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RESEARCH ARTICLE

BASEL III NORMS AND INDIAN BANKS –A NEW DEFINITION OF RISK MANAGEMENT

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Abstract

The Reserve Bank of India is a member of BASEL committee based in Basel, Switzerland. Basel III norms are the guidelines which are framed by this committee. The main aim of Basel III is to overcome the loopholes of previous norms and to tighten up the banking system all over the world .The three pillars of Basel II still standing in Basil III i.e. Capital requirement ,Supervisory Review and Market discipline .Basel III focus towards the risk in banking sector. It aims to fill up the gaps in Basel II guidelines.

These guidelines will ensure that the banks are sufficiently capitalized, have better liquidity and are ready to manage all types of risks, thereby strengthening the banks transparency. The Basel III norms are notified by RBI on May 2012, made effective from January 2013 in a phased manner and will be implemented fully from 31st March 2018.The components of Basel III are Capital Ratio Targets, RWA Requirements and Liquidity standards.

Introduction

A group of international banking authorities who work to strengthen the regulation, supervision and practices of banks and improve financial stability worldwide is called “The Basel Committee on Banking Supervision” (BCBS). The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.

It was established in the 1960s to help banks deal with emerging phenomenon of globalization, is situated in Basel, Switzerland. The activities of the Basel Committee on Banking Supervision (BCBS focus on exchanging information on national, and various banking-related supervisory issues, approaches and techniques. The BCBS develops banking guidelines and supervisory standards. It does not have any formal authority, and its decisions are not backed by legal force.

The Basel Committee on Banking Supervision's work is organized under four main subcommittees:

- **The Standards Implementation Group** was originally established to share information, promote consistency in the implementation of the Basel II Framework.
- **The Policy Development Group** identifies and reviews emerging supervisory issues. It also proposes and develops policies designed to create sound banking systems and supervisory standards.
- **The Accounting Task Force** helps ensure that international accounting and auditing standards and practices promote risk management at banks.It also develops reporting guidance and takes an active role in the development of these international accounting and auditing standards.

- **The Basel Consultative Group** facilitates supervisory dialogue with non-member countries on new committee initiatives by engaging senior representatives from various countries, international institutions and regional groups of banking supervisors that are not members of the committee.

Representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States are the BCBS members. Countries are represented on the Committee by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The Committee formulates supervisory standards and guidelines and recommends statements of best practice in the expectation that individual national authorities will implement

2. OBJECTIVE

Global economic crises revolved mainly around banks all over the world as well as in India. It was least expected after the implementation of BASEL II norms in the economy. The global economic crises have provided an opportunity for a fundamental restructuring of the approach and regulation in financial sector. Why banks were the epicenter of financial tornado? This paper looks into the BASEL III norms and how it has given new definition to risk management. It also attempts to find out how BASEL III norms will affect the stability of the Indian banks as well as the challenges that will be faced by the banking sector in India.

3. RESEARCH DESIGN

3.1 Research Type: The study is descriptive in nature, as it diagnoses the problems and discovers the new ideas with alternatives. It is basically to gain the background information more pricisely.The descriptive nature of the study gives an insight of the topic for developing new approach .Further it helps to establish priorities for further research.

3.2 Source of Data Collection: The source of data collection is secondary in nature**.**

4. LITERATURE REVIEW

4.1 According to -“Impact of the Basel III norms on the Indian banking system” August 2011 professes the adoption of Basel III norms significantly increase the regulatory capital requirement of Indian banks. Furthermore, within capital, the proportion of the more expensive core capital could increase. According to the proposed norms, the minimum core capital requirement is set to be raised to 4.5%. In addition, the introduction of the conservation and countercyclical buffer means that the capital requirement would increase to between 7% and 9.5%. Indian banks, as per the current norms are required to maintain Tier I capital of at least 6%. However, since innovative perpetual debt and perpetual non-cumulative preference shares cannot exceed 40% of the 6% Tier I capital, the minimum core capital is 3.6% (i.e., 60% of 6%).

4.2 Another study “leverage ratio framework and disclosure requirements - consultative document published in June 2013 says - An underlying feature of the financial crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. The Basel III reforms introduced a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The Basel Committee is of the view that a simple leverage ratio framework is critical and complementary to the risk-based capital framework and that a credible leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet leverage of banks. Revised Basel III .

4.3 Hammond, Clare **in his study “**Anchor rating to vary for Tier II India bank capital” August 2013 explained **Basel III** additional Tier I instruments will be typically rated five notches off the anchor rating to highlight non-performance risk and loss severity, which bring down the rating by three notches and two notches respectively. In a situation where the relevant anchor rating is 'BB+' or lower, ratings compression takes effect, narrowing the notching difference. However, the base case notching for **Basel III** debt will be at least one notch, regardless of rating.

4.4 An article “A sound capital planning process: fundamental elements” published in January 2014 focuses that - The Basel Committee has issued these sound practices to foster overall improvement in banks' capital planning practices. Indeed, an important lesson from the financial crisis concerned the need for banks to improve and strengthen their capital planning. Some of the observed weaknesses reflected processes that were not sufficiently comprehensive, appropriately forward-looking or adequately formalized. As a consequence, some banks underestimated the risks inherent in their business strategies and, in turn, misjudged their capital needs.

4.5 According to a study titled “Was Basel Iii Necessary And Will It Bring About Prudent Risk Management In Banking” puts the opinion that Banks competition reduces margins and impacts on profit. Banks have the incentive to take on more risks by easing their credit standards. Prudent banking is therefore undermined and capital adequacy requirements are used as instruments to limit banks failures. The purpose of this paper is therefore to assess whether Basel III is necessary and would be able to bring about prudent risk management in banking.

4.6 EVOLUATION OF REFORMS –A JOURNEY FROM BASEL I TO BASEL III

Figure :4.6(a)

BASEL I	➢ Ineffect since1988 ➢ Very simple in application ➢ Easy to achieve significant capital reduction with little or no risk transfer.	❖ Overly simple rules were subject to regulatory arbitration and poor risk management
BASEL II	➢ Ineffect since 2004 ➢ More risk sensitive ➢ Treats both exposures and banks very unequally	❖ Profoundly altered bank behaviour but contained ‘GAPS’ that banks exploited
BASEL III	➢ Fully implemented only in 2023 ➢ Addresses perceived shortcomings of BASEL II ➢ Greatest impact on trading bank liquidity and bank leverage	❖ Will increase capital charges materially and make certain banking activities much more capital intensive.

Fig 4.6(a) Source :- Lathman & watkins (www.garp.org)

4.7 BRIEF DESCRIPTION OF BASEL I & II

4.7.1 The Basel accords are a series of recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision (BSBS). The name for the accords is derived from Basel, Switzerland, where the committee that maintains the accords meets. The standards are not enforced by the Committee; however, countries that adopt the standards are expected to create and enforce regulations created from their specifications.

In 1988, the Basel I Capital Accord was created. Its purpose was to:
1. Strengthen the stability of international banking system.
2. Set up a fair and a consistent international banking system in order to decrease competitive inequality among international banks.
The basic achievement of Basel I has been to define bank capital and capital ratio. To set up a minimum risk-based capital adequacy applying to all banks and governments all over the world, a general definition of capital was required. The first step of the agreement was thus to define it.Basil I defines capital based on two tiers:

4.7.2. Tier 1 (Core Capital) :

Tier 1 capital includes stock issues (or share holders equity) and declared reserves, such as loan loss reserves set aside to cushion future losses or for smoothing out income variations.

4.7.3. Tier 2 (Supplementary Capital) :

Tier 2 capital includes all other capital such as gains on investment assets, long-term debt with maturity greater than five years and hidden reserves (i.e. excess allowance for losses on loans and leases). However, short-term unsecured debts (or debts without guarantees), are not included in the definition of capital.

4.7.4 Credit Risk is defined as the risk weighted asset (RWA) of the bank, which are banks assets weighted in relation to their relative credit risk levels. According to Basel I, the total capital should represent at least 8% of the bank's credit risk (RWA). In addition, the Basel agreement identifies three types of credit risks:

- The on-balance sheet risk
- The trading off-balance sheet risk. These are derivatives, namely interest rates, foreign exchange, equity derivatives and commodities.
- The non-trading off-balance sheet risk. These include general guarantees, such as forward purchase of assets or transaction-related debt assets.

4.7.5 The Basel I Capital Accord aimed to assess capital in relation to credit risk, or the risk that a loss will occur if a party does not fulfil its obligations. It launched the trend toward increasing risk modelling research.

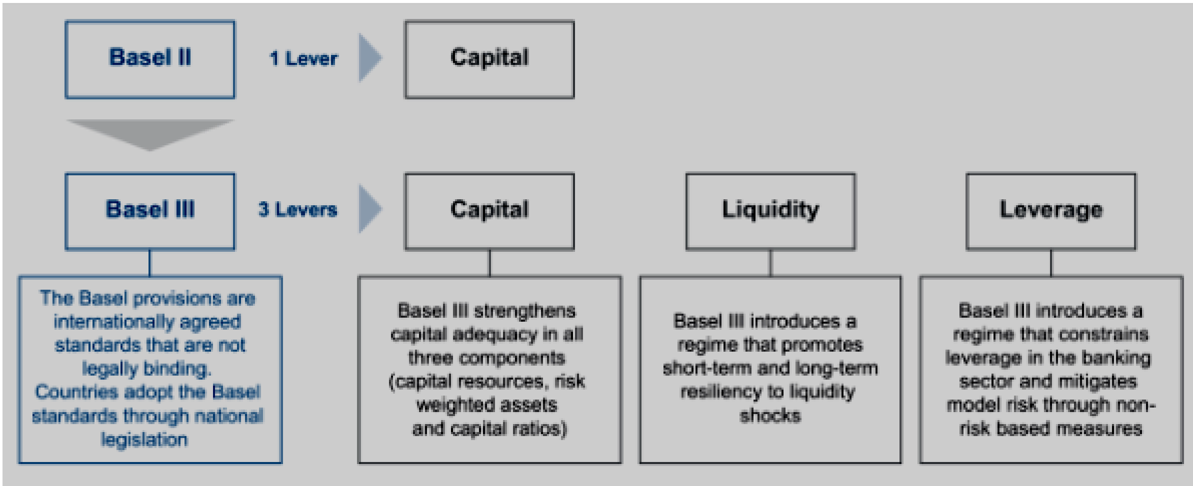
4.7.6 Basel II improved on Basel I, first enacted in the 1980s, by offering more complex models for calculating regulatory capital. Essentially, the accord mandates that banks holding riskier assets should be required to have more capital on hand than those maintaining safer portfolios. Basel II also requires companies to publish both the details of risky investments and risk management practices. The three essential requirements of Basel II are:

- Mandating that capital allocations by institutional managers are more risk sensitive.
- Separating credit risks from operational risks and quantifying both.
- Reducing the scope or possibility of regulatory arbitrage by attempting to align the real or economic risk precisely with regulatory assessment.

4.7.7 Basel II has resulted in the evolution of a number of strategies to allow banks to make risky investments, such as the subprime mortgage market. Higher risks assets are moved to unregulated parts of holding companies. Alternatively, the risk can be transferred directly to investors by securitization, the process of taking a non-liquid asset or groups of assets and transforming them into a security that can be traded on open markets.

4.7.8 The Basel II accord mandates that banks holding riskier assets have more capital on hand than those maintaining safer portfolios. According to Basel II, companies must publish both the details of risky investments and risk management practices. Basel III establishes more stringent capital requirements, tripling the amount of capital banks must keep on hand to absorb losses during financial crises. It also requires banks to maintain higher common equity than before, including a capital conservation buffer of 2.5% of their assets.

4.9 TOWARDS BASEL III - Figure :- 4.9(a)



5.0 THE BASEL III ACCORD

Basel III is a set of standards and practices created to ensure that international banks maintain adequate capital to sustain themselves during periods of economic strain.Basel III adds further controls to those required by Basel II, which in turn was a refinement of Basel I.

The Basel III guidelines aim to improve the banking sector's ability to endure long periods of economic and financial stress by laying down more rigorous and stringent capital and liquidity requirements for them. The Basel Committee on Banking Supervision (BCBS) published its latest recommendations on bank solvency and liquidity in December 2010 and January 2011. The new regulations are aimed at enhancing the quality, consistency and transparency of the capital base and strengthening the risk coverage of the capital framework.

5 (a) .PHASE IN ARRANGEMENTS FOR NEW FRAME WORK OF BASEL III

	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Parallel run 1 Jan 2013-1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to piller 1	
Minimum Common Equity Capital Ratio	3.50%	4.00%	4.50%	4.50%	4.50%	4.50%	4.50%
Capital Conservation Buffer				0.63%	1.25%	1.88%	2.50%
Minimum Common Equity plus Capital Conservation Buffer	3.50%	4.00%	4.50%	5.13%	5.75%	6.38%	7.00%
Phase -in of deductions from CET1 (Including amounts exceeding the limits for DTAs, MSRs and Financials)		20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital	4.50%	5.50%	6.00%	6.00%	6.00%	6.00%	6.00%
Minimum Total Capital	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%

Minimum total capital plus Conservation Buffer	8.00%	8.00%	8.00%	8.63%	9.25%	9.88%	10.50 %
Capital instruments that no longer qualify as Non -core Tier 1 Capital or Tier 2 Capital	Phased out over 10 year horizon beginning 2013						

Fig 5(b) Bank for International Settlements ,Basel Committee on Banking Supervision

Liquidty Coverage Ratio (Minimum Requirement)	observation period begins		60%	70%	80%	90%	100%
Net Stable Funding Ratio		observation period begins				Introduce minimum standard	

Source : Bank for International Settlements ,Basel Committee on Banking Supervision

5.1 HIGHLIGHTS OF BASEL III ACCORD

- **ENHANCED CAPITAL REQUIREMENT:-** Banks require to hold more reserves by January 2015 ,with common equity requirements raised to 4.5% from 2% at present
- **CAPITAL CONSERVATION BUFFER:-**This buffer is newly introduced to meet the crises in the time of stress. It's an additional reserve of 2.5%which brings the total Tier I Capital Reserves to 7%.
- **COUNTERCYCLE BUFFER :-**At any point of time if a nation's economy credit is expanding faster in comparison to GDP ,then Capital requirement can be increased with the help of countercyclical Buffer ,which varies between 0% -2.5% .
- **LEVERAGE RATIO :-**Basel III proposes that Tier I capital has to be atleast 3% of the Total Assets even where there is no risk weighting. It agrees to test a minimum Tier 1 leverage ratio of 3% by year 2017.
- **LIQUIDITY RISK MEASUREMENT :-** Liquidity Coverage Ratio (LCR) is newly introduced It is designed to ensure that a bank maintains an adequate level of unencumbered ,High quality Assets that can be converted into cash to meet its liquidity needs for a 30 days' time frame under acute liquidity stress. The standard requires ratio to be 100%.
- **NET FUNDING STABILITY RATIO :-** (NFSR) It is the ratio, for a bank, of its "available amount of stable funding "divided by its "required amount of stable funding". The standard requires the ratio be no lower than 100%.

5.2 MAJOR AMMENMENDS IN BASEL III

The amendments can be grouped into four heads:-

- **Capital**
- **Risk Weighted Assets**
- **Liquidity**
- **Timing**

5.2(a)CAPITAL

"Capital" is one of the most important concepts in banking. Unfortunately, it can be difficult for those outside the financial field to grasp, since there is no close analogy to capital in ordinary life. In its simplest form, capital represents the portion of a bank's assets which have no associated contractual commitment for repayment. It is, therefore, available as a cushion in case the value of the bank's assets declines or its liabilities rise. Banks attempt to hold the minimum level of capital that supplies adequate protection, since capital is expensive, but all parties recognize the need for such a cushion even when they debate the right amount or form.

5.2(b) AMMENMENDS

- A minimum of 7 per cent of a bank's RWAs must be core tier one to act as a buffer against losses. This compares with the 2 per cent required under Basel II
- The definition of which liabilities can be classified as core tier one will narrow.
- There is a counter-cyclical buffer of 0 to 2.5 per cent, which is to be built up when the economy is strong so that it can be called upon in tougher times
- Additional requirements will also be introduced for large banks deemed vital to the global financial system – so called Global Systemically Important Financial Institutions (G-SIFIs) – to hold an extra 1 to 2.5 per cent of core tier one capital.

5.2 (c) RISK WEIGHTED ASSETS

Basel II promulgated a different method for calculating the risk of assets that were held in trading accounts, based on the assumption that the risk level of trading assets was principally determined by how far the assets could realistically fall in value before a bank could dispose of the investments. Thus a "value at risk" (VAR) approach was used, utilizing statistical techniques to estimate from historical data how large a loss might be taken in unusually unfavorable circumstances.

5.2 (d) AMMENMENDS

- In addition to increasing the quality and quantity of capital, Basel III also updates the risk weighted asset (RWA) calculation for counterparty credit risk.
- This will see the introduction of the Credit Valuation Adjustment (CVA) capital charge, which increases the capital, held against the risk that the mark-to-market value of derivatives will deteriorate due to a change in counterparty credit worthiness.
- The Financial Institution Asset Value Correlation (FIAVC) will be amended to increase the RWAs for banks' exposures to large and / or unregulated financial institutions

5.2(e) LIQUIDITY

"Liquidity" refers to the ability to sell an asset, or otherwise convert it to cash, without incurring an excessive loss in doing so. The liquidity of a bank often refers to the matching of its obligations with its funding sources. A bank with highly liquid assets would generally be considered fairly liquid even if its funding sources were of quite short maturities, since the assets could be liquidated as needed to cover any loss of funding. A bank with less liquid assets might be fine if its funding sources were locked in for long periods, but could be in serious trouble if it relied on short-term debt or deposits that might flow away.

5.2(f) AMMENMENDS

- The Liquidity Coverage Ratio (LCR) defines the amount of unencumbered, low risk assets (such as cash or gilts) that banks must hold to offset forecast cash outflows during a 30-day crisis.
- Outflows are estimated, based on the nature of the customer relationship and the type of product Leverage.
- A new leverage ratio of 3 per cent is due to become mandatory in 2018. This seeks to ensure banks apply adequate capital to all their exposures, including those off balance sheets, and without applying any risk weightings

5.2(g) TIMING

Basel III will be phased in over twelve years period commencing 1st Jan 2011 with most changes becoming effective within next six years **.**The national implementation started on 1 January 2013. Thus, legislation and regulations will have to be amended during the period prior to that date.

5.2(h) AMMENMENDS

- Basel III requirements are being introduced from 2013 but some areas are still subject to change and total compliance is not expected until 2019. The long lead-in is designed to prevent sudden lending freezes as banks improve their balance sheets.
- In Europe, the regulations will be implemented through changes to the Capital Requirements Directive (CRD IV) and the introduction of a Capital Requirements Regulation (CRR). However, various observation and phase-in periods mean the standards will not be fully implementated until 1 January 2019

- In Asia, regulators in each country will implement the regulations individually, taking their steer from the financial centers of Hong Kong, Singapore and Australia
- In the US, consultations regarding local implementation of Basel III are ongoing.

5.3 BASEL III AND INDIAN BANKING

5.3.1 Basel III norms are to improve the banking sector's ability to absorb shocks arising from financial and economic stress. The main objective of the draft guidelines issued by Reserve Bank of India (RBI) on implementation of BASEL III regulations is unexceptionable.

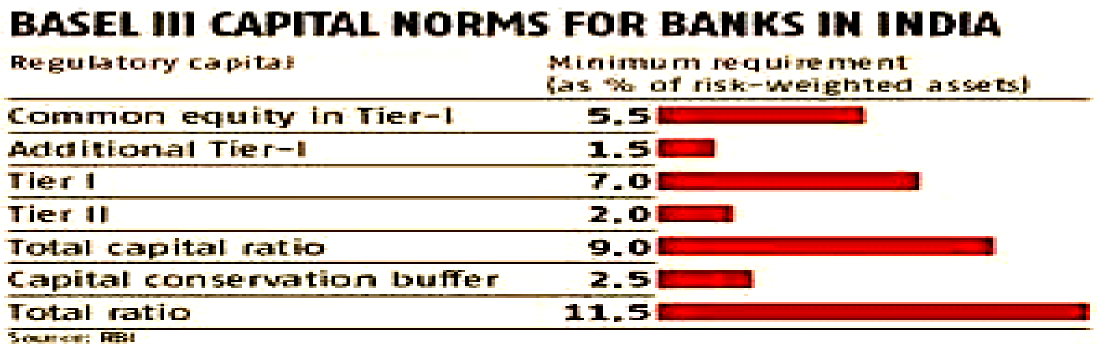


Figure: 5.3.1(a)

The adoption of Basel III norms significantly increases the regulatory capital requirement of Indian banks. Furthermore, within capital, the proportion of the more expensive core capital could increase. According to the proposed norms, the minimum core capital requirement is set to be raised to 4.5%. In addition, the introduction of the conservation and countercyclical buffer means that the capital requirement would increase between 7% and 9.5%. Indian banks, as per the current norms are required to maintain Tier I capital of at least 6%. However, since innovative perpetual debt and perpetual non-cumulative preference shares cannot exceed 40% of the 6% Tier I capital, the minimum core capital is 3.6% (i.e., 60% of 6%).

5.4 IMPACT OF CAPTAL ADEQUACY NORMS ON INDIAN BANKS

Given that most Indian banks are capitalized well beyond the stipulated norms, they may not need substantial capital to meet the new stricter norms. However, there are differences among various banks. While core capital in most of the private sector banks and foreign banks exceeds 9%, there are some public sector banks that fall short of this benchmark. These public sector banks, which account for more than 70% of the assets in the banking sector and are a major source of funding for the productive sectors, are likely to face some constraints due to the implementation of the Basel III norms. These banks are also unable to freely raise capital from the market as the government has a policy of maintaining at least 51% stake in these banks. Currently, there are only six banks where the government stake is higher than 70%. The other option is for the government to infuse capital to these banks to augment their core capital.

Moreover, a rise in risk-weighted assets as well as the proposed disqualification of some non-common Tier I and Tier II capital instruments for inclusion under regulatory capital would increase the requirement of additional capital. According to ICRA (2010), if risk-weighted assets were to grow at an annualized rate of 20%, there would be a requirement of additional capital by the banking sector (excluding foreign banks) of about Rs 6000 billion as a whole over the next nine years, ending on 31 March 2019. Of this, public sector banks would require about 75–80% of this additional capital and private Indian banks accounting for the rest.

5.4 IMPACT OF LEVERAGE RATIOS ON INDIAN BANKS

RBI already had Statutory Liquidity Ratio (SLR) as a regulatory mandate. The SLR portfolio of Indian banks is structured only for moderate risk i.e. Market risk and leverage ratio is excluded. The Tier I capital of most of the banks in India is under comfort zone and their derivatives activities are not very large .It can be figured out that the leverage ratio cannot be a constraint for Indian Banks .LCR should be complemented with the net stable funding ratio (NFSR) of 100% or more. This is meant to provide incentive to banks to seek more stable forms of funding.

5.5IMPACT OF COUNTER CYCLICAL BUFFER ON INDIAN BANKS

The concept of a countercyclical buffer is intuitively appealing, operationalizing it has many challenges. These include defining a business cycle in a global setting although business cycles are not globally synchronized, identifying an inflection point in the business cycle to indicate when to initiate building up the buffer, choosing the appropriate indicator that identifies both good and bad times, determining the right size of the buffer, etc. Given the different stages of financial sector development in different countries there will be a need to allow national discretion in applying the framework. In India there is also a concern about the variable (most likely the credit-to-GDP ratio) will be used to calibrate the countercyclical buffer. However, this may not be the most appropriate variable candidate for India (Subbarao 2010). Unlike in advanced countries, in India and other developing economies, the credit-to-GDP ratio is a volatile variable and is likely to go up for structural reasons like enhanced financial intermediation owing to high growth or efforts of deeper financial inclusion. Moreover, while credit growth can be a good indicator of the build up phase, credit contraction tends to be a lagging indicator of emerging pressures in the system.

5.5 IMPACT OF LIQUIDITY RISK MANAGEMENT ON INDIAN BANKS

Banks have made significant progress toward changing their risk governance frameworks in the wake of the financial crisis. Board risk committees are nearly universal, and members have received appropriate training in risk management. But the industry continues to wrestle with the process of embedding risk culture beyond the boardroom and into business units while ensuring adequate risk transparency. As a result, financial institutions must ensure that the risk pendulum doesn't swing too far the other way as the markets improve. The stress scenario specified by the BCBS for LCR incorporates many of the shocks experienced during the crisis that started in 2007 into one significant stress scenario for which a bank would need sufficient liquidity on hand to survive for up to 30 calendar days. The scenario, thus, entails a combined idiosyncratic and market-wide shock that would result in:

a) The run-off of a proportion of retail deposits;

b) A partial loss of unsecured wholesale funding capacity;

c) A partial loss of secured, short-term financing with certain collateral and counterparties;

d) Additional contractual outflows that would arise from a downgrade in the bank's public credit rating by up to three notches, including collateral posting requirements

e) Increases in market volatilities that impact the quality of collateral or potential future exposure future exposure of derivative positions and thus require larger collateral haircuts or additional collateral, or lead to other liquidity needs;

f) Unscheduled draws on committed but unused credit and liquidity facilities that the bank has provided to its clients; and

g) The potential need for the bank to buy back debt or honor non-contractual obligations in the interest of mitigating reputational risk.

5.7CHALLENGES FOR INDIAN BANKS

5.7(a) IMPLEMENTATION CHALLENGES

Fig . 5.7(a) Challenges of Basel III

5.8 Functional specifications of new regulatory requirements (e.g. Stress Testing) Limit System and risk quantification. Functional integration of new regulatory requirements into existing capital and risk management. Technical implementation of new regulatory requirements is also a challenge along with availability and quality of data.Organisational challenges may occur in the form of coordination of different units as well as within the group. There are countless responsibilities within the implementation and also beyond it .Availability of resources is another challenge.

5.9 The recent crisis also brought into focus the flaws of the incentive system adopted in some advanced countries regarding the compensation structure of key personnel. While the performance-based incentive system was devised to acquire and retain talent, it resulted in too much emphasis being given to short-term profits and compromising long-term interests. The BCBS proposes to increase the variable pay, aligning it with long-term value creation. In addition, the BCBS also proposes to institute deferral and claw-back clauses to offset future losses created by executives.

6.0 In India, more than 70% of the banking sector is dominated by public sector banks, where compensation is determined by the government with the variable component limited. Furthermore, private and foreign banks are statutorily required to obtain the RBI's regulatory approval for remuneration of their whole-time directors and chief executive officers. Recently, in a move to join the global initiative on compensation structures and align Indian compensation structures to Financial Stability Board (FSB) guidelines, RBI issued draft guidelines on compensation of high-level executives. These guidelines attempt to ensure effective governance of compensation, align compensation with prudent risk taking, and improve supervisory oversight of compensation. However, the Indian banking system is currently facing a different predicament. With the majority of the banking sector also a part of the public sector, ideally one would like to attract the best talent into this sector. However, there is a disparity between the compensation packages of public and private sector bank executives, the former receiving significantly less valuable packages. This disparity should be rectified as it is leading to a loss of talent from the public sector to private sector.

6.1 The primary objectives of the Basel reforms are to ensure the reduction of incidence, severity, and costs of financial crises and the associated output loss. However, the proposals enshrined in the reform package will be associated with some macroeconomic costs. These include a rise in lending rates as well as a drop in the overall quantum of lending.

6.2BANKS POSSIBLE RESPONSE TOWARDS BASEL III

"Basel III" the third version of these rules, will have a large effect on the world's financial systems and economies. On the positive side, newly toughened capital and liquidity requirements should make national financial systems and indeed the global financial system-SAFER. Unfortunately, enhanced safety will come at a cost, since it is expensive for banks to hold extra capital and to be more liquid. It is beyond serious dispute that loans and other banking services will become more expensive and harder to obtain. The real argument is about the degree, not the direction.

Banks' possible responses to the stricter capital requirements called for by the Basel III reform package shows that the effects on output depend, inter alia, on the strategy banks adopt in response to the reform, and that banks tend to prefer some strategies over others. Specifically, an increase in loan spreads minimizes banks' costs and induces the sharpest contraction in real activity and investment, in the immediate as well as long term. A recapitalization, or restrictions on dividends, have more modest effects on output, but are less likely to be preferred by banks. The undesired macroeconomic effects of the reform during the transition phase are significantly mitigated if the reform is announced well ahead of its actual implementation – as was done for the Basel III package.

6.3 AREAS OF DISAGREEMENT

There is broad agreement within the Basel Committee, at the G-20, and even in the financial markets, that capital requirements need to be raised in light of the financial crisis. However, there are disagreements, particularly between the banking industry and the committee, on the specific approaches being taken to achieve this purpose .The banking industry argues that the committee is going overboard in many areas and doing so in ways that will significantly, and unnecessarily, raise the cost of providing loans and other banking services. Some of the major areas of disagreement are the industry argues that the committee is going overboard in many areas and doing so in ways that will significantly, and unnecessarily, raise the cost of providing loans and other banking services. Some of the key areas of discord are:-

- **Net stable funding ratio**
- **Higher capital ratios**
- **Use of a leverage ratio**
- **Elimination of softer forms of capital**
- **Exclusion of some balance sheet items from capital**

Virtually every part of the Basel III proposals has been objected to by someone, so the above should not be viewed as a complete list, but merely the most important and controversial items.

6.4 LIKELY EFFECTS OF BASEL III

Everyone accepts that banks and the financial system would be safer as a result of these changes, but that this would come at the cost of slower economic growth in most years due to higher credit costs and reduced availability.

If the Basel Committee is right, the lowered growth rate during non-crisis years may be more than offset by the avoidance of truly severe recessions brought on every few decades by widespread, severe financial crises.

There were a host of other technical changes which will have real significance in aggregate. Fortunately, they appear broadly sensible and do not seem to undermine the intent of making the capital and liquidity requirements substantially more stringent. This should be good for the banking industry as a whole, as the increased safety should considerably outweigh the costs.

7. CONCLUDING NOTE

7.1 The Basel III accords are expected to generate positive response for economy. It will be of sure help and support as far as the leverage ratio, capital buffer and the proposal to deal with pro cyclicality is concerned. The impact of new international standards of banking regulations will vary under regional regulatory environment of each country, India is not an exception to this. It is more relevant at an economy's macro level to address issues such as systemic risk, market discipline, liquidity and transparency in the risk-management framework.

7.2 It is interesting to note that though risk capital may be the necessary safety cushion for banks, capital alone may not be sufficient to protect them from any extreme unexpected loss events. In reality, risk capital will remain only a number and may not be effective if banks do not assess their risk periodically and take timely corrective action when the risk exceeds the threshold limit. It is the responsibility of BASEL Committee to look into the regulatory matters of banking all over the globe and thus to stress the importance of monitoring and regulating the processes and develop the way each country adopts and implements the new regulations .Thus, whether it is Basel II or Basel III, it is crucial that a bank does not depend solely on "regulatory capital".

7.3 Basel II has not fully addressed many factors that were responsible for crises and the fundamental problems with BASEL I and BASEL II. More challenges lie ahead of banks, like sustainablity,recovery of profitability,etc.This will not only prepare the Indian banking industry more resilient to risk ,but it's also an opportunity for them to enrich their risk management culture and strategic decision making process sound. It will prepare them for enhancing their ability to serve the financial needs of the economy.

7.4. Monetary policies of RBI like CRR,SLR,REPO etc make it difficult to uniformly implement BASELnorms.Exercising control on the capital liquidity and leverage will ensure that they have the ability to withstand crises. Risk management should not merely be an activity to comply with regulatory requirements. The new BASELIII regulations will affect all banks; however the severity of the impact will differ according to the type, scale and location of banks. Indian policy makers reacted in a proactive manner and introduced a host of measures to assure the impact of the crises. Regarding the BASEL III norms, not all the reforms measures are going to be a binding constraint for India. Indian banking industry is in comfortable zone to meet and comply some of the proposed BASEL III norms, the implementation of some of the norms will be a challenge. Maintenance of financial stability requires constant vigilance and there is no place for complacency. Moreover, much of this vigilance must be done in good times to detect and negate any incipient signs of instability.

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