V Leeladhar: Basel II Accord and its implications

Speech by Mr V Leeladhar, Deputy Governor of the Reserve Bank of India, at the Bankers' Club, Mangalore, 11 March 2005.

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Ladies and gentlemen, it is my pleasure to share my thoughts with you on a subject which is currently engaging the attention of the banking community, not just in India but worldwide. Let me first admit upfront that although I am at the moment wearing the regulator's hat, yet I have been a commercial banker for most part of my professional career. So, the banker in me still goads me to put myself in bankers' shoes before evaluating any regulatory options. I can better appreciate some of nuances from a practical stand point, and therefore shall try to put them more from a banker's perspective rather than that of a regulator.

Managing risk is increasingly becoming the single most important issue for the regulators and financial institutions. These institutions have over the years recognized the cost of ignoring risk. However, growing research and improvements in information technology have improved the measurement and management of risk. It's but natural therefore, capital adequacy of a bank has become an important benchmark to assess its financial soundness and strength. The idea is that banks should be free to engage in their asset-liability management as long as they are backed by a level of capital sufficient to cushion their potential losses. In other words, capital requirement should be determined by the risk profile of a bank.

The initial capital accord of 1988 was hugely successful with more than 100 countries accepting it as a benchmark. One of the major reasons for the success of this framework was its being simple. It brought in uniformity and attempted to make regulatory capital requirement consistent with the economic capital. Reserve Bank of India introduced risk assets ratio system as a capital adequacy measure in 1992, in line with the Basel accord of 1988, which takes into account the risk element in various types of funded balance sheet items as well as non-funded off balance sheet exposures. In fact, RBI norms on capital adequacy at 9% are more stringent than Basel Committee stipulation of 8%.

Shortcomings in the present accord

However, the present accord has been criticized as being inflexible due to its focus on primarily credit risk and treating all types of borrowers under one risk category regardless of credit worthiness. The major criticism against the existing accord stems from its

- Broad brush approach – irrespective of quality of counter party or credit
- Encouraging regulatory arbitrage by cherry picking
- Lack of incentives for credit risk mitigation techniques
- Not covering operational risk

As time passed, some of the major international banks began using sophisticated models to measure risk. This was when a need was felt to upgrade the Basel framework. Therefore, the Basel Committee on Banking Supervision thought it desirable that the present accord is replaced by a more risk-sensitive framework.

Three pillars

The new Basel Accord has its foundation on three mutually reinforcing pillars that allow banks and bank supervisors to evaluate properly the various risks that banks face and realign regulatory capital more closely with underlying risks. The first pillar is compatible with the credit risk, market risk and operational risk. The regulatory capital will be focused on these three risks. The second pillar gives the bank responsibility to exercise the best ways to manage the risk specific to that bank. Concurrently, it also casts responsibility on the supervisors to review and validate banks' risk measurement models. The third pillar on market discipline is used to leverage the influence that other market players can bring. This is aimed at improving the transparency in banks and improve reporting.

Issues and Challenges

Having given you a brief overview of the current and proposed new framework, I shall now move on to the implementation challenges for the banks especially in a developing country like India. Here, I would skip the methodological details and technical nitty-gritty associated with the new accord, and concentrate instead on more profound implications for the banking industry.

ISSUES AND CHALLENGES

While there is no second opinion regarding the purpose, necessity and usefulness of the proposed new accord - the techniques and methods suggested in the consultative document would pose considerable implementational challenges for the banks especially in a developing country like India.

Capital Requirement: The new norms will almost invariably increase capital requirement in all banks across the board. Although capital requirement for credit risk may go down due to adoption of more risk sensitive models - such advantage will be more than offset by additional capital charge for operational risk and increased capital requirement for market risk. This partly explains the current trend of consolidation in the banking industry.

Profitability: Competition among banks for highly rated corporates needing lower amount of capital may exert pressure on already thinning interest spread. Further, huge implementation cost may also impact profitability for smaller banks.

Risk Management Architecture: The new standards are an amalgam of international best practices and call for introduction of advanced risk management system with wider application throughout the organization. It would be a daunting task to create the required level of technological architecture and human skill across the institution.

Rating Requirement: Although there are a few credit rating agencies in India, the level of rating penetration is very low. A study revealed that in 1999, out of 9640 borrowers enjoying fund-based working capital facilities from banks, only 300 were rated by major agencies. Further, rating is a lagging indicator of the credit risk and the agencies have poor track record in this respect. There is a possibility of rating blackmail through unsolicited rating. Moreover rating in India is restricted to issues and not issuers. Encouraging rating of issuers would be a challenge.

Choice of Alternative Approaches: The new framework provides for alternative approaches for computation of capital requirement of various risks. However, competitive advantage of IRB approach may lead to domination of this approach among big banks. Banks adopting IRB approach will be more sensitive than those adopting standardized approach. This may result in high-risk assets flowing to banks on standardized approach, as they would require lesser capital for these assets than banks on IRB approach. Hence, the system as a whole may maintain lower capital than warranted and become more vulnerable. It is to be considered whether in our quest for perfect standards, we have lost the only universally accepted standard.

Absence of Historical Database: Computation of probability of default, loss given default, migration mapping and supervisory validation require creation of historical database, which is a time consuming process and may require initial support from the supervisor.

Incentive to Remain Unrated: In case of unrated sovereigns, banks and corporates, the prescribed risk weight is 100%, whereas in case of those entities with lowest ratting, the risk weight is 150%. This may create incentive for the category of counterparties, which anticipate lower rating to remain unrated.

Supervisory Framework: Implementation of Basel II norms will prove a challenging task for the bank supervisors as well. Given the paucity of supervisory resources, there is a need to reorient the resource deployment strategy. Supervisory cadre has to be properly trained for understanding of critical issues for risk profiling of supervised entities and validating and guiding development of complex IRB models.

Corporate Governance Issues: Basel II proposals underscore the interaction between sound risk management practices and corporate good governance. The bank's board of directors has the responsibility for setting the basic tolerance levels for various types of risk. It should also ensure that management establishes a framework for assessing the risks, develop a system to relate risk to the bank's capital levels and establish a method for monitoring compliance with internal policies.

National Discretion: Basel II norms set out a number of areas where national supervisor will need to determine the specific definitions, approaches or thresholds that they wish to adopt in implementing the proposals. The criteria used by supervisors in making these determinations should draw upon domestic market practice and experience and be consistent with the objectives of Basel II norms.

Disclosure Regime: Pillar 3 purports to enforce market discipline through stricter disclosure requirement. While admitting that such disclosure may be useful for supervisory authorities and rating agencies, the expertise and ability of the general public to comprehend and interpret disclosed information is open to question. Moreover, too much disclosure may cause information overload and may even damage financial position of bank.

Disadvantage for Smaller Banks: The new framework is very complex and difficult to understand. It calls for revamping the entire management information system and allocation of substantial resources. Therefore, it may be out of reach for many smaller banks. As Moody's Investors Services puts it, "It is unlikely that these banks will have the financial resources, intellectual capital, skills and large scale commitment that larger competitors have to build sophisticated systems to allocate regulatory capital optimally for both credit and operational risks."

Discriminatory against Developing Countries: Developing countries have high concentration of lower rated borrowers. The calibration of IRB has lesser incentives to lend to such borrowers. This, along with withdrawal of uniform risk weight of 0% on sovereign claims may result in overall reduction in lending by internationally active banks in developing countries and increase their cost of borrowing.

External and Internal Auditors: The working Group set up by the Basel Committee to look into implementational issues observed that supervisors may wish to involve third parties, such a external auditors, internal auditors and consultants to assist them in carrying out some of the duties under Basel II. The precondition is that there should be a suitably developed national accounting and auditing standards and framework, which are in line with the best international practices. A minimum qualifying criteria for firms should be those that have a dedicated financial services or banking division that is properly researched and have proven ability to respond to training and upgrades required of its own staff to complete the tasks adequately.

With the implementation of the new framework, internal auditors may become increasingly involved in various processes, including validation and of the accuracy of the data inputs, review of activities performed by credit functions and assessment of a bank's capital assessment process.

CONCLUSION

Implementation of Basel II has been described as a long journey rather than a destination by itself. Undoubtedly, it would require commitment of substantial capital and human resources on the part of both banks and the supervisors. RBI has decided to follow a consultative process while implementing Basel II norms and move in a gradual, sequential and co-coordinated manner. For this purpose, dialogue has already been initiated with the stakeholders. A steering committee comprising representatives of banks and different supervisory and regulatory departments is taking stock of all issues relating to its implementation. As envisaged by the Basel Committee, the accounting profession too, will make a positive contribution in this respect to make Indian banking system stronger.