

Regulation and Risk Management: Implementing Basel II*

V. LEELADHAR

It is indeed an honour to be amongst you on the occasion of the Platinum Jubilee Celebrations of The South Indian Bank Ltd. Today we remember the founders and pay homage to their vision and drive that led to the establishment of this bank. It is not only a day to feel proud, it is a day to reflect, a day to share, and a day to celebrate. It is also an opportunity to re-emphasise what the institution stands for, which not only helps in projecting its corporate culture and identity, but also constitutes an integral part of the institutions' brand building exercise.

In it's more than 75 years of existence, the bank has traversed a long journey from a unit bank set up in Thrissur, with a capital of Rs. 22,000 contributed by 44 shareholders to a bank with capital funds of Rs. 474 crore contributed by 90,000 shareholders, and a branch network spread over 17 States/Union Territories. The South Indian Bank Ltd. has thus become a major old generation private sector bank with a regional origin and national presence.

I am told that as on 31 March 2005, the South Indian Bank Ltd. had recorded a total gross business turnover of Rs. 14,000 Crores with deposits of Rs.8523 Crores and advances of Rs.5727 Crores. Gross NPA ratio of the bank stood at 6.61 per cent and net NPA ratio at 3.87. The bank will have to work on reducing the level of existing NPAs, and put in place proper risk management systems to ensure a low level of incremental NPAs in future. This is essential for ensuring that the bank is in a position to compete successfully with the other banks in the post Basel II era. This brings me to the topic of my address - Regulation and Risk Management: Implementation of Basel II.

Friends, it is clear that we are at the beginning of a new phase in the Indian banking. The last decade has witnessed major changes in the financial sector: New

banks, new financial institutions, new instruments, new windows, and new opportunities and, along with all this, new challenges. The most prominent on our minds in the context of banking these days, perhaps, are the implications arising out of the Basel II accord. Banks, as we all know, are subjected to more intense regulation as compared to the non-financial firms. This is probably because the banks possess certain "special" characteristics: Banks are much more leveraged than the other firms due to their capacity to garner public deposits. The asset - liability structure of the banks is also different from not only the non-financial firms but also the financial firms. To illustrate, the risk in an insurance company arises mainly from the liability side of the balance sheet in the form of insurance claims whereas for the bank the risk mainly comes from the diminution of asset values (for example, illiquid loans that are not fully recoverable). The deposits which constitute a major part of the liability of banks are repayable on demand, unsecured and their principal amount does not change in value whereas the loans of a bank are illiquid and there can be erosion in the value of loans or of other assets. The liquidity transformation by an insurance company is in the reverse direction as compared to a bank. The balance-sheet structure of an insurance company is the least likely to give rise to systemic risk, whereas banks due to their typical asset liability mismatches, *i.e.*, long term assets funded by short term liabilities, may be prone to 'run' and pose a very high degree of potential systemic risk. The resolution costs of systemic bank insolvencies and significant banking problems can be substantial. The financial services regulators and Central Banks are increasingly focusing their attention not only on the health of the individual banks and financial institutions but also on issues of financial stability.

Bank regulation is now increasingly getting risk-centric. This process had its origin in the Cooke Committee or the Basel I proposals which for the first

* Address of Shri V. Leeladhar, Deputy Governor, delivered at the Platinum Jubilee Celebrations of the South Indian Bank Ltd., Thirussur on July 9, 2005

time prescribed a risk-based capital adequacy framework for banks by recognising that different counterparties had different risks and therefore had to be risk-weighted differently. Accordingly, the risk-weights of zero per cent, 20 per cent and 100 per cent were assigned for the exposures to Government, Banks and Corporates, respectively. Further, for the first time the framework required capital to be maintained for the off-balance sheet exposures also. Moreover, capital was seen as multi-tiered with Tier 1 and Tier 2 capital and some jurisdictions permit the use of Tier 3 capital as well. These proposals were path-breaking considering the credit risk management capabilities of the banks in 1980s. As we all know, more than 100 countries implemented Basel I which indicates the widespread impact it had on the bank regulation and risk management.

Basel I proposals forced the banks to look at credit risk and regulatory capital more closely than they had done earlier. As banks found ways to arbitrage regulatory capital, some of the provisions of Basel I became less relevant. Simultaneously, banks in the G-10 countries developed newer approaches to manage credit risk by building portfolio models for pricing, provisioning and allocating economic capital for the credit portfolios. These developments made the weaknesses in the Basel I framework more apparent and this set the stage for the creation of “International Convergence of Capital Measurement and Capital Standards: A Revised Framework”, popularly known as Basel II.

Concurrently, there has been a realisation that the traditional supervisory practices were out of step with the sophisticated risk management techniques being employed by the complex financial institutions and a risk-based approach to supervision was required to capture the various risks that the firms were undertaking and the controls built for addressing these risks. Although there are key differences in design and methodology of risk-based supervision framework in countries like America, Canada, UK and Australia, yet the underlying principles remain the same: the supervisory processes and tools are reoriented in accordance with the risks in the supervised

firms; specific tools of supervision are targeted to the areas of greatest risk and concern in individual firms and this results in a cost effective allocation of the finite supervisory resources across the regulated entities.

The Basel Committee on Banking Supervision¹ has observed that the fundamental objective in revising the 1988 Accord has been, and I quote, “to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks. The Basel Committee believes that the revised Framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits”.² Basel II has brought regulation and risk management to the centre stage: the regulatory capital is more closely aligned to the risks in banks and there is a trend towards convergence of the regulatory and economic capital, especially in the advanced approaches.

Basel II rests on the three pillars, Pillar I - minimum capital requirements, Pillar 2 - supervisory review process and market discipline as Pillar 3.

Pillar 1 – Minimum Capital Requirements

For the first time, capital charge for operational risk has been mandated under pillar 1. Moreover Pillar 1 provides for a menu of approaches for computing capital adequacy and banks have the freedom to choose the approach they would like to adopt. Basel II requires that all the three pillars need to be implemented and, therefore, each pillar is as important as the other one.

As you would be aware, India has decided that all the commercial banks would have to be Basel II compliant by adopting at a minimum, the Standardised Approach for credit risk and Basic Indicator Approach for operational risk under Pillar 1, with effect from March

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

² Basel Committee on Banking Supervision, “International Convergence of Capital Measurement and Capital Standards- A Revised Framework”, June 2004.

31, 2007. The adoption of internal ratings-based (IRB) approach may be permitted by RBI in due course after adequate skills are developed, both in banks and at supervisory levels.

Implementation of the simplified approaches also requires preparation on the part of the banks, banking regulators and the rating agencies. Banks have to gather data relating to the rated exposures in order to risk-weight them accordingly and track the ratings migrations of these exposures. The rating agencies have to demonstrate that they adhere, on an ongoing basis, to the six parameters laid down under Basel II for their recognition, *viz.*, Objectivity, Independence, International Access/ Transparency, Disclosure, Resources and Credibility. The rating agencies have also to develop frameworks for assigning Issuer Rating instead of the Issue Rating that they have carried out so far.

Pillar 2- Supervisory Review

Pillar 2 is meant not only for ensuring adequate capital to support all the risks in a bank, but also to encourage banks to adopt better risk management. It is the prime responsibility of the bank management to ensure that the bank has adequate capital commensurate with its risk profile and control environment. The role of supervisors is to evaluate whether or not the banks are assessing their capital requirements under pillar 2 properly in relation to their risks, and if necessary the supervisors may intervene to mandate a higher capital requirement. However, it is important to note that increased capital is not the only option for addressing increased risks in a bank. Although capital serves the purpose of meeting the unexpected losses, capital is not a substitute for inadequate control or risk management systems. Banks should strive to create sound internal control or risk management processes.

From the point of view of analyzing risks and assigning capital against those risks, Pillar 2 is much more inclusive in the sense that it not only captures the risks covered under Pillar 1 (credit risk, market risk and operational risk) but also the credit concentration risk which is not fully captured by Pillar 1. In addition, Pillar 2 must address the risks not captured by Pillar 1, such as, Interest rate risk in banking book, Liquidity risk, Business risk, Strategic risk and Reputation risk. The Business cycle effects which represent factors external to the bank are also to be covered under Pillar 2.

India has implemented the risk based supervision (RBS) framework which evaluates the risk profile of the banks through an analysis of 12 risk factors, *viz.*, eight business risks and four control risks. The eight business risks relate to: Capital, Credit Risk, Market Risk, Earnings, Liquidity Risk, Business Strategy and Environment Risk, Operational Risk and Group Risk. The control risks relate to Internal Controls Risk, Organisation Risk, Management Risk and Compliance Risk. The RBS framework is currently undergoing further refinement. The RBS methodology can be used as a starting point for the implementation of pillar 2 proposals in India.

Pillar 3- Market Discipline

Regulation is not and cannot be an alternative to market discipline. Actually, market discipline supplements regulation in the sense that monitoring of the banks and financial institutions is not only carried out by the regulators but also by the markets, which includes other banks and financial institutions, customers, depositors, subordinated debt instrument holders, rating agencies, *etc.* The discipline imposed by the markets can be as powerful as the sanctions imposed by the regulator.

Reserve Bank of India has been advising banks to make disclosures in order to enhance market discipline. Although banks in India make several disclosures in their Notes on Accounts to the Balance Sheet, for implementing Pillar 3 more work requires to be done. The banks are required to have a formal disclosure policy approved by their Board of Directors highlighting what disclosures the bank will make and the internal controls over the disclosure process. The banks also have to implement a process for assessing the appropriateness of their disclosures, including validation and frequency. The Reserve Bank of India may consider imposing a penalty including financial penalty in case of non-compliance with the prescribed disclosure requirements.

So far, we have covered the various issues in the implementation of the simplified approaches of Basel II. The implementation of Advanced Approaches, such as IRB Approach for credit risk and Advanced Measurement Approach for Operational Risk, require much more preparation and pose several challenges for both the banks as well as the supervisors. The banks would require to

meet the minimum requirements relating to internal ratings at the outset and on an ongoing basis, such as those relating to the design of the rating system, operations, controls, corporate governance and estimation and validation of credit risk components: Probability of Default (PD) for both Foundation and Advanced IRB, and Loss Given Default (LGD) and Exposure At Default (EAD) for Advanced IRB. The banks should have at a minimum PD data for five years and LGD and EAD data for seven years. The manpower skills, the IT infrastructure and MIS at the banks would have to be upgraded substantially. The supervisors would require developing skills in validation and back testing of models.

With the focus on regulation and risk management in the Basel II framework gaining prominence, the post Basel II era will belong to the banks who manage their risks

effectively. The banks with proper risk management systems would not only gain competitive advantage by way of lower regulatory capital charge but also add value to the shareholders and other stakeholders by properly pricing their services, adequate provisioning and maintaining a robust financial health.

As we stand at this juncture, I trust innovative and illuminating ideas, fresh insights and alternative ways of thinking about the competitive yet cooperative combat that the world of banking and finance is readying itself for will mark the South Indian Bank's business strategies and institutional development plans and will give you the emotive content to carry forward the legacy and vision of your founding fathers and take your institution to new heights. With these words I wish you every success in all your future endeavours.