Q&A

Implications of Basel II on BANKS

1. What is Basel II and what are the main provisions of Basel II?

Basel II is a new capital adequacy framework applicable to Scheduled Commercial Banks in India as mandated by Reserve Bank of India (RBI). 'Basel Capital Accord' deals with Capital measurement and Capital Standards for Banks, which align regulatory capital requirements more closely with underlying risks. The Accord has been accepted by over 100 countries including India. In April 2007, RBI published the final guidelines for Banks operating in India.

The main structure of 'Basel II' rests on three pillars:

I. Minimum Capital Requirements
II. Supervisory Review Process; and
III. Market Discipline

'**Minimum Capital Requirements**', have been prescribed for Credit Risk, Market Risk and Operational Risk.

Credit Risk:

Under the old Basel I framework, all assets used to get a 'one-size-fits-all' treatment and were given a uniform risk weightage of 100% while the stipulated minimum capital adequacy ratio (CAR) for a Bank was 9%. Under Basel II, while the minimum CAR is unchanged at 9%, the risk weights assigned to assets would be proportionate to the credit risk associated with these assets. Within Basel II, various approaches have been prescribed with progressively increasing risk sensitivity. In the first stage, Indian Banks would have to adopt 'Standardized approach' for Credit risk [followed by Foundation Internal Rating Based (IRB) Approach and Advanced IRB Approach]. Under the 'Standardized Approach', credit ratings awarded by recognized rating agencies (such as CARE) would be used to assign risk weights to bank exposures.

Market Risk:

Banks are to apply Standardized Duration Approach for computing capital requirement of market risks. This is not different from the approach under Basel I.

Operational Risk:

Basel II has also an additional provision for *Operational Risk* which was absent in Basel I. Operational risk deals with loss from failed systems and processes, people or as a result of external events. Various approaches have been prescribed by the Basel Capital Accord for addressing this risk, viz., Basic Indicator Approach, Standardized Approach and Advanced

Measurement Approach (in the order of increasing complexity and data requirements). To start with, RBI has prescribed adoption of 'Basic Indicator Approach' for Indian Banks.

The **Supervisory Review Process** is "intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks". "Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate."[1]

Market Discipline refers to disclosure requirements of Banks and is to complement both Pillar I and II. The guiding principle is to allow market participants to be able to assess key parameters (like CAR) of a Bank using such disclosures.

2. When does Basel II come into effect?

Foreign banks operating in India and Indian banks having operational presence outside India are to migrate to Basel II with effect from March 31, 2008. All other commercial banks (except Local Area Banks and Regional Rural Banks) are to migrate by not later than March 31, 2009.

RBI has also prescribed that all unrated exposures over Rs.50 crore of Banks migrating to Basel II w.e.f. March 31, 2008 would carry a 150% risk weight for the financial year 2008-09. The threshold is Rs.10 crore w.e.f. April 1, 2009.

3. What is CARE's role in Basel II?

CARE is one of the rating agencies recognized by RBI under Basel II. Accordingly, CARE Ratings would entail risk weights to be applied on Bank exposures.

[1] Source: Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version (June 2006)

4. What are CARE's rating symbols for Bank Loan Ratings?

A) Long Term

Symbols	Rating Characteristics
CARE AAA	Highest safety for timely servicing of loan obligations. Minimal credit risk.
CARE AA	High safety and very low credit risk.
CARE A	Adequate safety and low credit risk.
CARE BBB	Moderate safety and moderate credit risk.
CARE BB	Inadequate safety, high credit risk.
CARE B	Low safety, very high credit risk, susceptible to default.
CARE C	Very high likelihood of default.
CARE D	Either in default or are likely to be in default soon.

B) Short Term

Symbols	Rating Characteristics
PR -1	Strong capacity for timely payment of short-term loan obligations and lowest credit risk. Loans with relatively better credit characteristics are assigned PR 1+ rating.
PR -2	Adequate capacity for timely payment of short-term loan obligations
PR -3	Moderate capacity for timely repayment of short term loan obligations
PR -4	Inadequate capacity, susceptible to default.
PR -5	The loan is in default or is likely to be in default on maturity.

CARE assigns '+' or '-' signs to be shown after the assigned rating (wherever necessary) to indicate the relative position within the band covered by the rating symbol.

5. What would be the risk weights applicable to various ratings of CARE?

As per RBI circular, the following risk weights are applicable to CARE Rated exposures (as also similarly rated exposures of other recognized agencies):

Long Term Ratings:

CARE Rating	AAA	AA+, AA and AA-	A+, A and A-	BBB+, BBB and BBB-	BB+ and below	Unrated
Risk Weight (%)	20	30	50	100	150	100

Short Term Ratings:

CARE Rating	PR1+	PR1, PR1-	PR2+, PR2, PR2-	PR3+, PR3, PR3-	PR4 & PR5	Unrated
Risk Weight (%)	20	30	50	100	150	100

For example, if the entire loan assets (say Rs.100) of a Bank were to carry a 'AAA' rating, the risk weighted assets would be Rs.20 and the required Capital to achieve the minimum CAR of 9% would be only Rs.1.8 instead of Rs.9 as per Basel I guidelines (which prescribes uniform 100% risk weight for all assets of Rs.100). In effect, the Bank would achieve a 'capital relief' of Rs.7.2 in case it gets its exposure rated as above (subject to a prudential floor which is described later).

6. What is 'Parallel Run'?

Migration to Basel II is slated to commence from 2008-09 and for some Banks, it would be from 2009-10 only. In the meantime, in order to achieve a smooth transition to Basel II, apart from calculating CAR on Basel I terms, Banks are also required to calculate CAR using Basel II norms. This is termed as 'parallel run'. Parallel run has been already commenced by some banks starting from the third quarter of FY07.

7. Why should the Banks get their exposures rated?

As per RBI guidelines, for the financial year 2008-09, all fresh sanctions or renewals in respect of *unrated* claims on corporates in excess of Rs.50 crore will attract a risk weight of 150%. This is applicable for those banks migrating to Basel II as on this date. To illustrate, going back to our earlier example, instead of having to block Rs.9 as 'own funds' for every Rs.100 of loan assets, the Banks would have to keep Rs.13.5 for every Rs.100 lent. This would

effectively 'block' Rs.4.5 worth of their capital from being used for lending purposes. It would also mean higher borrowing cost for the bank trying to maintain a certain level of CAR.

On the other hand, exposures carrying high quality ratings would entail much lower risk weights (ranging from 20 to 100% as given in the table) which would result in 'capital relief' for banks.

8. Can one quantify 'capital relief' and the resultant advantages of getting the portfolio rated?

As said earlier, Banks earn capital relief by getting the exposures rated (irrespective of the quantum of exposure) provided the ratings obtained are Triple B and above[2]. There are two implications of this

a) Banks *save* cost of borrowing an equivalent capital from the market

b) Banks can *leverage* this additional capital they get (out of having the portfolio rated) and earn margins on such lending. Theoretically, this is an infinite process – as banks can further leverage on the margins earned and earn further margins and so on.

A numerical illustration is given below:

Particulars	Unrated	If rated AAA	If rated A
A. Asset Base (Rs.)	100	100	100
B. Risk Weighted assets (Rs.)	100	20	50
C. CAR required	9%	9%	9%
D. Capital required (Rs.) [B * C]	9	1.8	4.50
E. Capital Relief if rated (Rs.)	-	7.2	4.50
(i)Cost of borrowing impact			
F. Cost of Borrowing [E * 10%] (Rs.)	10%	0.72	0.45
(ii) Leveraging impact			
G. Lending possible keeping CAR of 12% [E/12%[3]] (Rs.)	-	60	37.5
H. NIM[$] on above [3% of G] (Rs.)	3%	1.8	1.13
Total advantage (F+H) (Rs.)	**-**	**2.52**	**1.58**

[2] RBI circular specifies certain exceptions, such as 125% risk weights for unrated restructured assets, personal loans, certain NBFCs etc.., and 150% for venture capital funds and commercial real estate. In due course, RBI also may apply higher weights to sectors, based on its risk perception. For details, please refer RBI circular.

[3] Though RBI stipulates a minimum CAR of 9%, Indian Banks have been maintaining higher CAR, in the range of 11-12%. The value of 12% is taken in this context that Banks would not like to lower their CAR from their existing level of say 12%. If we consider 9% in the calculations, capital relief and related advantages would be much higher.

$ Net Interest Margin. An average of 3% is considered for the purpose of illustration

In effect, getting a rating of Single A or above on an exposure would give an advantage to the Bank to the extent of Rs.1.58 to Rs.2.52 per hundred (every year), which in other words, would tantamount to a benefit of 1.58% and 2.52% respectively. The above example does not take into account the 150% risk weight applicable for large exposures as stated earlier. If this is considered, the advantage of getting the loans rated would be still higher.

9. Is there any limit on the quantum of capital relief a Bank can enjoy by rating its portfolio?

Yes. On a bank-wide basis, RBI has limited the extent of 'capital relief' a bank can enjoy compared to capital required as per Basel –I. RBI has prescribed a 'prudential floor' of capital requirement for a Bank in the first few years of implementation of Basel II. This floor would be 100% in FY08, 90% in FY09 and 80% in FY10.

Suppose

A = Capital Requirement as per Basel I

B = Capital requirement as per Basel II

The following table illustrates the minimum capital requirements for the next three years:

Applicable Year *	Minimum Capital Requirement
FY08	A or B whichever is higher
FY09	[90% of A] or B, whichever is higher
FY10	[80% of A] or B, whichever is higher

* for banks shifting to Basel II from March 31, 2008. For other Banks, the years would be FY09, FY10 and FY11 respectively.

Though there appears to be no 'relief' for banks for getting the portfolio rated in FY08, it should be kept in mind that Basel II has an additional 'Operational Risk' element. Capital relief could be obtained to the extent of additional capital requirements due to operational risk, even in FY08.

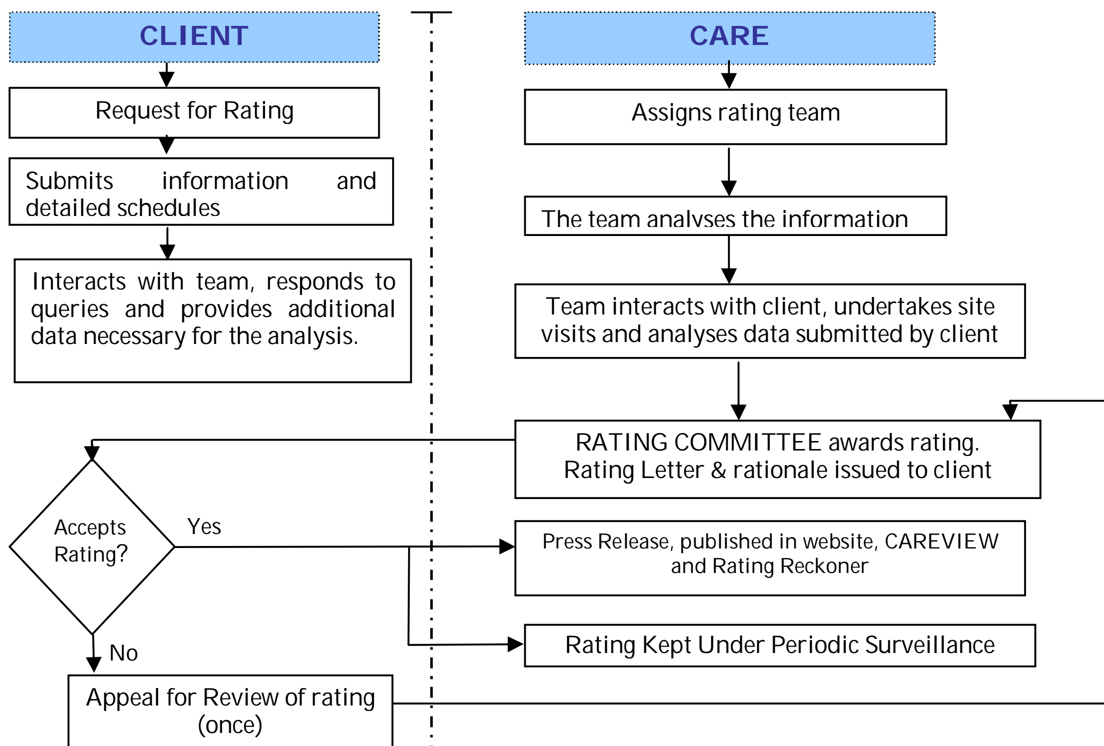
10. Do Banks need to get their entire portfolio rated?

No. As mentioned earlier, RBI has prescribed a high 150% risk weight for large unrated exposures. A segment of Bank exposures, termed as 'Regulatory Retail' (which have to satisfy certain conditions) entail only 75% risk weight and need not be rated. Nevertheless, in the event of having loans with rating of CARE A- [Single A Minus] or above, the Bank would get

capital relief, however small. It is suggested here that Banks should carry out an ABC analysis of their exposures and try to first get large loans/facilities rated and then move on to smaller exposures, in order to maximize the capital relief. As has been discussed earlier, certain specified exposures carry 125% or 150% risk weight irrespective of their rating. More details can be had from the RBI circular.

11. What is the rating process followed by CARE?

The rating process commences with the Request for rating received from the client. The rating process is pictorially given below:



The client has the right to accept or not accept every rating assigned by CARE. Only accepted ratings are kept under surveillance and made known in the public domain.

Only ratings which are accepted by the clients, kept under surveillance and published in the periodic bulletins of a Rating Agency are eligible to be risk weighted under Basel II. Further, the ratings so awarded should have been reviewed by the rating agency in the past 15 months, for Banks to take cognizance of the rating for risk weighting. CARE Ratings are regularly disseminated to the media by way of press releases, bi-monthly *Rating Reckoner* and daily updates in its website www.careratings.com

12. What are the rating methodologies adopted by CARE?

For detailed rating methodologies for various sectors please visit www.careratings.com

13. How much time does CARE take to assign ratings?

The rating process takes about three weeks after submission of initial information. The time taken critically depends on speed of information flow from clients.

14. Does CARE assign Issue ratings or Issuer Ratings?

CARE has the expertise to assign both issue and issuer ratings. However, RBI recognizes only issue specific rating, for the purposes of risk weighting in Basel II. Accordingly, it would be beneficial for banks only if they get their clients rated for each facility.

15. What type of facilities which would be rated by CARE?

CARE would rate all types of fund and non fund based facilities sanctioned by Banks. This would include cash credit, working capital demand loans, Letters of credit, Bank guarantees, Bill discounting, Project Loans, loans for general corporate purposes etc., to name a few.
For assets in the bank's portfolio that have contractual maturity less than or equal to one year, short term ratings accorded by the credit rating agencies would be relevant. For other assets with a contractual maturity of more than one year, long term ratings would be relevant. Cash credit exposures would require a long term facility rating.

16. Would CARE rate Foreign Currency Borrowings?

Yes. CARE would rate all types of borrowings of Indian corporates, including foreign currency borrowings.

17. Can rating for one facility used for another facility sanctioned by the Bank?

Yes, subject to certain conditions. In case one or more exposures of a borrower is rated, the rating can be *mapped* to another exposure of the same borrower provided the unrated claim has a lesser maturity and is senior to the rated claim. However, unrated short term claims would carry risk weight at one level higher than their rated counterpart.

18. What are the other relevant provisions of Basel II?

- Only solicited ratings are allowed to be risk weighted. That is, ratings have to be sought by the client (bank's borrower). For getting a rating from CARE, the client is required to sign a 'Letter of Request' which inter-alia, binds the client to give periodic information in order to enable CARE keep the rating current.
- Banks can reduce risk weights of those claims which have credit risk mitigants. Eligible mitigants include cash collaterals, Gold, Central or State Govt securities, liquid debt securities having investment grade rating, listed equities and mutual funds, etc.

For further information, kindly refer to the RBI guidelines on the above.

19. Has CARE tied up with any Bank for Basel II ratings?

CARE has entered into Memoranda of Understanding (MOU) with State Bank of India, Syndicate Bank, Indian Overseas Bank, Dena Bank and Indian Bank for Basel II ratings. The MOU inter-alia envisages concessional rates of rating fee for the borrowers of these banks.

20. Has CARE commenced doing facility ratings for Basel II?

Yes. Please visit the press releases section on www.careratings.com for the list of Basel II ratings.

21. Whom do I contact for obtaining a rating from CARE?

CARE is headquartered in Mumbai, with Offices all over India. The office addresses and contact numbers are given below:

HEAD OFFICE: MUMBAI

Mr. D.R. Dogra
Executive Director
Cell**:** +91-98204 16002
Direct: +91-22-6754 3434
E-mail : dr.dogra@careratings.com

Mr. Ankur Sachdeva
Head - Business Development
Cell: +91-9819698985
Direct: +91-22-6754 3495
E-mail: ankur.sachdeva@careratings.com

4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East),
Mumbai 400 022
Tel.: (022) 67543456 Fax: (022) 67543457
Website: www.careratings.com

REGIONAL/BRANCH OFFICES

Mr. Sukanta Nag Regional Manager E- mail: sukanta.nag@careratings.com 901 & 902, 9th Floor, Shubham Bldg 1, Sarojini Naidu Sarani Park Street Crossing **Kolkata - 700 017** Tel – 033 2283 1800/1803 Cell # 98311 70075	**Mr.T.N. Arun Kumar** Regional Manager E-mail :arun.kumar@careratings.com 2-B, Wellington Plaza, 90, Anna Salai, **Chennai - 600 002** Tel – 044 2860 0876/7812 Cell # 98400 84265
Ms. Swati Agrawal Regional Manager E-mail :swati.agrawal@careratings.com 710 Surya Kiran, 19 K.G. Road, **New Delhi - 110 001.** Tel – 011 2331 8701/2371 6199 Cell # 98117 45677	**Mr.Mehul Pandya** Regional Manager E-mail: mehul.pandya@careratings.com 307, III Floor, Iscon Mall, Near Jodhpur Cross Road, Satellite, **Ahmedabad - 380 015.** Tel – 079 6631 1821/22 Cell # 98242 56265
Ms.Sharmila Jain Branch-incharge E-mail: sharmila.jain@careratings.com No.G1, Canopy Royal Manor, Near Manipal Hospital, Rustombagh, Off Airport Road, **Bangalore - 560 017.** Tel – 080 2520 5575 Cell # 98860 24430	**Mr. Sajan Goyal** Branch-incharge E-mail: sajan.goyal@careratings.com 302, `Priya Arcade' 8-3-826, Yellareddyguda, Srinagar Colony, **Hyderabad - 500 073.** Tel – 040 6675 8386 Cell # 98491 74030