



Module-B Unit-3

CAIIB PAPER-2

BANK Financial Management(BFM)



CAIIB BFM Module B Unit 3: Risk Regulations In Banking Industry

Regulation of Banking Industries - Necessities And Goals

Banking and financial services, all over the world, are regulated usually by the **Monetary Authority of the land**. This is because banking and financial services are the backbone of an economy. A healthy and strong banking system is a must for any economy to function smoothly and to prosper. As we have seen, banks have risks and risk taking is their business. But if risk-taking is not regulated properly, banks may fail and it would have a disastrous effect on the economy. Therefore, Monetary Authorities across the world regulate functioning of the banks. In India, this function, as we all know, is with Reserve Bank of India, Country's monetary authority.

Regulations have several goals. They are:

- Improving the safety of the banking industry, by imposing capital requirements in line with bank's risks.

Note: Regulatory Authorities impose recognition of the core concept of the capital adequacy principle and of 'risk-based capital', which means banks' capital should be in line with risks. This implies a quantitative assessment of risks as well.

- Levelling the competitive playing field of banks through setting common benchmarks for all players.
- Promoting sound business and supervisory practices.
- Controlling and monitoring Systemic Risk'.
- Protecting interest of depositors as depositors cannot impose a real market discipline on banks.

Systemic Risk

- Systemic risk is the risk of failure of the whole banking system. An Individual bank's failure is one of the major sources of the systemic risk. This happens because of high inter-relations that exist on an ongoing basis between banks through mutual lending and borrowing and other commitments.

Basel Committee on Banking Supervision

Why BCBS?

- On 26th June 1974, a number of banks had released Deutschmarks to Bank Herstatt in Frankfurt in exchange for dollar payments that were to be delivered in New York.
- Due to differences in time zones, there was a lag in dollar payments to counterparty banks during which Bank Herstatt was liquidated by German regulators (Bundesbank), i.e., before the dollar payments could be effected.

Note: The risk of settlement that arises from time-difference came to be known as 'Herstatt Risk'.

The Basel Committee has the following five groups:

- Policy Development Group
- Supervision and Implementation Group
- Basel Consultative Group
- Macro prudential Supervision Group
- Accounting Experts Group

The five Committee groups report directly to the BCBS Chairman and form part of its permanent internal structure. Within each group are working groups - which support specified technical work - and task forces - which undertake specific tasks for a limited time. High-level task forces are also in place to support broader goals outside the Committee groups' primary activities.

BASEL NORM

Basel is a city in Switzerland which is also the **headquarters of Bureau of International Settlement (BIS).**

The **Bank for International Settlements (BIS)** established on **17 May 1930**, is the world's oldest international financial organisation. There are two representative offices in the **Hong Kong** and in **Mexico City**.

BASEL- I

- In 1988, The Basel Committee on Banking Supervision (BCBS) introduced capital measurement system called Basel capital accord, also called as Basel 1.

- It focused almost entirely on credit risk, It defined capital and structure of risk weights for banks.
- The minimum capital requirement was fixed at **8% of risk-weighted assets (RWA)**.
- India adopted **Basel 1 guidelines in 1999**.
- In India, however banks are required to maintain a minimum Capital-to-risk weighted Asset ratio (CRAR) of **9% on an ongoing basis**.

BASEL- II

In 2004, **Basel II guidelines** were published by BCBS, which were considered to be the refined and reformed versions of **Basel I accord**.

Three Pillars of Basel II

(i) First Pillar: Minimum capital Requirement

(a) Calculation of minimum capital requirements and constituents of capital

(b) Credit Risk

- Standardized Approach

- Internal Ratings-based Approach

- Securitisation Framework

(c) Market Risk

(d) Operational Risk

(ii) Second Pillar: Supervisory review process

(iii) Third Pillar: Market Discipline.

First Pillar: Minimum capital Requirement

The Capital base of the bank consist of the following three types of capital element. **Tier 1, Tier 2 and Tier 3 capital**. The sum of Tier 1, Tier 2 and Tier 3 element will be eligible for inclusion in the capital base, subject to the following limits.

(a) Total of Tier 2 (Supplementary) elements will be limited to a maximum of 100% of the Tier 1 element.

(b) Subordinated term debt will be limited to a maximum of 50% of Tier 1 elements.

(c) Tier 3 capital will be limited to 250% of a bank's Tier 1 capital that is required to support market risks.

(d) Where general provisions/general loan –loss reserves include amounts reflecting lower valuations of assets or latent but unidentified losses present in the balance sheet, the amount of such provisions or reserves will be limited to a maximum of 1.25% point.

(e) Asset revaluation reserves, which take the form of latent gains on unrealized securities, will be subject to a discount of 55%.

Second Pillar: Supervisory review process

The section discusses the key principles of supervisory review, risk management guidance and supervisory transparency and accountability, produced by the committee with respect to banking risks. This includes guidance relating to, among other things, the treatment of interest rate risk in the banking book, credit risk, operational risk etc.

Four key of Principles of Supervisory Review:

The Committee has identified four key principles of supervisory review, which complement those outlined in the extensive supervisory guidance that has been developed by the committee.

- **Principle 1:** Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
- **Principle 2:** Supervisors should review and evaluate Bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
- **Principle 3:** Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- **Principle 4:** Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Third Pillar: Market Discipline

- Disclosure Requirements
- Guiding Principles
- Achieving Appropriate Disclosure

BASEL - III

Basel III or Basel 3 released in December, 2010 is the third in the series of Basel Accords. These accords deal with risk management aspects for the banking sector. So we can say that **Basel III is the global regulatory standard on bank capital adequacy, stress testing and market liquidity risk. (Basel I and Basel II are the earlier versions of the same, and were less stringent).**

The RBI issued Guidelines based on the Basel III reforms on capital regulation on May 2 2012, to the extent applicable to banks operating in India. The Basel III capital

regulation has been implemented from April 1, 2013 in India in phase and it will be fully implemented as on March 31, 2019 but Extended.

- In Basel 3, implementation of CCB extended from 31.03.20 to 30.09.20 (further changed to 1.4.2021).
- In Basel 3, implementation of NSFR extended from 1.4.20 to 1.10.20 (further changed to 1.4.2021)

Aims of the Basel III

- Improve the banking sector's ability to absorb ups and downs arising from financial and economic instability
- Improve risk management ability and governance of banking sector
- Strengthen banks' transparency and disclosures

What are the major changes proposed in Basel iii over earlier accords i.e. Basel I and Basel II?

- **Better Capital Quality:** One of the key elements of Basel 3 is the introduction of much stricter definition of capital. Better quality capital means the higher loss-absorbing capacity. This in turn will mean that banks will be stronger, allowing them to better withstand periods of stress.
- **Capital Conservation Buffer:** Another key feature of Basel iii is that now banks will be required to hold a capital conservation buffer of 2.5%. The aim of asking to build conservation buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.
- **Countercyclical Buffer:** This is also one of the key elements of Basel III. The countercyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e. in bad times. The buffer will range from 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital.
- **Minimum Common Equity and Tier 1 Capital Requirements:** The minimum requirement for common equity, the highest form of loss-absorbing capital, has been raised under Basel III from 2% to 4.5% of total risk-weighted assets. The overall Tier 1 capital requirement, consisting of not only common equity but also other qualifying financial instruments, will also increase from the current minimum of 4% to 6%. Although the minimum total capital requirement will remain at the current 8% level, yet the required total capital will increase to 10.5% when combined with the conservation buffer.
- **Leverage Ratio:** A review of the financial crisis of 2008 has indicted that the value of many assets fell quicker than assumed from historical experience. Thus, now Basel III rules include a leverage ratio to serve as a safety net. A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis.

3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018.

- **Liquidity Ratios:** Under Basel III, a framework for liquidity risk management will be created. A new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are to be introduced in 2015 and 2018, respectively.
- **Systemically Important Financial Institutions (SIFI):** As part of the macro-prudential framework, systemically important banks will be expected to have loss-absorbing capability beyond the Basel III requirements. Options for implementation include capital surcharges, contingent capital and bail-in-debt.

Comparison of Capital Requirements under Basel II and Basel III

As a percentage of risk weighted assets

		Basel II	Basel III (January 2019)
A= (B+D)	Minimum Total Capital	8.0	8.0
B	Minimum Tier 1 Capital	4.0	6.0
C	Of which: Minimum common equity Tier 1 capital	2.0	4.5
D	Maximum Tier 2 Capital (Within Total capital)	4.0	2.0
E	Capital conservation buffer (CCB)	--	2.5
F=C+E	Minimum Common Equity Tier 1 capital +CCB	2.0	7.0
G=A+E	Minimum Total capital +CCB	8.0	10.5

Minimum Regulatory Capital Prescriptions (as percentage of risk weighted assets)

RBI Prescriptions

		Basel II Current	Basel III (March 31, 2018)	Basel II (January 2019)
A= (B+D)	Minimum Total Capital	9.0	9.0	8.0

B	Minimum Tier 1 Capital	6.0	7.0	6.0
C	Of which: Minimum common equity Tier 1 capital	3.6	5.5	4.5
D	Maximum Tier 2 Capital (Within Total capital)	3.0	2.0	2.0
E	Capital conservation buffer (CCB)	--	2.5	2.5
F=C+E	Minimum Common Equity Tier 1 capital +CCB	3.6	8.0	7.0
G=A+E	Minimum Total capital +CCB	--	11.5	10.5
H	Leverage Ratio (Ratio to total Assets)	--	4.5	3.0

Composition of Regulatory Capital

General

Banks are required to maintain a minimum Pillar 1 Capital to Risk-weighted Assets Ratio (CRAR) of 9% on an on-going basis (other than capital conservation buffer and countercyclical capital buffer etc.). The Reserve Bank will take into account the relevant risk factors and the internal capital adequacy assessments of each bank to ensure that the capital held by a bank is commensurate with the bank's overall risk profile. This would include, among others, the effectiveness of the bank's risk management systems in identifying, assessing/measuring, monitoring and managing various risks including interest rate risk in the banking book, liquidity risk, concentration risk and residual risk. Accordingly, the Reserve Bank will consider prescribing a higher level of minimum capital ratio for each bank under the Pillar 2 framework on the basis of their respective risk profiles and their risk management systems. Further, in terms of the Pillar 2 requirements, banks are expected to operate at a level well above the minimum requirement. A bank should compute Basel III capital ratios in the following manner:

Common Equity Tier 1 capital ratio	Common Equity Tier 1 Capital
	Credit Risk RWA* + Market Risk RWA + Operational Risk RWA
Tier 1 capital ratio (CETI + AT1)	Eligible Equity Tier 1 Capital
	Credit Risk RWA* + Market Risk RWA + Operational Risk RWA
Total Capital (CRAR)#	Eligible Total Capital
	Credit Risk RWA+ Market Risk RWA + Operational Risk RWA

* RWA = Risk weighted Assets;

Capital to Risk Weighted Asset Ratio

Elements of Regulatory Capital and the Criteria for their Inclusion in the Definition of Regulatory Capital

Components of Capital

Total regulatory capital will consist of the sum of the following categories:

- (i) Tier 1 Capital (going-concern capital)
 - (a) Common Equity Tier 1
 - (b) Additional Tier 1
- (ii) Tier 2 Capital (gone-concern capital)

From regulatory capital perspective, going-concern capital is the capital which can absorb losses without triggering bankruptcy of the bank. Gone-concern capital is the capital which will absorb losses only in a situation of liquidation of the bank.

Limits and Minima

- As a matter of prudence, it has been decided that scheduled commercial banks (excluding Local Area Banks and Regional Rural Banks) operating in India shall maintain a minimum total capital (MTC) of 9% of total risk weighted assets (RWAs) i.e. capital to risk weighted assets (CRAR). This will be further divided into different components as described hereunder.
- Common Equity Tier 1 (CET1) capital must be at least 5.5% of risk-weighted assets (RWAS) i.e. for credit risk + market risk + operational risk on an ongoing basis.
- Tier 1 capital must be at least 7% of RWAs on an ongoing basis. Thus, within the minimum Tier 1 capital, Additional Tier 1 capital can be admitted maximum at 1.5% of RWAS.
- Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 9% of RWAs on an ongoing basis. Thus, within the minimum CRAR of 9%, Tier 2 capital can be admitted maximum up to 2%.
- If a bank has complied with the minimum Common Equity Tier 1 and Tier 1 capital ratios, then the excess Additional Tier 1 capital can be admitted for compliance with the minimum CRAR of 9% of RWAS.
- In addition to the minimum Common Equity Tier 1 capital of 5.5% of RWAs, banks are also required to maintain a capital conservation buffer (CCB) of 2.5% of RWAs in the form of Common Equity Tier 1 capital. Details of operational aspects of CCB are given in RBI Circular.

Capital Charge for Credit Risk

Under the Standardised Approach, the rating assigned by the eligible external credit rating agencies will largely support the measure of credit risk. The Reserve Bank has identified the external credit rating agencies that meet the eligibility criteria specified under the revised Framework. Banks may rely upon the ratings assigned by the external credit rating agencies chosen by the Reserve Bank for assigning risk weights for capital adequacy purposes as per the mapping furnished in the RBI Guidelines.

The Circular issued by the Reserve Bank of India has laid down detailed guidelines on the capital adequacy requirements and the risk weights to be applied in case of the following claims:

- Claims on Domestic Sovereigns
- Claims on Foreign Sovereigns
- Claims on Public Sector Entities (PSES)
- Claims on Multilateral Development Banks, Bank for International Settlements and the International Monetary Fund
- Claims on Banks (Exposure to capital instruments)
- Claims on Primary Dealers
- Claims on Corporates, Asset Finance Companies and Non-Banking Finance Companies- Infrastructure Finance Companies
- Claims included in the Regulatory Retail Portfolios
- Claims secured by Residential Property
- Claims Classified as Commercial Real Estate Exposure
- Non-Performing Assets (NPAs)
- Specified Categories Venture Capital Funds
- Other Assets like loans and advances to bank's own staff
- Off-Balance Sheet Items
- Securitisation Exposures
- Capital Adequacy Requirement for Credit Default Swap (CDS) Positions in the Banking Book

Eligible Credit Rating Agencies

Reserve Bank has undertaken the detailed process of identifying the eligible credit rating agencies, whose ratings may be used by banks for assigning risk weights for credit risk. In line with the provisions of the Revised Framework, where the facility provided by the bank possesses rating assigned by an eligible credit rating agency, the risk weight of the claim will be based on this rating

In accordance with the principles laid down in the Revised Framework, the Reserve Bank of India has decided that banks may use the ratings of the following domestic credit rating agencies for the purposes of risk weighting their claims falling under Corporate exposures for capital adequacy purposes:

- Brickwork Ratings India Pvt. Limited (Brickwork);
- Credit Analysis and Research Limited;
- CRISIL Limited;

- ICRA Limited;
- India Ratings and Research Private Limited (India Ratings); and
- SMERA Ratings Ltd. (SMERA)
- INFORMERICS Valuation and Rating Pvt. Ltd (from June, 2017)

The Reserve Bank of India has decided that banks may use the ratings of the following international credit rating agencies (arranged in alphabetical order) for the purposes of risk weighting their claims for capital adequacy purposes where specified:

- Fitch;
- Moody's; and
- Standard & Poor's

Internal Rating Based Approach

One of the most innovative aspects of the New Accord is the IRB approach to measurement of capital requirements for credit risk. The IRB Approach offers the following two options: Foundation IRB Approach (FIRB) and Advanced IRB Approach (AIRB) version. The IRB approach differs substantially from the standardised approach to the extent that banks' internal assessments of key risk parameters serve as primary inputs to capital calculation. Since the approach is based on banks' internal assessments, the potential for more risk-sensitive capital requirements is substantial.

The salient features of IRB Approach are as under:

- The IRB Approach computes the capital requirements of each exposure directly before computing the risk-weighted assets.
- **Capital charge computation is a function of the following parameters:**

(i) Probability of Default (PD)

(ii) Loss Given the Default (LGD)

(iii) Exposure at Default (EAD)

(iv) Maturity (M)

The risk-weighted assets are derived from the capital charge computation.

- Probability of Default (PD), which measures the likelihood that the borrower will default over a time given horizon.

- Loss Given Default (LGD), which measures the proportion of the exposure that will be lost if a default occurs.
- Exposure At Default (EAD), which for loan commitment measures the amount of the facility that is likely to be drawn in the event of a default.
- Maturity (M), which measures the remaining economic maturity of the exposure.

Table	Differences between Foundation and Advanced IRB Approaches	
Parameter	Foundation IRB	Advanced IRB
PD	Bank	Bank
LGD	Supervisor	Bank
EAD	Supervisor	Bank
M	Bank or Supervisor	Bank
Risk Weight	Function provided by the committee	Function provided by the committee
Data Requirement	Historical data to estimate PD [5 years]	Historical loss data to estimate LGD (7 years) and historical exposure data to estimate EAD (7 years)] plus that for PD estimation

Credit Risk Mitigation

General Principles

Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised in whole or in part by cash or securities, deposits from the same counterparty, guarantee of a third party, etc.

The general principles applicable to use of credit risk mitigation techniques are as under:

- No transaction in which Credit Risk Mitigation (CRM) techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.
- The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.
- Principal-only ratings will not be allowed within the CRM framework.
- While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy, consideration of the underlying credit; valuation; policies

Legal Certainty

- In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met.
- All documentation used in collateralised transactions and guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review, which should be well documented, to verify this requirement.
- Such verification should have a well-founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents. Banks should also undertake such further review as necessary to ensure continuing enforceability.

Credit Risk Mitigation Techniques – Collateralised Transactions

A Collateralised Transaction is one in which:

- Banks have a credit exposure and that credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty. Here, “counterparty” is used to denote a party to whom a bank has an on- or off-balance sheet credit exposure.

- Banks have a specific lien on the collateral and the requirements of legal certainty are met.

Capital Charge for Market Risk

Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices.

The market risk positions subject to capital charge requirement are:

- The risks pertaining to interest rate related instruments and equities in the trading book; and
- Foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books).

Scope and Coverage of Capital Charge for Market Risks

These guidelines seek to address the issues involved in computing capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. *Trading book for the purpose of capital adequacy will include:*

- Securities included under the Held for Trading category
- Securities included under the Available for Sale category
- Open gold position limits
- Open foreign exchange position limits
- Trading positions in derivatives, and
- Derivatives entered into for hedging trading book exposures

Measurement of Capital Charge for Interest Rate Risk

- The capital charge for interest rate related instruments would apply to current market value of these items in bank's trading book. Since banks are required to maintain capital for market risks on an ongoing basis, they are required to mark to market their trading positions on a daily basis.
- The current market value will be determined as per extant RBI guidelines on valuation of investments.

The minimum capital requirement is expressed in terms of two separately calculated charges,

- “**Specific risk**” charge for each security, which is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer, both for short (short position is not allowed in India except in derivatives and Central Government Securities) and long positions, and
- “**General market risk**” charge towards interest rate risk in the portfolio, where long and short positions (which is not allowed in India except in derivatives and Central Government Securities) in different securities or instruments can be offset.

General Market Risk

The capital requirements for general market risk are designed to capture the risk of loss arising from changes in market interest rates.

The capital charge is the sum of four components:

- The net short (short position is not allowed in India except in derivatives and Central Government Securities) or long position in the whole trading book;
- A small proportion of the matched positions in each time-band (the “vertical disallowance”);
- A larger proportion of the matched positions across different time-bands (the “horizontal disallowance”); and
- A net charge for positions in options, where appropriate.

Capital Charge for Operational Risk

Operational Risk

- **Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.** This definition includes legal risk, but excludes strategic and reputational risk.
- Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

The Measurement Methodologies

The New Capital Adequacy Framework (NCAF) outlines three methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity:

- The Basic Indicator Approach (BIA);
- The Standardised Approach (TSA); and
- Advanced Measurement Approaches (AMA).

The Basic Indicator Approach

- **Under the Basic Indicator Approach, banks must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted as alpha) of positive annual gross income.**

Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. If negative gross income distorts a bank's

- Pillar 1 capital charge, Reserve Bank will consider appropriate supervisory action under
- Pillar 2. The charge may be expressed as follows:

$$KBIA = [\sum (GI_{1, \dots, n} \times \alpha)]/n$$

Where:

KBIA = the capital charge under the Basic Indicator Approach

GI = annual gross income, where positive, over the previous three years

n = number of the previous three years for which gross income is positive

α = 15 per cent, which is set by the BCBS, relating the industry wide level of required capital to the industry wide level of the indicator.

Gross income is defined as "Net interest income" plus "net non-interest income".

It is intended that this measure should:

- be gross of any provisions (e.g. for unpaid interest) and write-offs made during the year,
- be gross of operating expenses, including fees paid to outsourcing service providers, in addition to fees paid for services that are outsourced, fees received

by banks that provide outsourcing services shall be included in the definition of gross income;

- exclude reversal during the year in respect of provisions and write-offs made during the previous year
- exclude income recognised from the disposal of items of movable and immovable property;
- exclude realised profits/losses from the sale of securities in the "held to maturity" category;
- exclude income from legal settlements in favour of the bank;
- exclude other extraordinary or irregular items of income and expenditure; and
- exclude income derived from insurance activities (i.e. income derived by writing insurance policies) and insurance claims in favour of the bank.

Features of a Sound Risk Management System

A sound risk management system should have the following key features:

- Active board and senior management oversight;
- Appropriate policies, procedures and limits;
- Comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks;
- Appropriate management information systems (MIS) at the business and firm-wide level; and
- Comprehensive internal controls.

Guidelines for the SREP of the RBI and the ICAAP of Banks

The Basel capital adequacy framework rests on the following three mutually – reinforcing pillars:

- **Pillar 1: Minimum Capital Requirements** – which prescribes a risk-sensitive calculation of capital requirements that, for the first time, explicitly includes operational risk in addition to market and credit risk.
- **Pillar 2: Supervisory Review Process (SRP)** – which envisages the establishment of suitable risk management systems in banks and their review by the supervisory authority.
- **Pillar 3: Market Discipline** – which seeks to achieve increased transparency through expanded disclosure requirements for banks.

The Basel Committee also lays down the following four key principles in regard to the SRP envisaged under Pillar 2:

- **Principle 1:** Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
- **Principle 2:** Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with the regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
- **Principle 3:** Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- **Principle 4:** Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Pillar 3 - Market Discipline

The purpose of Market discipline is to complement the minimum capital requirements (detailed under pillar 1) and the supervisory review process (detailed under Pillar 2). The aim 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 principle, banks' disclosures should be consistent with how senior management and the Board of Directors assess and manage the risks of the bank. Under Pillar 1, banks use specified approaches/ methodologies for measuring the various risks they face and the resulting capital requirements. It is believed that providing disclosures that are based on a common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and comprehensive disclosure framework that enhances comparability.

Scope and Frequency of Disclosures

Pillar 3 applies at the top consolidated level of the banking group to which the Capital Adequacy Framework applies. Disclosures related to individual banks within the groups would not generally be required to be made by the parent bank. An exception to this arises in the disclosure of capital ratios by the top consolidated entity where an analysis of significant bank subsidiaries within the group is appropriate, in order to recognise the need for these subsidiaries to comply with the Framework and other applicable limitations on the transfer of funds or capital within the group. Pillar 3 disclosures will be required to be made by the individual banks on a stand-alone basis when they are not the top consolidated entity in the banking group.

Banks are required to make Pillar 3 disclosures as per RBI Guidelines at least on a half yearly basis, irrespective of whether financial statements are audited, with the exception of following disclosures:

- Table DF-2: Capital Adequacy;
- Table DF-3: Credit Risk: General Disclosures for All Banks; and
- Table DF-4: Credit Risk: Disclosures for Portfolios Subject to the Standardised Approach.

Leverage Ratio

Definition, Minimum Requirement and Scope of Application of the Leverage Ratio

Definition and minimum requirement: exposure

The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the measure (the denominator), with this ratio expressed as a percentage

$$\text{Leverage ratio} = \text{Capital Measure} / \text{Exposure Measure}$$

Regulatory Capital Requirement for Indian Banks under Basel III

Elements of Common Equity Tier 1 Capital:

Indian Banks

Elements of Common Equity component of Tier 1 capital will comprise the following:

- Common shares (paid-up equity capital) issued by the bank which meet the criteria for classification as common shares for regulatory purposes;
- Stock surplus (share premium) resulting from the issue of common shares;
- Statutory reserves;
- Capital reserves representing surplus arising out of sale proceeds of assets;
- Other disclosed free reserves, if any;
- Balance in Profit & Loss Account at the end of the previous financial year;
- Banks may reckon the profits in current financial year for CRAR calculation on a quarterly basis provided the incremental provisions made for non-performing assets at the end of any of the four quarters of the previous financial year have not deviated more than 25% from the average of the four quarters. The amount which can be reckoned would be arrived at by using the following formula:

$$E_{Pt} = \{N_{Pt} - 0.25 * D * t\}$$

Where;

E_{Pt} = Eligible profit up to the quarter 't' of the current financial year; t varies from 1 to 4

N_{Pt} = Net profit up to the quarter 't'

D = average annual dividend paid during last three years

- Revaluation Reserves at a discount of 55%;
- While calculating capital adequacy at the consolidated level, common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) which meet the laid down criteria; and
- Less: Regulatory adjustments/deductions applied in the calculation of Common Equity Tier 1 capital (i.e. to be deducted from the sum of items (i) to (viii)].

Foreign Banks' Branches

Elements of Common Equity Tier 1 capital will remain the same and consist of the following:

- Interest-free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms;
- Statutory reserves kept in Indian books;

- Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India;
- Interest-free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books provided they are non-repatriable and have the ability to absorb losses regardless of their source;
- Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India, and
- Less: Regulatory adjustments/deductions applied in the calculation of Common Equity Tier 1 capital [i.e. to be deducted from the sum of items (i) to (v)].

Definitions and General Terminology

Counterparty Credit Risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default. Unlike a firm's exposure to credit risk through a loan, where the exposure to credit risk is unilateral and only the lending bank faces the risk of loss, CCR creates a bilateral risk of loss : the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors.

Securities Financing Transactions (SFTs) are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, collateralised borrowing and lending (CBLO) and margin lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements.

Hedging Set is a group of risk positions from the transactions within a single netting set for which only their balance is relevant for determining the exposure amount or EAD under the CCR standardised method.

Current Exposure is the larger of zero, or the market value of a transaction or portfolio of transactions within a netting set with a counterparty that would be lost upon the

default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called Replacement Cost.

Credit Valuation Adjustment is an adjustment to the mid-market valuation of the portfolio of trades with a counterparty. This adjustment reflects the market value of the credit risk due to any failure to perform on contractual agreements with a counterparty. This adjustment may reflect the market value of the credit risk of the counterparty or the market value of the credit risk of both the bank and the counterparty.

One-Sided Credit Valuation Adjustment is a credit valuation adjustment that reflects the market value of the credit risk of the counterparty to the firm, but does not reflect the market value of the credit risk of the bank to the counterparty.

A central counterparty (CCP) is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts.

A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator overseer to operate as such with respect to the products offered.

A Clearing member is a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.

A client is a party to a transaction with a CCP through either a clearing member acting as a financial intermediary, or a clearing member guaranteeing the performance of the client to the CCP.

Initial margin means a clearing member's or client's funded collateral posted to the CCP to mitigate the potential future exposure of the CCP to the clearing member arising from the possible future change in the value of their transactions.

Variation margin means a clearing member's or client's funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.

Trade exposures include the current and potential future exposure of a clearing member or a client to a CCP arising from OTC derivatives, exchange traded derivatives transactions or SFTs, as well as initial margin.

Default funds, also known as clearing deposits or guarantee fund contributions (or any other names), are clearing members' funded or unfunded contributions towards, or underwriting of, a CCP's mutualised loss sharing arrangements. The description given by a CCP to its mutualised loss sharing arrangements is not determinative of their status as a default fund; rather, the substance of such arrangements will govern their status.

Offsetting transaction means the transaction leg between the clearing member and the CCP when the clearing member acts on behalf of a client (e.g. when a clearing member clears or novates a client's trade).

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