Everything You Need to Know About Basel Norms for Banking Exams

Banking exams such as IBPS PO, IBPS SO, IDBI PO etc. place a lot of importance on questions related to the Banking sector. The GA section of these exams is one of the most scoring sections. So, it is extremely important to update your general knowledge related to the Banking Sector. This might prove extremely useful to you. Basel Norms are Banking Supervision Accords/Regulations which are issued by the BCBS. It is the backbone of all banking structures. Keep reading to find out more about Basel Norms for Banking, Pillars of Banking and more!

Introduction - Basel Norms for Banking

Banks lend to different types of borrowers and each carries its own risk. They lend the deposits of public as well as money raised from the market – equity and debt. The intermediation activity exposes the bank to a variety of risks. Cases of big banks collapsing due to their inability to sustain the risk exposures are readily available. Therefore, Banks have to keep aside a certain percentage of capital as security against the risk of non – recovery. **Basel committee has produced norms called Basel Norms for Banking to tackle the risk.**

Basel is a city in Switzerland. It is the headquarters of **Bureau of International Settlement (BIS)**, which fosters cooperation 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 these groups of central banks – called the **Basel Committee on Banking Supervision (BCBS).** The set of the agreement by the BCBS, which mainly focuses on risks to banks and the financial system is called **Basel accords/Basel Norms.** The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorbs unexpected losses. **India has accepted Basel Norms for Banking.** In fact, on a few parameters, the RBI has prescribed stringent norms as compared to the norms prescribed by BCBS.

Basel I:

In 1988, BCBS introduced capital measurement system called Basel capital accord, also called 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). RWA means assets with different risk profiles. For e.g.: An asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral.

Assets of banks were classified and grouped into five categories according to credit risk, carrying risk weights of:

- 0% (for example cash, home country debt like Treasuries),
- 20% (securitizations such as MBS rated AAA)
- 50%,
- 100% (for example, most corporate debt), and
- Some assets are given no rating

India adopted Basel 1 guidelines in 1999.

The twin objectives of Basel I was:

1. To ensure an adequate level of capital in the international banking system
2. To create a more level playing field in the competitive environment

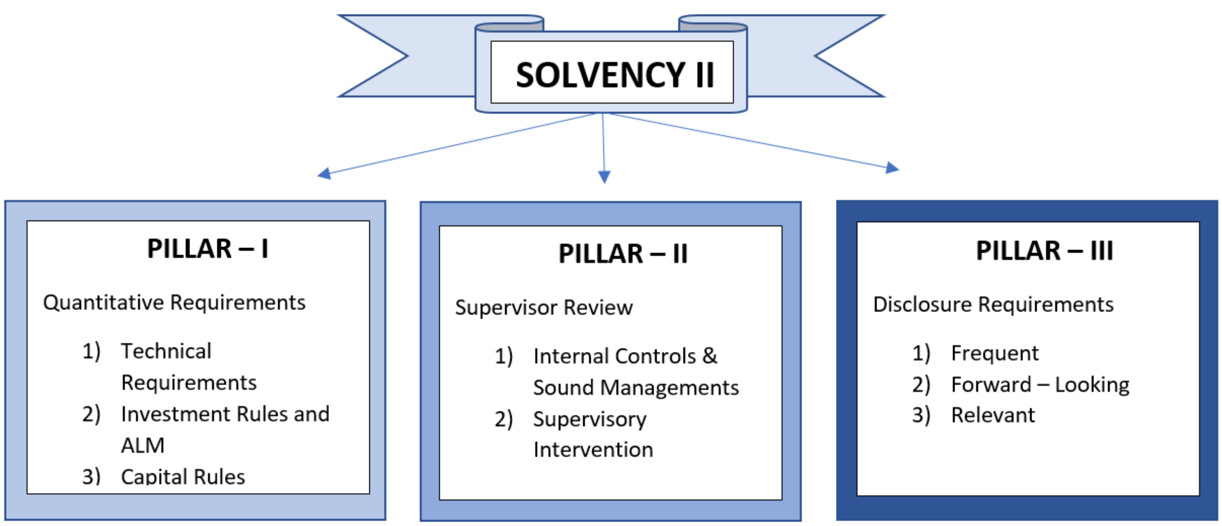
Basel II:

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:

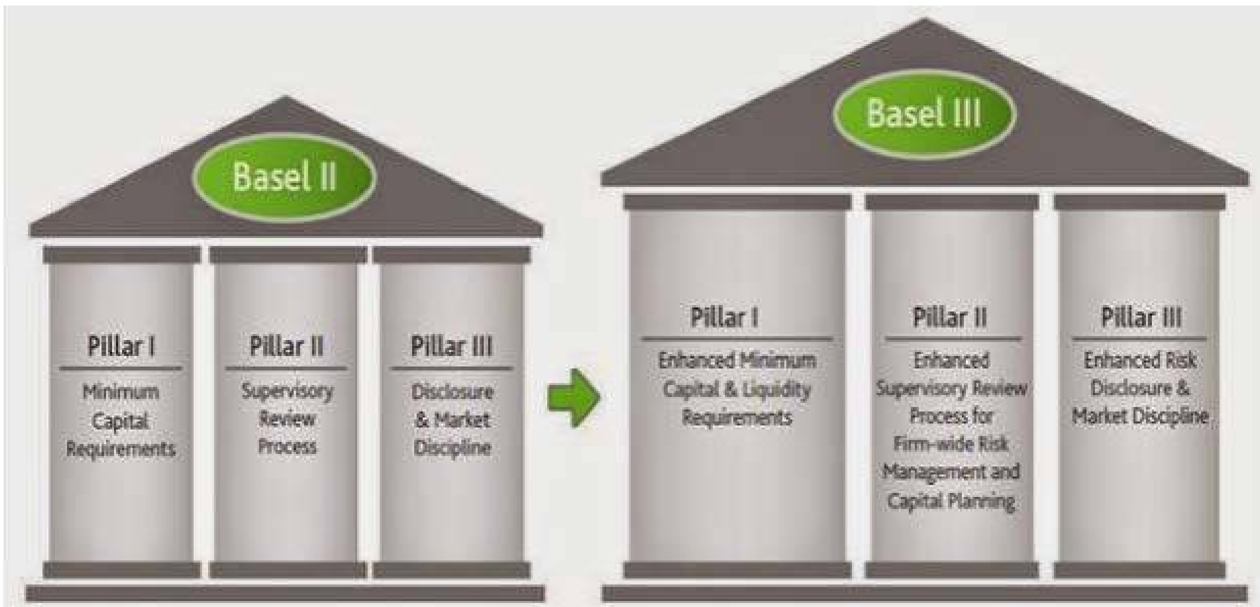
1. Banks should maintain a minimum capital adequacy requirement of 8% of risk assets.
2. Banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks
3. Banks need to mandatorily disclose their risk exposure, etc. to the central bank.

This Basel capital Accord focuses on three pillars:



Basel III:

Basel III or Basel 3 released in December 2010 is the third in the series of Basel Accords. These guidelines were introduced in response to the financial crisis of 2008. These accords deal with risk management aspects for the banking sector. In a nutshell, we can say that Basel iii is the global regulatory standard (agreed upon by the members of the Basel Committee on Banking supervision) on bank capital adequacy, stress testing, and market liquidity risk.



Objectives/aims of the Basel III:

- Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- Improve risk management and governance
- Strengthen banks' transparency and disclosures

Pillars of the Basel Norms for Banking

→ Pillar 1:

Minimum Regulatory Capital Requirements based on Risk Weighted Assets (RWAs): Maintaining capital calculated through credit, market and operational risk areas.

→ **Pillar 2:**

Supervisory Review Process: Regulating tools and frameworks for dealing with peripheral risks that banks face.

→ **Pillar 3:**

Market Discipline: Increasing the disclosures that banks must provide to increase the transparency of banks

Major Changes in Basel Norms for Banking

The Major Changes Proposed in Basel III over earlier Accords i.e. Basel I and Basel II or the Major Features of Basel III:

- **Better Capital Quality:** One of the key elements of Basel 3 is the introduction of a much stricter definition of capital. Better quality capital means the higher loss-absorbing capacity. This, in turn, will mean that banks will be stronger, allowing them to better withstand periods of stress.
- **Capital Conservation Buffer**: Another key feature of Basel iii is that now banks will be required to hold a capital conservation buffer of 2.5%. The aim of asking to build conservation buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.
- **Countercyclical Buffer:** This is also one of the key elements of Basel III. The countercyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e.

in bad times. The buffer will range from 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital.

- **Minimum Common Equity and Tier 1 Capital Requirements**: The minimum requirement for common equity, the highest form of loss-absorbing capital, has been raised under Basel III from 2% to 4.5% of total risk-weighted assets. The overall Tier 1 capital requirement, consisting of not only common equity but also other qualifying financial instruments, will also increase from the current minimum of 4% to 6%. Although the minimum total capital requirement will remain at the current 8% level, yet the required total capital will increase to 10.5% when combined with the conservation buffer.
- **Leverage Ratio**: A review of the financial crisis of 2008 has indicated that the value of many assets fell quicker than assumed from historical experience. Thus, now Basel III rules include a leverage ratio to serve as a safety net. A leverage ratio is a relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis. 3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018.
- **Liquidity Ratios**: Under Basel III, a framework for liquidity risk management will be created. A new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are to be introduced in 2015 and 2018, respectively.
- **Systemically Important Financial Institutions (SIFI):** As part of the macro-prudential framework, systemically important banks will be expected to have loss-absorbing capability beyond the Basel III requirements. Options for implementation include capital surcharges, contingent capital, and bail-in-debt.

According to new Basel-III norms, which will kick in from March 2019, Indian banks need to maintain a minimum capital adequacy ratio (CAR) of nine percent, in addition to a capital conservation buffer, which would be in the form of common equity at 2.5 percent of the risk-weighted assets.

Basel III guidelines are aimed at to improve the ability of banks to withstand periods of economic and financial stress as the new guidelines are more stringent than the earlier requirements for capital and liquidity in the banking sector.

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