



## Basel Norms

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### What are Basel norms?

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- Basel norms or Basel accords are the **international banking regulations issued by the Basel Committee on Banking Supervision.**
- The Basel norms is an effort to coordinate banking regulations across the globe, with the **goal of strengthening the international banking system.**
- It is the **set of the agreement by the Basel committee of Banking Supervision** which focuses on the risks to banks and the financial system.

### What is the Basel committee on Banking Supervision?

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- The **Basel Committee on Banking Supervision (BCBS)** is the **primary global standard setter for the prudential regulation of banks** and provides a forum for regular cooperation on banking supervisory matters for the central banks of different countries.
- It was **established by the Central Bank governors of the Group of Ten countries in 1974.**
- The committee expanded its membership in 2009 and then again in 2014. The BCBS **now has 45 members from 28 Jurisdictions**, consisting of Central Banks and authorities with responsibility of banking regulation.
- It provides a forum for regular cooperation on banking supervisory matters.
- Its objective is to enhance understanding of key supervisory issues and **improve the quality of banking supervision worldwide.**

### Why these norms?

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- **Banks lend to different types of borrowers and each carries its own risk.**
- They lend the deposits of the public as well as money raised from the market i.e, equity and debt.
- This **exposes the bank to a variety of risks of default** and as a result they fall at times.

- Therefore, Banks have to keep aside a certain percentage of capital as security against the risk of non – recovery.
- The Basel committee has produced norms called Basel Norms for Banking to tackle this risk.

## Why the name Basel?

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- Basel is a **city in Switzerland**.
- It is the **headquarters of the Bureau of International Settlement (BIS)**, which fosters cooperation among central banks with a common goal of financial stability and common standards of banking regulations.
- It was founded in 1930.
- The **Basel Committee on Banking Supervision is housed in the BIS offices in Basel, Switzerland**.

## What are these norms?

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

- **Basel-I**
  - It was introduced in 1988.
  - It **focused almost entirely on credit risk**.
  - Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Traditionally, it refers to the risk that a lender may not receive the owed principal and interest.
  - 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 example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral.
  - **India adopted Basel-I guidelines in 1999.**

- **Basel-II**

- In 2004, Basel II guidelines were published by BCBS.
- These were the refined and reformed versions of Basel I accord.
- The guidelines were **based on three parameters, which the committee calls it as pillars.**
  - **Capital Adequacy Requirements:** Banks should maintain a minimum capital adequacy requirement of 8% of risk assets
  - **Supervisory Review:** According to this, banks were needed 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.
  - **Market Discipline:** This needs increased disclosure requirements. Banks need to mandatorily disclose their CAR, risk exposure, etc to the central bank.
- **Basel II norms in India and overseas are yet to be fully implemented though India follows these norms.**

- **Basel III**

- In 2010, **Basel III** guidelines were released.
- These guidelines were introduced in response to the financial crisis of 2008.
- A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding.
- It was also felt that the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk.

- The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters **viz. capital, leverage, funding and liquidity**.
  - **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%.
  - **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.
    - 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 **deadline for the implementation** of Basel-III was March 2019 in India. It was postponed to March 2020. In light of the coronavirus pandemic, the **RBI** decided to defer the **implementation of Basel norms** by further 6 months.
  - Extending more time under Basel III means lower capital burden on the banks in terms of provisioning requirements, including the NPAs.
  - This extension would impact the perception of Indian Banks and central banks in the eyes of the global players.

## **Bank run**

It 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. As more people withdraw their funds, the probability of default increases, prompting more people to withdraw their deposits.

## **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**.
  - The key respect in which the CCCB differs from other forms of capital adequacy is that it works to help a bank counteract the effect of a downturn or distressed economic conditions.
  - With the CCCB, banks are required to set aside a higher portion of their capital during good times when loans are growing rapidly, so that the capital can be released and used during bad times, when there's distress in the economy.
- Although the RBI had proposed the CCCB for Indian banks in 2015 as part of its Basel-III requirements, it hasn't actually required the CCCB to be maintained, keeping the ratio at zero percent ever since.
- This is based on the RBI's review of the credit-GDP gap, the growth in GNPA, the industry outlook assessment index, interest coverage ratio and other indicators, as part of the first monetary policy of every financial year.

## Tier 1 Capital vs. Tier 2 Capital

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- Banks have **two main silos** of capital that are qualitatively different from one another.
  - **Tier 1:** It refers to a bank's core capital, equity, and the disclosed reserves that appear on the bank's financial statements.
    - In the event that a bank experiences significant losses, Tier 1 capital provides a cushion that allows it to weather stress and maintain a continuity of operations.
  - **Tier 2:** It refers to a bank's supplementary capital, such as undisclosed reserves and unsecured subordinated debt instruments that must have an original maturity of at least five years.
- Tier 2 capital is considered less reliable than Tier 1 capital because it is more difficult to accurately calculate and more difficult to liquidate.