Kishori J Udeshi: Implementation of Basel II - an Indian perspective

Address by Ms Kishori J Udeshi, Deputy Governor of the Reserve Bank of India, at the World Bank/IMF/US Federal Reserve Board 4th Annual International Seminar on Policy Challenges for the Financial Sector: Basel II, Washington DC, 2 June 2004.

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Yesterday we had very absorbing discussions on macro issues, regulatory perspectives and risk management challenges relating to Basel II. We are now not debating whether to go forward with Basel II but how to implement Basel II. In fact, understanding Basel II concepts is one step away from agreeing to it in principle. Implementing Basel II is another long step away from understanding it. Let me briefly detail some implementation issues with specific reference to India.

Features of Indian financial system

A feature, somewhat unique to the Indian financial system is the diversity of its composition. We have the dominance of Government ownership coupled with significant private shareholding in the public sector banks which in turn continue to have a dominant share in the total banking system. These public sector banks are listed on the stock exchange and their performance is reflected in their P/E ratios. The private sector banks especially the new ones are world class. We also have cooperative banks, whose numbers are large and pose a challenge because of the multiplicity of regulatory and supervisory authorities. There are also Regional Rural Banks with links to their parent commercial banks. Foreign bank branches operate profitably in India and by and large the regulatory standards for all these banks are uniform. The process of providing financial services is changing rapidly from traditional banking to a one stop shop of varied financial services and the old institutional demarcations are getting increasingly blurred.

Approach to prudential norms: a review

The Reserve Bank's approach to the institution of prudential norms has been one of gradual convergence with international standards and best practices with suitable country specific adaptations. Our aim has been to reach global best standards in a deliberately phased manner through a consultative process evolved within the country. This has also been the guiding principle in the approach to the New Basel Accord e.g. while the minimum capital adequacy requirement under the Basel standard is 8% in India, we have stipulated and achieved a minimum capital of 9%. On the other hand, banks in India are still in the process of implementing capital charge for market risk prescribed in the Basel document although since 1998 we have in place several surrogates such as an Investment Fluctuation Reserve of 5% of the investment portfolio, both in the AFS and HFT categories plus a 2.5% risk weight on the entire investment portfolio - whereas Basel norms take into account only the trading portfolio.

RBI's involvement in Basel II

RBI's association with the Basel Committee on Banking Supervision dates back to 1997 as India was among the 16 non-member countries that were consulted in the drafting of the Basel Core Principles. Reserve Bank of India became a member of the Core Principles Liaison Group in 1998 and subsequently became a member of the Core Principles Working Group on Capital. Within the CPWG, RBI has been actively participating in the deliberations on the Accord and had the privilege to lead a group of 6 major non G - 10 supervisors which presented a proposal on a simplified approach for Basel II to the Committee.

The Basel Committee on Banking Supervision is yet to issue the final Basel II document. The Reserve Bank's comments on the 3rd consultative document on the New Capital Accord on the basis of the quantitative impact studies (QIS 3) undertaken in co-ordination with select banks has brought out the need for more simplicity and greater flexibility on account of the different levels of preparedness of the banking system in India.

Policy approach

In general, keeping in view the RBI's goal to have consistency and harmony with international standards and our approach to adopt the pace as may be appropriate in the context of our country specific needs, the RBI had in April 2003 itself accepted in principle to adopt the new capital accord Basel II. The RBI has announced, in its Annual Policy statement in May 2004 that banks in India should examine in depth the options available under Basel II and draw a road-map by end December 2004 for migration to Basel II and review the progress made thereof at quarterly intervals. The Reserve Bank will be closely monitoring the progress made by banks in this direction. Hence, at a minimum all banks in India, to begin with, will adopt Standardized Approach for credit risk and Basic Indicator Approach for operational risk. After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to IRB Approach.

Regulatory initiatives

The regulatory initiatives taken by the Reserve Bank of India include:

- Ensuring that the banks have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital. The framework adopted by banks would need to be adaptable to changes in business size, market dynamics and introduction of innovative products by banks in future.
- Introduction of Risk Based Supervision (RBS) in 23 banks on a pilot basis.
- Encouraging banks to formalize their Capital Adequacy Assessment Programme (CAAP) in alignment with business plan and performance budgeting system. This, together with adoption of Risk Based Supervision would aid in factoring the Pillar II requirements under Basel II.
- Enhancing the area of disclosures (Pillar III), so as to have greater transparency of the financial position and risk profile of banks.
- Improving the level of corporate governance standards in banks.
- Building capacity for ensuring the regulator's ability for identifying and permitting eligible banks to adopt IRB / Advanced Measurement approaches.

Challenges envisaged

Against the above background and the complexities involved as also the areas of "constructive ambiguity" in concepts and their application we envisage the following regulatory and supervisory challenges ahead:

- India has three established rating agencies in which leading international credit rating agencies are stakeholders and also extend technical support. However, the level of rating penetration is not very significant as, so far, ratings are restricted to issues and not issuers. While Basel II gives some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to ratings of issuers. Encouraging ratings of issuers would be a challenge.
- Basel II provides scope for the supervisor to prescribe higher than the minimum capital levels for banks for, among others, interest rate risk in the banking book and concentration of risks / risk exposures. As already stated, we in India have initiated supervisory capacity building to identify slackness and to assess / quantify the extent of additional capital which may be required to be maintained by such banks. The magnitude of this task to be completed by December 2006, when we in India have as many as 100 banks, is daunting.
- Cross border issues have been dealt with by the Basel Committee on Banking Supervision recently. But, in India, foreign banks are statutorily required to maintain local capital and the following issues would therefore, require to be resolved by us :
  - Whether the internal models approved by their head offices and home country supervisor adopted by the Indian branches of foreign banks need to be validated

again by the Reserve Bank or whether the validation by the home country supervisor would be considered adequate?

    - Whether the data history maintained and used by the bank should be distinct for the Indian branches compared to the global data maintained and used by the head office?
    - Whether capital for operational risk should be maintained separately for the Indian branches in India or whether it may be maintained abroad at head office?
    - Whether these banks can be mandated to maintain capital as per SA / BIA approaches in India irrespective of the approaches adopted by the head office?

- Basel II could actually imply that the minimum requirements could become pro-cyclical. No doubt prudent risk management policies and Pillars II and III would help in overall stability. We feel that it would be preferable to have consistent prudential norms in good and bad times rather than calibrate prudential norms to counter pro-cyclicality.
- The existence of large and complex financial conglomerates could potentially pose a systemic risk and it would be necessary to put in place supervisory policies to address this.
- In the event of some banks adopting IRB Approach, while other banks adopt Standardised Approach, the following profiles may emerge:
    - Banks adopting IRB Approach will be much more risk sensitive than the banks on Standardised Approach, since even a small change in degree of risk might translate into a large impact on additional capital requirement for the IRB banks. Hence IRB banks could avoid assuming high risk exposures. Since banks adopting Standardised Approach are not equally risk sensitive and since the relative capital requirement would be less for the same exposure, the banks on Standardised Approach could be inclined to assume exposures to high risk clients, which were not financed by IRB banks. As a result, high risk assets could flow towards banks on Standardised Approach which need to maintain lower capital on these assets than the banks on IRB Approach.Similarly, low risk assets would tend to get concentrated with IRB banks which need to maintain lower capital on these assets than the Standardised Approach banks.
    - Hence, system as a whole may maintain lower capital than warranted.
    - Due to concentration of higher risks, Standardised Approach banks can become vulnerable at times of economic downturns.

These issues would need to be addressed satisfactorily.

Conclusion

In conclusion, I would say that keeping in view the cost of compliance for both banks and supervisors, the regulatory challenge would be to migrate to Basel II in a non-disruptive manner. We would like to continue the process of interaction with other countries to learn from their experiences through various international fora. I may mention that India is one of the early countries which subjected itself voluntarily to the FSAP of the IMF and our system was assessed to be in high compliance with the relevant principles. With the gradual and purposeful implementation of the banking sector reforms over the past decade, the Indian banking system has shown significant improvement on various parameters, has become robust and displayed ample resilience to shocks in the economy. There is therefore, ample evidence of the capacity of the Indian banking system to migrate smoothly to Basel II.