ratio), banks should increase their lending spreads on an average by about 15 basis points.

## 10. Conclusions

- (i) Indian banks are already subjected to more stringent capital adequacy requirements than their international counterparts. For instance, the common equity requirement for Indian banks is 3.6%, as against the 2% mentioned in the BASEL document. At the same time, the total capital

- adequacy requirement for Indian banks is 9%, as against the 8% recommended under BASEL II. Moreover, on an aggregate basis, the capital adequacy position of Indian banks is comfortable, and therefore, they may not need substantial capital to meet the new norms. However, there exists a variation in case of public sector and private sector banks in the sense that most of the private sector banks and foreign banks have core capital in excess of 9%, whereas that is not the case with some of the public sector banks. Therefore, public sector banks need to be focused upon. Overall, with the BASEL III being implemented, the regulatory capital requirement for Indian banks could go up substantially in the long run. Additionally, within in capital, the proportion of the more expensive core capital could also increase. Moreover, capital requirements could undergo a sea change in various scenarios, thereby putting restriction on bank's ability to distribute earnings
- (ii) As far as liquidity aspect is concerned, there is still a lot of time for the implementation of Net Stable Funding ratio (NSFR) which is likely to be implemented from 2019, whereas, the implementation of the Liquidity Coverage Ratio (LCR) from 2015 may necessitate banks to maintain additional liquidity since the LCR requirement is more stringent; also some assumptions on the rollover rates and the required liquidity for committed lines may be more stringent. However, considering the period of one month allowed by RBI and the fact that most Indian banks have upgraded their technology platforms, the transition to LCR may not be a very difficult one.
- (iii) By prescribing more stringent capital and liquidity requirements for the banks, the proposed BASEL III guidelines seeks to improve the ability of banks to withstand periods of economic and financial stress. ICRA has concluded the suggested capital requirement as a positive for banks as it raises the minimum core capital stipulation, introduces counter-cyclical measures, and enhances bank's ability to conserve core capital in the event of stress through a conservation capital buffer. When the banks all over the world will follow the prescribed liquidity requirements, there will be uniformity in the liquidity standards.
- (iv) Indian banks are already following strict capital adequacy norms; therefore, they may not face much difficulty in making transition to a stricter capital requirement regime than some of their international counterparts. Also, Indian banks have historically maintained their core and overall capital well in excess of the regulatory minimum.

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