5 reasons why Indian banks need to up the ante for Basel III compliance

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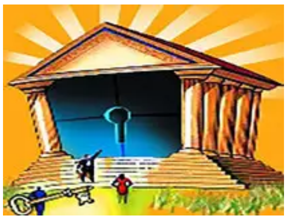

As with all new regulations, Basel III norms have various costs and benefits associated with banks.

By **Sanjeev Sinha**

The global economic meltdown of 2008, triggered by the Lehman Brothers' collapse, set alarm bells ringing for financial institutions. The Basel III accord is designed to mitigate such risks by making the banking sector stronger and more efficient. The norms call for improvement of the quantity and quality of capital of banks, stronger supervision, more stringent risk management and disclosure standards.

The Basel III norms account for more risk in the system than earlier. As a result, it increases banks' minimum capital requirements. Minimum tier 1 capital - the key constituent of the banks' funds a significant part of which should be in the form of shares - should amount to 7% of the lenders' risk weighted assets and the total capital at 9%. In addition, a 2.5% Capital Conservation buffer is to be maintained, taking the requirement to 11.5% of the risk weighted assets.

Company Summary NSE BSE

ICRA	-36.15 (-0.90%)
PSB	0.25 (0.51%)

As per the Reserve Bank of India's direction, the Basel III capital regulation is being implemented from April 1, 2013, in India in phases, and will be fully adopted by March 31, 2019.

As of now, Indian banks fare well on compliance with the capital norms, with an average capital adequacy of 13.3% as of March 2017. The continued stressed scenario of the industry is likely to bring this down by a further 2 percentage points by March 2018. However, many of India's banks, especially PSBs, are under-prepared to meet the stipulated deadline for total compliance. Macroeconomic headwinds as well as underlying infrastructural issues have necessitated strong actions and stricter discipline by the banks.

Reason # 1: Mounting pile of stressed assets

The banking sector in India is facing challenging times due to low credit growth, deterioration in asset quality and low profitability. India's banks have a stressed asset pile of almost Rs 10 trillion, which hampers their ability to give out fresh loans. Of this, gross non-performing assets account for Rs 7.7 trillion, the remaining comprising restructured loans. In order to protect their margins under the new Basel III norms, banks need to adopt a granular approach and a dynamic risk mitigation strategy.

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Reason # 2: Economic and policy changes
The banking sector is facing headwinds due to some recent policy and economic regulations such as demonetisation, GST rollout and the Real Estate (Regulation and Development) Act (RERA). This could slow the process for implementation of global risk norms under Basel III. For example, despite significant interest rate cuts and sops for affordable housing, growth in home loans fell to 10.5% in the 12 months ended July 2017, from 17.2% in the same period last year. The banks are slowly recovering from the after-effects of these changes, and this may slow the process of adapting to BASEL III norms.

Reason # 3: Capital requirements of public sector banks
The public sector banks (PSBs) in India are falling short of the stipulated capital requirements under Basel III. Media reports suggest that the Indian PSBs need Rs 2.4 lakh crore capital by 2019 to meet the norms. This will be a humongous task for the banks, more so because of the large amount of bad loans on their books -- the total bad loans on the 40 listed banks in India amount to Rs 3 lakh crore. According to estimates, the PSBs will need to raise tier 1 capital of Rs 1,72,000-2,10,000 crore during FY17-FY19 to meet the higher regulatory minimum capital requirements as well as fund growth. Strengthened organisational structure, stricter risk management and improved credit delivery discipline will be critical to a turnaround in PSB BSE 0.51 % performance. The proposed capital infusion by the government is expected to provide a fillip though details of the capitalisation of individual banks are not clear as yet. A proper risk culture has to be developed across all levels at banks, with stringent checks and controls.

Reason # 4: A race for survival and operational efficiency
To meet the new regulations, Indian banks will need to raise high quality capital while preserving the core capital and using it more efficiently. This may have a transformational impact on the banking landscape in India, leading to crowding out of weaker banks as it will get more difficult for them to raise the additional funding and capital. We may, therefore, see more consolidation in the sector, with the most efficient, competitive and agile banks emerging as the winners.

Reason # 5: Meeting investor and customer expectations
As with all new regulations, Basel III norms have various costs and benefits associated with them. Banks will now face the challenge of meeting stakeholder and customer expectations, all the while complying with the stringent new regulatory requirements. In this scenario, banks will need to fully embrace disruptive technologies such as Big Data and Artificial Intelligence to meet the increasing demands of their customers.

Implementing BASEL III norms will, no doubt, insulate Indian banks against domestic and financial shocks, consequently reducing spillover risks from the financial sector to the overall economy. Indian banks should take up this opportunity in their stride to emerge as stronger, more efficient and future-proof organisations.

(Sanjeev Sinha is MD & CEO of ICRA BSE -0.27 % Management Consulting Services. Views are his own)

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