



Relevance of basel norms in credit risk management of Indian banking industry

Mr. Remesh KK¹, Dr. Umesh U²

¹ Research Scholar, Bharathiar University, Coimbatore, Tamil Nadu, India

² Assistant Professor & PhD Guide Dept.of Commerce & management Studies, Amal College of Advanced Studies Kerala Santhigramam, Nilambur, Kerala, India

Abstract

The Indian Banking Industry has witnessed tremendous changes with the influence of financial sector reforms. Central bank of the country enabling effective implementation of regulatory framework. However the size of NPA in the Indian banking Industry has been on raise because of various factors. The problem of asset quality will affects all the stakeholders of the bank and creates negative impact on Indian economy. Reserve bank of India advises its banks to follow the prudential norms of lending to ensure the asset quality. RBI's goal in this regard is to achieve harmony with international standard of credit risk management. All banks should follow uniform and reliable norms for reducing the problem of credit risk element in lending portfolio. The uniformity in credit risk management approach helps the banks to handle the deterioration of asset quality in the industry. The capital requirement is uniformly applied to all commercial banks as per the Basel Norms. This paper makes an analysis on the relevance of Basel norms in credit risk management practices of Indian banking Industry.

Keywords: nonperforming assets, credit risk, basel accord, legal framework

1. Introduction

Banking services all over the world are regulated by the legal frame work of the land. The banking sector considered as the backbone of economic system of the country. A strong banking Industry is crucial one for leading the economy smoothly. If the credit risks management system in not regulated properly, it would have result disastrous impact on the economy. Monetary authorities regulate the functions of financial institution to stimulate the development. Regulation promotes better definition of risk, improve the safety of financial institutions, and develop systematic methodology for measuring risk. Deregulation in economic activities increased the competition and resulted high degree of risk element in the business. Overseas transactions lead to competition between multinational entities. The competition resulted in increasing the risk element in banking Industry and it translated into several bank collapses. The Basel committee report focused on reducing credit risk prescribing minimum capital requirement and credit risk weight assignment for the banks. The accord give in depth definition of capital, Tier I which include equity and disclosed reserves, and Tier II supplementary capital. Banks have to identify these two categories of capital and assign risk weights to assets. In India RBI advised banks to transfer 25% of surplus to reserve fund. All banks should attain capital adequacy norms.

2. Review of literature

Cygnus (2005), The Indian retail banking was thriving and retail loan portfolio would be biggest segment and would witness a incredible growth. The areas of concern identified in the study were mainly raising NPA in consumer loans. The rising trend in NPA due to the delinquency rates in credit cards and frauds in home loans. Increasing tenancy in

loan distribution invite the necessity of effective credit management system. He suggested for skilled work force, proper credit delivery, effective monitoring policy, and vigilant regulatory framework. These are all some of the requirements to meet the challenges in Indian banking Industry.

Noronha (2006), a study on "Non Performing Asset Management-Key to Robust Banking System". The main analysis includes the factors which cause for NPA and its impact. According to his findings, unfavorable climate conditions, natural calamities like flood were the main factors which results excessive defaults in agriculture loans. Another factor for huge amount of NPA was inadequate and untimely loans provided by the banks to farmers. According to the study accumulated NPAs were the result of large-scale government association in the banking sector and lose of proper control in the process of lending.

Bhatia (2007), conducted study on the topic, "Non-Performing Assets of Indian Public, Private and Foreign Sector Banks: An Empirical Assessment". The analysis sates that one of the important parameter to evaluate the performance and financial soundness of banks is the volume of NPA. The quantum of NPAs affects the stability and growth prospects of banking Industry.. The study revealed that macro economic factors and internal aspects influence the amount of NPA of banks.

Vivek Srivastava, Deepak Bansal (2012), studied "Trends of Non-Performing Assets in Private Banks in India". The evaluation is made on upward trend or downward trend of NPAs in Private banking sector. Study was based mainly on secondary data which was collected for period of 5 years. The statistical analysis is on the basis of averages and comparative percentage. The main finding of the study was the situation of Nonperforming assets was quite disturbing the effective function of the banks. However little

improvement in the asset quality reflected over the years of data. They recommended for preventive measures for avoiding degradation of performing assets of the banks. The asset quality in total credit portfolio is inevitable for preserve the liquidity and profitability.

RBI (2016) : As per baseline scenario projection by the Reserve Bank of India in its Financial Stability Report , Gross NPA of commercial banks could rise to 8.5 per cent of total advances by March 2017, from 7.6 per cent in March 2016, "The macro stress test that under the Baseline scenario, the gross NPA may rise to 8.5 per cent by March 2017," It stated that if the macro situation would deteriorate further, then the gross NPA ratio may increase to 9.3 per cent by March 2017.

3. Significance of the study

The effective management of credit risk is a critical component of a comprehensive approach to risk management. The goal of credit risk management should be maximizing risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters. An effective risk management process maintains the rate risk within prudent level. It is required for safety and strong banking operation. Management of risks starts with identification of and its quantification. The Basel Committee on Banking Supervision specifically addresses the area of establishing an appropriate credit risk environment. The main feature of Basel accord was framework for minimum capital requirements linked to credit exposure. The capital adequacy regulation is sufficiently consistent and helps to promote the adoption of stronger risk management practices.

4. Statement of problem

The banking sector in India faces the alarming situation of Nonperforming in the total credit portfolio. The existence and long survival is possible to these institutions by increasing the profitability and lending capacity. The capacity to produce adequate profit depends on sound credit risk management mechanism which facilitates identification and monitoring the risk element in lending portfolio. Among several proactive measures of RBI insisted the banks to maintain risk-weighted capital adequacy norms; these norms have been brought up to international standard. Basel Accord put forward capital adequacy framework with regard to minimum capital requirement for banks. Appropriate classification of assets according to credit risk weights enable the bank to maintain required provision. The framework of Basel accord progressively spread to different part of the world accepting it as an international standard. Considering the importance of Basel Accord in credit risk Management it is considered appropriate to analyse the relevance of Basel Accord in credit risk management of Indian banking Industry

5. Objectives of the study

1. To identify the capital adequacy norms of Basel Accord relating to credit risk management.
2. To examine various approaches of capital charge for credit risk in Basel Accord.
3. To analysis the regulatory initiative implemented by RBI relevant to Basel Accord

6. Research methodology

The objectives of the study want descriptive type of research design. Secondary data from various sources used to analyse the available information with regard to research topic. The researcher obtain the data from documents like recommendations Basel accord, RBI bulletins, financial journals and reports of various committees.

Capital adequacy Norms of Basel Accord.

The Basel accord suggested framework for minimum capital requirement for banks defining the term capital for the purpose of capital adequacy. Banks assets were grouped into five according to credit risk carrying credit risk weight of 0%, 10%, 20%, 50% and 100%. Credit risk weight of zero percentage includes government debt, twenty percentage credit risk weight for bank debt and other debt at hundred percentages. Banks are required to hold capital equal to 8% of risk weighted value of assets. The norms have given detailed definition of capital Tier 1 and Tier 2 capital. Tier 1 include equity and disclosed reserves; Tier2 is supplementary capital include undisclosed reserves, reserves on revaluation of assets, general provisions, capital instruments and subordinated debt. In 1998 the accord was amended with the following additions

1. Allows bank to adopt proprietary in-house models for assessing market risk
2. Banks using proprietary models must compute value at risk daily.
3. Allow banks to issue short term subordinate debt to meet a part of market risk
4. Banks are required to segregate the trading book and to mark all portfolio in the trading book
5. The above is applicable for trading activities of banks and non banking securities firms

Credit risk assessment under Basel norms is not risk sensitive enough. Capital need assessment as per the Basel Accord was not in position to differentiate between banks with lower risks and banks with higher risks. It did not recognize the role of risk mitigating instruments like credit derivatives, collaterals, securitization, and guarantees. It promotes financial decision making on the basis of regulatory framework instead of economic opportunities.

Basel Accord I has defined capital requirements as;

Capital = Minimum capital Ratio (8%) X (Credit risk+ Market Risk)

Base accord II defines capital requirement as

Capital = Minimum Capital Ratio (8%) X (Credit risk+ Market risk+ Operation Risk)

There is no major difference between the definition of Minimum capital requirements as per the norms of Basel Accord I and Basel Accord II. The minimum capital ratio is same; which remains 8% in two cases. The only difference is that in Basel Accord II there is provision for operation risk by way of capital charge.

Approaches of Credit risk

A sound credit management system demand implementation of advanced approach under the framework. The approaches relating to capital charge for credit is listed below:

1. Standardised Approach

The standardized approach establishes a fixed credit risk

weight for each supervisory category. It enhances risk sensitivity through external credit assessments. According to this approach the risk weights and the rating of counterparty are inversely related. The requirement of this approach is that 'past due' be risk weighted at 150%. Standardized Approach specifies special treatment for retail and small and medium size enterprises. These sectors follow a uniform credit risk weight of 75% irrespective of the individual risk rating of the component exposure.

2. Internal Rating Based Approach

Internal rating approach is one of the most innovative aspects of measurement of capital requirement for credit risk. This approach differs significantly from Standardized Approach as the credit risk weights are assigned on the basis of banker's internal assessment. Features of Internal Rating Based Approach are;

- Compute capital requirement directly before computing the risk weighted assets
- The parameters taken for capital charge computation are probability Default, Loss given the default, Exposure at Default and Maturity.
- The risk weighted assets are derived from the capital charge computation.

Regulatory initiatives of RBI

Some regulatory initiatives have been implemented by Reserve Bank of India with regard to Basel Accord II;

1. The banks should have suitable risk management framework directed towards their requirements. It is according to size of business, risk philosophy, expected level of capital and market perception.
2. Introduced Risk based supervision in selected banks on a pilot basis
3. Encouraging banks to formalize their Capital Adequacy Assessment Process in association with business plan. The adoption of Risk Based Supervision should help to attain the requirements in Pillar II of Basel Accord II
4. Directed to expand the area of disclosure to attain greater transparency in financial position and risk profile of banks.
5. Identify the eligible banks and permit them to implement Advanced Measurement Approaches.

Reserve Bank of India is currently emphasis on the issue of identification of external rating agencies for use in the Standardized Approach of credit risk. With a view to ensure migration to Basel Accord II, participative approach has been adopted for implementing the new framework.

Conclusion

The factor of credit risk in lending portfolio considered as crucial one as it has a direct bearing on the asset quality of banking system. It is believed that inadequate credit risk assessment and slack monitoring system which leads the banking institution in the problem of accumulated NPA. The banks have to modify their credit appraisal techniques; monitoring mechanism and decision support system to maintain better credit quality. The Reserve Bank of India issues guidelines aiming the reduction of stock of NPA. The legal framework of RBI now is in international standard. The legal framework for capital adequacy norms and credit risk weight assignment are the result of migration to advanced approaches available under Basel Accord II.

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