BASEL III IMPLEMENTATION IN SOUTH ASIA

A. Introduction

1. Basel III was introduced post-Global Financial Crisis to (i) enhance minimum capital requirements, (ii) introduce standardized short-term and long-term liquidity requirements, and (iii) improve credit and market risk disclosures.

2. Enhanced capital adequacy requirements. Basel III includes a higher common equity tier 1 ratio of 4.5% with minimum total tier 1 ratio to risk-weighted asset (RWA) expected at 6.0%. In addition to a minimum total capital adequacy ratio of 8.0%, a capital conservation buffer of up to 2.5% has been introduced.

3. Standardized liquidity requirements. For Basel III compliance, financial institutions will be expected to adopt a liquidity coverage ratio, a ratio of high-quality liquid asset to net cash outflows over 30 days, of at least 100%. South Asian regulators have also set forth a commitment to set minimum standards for the net stable funding ratio to meet longer term liquidity needs.

4. Basel III beyond 2019 and beyond capital adequacy and liquidity requirements. While much focus has been on capital adequacy and liquidity requirements, Basel III includes more reforms, especially in market, credit, and operational risks up until 2022.
   (i) Credit risk. Reforms to credit risk will include greater granularity on measuring and reporting RWAs. For the standardized approach, amongst other detailed reforms, the RWA for exposure to unrated small and medium enterprise (SME) is higher at 85%, the RWA more granular for real estate loans, categorized by residential and non-residential and loan-to-value ratios, and will differentiate based on delinquency in repayment.
   (ii) Market risk. An additional capital charge for credit value adjustment will capture previously unavailable mark-to-market losses arising from the deterioration in counterparty credit worthiness.

5. In South Asia,1 Bangladesh, India, Nepal, and Sri Lanka have adopted Basel III with phasing-in already in progress, and full implementation of the capital and liquidity components expected within 2019–2020. At full implementation in these jurisdictions, minimum total capital ratios, including capital conservation buffer, will range between 11.0% and 14.0%. The timeline of implementation and measures adopted are thus far comparable with other countries including those in the Asia and the Pacific region such as Indonesia, Malaysia, and Thailand.

6. Furthermore, in Bangladesh, India, and Sri Lanka, authorities have either put together a framework to identify or have already instituted surcharges for domestic systemically important banks (D-SIBs). For example, in Sri Lanka, the six domestic banks identified as D-SIBs are required to have minimum capital adequacy ratio of 14.0%. This is within Basel III’s recommendation of an additional 1.0%–3.5% capital surcharge for global systemically important banks (G-SIBs).

B. Impact

7. Nudge towards risk-based pricing. Early research suggests that financial institutions that will become constrained by stricter capital requirements may skew their portfolio towards

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1 Refers to ADB’s regional classification that includes India, Bangladesh, Sri Lanka, Nepal, Bhutan, and Maldives.
lower risk assets. Thus, it is likely that proper adoption of Basel III requirements will encourage risk-based pricing in a region that has traditionally practiced relationship-based pricing through optimal re-allocation of resources with best practices in risk management. Sources of financing may become more diversified as banks and customers reallocate portfolios.

8. **Shortage of quality assets.** The ability of financial institutions to meet requirements for better quality of capital and high-quality liquid assets will largely be constrained by the depth of the South Asian financial sector. For example, in India, the Basel Committee’s Regulatory Consistency Assessment Programme highlighted that the Reserve Bank of India’s recognition of state development loans as Level-1 high-quality liquid asset (HQLA) is not internationally comparable.

9. **Challenging environment to issue Basel III-compliant instruments.** The inability of financial institutions to meet Basel III requirements with existing assets will be further compounded by their inability to raise the necessary capital due to a lack of depth in the financial sector. The financial institutions will find that they will have to raise assets that meet tier 1 and/or tier 2 capital requirements, and also HQLA in a nascent South Asian financial system that may not always meet the eligibility criteria for Basel III.

10. **Need for capital support.** In India, studies by various research institutes, show that Indian banks will need between Rs4–6 trillion (~$60–$90 billion) in capital injection. The estimates highlight a growing concern even with recent recapitalization plans. In Bangladesh, poor asset quality and weak governance have resulted in an estimated capital shortfall of BDT147 billion (~$1.8 billion) for the state-owned banks, emphasizing the capital needs required for banks to achieve Basel III compliance. In Sri Lanka, RDB, and two other state-owned banks, Bank of Ceylon and People’s Bank, have received or will need capital injections to meet Basel III capital requirements.

11. **Financing constraints.** Even without the granular requirements for RWA calculation as part of better credit risk disclosures and increased requirements for market risk and operational risk, financial institutions would already find themselves quite constrained to extend credit amid increased capital adequacy needs. Amongst others, banks will likely find it difficult to supply credit for infrastructure financing, housing financing, and SME financing.

12. **Impact on profitability.** With the leverage ratio requirement, constraints on margins and increased operational costs to meet the requirements of Basel III, banks will find that their profitability will be affected. In Bangladesh, where return on equity has been negative, especially for state-owned banks, the impact on profitability from Basel III implementation will be even more severe for business operations.

13. **Overall impact on economic activity.** With even more constraints on financial access, different sectors of the economy will find their growth somewhat limited. Combined with the impact on financial institutions’ profitability, the adoption of more prudent capital and liquidity requirements under Basel III will have spillover impact on macroeconomic conditions dependent on individual economic structures and financial system readiness.

C. **Government Measures to Alleviate Implications Arising from Basel III**

14. **India.** In late 2017, the Government of India announced a Rs2.1 trillion ($32.7 billion) 2-year recapitalization plan for its largest banking sector asset holders, public sector banks. Of which, Rs1.35 trillion ($ 20.9 billion) would be funded through sales of recapitalization bonds, and
the remainder of which would be in the form of budgetary support and cash raised. This was in addition to the Rs700 billion ($10.9 billion) in conditional capital infusion that the government had planned to provide over 4 years as part of the Indradhanush Plan.

15. In 2018, the Government of India yet again announced a recapitalization plan for 20 public sector banks amounting to Rs800 billion ($12.5 billion) amid mounting concerns of bad debt. Rumors were also rife that the Government of India will liberalize foreign investment in banks (private banks from 74% to 100%, state-owned banks from 20% to 49%), but these liberalization measures to increase foreign direct investment and overseas portfolio allocation in Indian banks have not been announced.

16. **Bangladesh.** In Bangladesh, state-owned banks constitute a smaller size of the banking system—the six state-owned commercial banks and development financial institutions hold approximately 30% of the banking system’s assets. Yet, there are reasons to believe that the poor performance in the banking system is not limited to just state-owned banks. While nonperforming loans (NPLs) have been unsurprisingly elevated for state-owned commercial banks, some private commercial banks have also failed to meet provisioning requirements, have negative returns, and have failed to meet the minimum capital adequacy ratio of 10%.

17. The Government of Bangladesh has continued to support the state-owned banks through almost annual capital infusions raising concerns of moral hazard as state-owned banks continue with poor business practices and have limited incentives to revamp. In June 2017, the Government of Bangladesh allocated Tk20 billion ($250 million) to recapitalize state-owned banks against a March 2017–identified capital shortfall of Tk147 billion ($1.8 billion). In March 2017, three state-owned banks were also approved to raise capital including through the issuance of government guaranteed bonds and subordinated bonds.

18. Concerns remain on the elevated NPL ratios in the Bangladeshi banking system, especially with its six state-owned banks. Furthermore, the relatively new practice of writing off bad loans and poor practice of constantly restructuring bad loans may reveal more asset quality concerns in the future. These and the implementation of Basel III requirements would place significant pressures on the financial system at large, and calls into question the readiness of the banking system to fully implement Basel III capital and liquidity requirements.

19. **Sri Lanka.** While Sri Lankan banks have increased issuances of Basel III tier 2 instruments, Fitch Ratings still estimates there to be a Basel III-compliant capital shortfall of Rs19 billion ($104.1 million) with state-owned banks accounting for the majority of this shortfall. To date, two large state-owned banks, People’s Bank and Bank of Ceylon, have received capital infusions of Rs5 billion ($27.4 million) each from the Government of Sri Lanka.² In its FY2018 budget, the Government of Sri Lanka approved Rs2.5 billion ($13.7 million) for Regional Development Bank.

D. **Assessment**

20. Within South Asia, the implications on the banking and financial systems are somewhat idiosyncratic and the effects will be on a spectrum both from a country-wise and bank type-wise perspective. State-owned banks will likely need the most assistance to meet Basel III requirements.

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21. Furthermore, a perfect storm of regulatory adoptions—introduction of other regulatory requirements including International Financial Reporting Standard 9 (IFRS 9) for more stricter provisioning requirements, and the continued parallel requirement of statutory liquidity requirements in South Asia, will constrain the ability of financial institutions to meet Basel III requirements while optimally conducting business. While regulatory authorities in India have deferred the adoption of IFRS 9, Sri Lankan authorities have indicated that Sri Lanka Accounting Standard 9 Financial Instruments will be adopted as planned.

22. With less than a year to go until the full implementation of Basel III capital and liquidity requirements in Bangladesh, India, Nepal, and Sri Lanka, increased concerns on asset quality, availability of quality tier 1 and tier 2 capital, and availability of HQLA, suggests that full implementation will limit domestic credit growth and constrain banks’ profitability. While the magnitude of the macroeconomic implication is uncertain, there is concurrence that Basel III norms in South Asia will lead to a more resilient financial sector in the longer term but with short-term implications.