ISSN Print: 2394-7500
ISSN Online: 2394-5869
Impact Factor: 5.2
IJAR 2016; 2(10): 89-94
www.allresearchjournal.com
Received: 16-08-2016
Accepted: 17-09-2016

Hemali Tanna
a) Ph.D Scholar, Management Department, Gujarat Technological University, Gujarat, India
b) Assistant Professor, Marwadi Education Foundation's Group of Institutions, Rajkot, Gujarat, India

Correspondence
Hemali Tanna
a) Ph.D Scholar, Management Department, Gujarat Technological University, Gujarat, India
b) Assistant Professor, Marwadi Education Foundation's Group of Institutions, Rajkot, Gujarat, India

Basel II norms and its impact on banks in India

Hemali Tanna

Abstract
In this competitive era, implementations of Basel II norms by Indian banks will make them manage their risks in a better way and in turn make them globally competitive. With this frame, the present research paper highlights the significant aspects of Basel II Accord for the banking system. It discusses the impact of implementation of Basel II norms on the banks in India. As every coin has two sides, the same applies to Basel II Accord as well, and hence the paper outlines the positive and negative impact of implementing Basel II norms on the Indian Banking System.

Keywords: Basel II norms, implementation of Basel II accord, impact in India

1. Introduction

1.1 Background of the study

The author has tried to understand the structure of Basel II Accord as instructed by its parent regulatory body named Basel Committee on Banking Supervision (BCBS). The study highlights the main three pillars of Basel II norms and its important parameters to implement the same in banking operations. The present study intends to analyse the impact of adopting Basel II framework in the Indian Banking Industry.

1.2 The objectives of the study

- To study the significant features of Basel II Norms and understand its framework for implementation
- To understand and examine the impact of implementation of Basel II Norms on the banks in India
- The paper is aimed to enhance the knowledge of Basel II Norms to bankers, strategists, policy makers, academic researchers and other financial professionals.

2. Methodology

This paper is the outcome of secondary data collection and analysis of Basel II Norms and Indian banking sector collected from various appropriate sources. The article is sectioned into three parts. The first part includes the foreword of Basel Norms and concise information on Basel I Accord. The second part discusses the Basel II norms, its salient features and implementation of Basel II framework in Indian Banking System. Finally, the third part outlines the impact of adopting Basel II Accord on the banks in India.

2.1 Introduction to Basel Norms

With the beginning of globalization, banks are now facing a number of risks. Hence, in order to mitigate risks, some stringent norms are required. Basel norms are one such internationally accepted model (of rules and regulations) applicable to banks, to overcome the challenges faced by them in performing various activities on routine basis. In order to protect banks from global financial crisis, several guidelines are given by Regulatory Bodies all over the world. One such guideline is laid down by Basel Committee on Banking Supervision (BCBS) for maintaining capital adequacy and supervision of banks.
In India, Reserve Bank of India (RBI) being the regulatory authority has prescribed to follow Basel Norms which are implemented by banks across the world.

2.1.1 Importance of Basel Norms
Common international rules and frameworks for the Banking Industry are of great importance for the reliability and development of financial system and economies of various countries [1]. Basel II norms has got not only statutory importance, rather it has an interest of policy makers and business world. Basel II norms should not be considered as needs of banks, but it should be viewed as benefits arising from the application, acceptance and implementation of best practices in banking industry.

2.1.2 The Basel Capital Accords
After disturbances to the international currency and banking markets, a group of ten countries, G-10, founded the Basel Committee in 1974 in an attempt to increase financial stability. G-10 countries were Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States [2]. Their aim was to stabilize the financial system by formulating capital adequacy requirements and supervisory projects for banks. In 1988, Basel I was introduced which consisted of international capital requirements. [1]. However, as the financial markets developed and became more complex, the need for a new framework was inevitable and in 2004, the Basel Committee therefore presented Basel II – the New Capital Accord [2].
The Basel Committee on Banking Supervision (BCBS) is one of the reputed committees whose head office is located at Bank for International Settlements (BIS), Basel, Switzerland. The BCBS works for the development of common supervisory standards of banks across nations and is the author of all the Basel Accords.

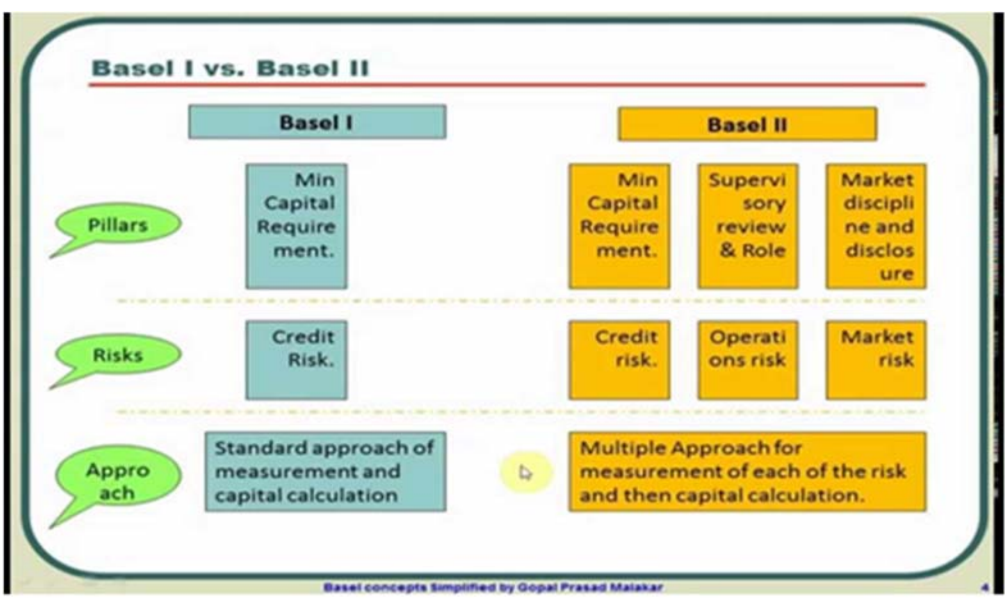
2.1.3 Basel I Accord
In 1988, the committee came up with a framework governing capital measurement, which was the first Basel Capital Accord, familiarly known as Basel I norms. Basel I provided for two categories of capital – core capital and supplementary capital. Different categories of assets and off-balance sheet exposures were prescribed for calculation of risk weights. The guidelines for calculating risk were simple and accounted for credit risk only. The committee suggested a target standard ratio for CRAR (Capital to Risk-Weighted Asset Ratio) of 8%, of which core capital was set at 4%.
An amendment was made to Basel I in 1996, to incorporate market risks in capital charge. This move was made to protect banks from the risks they were exposed to, especially from the business activities of banking. The amendment was implemented in India in a phased manner in 2005 and 2006.

2.2 Basel Ii Accord
Basel Capital Accord can be described in one line as, some common rules framed by Basel Committee on Banking Supervision (BCBS), to provide a level playing field for banks across the globe. The intention of Basel II accord is to lower banks' capital requirement, by presenting banks the ability to select a method that reveals their reality when calculating risk [3].

2.2.1 Objectives of the Basel II Accord
- To encourage safety and security in the financial system
- To improve competitive equality among banks
- To represent a more comprehensive approach for dealing with risks faced by banks

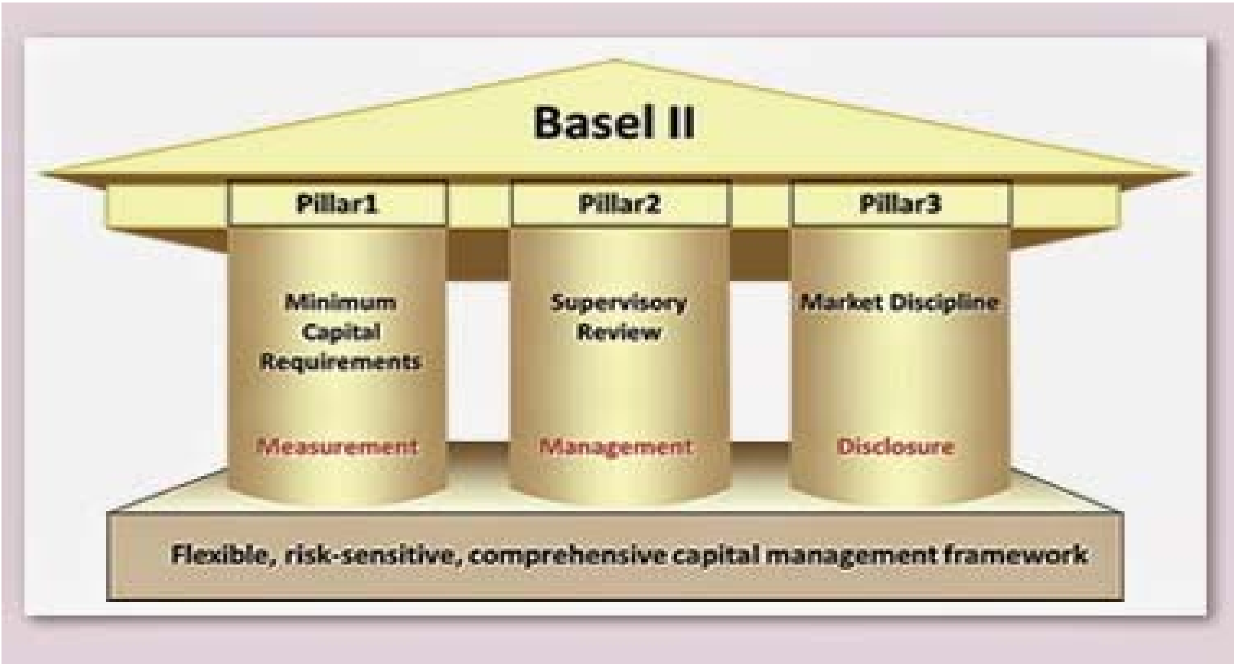
"Basel II is not intended simply to ensure compliance with a new set of capital rules. Rather, it is intended to enhance the quality of risk management and supervision." Jaime Caruana, Governor of the Banco de España, Former Chairman of Basel Committee.

2.2.2 Difference between Basel I and Basel II Norms



The Basel II is different from the First Accord in three respects - Firstly, the capital formula is being substantially revised. Secondly, guidelines on the supervisory review of bank capital adequacy are being added and thirdly, the concept of market discipline is being introduced through improved disclosure rules [4]. The key principle underlying Basel II, and the basis for the advancement from Basel I, is greater risk sensitivity [5].

The BCBS spend the entire period from 1999 to 2004 in developing and finalizing the second Basel accord, known as Basel II norms, which increased the scope of capturing all banking risks in the capital adequacy framework. The second Basel accord is based on three pillars – Minimum Capital Requirements, Supervisory Review and Market Discipline. A wider range of risk weights for credit risk were introduced, greater recognition for collateral and a capital charge for operational risk was introduced, among other important developments.



Initially, banks are required to follow the Standardised Approach for credit and market risk assessment, and the Basic Indicator Approach for operational risk assessment. However, as systems and procedure develop with time, banks will be required to shift to the Internal Models Approach for better risk evaluation and mitigation.

2.2.3 Details about Basel II norms

The principal reason for adopting Basel II norms was that, it considers both credit and operational risks apart from market risk as the major sources of risks. Basel II norms direct banks to allocate adequate amounts of capital for these types of risks unlike Basel I. The revised framework i.e. Basel II norms presents an array of options for determining the capital requirements for credit risk and operational risk. This facilitates banks and supervisors to identify and implement approaches which are most suitable for their banking operations.

The main structure of Basel II depends on 3 Pillars concept:

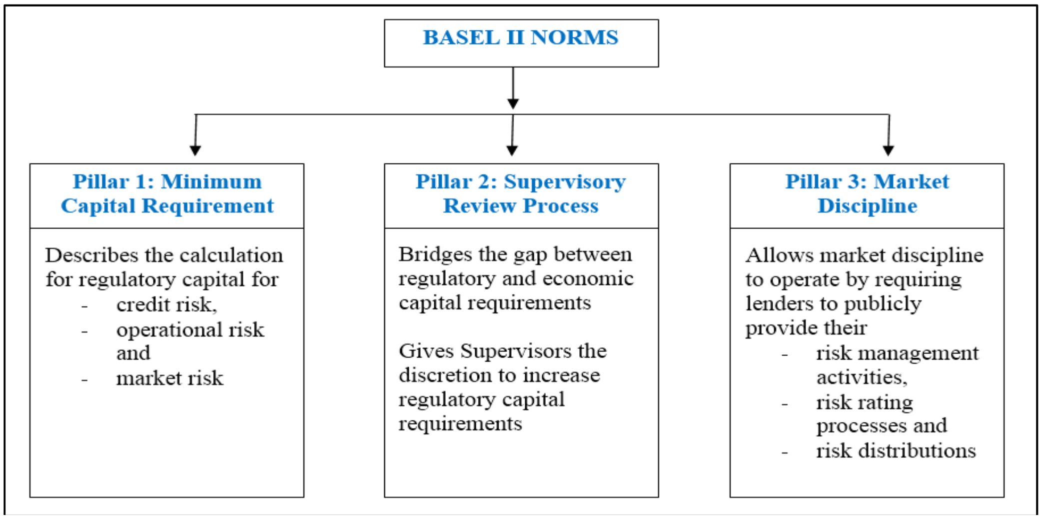
1. Minimum Capital Requirements
2. Supervisory Review of Capital Adequacy
3. Market Discipline

2.2.3.1 The First Pillar: Minimum Capital Requirement: The first pillar measures the minimum regulatory capital that needs to be maintained by banks after considering three risks namely credit risk, operational risk and market risk.

2.2.3.2 The Second Pillar: Supervisory Review Process: The second pillar deals with management of various risks faced by banks such as systematic risk, risks related to strategy, reputation, liquidity and legal issues. It provides banks to check and reconsider their Risk Management System by developing their own risk management techniques to administer and manage their risks. Supervisors are assigned the task of evaluating and reviewing the capital requirement of banks with respect to various risks faced by them.

2.2.3.3 The Third Pillar: Market Discipline: The third pillar focuses on disclosure of various important information of banks which facilitates market participants to consider aspects like risk exposure, techniques of risk assessment and capital adequacy maintained by banks. Market discipline aims to share this vital information of banks which is used to assess bank performance by market participants like investors, customers, financial experts and analysts, other banks and rating agencies.

In a nutshell, all the three pillars of Basel II norms focuses on to provide greater stability in the financial system by ensuring adequate capital to manage risks faced by banks, reviewing the risk management by Supervisors and sharing the significant information by way of market disclosure. The same is described in the figure below.



Basel I norms dealt with only parts of the above pillars whereas Basel II norms represents a basic change in how bank capital is to be determined for regulatory purposes.

2.2.4 Introduction of Basel Norms in Indian Banking System

In response to the Basel I Accord of 1988, Reserve Bank of India issued required guidelines and instructions to all the Indian Banks for implementing the norms as per best international banking practices. RBI issued broad guidelines and directives in an attempt to execute, supervise prudential norms of credit like practices of supervision, licensing, liquidity, risk management and techniques of banking supervision on a regular basis [6].

In India, Basel I framework was put into practice from 1992-93 which was extended for three years. Banks with branches abroad were required to conform completely by March 31, 1994 and other banks were required to abide by the rules by March 31, 1996. In response to the 1996 amendment of Basel I framework, India accepted and made necessary changes for the banks to maintain capital for market risk component, by imposing various reserves and capital charges in the beginning, for these risks between 2000 and 2002. Later on, these were replaced with capital charges as stipulated by Basel I framework in June 2004, which came into existence completely from March 2005. The Indian Banking System has shown considerable improvement on several factors due to the successful implementation of banking sector reforms since 1991. And hence the Indian Banking System is competent enough to shift to Basel II norms efficiently [7].

Commercial banks in India began implementing Basel II framework from March 31, 2007. RBI gave instructions in October 2006 that foreign banks operating in India and Indian banks located abroad would adopt the Standardised Approach for measuring credit risk and the Basic Indicator Approach for calculating operational risk component under Basel II norms, applicable from March 31, 2008 whereas all other scheduled commercial banks are required to move to Basel II framework by March 31, 2009 [8].

2.3 Impact of Basel Ii Norms on Banking System

Basel II framework will increase the volatility of the capital requirements of any developing country. This is because the credit rating process and access is less in a developing country compared to a developed country, where it is very easily put into practice. The same is the case with India where credit rating is less penetrated, so majority of the proportion of bank assets in its balance sheets are unrated claims [9]. As per Basel II norms, less credit rating requires more capital adequacy to mitigate the risk which might arise from the assets. This also means that the operational risk requirement may increase and hence the overall capital requirement of the bank will be more. This may act as a hurdle to implement Basel II norms in some countries.

Many countries across the world implemented Basel I Accord, but they had maintained a slightly higher capital than the minimum requirement of 8%. As per second pillar of review process, supervisors with their agency focus on improving the internal risk management of banks so that they can switch to IRB Approach, rather than implementing standard approach of measuring risk, like other competitor banks. Moreover, the supervisors who are in-charge of audit and review of Basel II Norms in banks should aim to check the capital adequacy, size, domestic capital markets, availability and disclosure of information, degree of measuring and monitoring the provision of loans and losses [10].

Many countries will most likely decide to implement simpler and easier approaches of Basel II like Simplified Standardized Approach and Standardized Approach because the former uses only the ratings of official export credit guarantee agencies for sovereign risk assessment whereas the latter will use the credit ratings from private agencies. Still the developing countries faced problem in implementing alternative approaches for measuring capital as per Basel II, i.e. there are two versions of Standardized and IRB Approaches, but it does not highlight appropriate reasons or benefits to use the most risk-sensitive approach, thereby developing arbitrage possibilities. Moreover, in countries with less developed capital market and financial system, reliable credit ratings are not available for most of the assets in the bank's credit portfolio. In such cases, the Standardized Approach will assist very little to relate risk with capital requirement and hence it would be a poor replacement of Basel I framework. Hence the capital requirement in developing countries will increase which they are not prepared for. Moreover, the regulatory and supervisory bodies in those countries are not all set to meet the challenge of second pillar of Basel II norms, due to lack of developed infrastructure, insufficient human capital etc. [10].

The implementation of Basel II framework on the Japanese Banking industry resulted in decrease of share prices and reduction of loan provisions for banks that had low capital ratios. This is because second pillar of Basel II norms enforces a large burden on minimum capital requirement to be maintained by banks. Moreover, the second pillar also increases the regulatory capital requirement of banks [11].

Thus, in order to relate the existing literature about the implementation of Basel II in a developing country, the researcher analyzes the impact of Basel II Norms on the Indian Banking sector as India itself is a developing country and has adopted Basel II Norms in its banking system.

2.3.1 Positive Impact of Basel II on Banks in India

Basel II Norms will have a positive impact on the Indian Banking System in the following ways:

Firstly, the implementation of Basel II norms results in reduction of regulatory capital by reducing the credit risk weights, this can be done by suitably altering the bank's portfolios. The Internal Ratings Based (IRB) Approach would provide autonomy to the individual banks to evaluate their own risk and determine the requirement of economic capital [12].

The Standardised and Internal Ratings Based (IRB) Approaches are advanced approaches for calculating credit and operational risk component respectively as per Basel II norms. These methods will help consider most of the risks faced by banks and hence are required to maintain lower capital which will result in lower costs following these approaches [13].

Basel II framework considers economic risk in line with regulatory risk faced by banks. This will result in easy disbursement of loans to corporate, increase in retail loans and mortgage loans with higher margins. It will also transform the way credit risk is managed by banks because it will make sure that banks have sufficient capital to face operational risk. The other benefit to banks is the development of better risk assessments system, leading to an edge over other banks, by focusing on only those target segments, markets and customers who have high risk and high return ratio [14].

The other advantage to banks for implementing Basel II norms is superior understanding of risk return trade-off for estimating risks for capital supporting specific business, corporate, customers, products, services and various processes.

The other benefits that the banks would receive by adopting Basel II framework would be the robust risk estimation, measurement and management process, which will result in serving the customers better including small and medium sized businesses. It will lead to liquidity for those small businesses and help them for their growth and expansion needs [15].

The second pillar of Basel II Accord considers the very important Supervisory Review Process. It brings in the concept of Economic Capital which will assist the banks to decide a minimum capital adequacy requirement based on the level of risk resulted from the transaction. It benefits the bank to achieve an improved relationship between risk and minimum capital required to be maintained by respective banks [15].

Basel II norms will also offer banks with business benefits like improving corporate governance and allocation of capital. The risk-based pricing will help to improve the bank's competitiveness. Capital will be saved and better decision making will allow counter parties to deal in a better way and increasing the value of stakeholders [16].

Basel II offers the banks with several alternatives, from which they can select appropriate risk measurement approaches applicable to them. For example, large banks are expected by the market and supervisors to implement advanced risk management techniques whereas small banks with relatively easy operations may use a simple and less expensive risk management system. This is because Basel II framework is drafted flexibly to integrate any changes which may occur in future, the same principles can be included without making changes in the basic arrangement. Banks will have the autonomy in its operations but has some constraints to ensure a basic minimum capital adequacy requirement [17].

Other additional advantages of Basel II norms are adopting a more active portfolio management system and advanced, progressive risk measurement system. The portfolio of banks is managed by taking into consideration high risk and high return assets, this is possible because banks has access to better, reliable, timelier and higher quality risk information and capital requirement in advance. The pricing of products will be more risk sensitive and proactive which results in overall improvement in the performance management of banks [18].

2.3.2 Negative Impact of Basel II on Banks in India

After implementing Basel II norms, Banks in India might face certain negative aspects, which are mentioned as follows:

The first disadvantage with Basel II framework is with reference to higher capital requirement by banks. The Basic Indicator Approach states that banks should maintain capital charge for operational risk component which should be equivalent to the average of the 15% of annual positive gross income of last three years, excluding any year when the gross income was negative. It also indicates that capital required by the banks would depend on the level of Non-Performing Assets (NPAs) of banks.

The second disadvantage of implementing Basel II norms deals with investment and expenditure pattern of banks. The banks in order to be risk aversive, give priority to investment in government securities rather than giving loans to small businesses. This has resulted in negatively affecting the credit disbursed to agriculture and small-scale industries [12].

The third and the fourth negative aspect is role of rating agencies and regulatory bodies in India. As per the directives of Basel II Accord, banks are required to gather new information and the same is supposed to be disclosed to the general public as a part of Market Discipline, to make sure its transparency. There are only four rating agencies in India, initially they had common rules which will be updated to incorporate new Basel II framework. Regulatory bodies too will encounter challenge as they have to provide same level playing field in terms of jurisdiction at international level, as Basel II norms are adopted in various countries. Moreover, they have to make sure that their auditors and supervisors are sufficiently trained to evaluate banks' compliance as per new capital rules [15].

3. Results and Discussions

The study highlights that implementing Basel II norms in the Indian Banking System has some remarkable benefits like determining minimum capital adequacy requirement well in advance considering the risks beforehand, better portfolio management, considering risk-return trade-off while lending and investing, being more risk sensitive in the areas of credit, market and operational risk, supervise better risk management system, more transparency and better clarity of banking operations to market participants. Nevertheless the Basel II norms have some serious implications like cost of minimum capital requirement is quite high and difficult to be maintained by smaller banks, neglecting priority sector lending to agriculture and small scale industries and overdependence on rating agencies.

4. Conclusion

The present study describes the understanding of Basel II norms and its impact on the Indian Banking System. The summarized findings focus on the positive and negative impact of adopting Basel Accord on the banks in India. It outlines that even though there are a few loopholes in the Basel II framework which has some demerits, but it has far longer list of benefits which outweighs all the disadvantages. Hence, implementation of Basel II framework by banks in India has resulted in better performance of banks, benefitting all its stakeholders.

5. References

1. Johansson E, Ekstrom F. The development of Swedish Banking Industry during the implementation of Basel II, dissertation submitted to University of Gothenburg, Gothenburg, 2011
2. Basel Committee on Banking Supervision (BCBS) Guidelines issued by Bank for International Settlements (BIS), 2009
3. Basel Committee on Banking Supervision (BCBS) Guidelines issued by Bank for International Settlements (BIS), 2004
4. Illing M, Paulin G. Basel II and the cyclicality of bank capital, Canadian Public Policy. 2005; 31(2):161-180.
5. Gilleran EJ. Testimony on Basel II Capital Accord, 2003
6. Gupta V. Basel II accord: Impact on Indian Banks. ICRA rating feature, 2005
7. Leeladhar V. Demystifying Basel II, FICCI-IBA Conference, 2006
8. Chandrasekhar PC, Ghosh J. Basel II and India's Banking Structure, Macroscan, 2007
9. Powell, A. Basel II and Developing Countries: Sailing through the Sea of Standard, The World Bank, 2004
10. Manjoni G, Powell A. Reforming Bank Capital Requirements: Implications of Basel II for Latin American Countries, Journal of Banking and Finance, 2005; 25(1):115-48
11. Rixtel VA, Alexopoulou I, Harada K. The New Basel Accord and Its Impact on Japanese Banking: A Qualitative Analysis, Centre for Economic Institution Working Paper Series, Institute of Economic Research, 2003, number 2003-25
12. (www.ibase.br/userimages/FLGG%20-20Chalapurath%20Chandrasekhar.pdf).
13. Francis, S., The Revised Basel Capital Accord: The Logic, Content and Potential Impact for Developing Countries, 2006 (http://www.networkideas.org/featart/aug2006/Capital_Accord.pdf)
14. Crockett A, The Economic Consequence of Basel II, Financial Market group, 2005, (http://www.fmg.lse.ac.uk/upload_file/384_A_Crockett.pdf for)
15. (www.us.kpmg.com/microsite/FSLibraryDotCom/docs/Basel_AWorldwide%20Challenge_web%20(2)).
16. Oosthuizen C. Basel II: An Introduction to the nuts and bolts, 2005, (http://www.banking.org.za/documents/2005/FEBRUARY/BaselWorkshop_NutsBolt s_070205.pdf for basel workshop)
17. Lind G. Basel II: The new Framework for Bank Capital, Economic Review, 2005
18. (www.kpmg.com.mx/gobiernocorporativo//libreria_gc/rrr/Basilea%20II/basel_ii.pdf)
19. Basel II – A Challenge and an opportunity to Indian Banking: Are we ready for it? (www.ficci.com/surveys/II.pdf)
20. Mittal S. How will Basel II change banking in India? dissertation submitted to IIM Lucknow, 2008
21. Mathew M. How will Basel II change banking in India? dissertation submitted to, Loyola Institute of Business Administration, Chennai, 2008
22. Harlalka S. A Study on an analysis of Impact of Basel II in India: A Qualitative Approach, dissertation submitted to University of Nottingham, UK, 2007
23. Hasmi S. A Study on the factors affecting the Internal Capital Adequacy Assessment Process (ICAAP) of banks in India with respect to Basel Guidelines submitted to Jagdishprasad Jhabarmal Tibrewala University, Rajasthan