NIBM WORKING PAPER SERIES

(Policy Research Notes)

Basel III Capital Regulation – A Brief Discussion

Sanjay Basu

Working Paper
(WP16/2022)

NATIONAL INSTITUTE OF BANK MANAGEMENT
Pune, Maharashtra, 411048
INDIA
May 2022

The views expressed herein are those of the authors and do not necessarily reflect the views of the National Institute of Bank Management.

NIBM working papers are circulated for discussion and comment purposes. They have not been peer-reviewed or been subject to the review for Journal or Book Publication

© 2022 by Sanjay Basu

Citation Guideline:
Basu, Sanjay (2022), "Basel III Capital Regulation – A Brief Discussion". NIBM Working Paper Series: Policy Research Notes WP16/May.

https://www.nibmindia.org/static/working_paper/NIBM_WP16_SB.pdf

Basel III Capital Regulation – A Brief Discussion
Sanjay Basu
NIBM Working Paper No. 16
May 2022

ABSTRACT

The comprehensive RBI Master Circular on Basel III Capital Regulations, dated 1st April 2022, retains most of the guidelines covered by the previous Master Circular dated 1st July 2015. It prefers to continue with Basel II-style Standardized Approaches, for all risk categories. However, it includes the Large Exposure Framework (LEF), to dissuade banks from ever bigger loans to large borrowers. It also lowers risk weights on retail home loans (secured by residential property) and reduces the Leverage Ratio for the banking sector, relative to the Master Circular of July 2015. Such measures reduce capital requirements and spur credit growth in general, and home loans in particular. This Master Circular could have introduced Internal Liquidity Adequacy Assessment Process (ILAAP), for a more scientific approach to Liquidity Risk Management in India.

Sanjay Basu (*Corresponding Author*)
s_basu@nibmindia.org

Basel III Capital Regulation – A Brief Discussion

Introduction

On the 1st of April 2022, the Reserve Bank of India issued the latest Master Circular on Basel III Capital Regulations. This document consolidates thirty-two circulars between 2015 and 2021. The previous Master Circular on Basel III was issued on the 1st of July 2015. In the last seven years, the BFSI sector in India has been shaken by a series of seismic shocks – the NPA crisis, the NBFC crisis, and the Covid-19 pandemic. These events have resulted in significant erosion of business and capital, for Scheduled Commercial Banks (SCBs) in India. Hence, the latest Master Circular chooses continuity over radical change in capital regulations. Most of the guidelines, in the previous Master circular, have been retained.

Across the world, banks that suffered the most during the global financial crisis had some common features. They had scant Tier 1 Capital, leverage was high and the liability side was dominated by short-term wholesale deposits. Even Indian banks which were brought under the Prompt Corrective Action (PCA) framework exhibited a chronic deficiency of Tier 1 capital. Therefore, the stated goal of the Basel III regulations was to increase bank reliance on Tier 1 Capital, under normal and stressed conditions. This is the most important message conveyed by both the 2015 and 2022 Basel III Master Circulars as well:

Minimum Common Equity Tier 1 (CET1) Capital: 5.5 percent

Capital Conservation Buffer (of CET1): 2.5 percent (to absorb idiosyncratic and systemic stressed losses)

Minimum Additional Tier 1 Capital: 1.5 percent

Tier 2 Capital: 2 percent

Hence Basel III establishes the primacy of Tier 1 capital and makes Tier 2 capital peripheral.

The Capital Adequacy Ratios are concerning Risk-Weighted Assets (RWAs). The RWAs in the Master Circular of April 2022 is at least as conservative as those under the 2017 Basel III guidelines issued by the Basel Committee. This means that the minimum Pillar I Capital Buffer prescribed by the Master Circular is as large as the one proposed by the Basel Committee, if not more. However, the latest RBI Circular is silent on liquidity risk and its implications for capital adequacy. This issue could have been addressed with a discussion on Internal Liquidity Adequacy Assessment Process (ILAAP) when Pillar II risks were covered. We will return to these two topics, in some detail, in due course.

Summary

The Circular begins with a clear exposition of the need for Basel III reforms, in the wake of the global financial crisis, to improve the level and quality of bank capital worldwide. In terms of regulatory capital assessment for Pillar I (i.e. credit, market, and operational) risks, its emphasis on the standardized approaches, for all risk categories, implies that the RBI prefers banks in India to continue with such a framework, rather

than the advanced approaches, in the current environment. The Circular discusses capital requirements at the solo and group levels, with 9 percent of risk-weighted assets as the floor. It also highlights the significance of Tier 1 - which consists of common equity – rather than Tier 2 (dominated by debt instruments), in the regulatory capital structure, under Basel III.

Part A focuses on the computation of Capital Charges, for different risk categories. The guidelines are the most comprehensive for Credit Risk. They include exposures to sovereigns and multilateral development institutions, banks, corporates and NBFCs, retail portfolios and real estate, off-balance sheet items and NPAs, credit default swaps, and securitization. There is detailed deliberation on credit risk mitigation techniques and the choice of external credit rating agencies. The most notable feature is that, despite the granularity of treatment, none of the risk weights (or credit conversion factors for off-balance sheet items) are lower than those suggested by the final (2017) Basel III guidelines. Hence, the credit risk capital requirements in India are at least as high as the global benchmarks.

The same observation holds for Market Risk Capital Charges. The RBI Master Circular has chosen to continue with the Basel I/Basel II Standardized Duration Approach (SDA), perhaps because the implementation of the best possible alternative (Simplified Standardized Approach (SA) under the Fundamental Review of the Trading Book [FRTB]) has been postponed by the Basel Committee to January 2023. The same approach will prevail under FRTB: (a) general market risk capital charges on (i) interest rate sensitive instruments assessed with modified duration and regulatory yield shocks and (ii) equities, currencies, and gold positions fixed at 9 percent and (b) specific risks for bonds and equities based on issuer credit and liquidity risks. The only difference is that, for each asset class, a regulatory multiplier will be applied under FRTB to scale up the capital requirements. Therefore, the capital charges are comparable under SDA and SA-FRTB. As market conditions improve, banks may be in a better position to create a bigger capital buffer for FRTB. Till then, they may persist with SDA.

In a similar vein, the guidelines retain the Basic Indicator Approach to Operational Risk, which was recommended under Basel II. Under this approach, Operational Risk Capital Charges are equal to 15 percent of Average Gross Income over the last three years (provided gross income is positive each year). Therefore, for regulatory capital charge estimation, banks will continue to assume that the size of operational losses increases with the scale of business (i.e. gross income) and there are no diversification benefits across business lines.

Part B of the guidelines pertains to the Internal Capital Adequacy Assessment Process (ICAAP), which is an important component of the Supervisory Review and Evaluation Process (SREP) under Pillar II of the Basel Accords. This section discusses the salient features of ICAAP, which captures those risks which are not included under Pillar II, under normal and stressed conditions, for up to five years. These include credit concentration risk, interest rate risk in the banking book, liquidity risk, strategic risk, and reputation risk. Unlike Pillar I, risk models under Pillar II are bank-specific and incorporate changes in the macroeconomic environment, with the passage of time. Hence, there is a need for the supervisor to validate these models, to rule out the underestimation of capital and liquidity buffers. The ICAAP makes banks aware of newer risks, new sources of shocks to traditional risks, and new tools to manage them, as portfolios and market conditions change over time.

Part C focuses on Market Discipline, which is under Pillar III of the Basel Accords. The goal is to develop a set of disclosures to share vital information on bank performance, capital adequacy, capital planning, and capital structure and risk profiles in key business segments. Such information helps the market assess the risk-adjusted performance of a bank and the extent to which it adds shareholder value. Better performers can raise funds from equity and bond markets, while the inferior ones are starved of resources.

Part D describes the Capital Conservation Buffer (CCB), which denotes CET 1 equal to 2.5 percent of RWAs. The purpose of this cushion, introduced under Basel III, is to absorb losses due to idiosyncratic and systemic stress shocks. In other words, it can be treated as *Capital to Protect Capital* - even if the CCB is wiped off by stressed losses, banks have enough capital to absorb losses under normal conditions and continue as going concerns. This section also mentions the constraints on the distribution of future earnings (e.g. through dividends, share buybacks, and discretionary bonus payments) once the CET1 Ratio falls below 8 percent of RWAs (i.e. minimum 5.5 percent +CCB 2.5 percent). The restrictions become more stringent as the ratio moves towards 5.5 percent.

Part E explains the Basel III Leverage Ratio in detail. This tool is designed to reduce excessive debt on bank balance sheets and ensure that the asset side is funded by enough owner's equity or Tier 1 Capital. It states that the ratio of Tier 1 Capital to Total Exposure (Leverage Ratio) should be at least 4percentt for Domestic Systemically Important Banks (D-SIBs) and 3.5 percent for other banks. Close scrutiny of this section shows how difficult it is to define the concept of *exposure* for large and complex banks that have sizeable derivative portfolios, off-balance sheet commitments, and securities financing transactions (in repo markets).

Part F discusses the concept of Basel III Countercyclical Capital Buffer (CCCB) which has not yet been implemented in India. It is a regulation that makes banks build up capital buffers during a financial upswing phase, i.e. a period of excessive credit growth. Such a cushion will ensure the flow of credit during a financial downswing. Moreover, a higher capital burden will also dissuade banks from rapid credit growth during good times. In India, if the gap between the credit-GDP ratio and its long-term trend exceeds 3 percent, RBI may announce the CCCB four quarters in advance. As the Credit-GDP gap widens, the CCCB rises from 0 percent to 2.5 percent of RWAs. The CCCB hits the ceiling of 2.5 percent of RWAs when the Credit-GDP gap reaches 15 percent. The CCCB is a macro-prudential tool because it affects all banks in the same manner, whether their own credit growth is high or not. The imposition of the CCCB may also force some banks to restrict earnings distribution, as they would face CCB if the CET1 ratio is low.

Newer Elements

There are some important differences between the 2015 Master Circular and the 2022 version. These are as follows:

1. The 2015 Master Circular set out some important milestones for migration to the Advanced Approaches for all risk categories. It was expected that most banks would apply by 2013 and the RBI would grant permission by 2015. However, the 2022 Master Circular is silent on such timelines. It seems that, after three shocks to the banking sector in quick succession (NPA Crisis, NBFC Default, and Covid pandemic), the RBI has adopted a wait and watch policy. After normalcy is restored and business growth in the BFSI sector is revived, it may first ask banks to adopt the revised Standardized approaches under Basel III. The migration to the advanced, risk-sensitive, capital models appears a distant dream, at this stage.

2. The Risk Weights on Housing Loans have been relaxed since 2015. For retail home loans secured by residential property, the minimum risk weight has been reduced from 50 percent to 35 percent (for LTV ≤ 80 percent), while the minimum loan size has been increased from Rs. 20 lakh to Rs. 30 lakh, in 2022 circular. With the collapse of corporate credit, for a variety of reasons, the RBI has encouraged banks to switch over to small-ticket retail home loans, between 2015 and 2022.

3. The Large Exposure Framework (LEF) has been introduced in 2016. Since the NPA Crisis was caused by large borrower defaults, the RBI has tried to encourage banks to subscribe to their bonds, rather than disburse more loans. The bonds are permitted to be held in the Available for Sales (AFS) and Held for Trading (HFT) portfolios while additional loans (over and above Normally Permitted Lending Limit) attract much higher provisions and risk weights. Since the penalty on exposure to large borrowers is an outcome of the NPA crisis, it was not covered by 2015 circular. However, it appears in the 2022 guidelines.

4. Several new risks have been added under ICAAP in the 2022 Master Circular. These include Cyber Security/IT Infrastructure Risk, Human Capital Risk, Group Risk, Outsourcing/Vendor Management Risk, and Collateral Risk. This shows why ICAAP is important for banks. Even if the nature of Credit, Market, and, Operational Risks (Pillar I) remains unchanged over time, the nature of Pillar II risks may be transformed as the business landscape undergoes tectonic shifts. The responsibility of ICAAP is to identify these risks, as they evolve, so that they may be measured and managed, wherever possible.

5. The minimum Leverage Ratio has been reduced from 4.5 percent to 3.5 percent, between 2015 and 2022. This will allow banks to do more business with the same amount of CET1 capital. In the wake of the NPA crisis, many Indian banks may have found it difficult to raise enough CET1 Capital. The higher Leverage Ratio constraint of 4.5percentt could have affected their credit growth which, in turn, had hurt the Indian economy at large. Perhaps, this is why the leverage ratio was lowered to a level that is still well above the Basel III threshold of 3 percent.

Implications for the Banking and Financial Sector

The RBI Master Circular on 1st April 2022 gives the Indian banking sector a sense of stability and continuity. The capital burden is not expected to escalate, even as banks comply with these guidelines. In fact, the relaxation in risk weights on retail home loans and the reduction of the minimum leverage ratio are expected to improve the Capital Adequacy Ratios of scheduled commercial banks in India. The large exposure framework may also provide a fillip to the nascent corporate bond market, for the non-financial sector, and reduce the likelihood of credit crises in the future.

At the same time, the abundance of liquidity in Indian markets, in the aftermath of the Covid-19 pandemic, should encourage banks to replenish their high-quality liquidity buffers at a reasonable cost. Effective Liquidity Risk Management, at this stage, should be an important component of the Internal Liquidity Adequacy Assessment Process (ILAAP) at every bank. The RBI could have devoted special attention to ILAAP, just as other reputed central banks in England and Netherlands have already done, after the global financial crisis. Liquidity Risk Management is no longer a component of ICAAP – it deserves a distinct identity and significance, in light of several bank failures in India and abroad. Had the RBI given ILAAP its due importance, in the 2022 Master Circular, banks

in India could have been motivated to adopt more scientific methods for Liquidity Risk Management, at a time when funds are cheap.

References

BIS (2017): High Level Summary of Basel III Reforms, Bank for International Settlements, December.

RBI (2015): Master Circular – Basel III Capital Regulations, RBI/2015-16/58: DBR.No.BP.BC.1/21.06.201/2015-16, July 1.

RBI (2022): Master Circular – Basel III Capital Regulations, RBI/2022-23/12: DOR.CAP.REC.3/21.06.201/2022-23, April 1.