The pre-Basel era was characterized by increasing globalization, leading to rapid expansion of international financial services sector. The swift proliferation contributed to gradual deregulation, which created new revenue opportunities for banking institutions, and intensified competition. International banks indulged in regulation arbitrage, and relocated to less stringent geographies.

The need for a stricter and more stringent banking regulation arose from the collapse of the financial markets in 1973. The trigger originated from the abolition of the Bretton Woods International Monetary System of fixed exchange rates but widespread foreign currency losses for major banks. Bankhaus ID Herstatt was the first to lose its banking license on instruction of the West Germany Federal Banking Supervisory Office. The collapse triggered a chain reaction of for all banks associated with Herstatt’s unsettled trades. This disruption
of financial markets spread globally and Franklin National Bank, New York too went out of business owing to foreign exchange losses. These events along with other anomalies in forward transactions prompted the need for banking regulations coupled with international cooperation. This lead to the establishment of the Basel Committee on Banking Supervision in 1974 by the Central Bank Governors of the G-10 member states. The goal of the BCBCS was worded as “...extend regulatory coverage, promote adequate banking supervision, and ensure that no foreign banking establishment can escape supervision” Since its inception in 1975 the exclusive G-10 committee expanded in 2009 and 2014; it now compromises of 28 members. The Basel Committee meets four to five times annually with the European Commission and the European Central Bank acting as a supervisory observer. Countries are represented in the committee through their central bank and although their decisions are not legally binding, there looms a great degree of expectancy from the members to strictly implement the standards outlined. Hence, the committee solely relies on its members to accept and implement its rules and guidelines at an individual level. To further enforce implementation, the committee began monitoring its members to promote a unified regulatory framework for international banks.

The main task of the Basel Committee is to reinforce the system and to ensure the stability of the international banking system. The main tools for achieving this goal are the cross-border cooperation of banking supervisor authorities, the prudential supervision and, above all, the appropriate assessment and management of risks in which banks are exposed.

The Basel Committee’s foremost aim looked at establishing cooperation between international banks. This assured that every banking institution would be supervised and that the supervision would be consistent and standardised across all member states. The Concordat paper published in 1975 established clear guidelines for financial institutions and all their foreign branches, subsidiaries, joint ventures, etc. In 1983 after final amendments it was republished as ‘Principles for the Supervision of Banks’ foreign establishments. Overview of Basel I:

The publishing of the Concordat in 1975 had helped establish the basis of standardised banking supervision at an international scale. This shifted the focus of the committee towards capital adequacy. There was a unanimous agreement for establishing an international accord to further strengthen the global banking system as well as eradicate competitive disadvantage due to varying regional capital requirements. The worsening capital ratios of major global banks along with the onset of the Latin-America debt crisis only heightened the committees concerns and accelerated the process. This lead to the formation of the Basel Capital Accord in 1988. It was essentially a capital measurement system that required a minimum ratio of capital and risk weighted assets to be 8%. It aimed at being implemented by 1992 amidst the member states and eventually any country with functional multi-national banks.

The Basel I Accord is divided into four key pillars:

The Constituents of Capital: Enlists types of capital that can be considered as bank reserves and the quantity of each type that a bank may hold. Capital was classified into two distinct tiers. Tier I comprised of core capital that possessed a higher capability to absorb losses due to its permanent nature. Tier I comprised of equity capital and disclosed bank reserves. Tier II on the other hand was not defined by a strict boundary and consisted of revaluation reserves, hybrid debt capital instruments, subordinated term debt, etc. Owing to the higher precedence and permanence of core capital, Tier I elements were required to constitute at least 50% of the bank’s capital.

Risk Weighting: Division of all the banks’ assets within five risk categories, with risk-less assets (eg. OECD debt) at 0% to high risk (non-OECD bank debt) at 100%. The provisions of Basel I refer to the calculation of capital requirements for the coverage of international banks over their exposure to credit risk. This is defined as the rule of 8 per cent, which is the minimum value of the solvency ratio and covers the risk of non-fulfilment of the obligations of the counterparts in all forms. Namely, a grant of €100 requires the existence of equity amounting to €8, i.e. Regulatory Capital = Exposure x Weight x 8% Off-balance sheet assets, namely letters of credit, guarantees and Over the counter derivative instruments need to be initially converted to a credit equivalent and then classified into their respective risk weights. Both on balance sheet and off-balance sheet assets are depicted in the tables below.

The aforementioned guidelines were only validated for OECD nations. The non-OECD nations were enforced
with far more stringent conditions. A major difference was the risk weight allotted on government and central bank claims could potentially be 100% unless those debts were issued and funded in the local currency (Thomas Reuters, 2014). If non-OECD countries complied with these stricter guidelines the risk weight associated with those assets would be 0%

Target Standard Ratio: Combines pillars 1 and 2 whereby 8% of a bank’s risk-weighted assets (RWA) must be covered by Tier 1 (minimum 4%) and Tier 2 capital reserves.

Transitional and Implementing Agreements: Central banks are entrusted to implement the accords through strict surveillance. Transitional weights are enforced over a four year tenure to meet the guidelines set in the accords. The committee aimed to achieve 7.25% by 1990 and the 8% by 1992.

Shortcomings of Basel I:
- Non-separation of borrowers in rating classes, creating an incentive to provide credit to businesses with low reliability, resulting in greater risk-taking and the deterioration of loan portfolios.
- Incentive (lower capital requirement) for investment in government securities not classified for their risk (junk).
- Allowing development of internal models for calculating capital adequacy, thus, helping credit institutions to conceal their real exposure to credit risk.
- Contribution to the development of creative accounting so as to hide the true picture of the institution.
- Development of incentives for notional reduction of the weight factors of assets (securitization).

Disadvantages of Basel I:
- Some shortcomings appeared, such as the lack of capital requirements for risks other than credit, the mismatch between credit risk weights and the actual level of risk and the limited recognition of the results of risk reduction techniques.
- These deficiencies have been severely criticized by both the regulators and the supervised banks. The result of these criticisms was the amendment of the Accord with the first consultation paper in 1999, the second one in 2001 and the third in 2003. The European Union implemented the revised Accord gradually and supported it mainly on issues related to the Monetary Union.
- Particularly, Basel Committee, recognizing that Basel I had become obsolete and insufficient to meet the new challenges in the financial sector internationally, began the process for the revision, with the publication of the rst advisory paper in June 1999. This was followed by a number of consultative documents, quantitative studies and published research of specialized working groups, which led to the new regulatory framework for the capital deficiency of banks, Basel II.

Basel II: Transition from Basel I to Basel II: The transition from Basel I to Basel II occurred due to two main reasons. Firstly, the criticism levied on Basel I from both supervising authorities and the supervised institutions. Secondly, the banking crisis of the 1990’s. This lead to revised accord that was named “A Revised Framework on International Convergence of Capital Measurement and Capital Standards”. The new framework still revolved around the pillar system established in Basel I yet continued to grow its scope and benefits.

The Basel II accords consisted of a three pillar framework:

Capital Requirements- Tier 1: This pillar showed the greatest expansion in comparison to Basel I. The main aim was to further enlarge the umbrella of regulation for banks. This meant that all subsidiaries of the parent company within a bank were equally regulated. This prevented the banks from transferring risky assets to their subsidiaries in an attempt to hide them.

Credit Risk: Basel II aimed to measure the risk-weighted assets (RWAs) of a bank more carefully. This revised framework placed forth three methodologies to determine the risk rating of a bank’s assets – the Standardized Approach and two Internal Ratings Based Approaches (IRB approaches). The Standardized Approach directed banks to use ratings from external credit rating agencies to compute capital requirements commensurate with the level of credit risk. There are 13 categories of individual assets specifically named in the Basel II accord with risk-weighting norms. Basel II leans towards the two Internal Ratings Based Approaches – the Foundation IRB (abbreviated as F-IRB) and the Advanced IRB (abbreviated as A-IRB). Foundation IRB gives banks the freedom to develop their own models to ascertain risk weights for their assets. These are, however, subject to the approval of the banking regulator. Further, the regulators provide the model assumptions – loss given default (LGD), exposure at default (EAD), and effective maturity (M).
Banks are, however, allowed to use their own estimates of the probability of default (PD). Advanced IRB is fundamentally the same as Foundation IRB, except that banks are free to use their own assumptions (of LGD, EAD and M) in the models they develop. Understandably, this approach can be used only by a select set of banks.

Operational Risk: The Basic Indicator Approach suggests that banks hold 15 percent of their average annual gross income (over the past three years) as capital. On the basis of risk assessments of individual banks, regulators may adjust the 15 percent threshold. The Standardized Approach basically splits a bank into compartments based on its business lines. The idea is that business lines with lower operational risk (asset management, for instance) would translate into lower reserve requirements. Table 3 details the actual percentage of profits (technically referred to as the beta factor) that needs to be set aside in the form of reserves. The Advanced Measurement Approach gives banks the freedom to perform their own computations for operational risk. Once again, these are subject to regulatory approval. There is a striking similarity between this approach and the IRB approaches outlined earlier, especially in terms of their self-regulating nature.

Market Risk: Market risk is simply the risk of loss as a result of movements in the market prices of assets. In this regard, Basel II makes two clear distinctions – one in respect of asset categories, and the other regarding types of principal risks. In terms of assets, fixed income products are treated differently as compared to others. In terms of principal risk, there are two segments specifically identified – interest rate risk and volatility risk. These risks come together in overall market risk.

2. Regulator-Bank Interaction

Pillar II focuses on the aspect of regulator-bank interaction. Specifically, it empowers regulators in matters of supervision and dissolution of banks. For instance, regulators may supervise internal risk evaluation mechanisms outlined in Pillar I – and change them to more conservative or simpler ones, as the case demands. Regulators are permitted to create a buffer capital requirement over and above the minimum capital requirements as per Pillar I.

3. Banking Sector Discipline

Pillar III aims to induce discipline within the banking sector of a country. Basel II suggested that, disclosures of the bank’s capital and risk profiles which were shared solely with regulators till this point should be made public. The premise was that information to shareholders could be widely disseminated. They would be able to ensure prudence in the risk levels of banks.

1.4 Basel II shortcomings

In the aftermath of the catastrophic effects of the current financial crisis and the consequential global recession, the authorities were motivated to review the international regulatory framework for the banking system, a process that led to the creation of Basel II. The new agreements, developed by the Basel Committee, address the whole range of regulatory and supervisory issues, including liquidity standards, credit risk, operational risk, market risk and the accounting principles. However, the main feature of these regulations is that banks must comply with a minimum required Tier 1 and capital adequacy ratio, on the RWA, of 4 per cent. The objectives of this capital requirement are to absorb unexpected losses, but the financial crisis showed, in the most harmful way, that the expectations were not met.

• The capital adequacy ratio of 4 per cent was insufficient to offset the huge losses that banks suffered.
• The responsibility for assessing the risk of the counterparty is assigned to the credit rating agencies (CRAs) (S&P, Fitch, Moody’s), which have proved to be vulnerable to potential conflicts of interest.
• Capital requirement is pro-cyclical: when the global economy is growing and there is a rise in asset prices, then the risks of counterparty and country tend to be reduced, so the capital requirement is respectively lower. However, in case of a recession, we have the opposite effects, as banks’ capital requirements increase and greater loan retention is needed.
• Basel II provides incentives for greater use of the process of securitization. This happens when the financial institutions re-package loans into asset-backed securities and then move them off their balance sheets, so as to reduce their assets’ risk weighting. As a result, this process allowed many banks to reduce their capital requirements and to take risks, while increasing their leverage.

Basel III: The new set of norms

There were several limitations of Basel II. It was recommended for G-10 counties, thus leaving out the emerging economies. The scope of responsibilities for regulators in emerging economies may be too much
for them to handle. Central banks might not be stringent enough in regulating private banks, thus letting them raise their risk exposure – defeating the entire purpose. The essence of Basel III revolves around compliance regarding capital and liquidity. While good quality of capital will ensure stable long term sustenance, compliance with liquidity covers will increase ability to withstand short term economic and financial stress.

i. Liquidity Rules: The two standards of liquidity are:

a. Liquidity Coverage Ratio (LCR): This is to safeguard banks against sustained financial stress for 30 days period.
   \[ \text{Reserves} = 8\% \times \text{Risk-Weighted Assets} + \text{Operational Risk Reserves} + \text{Market Risk Reserves} \]

b. Net Stable Funding Ratio (NSFR): The objective of long term stability of financial liquidity risk profile is met by maintaining a ratio of amount available of stable funding to required amount of stable funding at a minimum of 100%.


a. Capital Conservation Buffer: A buffer of 2.5% (entirely out of Tier I capital) above minimum capital requirement to be maintained to ensure that banks accumulate buffers in time of low financial stress. It discourages distribution of earnings as a signal of financial strength in times of reduced buffers.

b. Countercyclical Buffer: This buffer can be enacted by national authorities when they believe that the excess credit growth potentially implies a threat of financial distress.

c. Leverage Ratio: This aims to avoid the overuse of on- and off-balance sheet leverage in the banking sector, despite portraying healthy risk based capital ratios, a characteristic of the 2007 financial crisis.

The calibration of the capital framework and the time schedule of phase wise implementation of Basel III can be found in Exhibits 1 and 2 respectively.

Basel Regulatory Framework and India:

There exists an extensive network of research covering the Basel Accords. The focus shall be on the Indian sector below.

Goel and Kumar (2013) define the Basel III norms’ as a way to increase the banks capability to manage and reduce risk from financial stress and increase the banking sector’s transparency. The believe that Indian banks are ideally placed to meet the increased capital requirements leading to the RBI setting an even shorter horizon for implementing these accords compared to the BIS. However, concern is expressed over public sector banks taking longer to adapt to these norms as they lack the high capital adequacy ratios and equity compared to modern private sector banks in the country.

According to senior officials of top Indian banks and risk managers there exists a conflict of interest in maintaining a higher capital and the ever increasing demand for credit. To conclude this meant that Basel III implementation would lead to a lower return on equity due to lowered leverage (Jayadev, 2012)

Shah (2013) also backs the findings of Jayadev. She claims that the implementation of Basel III will cause the capital of banks in India to fall by 60% owing to removal of certain elements from Tier 1 and the expected growth of risk weighted assets by 200%. This combination shall have a drastic negative effect on the ROE and profitability of banks. The added expense of shifting from short-term liquidity to long-term will only further eat into the banks’ profitability. Shah also voices her concerns over the new leverage ratios impacting the lending power of Indian banks, thus risking an onset of recession in an emerging economy. This statement is rounded of by concerns over banking regulation coming at the price of poverty alleviation and economic growth.

Kumari (2013) pegs the external capital requirement of Indian banks at Rs. 6,00,000 crore over a nine-year period. Since public sector banks (PSBs) constitute a bulk of Indian banking activity, the paper also observes that most of the external capital will be needed by these banks. Mehta (2012) also takes into account the fact that the government is hesitant in disinvesting its shareholding in PSBs, which naturally means that the capital infusion has to come from public money. In the Indian context, where the government is always cash-strapped, it cannot be effortlessly assumed that such capital infusion is practical and/or optimal. The paper thus proposes that the government should be willing to bring down its shareholding in these PSBs to 51
percent.

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