BASEL III and SIMILAR REGULATIONS AFTER 2008 CRISIS

Introduction

Following the 2008 financial crisis, a regulatory framework targeted at investment due diligence integrity was developed and implemented. This regulation was what is now known as the Basel Accord, Basel III in particular. The Accords were developed over a number of years from the 1980's right through to the agreement of the Basel III in November 2010. This focuses specifically on Minimum Common Equity as well as Minimum Liquidity Ratios so as to ensure enough capital to meet obligations and cover unexpected losses.

I. Specific Outline

As a result of the Lehman Bros collapse and the subsequent financial crises in 2008, Basel III gives rise to revised capital and liquidity requirements specifically targeted at enhancing:

- Supervision
- Risk Management and,
- Regulation of the whole Finance and Banking sector.

The agreement was agreed upon in November 2010 by the Basel Committee on Banking Supervision (BCBS) which itself had been introduced in 1974 and had signed two other agreements prior to this one. Originally intended for implementation in 2013, changes in the implementation year caused a delay March 2018. This was a strengthening of the 3 pillars with added safeguards and requirements.

II. The Intended Effect of the Regulation

The regulation set out specific capital requirements to safeguard depositors in the unwanted case of failure. The focus of this agreement was to facilitate the ability and soundness of institutions to be able whether future periods of stressed markets. The measures are outlined below

Capital Requirements

Capital requirements were established to enable financial institutions to compensate depositors in the event of failure. A few of these measures are:

- Capital Conservation Buffer
- Countercyclical Capital Buffer
- Higher Common Equity Tier 1 (CET1)

Liquidity Requirements

Liquidity Coverage Ration
Ensures sufficient high quality liquid asset levels over a period of one month.

Net Stable Funding Ration (NSFR)
Encourages an ability to whether storms over the long term horizon via funding investment ventures through stable sources in a continuous and structured fashion.

Leverage Ratio

This is a calculation by finding the ratio of the Bank's Tier 1 capital to the average of its total consolidated assets. A minimum leverage ratio above 3% was stipulated under the Basel III, but the federal bank set it at 6% for about 8 banks and 5% for their holding companies.

Counter Party Credit Risk

This was to cover the adjustment risk of credit value, particularly through outlining capital requirements for securitized products.

III. <u>What Role did this play in Global Financial Crisis?</u>

Globally, Banks have taken it as a mission to play by the rules set up by international regulatory authorities to safeguard against a repeat of the 2008 financial crisis. The collapse of Global and Domestic Systematically Important Banks (GSIBs & DSIBs) is particularly what the Basel III accord is primarily focused on.

These standards and others are largely based on Euro and US markets, and this generic model being applied to all markets may not equally apply to all international jurisdictions, frameworks, Religious and financial cultures. For instance, Asian Markets differ from Euro/US Markets significantly with the rate of growth as well as the concentration of the fundamental economic drivers, with stronger focus on Agriculture than Tech and Industry like their counterpart markets. This in turn goes to treason that the universal glove approach does not work but a rather market specific calibration will reduce the varying degrees of compliance.

IV. <u>Possible advantages and disadvantages of the regulation</u>

- One size fits all may not be relevant across all markets.
- Constraining Banks in their lending and investing activities could reduce inter-bank activities, which could lead to reduced high quality liquid assets.
- There is a strong belief from some credit analysts that Basel III will result in a complete change of some banking business models and Balance sheet structures.
- The emphasis on new liquidity standards could enhance and fortify Bank's liquidity positions, improving the supervisory review processes.
- Smaller commercial deposit taking retail banks would find it easier to maintain the standards as opposed to the larger institutions without restricting growth.
- Restricting the definition of liquid assets too stringently could reduce the amount of long-term funding and in turn returns from trading and lending activities.
- The requirements on leveraging ratios could mean low yields, causing banks to move towards high risk high return asset holdings.

V. <u>Comparison of intended effects and advantages-disadvantages of the regulation</u>

Intended Effect	Downsides

The intention behind Basel III was to reduce systemic banking risk	Since Basel III, borrowers have taken on more financial risks by concentrating sales in fewer segments and investing more in intangible assets, R&D expenditures, and capital expenditures and, thus, experienced greater volatility in performance and chance of default (Wen). Negatively impacted the volume, composition, and stability of cross-border flows to Emerging Markets and Developing Economies (EMDE) which will dampen the development goals of the EMDEs. Created higher cost both in terms of margin and capital requirements which is detrimental to derivative trading by the banks
Dodd-Frank Act seeks to restore stability and oversight to the financial system and prevent a repeat of the crisis.	Bureaucracy was introduced, and corporate establishments were not able to fully pursue the cause of action they deem fit for them. It gave the federal government unprecedented, unchecked power.
To prevent the excessive risk-taking that led to the financial crisis	It stiffens competition by entrenching current market leaders' position
To provide common-sense protections for American families	Government price control over credit card
To create a new consumer watchdog to prevent mortgage companies and pay-day lenders from exploiting consumers	Volcker Rule pushed several critical banking functions into the shadow banking system. this institution have learnt to improvise. Failure to reform Fannie Mae and Freddie Mac halted any housing reform measures going forward
To substantially boosted resilience without unduly limiting credit availability or economic growth	Increased downgrades risk regardless of credit quality by Credit Rating Agencies (CRA) due to greater regulatory pressure (Sharma et al.). This was an anti-climax for credit availability or economic growth.
The law sought to limit the damage arising in the event of any systemically important financial institution's failure.	Preferential treatment of some institutions against others. Violation of all the rules of laws requirement for regulatory intervention

VI. What was this regulation in response to ?

"The Dodd-Frank Act, enacted in 2010, was a direct response to the financial crisis of 2007–2008 and the ensuing government bailouts under the Troubled Asset Relief Program (TARP)" (Hayes). Under the law, so many provisions existed that attend to all the fabrics of the financial services, it was termed the biggest legislation in the history of the US financial services industries. Some of the accompanying provisions are as follows:

- The Consumer Financial Protection Bureau (CFPB) has the mandate of preventing predatory mortgage lending.
- The Volcker Rule was to restrict how banks can invest, limiting speculative trading and eliminating proprietary trading.
- The Securities and Exchange Commission's (SEC's) Office of Credit Ratings was also charged with ensuring that agencies provide meaningful and reliable credit ratings of the entities that they evaluate
- Dodd-Frank was also to strengthened and expand the existing whistle-blower program promulgated by the Sarbanes-Oxley Act (SOX)
- Dodd-Frank was to keep consumers and the economy safe from risky behaviour by insurance companies and banks.

Like Dodd-Frank regulation, the Basel III accord with a specific outline for supervision, risk management, and regulation of the whole Finance and Banking sector was also far-reaching. While Basel III was on a global scale, Dodd-Frank was US's direct response to the financial crisis localized.

VII. Possible causes of the crisis

One can hardly separate any of the listed as part of the behavioural cause of the crises all the behavioural characteristic was well orchestrated to provide a perfect fiasco the market needed to collapse.

Carelessness was driven by the excess liquidity in the market before the collapse, this prompted the use of financial derivatives that masked risk inherent in some of these products with fraudulent ratings championed by the biggest rating agencies in the world. Overconfidence fuels greed and that is always rampant when caution is thrown into the wind by participants, the borrower's creditworthiness becomes secondary.

This is closely followed by bad assumptions that the liquid market will continue to rise unabated. Ignorance too, due to the herd's effect drew some unsophisticated investors to the market and they bet all their life savings on a venture that was never tested but because other people's testimonies drove them into it.

The negligence by the supposed watchdogs created unrestricted operations by the operators which eventually brought everything to a halt at the climax of the excesses. Negligence, carelessness, bad assumptions, ignorance, greed, and outright fraud played a pivotal role in the debacle of the global financial crisis.

VIII. Would Ethics training have helped ?

Ethics training across finance is of utmost importance, as prime effect of ethics training in finance is prevention of informal and careless practices, However no matter how hard system tries training of its personel on ethics, this may not be prime problem in financial crisis of 2008.

As Lehman Brothers had been a proficient company in finance business full of PhD.s in various walks of finance, they had not seemed to lack any ethics issues, as ethics is an integral part of financial training. Thus ethics training would not have prevented these problems in the case of 2008 financial crisis as it was not possible to get rid of the crisis for Lehman Brothers although this company has already been intrinsically brought up by the BASEL III regulations. (Cangurel, 2010)

IX. Is the regulation effective ?

It is obvious that a banking system with a much stronger capital structure together with Basel III have a positive effect on macroeconomic balances.

Basel III decisions bring a more transparent structure to the financial sector. Basel III process will help to limit systematic risk at macro and micro level.

Perhaps the most important effect of the Basel III process manifests itself in the contraction of the informal economy, which will bring an effort to work more effectively in the banking surveillance and supervision system.

By effectively implementing asset-liability management, the link and information flow between market risk management and management will become stronger. It will bring about important changes in the risk appetite and risk perceptions of banks.

It also supports the improvement of the asset quality of the banks by helping to experience a positive development in the institutionalization process of the commercial and corporate customers of the banks. Because of the mentioned impacts the regulation definitely defers corporations from performing actions led to 2008 crisis. (Dunya, 2013)

X. Was the crisis due to invidual behaviour or systemic risk ?

Systemic risk is defined as the risk that the effects of bad news about a financial institution or the bankruptcy of a financial institution will spread throughout the system and cause the bankruptcy of more financial institutions in the system.

Thus underlying problems are also a part of systemic risk since when a big company or bank may introduce kind of a contagion effect on the whole financial system.

Contagion mechanism inherent in systemic risk and occurs when systemic risk materializes. Contagion is the main mechanism by which financial instability spreads until crises reach systemic dimensions and are the focus of this chapter. A contagion effect is an effect that spreads throughout the system, where the instability or probability of failure of an institution (market, instrument or financial sector) has a negative impact on the entire financial system. The contagion effect, which starts with a first shock that may become a systemic risk, will be evaluated in terms of systemic risk according to the rate of spread and permeability within the system.

The contagion effect results from the inability of market participants to take into account the negative externalities (increasing systemic risk) arising from their activities and interdependencies. The contagion effect affects all institutions. It covers not only the institutions in weak financial situation, but also the expected situations arising from the changing financial market conditions and the secondary effects of the domino effect. These situations may include emergency sales of assets cheaper than the balance sheet value in order to overcome the liquidity problem, which we call fire sales, where asset prices can depreciate significantly in market valuation.

The vulnerability to contagion risk is mainly due to high leverage, interconnectedness, growth of shadow banking, risk of loss of confidence and the use of an aggressive liquidity management strategy, i.e. high reliance on funds from the interbank market. Reasons for not considering the risk of contamination; not paying attention to repo positions, providing a dual stock concentration and being exposed to systemic risk, having the capacity to import the risk of contamination, not taking into account the out-of-balance sheet items, underestimating the payment and settlement risks. In addition, overestimating the risk of contamination is also a contagion problem. These; ignoring the reactions of the central banks, ignoring the netting agreements, ignoring the potential measurements of the regulatory authorities or ignoring the potential reactions of the banks. (Serbetli, 2018)

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