**B.com 4th Semester, 2020**

**SUB: International Banking (Finance Major)**

**UNIT 5: REGULATIONS OF INTERNATIONAL BANKING**

**Question: Explain about Basel Committee on Banking Supervision (BCBS). 10 marks.**

**Introduction of Basel Committee (Basel Norms):**

The Basel Committee was formed in response to the messy liquidation of [Cologne](https://en.wikipedia.org/wiki/Cologne)-based [Herstatt Bank](https://en.wikipedia.org/wiki/Herstatt_Bank) in 1974. On 26 June 1974 a number of banks had released [Deutschmarks](https://en.wikipedia.org/wiki/German_mark) (the German currency) to the [Herstatt Bank](https://en.wikipedia.org/wiki/Herstatt_Bank) in exchange for [dollar](https://en.wikipedia.org/wiki/US_dollar) payments deliverable in [New York City](https://en.wikipedia.org/wiki/New_York_City). Due to differences in the [time zones](https://en.wikipedia.org/wiki/Time_zone), there was a lag in the dollar payment to the [counterparty](https://en.wikipedia.org/wiki/Counterparty) banks; during this lag period, before the dollar payments could be effected in New York, the Herstatt Bank was liquidated by German regulators.

This incident prompted the G-10 nations to form the Basel Committee on Banking Supervision in late 1974, under the auspices of the [Bank for International Settlements](https://en.wikipedia.org/wiki/Bank_for_International_Settlements) (BIS) located in [Basel](https://en.wikipedia.org/wiki/Basel), [Switzerland](https://en.wikipedia.org/wiki/Switzerland).

**Basel I (Basel Accord):**

**Basel I** is the round of deliberations by [central bankers](https://en.wikipedia.org/wiki/Central_banking) from around the world, and in **1988,** the [**Basel Committee on Banking Supervision**](https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision) **(BCBS) in**[**Basel**](https://en.wikipedia.org/wiki/Basel)**,**[**Switzerland**](https://en.wikipedia.org/wiki/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**](https://en.wikipedia.org/wiki/Group_of_Ten_%28economic_1962%29)**(G-10)** countries in 1992. A new set of rules known as [Basel II](https://en.wikipedia.org/wiki/Basel_II) was later developed with the intent to supersede the Basel I accords. 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](https://en.wikipedia.org/wiki/Subprime_mortgage_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](https://en.wikipedia.org/wiki/Basel_III) was developed in response to the [financial crisis](https://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932010); it does not supersede either Basel I or IIbut focuses on different issues primarily related to the risk of a [bank run](https://en.wikipedia.org/wiki/Bank_run).

Basel I, that is, the 1988 Basel Accord, is primarily focused on [credit risk](https://en.wikipedia.org/wiki/Credit_risk) and appropriate [risk-weighting of assets](https://en.wikipedia.org/wiki/Risk-weighted_asset). Assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of 0% (for example cash, [bullion](https://en.wikipedia.org/wiki/Bullion), home country debt like Treasuries), 20% (securitizations such as [Mortgage-Backed Securities](https://en.wikipedia.org/wiki/Mortgage-backed_security) (MBS) with the highest **AAA**[**rating**](https://en.wikipedia.org/wiki/Bond_credit_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).

**The tier 1 capital ratio = tier 1 capital / all RWA**

**The total capital ratio = (tier 1 + tier 2 capital) / all RWA**

**Leverage ratio = total capital/average total assets**

Banks are also required to report [off-balance-sheet](https://en.wikipedia.org/wiki/Off-balance-sheet) items such as letters of credit, unused commitments, and derivatives. These all factor into the risk weighted assets. The report is typically submitted to the [Federal Reserve Bank](https://en.wikipedia.org/wiki/Federal_Reserve_Bank) as HC-R for the bank-holding company and submitted to the [Office of the Comptroller of the Currency](https://en.wikipedia.org/wiki/Office_of_the_Comptroller_of_the_Currency) (OCC) as RC-R for just the bank.

From 1988 this framework was progressively introduced in member countries of G-10, comprising 13 countries:  [**Belgium**](https://en.wikipedia.org/wiki/Belgium)**,**[**Canada**](https://en.wikipedia.org/wiki/Canada)**,**[**France**](https://en.wikipedia.org/wiki/France)**,**[**Germany**](https://en.wikipedia.org/wiki/Germany)**,**[**Italy**](https://en.wikipedia.org/wiki/Italy)**,**[**Japan**](https://en.wikipedia.org/wiki/Japan)**,**[**Luxembourg**](https://en.wikipedia.org/wiki/Luxembourg)**,**[**Netherlands**](https://en.wikipedia.org/wiki/Netherlands)**,**[**Spain**](https://en.wikipedia.org/wiki/Spain)**,** [**Sweden**](https://en.wikipedia.org/wiki/Sweden)**,**[**Switzerland**](https://en.wikipedia.org/wiki/Switzerland)**,**[**United Kingdom**](https://en.wikipedia.org/wiki/United_Kingdom)**and the**[**United States of America**](https://en.wikipedia.org/wiki/United_States_of_America)**.**

Over 100 other countries also adopted, at least in name, the principles prescribed under Basel I. The efficacy with which the principles are enforced varies, even within nations of the Group.

**Basel I A:**

**Basel IA** was proposed as an intermediate between the current [Basel I](https://en.wikipedia.org/wiki/Basel_I) accord and the [Basel II](https://en.wikipedia.org/wiki/Basel_II) accord that is being implemented. Basel IA would have been more risk sensitive than Basel I but would not be as complex as the advanced approach under Basel II.

On July 20, 2007 by a deal between the various US banking regulators ([The Federal Reserve](https://en.wikipedia.org/wiki/The_Federal_Reserve), the [Office of the Comptroller of the Currency](https://en.wikipedia.org/wiki/Office_of_the_Comptroller_of_the_Currency), the [Office of Thrift Supervision](https://en.wikipedia.org/wiki/Office_of_Thrift_Supervision) and the [Federal Deposit Insurance Corporation](https://en.wikipedia.org/wiki/Federal_Deposit_Insurance_Corporation)) it was decided to drop the proposed Basel IA and allow Basel II Standardized in its place.

The US initially proposed that banks would need to use the advanced approach only if they were to implement Basel II. The idea of Basel IA was to enable smaller US banks to adopt a methodology that is more risk sensitive than Basel I that they are currently using for calculating capital adequacy. The Fed chairman mentioned that smaller banks who do not wish to move to Basel II Advanced or Basel IA could continue to operate under Basel I.

**Basel II:**

**Basel II** is the second of the [Basel Accords](https://en.wikipedia.org/wiki/Basel_Accords), (now extended and partially superseded by [Basel III](https://en.wikipedia.org/wiki/Basel_III)), which are recommendations on banking laws and regulations issued by the [Basel Committee on Banking Supervision](https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision).

The Basel II Accord was published initially in June 2004 and was intended to amend international banking standards that controlled how much capital banks were required to hold to guard against the financial and operational risks banks face. These regulations aimed to ensure that the more significant the risk a bank is exposed to, the greater the amount of capital the bank needs to hold to safeguard its [solvency](https://en.wikipedia.org/wiki/Solvency) and overall economic stability. Basel II attempted to accomplish this by establishing [risk](https://en.wikipedia.org/wiki/Risk_management) and capital management requirements to ensure that a bank has [adequate capital](https://en.wikipedia.org/wiki/Capital_adequacy) for the risk the bank exposes itself to through its lending, investment and trading activities. One focus was to maintain sufficient consistency of regulations so to limit competitive inequality amongst internationally active banks.

Basel II was implemented in the years prior to 2008, and was only to be implemented in early 2008 in most major economies; the [financial crisis of 2007–2008](https://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932008) intervened before Basel II could become fully effective. As [Basel III](https://en.wikipedia.org/wiki/Basel_III) was negotiated, the crisis was top of mind and accordingly more stringent standards were contemplated and quickly adopted in some key countries including in Europe and the US.

**Objectives:**

The final version aims at:

1. Ensuring that [capital allocation](https://en.wikipedia.org/wiki/Capital_requirement) is more risk-sensitive;
2. Enhancing disclosure requirements which would allow market participants to assess the capital adequacy of an institution;
3. Ensuring that [credit risk](https://en.wikipedia.org/wiki/Credit_risk), [operational risk](https://en.wikipedia.org/wiki/Operational_risk) and [market risk](https://en.wikipedia.org/wiki/Market_risk) are quantified based on data and formal techniques;
4. Attempting to align economic and regulatory capital more closely to reduce the scope for [regulatory arbitrage](https://en.wikipedia.org/wiki/Regulatory_arbitrage).

While the final accord has at large addressed the regulatory arbitrage issue, there are still areas where regulatory [capital requirements](https://en.wikipedia.org/wiki/Capital_requirement) will diverge from the [economic capital](https://en.wikipedia.org/wiki/Economic_capital).

## Three (3) pillars of Basel Accord:

Basel II uses a "three pillars" concept –

(1) [minimum capital requirements](https://en.wikipedia.org/wiki/Capital_requirement) (addressing risk),

(2) [supervisory review](https://en.wikipedia.org/wiki/Bank_regulation#Supervisory_review) and

(3) [market discipline](https://en.wikipedia.org/wiki/Market_discipline).

The [Basel I](https://en.wikipedia.org/wiki/Basel_I) accord dealt with only parts of each of these pillars. For example: concerning the first Basel II pillar, only one risk, credit risk, was dealt with easily while the market risk was an afterthought; operational risk was not dealt with at all.

### The first pillar: Minimum capital requirements

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: [credit risk](https://en.wikipedia.org/wiki/Credit_risk), [operational risk](https://en.wikipedia.org/wiki/Operational_risk), and [market risk](https://en.wikipedia.org/wiki/Market_risk). Other risks are not considered fully quantifiable at this stage.

1. The [credit risk](https://en.wikipedia.org/wiki/Credit_risk) component can be calculated in three different ways of varying degree of sophistication, namely [standardized approach](https://en.wikipedia.org/wiki/Standardized_approach_%28credit_risk%29), [Foundation IRB](https://en.wikipedia.org/wiki/Foundation_IRB), [Advanced IRB](https://en.wikipedia.org/wiki/Advanced_IRB). IRB stands for "Internal Rating-Based Approach".
2. For [operational risk](https://en.wikipedia.org/wiki/Operational_risk), there are three different approaches –
	1. [basic indicator approach](https://en.wikipedia.org/wiki/Basic_indicator_approach) or BIA,
	2. [standardized approach](https://en.wikipedia.org/wiki/Standardized_approach_%28operational_risk%29) or TSA,
	3. the internal measurement approach (an advanced form of which is the [advanced measurement approach](https://en.wikipedia.org/wiki/Advanced_measurement_approach) or AMA).
3. For [market risk](https://en.wikipedia.org/wiki/Market_risk) the preferred approach is VaR ([value at risk](https://en.wikipedia.org/wiki/Value_at_risk)).

As the Basel II recommendations are phased in by the banking industry it will move from standardized requirements to more refined and specific requirements that have been developed for each risk category by each bank. The upside for banks that do develop their bespoke risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In the future, there will be closer links between the concepts of economic and regulatory capital.

### The second pillar: Supervisory operations

This is a regulatory response to the first pillar, giving [regulators](https://en.wikipedia.org/wiki/Bank_regulation) better 'tools' over those previously available. It also provides a framework for dealing with [systemic risk](https://en.wikipedia.org/wiki/Systemic_risk), [pension risk](https://en.wikipedia.org/w/index.php?title=Pension_risk&action=edit&redlink=1), [concentration risk](https://en.wikipedia.org/wiki/Concentration_risk), [strategic risk](https://en.wikipedia.org/wiki/Strategic_risk), [reputational risk](https://en.wikipedia.org/wiki/Reputational_risk), [liquidity risk](https://en.wikipedia.org/wiki/Liquidity_risk) and [legal risk](https://en.wikipedia.org/wiki/Legal_risk), which the accord combines under the title of residual risk. Banks can review their risk management system.

The Internal Capital Adequacy Assessment Process (ICAAP) is a result of Pillar 2 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](https://en.wikipedia.org/wiki/Market_discipline) supplements regulation as sharing of information facilitates the 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. It must be consistent with how the senior management, including the board, access and manage the risks of the institution.

When market participants have a sufficient understanding of a bank's activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organizations so that they can reward those that manage their risks prudently and penalize those that do not.

These disclosures are required to be made at least twice a year, except qualitative disclosures providing a summary of the general risk management objectives and policies which can be made annually. 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.

In India, [Reserve Bank of India](https://en.wikipedia.org/wiki/Reserve_Bank_of_India) has implemented the Basel II standardized norms on 31 March 2009 and is moving to internal ratings in credit and AMA (Advanced Measurement Approach) norms for operational risks in banks.

Existing RBI norms for banks in India (as of September 2010): Common equity (inclusive of buffer): 3.6% (Buffer Basel 2 requirement requirements are zero); Tier 1 requirement: 6%. Total Capital: 9% of risk-weighted assets.

According to the draft guidelines published by RBI the capital ratios are set to become: Common Equity as 5% + 2.5% (Capital Conservation Buffer) + 0–2.5% (Counter Cyclical Buffer), 7% of Tier 1 capital and minimum capital adequacy ratio (excluding Capital Conservation Buffer) of 9% of Risk Weighted Assets. Thus the actual capital requirement is between 11 and 13.5% (including Capital Conservation Buffer and Counter Cyclical Buffer).

The Basel III standard aims to strengthen the requirements from the Basel II standard on bank's minimum capital ratios. In addition, it introduces requirements on liquid asset holdings and funding stability, thereby seeking to mitigate the risk of a [run on the bank](https://en.wikipedia.org/wiki/Run_on_the_bank).

**Basel III** (**Third Basel Accord** or **Basel Standards**):

Basel III (Third Basel Accord or Basel Standards) is a global, voluntary regulatory framework on bank [capital adequacy](https://en.wikipedia.org/wiki/Capital_adequacy),[stress testing](https://en.wikipedia.org/wiki/Bank_stress_tests), and [market liquidity](https://en.wikipedia.org/wiki/Market_liquidity) [risk](https://en.wikipedia.org/wiki/Liquidity_risk). This third installment of the [Basel Accords](https://en.wikipedia.org/wiki/Basel_Accords) was developed in response to the deficiencies in [financial regulation](https://en.wikipedia.org/wiki/Financial_regulation) revealed by the [financial crisis of 2007–08](https://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%9308). It is intended to strengthen bank [capital requirements](https://en.wikipedia.org/wiki/Capital_requirement) by increasing bank liquidity and decreasing bank [leverage](https://en.wikipedia.org/wiki/Leverage_%28finance%29).

Basel III was agreed upon by the members of the [Basel Committee on Banking Supervision](https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision) in November 2010, and was scheduled to be introduced from 2013 until 2015; however, implementation was extended repeatedly to 31 March 2019 and then again until 1 January 2022.

### Capital requirements:

The original Basel III rule from 2010 required banks to fund themselves with 4.5% of [common equity](https://en.wikipedia.org/wiki/Common_equity) (up from 2% in Basel II) of [risk-weighted assets](https://en.wikipedia.org/wiki/Risk-weighted_asset) (RWAs). Since 2015, a minimum Common Equity Tier 1 (CET1) ratio of 4.5% must be maintained at all times by the bank.This ratio is calculated as follows:

CET1RWAs≥4.5%{\displaystyle {\frac {\mbox{CET1}}{\mbox{RWAs}}}\geq 4.5\%}The minimum [Tier 1 capital](https://en.wikipedia.org/wiki/Tier_1_capital) increases from 4% in Basel II to 6%, applicable in 2015, over RWAs.This 6% is composed of 4.5% of CET1, plus an extra 1.5% of Additional Tier 1 (AT1).

**Two (2) additional pillars of Basel III:**

A mandatory "capital conservation buffer", equivalent to 2.5% of risk-weighted assets. Considering the 4.5% CET1 capital ratio required, banks have to hold a total of 7% CET1 capital ratio, from 2019 onwards.

1. A "discretionary [counter-cyclical](https://en.wikipedia.org/wiki/Counter-cyclical) buffer", allowing national regulators to require up to an additional 2.5% of capital during periods of high credit growth. The level of this buffer ranges between 0% and 2.5% of RWA and must be met by CET1 capital.

### Leverage ratio:

Basel III introduced a minimum "leverage ratio". This is a non-risk-based leverage ratio and is calculated by dividing Tier 1 capital by the bank's average total consolidated assets (sum of the exposures of all assets and non-balance sheet items).The banks are expected to maintain a leverage ratio in excess of 3% under Basel III.

Tier 1 CapitalTotal exposure≥3%{\displaystyle {\frac {\mbox{Tier 1 Capital}}{\mbox{Total exposure}}}\geq 3\%}In July 2013, the [U.S. Federal Reserve](https://en.wikipedia.org/wiki/U.S._Federal_Reserve) announced that the minimum Basel III leverage ratio would be 6% for 8 [Systemically important financial institution](https://en.wikipedia.org/wiki/Systemically_important_financial_institution) (SIFI) banks and 5% for their insured bank holding companies.

### Liquidity requirements:

Basel III introduced two required liquidity ratios.

* 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](https://en.wikipedia.org/wiki/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 IV:**

**Basel IV** is a contested term for the changes agreed in 2016 and 2017 to the international banking standards known as the [**Basel Accords**](https://en.wikipedia.org/wiki/Basel_Accords). Regulators argue that these changes are simply completing the [Basel III](https://en.wikipedia.org/wiki/Basel_III) reforms, agreed in principle in 2010–11, although most of the Basel III reforms were agreed in detail at that time. The Basel Committee (BCBS) itself calls them simply "finalized reforms" and the UK Government has called them **"Basel 3.1".** Critics of the reform, in particular those from the banking industry, argue that Basel IV require a significant increase in capital and should be treated as a distinct round of reforms.

Basel IV introduces changes that limit the reduction in capital that can result from banks' use of internal models under the [Internal Ratings-Based approach](https://en.wikipedia.org/wiki/Internal_ratings-based_approach_%28credit_risk%29). This includes:

* A standardized floor, so that the capital requirement will always be at least 72.5% of the requirement under the [Standardized approach](https://en.wikipedia.org/wiki/Standardized_approach_%28credit_risk%29).
* A simultaneous reduction in standardized [risk weights](https://en.wikipedia.org/wiki/Risk-weighted_asset) for low risk mortgage loans.
* Requiring banks to meet higher maximum leverage ratios (an initial leverage ratio maximum is likely to be set as part of the completion of the Basel III package);
* A higher [leverage ratio](https://en.wikipedia.org/wiki/Leverage_%28finance%29) for [Global Systemically Important Banks](https://en.wikipedia.org/wiki/Systemically_important_financial_institution) (G-SIBs), with the increase equal to 50% of the risk adjusted capital ratio.
* More detailed disclosure of reserves and other financial statistics.