EduTap

Basel Norms in

Risk Management **Finance**

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Basel Norms

Basel Norms- Concept

Basel is a city in Switzerland. It is the headquarters of **Bureau of International Settlement (BIS)**, which fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations.

Every two months BIS hosts a meeting of the governor and senior officials of central banks of member countries.

Basel guidelines refer to broad supervisory standards formulated by this group of central banks - called the **Basel Committee on Banking Supervision (BCBS)**. The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called **Basel accord/Basel Norms.**

The BCBS now has 45 members from 28 Jurisdictions, consisting of Central Banks and authorities with responsibility of banking regulation.

Why a need of Basel Norms?

It is not for nothing that banks are considered important for an economy, especially if it is a developing country like India. Go back to 2008, the crisis in the US banking sector wreaked havoc throughout the world. The US is still trying to limp back to economic growth. A banking collapse is one of the worst crises a country can face.

The BASEL norms have three aims:

1) Make the banking sector strong enough to withstand economic and financial stress.

2) Reduce risk in the system,

3) Improve transparency in banks.

The Basel norms is an effort to coordinate banking regulations across the globe, with the goal of strengthening the international banking system.

Basel Regulations

The Basel Committee has issued three sets of regulations known as Basel-I, II, and III.

Basel – I Norms

Basel-1 was introduced in the year 1988. It focused primarily on credit (default) risk faced by the banks.

As per Basel-1, all banks were required to maintain a **capital adequacy ratio of 8%.**

The capital adequacy ratio is the minimum capital requirement of a bank and is defined as the ratio of capital to risk-weighted assets.

- The capital was classified into Tier 1 and Tier 2 capital.
- **Tier 1 capital** is the core capital of a bank that is permanent and reliable. It includes equity capital and disclosed reserves.
- **Tier 2 capital** is the supplementary capital. It includes undisclosed reserves, general provisions, provisions against Non-performing Assets, cumulative non-redeemable preference shares, etc.

The risk-weighted asset is the bank's assets weighted according to risks.

Understanding Risk Weighted Assets:

The assets of the bank were classified into 5 risk categories of 0 % or 0, 10 % or 0.1, 20 % or 0.2, 50 % or 0.5 and 100 % or 1. Example- cash into 0 % risk category, home mortgage into 20 % risk category and corporate debt into 100 % risk category.

Let's say- a bank has Rs.100 as cash reserves, Rs.200 as home mortgage and Rs.300 as loans given out to companies. The risk-weighted assets= (Rs.100 * 0) + (Rs.200 * o.2) + (Rs.300 * 1) = 0 + 40 + 300 = Rs340

Therefore, this bank has to maintain 8 % of Rs.340 as minimum capital. (at least 4 % in tier-1 capital)

India adopted Basel-1 in 1999.

Basel – II Norms

Basel-II was issued in 2004.

This framework is based on three parameters.

1. **Minimum capital requirements**: Banks should continue to maintain a minimum capital adequacy requirement of 8% of risk-weighted assets. However, the definition of capital adequacy ratio was refined.

- Also, Basel-II divides the capital into 3 tiers. **Tier-3 capital** includes short-term subordinated loans. (Subordinated loans means lower in the ranking. It is repaid after other debts in case of bank liquidation.)
- Tier 3 capital is capital banks hold to support market risk in their trading activities.

1. **Regulatory supervision**: According to this, banks were required to develop and use better risk management techniques in monitoring and managing all the three types of risks that a bank faces, viz. **credit, market, and operational risks.**
2. **Market Discipline**: It increased disclosure requirements. Banks need to mandatorily disclose their **CAR, risk exposure, etc. to the central bank.**

Though, presently, India follows Basel II norms, they are yet to be fully implemented in India and overseas.

Basel – III Norms

In 2010, Basel III guidelines were released. The guidelines aim to promote a more resilient banking system. The financial crisis of 2007-08 revealed shortcomings in the Basel norms. Therefore, the previous accords were strengthened.

- **Capital:** The capital adequacy ratio is to be maintained at 12.9%. The minimum Tier 1 capital ratio and the minimum Tier 2 capital ratio have to be maintained at 10.5% and 2% of risk-weighted assets respectively.

  In addition, banks have to maintain a capital conservation buffer of 2.5%.

  Counter-cyclical buffer

  is also to be maintained at 0-2.5%.

Countercyclical capital buffer (CCCB)

- Following Basel-III norms, central banks specify certain capital adequacy norms for banks in a country. The CCCB is a part of such norms and is calculated as a fixed percentage of a **bank's risk-weighted loan book.**
- Countercyclical capital buffers require banks to hold capital at times when credit is growing rapidly so that the buffer can be reduced if the financial cycle turns down or the economic and financial environment becomes substantially worse.
- Banks can use the capital buffers they have built up during the growth phase of the financial cycle to cover losses that may arise during periods of stress and to continue supplying credit to the real economy.
- **Leverage:** The leverage rate has to be at least 3 %. The leverage rate is the ratio of a bank's tier-1 capital to average total consolidated assets.
- **Funding and Liquidity:** Basel-III created **two liquidity ratios: LCR and NSFR.**
  - The **liquidity coverage ratio (LCR)** will require banks to hold a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short term stress scenario as specified by supervisors.
  - This is to prevent situations like "**Bank Run**". The goal is to ensure that banks have enough liquidity for a 30-days stress scenario if it were to happen.

A **bank run** occurs when a large number of customers of a bank or other financial institution withdraw their deposits simultaneously over concerns of the bank's solvency.

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  - The **Net Stable Funds Rate (NSFR)** requires banks to maintain a stable funding profile in relation to their off-balance-sheet assets and activities. NSFR requires banks to fund their activities with stable sources of finance (reliable over the one-year horizon).
  - The minimum NSFR requirement is 100%. Therefore, LCR measures short-term (30 days) resilience, and NSFR measures medium-term (1 year) resilience.

The Reserve Bank of India (RBI) introduced the Basel norms in India in 2003. It now aims to get all commercial banks BASEL III-compliant by March 2019. So far, India's banks are compliant with the capital needs. On average, India's banks have around 8% capital adequacy. This is lower than the capital needs of 10.5% (after taking into account the additional 2.5% buffer). In fact, the BASEL committee credited the RBI for its efforts.

The deadline for the implementation of Basel-III was March 2019 in India. It was postponed to March 2020.

Update: In light of the coronavirus pandemic, the RBI decided to defer the implementation of Basel norms by further 6 months.

Basel III Framework

- Major Features of Basel III
  - ✓ Revised Minimum Equity & Tier I Capital Requirements
  - ✓ Better Capital Quality
  - ✓ Leverage Ratio
  - ✓ Liquidity Ratio
  - ✓ Countercyclical Buffer
  - ✓ Capital Conservation Buffer
- Ratio under consideration

$$\text{CAR} = \frac{\text{(Tier 1 Capital + Tier 2 Capital)}}{\text{Risk Weighted Assets}}$$

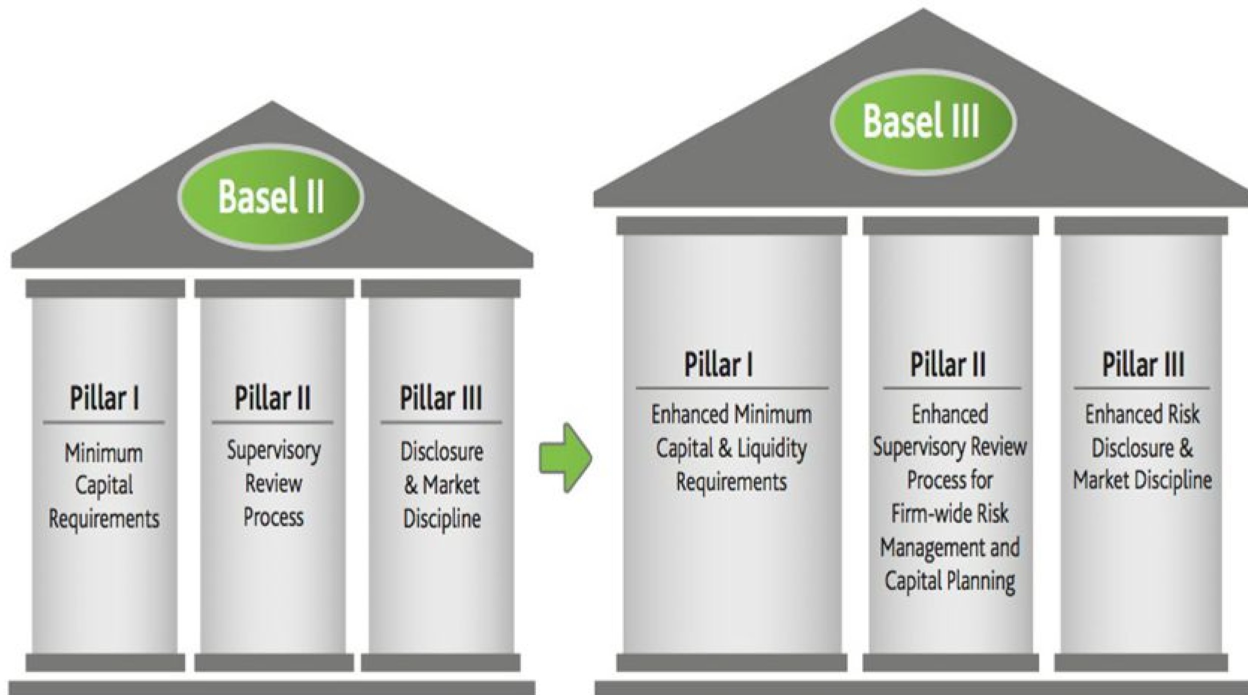
$$\uparrow \text{Capital Ratio} = \frac{\text{Eligible Capital} \downarrow}{\text{Risk-weighted Assets} \uparrow}$$

$$\text{Leverage Ratio} = \frac{\text{Tier 1 Capital}}{\text{Total Exposure}} \geq 3\%$$

$$\text{Liquidity Coverage Ratio} = \frac{\text{High-quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100\%$$

$$\text{Net Stable Funding Ratio} = \frac{\text{Available stable funding}}{\text{Required stable funding}} \geq 100\%$$

Three pillars of BASEL-III



Challenges for Indian banks

Complying with BASEL III norms is not an easy task for India's banks, which have to increase capital, liquidity and also reduce leverage. This could affect profit margins for Indian banks. Plus, when banks keep aside more money as capital or liquidity, it reduces their capacity to lend money. Loans are the biggest source of profits from banks. Plus, India banks have to meet both LCR as well as the RBI's Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) norms. This means more money would have to be set aside, further stressing balance sheets.

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