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Changing Basel Reforms for Banking Sector

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I Introduction:

As the economy is becoming globalised the scope of money market is also going to rise which leads to the existence of huge number of banks. The financial sector reforms started in 1991 had provided the necessary platform for the banking sector to operate based on operational flexibility and functional autonomy enhancing productivity, efficiency and profitability. While several committees have gone in to the problems of commercial banking in India, the two most important of them are:

a. Narasimham Committee I (1991)
b. Narasimham Committee II (1998)

These committees proposed various reforms in order to improve the profitability and efficiency of the banking system.

Basel accord also adds its reforms for an efficient operation in banking sector too.

Basel I is the round of deliberations by central bankers from around the world, and in 1988, the Basel Committee on Banking Supervision (BCBS) in Basel, Switzerland, published a set of minimum capital requirements for banks. This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992. However they were criticized by some for allowing banks to take on additional types of risk, which was considered part of the cause of the US subprime financial crisis that started in 2008. In fact, bank regulators in the United States took the position of requiring a bank to follow the set of rules (Basel I or Basel II) giving the more conservative approach for the bank. Because of this it was anticipated that only the few very largest US Banks would operate under the Basel II rules, the others being regulated under the Basel I framework. Basel III was developed in response to the financial crisis; it does not supersede either Basel I or II, but focuses on different issues primarily related to the risk of a bank run.

II Objectives of the Study:

The objective of this study is:
To make a simple assessment of the banking sector reforms in India
To know the importance of financial sector reforms in the process of banking reforms
To study major reforms of Indian baking sector
To find out the impacts of these reform on the economy

III Statement of the Problem: As banking sector is launching with a numerous products and services it is important to focus on the banking reforms to make the system more effective and efficient. Basel accord has brought some reforms for proper functioning of the banking sector.

IV Review of Literature: An attempt has also been made to review the relevant literature on the subject. An analysis has been made to compare the changes in Basel reforms from Basel I Accord to Basel II to Basel III and Basel IV.

Basel Accord is primarily focused on credit risk and appropriate risk-weighting of assets. Assets of banks were classified and grouped in the following categories according to credit risk, carrying risk weights of

- 0% (for example cash, bullion, home country debt like Treasuries),
- 20% (securitisations such as mortgage-backed securities (MBS) with the highest AAA rating), 50% (municipal revenue bonds, residential mortgages),
- 100% (for example, most corporate debt), and some assets given No rating.
- Banks with an international presence are required to hold capital equal to 8% of their risk-weighted assets (RWA).

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Basel II is the second of the Basel Accords which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Basel II was intended to create an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks (and the whole economy) face. It is believed that such an international standard could help to protect the international financial system from the types of problems that might arise from the major bank or a series of banks collapse. Basel II attempted to accomplish this by setting up risk and capital management requirements designed to ensure that a bank has adequate capital for the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

Basel II uses a "three pillars" concept – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline.

The First Pillar: Minimum Capital Requirement

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk, and market risk. Other risks are not considered fully quantifiable at this stage.

The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, Foundation IRB, Advanced IRB and General IB2 Restriction. IRB stands for "Internal Rating-Based Approach".

For operational risk, there are three different approaches – basic indicator approach or BIA, standardized approach or TSA, and the internal measurement approach (an advanced form of which is the advanced measurement approach or AMA).

For market risk, the preferred approach is VaR (value at risk).

The Second Pillar-Supervisory Review

This is a regulatory response to the first pillar, giving regulators better 'tools' over those previously available. It also provides a framework for dealing with systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. Banks can review their risk management system.

It is the Internal Capital Adequacy Assessment Process (ICAAP) that is the result of Pillar II of Basel II accords.

The Third Pillar-Market Discipline

This pillar aims to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy of an institution.

Market discipline supplements regulation as sharing of information facilitates assessment of the bank by others, including investors, analysts, customers, other banks, and rating agencies, which leads to good corporate governance. The aim of Pillar 3 is to allow market discipline to operate by requiring institutions to disclose details on the scope of application, capital, risk exposures, risk assessment processes, and the capital adequacy of the institution. These disclosures are required to be made at least twice a year. Institutions are also required to create a formal policy on what will be disclosed and controls around them along with the validation and frequency of these disclosures. In general, the disclosures under Pillar 3 apply to the top consolidated level of the banking group to which the Basel II framework applies.

Global Financial Crisis-Leads to Introduction of Basel III

In response to the financial crisis, the Basel Committee on Banking Supervision published revised global standards, popularly known as Basel III. The Committee claimed that the new standards would lead to a better quality of capital, increased coverage of risk for capital market activities and better liquidity standards among other benefits.

Nout Wellink, former Chairman of the BCBS, wrote an article in September 2009 outlining some of the strategic responses, which the Committee should take as response to the crisis. He proposed a stronger regulatory framework, which comprises five key components: (a) better quality of regulatory capital, (b) better liquidity management and supervision, (c) better risk management and supervision including enhanced Pillar 2 guidelines, (d) enhanced Pillar 3 disclosures related to securitization, off-balance sheet exposures and trading activities that would promote transparency, and (e) cross-border supervisory cooperation. Given one of the major factors, which drove the crisis, was the evaporation of liquidity in the financial markets, the BCBS also published principles for better liquidity management and supervision in September 2008.

A recent OECD (Organization for Economic Cooperation and Development)study suggest that bank regulation based on the Basel accords encourage unconventional business practices and contributed to or even reinforced adverse systemic shocks that materialised during the financial crisis. According to the study, capital regulation based on risk-weighted assets encourages innovation designed to circumvent regulatory requirements and shifts banks' focus away from their core economic functions. Tighter capital requirements based on risk-weighted assets, introduced in the Basel III, may further contribute to these skewed incentives. New liquidity regulation, notwithstanding its good intentions, is another likely candidate to increase bank incentives to exploit regulation.

Think-tanks such as the World Pensions Council (WPC) have also argued that European legislators have pushed dogmatically and naively for the adoption of the Basel II recommendations, adopted in 2005, transposed in European Union law through the Capital Requirements Directive (CRD), effective since 2008. In essence, they forced private banks, central banks, and bank regulators to rely more on assessments of credit risk by private rating agencies. Thus, part of the regulatory authority was abdicated in favor of private rating agencies.

Long before the implementation of Basel II George W. Stroke and Martin H. Wiggers pointed out, that a global financial and economic crisis will come, because of its systemic dependencies on a few rating agencies. After the breakout of the crisis Alan Greenspan agreed to this opinion in 2007. At least the Financial Crisis Inquiry Report confirmed this point of view in 2011.

It was difficult to implement Basel II in the regulatory environment prior to 2008, and progress was generally slow until that year's major banking crisis caused mostly by credit default swaps, mortgage-backed security markets and similar derivatives, which leads to introduction of Basel III. As Basel III was negotiated, this was top of mind, and accordingly much more stringent standards were contemplated, and quickly adopted in some key countries including the USA.

Basel III is a global, voluntary regulatory standard on bank capital adequacy, stress testing and market liquidity risk. It was agreed upon by the members of the Basel Committee on Banking Supervision in 2010–11, and was scheduled to be introduced from 2013 until 2015; however, changes from 1 April 2013 extended implementation until 31 March 2018 and again extended to 31 March 2019. Basel III was supposed to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

Key Principles

Capital Requirements

The original Basel III rule from 2010 was supposed to require banks to hold 4.5% of common equity (up from 2% in Basel II) and 6% of Tier I capital (including common equity and up from 4% in Basel II) of "risk-weighted assets" (RWAs).[3] Basel III introduced two additional "capital buffers"—a "mandatory capital conservation buffer" of 2.5% and a "discretionary counter-cyclical buffer" to allow national regulators to require up to an additional 2.5% of capital during periods of high credit growth.

Leverage Ratio

Basel III introduced a minimum "leverage ratio". The leverage ratio was calculated by dividing Tier 1 capital by the bank's average total consolidated assets (not risk weighted); The banks were expected to maintain a leverage ratio in excess of 3% under Basel III. In July 2013, the U.S. Federal Reserve announced that the minimum Basel III leverage ratio would be 6% for 8 Systemically important financial institution (SIFI) banks and 5% for their insured bank holding companies.[6]

Liquidity Requirements

Basel III introduced two required liquidity ratios.[7] The "Liquidity Coverage Ratio" was supposed to require a bank to hold sufficient high-quality liquid assets to cover its total net cash outflows over 30 days; the Net Stable Funding Ratio was to require the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress.

Basel 4 is a proposed standard on capital reserves, for banks, which would follow Basel III

Basel 4 is likely to include:

- Requiring higher leverage ratios for banks;
- Emphasizing simpler or standardized models, rather than banks' internal models, for calculation of capital requirements;
- More detailed disclosure of reserves.

British banks alone may have to set aside another £50Bn of reserves. Basel III's rules increased the amount of capital that banks must hold, and set a core tier 1 capital ratio of 7%. The technical implementation deadline for Basel III is 2019, but recent developments in the banking market have suggested that even stricter rules may be applied by a later framework, which has been dubbed "Basel 4". The Basel Committee on Banking Supervision released a consultative paper, seeking out views on the Committee's plan to change how capital requirements and market risks are calculated.

V Research Methodology:

This paper focus on the reforms instituted in the banking industry special reference to Basel Accord. The data are collected from various sources such as paper, articles, journals, magazines, various websites etc.

VI Conclusions and Findings:

Indian banks have come a long way since independence and more so after LPG era, however, still they have to cover some distance so as to become the best banks globally. The banking reforms which are in the process are on the right direction and the Indian banks too.

Unlike Basel I and Basel II, which focus primarily on the level of bank loss reserves that banks are required to hold, Basel III focuses primarily on the risk of a run on the bank by requiring differing levels of reserves for different forms of bank deposits and other borrowings. Therefore, Basel III rules do not, for the most part, supersede the guidelines known as Basel I and Basel II; rather, it will work alongside them.

Basel IV is a proposed standard on capital reserves, for banks, which would follow Basel III such as requiring higher leverage ratios for banks; Emphasizing simpler or standardized models, rather than banks' internal models, for calculation of capital requirements; More detailed disclosure of reserves.

These reforms have some positive responds on various economic variables like enhancing the role of market forces, huge decline in the rate of interest, reduction of NPAs, up gradation of technology etc. They have adopted best structures, processes and technologies available worldwide and have moved from strength to strength. Still the future poses challenging for the banking industry.

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