Mains Practice Question

Q. What do you mean by Basel accords? Discuss the major changes proposed in Basel III over earlier accords and its significance over the Indian banking sector. (250 words)

14 Aug, 2020 GS Paper 3 Economy

Approach

- Explain Basel accord.
- Mention major changes proposed in Basel III over earlier accords.
- Discuss the significance of these accords for Indian banking sector.
- Conclude with the likely impact on Indian banking sector.

Introduction

- Basel accords or Basel norms are the international banking regulations issued by the Basel Committee on Banking Supervision (BCBS).
- The Basel accords are an effort to coordinate banking regulations across the globe, with the goal of strengthening the international banking system.
- These are designed to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses.
- It is the set of the agreement by the BCBS which focuses on the risks to banks and the financial system.
- Basel Committee has issued three sets of regulations which are known as Basel-I, II, and III.

Body

Major difference between the three Basel norms

Basel I

- It was created in response to the growing number of international banks and the increasing integration and interdependence of financial markets.
- It focused on the capital adequacy of financial institutions.
- Under Basel I, banks that operate internationally are required to have a risk weight of 8% or less.

Basel II

- These were the refined and reformed versions of Basel I accord.
- Basel II included new regulatory additions and was centered around improving three key issues – minimum capital requirements, supervisory mechanisms and transparency, and market discipline.

Basel III

- Basel III identified the key reasons that caused the financial crisis of 2008. They include poor corporate governance and liquidity management, poor risk management, inappropriate incentive structures, and misaligned incentives in Basel I and II.

- Basel III is a continuation of the three pillars along with additional requirements and safeguards. For example, Basel III requires banks to have a minimum amount of common equity and a minimum liquidity ratio.
- Basel III also includes additional requirements for what the Accord calls **"systemically important banks"** or those financial institutions that are considered **"too big to fail".**
- Basel III strengthened the minimum capital requirements outlined in Basel I and II. In addition, it introduced various capital, leverage, and liquidity ratio requirements.
- Basel III implementation has been extended repeatedly, and the latest completion date is expected to be January 2022.

Significance of Basel accord for Indian Banking Sector

- **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 huge stressed assets and high gross Non Performing Assets which hamper their ability to give out fresh loans.
    - The new Basel III norms can help increase banks’ risk mitigation and protect their gain margins.
- **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. Such changes should act as complementary to the Basel norms.
- **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.
    - It may lead to consolidation in the sector, with the most efficient, competitive and agile banks emerging as the winners.
- **Meeting investor and customer expectations**: Due to all new regulations the banks will 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.

Conclusion

Implementing BASEL III norms will 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.