BASEL NORMS - Explained in Simple Language

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 organisation. 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 GDP.

Objective

- The set of the 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 the obligations and absorb unexpected losses.
- India has accepted Basel accords for the banking system.
- BASEL ACCORD has given us three BASEL NORMS which are BASEL 1,2 and 3.

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= Tier1+ Tier2 capital

Tier 1 - The Tier- I Capital is the core capital
Paid up Capital, Statutory Reserves, Other disclosed free reserves, Capital Reserves which represent surplus arising out of the sale proceeds of the assets, other intangible assets belong from the category of Tier1 capital.

Tier 2 - Tier-II capital can be said to be subordinate capitals.
Undisclosed reserves, Revaluation Reserves, General Provisions and loss reserves , Hybrid debt capital instruments such as bonds, Long term unsecured loans, Debt Capital Instruments etc belong from the category of Tier 2 capital.

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-I

- 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.**

BASEL-II

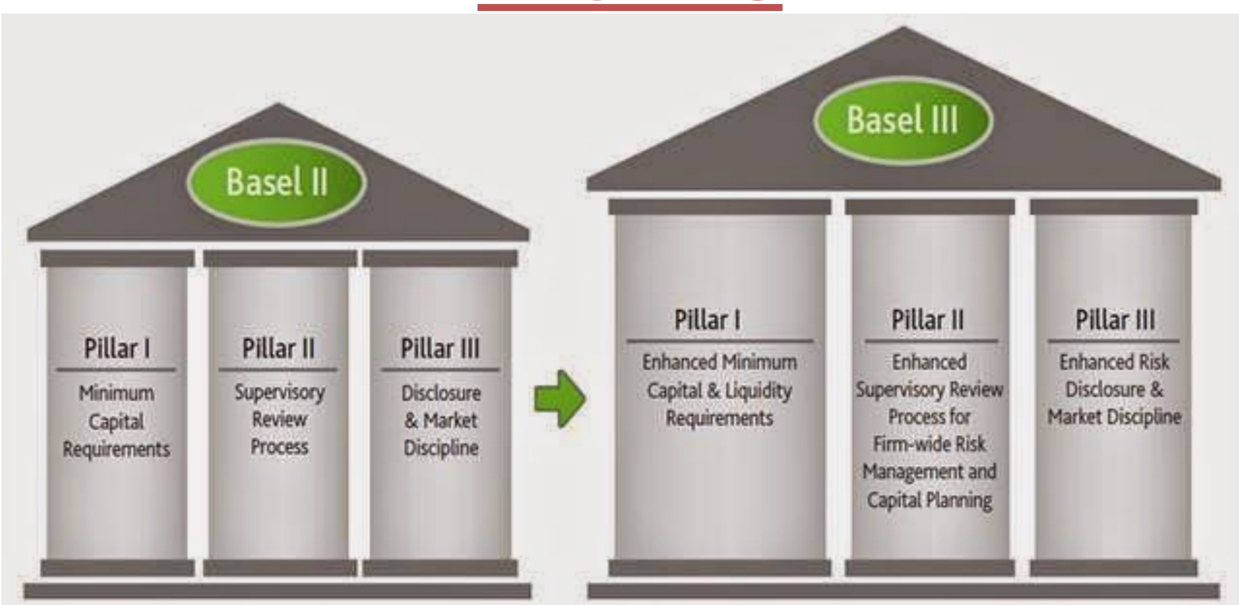
In 2004, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord.

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.

The three pillars of BASEL-3 can be understood from the following figure

BASEL-3



Basel III

- 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 year to March 31, 2019.

Important Points Regarding Implementation of Basel III

- The government of India is scaling disinvesting their holdings in PSBs to 52 per cent.
- The 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 fulfil this obligation.

Basel II and Basel III Norms - All that you Need to Know

Today I am providing a useful write up on BASEL Accords, complying with the many requests from readers.

1. *Brief History*:

The Basel Committee on Banking Supervision – ***is an international banking regulatory committee formed to develop banking supervisory regulations***. It was established by the Governors of the Central Banks of a group of 10 countries (initially) in 1974.

The objective of the BCBS is to gain a better understanding of the challenges faced by modern banking system in terms of risk and it risk management and to frame supervisory and regulatory standards and guidelines to help the banking system diminish these risks and function properly

- India is a member of the BCBS along with Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, U.K. and USA.
- The present ***Chairman of the BCBS is Stefan Ingves***, who is the Governor of the central bank of Sweden.

2. ***Why needed in today's banking sector?***

The Global Economic Crisis (2007-08) showed us all how banking sector in the 21st C, though highly developed was still prone to the financial shocks. Also the spillover into the banking system from other sectors was also seen, and thus it was felt globally that, as far as banking system was concerned, unified and stricter norms should be welcomed.

3. ***BASEL II*:**

The predecessor of BASEL III and successor of BASEL I, was in place during the global economic meltdown, and showed the shortcomings in the existing regulatory and supervisory framework.

The pillars of BASEL II are further down in the article.

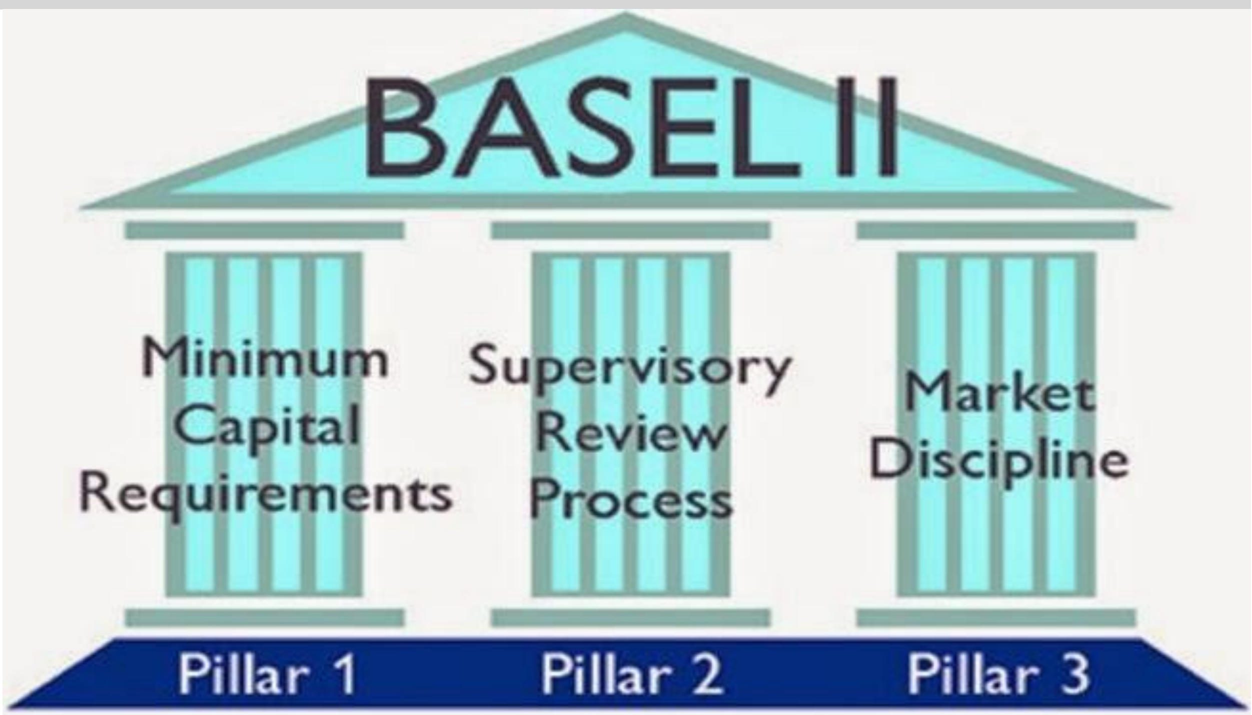
4. ***BASEL III and why it had to come*:**

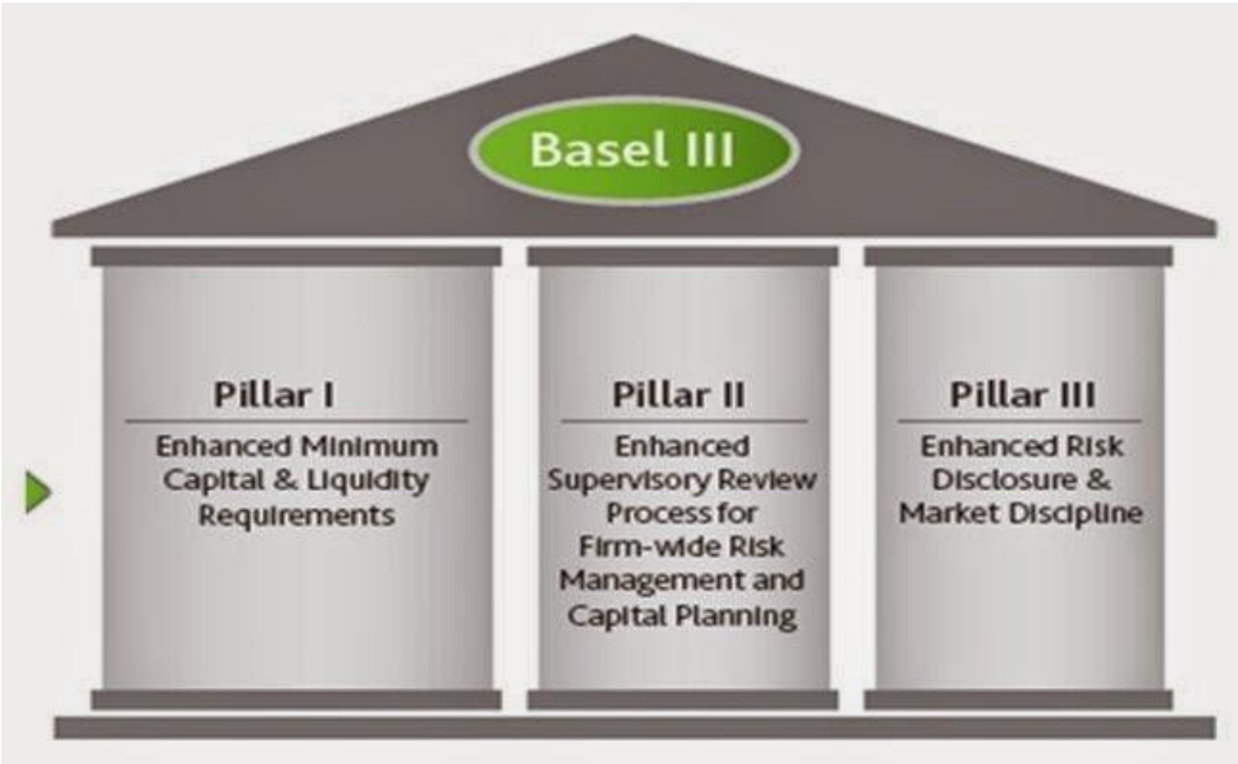
BASEL III which is formally known as the '3rd BASEL Accord' – was released in December, 2010 after being ratified in November

2010 by G20 summit in Seoul – with a view to upgrade the existing norms, i.e., that of Basel II.

- BASEL III is the result of the financial crisis of 2007-2008, which made the BCBS feel that a more stringent supervisory guidelines were required to prevent such mishaps from happening in the future;
- Its aim, among other things, is to strengthen the banking sector to be able to withstand such severe financial crisis without crumbling.
- According to BCBS "Basel III is *a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector*".

5. The Pillars of BASEL 2 and 3 for your comparison benefit!





5. ***<u>Difference between BASELs II and III?</u>***

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

Where the BCBS recommends 10.5%, ***<u>India has plans to achieve</u>***

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.

6. *Indian Scenario:*

(i) As recently as October 2014, the RBI has revised Basel III liquidity guidelines to meet the liquidity coverage ratio ***(LCR) threshold of 60 % by January 2015***.

(ii) Wholly implementation of ***BASEL III in India is marked for 31 March, 2019*** (revised from 31.3.2018); while ***internationally it is 1 January, 2019***.