Approach to Basel II

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Ladies and Gentlemen, it is my pleasure to be here at this program on emerging paradigms in risk management. As expected of me, in my address today, I intend to share with you the broad contours of the regulatory approach, process and thinking in regard to some of the issues arising in context of Basel II.

Basel II aims to encourage the use of modern risk management techniques; and to encourage banks to ensure that their risk management capabilities are commensurate with the risks of their business. Previously, regulators' main focus was on credit risk and market risk. Basel II takes a more sophisticated approach to credit risk, in that it allows banks to make use of internal ratings based Approach - or "IRB Approach" as they have become known - to calculate their capital requirement for credit risk. It also introduces, in addition to the market risk capital charge, an explicit capital charge for operational risk. Together, these three risks - credit, market, and operational risk - are the so-called "Pillar 1" risks.

Banks' risk management functions need to look at a much wider range of risks than this - interest rate risk in the banking book, foreign exchange risk, liquidity risk, business cycle risk, reputation risk, strategic risk. The risk management role of helping identify, evaluate, monitor, manage and control or mitigate these risks has become a crucial role in modern-day banking. Indeed, it is probably not exaggerating the importance of this to say that the quality of a bank's risk management has become one of the key determinants of a success of a bank.

The policy approach to Basel II in India is to conform to best international standards and in the process emphasis is on harmonization with the international best practices. Commercial banks in India will start implementing Basel II with effect from March 31, 2007 though, as indicated by Governor, a marginal

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stretching beyond this date cannot be ruled out in view of latest indications of the state of preparedness. Though the Basel II framework provides various options for implementation, special attention was given to the differences in degrees of sophistication and development of the banking system while considering these options and it was decided that banks in India will initially adopt the Standardised Approach (SA) for credit risk and the Basic Indicator Approach (BIA) for operational risk. The prime considerations while deciding on the likely approach included the cost of implementation and the cost of compliance.

Before coming to specifics I may like to mention that overall capital is what makes financial systems stable. In general, expected losses are to be covered by earnings and provision and hence the need to price risk appropriately. Unexpected losses or losses beyond the normal range of expectations need have to be met by capital.

Let me briefly review the steps taken for implementation of Basel II and the emerging issues.

- The RBI had announced in its annual policy statement in May 2004 that banks in India should examine in depth the options available under Basel II and draw a road-map by end-December 2004 for migration to Basel II and review the progress made at quarterly intervals.
- The Reserve Bank organized a two-day seminar in July 2004 mainly to sensitise the Chief Executive Officers of banks to the opportunities and challenges emerging from the Basel II norms.
- Soon thereafter all banks were advised in August 2004 to undertake a self-assessment of the various risk management systems in place, with specific reference to the three major risks covered under the Basel II and initiate necessary remedial

measures to update the systems to match up to the minimum standards prescribed under the New Framework.

- Banks were also advised to formulate and operationalise the Capital Adequacy Assessment Process (CAAP) as required under Pillar II of the New Framework.
- Reserve Bank issued a Guidance Note on operational risk management in November 2005, which serves as a benchmark for banks to establish a scientific operational risk management framework.
- We have tried to ensure that the banks have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital.
- Risk Based Supervision (RBS) in 23 banks has been introduced on a pilot basis.
- As per normal practice, and with a view to ensuring migration to Basel II in a non-disruptive manner, a consultative and participative approach had been adopted for both designing and implementing Basel II. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) had been constituted wherein representation from the Indian Banks' Association and the RBI was ensured. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework have been issued.
- The Reserve Bank has constituted a sub group of the Steering Committee for making recommendations on the guidelines that may be required to be issued to banks with regard to the Pillar 2 aspects. The guidelines with regard to Pillar 2 aspects proposed to

be issued would cover the bank level initiatives that may be required under Pillar 2.

The underlying philosophy while prescribing the Basel II principles for the Indian banking sector was that this must not result in further segmentation of the sector. Accordingly, it was decided that all scheduled commercial banks in India, both big and small, shall implement the standardised approach for credit risk and the basic indicator approach for operational risk with effect from March 31, 2007. However, the existing three-tier structure in respect of SCBs, the cooperative banks and RRBs may continue. Currently, the commercial banks are required to maintain capital for both credit and market risks as per Basel I framework; the cooperative banks, on the second track, are required to maintain capital for credit risk as per Basel I framework and through surrogates for market risk; the Regional Rural Banks, on the third track, have a minimum capital requirement which is, however, not on par with the Basel I framework.

By opting to migrate to Basel II at the basic level, the Reserve Bank has considerably reduced the Basel II compliance costs for the system. In a way, the elementary approaches which have been identified for the Indian banking system are very similar to the Basel I methodology. For instance,

a) there is no change in the methodology for computing capital charge for market risks between Basel I and Basel II;
b) the computation of capital charge for operational risk under the BIA is very simple and will not involve any compliance cost;
c) the computation of capital charge for credit risk will involve compilation of information in a marginally more granular level, which is expected to be achieved with a slight re-orientation of the existing MIS.

In the above circumstances, it might not be an entirely correct assessment that implementation of the elementary levels of Basel II significantly increases the cost of regulatory compliance. No doubt some additional capital would be required, but the cushion available in the system, which at present has a Capital to Risk Assets Ratio (CRAR) of over 12 per cent, provides for some comfort.

The banks have also started exploring various avenues for meeting the capital requirements. The Reserve Bank has, for its part, issued policy guidelines enabling issuance of several instruments by the banks viz., innovative perpetual debt instruments, perpetual non-cumulative preference shares, redeemable cumulative preference shares and hybrid debt instruments so as to enhance their capital raising options.

With a view to have an objective assessment of the true cost of implementation of Basel II, banks would be well advised to institute an internal study to make a true assessment of the costs involved – exclusively for the elementary approaches. The informal feedback that we have from banks reflects that they do not see Basel II implementation as a 'costly' proposition.

However, banks need to ensure that expenditure incurred by them to improve their risk management systems, IT infrastructure, core banking solutions, risk models etc. should not be included as Basel II compliance costs, since these are expenses which a bank would incur even in the normal course of business to improve their efficiencies.

Operational Risk

Operational risk was one area which was expected to increase capital requirement for the banks. The Reserve Bank had announced in July 2004 that banks in India will be adopting the Basic Indicator Approach for operational risk. This was followed up with the draft guidelines for the Basel II framework in February 2005 where the methodology for computing the capital requirement under the Basic Indicator Approach was explained to banks. Even at the system level, we find that the CRAR of banks is at present well over 12 per cent. This reflects adequate cushion in the system to meet the capital requirement for operational risks, without breaching the minimum CRAR.

There is also a perception that the capital requirement for operational risk will be lower under the advanced approaches rather than under the Basic Indicator

Approach. I feel that, in the absence of details of the quality of operational risk management systems in banks and their operational risk loss experience, it may not be correct for the banks to assume that adoption of the advanced approaches would result in lesser capital than under the BIA.

Having addressed the specific issues on which I was supposed to 'brief', let me now turn to some other important issues.

Rating agencies

In terms of Basel II requirements, national supervisors are responsible in determining whether the rating agencies meet the eligibility criteria. The criteria specified are objectivity in assessment methodology, independence from pressures, transparency, adequate disclosures, sufficient resources for high quality credit assessments and credibility.

India has four rating agencies of which three are owned partly/wholly by international rating agencies. Compared to developing countries, the extent of rating penetration has been increasing every year and a large number of capital issues of companies has been rated. However, since rating is of issues and not of issuers, it is likely to result, in effect, in application of only Basel I standards for credit risks in respect of non-retail exposures. While Basel II provides some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to rating of issuers. Encouraging rating of issuers would be essential in this regard.

An internal working group is examining the process for identification of the domestic credit rating agencies which would be meeting the eligibility criteria prescribed under Basel II. It is expected that by this process would be over soon and banks would be informed the details of the rating agencies which qualify. Thereafter, the borrowers are expected to approach the rating agencies for

getting themselves rated, failing which banks would be constrained to assign 100% risk weight at the minimum for unrated borrowers.

The Reserve Bank had invited all the four rating agencies to make a presentation on the eligibility criteria and a self assessment with regard to these criteria. The rating agencies have since made their presentations and these are under examination vis-à-vis the eligibility criteria for recognising the rating agencies, whose ratings can be used by banks for risk weighting purposes.

Migration to advanced approaches

After adequate skills are developed, both by the banks and also by the supervisors, **some** banks may be allowed to migrate to the Internal Rating Based (IRB) Approach. The obvious corollary is that only a few banks are expected to migrate to the advanced approaches – though after some time, and not immediately. Hence, the small banks would be well advised to focus their resources on understanding the mechanics of the functioning of the elementary approaches and identify the minimum requirements that these approaches demand. It would be in their interests to take the necessary initiatives which make the implementation of the elementary approaches effective and meaningful.

As a well established risk management system is a pre-requisite for implementation of advanced approaches under the New Capital Adequacy Framework, banks were required to examine the various options available under the Framework and lay a road-map for migration to Basel II. The feedback received from banks suggests that a few banks may be keen on implementing the advanced approaches but all are not fully equipped to do so straightaway and are, therefore, looking forward to migrate to the advanced approaches at a later date. Basel II provides that banks should be allowed to adopt / migrate to advanced approaches only with the specific approval of the supervisor, after ensuring that they meet / satisfy the minimum requirements specified in the

Framework, not only at the time of adoption / migration, but on a continuing basis. *[The minimum requirements to be met by banks relate to (a) internal rating system design, (b) risk rating system operations, (c) corporate governance and oversight, (d) use of internal ratings, (e) risk quantification, (f) validation of internal estimates, (g) requirements for recognition of leasing, (h) calculation of capital charges for equity exposures and (i) disclosure requirements.]* Hence, it is necessary that banks desirous of adopting the advanced approaches do a stringent assessment of their compliance with the minimum requirements before they shift gears to migrate to these approaches. In this context, current non-availability of acceptable and qualitative historical data relevant to ratings, along with the related costs involved in building up and maintaining the requisite database, does influence the pace of migration to the advanced approaches available under Basel II.

Banks which are internationally active should look to significantly improve their risk management systems and migrate to the advanced approaches under Basel II since they will be required to compete with the international banks which are adopting the advanced approaches. This strategy would also be relevant to other banks which are looking at adoption of the advanced approaches. As you are aware adoption of the advanced approaches might help these banks to maintain lower capital. However, it would be relevant to refer here to the inverse relationship between the capital requirements and information needs. Adoption of the advanced approaches will require adoption of superior technology and information systems which aid the banks in better data collection, support high quality data and provide scope for detailed technical analysis - which are essential for the advanced approaches. Hence, banks aiming at maintaining lower capital by adopting the advanced approaches would also have to be prepared to meet the higher information needs.

While migration to the advanced approaches will basically be a business decision, I would like to mention a few things which may perhaps influence those decisions:

- Implementation of advanced approaches under Basel II will not be mandatory for small banks which are undertaking traditional banking business and have a regional or limited presence.
- Implementation of advanced approaches under Basel II should not be considered as fashionable and implementation of elementary approaches should not be considered as inferior.
- Any decision to migrate to the advanced approaches should be a well deliberated, conscious decision of the bank's Board, after taking into account, not only their capacity to compute the capital requirement under those approaches but also their capacities to sustain the bank's risk profile and the consequent capital levels under various scenarios, especially stress scenarios.
- The preconditions for migration to the advanced approaches would include (a) well established, efficient and independent risk management framework; (b) supported by well established, efficient IT and MIS infrastructure; (c) cost benefit analysis of adoption of advanced approaches; (d) availability of appropriate skills and capacity to retain / attract such skills at all points in time; and (e) a well established, effective and independent internal control mechanism for supplementing the risk management systems.

I hope the subsequent sessions would discuss in greater detail some of these issues. It is important for the sector as a whole to appreciate and internalize the basic philosophy of the Basel II, with all attendant costs and benefits.

Undoubtedly the discipline of risk management has significantly altered the ethos of the banking as an economic activity. But one point I would like to stress in conclusion is that banks should view the opportunities opened up by these complex financial instruments in the perspective of larger systemic interest. Today internationally, when market discipline is being considered an integral part

of the regulatory framework, it is imperative for banks to realize that they are equal partners in ensuring financial stability; and this involves helping build up a risk management culture across all stakeholders. Any distortions brought about by misalignment of risk needs and the product being offered to address the risk can only harm and arrest the development of a healthy market.