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RESERVE BANK OF INDIA

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February 15, 2005

To
The Chairmen of
all Scheduled Commercial Banks

Dear Sir,

Prudential Guidelines on Capital Adequacy- Implementation of the New Capital Adequacy Framework

The Basel Committee on Banking Supervision (BCBS) has released the document, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" on June 26, 2004. The revised Framework has been designed to provide options for banks and banking systems, for determining the capital requirements for credit risk and operational risk and enables banks / supervisors to select approaches that are most appropriate for their operations and financial markets. The Framework is expected to promote adoption of stronger risk management practices in banks.

2. The Revised Framework, popularly known as Basel II, builds on the current framework to align regulatory capital requirements more closely with underlying risks and to provide banks and their supervisors with several options for assessment of capital adequacy. Basel II is based on three mutually reinforcing pillars - minimum capital requirements, supervisory review, and market discipline. The three pillars attempt to achieve comprehensive coverage of risks, enhance risk sensitivity of capital requirements and provide a menu of options to choose for achieving a refined measurement of capital requirements.

3. The Revised Framework consists of three-mutually reinforcing Pillars, viz. minimum capital requirements, supervisory review of capital adequacy, and market discipline.

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Under Pillar 1, the Framework offers three distinct options for computing capital requirement for credit risk and three other options for computing capital requirement for operational risk. These approaches for credit and operational risks are based on increasing risk sensitivity and allows banks to select an approach that is most appropriate to the stage of development of bank's operations. The approaches available for computing capital for credit risk are Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The approaches available for computing capital for operational risk are Basic Indicator Approach, Standardised Approach and Advanced Measurement Approach.

4. With a view to ensuring migration to Basel II in a non-disruptive manner, the Reserve Bank has adopted a consultative approach. A Steering Committee comprising of senior officials from 14 banks (private, public and foreign) has been constituted where Indian Banks' Association is also represented. Keeping in view the Reserve Bank's goal to have consistency and harmony with international standards it has been decided that at a minimum, all banks in India will adopt Standardized Approach for credit risk and Basic Indicator Approach for operational risk with effect from March 31, 2007. After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to IRB Approach after obtaining the specific approval of Reserve Bank.

5. On the basis of the inputs received from the Steering Committee 'draft' guidelines for implementation of Basel II in India have been prepared and are enclosed. Banks are requested to study these guidelines and furnish their feedback to us within three weeks from the date of this letter. These draft guidelines are also placed on the web-site for wider access and feedback.

6. Please acknowledge receipt

Yours faithfully,

(C. R. Muralidharan)
Chief General Manager-in-Charge