Kishori Udeshi: Financial system stability and Basel II - way forward

Address by Ms Kishori Udeshi, Deputy Governor of the Reserve Bank of India, at the 17th Annual Convention of the Association of Professional Bankers, Colombo, Sri Lanka, 26 August 2005.

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The initiative of the Association of Professional Bankers – Sri Lanka in organising this conference on Financial System Stability and Basel II – Way Forward is indeed commendable. Basel II is an important milestone in banking regulation and supervision and ought to be viewed as a necessary process for promoting the safety and soundness of the banking sector and thereby strengthening financial stability.

What is financial stability?

In a situation of financial stability, financial institutions and markets are able to efficiently mobilise savings, provide liquidity and allocate investment. The growing role of the financial sector in the right allocation of resources at appropriate prices could significantly enhance the efficiency with which our economies function. If financial markets work well, they will direct resources to their most productive uses. Risks will be more accurately priced and will be borne by those who have appetite for absorbing risks. Real economic activity with higher investments, in both quantity as well as quality, would result in growth with macroeconomic stability and fewer financial uncertainties. The objectives of financial and macro-economic stability are, thus, mutually reinforcing. As Governor Reddy has put it, 'financial stability needs to be particularly ensured when the financial system is undergoing structural changes'.

Financial stability does not mean total absence of failure of individual financial institutions, and fluctuation of prices in markets for financial assets. Such events become a cause for concern only if they lead to an impairment of the basic intermediation function or a severe misallocation of capital.

Before talking about the Indian financial system I must commend the efforts made by the Sri Lankan authorities towards strengthening the financial sector. Its resilience is borne out by the fact that the Tsunami devastation at the end of 2004 did not affect the stability of the Sri Lankan financial sector.

Indian financial system

In recent years, there has been a considerable widening and deepening of the Indian financial system, coupled with the increasing globalisation of financial services. India is fast approaching an era of financial conglomerisation and 'bundling' in the provision of financial services. These developments are opportunities for the market participants but nevertheless pose serious challenges to regulation and supervision of the banking system.

In India, the pursuit of financial and macroeconomic stability has emerged as the central plank of financial sector reforms. Stability of the financial system has a critical influence on price stability and sustained growth, which constitute the principal objectives of policy. A stable financial system facilitates efficient transmission of monetary policy initiatives and the smooth operation of payment systems. From the perspective of regulation and supervision, safeguarding depositors' interest, and ensuring strong risk management within payment, clearing and settlement systems, is the mandate of the Reserve Bank of India (RBI). The RBI has put in place Prudential Supervisory Reporting System, covering all vital aspects and a wide range of indicators, which serves as an early warning signal as well. Macro-Prudential Indicators (MPIs) are being compiled since March 2000, collating data from

various reports that are received in the regulatory and supervisory wings of the Bank. The review of MPIs covers the areas of capital adequacy, asset quality, risk management, management soundness, earnings and profitability liquidity, interest rate, maturity structure of assets and liabilities, and various indicators pertaining to major segments of financial markets such as debt, forex, capital market segments, besides macroeconomic indicators such as growth, inflation, interest rate and exchange rate. The MPI review is accompanied by a review of developments in the global environment. As part of the efforts to disseminate these Financial Soundness Indicators (FSIs), the Reserve Bank has started publishing the core set of indicators in its various publications.

Financial sector reforms adopted in the 1990s have enhanced the strength of banks and financial institutions in India. A striking feature of these institutions has been their improved resilience to the domestic and the external environment. The reform process has changed the relationship between the RBI and commercial banks from one of micro regulation to that of macro management. Aided by the robust macroeconomic environment, banks' bottom lines have improved significantly over the last two years. The aggregate capital ratios of scheduled commercial banks at 12.83 per cent as at end March 2005 have been well above the stipulated level of 9 per cent.

The Reserve Bank, along with the Government, has initiated several institutional measures to contain the levels of NPAs. Notable among these include establishment of Debt Recovery Tribunals, Lok Adalats (people's courts), Asset Reconstruction Companies (ARCs) and Corporate Debt Restructuring (CDR) mechanism. Settlement Advisory Committees have been formed at regional and head office level of commercial banks. Enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 has helped in improving the recovery climate in the country. The Government amended the relevant provisions of the Act to address the concerns expressed by the Supreme Court regarding a fair deal to borrowers through an ordinance dated November 11, 2004. The declining trend in gross and net NPLs for scheduled commercial banks has continued despite the adoption of 90-day delinquency norm and unprecedented surge in growth of advances.

Legislation has since been enacted to facilitate the compilation and dissemination of credit information including data on defaults to the financial system by the Credit Information Bureau of India Ltd. (CIBIL). The legal provisions and practice in bankruptcy of the real sector are however still inadequate and need further reform.

The Reserve Bank is also making efforts to formulate policies to deal with risks arising on account of operations of large and complex financial institutions as these pose a systemic risk. As a first step in this direction, an inter-agency Working Group on Financial Conglomerates (FC) comprising three supervisory bodies, viz., the Reserve Bank, the Securities and Exchange Board of India and Insurance Regulatory and Development Authority, in June 2004, identified 23 FCs and a pilot process for obtaining information from these conglomerates has been initiated.

The year 2004-05 has witnessed a surge in credit off-take leading to a sizeable decline in the liquid assets of the bank. Consistent with the shift to functioning in a competitive economy and to the adoption of prudential best practices, the major challenges facing the banking sector are the deployment of funds in quality assets and the management of revenues and costs.

Basel II

Unlike Basel I, which is simple, Basel II is complex. Therefore, the BCBS does not expect Basel II to be adopted widely or quickly. They believe that countries should adopt the options and approaches that are most appropriate for the state of their markets, their banking

systems, and their supervisory structures. Supervisors can adopt the framework on an evolutionary basis and use elements of national discretion to adapt it to their needs.

Why move to Basel II

Under Basel II the capital requirements are more risk sensitive as these are directly related to the credit rating of each counter-party instead of counter-party category as it is under Basel I. Further, it requires banks to hold capital not only for credit and market risk but also for operational risk (OR) and where warranted for interest rate risks, credit concentration risks, liquidity risks etc. This makes Basel II more comprehensive than Basel I. Where banks were required to hold a uniform level of 8 per cent as minimum capital under Basel I, supervisors have the discretion to require banks to hold higher levels of minimum capital under Basel II. Basel II has other advantages such as providing a range of options for counter-party capital requirements and in the process reducing the gap between required capital and regulatory capital. Basel II recognises a wider range of collaterals and provides incentives for improved risk management practices.

An interesting point to note here is that Basel II recognises the element of diversification of risk in the SME sector and has assigned a lower risk weight for retail SME exposure under standardised approach. The non-retail SME exposure would also attract a lower risk weight where they have better external ratings under the standardised approach. Shifting to Basel II, therefore, could be advantageous for economies whose banks have significant SME exposure.

Indian Approach to Basel II

With the commencement of the banking sector reforms in the early 1990s, the RBI has been consistently upgrading the Indian banking sector by adopting international best practices. The approach to reforms is one of having clarity about the destination as also deciding on the sequence and pace of reforms to suit Indian conditions. This has helped us in moving ahead with the reforms without disruption. With the successful implementation of banking sector reforms over the past decade, the Indian banking system has shown substantial improvement on various parameters. It has become robust and displayed significant resilience to shocks. There is ample evidence of the capacity of the Indian banking system to migrate smoothly to Basel II norms.

The policy approach to Basel II in India is such that external perception about India conforming to best international standards is positive and is in our favour. Commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some banks may be allowed to migrate to the Internal Rating Based (IRB) Approach.

Some of the regulatory initiatives taken by the Reserve Bank of India, relevant for Basel II are as follows: First, we have tried to ensure that the banks have suitable risk management frameworks oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital. Second, Risk Based Supervision (RBS) in 23 banks has been introduced on a pilot basis. Third, we have been encouraging banks to formalize their capital adequacy assessment process (CAAP) in alignment with their business plans and performance budgeting systems. This, together with the adoption of RBS, would enable factoring in of the Pillar II requirements under Basel II. Fourth, we have been expanding the area of disclosures (Pillar III), so as to have greater transparency in the financial position and risk profile of banks. Finally, we are trying to build capacity for ensuring the regulator’s ability for identifying and permitting eligible banks to adopt IRB / Advanced Measurement approaches.

As per normal practice, and with a view to ensuring a smooth migration to Basel II, a consultative and participative approach has been adopted for both designing and implementing Basel II. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) has been constituted with representation from the Indian Banks' Association and the RBI. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework have been issued.

Implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. Though the cushion available in the system, which at present has a CRAR of over 12 per cent, is comforting, banks are exploring various avenues for meeting the capital requirements under Basel II.

Even while we have decided to take the Indian banking system on to the simple approaches under Basel II, we have taken some initiatives which would clearly demonstrate that we have no intentions of either diluting the standards or picking on the less stringent options laid down in Basel II. Through these initiatives, we have prescribed stringent prudential requirements for banks in India e.g. with regard to adoption of risk weights for claims on State Governments, Public Sector Enterprises, banks and for capital market and real estate exposures. Further even though banks can be allowed to use unsolicited ratings under the Standardised Approach, we would not allow the use of unsolicited ratings.

Also, we have been expanding the area of disclosures so as to have greater transparency with regard to the financial position and risk profile of banks. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain. Such proactive disclosures by the Regulator are expected to have a salutary effect on the functioning of the banking system. In addition to the above, any penal action taken against any foreign bank branches in India are also shared with the Home country regulator with a view to enhance the quality of consolidated supervision. These initiatives will be an important supplement to the Pillar 3 disclosures prescribed under Basel II, which in our opinion will further the cause of a stable banking system.

The way forward

On the way forward it has to be recognised that implementation of Basel II will make considerable demands on scarce resources in terms of both economic resources and human resources. Banks must take on the challenges and convert these into opportunities.

Here I would like to quote Ms. Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System:

"Banking will remain a highly dynamic industry. Supervisors will have to be especially attentive to changing best practices and ensure that Basel II does not inhibit adoption of new banking practices and financial instruments"

"Maintaining financial stability in global banking and financial markets continues to be an important objective of regulators, bankers, and other market participants, particularly because of the negative impact that financial instability has on economies as a whole. Basel II, in my view, will help improve financial stability…Even though minimum regulatory capital ratios are likely to be more volatile under Basel II, this reflects greater risk sensitivity."

Some of the issues which emerging economies in particular would need to address on the way ahead are higher capital requirements, improved IT architectures, data issues, consolidation, capacity building, external ratings, use of national discretion, validating the concept of economic capital and corporate governance.

Higher capital requirements – The Basel document prescribes the minimum capital requirements and banks need to be encouraged to hold more capital than the minimum. As a part of their strategy, banks are expected to operate at levels above the minimum to take care of the fluctuations in capital requirements in response to the fluctuations in the quality of risk exposures. Further, it will be necessary to ensure that all elements of expected losses should be fully met by provisioning and that capital is available exclusively to support unexpected losses.

Higher capital requirements could pose difficulties if there are state owned banks. This may require consideration of options such as preference shares and other innovative tier-I instruments, hybrid tier-II capital instruments and tier-III capital instruments.

Improved IT architecture/MIS – The basic requirement for implementation of Basel II is improved information systems for managing and using data for business decisions. Banks should, therefore, be encouraged to strengthen their IT architecture and also improve their information and reporting systems. This would also equip banks to cope appropriately with the Pillar 3 disclosure requirements.

Consolidation – In the normal course of operations banks would be constantly looking for opportunities of inorganic growth. Banks which operate with capital above the minimum levels have an edge over the other banks to the extent that they would be able to seize an opportunity for merger / acquisition as and when it is available without any loss of time. However, it would be necessary for such banks to improve their internal controls and risk management systems before embarking on a path of inorganic growth. Basel II implementation would enable banks to meet the above pre-requisites and place them in a situation where they can take advantage of opportunities as and when they arise.

Data issues – Implementation of Basel II, both under Standardised Approach and IRB Approaches, would involve utilisation of data for computing capital requirements. While the dependence on data under the Standardised Approach would be largely similar to Basel I, the data requirements are considerable under the Advanced Approaches. Banks would require adequate and acceptable historical data to compute capital requirement under these Approaches. At the minimum banks need to have historical data for computing the probability of default, loss given default and operational risk losses. While building up this data base banks also need to ensure purity and integrity of such data.

Capacity Building – Above all, capacity building, both in banks and the regulatory bodies is a serious challenge, especially with regard to adoption of the advanced approaches. Banks would need to focus on equipping their staff suitably to handle the advanced risk management systems and supervisors need to equip themselves with equal skills to have effective supervision. Given the demand for skills in the sector, the level of attrition is likely to be high. Hence, banks need to focus on motivating the skilled staff and retaining them. We have initiated supervisory capacity-building measures in India to identify the gaps and to assess as well as quantify the extent of additional capital, which may be required to be maintained by such banks. The magnitude of this task, which is scheduled to be completed by December 2006, appears daunting since we have as many as 90 scheduled commercial banks in India.

External ratings – In a situation where countries do not have domestic rating agencies or where the extent of rating penetration is low the capacity of banks in these countries to relate capital requirements to the actual underlying risk will be seriously handicapped. It would be necessary to develop domestic rating agencies and look at methods for increasing the rating penetration of the rating agencies.

Use of national discretion – As I have mentioned earlier, discretion is available to national supervisors under Basel II framework on many aspects. It would be necessary for the national supervisors to exercise this discretion with caution. There could be various sectors of the economy which may deserve a preferential treatment taking into account their national relevance. It would be in order to lighten the burden of Basel II on these sectors within the

limitations of national discretion provided the resulting capital requirements reflect the underlying risks in these sectors. In case the situation prevailing in a country reflects higher risks then it would perhaps be necessary for the supervisor to factor this while formulating the national rules for Basel II implementation.

Validating the concept of economic capital – The Basel II Framework will promote adoption of stronger risk management practices by banks which will address all major risks comprehensively. Basel II, by being risk sensitive, will enable banks to bridge the gap between economic capital and regulatory capital. Through the Pillar II requirements under Basel II, banks are expected to have their own internal methodologies for assessing the risks and computing the capital requirements to support those risks even for banks adopting the standardised approach for credit risk. This would aid the banks to move in the direction of building their own economic capital models, which can direct their business strategies. It is possible that many of the banks in emerging economies might not have developed their internal capital adequacy assessment processes (ICAAP). Implementation of Basel II would now require these banks to have in place an ICAAP which meets the Basel II specifications. The regulators would perhaps be required to take the initiative in this regard to enhance the level of understanding of ICAAP in banks, the benefits that may accrue to them by adoption of ICAAP and the likely focus of supervisory assessments in this regard.

Improving governance standards and oversight – The Basel II framework places considerable emphasis on internal processes for managing risk and for managing capital requirements. This along with the Pillar 3 disclosure requirements places tremendous demand on the Governance and oversight standards within a bank. Banks should therefore focus their energies on raising their governance and oversight standards to greater heights. The Basel Committee recognises that primary responsibility for good corporate governance rests with boards of directors and senior management of banks. Corporate Governance can be improved by addressing a number of legal issues such as protecting and promoting shareholder rights, clarifying governance roles. Ensuring that corporations function in an environment that is free from corruption and bribery; and aligning the interests of managers, employees and shareholders through appropriate laws, regulations and other measures. All of these can help promote healthy business and legal environments that support sound corporate governance and related supervisory initiatives. In India the governance issues have been addressed by prescribing guidelines on corporate governance in banks. These include fit and proper standards for not only the Board of Directors but also for the shareholders and the chief executives. In this regard, it might be appropriate to mention that importance of corporate governance is relevant for the state owned banks also. The focus of the standards should be, at the least, to equip the boards of banks to ask the right questions.

Conclusion

Basel II is expected to foster financial stability through its risk sensitive framework which will encourage banks to adopt improved risk management practices; require supervisors to review the efficiency of banks' risk management practices and capital allocation methodologies; and empower market participants to make informed judgements on the efficiency of banks and accordingly punish or reward banks.

While it is true that implementation of Basel II is not the be all and end all on the subject of financial stability it must be recognised that banks are “special”. Their sound and efficient functioning is critical not only to the growth of the real sector but also for strengthening the social infrastructure. Internationally, therefore, banks have moved centre-stage and their performance is the cynosure of all eyes.

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