Hello!!! This is NBSC-in-Voice and thanks for listening in. I am Sanjay Talukdar and this Pod Cast is on 'BASEL III'

You may have often heard BASEL III norms mentioned in the news. These are important global norms that set a common standard for banks across countries. Originally set in 1974, the most recent set of norms, called BASEL III, is under implementation in India from 2019. As an Officer in NABARD (or if posted in DoS / IDD), you may need to know about the BASEL III norms. "Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision (or BCBS), to strengthen regulation, supervision and risk management aspects of the banking sector".

Why do we need BASEL norms? It is not for nothing that banks are considered important for an economy, especially if it is a developing country like India. Go back to 2008, the crisis in the US banking sector wreaked havoc throughout the world. The US was still trying to limp back to stable economic growth till Covid -19 surfaced. Pandemics aside, a banking collapse is one of the worst crises a country can face.

The BASEL norms have three aims: Make the banking sector strong enough to withstand economic and financial stress; reduce risk in the system, and improve transparency in banks.

What Basel III is all about? The BASEL III rules, released in December, 2010 is the third in the series of Basel Accords. These accords deal with risk management aspects for the banking sector. Until BASEL III, the regulators had only considered some of the risks related to credit, the market, and operations. To meet these risks, banks were asked to maintain a certain minimum level of capital and not lend all the money they receive from deposits. This acts as a buffer during hard times. The BASEL III norms, in addition to capital, also considers leverage and liquidity risks.

We can say that Basel III is the global regulatory standard on bank capital adequacy, stress testing and market liquidity risk. Basel I and Basel II are the earlier versions of the same, and were less stringent. In comparison to BASEL II, the BASEL III framework prescribes more of common equity, creation of capital buffer, introduction of Leverage Ratio, introduction of two Liquidity Ratios namely Liquidity Coverage Ratio, and Net Stable Funding Ratio.

Let us start with Capital needs: When you are exposed to more risk, you need a larger safety buffer. Same is the case with modern banks. The BASEL III norms account for more risk in the system than earlier. As a result, it increases banks'

minimum capital requirements. Tier 1 capital – the main portion of the banks' capital, usually in the form of equity shares – should amount to 7% of the banks' risks. So, if the bank has risky assets worth Rs 100, it needs to have Tier 1 capital worth Rs 7. This capital can be easily used to raise funds in times of troubles. Plus, banks also have to hold an additional buffer of 2.5% of risky assets.
A per the RBI norms, Indian scheduled commercial banks are required to maintain a Capital Adequacy Ratio of 9% i.e. total regulatory capital should be at least 9% of risk weighted assets. This minimum total capital i.e. 9% of total risk weighted assets is further divided into two different components viz. Tier 1 and Tier 2. Within 9% regulatory capital, Tier 1 capital should be at least 7% of risk weighted assets on an ongoing basis. Therefore, Tier 2 capital can be admitted maximum up to 2% of RWA only. Components under tier 1 capital includes common equity and Additional Tier 1 Capital. Within Tier 1, the Common Equity must be at least 5.5% of RWA.

Let us now turn to Tier II Capital. The term tier 2 capital refers to one of the components of a bank's required reserves. Tier 2 is designated as the second or supplementary layer of a bank's capital. In terms of comparison, Tier 1 is a very good indicator of a bank's financial health.

Banks are also required to maintain a capital conservation buffer (CCB) of 2.5% of RWAs in the form of Common Equity Tier 1 capital. Finally, the minimum total capital (i.e. tier1 and tier II) plus capital conservation buffer together constitute a minimum 11.5 % of Risk Weighted assets.

Let us now turn to Leverage risk. Banks can also pile on debt like other companies. This increases the risk in the system. The Basel III norms limit the amount of debt a bank can owe even further. This is called the Leverage Ratio. This is especially applicable for banks that trade in high-risk assets like derivatives. RBI has decided that the minimum leverage ratio shall be 4% for domestic systemically important banks (colloquially D-SIBs) and 3.5% for other banks. The leverage ratio is defined as the tier I capital measure divided by the exposure measure, expressed as a percentage. The capital measure is tier 1 capital and the exposure measure includes both on-balance sheet exposure and off-balance sheet items. Balance sheet exposures refer to activities that are effectively assets or liabilities of a bank that appear on the balance sheet. Off-balance sheet exposures refer to activities that are effectively assets or liabilities of a bank but do not appear on the banks' balance sheet. The off-balance sheet exposures do not involve loans and deposits but generate fee income to the banks. Non-fund based facilities like Issuance of letter of guarantee, letter of credit, deferred payment guarantee, letter of comfort etc. which are contingent in nature are some of the examples of off -balance sheet exposures. **The higher the tier 1 leverage ratio, the higher the likelihood of the bank withstanding negative shocks to its balance sheet.**

Let us now talk about Liquidity. Capital is money that is invested in assets like equity or government bonds. This money, therefore, is not readily available for day-to-day activities. Moreover, during a crisis, the value of investments can fall suddenly like in the 2008 financial crisis. This means, the capital a bank holds can fall during times of need. This is why the BASEL III norms ask banks to hold liquid money. This is measured by the Liquidity Coverage Ratio (or LCR), a ratio of the liquid money to total assets. This should equal the banks' net outflows during a 30-day stress period. In other words, the LCR requires banks to hold enough high-quality liquid assets – such as short-term government debt – that can be sold to fund the bank during a 30-day stress scenario. As a Covid-19 relief measure, RBI has reduced the LCR requirement for banks in India to 80 per cent (instead of 100 per cent) of net outflows. The LCR requirement will gradually be restored back by April 1, 2021.

The other Liquidity Ratio prescribed in BASEL III is Net Stable Funding Ratio or NSFR. While liquidity Coverage Ratio promotes short term resilience of a bank's liquidity profile, NSFR, on the other hand, ensures reduction in funding risk over a longer time horizon i.e. one year. The NSFR requirements ensures that banks fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress. Stable Funding is the amount of funding which a bank needs to fund its assets and off balance sheet commitments. "Available stable funding" or ASF is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which for Banks in India extends to one year. The amount of stable funding required i.e. required stable funding or RSF of a bank is a function of the liquidity characteristics and residual maturities of the various assets held by that bank as well as those of its off-balance sheet or OBS exposures. The NSFR is defined as the ratio between the amount of stable funding available and the amount of stable funding required. The NSFR is calculated by dividing a bank's Available Stable Funding (ASF) by its Required Stable Funding (RSF). This ratio should be equal to at least 100% on an ongoing basis. In other words the ratio must always be greater than 100%. The Net Stable Funding Ratio limits banks' overreliance on short-term wholesale funding, encourages better assessment of funding risk across all on- and off-balance sheet items, and promotes funding stability. While Liquidity Coverage Ratio or LCR is a measure for Banks' Short Term resilience, Net Stable Funding Ratio measures a bank's medium and long term resilience. As a Covid-19 measure, 100 per cent Net Stable Funding Ratio (NSFR) implementation for scheduled Commercial Banks in India was deferred by one year from 1 April 2020 to 1 April 2021.

Complying with BASEL III norms is not an easy task for India's banks, which have to increase capital, liquidity and also reduce leverage. This could affect profit margins for Indian banks. Plus, when banks keep aside more money as capital or liquidity, it reduces their capacity to lend money. And, as you know, loans are the biggest source of profits for banks! Plus, banks in India have to meet both LCR as well as the RBI's Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) norms. This means, more money would have to be set aside, and thus further stressing the balance sheets.

For supervised entities of NABARD viz. Regional Rural Banks and the Cooperative Banks, BASEL III norms are still not applicable fully. However, observing their participation in the money and capital markets and increasing risk associated in their business transactions, it is most likely that the regulator will bring these financial entities under BASEL III norms sooner than later.

That's all for this episode. And Thanks again. We hope you enjoyed listening to NBSC-in-Voice. The content of this Pod Cast is also available at NBSC Corner in NABNET. This is Sanjay Talukdar signing off. Have a great day!!!

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