

Basel-II: Tough task for Indian banks

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Basel II is an accord on banking system formulated by BIS to secure international convergence on regulations governing the capital adequacy ratio (CAR). Capital adequacy is a measure of bank's capital and is expressed as a percentage of bank's risk weighted assets. The objective of the accord is to develop a framework that would strengthen the soundness and stability of international banking system.

The accord consists of three pillars, viz minimum capital requirement, supervisory review and market discipline. The first pillar is on capital requirement, wherein, it identifies three different types of risk: credit risk, operational risk and market risk. Supervisory review process focuses on the bank's internal processes and systems. Market discipline focuses on market disclosures being made by the bank. The other two pillars have been added in Basel-II as reinforcement to the first pillar. Supervisory review is to ensure that the bank's implementing Basel-II accords have proper processes in place for assessing their capital adequacy. The purpose of pillar 3 - market discipline is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. In this article we will concentrate on credit risk element of pillar 1.

Basel has provided flexibility to banks to calculate the capital requirement on account of credit risks using two different approaches - the standardised approach and the internal ratings based approach. The standardised approach is similar to the risk weighted approach as suggested in Basel I except for the difference that the risk weights have been changed.

The internal ratings based (IRB) approach is an advanced approach for calculating capital adequacy and is more risk sensitive. Basel has laid down some minimum requirements that a bank must meet for entry and ongoing use of the IRB approach. The minimum requirement lays a strong emphasis on rating and risk estimation systems and processes that provide a meaningful differentiation of customer risk. As per the Basel document, the term "rating system" comprises all the methods, processes, controls, data collection and IT Systems that support the assessment of credit risk, the assignment of internal risk rating and quantification of probability of default (PD).

To become Basel-II compliant banks should start off by forming an internal team or hire external consultants to do a gap analysis. The gap analysis should primarily focus on existing IT infrastructure, data capture, data adequacy, processes & system and map it with the ideal scenario. Having identified the gaps a detailed project plan should be prepared to become Basel compliant.

Big banks like ICICI, HDFC, IDBI, UTI will have the necessary IT Infrastructure. However, most of the banks including some of the big banks in India will find gaps in data management, and it is the most important element for building rating systems. The gaps could be in data capture, data quality, and non-availability of 5 years' historical data. If data availability is the issue then the banks need to put in place systems and processes to ensure that they capture complete data of through-the-door population. If possible the bank should also get the data of customers acquired in the past in electronic format.

The next step is to design and implement rating system. If the bank already has such a system in place then gaps identified during the gap analysis phase should be plugged. A qualifying rating system must consider the borrower characteristics like demographics, and transaction specific

factors like loan type, collateral. The rating system should have a rating structure, which comprises at least 7 grades for non-default customers and one grade for defaulted customers. The grades should be so designed that the bank can assign each exposure into a particular pool of homogeneous exposures and having similar loss characteristics, viz PD, LGD & EAD. For quantifying the risk in IRB approach the bank needs to develop its own rating models to estimate the risk components viz. probability of default (PD), loss given default (LGD), exposure at default (EAD) and effective maturity (M) and get necessary approvals from the supervisory body.

Building the rating system, ensuring the performance and robustness of the risk models, and putting in place a system to ensure ongoing compliance with Basel-II requirement is a huge task. Banks that plan to go with IRB approach should follow a phase-wise implementation strategy across various asset products. According to draft guidelines for implementation of Basel-II, Indian banks will start implementing Basel-II by March 31, 2007 and in the initial phase all banks will be adopting the standardised approach for credit risk. However, banks like SBI, ICICI, HDFC, IDBI may try to implement IRB approach in some of their asset products parallel with standardised approach.

The IRB approach will make business sense for advanced banks with sound risk management policies as it provides an incentive in the form of lower capital requirement. The smaller banks will go with the standardised approach, as they may not have the required rating systems in place.

It is expected that the regulatory capital requirement of these banks will increase on implementing Basel-II and as a result these banks will require further capital infusion to expand their business. The increased capital requirement can lead to further consolidation in banking industry and one can expect more mergers in the time to come.

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