An Overview on Basel Committee

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ABSTRACT

Face of Global Banking is undergoing a transition. Banking is now a global issue. Reforms in the financial sector, covering banking, insurance, financial markets, trade, taxation etc. It is a major catalyst in strengthening the fundamentals of the Indian economy. The reform measures have brought about sweeping changes in this critical sector of the Indian's economy. This article aims to first build a deeper understanding of the emergence of Basel banking norms (Basel I), and the transition to each of the subsequent regulations (Basel II and Basel III). The primary purpose of developing this understanding is to further analyze the extent of effectiveness of the Basel norms. To explore how such regulations impact an economy, we have specifically looked at four economies of the world, which are geographically apart, in this context. The idea here is to study how, for instance, banking institutions have shaped up to these norms – and whether the effects were favorable or adverse. We then conclude by conceptually looking at the future direction of regulations such as the Basel norms in the banking industry.

KEYWORDS: Basel Norms, Basel Committee, Banking Regulation, Basel I, Basel II, Basel III

INTRODUCTION

The Basel Committee - initially named the Committee on Banking Regulations and Supervisory Practices - was established by the central bank Governors of the Group of Ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets (notably the failure of Bankhaus Herstatt in West Germany). The Basel Banking Accords are norms issued by the Basel Committee on Banking Supervision (BCBS), formed under the auspices of the Bank of International Settlements (BIS), located in Basel, Switzerland. The committee formulates guidelines and makes recommendations on best practices in the banking industry. The Basel Accords, which govern capital adequacy norms of the banking sector, aim to ensure financial stability and thereby increase risk absorbing capability of the banks.

The Committee, headquartered at the Bank for International Settlements in Basel, was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters. The Committee's first meeting took place in February 1975, and meetings have been held regularly three or four times a year since. Since its inception, the Basel Committee has expanded its membership from the G10 to 45 institutions from 28 jurisdictions. Starting with the Basel Concordat, first issued in 1975 and revised several times since, the Committee has established a series of international standards for bank regulation, most notably its landmark publications of the accords on capital adequacy which are commonly known as Basel I, Basel II and, most recently, Basel III.

THE OBJECTIVE OF BASEL COMMITTEE:

The purpose of BCBS is to encourage convergence toward common approaches and standards. The Committee is not a classical multilateral organization, in part because it has no founding treaty. BCBS does not issue binding regulation; rather, it functions as an informal forum in which policy solutions and standards are developed.

Methodology:

The type of data that is used in the study is stated here. For this study, we have relied totally on books, magazine, various reports and different government websites. Thus the type of data used here is SECONDARY data.

Implementation of BASEL Committee:

A first step in this direction was the paper issued in 1975 that came to be known as the "Concordat". The Concordat set out principles for sharing supervisory responsibility for banks' foreign branches, subsidiaries and joint ventures between host and parent (or home) supervisory authorities. In May 1983, the Concordat was revised and re-issued as Principles for the supervision of banks' foreign establishments.

In April 1990, a supplement to the 1983 Concordat was issued. This supplement, Exchanges of information between supervisors of participants in the financial markets, aimed to improve the cross-border flow of prudential information between banking supervisors. In July 1992, certain principles of the Concordat were reformulated and published as the Minimum standards for the supervision of international banking groups and their cross-border establishments. These standards were communicated to other banking supervisory authorities, which were invited to endorse them.

In October 1996, the Committee released a report on the supervision of cross border banking, drawn up by a joint working group that included supervisors from non-G10 jurisdictions and offshore centre. The document presented proposals for overcoming the impediments to effective consolidated supervision of the cross-border operations of international banks. Subsequently endorsed by supervisors from 140 countries, the report helped to forge relationships between supervisors in home and host countries.

The involvement of non-G10 supervisors also played a vital part in the formulation of the Committee core principles for effective banking supervision in the following year. The impetus for this document came from a 1996 report by the G7 finance ministers that called for effective supervision in all important financial marketplaces, including those of emerging market economies. When first published in September 1997, the paper set out 25 basic principles that the Basel Committee believed should be in place for a supervisory system to be effective. After several revisions, most recently in September 2012, the document now includes 29 principles, covering supervisory powers, the need for early intervention and timely supervisory actions, supervisory expectations of banks, and compliance with supervisory standards.

Basel I: The Basel Capital Accord

In the early 1980s, the onset of the Latin American debt crisis heightened the Committee's concerns that the capital ratios of the main international banks were deteriorating at a time of growing international risks. Backed by the G10 Governors, Committee members resolved to halt the erosion of capital standards in their banking systems and to work towards greater convergence in the measurement of capital adequacy. This resulted in a broad consensus on a weighted approach to the measurement of risk, both on and off banks' balance sheets.

There was strong recognition within the Committee of the overriding need for a multinational accord to strengthen the stability of the international banking system and to remove a source of competitive inequality arising from differences in national capital requirements. Following comments on a consultative paper published in December 1987, a capital measurement system commonly referred to as the *Basel Capital Accord* was approved by the G10 Governors and released to banks in July 1988.

The Accord was always intended to evolve over time. It was amended in November 1991 to more precisely define the general provisions or general loan loss reserves that could be included in the capital adequacy calculation. In April 1995, the Committee issued another amendment, to take effect at the end of that year, to recognize the effects of bilateral netting of banks' credit exposures in derivative products and to expand the matrix of add-on factors. In April 1996, another document was issued explaining how Committee members intended to recognize the effects of multilateral netting.

The Committee also refined the framework to address risks other than credit risk, which was the focus of the 1988 Accord. In January 1996, following two consultative processes, the Committee issued the *Amendment to the Capital Accord to incorporate market risks* (or Market Risk Amendment), to take effect at the end of 1997. This was designed to incorporate within the Accord a capital requirement for the market risks arising from banks' exposures to foreign exchange, traded debt securities, equities, commodities and options. An important aspect of the Market Risk Amendment was that banks were, for the first time, allowed to use internal models (value-at-risk models) as a basis for measuring their market risk capital requirements, subject to strict quantitative and qualitative standards. Much of the preparatory work for the market risk package was undertaken jointly with securities regulators.

Basel I Accord attempts to create a cushion against credit risk. It comprises of **four pillars**, namely

i. **Constituents of Capital**: It prescribes the nature of capital that is eligible to be treated as reserves.

ii. **Risk Weighting**: Risk Weighting created a comprehensive system to provide weights to different categories of bank's assets (on balance sheet as well as off balance sheet assets) on the basis of relative riskiness.

iii. **Target Standard Ratio**: This acted as a unifying factor between the first two pillars. A universal standard of 8% coverage of risk weighted assets by Tier I and II capital was set, with at least 4% being covered by Tier I capital alone.

iv. **Transitional & implementing arrangements**: Phase wise implementation deadlines were set wherein a target of 7.25% was to be achieved by the end of 1990 and 8% by the end of 1992.

Basel II: the new capital framework

In June 1999, the committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord. This led to the release of a revised capital framework in June 2004. Generally known as "Basel II", the revised framework comprised **three pillars**:

1. Minimum capital requirement, which sought to develop and expand the standardized rules set out in the 1988 Accord
2. Supervisory review of an institution's capital adequacy and internal assessment process
3. Effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices.

The new framework was designed to improve the way regulatory capital requirements reflect underlying risks and to better address the financial innovation that had occurred in recent years. The changes aimed at rewarding and encouraging continued improvements in risk measurement and control.

The framework's publication in June 2004 followed almost six years of intensive preparation. During this period, the Basel Committee consulted extensively with banking sector representatives, supervisory agencies, central banks and outside observers in order to develop significantly more risk-sensitive capital requirements.

Committee members and several non-members agreed to adopt the new rules, albeit on varying timescales. One challenge that supervisors worldwide faced under Basel II was the need to approve the use of certain approaches to risk measurement in multiple jurisdictions. While this was not a new concept for the supervisory community - the Market Risk Amendment of 1996 involved a similar requirement - Basel II extended the scope of such approvals and demanded an even greater degree of cooperation between home and host supervisors. To help address this issue, the Committee issued guidance on information-sharing in 2006, followed by advice on supervisory cooperation and allocation mechanisms in the context of the advanced measurement approaches for operational risk.

Basel III:

Basel III is an extension of the existing Basel II Framework, and introduces new capital and liquidity standards to strengthen the regulation, supervision, and risk management of the whole of the banking and finance sector. It was agreed upon by the members of the Basel Committee on Banking Supervision in 2010–2011, and was scheduled to be introduced from 2013 until 2015. However, changes made from April 2013 extended implementation until March 31, 2018.

The Basel III requirements were in response to the deficiencies in financial regulation that is revealed by the 2000's financial crisis. Basel III was intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

The global capital framework and new capital buffers require financial institutions to hold more capital and higher quality of capital than under current Basel II rules. The new leverage ratio introduces a non risk-based measure to supplement the risk-based minimum capital requirements. The new liquidity ratios ensure that adequate funding is maintained in case there are other severe banking crises.

Basel III comprised **three pillars**:

Pillar 1- Minimum Capital Requirement (Basel III Pillar 1 Enhanced Minimum Capital & Liquidity Requirement.)

Pillar 2- Supervisory Review Process

Pillar 3- Enhanced Disclosure (Discipline of Market).

The proposed standards were issued by the Committee in mid-December 2010 (and have been subsequently revised). The December 2010 versions were set out *in Basel III: International framework for liquidity risk measurement, standards and monitoring and Basel III: A global regulatory framework for more resilient banks and banking systems*. The enhanced Basel framework revises and strengthens the three pillars established by Basel II, and extends it in several areas. Most of the reforms are being phased in between 2013 and 2019:

- stricter requirements for the quality and quantity of regulatory capital, in particular reinforcing the central role of common equity
- an additional layer of common equity - the capital conservation buffer - that, when breached, restricts payouts to help meet the minimum common equity requirement
- a countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts
- a leverage ratio - a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting
- Liquidity requirements - a minimum liquidity ratio, the Liquidity Coverage Ratio (LCR), intended to provide enough cash to cover funding needs over a 30-day period of stress; and a longer-term ratio, the Net Stable Funding Ratio (NSFR), intended to address maturity mismatches over the entire balance sheet.

The Committee completed its Basel III post-crisis reforms in 2017, with the publication of new standards for the calculation of capital requirements for credit risk, credit valuation adjustment risk and operational risk. The final reforms also include a revised leverage ratio, a leverage ratio buffer for global systemically important banks and an output floor, based on the revised standardized approaches, which limits the extent to which banks can use internal models to reduce risk-based capital requirements. These final reforms address shortcomings of the pre-crisis regulatory framework and provide a regulatory foundation for a resilient banking system that supports the real economy. A key objective of the revisions was to reduce excessive variability of risk-weighted assets (RWA).

CONCLUSION:

The Basel norms, at some level, aim to create a global banking system that is fairly homogenous. While this very aim purports to build a more robust financial system, it may actually be its undoing. Simply speaking, a diverse group is an advantage since an attack only affects a certain percentage of its constituents. The Basel norms also fail to consider national competencies. We have a global scenario where individual countries vastly differ in their extent of development. In an age where international banks are so prevalent, such differences across geographies can become tricky to deal with. The Basel Committee intends to replace the current Capital Accord with a New Framework which is built on a three-pillar approach minimum capital requirement, supervisory review and market. There is also a need for improving further the accounting and disclosure standards to fall in line with the international best practices. Refinements in market risk management will have to be made by adopting sophisticated techniques like duration and simulation and adoption of internal model-based approaches and credit risk modeling techniques by top banks.

The RBI has accepted the Basel Committee's Core Principles for effective banking supervision. There are gaps in the areas of consolidated supervision, country and transfer risk monitoring, inter-agency co-operation and cross border supervision. The Basel accords need to incorporate, in some form, the element of national competencies so as to create a level-playing field. While the Basel accords aim to bring along a host of benefits, they inevitably imply high costs for the adopting nations. This is especially true because there is no single set of dates corresponding to the implementation of a particular Basel regulation (say, Basel III) worldwide. This lack of synchronization in the adoption of the norms dilutes their efficacy. The proposal of phases and timelines for implementation should be put forth in a manner that ensures a fair amount of coordinated adoption.

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