

## **Y V Reddy: Challenges and implications of Basel II for Asia**

Remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Seminar on “Challenges and implications of Basel II for Asia” as a part of the Asian Development Bank’s 39th Annual Meeting of the Board of Governors, Hyderabad, 3 May 2006.

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Mr. Chairman and friends,

I am thankful to the organisers for inviting me to participate in the annual meetings of the Asian Development Bank and give my views on Basel II in the Asian context. I have a special affinity to the city of Hyderabad. I started in this city as a Research Scholar in 1960, then taught as a lecturer in Osmania University till 1964, and later, was the Collector and District Magistrate of Hyderabad city in 1976-77. Again, I worked here as Secretary in Finance and Planning Department of the Government of Andhra Pradesh for most part of the decade of 1980s. So, as a Hyderabadi, I extend a warm welcome to the distinguished delegates from all over the world.

### **Basel I : voluntarism and gradualism in India**

Let me start with Basel I framework for capital adequacy, which was introduced in 1988. The Basel I framework was designed to establish minimum levels of capital for internationally active banks. However, its simplicity encouraged over 100 countries across the world to not only adopt the Basel I framework but also apply it across the entire banking segment without restricting it to the internationally active banks. Thus, the voluntary adoption of Basel I framework by several countries has made it, *de facto*, a globally accepted standard, though not all countries are fully compliant with all the aspects.

Adopting our general approach of gradualism, we in India have implemented the Basel I framework with effect from 1992-93 which was, however, spread over three years – banks with branches abroad were required to comply fully by end March 1994 while the other banks were required to comply by end March 1996. Further, India responded to the 1996 amendment to the Basel I framework, which required banks to maintain capital for market risk exposures, by initially prescribing various surrogate capital charges for these risks between 2000 and 2002. These were replaced with the capital charges as required under the Basel I framework in June 2004, which became effective from March 2005. We have gone a step further than the Basel I requirement and have required the banks in India to maintain capital charge for market risks on their ‘Available for Sale’ portfolio also with effect from March 2006. We continue to see considerable merit in pursuing a policy of gradualism in harmonising our regulations with the global standards.

### **Basel II : benefits and major issues**

The complexity of Basel II arises from several options available and these are well known. Consequently, many of the countries which have voluntarily adopted Basel I also view these issues with considerable caution. Compared to Basel I, the revised framework, namely Basel II, is considered to be highly complex, making its understanding and implementation a challenge to both the regulatory and the regulated community.

### **Dangers of premature adoption**

Since the revised Framework has been designed to provide options for banks and banking systems worldwide, the Basel Committee on Banking Supervision (BCBS) acknowledges that moving toward its adoption in the near future may not be the first priority for all non-G10 supervisory authorities in terms of what is needed to strengthen their supervision. Each national supervisor is expected to consider carefully the benefits of the revised Framework in the context of its domestic banking system when developing a timetable and approach for implementation.

The views of the Executive Board of the International Monetary Fund clearly indicate that premature adoption of Basel II in countries with limited capacity could inappropriately divert resources from the more urgent priorities, ultimately weakening rather than strengthening supervision. They agreed that countries should give priority first to strengthening their financial systems comprising institutions, markets and infrastructure and focus on achieving greater level of compliance with the Basel Core Principles. Against this background, the IMF has cautioned that Fund staff should avoid conveying the perception that countries will be criticised for not moving to adopt the Basel II framework. They have urged staff to be completely candid when asked to assess countries' readiness to move to Basel II and to indicate clearly the risks of moving too quickly and too ambitiously.

### **Varying implementation plans across jurisdictions in Asia-Pacific**

The implementation plans in regard to Basel II, as far as Asia-Pacific is concerned, may be broadly divided into three ranges – one, where the simplest approaches and the most advanced approaches are available at the time of first implementation (Australia, Korea, Singapore, New Zealand); second, where the simplest approaches are available initially and at least one of the most advanced approaches is available within a year or two thereafter (Hong Kong, Japan, Indonesia, Thailand); and third, where the simplest approaches are allowed initially and the date of availability of the most advanced approaches is yet to be announced or are available after more than two years (China, India, Malaysia, and Philippines). Further, one might be able to link the choice of the above broad ranges to the extent of share of foreign banks in the respective banking sectors.

It is observed that the banking systems where foreign banks account for a significant share in the banking assets (Singapore, Hong Kong) are reflecting a desire to adopt the advanced approaches ahead of those territories where the foreign bank share is not significant (India). One might also see a similar trend in respect of countries which might remain on Basel I for a longer period before migrating to Basel II (China).

### **Implementation in India**

The policy approach to financial sector in India is that the ultimate goal should be to conform to the best international standards and in the process, the emphasis is on gradual harmonisation with the international best practices. Consistent with this approach, for Basel II also, currently all commercial banks in India are expected to start implementing Basel II with effect from March 31, 2007 – though a marginal stretching beyond this date should not be ruled out in view of the latest indications on the state of preparedness. While considering implementation of Basel II, special attention was given to the differences in degrees of sophistication and development of the banking system and it was decided that 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 of the banks may be allowed to migrate to the Internal Rating Based (IRB) Approach.

As per normal practice in regard to all changes in financial sector, and with a view to ensuring a particularly smooth migration to Basel II, a consultative and participative approach has been adopted for both - designing and implementing Basel II.

On current indications, 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. The cushion available in the system, which at present has a Capital to Risk Assets Ratio (CRAR) of over 12 per cent, provides for some comfort but the banks are exploring various avenues for meeting the capital requirements under Basel II. The Reserve Bank has, for its part, issued policy guidelines enabling issuance of several instruments by the banks viz., innovative perpetual debt instruments, perpetual non-cumulative preference shares, redeemable cumulative preference shares and hybrid debt instruments so as to enhance their capital raising options.

### **Three-track approach for implementation in India**

In India, we have 85 commercial banks, which account for about 78% (total assets) of the financial sector; over 3000 cooperative banks, which account for 9%; and 196 Regional Rural Banks, which account for 3%. Taking into account the size, complexity of operations, relevance to the financial

sector, need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to these entities have been maintained at varying levels of stringency. One might say that we are adopting a three-track approach with regard to capital adequacy rules. Given the differential risk appetite across banks and their business philosophies, it is likely that banks would 'self select' their own approach, which in turn, is likely to engender a stabilising influence on the system as a whole.

On the first track, the commercial banks are required to maintain capital for both credit and market risks as per Basel I framework; the cooperative banks, on the second track, are required to maintain capital for credit risk as per Basel I framework and through surrogates for market risk; the Regional Rural Banks, on the third track, have a minimum capital requirement which is, however, not on par with the Basel I framework. Consequently, we have a major segment of systemic importance on a full Basel I framework, a portion of the minor segment partly on Basel I framework, and a smaller segment on a non-Basel framework.

It is for the same reasons that, at least initially, a similar diversity may be visible in the Indian banking segment even after the commercial banks begin implementing Basel II framework in March 2007. In the post-March 2007 scenario we may witness Basel II, Basel I and non-Basel entities operating simultaneously in the Indian banking system. It is useful to note that a somewhat similar choice has been exercised even in the USA where one is likely to see at least Basel II and Basel I-A entities operating simultaneously. Similarly, even amongst the Basel II entities, it is likely that banks will be implementing various combinations of the multiple options available for computing capital requirements for the three major risks. Consequently, we may see Basel II implementation as a part of a *spectrum* of frameworks within which there can be progressive enhancement of quality amongst different categories.

It is likely that on implementation of Basel II, some banks might adopt the IRB Approach for credit risk while some other banks in the same jurisdiction, might adopt the Standardised Approach. Since the IRB Approach is more risk sensitive vis-à-vis the Standardised Approach, a small change in the degree of risk could result in a large additional capital requirement for the banks following the IRB approach - which would dissuade such banks from assuming high-risk exposures. From a systemic point of view, therefore, the banks adopting the Standardised Approach, and consequently, having a greater concentration of high-risk assets in their portfolio, could perhaps become vulnerable in times of economic downturns. These issues would need to be appropriately taken into account while deciding on the implementation of the Basel II.

### **Implementation challenges in developing countries**

Even though it has been mentioned in several places that over 100 countries had implemented Basel I, the assessments done in 71 countries as a part of Financial Sector Assessment Program (FSAP) have revealed many deficiencies in the areas of risk management, consolidated supervision and corrective action for undercapitalised institutions, which are considered to be crucial to sound supervision and proper Basel II implementation. While a supervisory system which is fully or largely compliant with Basel Core Principle 6, which incorporates Basel I as the capital adequacy standard, is considered necessary for moving to Basel II, the assessments reveal that about 37% of these countries had not complied with this Core Principle. The remaining countries were at various stages of compliance. Given this level of compliance, the challenges that are likely to be faced by the developing economies in implementing the Basel II framework, will be daunting.

As acknowledged by the IMF, they do not have adequate internal expertise to assess and assist Basel II implementation in various jurisdictions. Given the complexities of financial regulation and the added complexities of the Basel II framework, which will have to be specifically tailored to suit the domestic economies and the domestic banking systems, the regulators are right in insisting on the freedom and flexibility for adopting and implementing an appropriate roadmap without being constrained by any external pressures, direct or indirect. The ideal solution for managing a complex task of this nature is through mutual cooperation and assistance amongst the central banks.

### **Dangers of asymmetry in financial intermediation**

A likely scenario, which might arise post-Basel II implementation, is the asymmetry in regulatory regime amongst the competing broad segments of the financial sector viz., banking, securities and

insurance sectors. While the commercial banking sector is expected to migrate to the Basel II regimen soon, the other segments are not likely to be subjected to the same or similar discipline unless they are a part of a banking group, where Basel II regimen would apply indirectly through the parent bank. Hence, we are likely to see some scope for regulatory arbitrage amongst the three broad segments unless the regulators of these segments also recognise the need and relevance of a comparable prescription for those segments. The Joint Forum has taken some initiatives in this direction, which may have to be pursued further to achieve parity in the level of regulatory burden across the three sectors, which compete amongst themselves for the business of financial intermediation.

### **Basel II and social dimensions**

The three-track theme to Basel II implementation, which I had mentioned earlier, might give rise to scope for regulatory arbitrage within the banking system. This would, however, not be of much concern in the Indian context on account of the relatively insignificant size of the non Basel II entities and their relevance from the systemic perspective. While the desire would be to reduce the scope for regulatory arbitrage, we may have to strike a delicate balance to ensure that this desire does not constrain the non-Basel II entities from discharging their respective specified roles in the national economies viz., achieving greater financial inclusion, playing a developmental role, and acting as conduits for credit delivery to the neglected sectors. I think, the multi-track theme for Basel II implementation and the consequent handling of regulatory arbitrage and stability issues may be reflected in other similarly placed emerging market economies as well.

### **A roadmap approach for implementation of Basel II**

In the light of experience gained by us, it appears that the balance of advantage would lie in favour of encouraging the central banks / banking sector regulators to implement Basel II framework at their own pace and in a manner as appropriate to their economies, banking systems and supervisory mechanisms. It is also possible that the multilateral development agencies are yet to get fully equipped to assist in Basel II implementation. Ideally each country may devise a road map to be implemented flexibly taking account of the country context. In Telugu, the official language of the State of Andhra Pradesh, we say 'samayam, sanderbham mukhyam'. It means timing and context are vital for anything and, in my submission, it also includes Basel II in Asia.

Thank you.