Introduction

Basel is a city in Switzerland which is also the headquarters of Bureau of International Settlement (BIS).

BIS fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations.

The Bank for International Settlements (BIS) established on 17 May 1930,is the world's oldest international financial organization. There are two representative offices in the Hong Kong and in Mexico City. In total BIS has 60 member countries from all over the world and covers approx. 95% of the world's GDP.

History of Basel Committee

- The breakdown of the Bretton Woods system of managed exchange rates in 1973 soon led to casualties . On 26 June 1974, West Germany's Federal Banking Supervisory Office withdrew Bankhaus Herstatt's banking licence after finding that the bank's foreign exchange exposures amounted to three times its capital.
- Basel Committee on Banking Supervision [BCBS] was established by the central-bank governors of the G10 countries in 1974.
- Meets at the Bank for International Settlements in Basel, Switzerland
- Its objective was to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.
- Formulates broad supervisory standards and guidelines
- First major result was the 1988 Capital Accord
- In 1997, developed a set of "Core Principles for Effective Banking Supervision", which provides a comprehensive blueprint for an effective supervisory system.
- Later renamed as the Basel Committee on Banking Supervision.
- The Committee was designed as a forum for regular cooperation between its member countries on banking supervisory matters.
- Its aim was and is to enhance financial stability by improving supervisory know how and the quality of banking supervision worldwide.

OBJECTIVE

The set of agreement by the BCBS(BASEL COMMITTEE ON BANKING SUPERVISION), which mainly focuses on risks to banks and the financial system are called Basel accord. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. India has accepted Basel accords for the banking system.

Up till now BASEL ACCORD has given us three BASEL NORMS which are BASEL 1,2 and 3 but before coming to that we have to understand following terms-

CAR/CRAR- Capital Adequacy Ratio/ Capital to Risk Weighted Asset Ratio

RWA- Risk Weighted Assets

Formulae for CAR=Total Capital/RWA*100

Now here, Total Capital = Tier 1 + Tier 2 capital

The Committee seeks to achieve its aims

- By setting minimum supervisory standards.
- By improving the effectiveness of techniques for supervising international banking business.
- By exchanging information on national supervisory arrangements. And, to engage with the challenges presented by diversified financial conglomerates.

- The Committee also works with other standard-setting bodies, including those of the securities and insurance industries.
- The Committee's decisions have no legal force . Rather, the Committee formulates supervisory standards and guidelines and recommends statements of best practice in the expectation that individual national authorities will implement them.
- In this way, the Committee encourages convergence towards common standards and monitors their implementation, but without attempting detailed harmonization of member countries' supervisory approaches.
- One important aim of the Committee's work was to close gaps in international supervisory coverage so that-
- No foreign banking establishment would escape supervision.
- That supervision would be adequate and consistent across member jurisdictions.

RISK WEIGHTED ASSETS

RWA means assets with different risk profiles; it means that we all know that is much larger risk in personal loans in comparison to the housing loan, so with different types of loans the risk percentage on these loans also varies.

BASEL-1

- In 1988, The Basel Committee on Banking Supervision (BCBS) introduced capital measurement system called Basel capital accord, also called as Basel 1. It focused almost entirely on credit risk; it defined capital and structure of risk weights for banks.
- The minimum capital requirement was fixed at 8% of risk weighted assets (RWA).
- India adopted Basel 1 guidelines in 1999.
- In 1988, the Basel Committee (BCBS) in Basel, Switzerland, published a set of minimal capital requirements for banks, known as 1988 Basel Accord or Basel 1.
- Primary focus on credit risk
- Assets of banks were classified and grouped in five categories to credit risk weights of zero '0', 10, 20, 50 and up to 100%.
- Assets like cash and coins usually have zero risk weight, while unsecured loans might have a risk weight of 100%.
- Created in 1988, Basel I Capital Accord had general purpose:
- To strengthen the stability of International Banking System
- To set up a fair and consistent international banking system in order to decrease competitive inequality among international banks.
- Focused on Credit Risk
- Set up an international 'minimum' amount of capital that bank should hold

- **Tier I (Core Capital) :** Tier I capital includes stock issues (or shareholder equity) and declared reserves, such as loan loss reserves set aside to cushion future losses or for smoothing out income variation.
- **Tier II (Supplementary Capital) :** Tier II Capital includes all other capital such as gains on investment assets, long term debt with maturity greater than 5 years and hidden reserves. However, short-term are not included.
- Limited differentiation of credit risk
- Strategic Measure of default risk
- No recognition of term-structure of credit risk
- Simplified calculation of potential future counterparty risk
- Lack of recognition of portfolio diversification effects Pitfall of Basel – I
- According to Basel I, the total capital should represent at least 8% of the bank's credit risk.

Purpose of Basel 1 –

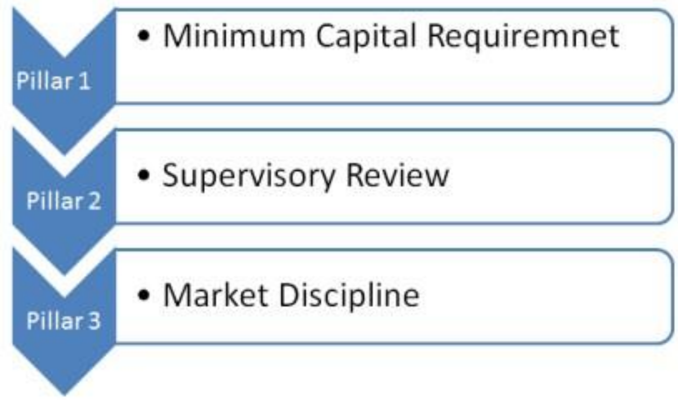
- Strengthen the stability of international banking system.
- Set up a fair and a consistent international banking system in order to decrease competitive inequality among international banks
- To set up a minimum risk-based capital adequacy applying to all banks and governments in the world

BASEL-2

Basel II was intended:

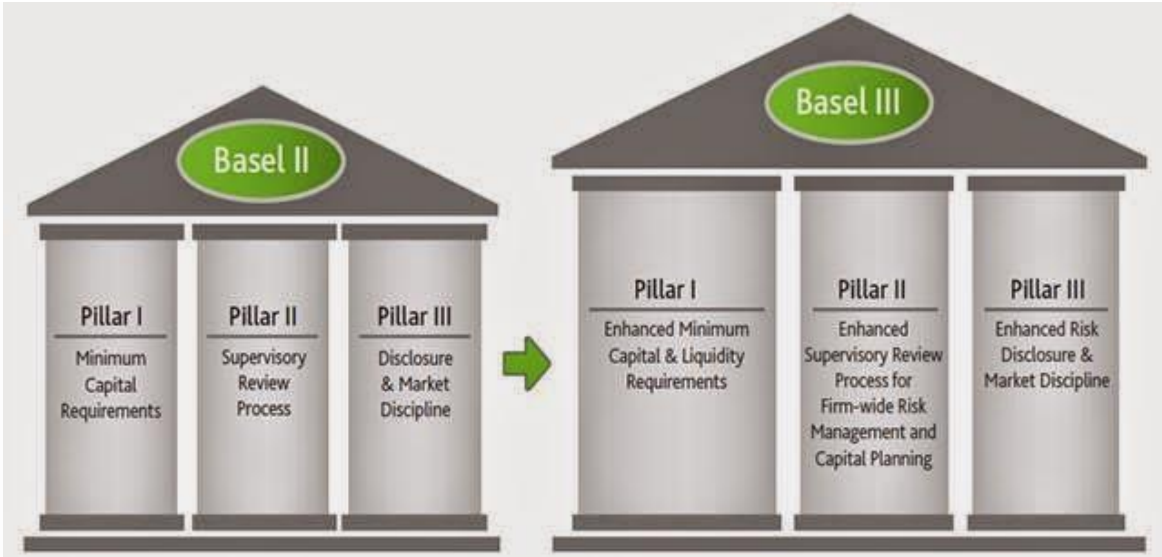
- To create an international standard for banking system
- To maintain sufficient consistency of regulations
- To protect the international financial system
- To reduce scope of regulatory arbitrage
- Defined new calculation of credit Risk
- Addition of operation risk in the existing norms
- Ensuring that capital allocation is more risk sensitive Basel – II Norms (2004)

Basel II Norms has Three Pillar Concept, These are as follows:



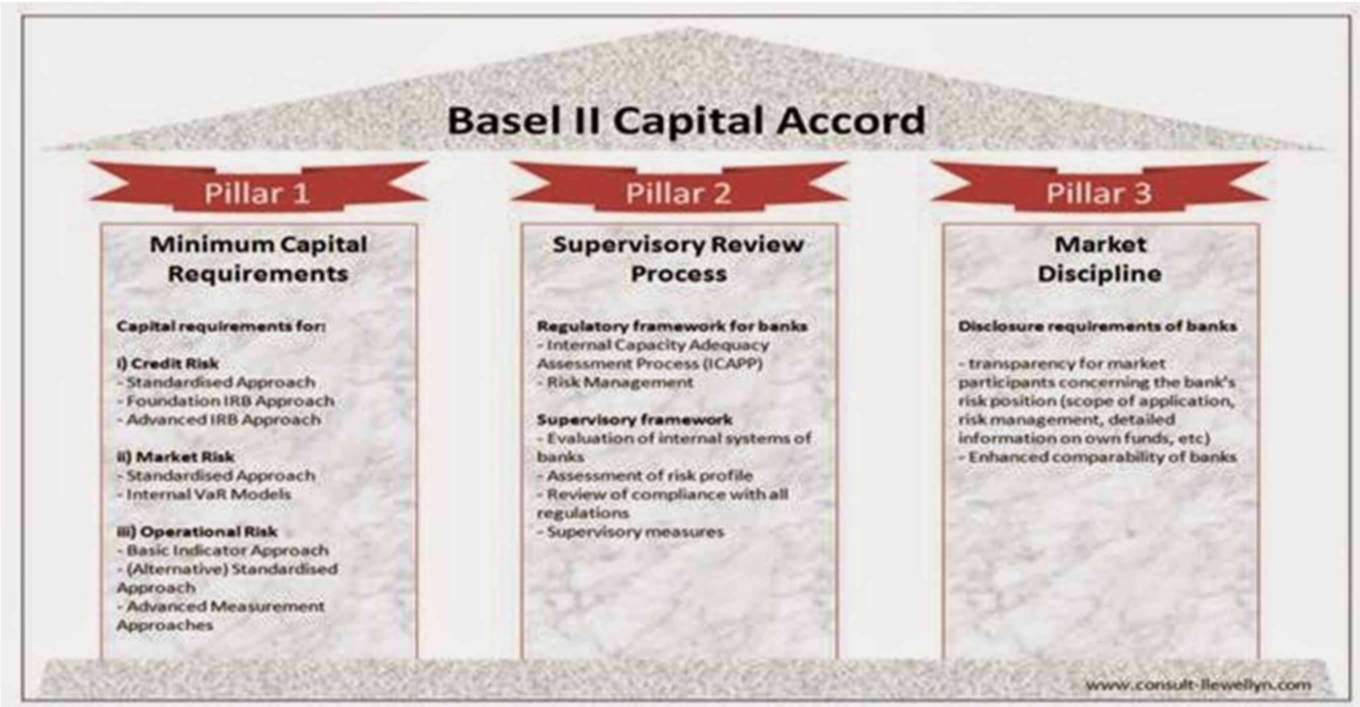
- In 2004, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord.
- The guidelines were based on three parameters which are as follows-
- Banks should maintain a minimum capital adequacy requirement of 8% of risk assets.
- Banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that is credit and increased disclosure requirements.
- The three types of risk are- operational risk, market risk, capital risk.
- Banks need to mandatory disclose their risk exposure, etc to the central bank.
- Basel II norms in India and overseas are yet to be fully implemented.

BASEL-3



- In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008.
- In 2008, Lehman Brothers collapsed in September 2008, the need for a fundamental strengthening of the Basel II framework had become apparent.
- Basel III norms aim at making most banking activities such as their trading book activities more capital-intensive.
- The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity.
- Presently Indian banking system follows basel II norms.
- The Reserve Bank of India has extended the timeline for full implementation of the Basel III capital regulations by a Basel – 3 Norms (2010)
- The G-20 endorsed the new 'Basel 3' capital and liquidity requirement as remedy to overcome financial crisis of 2008-2009.
- The new accord aims to: -
    - Have special emphasis on Capital Adequacy Ratio
    - Improve banking sectors ability to absorb shocks arising from financial and economic stress
    - Strengthen banks transparency and disclosures
- The accord provides a substantial strengthening of capital requirements
- Places greater emphasis on loss-absorbency capacity on a going concern basis.

The three pillars of BASEL-3 can be understood from the following figure---year to March 31, 2019.



Features of Basel 3

- Revised Minimum Equity & Tier I Capital Requirements
- Better Capital Quality
- Leverage Ratio
- Liquidity Ratio
- Countercyclical Buffer
- Capital Conservation Buffer
- Ratio under consideration - CAR =

Impact on Indian Banking System

- Reduced Systematic Risk and absorb economic-finance stress
- Challenge for Weaker Banks to survive
- Increased Supervisory Vigil
- Reorganisation of Institutions with more mergers & acquisitions
- Chances of increased International Arbitrage
- Bank Capital – Increased NPA, reduced Tier II CAR Ratio
- Increased Tier I capital requirement
- Presently PSU banks carry adequate CAR.
- Over next few years, Tier I Capital specially Equity Shares will be of prime importance instead of CAR.
- Public Sector Banks need Rs. 4.15 trillion additionally to meet the requirement – Rs. 2.72 trillion for non-equity capital and approx Rs. 1.43 trillion for equity capital over a period .
- Government to recapitalize an estimated Rs. 900 billion at existing stake holding position or Rs. 660 billion if reduce its shareholding down to 51% .
- Some public sector banks are likely to fall short of the revised core capital adequacy requirement .
- Increase in requirement of capital will affect the ROE of the public banks.

IMPORTANT POINTS REGARDING TO THE IMPLEMENTATION OF BASEL-3

- Government of India is scaling disinvesting their holdings in PSBs to 52 per cent.
- Government will soon infuse Rs 6,990 crore in nine public sector banks including SBI, Bank of Baroda (BoB), Punjab National Bank (PNB) for enhancing their capital and meeting global risk norms.
- This is the first tranche of capital infusion for which the government had allocated Rs 11,200 crore in the Budget for 2014-15.
- The government has infused Rs 58,600 crore between 2011 to 2014 in the state-owned banks.
- Finance Minister Arun Jaitley in the Budget speech had said that "to be in line with Basel-III norms there is a requirement to infuse Rs 2,40,000 crore as equity by 2018 in our banks. To meet this huge capital requirement we need to raise additional resources to fulfill this obligation.

Difference between BASELs II and III

As you can see from the two images, the difference in the wordings in the three pillars...the word 'enhanced' has been added to the three pillars of BASEL III.

This simply means that supervisory/regulatory controls are now improved and better in BASEL III, than the previous Basel II.

The important Key elements of BASEL III and it's difference from BASEL II can be understood as follows:

(i) ***Capital and it's stricter standards***: BASEL III requires overall capital to be ***10.5 % of the Risk Weighted Assets*** (RWAs and important from exam/interview point of view!)

Where the BCBS recommends 10.5%, ***India has plans to achieve 11.5%*** of RWAs as the overall capital, including Tier I, Tier II and Common Tier Equity and ***Capital Conservation Buffer (CCB) at 2.5%***

(ii) ***Capital conservation buffer*** (at 2.5%) has been introduced with the aim of ensuring that banks maintain a *buffer* (like a cushion or a shock absorber) of capital – that can be utilized to withstand losses and financial and economic crises.

(iii) ***Counter-cyclical buffer*** (CCCB), ***ranging within 0 - 2.5%*** - has been introduced in BASEL III, to achieve a broader and blanket goal of protecting the banking sector of excess credit growth – which directly means increase in risk in bank sector at such times.