

**“HOW WILL BASEL II CHANGE BANKING IN
INDIA?”**

By

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1. EXECUTIVE SUMMERY

Indian banking scenario is going through a transition. What such a transition does to an industry is profound, and how the industry manages this transition determines its future.

This paper looks at the complementing roles of quantitative tools and qualitative standards to achieve this crossover. The paper explores the necessity to transplant learnings from rating agencies and the insurance sector, the challenges of loss quantification in banking and the need for an industry level loss database. A detailed roadmap for an industry wide implementation of the loss database has been laid out.

The paper explores the need for proper representation of Risk Management at the Top Management level, escalation and delegation matrices, 360 degree feedback mechanisms, implementation of information technology supported by highly trained staff, challenges of outsourcing and overseas operations, the changing dimension of competition, the requirement for further strengthening of the 3 pillars, the creation of a super regulatory structure and the setting up of an Indian Institute of Risk Management . In the light of the discussions, the emerging opportunities for Indian banking have been laid out. The paper highlights the need for Indian Banks to step out of the old ruts and the need to adapt to the changing structure.

2. INTRODUCTION

“Learn from yesterday, live for today, hope for tomorrow. The important thing is not to stop questioning”¹

The BCBS² released the “International Convergence of Capital Measurement and Capital Standards: a Revised Framework” in June 2004 with the fundamental objective being “to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks”. This document, further supplemented by the “Amendment to the Capital Accord to Incorporate Market Risks” in November 2005, and today popularly known as the “Basel II framework” was brought out with the intention of revising and setting right the inadequacies of the 1988 Basel I Accord.

Indeed the lessons have been aplenty to learn - from the original framework, through the revised framework, to today – from the bankruptcy of Herstatt Bank in 1974, the liquidation of BCCI³ in the summer of 1991, the loss of over USD 1.4 bn in the oil futures market by Metallgesellschaft in 1993, the spectacular investment fund meltdown of Orange County in 1994, the collapse of Barings Bank in 1995, the ouster of Daiwa from the US markets in 1995, the staggering loss of approximately USD 2.6 bn suffered by Sumitomo Corporation in 1996, the downfall of LTCM in 1998 and many more. So much so, that the financial world is rapidly moving towards a Basel III Framework. (refer Appendix A for a perspective on Basel III).

¹ Albert Einstein

² Basel Committee on Banking Supervision

³ Bank of Credit and Commerce International

3. INDIAN BANKS' LEVEL OF PREPAREDNESS FOR BASEL II

The Indian Banking System has made noteworthy strides, post the reforms it implemented after the adoption of the Basel I framework in 1992, and a further gearing up to meet the requirements of the Basel II framework. The RBI⁴ has set a *revised* target of March 31st 2008 for the implementation of the Basel II framework for foreign banks in India and Indian banks with foreign operations; and a deadline of March 31st 2009 for migration to Basel II approaches by all other Scheduled Commercial Banks, and a target of achieving the Tier I capital ratio of 6% not later than March 31, 2010, both on solo as well as consolidated basis. *Diffidence or prudence?*

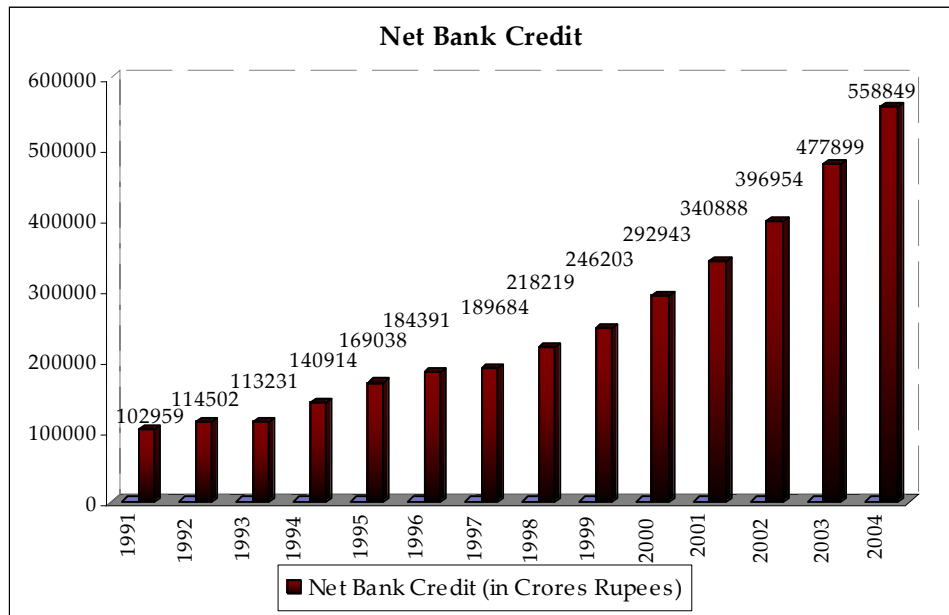
A gap between the bat and the pad has always been risky, increasingly more so given the sophistication of the new instruments being introduced, the relative lack of knowledge of these instruments on the banks' side as well as the Regulators side, and the fact that *a loophole in the system invariably will be exploited- both by insiders as well as outsiders.* The very fact that the RBI decide to postpone the target migration date from 31st March 2007 to 31st March 2008 shows that the RBI would prefer a slow and steady implementation of the Basel framework to a hasty dash (Refer Appendices B & C for Indian Banks' level of preparedness for Basel II). – The maxim being that plodding tortoise can always overtake the racing hare.

4. THE GROWTH OF BANK CREDIT IN INDIA

A quick look at the growth of bank credit and the improvement of the the asset quality of the Scheduled Commercial Banks post the reforms implemented stands testimony to the fact that the Indian banking system is indeed moving in the right direction. (Refer graphs 1 & 2)

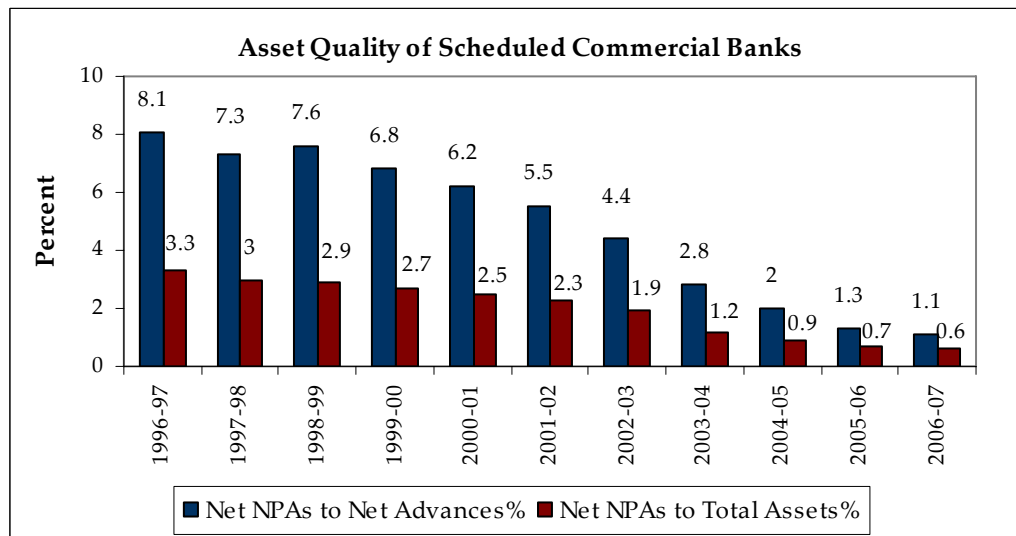
⁴ Reserve Bank of India

Graph 1: Net Bank Credit of Public Sector Banks in India



Source: Final Report, Independent Commission on Banking & Financial Policy, 2006, All India Bank Officers' Confederation

Graph 2: Asset Quality of Scheduled Commercial Banks



Source: Reserve Bank of India

5. CHALLENGE FOR INDIAN BANKING

The Indian banking scenario is marked by a robust dialogue between the Regulator and the banks- which is its strength; however marred by the fact that it is marked by a traditionally paternalistic approach by the RBI, which has left Indian banks perennially looking up to the regulator to show the way ahead. This has left the Indian banks in an

awkward position when competing with global banks which have developed over the years on a strong engine backed by self driven initiatives. (And they have learnt their lessons well from mistakes, and emerged stronger from them). The challenge here is to make up for our lack of self learned lessons with learnings from the mistakes already made- not just by International banks but across financial institutions.

6. QUANTITATIVE TOOLS – THE NEED TO LEARN FROM THE EXPERTS

Fundamental to the successful implementation of the Basel II norms is an inconvenient but necessary marriage of two of unmatched hor(r)o(r)scopes- Qualitative tools and Quantitative standards. Bankers are traditionally practitioners who go by guidelines born of experience. On the other hand we have the rating agencies and the insurance sector who are masters at number crunching. *Why reinvent the wheel when it already exists.* We need to focus on transplanting learnings.

6.1 INSIGHTS FROM THE USE OF QUANTITATIVE TOOLS

The world has progressed far in credit risk modelling and market risk modelling; and has advanced tools aiding forecasting. However reality can defy the forecasts made by models, proving that even the oracle may be *occasionally* wrong. Hence the learning here should be that risk management is not an absolute science. *It is part science, part art -an admixture of different disciplines, loads of common sense, and requires a multi lateral approach.*

6.2 CHALLENGES IN THE AREA OF QUANTIFICATION

Some of the challenges facing Indian banks in the area of quantification are:

6.2.1 Need for an Industry wide loss database. Models and quantifications are as good as the data they build on. Hence there is a need to focus on building up quality data.

Indian Banks today are hampered by the lack of a comprehensive loss database. Collated and cleaned data does not exist. The industry is going back in its annals to collate data. It is recommended that an external loss database be created under the aegis of the Indian

Bank's Association.⁵ (Refer to Appendix D for a recommended roadmap for an industry wide implementation of the loss database)

6.2.2 Models need to be sensitive to the changing business conditions. Models need to be perfected through trial and error. And by the time they are perfected *if in a sterile environment*, the premises on which they were created would have undergone a sea change given the rapidly changing business conditions, rendering them useless. Model building must factor in the changing business conditions.

6.2.3. The unique challenge of quantifying operational risks. The practice of ignoring outliers can vastly change outputs of models and even be misleading, especially when attempting to model the distribution of operational risks.

The lesson that most of the financial fiascos have been a deadly combination of credit risks or market risks and operational lapses just goes to highlight the criticality of Operational Risks.

The uniqueness of Operational Risks stresses on a different approach to modelling the distribution of risks. The golden rule here should be to make the important measurable not the measurable important⁶. There is a need to guard against the tendency to change the facts to fit the theory.

6.3 FOCAL POINT WHEN RELYING ON THE EXPERTS

It is imperative that banks should manage their risk, not outsiders. Development of expertise is a must; else the entire banking structure will be growingly dependent on external support for assistance, leaving the banking system vulnerable in the long run.

The challenge before Indian banks in quantitative modelling is in drawing on the expertise of the rating agencies and the insurance sector keeping in mind the unique

⁵ 'Pooled' data from multiple banks and Non Banking Financial Companies can not only be used for regulatory purposes but also by individual financial institutions for leveraging on learnings and shortening the learning curve.

⁶ McNamara

features of the banking sector. The key here is to transplant these learnings to evolve a line of quantification tools that is unique to the banking sector.

7. CRITICALITY OF QUALITATIVE TOOLS

Given the breadth and complexity of Risk Management, risk mitigation in Banks will not succeed without the implementation of a strong qualitative framework. Good Risk Management is more an offensive tool of attack than a defensive weapon. The guiding principle for banks when approaching the qualitative framework should be that the *biggest asset of a financial institution is the trust it enjoys*. And this asset if maligned will shake the foundations of not just the banking industry, but the financial structure of the economy itself.⁷

7.1 NEED FOR TOP MANAGEMENT SUPPORT

No new initiative can succeed without the strong backing of the Top Management. International banks have already established accountability with Top Management by creating space for Credit Risk Head, Information Security Head, Compliance Head and Fraud Management Head, to name a few - to the extent that there has been a super specialization effect, accounting for their strong risk management architecture. Our banks have a long way to go.

7.2 CREATION OF A CHIEF RISK OFFICER PROFILE

Creation of a Chief Risk Officer profile with heads reporting in for broken-down functions of Risk Management has become imperative.

Risk Management is an amalgamation of functions, too complex to be handled through a narrow line. Breaking down of Risks into various functional areas is a pre-requisite for successful representation of the various categories of risks at the Top Management level.

⁷ The import of the statement needs to be seen from the significance of banks from the social view (financing socially profitable enterprises), development view (intervention to overcome scarcity of capital), political view (channel funds for meeting political objectives) and agency view (cost of bureaucracy versus impact of social gains)

This goes hand in hand with the *quality of top management* which can else translate as bankruptcy, forced mergers or capital injection.

7.3 REFINEMENT OF ESCALATION GRIDS & CREATION OF DELEGATION MATRICES

Another requirement is the refinement of the escalation grids which exist in Indian banks. The pre-requisites are two fold. Firstly to remove the ambiguity among executives as to whom to escalate matters to. Secondly to set accountability with executives at appropriate levels of the escalation grid.

The steps to be taken are:

- Refine the current escalation grids with *executive names* attached, starting with manager level for the entire country operations. (and kept up to date with changes.)
- The powers delegated to the various levels to be charted along with the escalation grid.
- Knowledge of both escalation and delegation matrices to percolate to the floor level so that it can be effectively employed.

Challenging definitely, but not impossible. And the results would be far-reaching in curbing tendencies to either duck responsibility or exceed the powers granted to executives, which can place the organization at risk.

7.4 360 DEGREE APPRAISALS AND FEEDBACK SYSTEMS

Another requirement is the introduction of a 360 degree monitoring and appraisal system, the lack of which, today, prevents many from speaking up about breach of controls fearing reprisals. Provision of hotlines for reporting breach of controls with anonymity guaranteed is another must.

7.5 TECHNOLOGY AND PEOPLE DEVELOPMENT

Implementation of *scalable* information technology tools needs to be addressed. This includes creation of data warehouses, implementation of analytical packages and management information systems. However the architecture of risk management would not be complete without the creation of a risk culture. The tools are only as good as the

tool wielder. Across the leading financial institutions, it is not just technology, but also the quality of the *trained* workforce that has played a significant role in controlling losses on account of defaults and financial frauds by identifying and responding rapidly to emerging cases. This involves making every *person* a risk manager within his/her role-starting from the top to the very bottom. Syllabi like Fraud Awareness, Information Security, Code of Conduct, General Compliance and Anti-Money Laundering should be an integral part of the training structure along with functional training.

8. NEED TO STRENGTHEN THE THREE PILLARS

8.1 PILLAR ONE: CAPITAL ADEQUACY

The coming years will see the members of the financial fraternity increasingly employ Credit Derivatives⁸ to expand their footprint. Much desirable as these instruments might be, the aggressive employment of these products with a focus on market share than on risk can exacerbating an increase in credit volume, and under perfect conditions result in spectacular losses and domino effects. Hence there is a need to strengthen the pillar one requirement of Capital Adequacy.

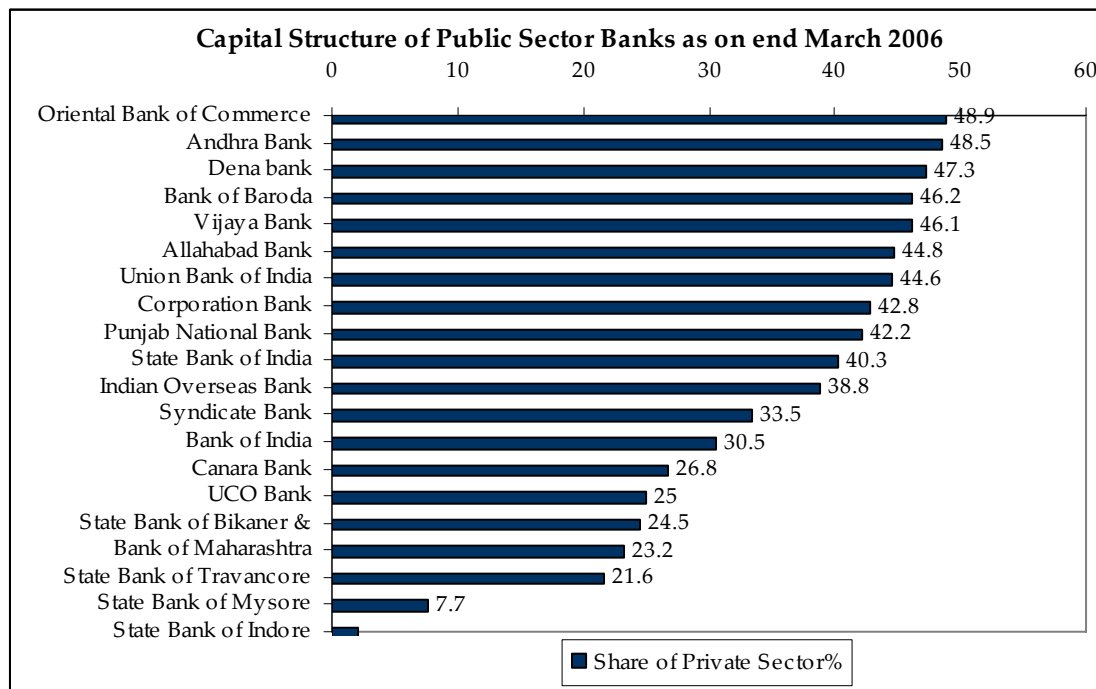
8.2 PILLAR TWO: SUPERVISORY REVIEW

Throughout the world, bank regulation has helped to limit the scope and cost of bank failures. The RBIs move towards pulling the plug on ailing banks instead of keeping them alive on life support is a welcome move. The RBIs success lies in curbing excessive risk taking through the effective enforcement of the 3 pillars. Early identification of imbalances and early warning systems will go a long way in limiting losses. Some of the laudable efforts of the RBI include limiting exposure of banks to specific sectors, and laying down specific norms for priority sector lending. Despite the *obvious* advantages of the Eurodollar market, the RBI would continue to regulate access to it till a catastrophe forces other regulators across the globe sit up and take action.

⁸ Securitization, credit default swap, credit linked notes, credit linked deposits, repackaged notes, collateralized debt obligations and total return swaps to name a few.

8.2.1 RBI's efforts to make Public Sector Banks accountable to the market. The RBI's efforts to move to the side wings and make the Indian Banks accountable to the market has been done with the intention of making Indian Banks more competitive and efficient. The efforts at passing the reins to the market are currently at the stage reflected in the chart.

Graph 3: Capital Structure of Public Sector Banks as on end March 2006



Source: RBI

8.2.2. Need for a Super Regulator. The banking system is an integral part of the larger financial system, with growing meshing of activities of various sectors. With the increasing overlapping of functions, activities and products, either a closer working between the regulators or the formation of a super regulator cutting across the various regulators is inevitable⁹.

8.2.3 Supervisory challenges as Indian banks go global. Challenges of the RBI as Indian Banks aspire to go global lie in prohibition of corporate structures that impede supervision; so is preventing banks from establishing a presence in suspect jurisdictions. Right incentives to owners and managers should be provided.

⁹ Including the RBI, SEBI, IRDA and TRAI

8.2.4. Home Country- Host Country Supervisory Co-operation. Another requirement would be increased focus on home country and host country supervision. The following years would be marked by rapid improvement of gateways for sharing information and collaboration among supervisors, provided they overcome their mutual mistrust.

8.3 PILLAR THREE: MARKET DISCIPLINE

A move towards strengthening of the third pillar of market disclosure is highly desired. Strengthening of Corporate Governance norms is much welcomed. *Transparency over the willingness to provide information to the market can reduce rather than accentuate panic.*

9. OTHER MACRO LEVEL DEVELOPMENTS & CHALLENGES

9.1 CHANGING DIMENSION OF COMPETITION

Competition at the frontend and co-operation at the backend will find new meaning as banks and NBFCs¹⁰ extend not just technological support but also knowledge support to each other (see the *Need for an Industry wide loss database*)

9.2 MANAGING OUTSOURCING AND GLOBAL OPERATIONS

With the growing trend of outsourcing among banks and/or the aspirations of going global, it is important to control fully overseas and outsourced activities too. With regards to both, the requirements are clear reporting lines, close supervision of employees, empowerment of both back office staff and front office executives with jurisdictions defined, and recognizing the importance of internal controls and audits. The relationship between parent company and outsourced units/ overseas units needs to be clearly defined.

¹⁰ Non Banking Financial Companies

9.3 NEED FOR AN INDIAN INSTITUTE OF RISK MANAGEMENT

Another feature is the emergence of more risk categories, over and above the traditionally identified areas.¹¹ Much work remains to be done in the area of risk management. It is time that an Indian Institute of Risk Management is set up combining the skills and resources of the various players with the *focus on skill development and cutting edge research*.

9.4 CONSOLIDATION AND DE-CONGLOMERIZATION

Another trend is a movement towards consolidation. Two phenomena will be observed. The stronger players will absorb the weaker ones with the intention of acquiring specific resources. Alongside if not later there will be a move among the large players towards hiving off specific sections of their peripheral business to reduce the drag on profitability and make businesses more efficient.¹²

10. THE EMERGING OPPORTUNITIES

Indian Banking scenario is *indeed* going through a transition. What such a transition does to a business is profound, and how the business manages this transition determines its future. Some of the opportunities being opened up in this transition are as follows:

1. Potential to accomplish Inclusive Banking in its true sense, and allow all sections to be partners in achieving economic progress.
2. Potential to employ the increasingly sophisticated instruments that are being churned out in the market.

¹¹ Credit risk, market risk, operational risk, strategy risk, reputation/brand risk, underwriting risk, business risk, liquidity risk, currency risk, interest rate risk, litigation risk, Intrusion, theft/crimes/fraud, cross border risks, change management, team departures, infrastructure shutdown, timing risk, court decisions, refinancing, character risk, rogue trading, syndication, motivation risk, emerging markets risk, know-how, risk ratings, social unrest, bridge finance, syndication risk, centralization versus decentralization risk, deal break-up, control procedures, globalization, know your client, money laundering, channels/internet risk, systemic risk, financing models, new business risk, management structure and public relations risk- the list is growing.

¹² ABN AMRO Bank sold their Asian equity business to Macquarie Bank. Citibank hived off their Smith Barney Asset Management subsidiary. UBS one of the largest Swiss banks has sold their SBC Wealth and Asset Management business to Julius Baer. Deutsche Bank AG, Germany reduced their stakes in Daimler Chrysler the manufacturer of the world known Mercedes Benz cars and other engineering goods.

3. Increasing potential to partner corporates towards achieving economic progress-through the employment of the new instruments and effective risk management.
4. Increasing opportunities to go global and/or rapidly scale up existing international operations.
5. Potential to play an important role in transforming economies¹³ and developing economies.
6. Potential to spearhead the further development of risk management techniques among the developing nations.

10. CONCLUSION

Clarity of direction, which includes describing what we are going after as well as describing what we will not be going after, is exceedingly important at this stage. However, resolution comes through experimentation. Only stepping out of the old ruts will bring in new insight.¹⁴ Its time that we reminded ourselves that it is not the strongest of the species that survives, nor the most intelligent that survives, it is the one that is the most adaptable to change that survives.¹⁵

¹³ Former CIS Nations

¹⁴ Andre S Grove in "Only the Paranoid Survive"

¹⁵ Charles Darwin

APPENDIX A

TOWARDS BASEL III – *A perspective*

The learnings are from a separate research titled “Creation of Risk Register for the Banking Sector” conducted by me. This is an attempt to trace the progress of the Basel Accord, and *visualize* the Basel III framework.

Stage 0 (Pre-1988):

Though bank failures were not unheard of, it was the failure of Bank Herstatt in Germany, in 1974, which received international attention, on account of its regulatory implications. The bank became insolvent on account of its large and risky foreign exchange business, and its losses amounted to DM 470 million. The tremors felt in the International structure as a result of this catastrophe led to the drawing up of the Basel I Accord by the Basel Committee on Banking Supervision (BCBS) in 1988.

Stage 1 (1988- 2004):

The Basel I Accord was built on the sole pillar of Capital adequacy, to insulate the banking structure from losses incurred. Though the recommendation of 8% capital adequacy (figure arrived at post intense debate and discussion), were not regulatory in nature, the recommendations were implemented by most Central Banks.

However, despite the implementation of the Basel I framework, a series of incidents continued to send tremors throughout the financial world.

1. Bank of Credit and Commerce International (1991): one of the world’s worst financial scandals and what was called a “\$20-billion-plus heist”. The Bank of England closed down BCCI after it was found to be involved in money laundering, bribery, support of terrorism, arms trafficking, the sale of nuclear technologies, the commission and facilitation of tax evasion, smuggling, illegal immigration, and the illicit purchases of banks and real estate. The bank was found to have at least \$13 billion unaccounted for.
2. Metallgesellschaft – a subsidiary of Deutsche Bank (1993): losses of over \$1.4 billion due to ‘model error’ resulting from incorrect assumptions about futures prices in energy markets.

3. Bankers Trust (1993): losses of over \$400 million due to selling 'inappropriate' derivative products to clients;

Stage 2 (2004 – the Present)

Following the failure of the one size fits all approach and the lessons drawn from financial tragedies, the BCBS released the Basel II framework in 2004. The Basel II framework rested on the 3 pillars of Capital Adequacy, Supervisory Review and Market Discipline. Operational Risk was defined as a new risk category requiring specific attention.

While the Central Banks across the world debated over the proposed framework, the moral degradation across the international financial world continued.

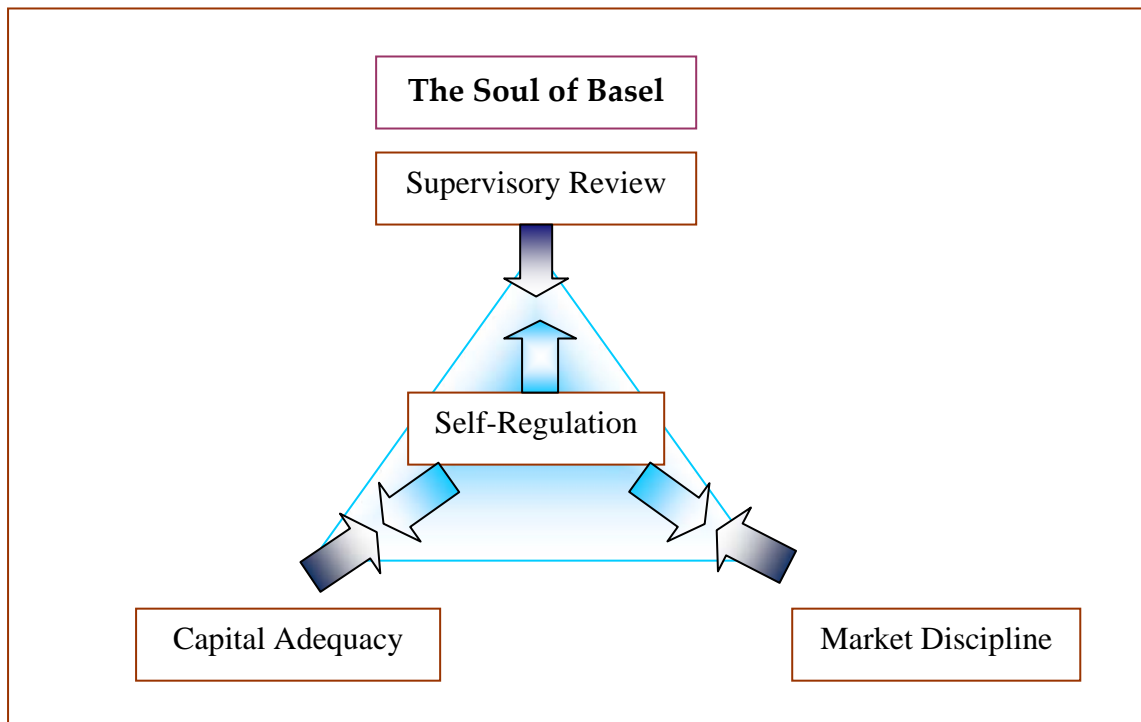
1. Kidder Peabody (1994): losses of over \$350 million due to alleged concealment of trading losses to protect bonuses.
2. Barings Bank (1995) Collapsed in 1995 after one of the bank's employees, Nick Leeson, lost \$1.4 billion in speculation primarily on futures contracts.
3. Daiwa Bank (1995): losses of over \$1.1 billion due primarily to fraudulent trading over 11 years by an employee to cover trading losses.
4. Republic Securities (1999): losses of over \$600 million and loss of trading licence due to its support of fraudulent trading by a broker for which it provided false documentation to the broker's clients and regulators. The broker's fraudulent activities were known to the management of the firm's futures division and persisted for several years and hence should have been picked up by management and auditors.
5. Enron (2001): achieved infamy when it was revealed that its reported financial condition was sustained mostly by institutionalized, systematic, and creatively planned accounting fraud. Enron has since become a popular symbol of willful corporate fraud and corruption.
6. Allied Irish Bank (2002): losses of \$691.2 million on account of an apparent currency fraud at its Baltimore based subsidiary, Allfirst, perpetrated by a trader named John Rusnak. It was one of the biggest 'rogue trader' scandals since Nick Leeson brought down Barings bank in 1995.

7. China Aviation Oil (2004): Losses of over \$500 million due to fraudulent trading by an employee to cover energy trading losses

Stage 3 (The Present- Basel II)

Increasingly it is becoming evident that Capital Adequacy norms alone are insufficient. In fact capital adequacy is a tool being employed at the lower end of the value chain, rendered toothless if not supported by strong supervisory norms and market disclosure requirements. With the 3 point pressure being applied on banks, banks would either implode under the pressure, or strengthen the internal structure and emerge stronger. It is a classic case of Newton's Law- *"For every action there is an equal and opposite reaction"*.

The trends indicate that by the time a Basel III happens, a fourth pillar would have emerged- The Pillar of Self Governance, which would be the cornerstone on which the other 3 pillars rests. And probably the emergence of the 4th pillar is the soul of the Basel Accord.



APPENDIX B

Some of the key findings of a survey report launched in November 2006 by KPMG titled '*India: Ready for Basel II?*' were the following:

1. Banks surveyed seemed confident in their ability to meet the RBI guidelines for achieving The Standardised Approach for Credit Risk and The Basic Indicator Approach in respect of Operational Risk.
2. Compliance with regulation is driving the Basel II implementation programme in 46% of the banks surveyed. New private sector banks ranked enterprise risk management over compliance as their key driver.
3. Only 16% of the banks surveyed had commenced the process of planning for the more advanced approaches of Basel II, including collection of loss data, risk mitigation techniques and capital modelling.
4. From a technology perspective, the level of preparedness in case of operational risks did not match the progress that had been made in credit and market risk management
5. Approximately 75% of the banks' surveyed had not specifically budgeted funds for their Basel II programme.
6. 89% of the banks surveyed indicated that they had a 'dedicated team' responsible for Basel II implementation. However, very few banks had established the position of Chief Risk Officer with a reporting line to the CEO/Board and whose role has been defined with sufficient clarity.
7. 90% of the banks believe that successful implementation will not only result in better compliance but will also improve efficiency of capital management, enhance shareholder value and lead to improved management of their operational risks.
8. Over 95% of the private sector banks surveyed view 'regulatory validation of their risk management systems and models' as their biggest Basel II challenge, which would be addressed gradually as more detailed guidance is provided by the Regulator. On the other hand, public sector banks view 'validation of systems/models by internal and external auditors' as the bigger challenge.

APPENDIX C

Some of the key findings of a Survey on state of preparedness of Commercial banks in respect to Basel II conducted by FICCI in 2006 were the following.

1. 87% of the respondents were confident of meeting the deadline of implementing the Basel II norms by 31st March 2007.
2. 80% of these banks faced Data Collection as the biggest challenge in preparing the Basel II roadmap. They also expressed that they require an ongoing support from the regulatory authorities in this regard.
3. 77% of respondent banks were still in the process of putting in place a robust Management Information System (MIS) in order to comply with the requirements of Pillar III – Market Discipline of the new norms.
4. 54 % of the banks were technologically equipped to face the future challenges being posed by the Basel II norms. These banks had already put in place the core banking solutions. Also enough attention had been focused upon networking the banks.
5. All the respondent banks already had 70-90 % level of computerization in their bank. However 60 % of these banks were of an opinion that lower level of computerization would not hinder their progress in implementing these norms.
6. 87% of respondent banks had already estimated the incremental capital required for this purpose in their organization. 27% banks expected their capital requirements to increase by 1-2 % while 20 per cent banks expect their capital requirements to increase by more than 3 % during the implementation stage of Basel II norms.
7. 62 % of the respondent banks believed that there is a high degree of relationship between the size of the banks and associated risk. Since the complexity of the new framework may be out of reach for many smaller banks, majority of the respondents agree to the fact that this would trigger off a need for consolidation in Indian banking system.
8. 87 % of the respondent banks quoted that increased capital requirements imposed by the Basel accord will not make their banks more risk averse towards credit

dispensation. Merely 13% felt that implementation of Basel II could have an adverse impact on banks lending to commercial sector.

9. 87% of the respondents were completely satisfied with the support given by the RBI in respect to Basel II implementation.
10. Only 50% of respondents expressed that they were completely comfortable with stricter disclosure requirements, whereas rest felt that they were comfortable to some extent.
11. 73% of respondents quoted that capital allocation to operational risk would not be counter productive.

APPENDIX D

ROADMAP FOR THE INDUSTRY WIDE IMPLEMENTATION OF A LOSS DATABASE – A SEPARATE RESEARCH

The following is a recommended roadmap for an industry wide implementation of the Loss database. The recommendations are from a separate study titled “Creation of Risk Register for the Banking Sector” conducted by me.

1. It is recommended that an external loss database cum Knowledgebase, operated by a not-for-profit consortium of financial services institutions be set up. (ideally under the aegis of the Indian Bank’s Association). ‘Pooling’ external information provides participants with a depth of information that is much wider than the experience of their own institution.
2. Let applications to join be made welcome (if not made mandatory by regulators) from any financial institution, including Non Banking Financial Companies. This would help in strengthening the database, in accelerating the learning pace, and thus raising the bar in Risk Management practices of the participating members. If possible let not membership to the association be a pre-requisite for *contribution* to the database.
3. Let participation in the Database be approved by a Management Committee and subject to legal agreement, joining fees and annual subscription fees.

4. Let the funds be held by the Association on behalf of the participants, with payments authorized by the Management Committee.
5. Let participants provide data in accordance with timetables and processes specified by the Association and commit to provide data to the best of their institutional ability, dependant upon internal reporting capabilities. Participants should aspire to provide worldwide group information (specific to companies with global operations).
6. Let Institutions supply information regarding loss events, corrective measures, control strengthening measures and learnings to the Team, where it is validated for accuracy and consistency before being anonymised and consolidated into a report which is made available for nominated individuals within the participating institutions.
7. Let the Association preserve the anonymity of individual participants' data. Ensure that all information exchanges are conducted by the consortium within a secure website environment. The Association should maintain and develop the database solely for the purposes of the participants.
8. The Association needs to validate the submitted information, but not be held legally liable for the quality of the consolidated knowledgebase.
9. A "common language" among banks/ financial institutions is difficult, particularly for Operational Risk Management, its application and interpretation could still vary widely. Hence allow participating Institutions to adapt the information and guidelines to their specific organizational environment.
10. Consolidated information in the database received by participants needs to be confidential and may be used only for their own internal risk management purposes.
11. The Association should have the right to retain a participants' data should participation be terminated.

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