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Theme 230

NEW CAPITAL FRAMEWORK FOR BANKS -BASEL III PART I

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Theme No. 230 : NEW CAPITAL FRAMEWORK FOR BANKS – BASEL III PART I

When business enterprises depend on debt funds, a minimum level of capital – own funds - will be required for ensuring solvency of the enterprise. This means that even in extreme stress situations, the enterprise should be able to pay back fully its creditors. The capital funds apart from bringing in the stake of the owner, also serves as a cushion absorbing any unexpected losses, which cannot be passed on to the creditors. When banks lend funds to the borrowers, they stipulate the minimum capital funds the borrower has to bring in to ascertain stake of the borrower as well as solvency of the enterprise so that the bank loans may be recoverable any time. But when banks do the business of banking, what should be the capital requirement for the banks? What should be the minimum level of adequate capital whereby the depositors'/ creditors' interests are protected? The Basel Committee, under the auspices of the Bank for International Settlements based in Basle in Switzerland issued guidelines for capital ratios for banks, known as Basel I in 1988 and Basel II in 2004 and has now come out with a new capital framework known as Basel III. In the aftermath of the global economic crisis, originated from the sub-prime mortgage lending by the banks in the US, that resulted in bankruptcy and failure of many banks, it was found imperative that the new framework should address these issues comprehensively to account for the risk-taking business of the banks.

Briefly trace the developments in determining capital adequacy for banks under the Basel Committee?

The Basel I was the first internationally agreed capital standard, which was issued in 1988. It linked capital requirement of the bank to the assets it owns and specifically was made dependent on the 'riskiness' of the assets – capital should be adequate to account for the credit risk. Thus capital to risk-weighted assets ratio was considered appropriate for banking institutions to take care of the interests of the depositors and other stakeholders. The Basel I required that 8 percent is the minimum level of capital to be held against the sum of all risk-weighted assets.

In 1996, the dimension of market risk was added to the framework of capital adequacy wherein it was mandated that there should be enough capital to account for the volatilities in the prices of assets the bank holds in the form of securities, gold, and foreign exchange.

Then in 2004, Basel II framework of capital ratio was introduced to further fine-tune capital standards for banks. Operational aspects such as failure of systems, procedures and personnel had caused heavy casualties for banks leading to their bankruptcy, and thus it was considered essential to account for the risks arising from such operations in the capital ratio of banks. Various methods were recommended to account for operational risk in practice. Also, as part of capital standards, apart from minimum capital ratio requirements, two additional dimensions were added for determination of adequacy of capital for a bank – capital ratio being subject to supervisory review process and disclosure requirements. The Basel II also allowed banks to use internal risk rating systems and approaches to measure credit and operational risk for capital purposes.

Explain the circumstances leading to the revision of capital ratios under Basel III?

The global economic crisis that emanated from banking crisis in the US led to a rethinking on banks' capital standards. Inadequacy of capital cannot be stated to the sole cause of the crisis. But it was found that the existing capital framework did not take into account some of the most prominent risky business segments of the banks. Therefore the coverage of risk-based assessment of capital needed to be extended. Capital adequacy had to address not only firm-level / individual bank level risks but also systemic risks which are beyond the control of individual banks. The issues of 'too big to fail/save' and 'too interconnected to fail' needed to be addressed in the new capital framework. Before the crisis, there was a belief that the big banks will never fail and that the system is too interconnected to cause any major disruption. So from the failure of the banks and financial systems, it was deemed necessary to strengthen them by more relevant regulatory standards and capital ratios.

Risk assessment was based on Value at Risk (VaR) which was more appropriate for normal periods – it was based on normality assumption. The financial crisis events of the recent periods are considered to be 'tail events'- events with low frequency but severe impact. These are also to be accounted for in any sustainable

capital framework for banks. Again, abundance and imbalances of global liquidity are stated to be the prime causes of the recent economic crisis. But, once the crisis evolved, banks suffered from liquidity shortage, leading to bankruptcy of many banks. Thus, it was found necessary to address short-term and long-term requirements of sufficient liquidity for the banking system.

What are the new major themes of Basel III?

Capital ratio is defined as the ratio of capital to the risk weighted assets. In this ratio, the numerator denotes capital and the denominator indicates risk-weighted assets. It is envisaged in Basel III to aim for better and higher quality of capital – the component of common equity will increase in the numerator of the ratio. As regards the denominator, better risk coverage of the assets is ensured. Aside from the basic capital ratio, there are two additional capital requirements in Basel III – Capital Conservation buffer and Contracyclical capital buffer. These capital buffers are like shock absorbers in crisis times. A leverage ratio is introduced in Basel III as a backstop to the risk-based capital ratio. This will take into account total assets of the bank including off-balance sheet items, which had a phenomenal growth in the periods prior to the banking crisis.

Basel III has two types of global liquidity standards which are meant to address short-term and long-term liquidity requirements of the banks. Systematically Important Financial Institutions (SIFI) and Systematically Important Markets and Infrastructure (SIMI) are two important segments which can cause disruption to the financial system owing to malfunctioning. The banking crisis aggravated owing to failure of banks considered "too big to fail" and failure of the liquidity system considered "too interconnected to fail". Basel III recommendations include developing standards requiring additional capital for SIFIs and setting up robust payment and settlement systems in place of OTC (over-the –counter) markets. Thus capital framework of Basel III has wider coverage to enhance the efficacy of the supervisory regime.

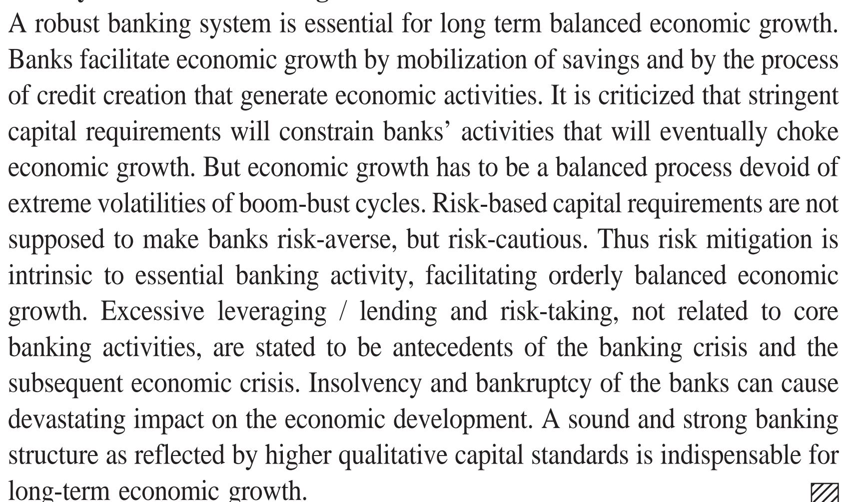
How is Basel III related to earlier Basel Accords – I & II?

The scope and coverage of capital requirements have been amplified under the successive Basel Accords – I, II and III. The main theme of capital to risk weighted assets ratio (CRAR) has continued from the Basel I Accord. The capital supervision framework of the banks has been demarcated as consisting of three segments known as pillar I, pillar II and pillar III under Basel II. The pillar I consists of

minimum capital requirements. The pillar II pertains to supervisory review process and Pillar III overviews disclosure and market discipline relating to capital adequacy. Basically, the same supervisory structure has been maintained in Basel III. But there are enhanced requirements to be fulfilled under each supervisory mechanism.

The capital buffers, leverage ratio and global liquidity standards are innovative developments under Basel III against the backdrop of the recent banking crisis. Also the mechanisms to control SIFIs and SIMI are recommended under Basel III. Credit risk, market risk and operational risk are the risk factors for which risk absorbing capital requirements were stipulated under Basel I and Basel II. Basel III accounts for an additional risk factor in the financial system called as system-wide systemic risks. Banks may fail owing to the failure of the other system components in the overall financial system. This necessitates extension of financial regulation from firm-level micro-prudential regulation to system-wide macro-prudential regulation. These aspects are covered under Basel III.

Is it correct to say that enhanced capital standards will curtail banking activity and thus economic growth?



A robust banking system is essential for long term balanced economic growth. Banks facilitate economic growth by mobilization of savings and by the process of credit creation that generate economic activities. It is criticized that stringent capital requirements will constrain banks' activities that will eventually choke economic growth. But economic growth has to be a balanced process devoid of extreme volatilities of boom-bust cycles. Risk-based capital requirements are not supposed to make banks risk-averse, but risk-cautious. Thus risk mitigation is intrinsic to essential banking activity, facilitating orderly balanced economic growth. Excessive leveraging / lending and risk-taking, not related to core banking activities, are stated to be antecedents of the banking crisis and the subsequent economic crisis. Insolvency and bankruptcy of the banks can cause devastating impact on the economic development. A sound and strong banking structure as reflected by higher qualitative capital standards is indispensable for long-term economic growth.

Implementation of Basel Accord I, II & III

July 1988	Basel I regulations issued
December 1992	Basel I regulations fully implemented
December 1996	Market Risk regulation issued
December 1997	Market Risk regulations implemented
June 2004	Basel II Accord issued
December 2006	Basel II implemented
December 2007	Basel II advanced approaches implemented
July 2009	Revised securitization & trading book rules issued
December 2009	Basel III consultative document issued
November 2010	G20 national leaders endorsed Basel III rules
December 2011	Trading book rules to be implemented
January 1, 2013	Basel III implementation begins
January 1, 2019	Basel III to be fully implemented

Basel I Accord was issued as the first internationally agreed capital standard for banks. Capital adequacy was related to credit risk and 8 percent minimum level of capital was stipulated against risk-weighted assets. Later, market risk was included to account for capital adequacy. Basel II Accord was issued in 2004 and it added operational risk also for capital adequacy. It expanded credit risk weighting system and provided for internal credit rating approaches to measure credit and operational risks. Basel III is formulated against the backdrop of the banking crisis and seeks to strengthen capital ratio with more enhanced features.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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