Basel II Capital Accord

- The Challenge for Indian Banking System

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Roll No. 75

Basel II Capital Accord

The Introduction

Introduction

- BIS (Bank for International Settlements)
- BCBS (Basel Committee on Banking Supervision)
- Basel I Accord.
- Basel II Capital Accord.

BIS Headquarters in Basel

Sub prime Mortgage Crisis???

- What is it?
- Reasons:-
- Corrective Measure:-
- Evolution of Need of Basel II:-

Bankhaus Herstatt???

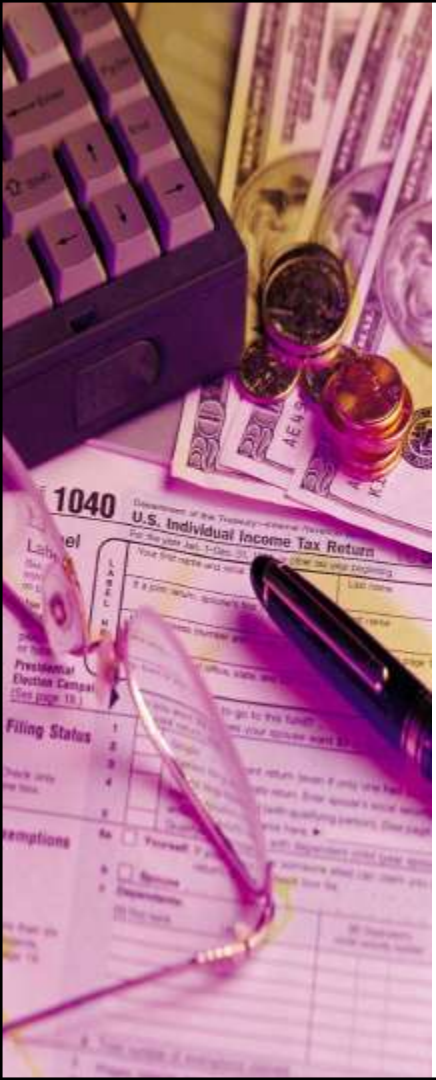
- Bank in Germany.
- Went Bankrupt on 26 June 1974.
- In a famous incident illustrating settlement risk in international finance.
- It causes serious disturbance in international currency & banking.
- Corrective step by establishing BCBS (Basel Committee for Banking Supervision)

Need for Basel II Capital Accord

- To create a level playing field for internationally active banks
  - Banks from the different countries competing for the same loans would have to set aside roughly the same amount of capital on the loans.
- Securing the risk in banking business.

First Basel Accord

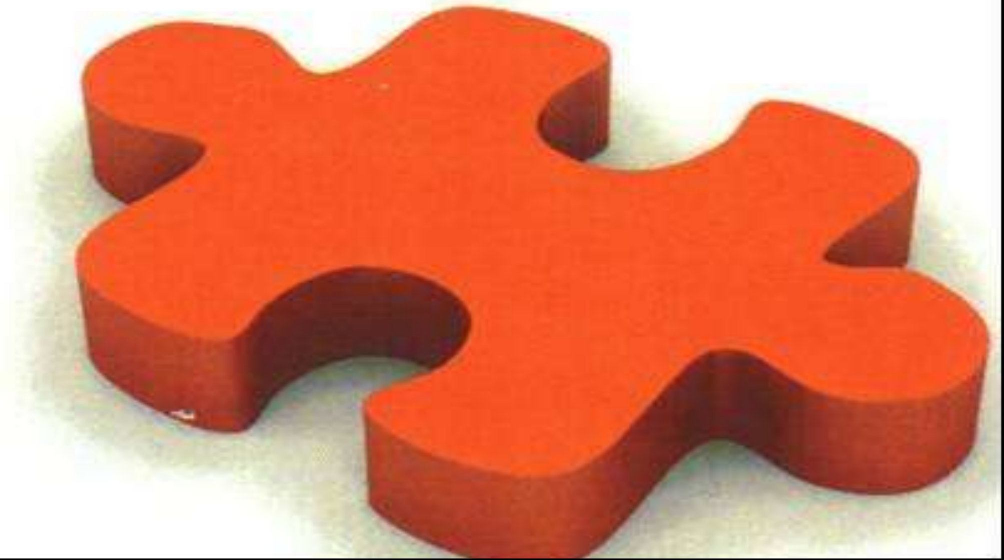
- The first Basel Accord (Basel I) was completed in 1988.
  - Set minimum capital standards for banks.
  - Standards focused on credit risk, the main risk incurred by banks.
  - Became effective at the end of year 1992.



1988 Capital Accord Requirement

- Capital was set at 8% and was adjusted by a loan’s credit risk weight.
- Credit risk was divided into 5 categories:-
- 0%, 10%, 20%, 50%, and 100%
  - For example, Commercial loans were assigned to the 100% risk weight category.

Basel II Capital Accord



Risk Weights

- Risk weights are assigned to various types of loans considering the risk factor in it.
- On the basis of such risk weights, a bank have to make provision in its capital while providing a loan.

- Risk weights assigned to claims on Sovereigns and their central banks under Basel II norms are given in the following table:-

Credit Risk Rating	AAA to AA-	A+ to A+	BBB+ to BBB-	BB+ to B-	Below B-
Risk Weight Assigned	0%	20%	50%	100%	150%

Source: www.bis.org

- Risk weights assigned to different types of claims are given in the following table:-

Credit Risk Rating	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk Weight Assigned	20%	50%	100%	150%	100%

Source: www.bis.org

- Risk weight assigned to claims on corporate (i.e. loans to companies) depends on the credit rating of the company.

- Risk weights assigned to various assets by our Central Bank (RBI) are given in following table:-

Type of Loan	Risk Weight Attached
Investment in Government Securities	0%
Housing Loan	50%
Consumer credit including personal loans and credit cards	125%
Investments in Venture Capital Funds	150%

Source: www.rbi.org

Basel II Accord
Capital Requirements

- Capital to Risk Weighted Asset Ratio is set to 8% of Risk Weighted Assets.
- Credit Rating by domestic Credit Rating Agencies such as CRISIL, ICRA etc. is made mandatory.
- Tier I capital is set to 6%.

Calculation of Risk Weighted Capital

- To calculate required risk weighted capital, a bank would multiply the assets in category's risk weight.
  - Thus a Rs.100/- housing loan would be multiplied by 50%, thus the risk weighted capital is Rs.50/-.
  - Commercial loan of Rs.100/- should be multiplied by 100%, thus the risk weighted capital is Rs.100/-

The Terminology

- **CRAR**
- **Tier I Capital (Core Capital)**
- **Tier II Capital (Subsidiary Capital)**

CRAR
(Capital to Risk Weighted Assets Ratio)

- It is also known as Capital Adequacy Ratio which indicates the bank's risk taking ability.
- The RBI uses CRAR to track whether a bank is meeting its statutory capital requirements and is capable of absorbing a reasonable amount of loss.
- CRAR = (Tier I Capital + Tier II Capital)/Risk Weighted Assets.

Some Facts about CRAR

- It is mandatory for all the banks that they have to maintain their Capital to Risk Weighted Assets Ration (CRAR) above the stipulated requirement of Basel Guidelines (8%) and RBI Guide lines (9%).
- The Govt. of India has stated that public sector banks must have a capital cushion with a CRAR of at least 12%, higher than the threshold limit of 9% prescribed by the RBI.

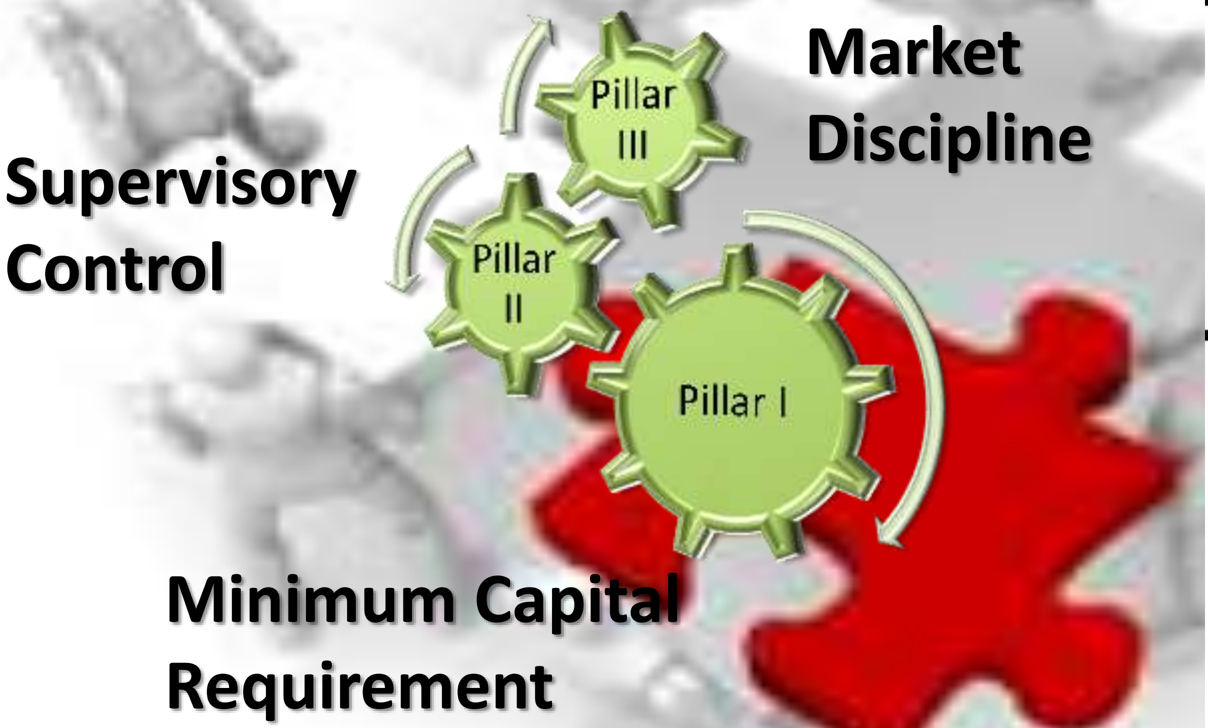
Tier I Capital (Core Capital)

- Tier I Capital is the most reliable form of capital. The major components of Tier I capital are paid up equity share capital and disclosed reserve viz. statutory reserves, general reserves, capital reserves (other than revaluation reserves) and any other type of instrument notified by the RBI.
- Examples of Tier I capital are common stock, preferred stock that is redeemable & non-cumulative, and retained earnings.

Tier II Capital (Supplementary Capital)

- Tier II capital is a measure of a bank's financial strength with regard to second most reliable forms of capital.
- It consists mainly of undisclosed reserves, revaluation reserves, general provisions, subordinate debt, and hybrid instruments.
- This capital is less permanent in nature.

Structure of Basel II Accord



Pillar One

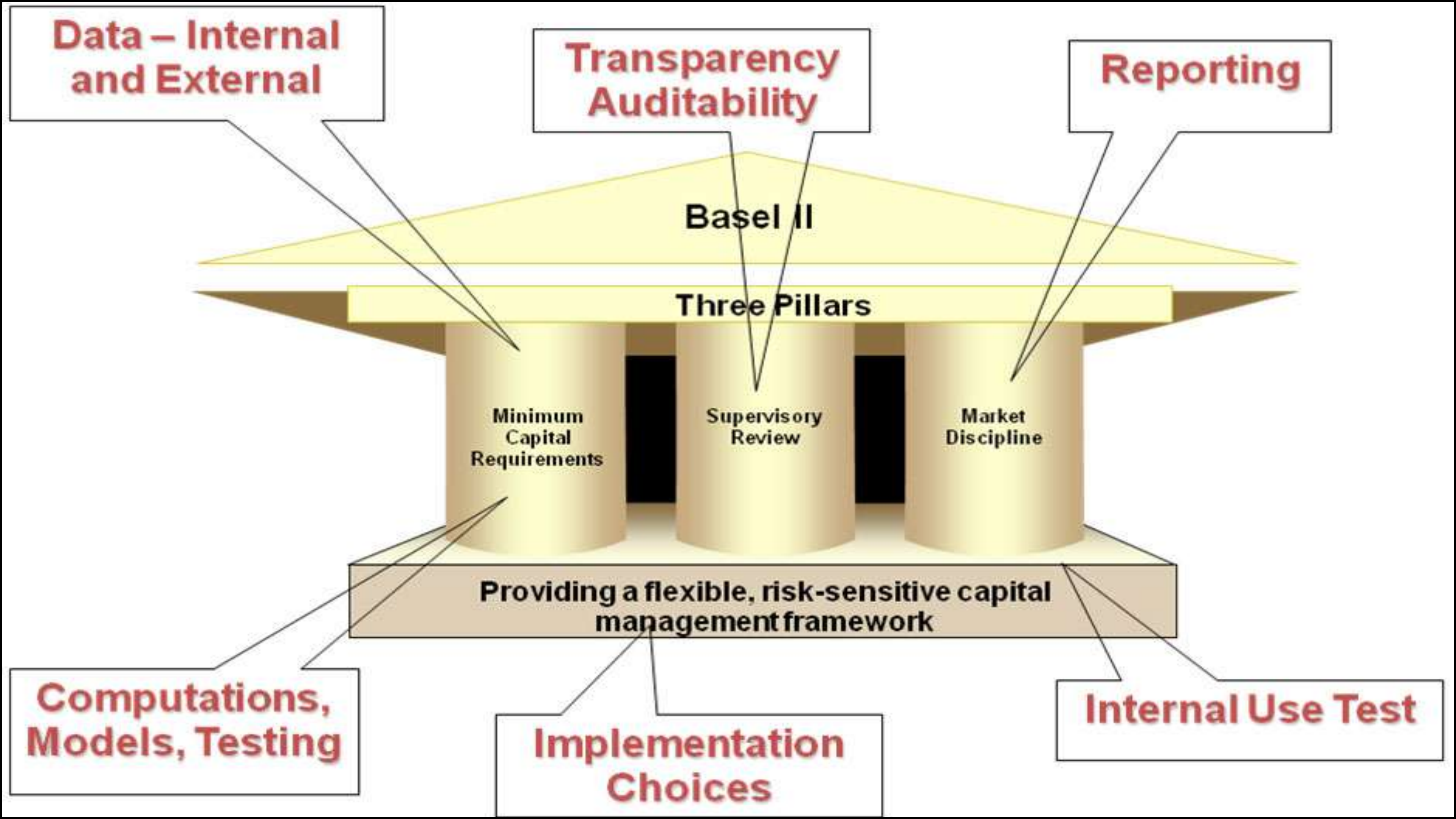
Minimum Capital Requirements

Pillar Two

Supervisory Committee

Pillar Three

Market Discipline


Data – Internal and External
Transparency Auditability
Reporting
Basel II
Three Pillars
Minimum Capital Requirements
Supervisory Review
Market Discipline
Providing a flexible, risk-sensitive capital management framework
Computations, Models, Testing
Implementation Choices
Internal Use Test

BASEL II CAPITAL ACCORD

Pillar 1. MINIMUM CAPITAL REQUIREMENTS

- Sets minimum acceptable Capital level
- Enhanced approach for credit risk
  - Public ratings
  - Internal ratings
  - mitigation
- Explicit treatment of Operational Risk
- Market risk framework, capital definition/ratios are unchanged

Pillar 2. SUPERVISORY REVIEW OF CAPITAL ADEQUACY

- Banks must assess solvency vs. risk profile
- Supervisory review of bank's calculations & capital strategies
- Banks should hold in excess of minimum level of capital
- Regulators will intervene at an early stage if capital levels deteriorate

Pillar 3. MARKET DISCIPLINE

- Improved disclosure of capital structure
- Improved disclosure of risk measurement and management practices
- Improved disclosure of risk profile
- Improved disclosure of capital adequacy

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Pillars of the Basel II

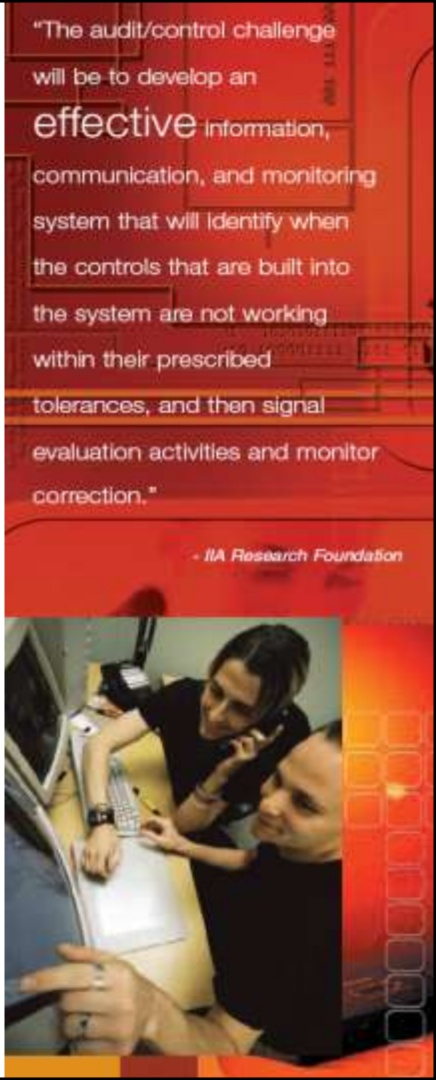
Credit Risk

- It refers to the risk that the borrower or the counterparty fails to meet his obligation as per agreed terms, e.g. risk that the borrower fails to repay the loan amount and interest due.
- Credit risk depends on credit worthiness of a borrower, his repayment capacity and purpose of loan.



Market Risk

- Market risk refers to possibility of loss faced by the banks due to change in market variables.
- It consists of following components:-
  - Interest Rate Risk.
  - Liquidity Risk.
  - Foreign Exchange Risk.
  - Commodity Price Risk.



Operating Risk

- Operating Risk refers to the risk that the bank's net income & asset get adversely affected due to defects in operations or business process of bank.
- It arises due to gaps in people, processes & technology.
- It include fraud risk, regulatory risk, personnel risk & technology risk.

Pillar II:- Supervisory Reviews

- Basel II norms propose detailed supervisory review and frequent communication between bankers and regulators.
- It specifies that the banks should have efficient processes to assess & monitor capital adequacy levels on a continuous basis.
- The regulator should evaluate the efficiency of these processes to ensure that capital adequacy of banks never fall below the prescribed levels.

- After detailed review of bank’s risk profile and risk mitigation strategies, supervisor may require banks to provide additional capital.
- Additional capital requirements are specified by supervisor, when risk management techniques are found to be weak or in effective.

Pillar III :- Market Discipline

- This pillar stress on transparent reporting on risk exposures and risk management mechanisms on banks so that the public can evaluate the competence of the banks to manage their exposures towards various risks.
- It focuses on effective public disclosures of banks and complementary to other two pillars.

Effect of Basel II Accord on Indian Financial System

- Revolution in Banking Sector
- Reforms in Public Sector Banking.
- Risk Evaluation by commercial banks.
- Banks became more cautious while lending.
- Asset Liability Management (ALM).
- Indian banks are at the doorstep of the Global Capital Market.

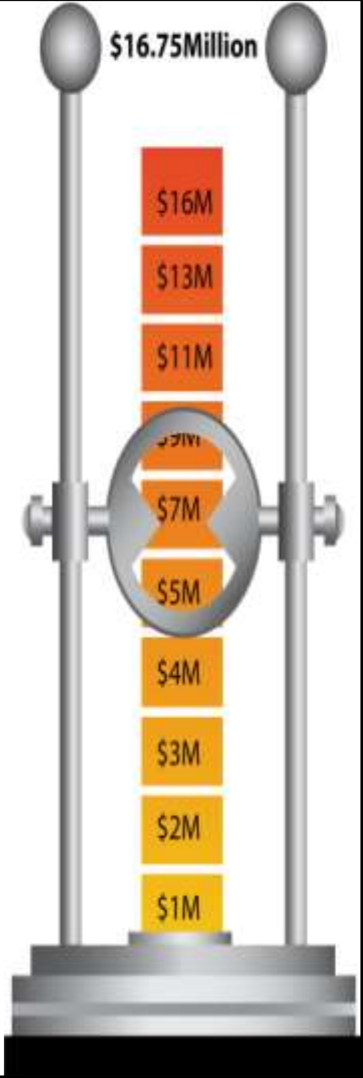
- Implementation of Basel II Accord in India from Financial year 2010 – 2011 onwards, causes the Indian Banking Sector to be stronger in leverages position.
- The financial system channelise money form surplus sector to the needy sector of the economy, so it is an important factor in the economy as a whole.
- The Financial System will be more stronger to face credit risk crisis.

Re-capitalization of Public Banks - a boon

- The Prime Minister announced that public sector banks with CRAR less than 12%, well above the Basel II norm of 8%, and RBI stipulated norm of 9%, will be recapitalized by the Government.
- Public Sector Banks are helped by the State & Central Govt. which can infuse funds to fulfill their capital adequacy.

- Capitalization by the Govt. will be done via debt instruments such as Tier – II bonds or preference shares, which will be issued by the banks and subscribed by the Government.
- Under 1st round of re-capitalization package, Govt. announced a sum of Rs.3800 Crores for Central Bank, UCO Bank, and Vijaya Bank.
- 2nd round of re-capitalization is also being considered. Dena Bank & Bank of Maharashtra are likely to be funded.

Modes of Fund Raising

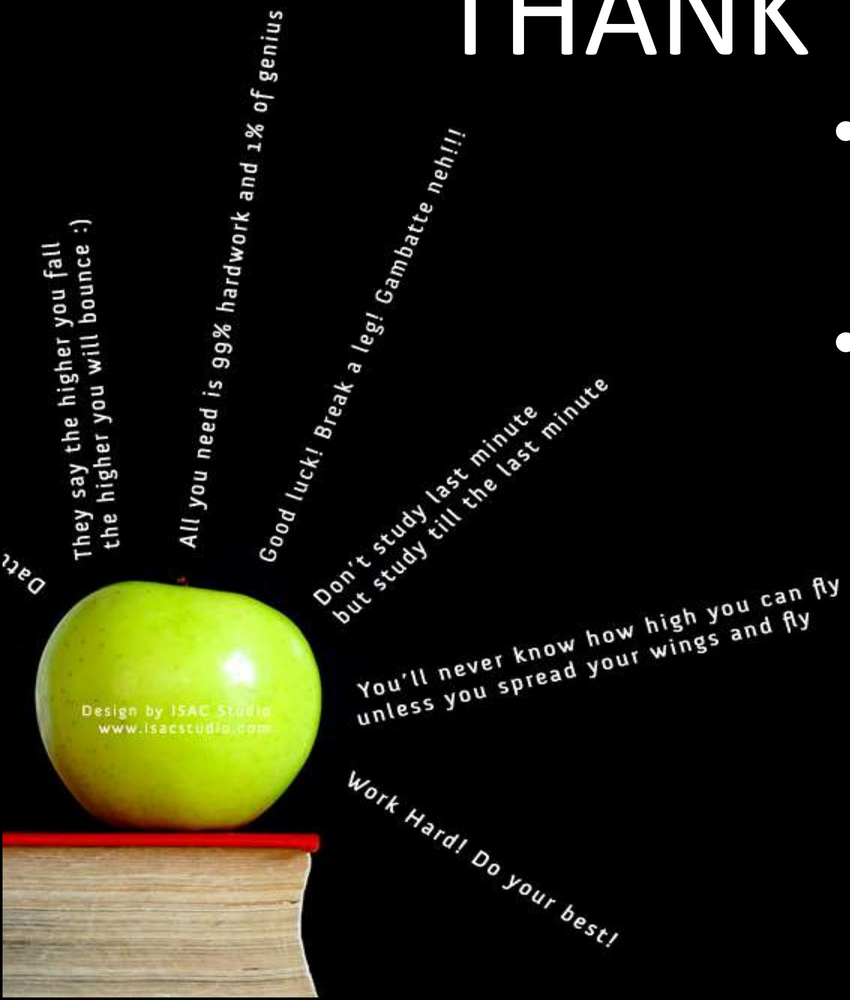


- Banks could use the capital markets to meet capital requirements and go for IPOs or private placements to gather the capital.
- A significant proportion of fund could be met via internal resources of the banks, such as growth in reserves and surplus through efficient operations in coming years.

- Indian Economy – ***Saving Economy***.
  - Has its inherent capacity of saving.

- Foreign Economy – ***Loan Economy***.

THANK YOU!



- <u>Guidance:-</u>

  Prof. S. M. Sonalkar Sir.

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