Chapter 14
Are the Banks in India Comfortable on the Eve of Basel III?

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ABSTRACT
Non-occurrence of the banking crises in India like those in the mature economies of Germany, Japan, Norway, Spain, UK, and USA is not because Indian banks are strong in terms of risk management expertise and healthy in terms of capital, but because the public sector undertaking banks holding majority of businesses in terms of deposits and loans get solutions or waivers from the regulator for the problems they cannot manage and get capital infusion from the government. In these circumstances, their fear of default during economic slowdown is making the credit-financed trading and exporting activities suffer from resource dry-up. Against this backdrop, this chapter throws light on (1) the relationship between credit risk premium on loans and risk free rates, (2) credit rating migration during economic slowdown, (3) the fall-out of maturity-mismatch between assets and liabilities on basis risk and yield curve risk, and (4) the level of preparation of Indian banks for Basel III implementation in terms of enhanced requirements of capital.

BACKGROUND
Though Basel II framework was published in June 2004 and supposed to be implemented by the end of 2006, the Reserve Bank of India (RBI) postponed it to 31st March 2008 for foreign banks in India and the Indian banks with foreign operations and 31st March 2009 for other scheduled commercial banks keeping in view their slow pace of progress towards the prescribed compliance. Notwithstanding the facts that over last two post liberalization decades net bank credit of public sector banks enjoying the largest share in the Indian banking industry composed of public sector banks, new generation private sector banks, old generation private sector banks and foreign banks has been increasing and asset quality of scheduled commercial banks in terms of the ratio of net non-performing assets to...
net advances and the ratio of net non-performing assets to total assets has been improving till the middle of 2008, industrial research detected the practice of Indian domestic banks especially nationalized banks and old generation private sector banks to look towards RBI for solution because they did not learn during the past comfortable periods how to take decision, unlike a few of the new generation private sector banks and foreign banks, during stressful situations. Hence Herstatt’s failure can not happen in India because the question of wrong speculation does not arise in the case of the banks, who did not learn how to speculate. Japanese and UK kinds of financial crises also can not happen in India because (1) weak banks are merged with strong ones, e.g. of late the merger of Bank of Rajasthan with ICICI Bank and this is also true that if - for the argument’s sake - any bank is expected to be bankrupt because of fraud, it will be taken over by another bank before bankruptcy takes place, (2) secondly there is a centralized agency named Credit Information Bureau India Ltd serving as an effective mechanism for exchange of information between banks and financial institutions on the one hand and the loan-applicants on the other, for curbing growth of NPAs for last one decade. Norwegian kind of crisis is also difficult to happen in India because (1) in absence of the banking industry’s own guaranteed funds and any deposit guarantee limit beyond the extant INR one lakh or 0.1 million per depositor, there is periodical capital infusion into the troubled banks including the largest public sector bank State Bank of India like one round infusion in October 2011 and another proposed in March 2012, by the Ministry of Finance of Government of India (GoI) for the purposes like maintaining Tier I capital. Nationalization of the banks in 1969 and 1980 leading to the control of 91% of banking business in the hands of GoI and regulated interest rate regime with hardly any scope for derivative and structured products in the underdeveloped stage of the market lasting till the beginning of 1990s were the factors contributing to becoming of an environment, which is different than what could give birth of Spanish kind of crisis. Finally, unlike US, the kind of freedom enjoyed by savings and loan associations enabling them to extend junk loans does not exist with their Indian counterparts.

Patnaik and Shah (2002) tried to throw light on basis risk and yield curve risk facing Indian banks. They resorted to a detailed process of imputation of cash-flows associated with assets and liabilities of all maturities using public domain information. They faced difficulty in discerning behavioural assumptions required about the stability of demand deposits. They engaged in sensitivity analysis in order to address this issue. They created a ‘baseline’ scenario with plausible assumptions and perturbed it to create optimistic and pessimistic scenarios. They showed computations for an RBI scenario using the then extant rules governing stability of demand deposits (p. 4). They mentioned the impact of interest rate fluctuations on the stock prices of the banks exposed to interest rate risk (p. 7). Sy (2005) tried to cover the aspects of duration and value at risk in the government securities portfolio of Indian banks. But the nature and extent of intra-bucket spread fluctuations and shifts in yield curve were to be assessed in terms of measures of drift and volatility and impacts on net interest income (NII) and economic value of equity (EVE). CRISIL (2010) reflected increasing credit default in 2008-2010. It noted a surge in ratings in the ‘BBB’, ‘BB’, and ‘B’ categories with smaller companies entering the bank loan market while the statistics indicate a steady decline in default rates from 1998 to 2007, increase in 2008 and 2009 due to the economic slowdown, and a decrease in 2010. (p. 3). It found the highest number of defaults, in absolute terms, since inception in 2010 (p. 9). Rakshit (2009) referred to the banks’ fear about potential default consequent upon interruption to credit finance activities like exports. He also described the adverse consequences of global financial crisis on demand for exportables and flow