Introduction

What are Basel Norms?

Basel is a city in Switzerland. It is the headquarters of Bureau of International Settlement (BIS), which fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations.Basel guidelines refer to broad supervisory standards formulated by this group of central banks - called the Basel Committee on Banking Supervision (BCBS)The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses

Basel I

BCBS introduced capital measurement system called Basel capital accord, also called as Basel 1 in 1988. It focused almost entirely on credit risk. It defined capital and structure of risk weights for banks. The minimum capital requirement was fixed at 8% of risk weighted assets (RWA).

Basel II

Basel II guidelines were published by BCBSin June 2004, it is considered to be the refined and reformed versions of Basel I accord. The guidelines were based on three parameters,**(1)Capital Adequacy Requirements**: Banks should maintain a minimum capital adequacy requirement of 8% of risk assets - **(2)Supervisory Review**: According to this, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that a bank faces,**(3)Market Discipline:** This need increased disclosure requirements.

Basel III

Basel III guidelines were released in 2010. These guidelines were introduced in response to the financial crisis of 2008. A need was felt to further strengthen the system as banks in the developed economies were under-capitalised, over-leveraged and had a greater reliance on short-term funding. Also the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk. Basel III norms aim at making most banking activities such as their trading book activities more capital-intensive. The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity

Basel guidelines on Capital and Liquidity

Bank's capital (common equity and other permitted classes of capital) acts as loss absorbing buffer protecting depositors in the event of losses faced by the bank. Further, capital also limits leverage of the bank, ensuring its safety.

Under the Basel Capital Adequacy framework, banks' capital requirements have been linked to the risk profile of their asset classes, requiring riskier banks to keep larger capital buffers. The Basel framework evolved over a period of time since the introduction of Basel I framework in 1988, which required the banks to hold capital as a percentage of their credit risk exposures. Gradually the framework was expanded to include other risks on the banks' balance sheet such as market risk and operational risk. The comprehensive Basel II guidelines issued in 2006 provided banks with a flexibility to assess risks using their internal models in addition to the standardised models.

The global financial crisis which witnessed the breakdown of even well capitalised banks, triggered an overhaul of the capital framework and led to the introduction of Basel III. The new framework seeks to increase the quantity and quality of capital, enhance the risk coverage and introduce macro prudential elements such as leverage ratio, countercyclical buffers and liquidity ratios. A detailed explanation of various elements of Basel III is given in the Box 2.

Reserve Bank issued guidelines on Capital and liquidity requirements for banks in line with the international framework. As against the international norms of capital to risk-weighted assets ratio (CRAR) of 8 per cent, the CRAR for banks in India has been stipulated higher at 9 per cent, in line with the conservatory approach of the regulator.

Key Elements of Basel III Framework

Increased Quantity and Quality of Capital Under Basel III, Tier 1 capital is the predominant form of regulatory capital. It is stipulated at a minimum 75% of the total capital of 8%, i.e., 6%, as against 4% under BaselII. Within Tier1 capital, common equity is the predominant form of capital at minimum75%,i.e.,4.5%,from the previous level of 2%. This is a significant increase of core capital. Further, the definition of capital has been fine-tuned under Basel III so as to exclude inferior types of capital from the eligible list.

Enhancing risk coverage

In view of significant shortcomings noticed in the management and capitalisation of counter party credit risk, measures have been introduced under Basel III, to strengthen the capital requirements for counter party credit exposures arising from banks' OTC derivatives, repo and securities financing activities. These reforms raise the capital set against these exposures, reduce pro cyclicality and provide additional incentives to move OTC derivative contracts to central counter parties, thus helping to reduce systemic risk across the financial system. They also provide incentives to strengthen the risk management of counter party credit exposures

Leverage ratio

Pre-crisis, the leverage of some of the internationally active banks was at a high level of about 50 times of the capital, even though such banks complied with capital adequacy requirement. The risk of leverage, particularly when built up with short term borrowings, and the consequential impact of deleveraging during periods of stress by withdrawing credit to the real sector, accentuated the crisis.

The Basel Committee has, therefore, introduced a simple, transparent, non-risk-based leverage ratio as a supplementary "backstop" measure to the risk-based capital requirements. The leverage ratio has both micro-prudential and macro-prudential elements. At the micro level, it serves the purpose of containing excessive risk, as a supplement to the risk-based capital ratio. The leverage ratio as a simple accounting measure will capture the risk of excessive leverage on account of having low risk assets that the traditional risk-based capital ratio does not capture. The Basel Committee has stipulated a minimum Tier 1 leverage ratio of 3% (33.33 times) to start with as a Pillar 2 measure which will eventually be made a Pillar 1 requirement. Indian banks are required to keep a higher leverage ratio of 4.5% (higher leverage ratio denotes lower leverage)

Liquidity regulations

Basel has introduced two new liquidity standards to improve the resilience of banks to liquidity shocks. In the short term, banks will be required to maintain a buffer of highly liquid securities measured by the Liquidity Coverage Ratio (LCR). This liquidity buffer is intended to promote resilience to potential liquidity disruptions over a 30-day horizon. It will help ensure that a global bank has sufficient unencumbered, high-quality liquid assets to offset the net cash outflows it could encounter under an acute short-term stress scenario of 30 days. The scenarios may include a significant downgrade of the institution's public credit rating, a partial loss of deposits, a loss of unsecured wholesale funding, a significant increase in secured funding haircuts and increases in derivative collateral calls and substantial calls on contractual and non- contractual off-balance sheet exposures, including committed credit and liquidity facilities. Indian banks are required to comply with LCR guidelines in a phased manner from Jan 1, 2015 with full implementation effective from Jan 1, 2019.

Another liquidity risk measure, the Net Stable Funding Ratio (NSFR), requires a minimum amount of stable sources of funding at a bank relative to the liquidity profile of the assets, as well as the potential for contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon. The NSFR aims to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items. The objective of the NSFR is to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis.

Capital conservation buffer

Drawing lessons from the crisis that banks were distributing earnings even during periods of stress, Basel III prescribes that a capital conservation buffer of 2.5% of RWAs, comprising common equity Tier 1 capital, over and above the minimum common equity requirement of 4.5% and total capital requirement of 8% (5.5% and 9% respectively for Indian banks), needs to be built up outside periods of stress. This can be drawn down as losses are incurred during periods of stress. When buffers have been drawn down, banks can build them up either through a reduction in distribution of dividend, share buyback and staff bonus payments or raising capital from the private sector.

Countercyclical capital buffer

The countercyclical capital buffer is aimed at ensuring that banking sector capital requirements take account of the macro-financial environment in which banks operate. National authorities will monitor credit growth and other indicators which may signal a build-up of system-wide risk and, accordingly, they will put in place a countercyclical capital buffer requirement as and when circumstances warrant. This requirement will be released when system-wide risk crystallises. The buffer will be implemented through an extension of the capital conservation buffer and vary between zero and 2.5% of RWAs, depending on the extent of the build-up of system-wide risks. Banks are required to meet this buffer with common equity Tier 1 capital or other fully loss-absorbing capital.