V Leeladhar: India's preparedness for Basel II implementation

Address by Mr V Leeladhar, Deputy Governor of the Reserve Bank of India, at the panel discussion during the "FICCI-IBA Conference on Global Banking: Paradigm Shift", Mumbai, 13 September 2007.

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Dear Friends,

It is my pleasure and privilege to be here with you this morning and to be sharing my experience and views with this august audience regarding India's preparedness for Basel II implementation. I am very thankful to the organisers for having afforded me this opportunity today. As you are well aware, implementation of the new capital adequacy framework has been a long and exacting journey in most of the jurisdictions, and so is the case with India. The countries are at various stages of implementation. In India, having regard to the country context and in tune with the overall approach to regulatory reforms, we have adopted a calibrated approach for a phased implementation of Basel II so as to secure a non-disruptive migration to the new framework. In my remarks today, I would like to briefly touch upon the evolution of the revised framework, its broad structure, preparatory measures taken by the RBI for implementing this framework and the challenges that will need to be tackled in migration to Basel II.

At the outset, let me hasten to add that while we are moving towards the Basel II Framework, the RBI has adopted a three-track approach to capital adequacy regulation in India, with the norms stipulated at varying degrees of stringency for different categories of banks. Similar differentiated approach has been adopted in some other jurisdictions also. This has been a deliberate choice for us having regard to the size, nature and complexity of operations and relevance of different types of banks to the Indian financial sector, the need to achieve greater financial inclusion and to provide an efficient credit delivery mechanism. Thus, the commercial banks, which account for the lion's share in the total assets of the banking system, will be on Basel II standards while the co-operative banks will remain on Basel I norms for credit risk with surrogate measures for market risk. The Regional Rural Banks, on the other hand, which have limited operations in rural areas, will be on non-Basel standards.

Basel II

The attempts at harmonising the capital adequacy standards internationally date back to 1988, when the "Basle Committee on Banking Regulations and Supervisory Practices", as it was then named, released a capital adequacy framework, now known as Basel I. This initiative set out the first internationally accepted framework for measuring capital adequacy and a minimum ratio to be achieved by the banks. This norm was widely adopted in over 100 countries, and in India, it was implemented in 1992. Over the years, however, the Basel I framework was found to have several limitations such as its broad-brush approach to credit risk, its narrow coverage confined to only credit and market risks, and non-recognition of credit risk mitigants, which encouraged capital arbitrage through structured transactions. Moreover, the rapid advances in risk management, information technology, banking markets and products, and banks' internal processes, during the last decade, had far outpaced the simple approach of Basel I to measuring capital. A need was, therefore, felt to replace this Accord with a more risk-sensitive framework, which would address these shortcomings.

Accordingly, after a wide-ranging global consultative process, the Basel Committee on Banking Supervision (BCBS) released on June 26, 2004 the document "International Convergence of Capital Measurement and Capital Standards : A Revised Framework", which was supplemented in November 2005 by an update of the Market Risk Amendment. This document, popularly known as "Basel II Framework", offers a new set of international

standards for establishing minimum capital requirements for the banking organisations. It capitalises on the modern risk management techniques and seeks to establish a more risk-responsive linkage between the banks' operations and their capital requirements. It also provides a strong incentive to banks for improving their risk management systems. The risk sensitiveness is sought to be achieved through the now-familiar three mutually reinforcing Pillars.

The Pillar 1 stipulates the minimum capital ratio and requires allocation of regulatory capital not only for credit risk and market risk but additionally, for operational risk as well, which was not covered in the previous Accord. The Pillar 1, unlike the previous Accord, provides a menu of approaches, from the simplified to the advanced ones, for determining the capital charge for each of the three categories of risks. The credit risk mitigants used by the banks have been specifically recognised to provide appropriate capital relief.

The Pillar 2 of the framework deals with the "Supervisory Review Process" (SRP), and is probably not that well understood as the other two Pillars. In fact, this is the element which makes the revised framework very comprehensive in its sweep by addressing the entire risk domain of the banks. Let me elaborate a little. It requires the banks to develop an Internal Capital Adequacy Assessment Process (ICAAP) which should encompass their whole risk universe – by addressing all those risks which are either not fully captured or not at all captured under the other two Pillars – and assign an appropriate amount of capital, internally, for all such risks, commensurate with their risk profile and control environment. Under the Supervisory Review, the supervisors would conduct a detailed examination of the ICAAP of the banks, and if warranted, could prescribe a higher capital requirement, over and above the minimum capital ratio envisaged in Pillar 1.

The Pillar 3 of the framework, Market Discipline, focuses on the effective public disclosures to be made by the banks, and is a critical complement to the other two Pillars. It recognises the fact that apart from the regulators, the banks are also monitored by the markets and that the discipline exerted by the markets can be as powerful as the sanctions imposed by the regulator. It is premised on the basic principle that the markets would be quite responsive to the disclosures made and the banks would be duly rewarded or penalised, in tune with the nature of disclosures, by the market forces.

Preparatory measures for Basel II implementation

Let me now say a few words about the process adopted in India for implementation of Basel II. Though the Indian banks became fully compliant with Basel I Accord in March 2005, the RBI had initiated preparatory measures even prior to that. In August 2004, soon after the new framework was released by the BCBS, the banks were advised to conduct a self-assessment of their risk management systems and to initiate remedial measures, as needed, keeping in view the requirements of the Basel II framework. Further, to secure a consultative and participative approach for a non-disruptive migration to Basel II, a Steering Committee was constituted in October 2004, comprising senior officials from 14 select banks (a mix of public sector, private sector and foreign banks). It formed several sub-groups to address specific issues under Basel II and made its recommendations to the Reserve Bank. Based on these inputs, in February, 2005, the RBI issued the draft guidelines, for public comments, on implementation of Pillar 1 and Pillar 3 requirements of the Basel II framework. In the light of the feedback received from a wide spectrum of banks and other stake holders, the draft guidelines were revised and again placed in public domain on March 20, 2007 for a second round of consultations. Keeping in view the additional feedback received, the guidelines were finalised and issued on April 27, 2007. As regards the Pillar 2, the banks have been asked to put in place the requisite Internal Capital Adequacy Assessment Process (ICAAP) with the approval of their Boards.

I may mention here that even before the final guidelines were issued, the RBI had asked the banks in May 2006 to begin conducting parallel runs, as per the draft guidelines, so as to

familiarise them with the requirements of the new framework. During the period of parallel run, the banks are required to compute, parallely, on an on going basis, their capital adequacy ratio – both under Basel I norms, currently applicable, as well as the Basel II guidelines to be applicable in future. This analysis, along with several other prescribed assessments, is to be placed before the Boards of the banks every quarter and is also transmitted to the RBI. These reports received in the RBI indicate that implementation of Basel II in the banks is in the process of getting stabilised.

The minimum capital adequacy ratio prescribed under the Basel II norms continues to be at nine per cent, at solo as well as consolidated level. This, however, is subject to the stipulated prudential floors for the first three years of implementation to guard against any significant decline in the capital ratios of the banks arising from the capital relief that they might accrue to them under Basel II. The banks are, however, expected to operate at a level well above the minimum capital requirement. The banks are also required to achieve the Tier I capital ratio of six per cent not later than March 31, 2010, both on solo as well as consolidated basis.

A two-stage implementation of the guidelines is envisaged to provide adequate lead time to the banking system. Accordingly, the foreign banks operating in India and the Indian banks having operational presence outside India are required to migrate to the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk with effect from March 31, 2008. All other Scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them, but, in any case, not later than March 31, 2009. It has been a conscious decision to begin with the simpler approaches available under the framework. As regards the market risk, the banks will continue to follow the Standardised-Duration Method, already adopted under the Basel I framework, under Basel II also.

Thus, reckoning the well-planned and carefully-sequenced preparatory work already done, the choices exercised by the RBI under the national discretion, coupled with a phased implementation schedule, I am inclined to believe that the Indian banking system could be considered to be in a high state of preparedness and would be well poised for a seamless migration to Basel II next year, in tune with the envisaged timeframe. This, however, is not to say that the process would be a cake-walk – as there would be considerable challenges too that lie head for all of us, during the current phase of implementation as also for moving to the advanced approaches.

The challenges ahead

Let me now briefly outline some of the salient issues and challenges that might arise for the Indian banking system from the adoption of the Basel II framework. The list here is, however, by no means exhaustive.

First, the new norms might, in some cases, lead to an increase in the overall regulatory capital requirements for the banks, particularly under the simpler approaches adopted in India, if the additional capital required for the operational risk is not offset by the capital relief available for the credit risk. This would of course depend upon the risk profile of the banks' portfolios and also provide an incentive for better risk management but the banks would need to be prepared to augment their capital through strategic capital planning.

Second, the Standardised Approach for credit risk leans heavily on the external credit ratings. While the RBI has accredited four rating agencies operating in India, the rating penetration in India is rather low. Moreover, credit rating in India is confined to rating of the instruments and not of the issuing entities as a whole. Besides, the credit rating provides only a lagged indicator of the credit standing of an entity, and is not a lead indicator. The banks would, therefore, need to actively reckon this aspect in their ICAAP exercise.

Third, the risk weighting scheme under Standardised Approach also creates some incentive for some of the bank clients to remain unrated since such entities receive a lower risk weight of 100 per cent vis-à-vis 150 per cent risk weight for a lowest rated client. This might specially be the case if the unrated client expects a poor rating. The banks will need to be watchful in this regard.

Fourth, the new framework could also intensify the competition for the best clients with high credit ratings, which attract lower capital charge. This could put pressure on the margins of the bank. The banks would, therefore, need to streamline and reorient their client acquisition and retention strategy.

Finally, implementing the ICAAP under the Pillar 2 of the framework would perhaps be the biggest challenge for the banks in India as it requires a comprehensive risk modelling infrastructure to capture all the risks that are not covered under the other two Pillars of the framework. The validation of the internal models of the banks by the supervisors would also be an arduous task.

In regard to adoption of advanced approaches available under Basel II, the RBI has not stipulated any timeframe for adoption of these approaches but a migration to advanced approaches would certainly pose significant challenges to both – the banks as well as the supervisors. In this case, a slightly different set of issues and challenges is likely to arise which would need to be kept in view in any decision to migrate to them.

First and foremost, the banks will need to demonstrate to the supervisors that they meet the minimum criteria stipulated in the Basel II framework to be eligible to adopt the IRB approaches. This could require, inter alia, suitable adjustments in the risk-rating design and its operations for various product lines in the banks as also the governance structure to ensure the integrity of the rating process.

Second, unlike the simpler approaches under Basel II, the advanced approaches are very data intensive and require high-quality, consistent, time-series data for various borrower- and facility-categories for a period of five to seven years to enable computation of the required risk parameters (such as default probability and loss given default, etc.). The banks would perhaps need a thorough review of their internal processes with a view to redesign and upgrade them to be able to capture the information needed for creating the requisite databases.

Third, a robust risk management architecture, including a strong stress-testing framework for scenario analyses, would be a necessity under the advanced approaches. A system within the banks to validate the accuracy of the internal rating processes would be an essential element of the risk management set up.

Fourth, an overarching requirement for efficient data management and for effective risk management structures, would be an state-of-the-art technological infrastructure which might need significant investment and improvement to achieve seamless enterprise-wide integrated risk management, for which sharply focused strategic planning would be necessary.

Fifth, with considerable leeway available to the banks under the advanced approaches in determining the regulatory capital requirements, the highest standards of corporate governance would be critical for maintaining the integrity of the advanced approaches.

Sixth, the complexity of advanced approaches requires highly skilled staff and the human resource management in the banking industry, particularly for the public sector banks, could emerge to be a binding constraint, in adopting advanced approaches. This would need innovative strategies and concerted efforts on the part of the banks to be able to attract and retain the right mix of talent in the organisation.

Finally, the advanced approaches would also cast an onerous responsibility on the supervisors of not only guiding the banking system through the implementation phase but

also of validating the internal models, system and processes adopted by the regulated banks. This, needless to say, would require considerable capacity building and augmentation of the domain knowledge and expertise of the supervisors themselves to ensure a non-disruptive migration to the advanced approaches under Basel II. Let me hasten to assure all of you that we, in the RBI, are quite live to the issue and strategic interventions have already been planned in this regard.

Conclusion

I have provided a brief overview of the Indian approach to implementing Basel II framework and the state of preparedness of the banks in India. Let me conclude by reminding those present here that the Basel II framework provides significant incentives to banks to sharpen their risk management expertise to enable more efficient risk-return trade offs; it also presents a valuable opportunity to gear up their internal processes to the international best standards. This would require substantial capacity building and commitment of resources through close involvement of the banks' Top Management in guiding this arduous undertaking. It is, no doubt, a demanding and daunting task, both for the banks as also the supervisors, but I am sure that with concerted and dedicated efforts of all of us, we would be able to measure equal to the task and cross yet another important milestone in our journey of successfully implementing the regulatory reforms in the country.

Thank you.