For B.Com II sem.
Banking Operations
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BASEL NORMS

Introduction:

The need for banking regulation conceives its roots in the concern towards the socio-economic costs that arise out in case of breakdown of the banking system or that of bank failures and systemic crises. As a result, the major aim of banking industry regulation is to maintain financial stability in order to ensure a safe and sound banking system to protect the interest of depositors in particular and to promote a healthy investment environment in general.

The banking industry is one of the major key areas responsible for economic growth of a nation, but, with the globalization of the same, there comes a phenomenon of sequential prostration calling for the implementation of minimum global banking regulation standards to avoid cross-country impact of banking disruptions or crises. Therefore, following the Herstatt Bank debacle and for harmonize the banking activities internationally, the the Basel Committee on Banking Supervision (BCBS) issued the *"International Convergence of Capital Measurements and Capital Standards"*, which are popularly known as *"Basel I Capital Accords of 1988"*. After their release, a framework for maintaining the capital structure of the banks came into the picture.

Basel I Accords: Having main thrust on credit risks of banks, they basically refer to the following four pillars:

1) Elements of Capital (includes Tier-1 and Tier-2 Capital)
2) System of Risk Weighting (includes five weights: 0%, 10%, 20%, 50%, and 100%)
3) Basel Capital Adequacy Ratio
4) Arrangements regarding implementation

Being simple, Basel I Accords played a vital role to make international banking system sustainable to an extent but they hadn't considered the variation in types of risks banks are exposed to on one hand, and variation in size of banks which is very important for risk management. Consequently, *"International Convergence of Capital Measurements and Capital Standards, A Revised Framework Comprehensive Version"*, also known as *"Basel II Capital Accords"* were issued by the Basel Committee on Banking Supervision (BCBS) in 2004.

Basel II Accords: Focusing mainly on operational risk aspect, they aimed to develop more risk-sensitive capital requirements. For providing a flexible and risk-sensitive capital management framework, following three pillars were considered in:

1) Minimum Capital Requirements (includes weighted risks and expanded capital requirements)

2) Supervisory Review (includes regulatory intervention guided by a set of four principles)
3) Market Discipline (includes transparency and accountability dimensions)

Despite being a comprehensive framework, it has certain shortcomings in terms of being a pro-cyclical approach, not considering liquidity risk of capital regulation, etc. Therefore, there felt a need to make the banking sector strong enough to withstand economic and financial stress, reduce risk in the system, and improve transparency in banks.

Basel III Accords: The global financial crises of 2008, triggered by the Lehman Brothers' collapse, set alarm bells ringing for financial institutions. The Basel III framework is designed to make the banking sector more efficient. *Basel III is a comprehensive set of reform measures which are designed & developed by the Basel Committee on Banking Supervision with an aim to strengthen the regulation, supervision and risk management of the banking sector (BCBS).*The norms call for improvement of the quantity and quality of capital of banks, stronger supervision, and more stringent risk management and disclosure standards. Therefore, in December 2010, the Basel Committee on Banking Supervision (BCBS) released a comprehensive reform package entitled– *"Basel–III: A Global Regulatory Framework for More Resilient Banks and Banking System"* with following two principal objectives:

1) To strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector.
2) To improve the banking sectors stability to absorb shock arising from financial and economic stress, which, in turn would reduce the risk of a spillover from the financial sector to the real economy.

Figure: The Basel III Framework

Capital			Liquidity
Pillar 1	**Pillar 2**	**Pillar 3**	
• Capital - Quality and level of capital (4.5%) - Capital loss absorption - Capital conservation buffer - Countercyclic buffer • Risk Coverage - Securitisation - Higher capital for trading book - Counterparty credit risk • Leverage - Leverage ratio	Supplemental requirements including capturing risk that is connected to off-balance sheet exposure and securitisation activities.	Revised disclosure requirements relating to off-balance sheet exposure and securitisation activities.	- Liquidity coverage ratio - Net stable funding ratio - Principles for sound liquidity risk management and supervision - Supervision monitoring

Systemically important financial institutions (SIFIs)
These must have a higher loss absorbency ratio than other banks because of the greater risk they are to the financial system. A Tier 1 extra capital requirement ranging from 1-2.5 percent.

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Implementation of Basel III in India: The Basel III accords are to be implemented in India in a phase-wise manner from April 1, 2013 to March 31, 2019 in the light of the guidelines issued by Reserve Bank of India in May 2012 with an aim to attain sustainability on micro as well as on macro level. Basel III reforms are aimed at strengthening the regulatory norms at bank-level or we can say the micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. In addition to this, the reforms also have a macro prudential focus as they are likely to address the system wide risks which can build up across the banking sector along with the the pro-cyclical amplification of these risks over time (RBI 2015).

The Basel III Capital Regulations guidelines issued by RBI have six constituents:

1) Minimum Capital Requirements
2) Supervisory Review and Evaluation Process
3) Market Discipline
4) Capital Conservation Buffer Framework
5) Leverage Ratio Framework
6) Countercyclical Capital Buffer Framework

Capital Requirements in India

Regulatory capital	*AS % TO RWAs*
Minimum common equity tier 1 ratio	5.5
CCB	2.5
Minimum common equity tier 1 ratio plus CCB	8.0
Additional tier 1 capital	1.5
Minimum tier 1 capital ratio (I + IV)	7.0
Tier 2 capital	2.0
Minimum total capital ratio (V + VI)	9.0
Minimum total capital ratio plus CCB	11.5

Source: RBI Master Circular – Basel 3 Capital Regulations

Moreover, the guidelines on "Liquidity Risk Management by Banks" were issued by RBI circular along with two minimum standards viz.; Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) for funding liquidity were prescribed. Additionally, a set of five tools to be used for monitoring the liquidity risk exposures of banks was also prescribed which are as follows:

1) Contractual Maturity Mismatch

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2) Concentration of Funding
3) Available Unencumbered Assets
4) Liquidity Coverage Ratio by Significant Currency
5) Market-related Monitoring Tools