Basel III Professional Sample Material

VS-1236

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1. BANK REGULATION AND BASEL ACCORDS

The chapter discusses the need for bank regulations and their impact for evolution of BASEL accords.

1.1. What are Bank Regulation

Bank regulation is a form of government regulation which subjects banks to certain requirements, restrictions and guidelines, designed to create market transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things.

Given the interconnectedness of the banking industry and the reliance that the national (and global) economy hold on banks, it is important for regulatory agencies to maintain control over the standardized practices of these institutions. Supporters of such regulation often base their arguments on the "too big to fail" notion. This holds that many financial institutions (particularly investment banks with a commercial arm) hold too much control over the economy to fail without enormous consequences. This is the premise for government bailouts, in which government financial assistance is provided to banks or other financial institutions who appear to be on the brink of collapse. The belief is that without this aid, the crippled banks would not only become bankrupt, but would create rippling effects throughout the economy leading to systemic failure.

The objectives of bank regulation, and the emphasis, vary between jurisdictions. The most common objectives are:

- ✓ prudential – to reduce the level of risk to which bank creditors are exposed (i.e. to protect depositors)
- ✓ systemic risk reduction – to reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures
- ✓ to avoid misuse of banks – to reduce the risk of banks being used for criminal purposes, e.g. laundering the proceeds of crime
- ✓ to protect banking confidentiality
- ✓ credit allocation – to direct credit to favored sectors
- ✓ it may also include rules about treating customers fairly and having corporate social responsibility.

General principles of bank regulation

Banking regulations vary widely between jurisdictions and are as

- ✓ Licensing and supervision - Banks usually require a banking license from a national bank regulator before they are permitted to carry on a banking business, whether within the jurisdiction or as an offshore bank. The regulator supervises licensed banks for compliance with the requirements and responds to breaches of the requirements by obtaining undertakings, giving directions, imposing penalties or (ultimately) revoking the bank's license.
- ✓ Minimum requirements - A national bank regulator imposes requirements on banks in order to promote the objectives of the regulator. Often, these requirements are closely tied to the level of risk exposure for a certain sector of the bank. The most important minimum requirement in banking regulation is maintaining minimum capital ratios. To some extent, U.S. banks have some leeway in determining who will supervise and regulate them.

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- ✓ Market discipline - The regulator requires banks to publicly disclose financial and other information, and depositors and other creditors are able to use this information to assess the level of risk and to make investment decisions. As a result of this, the bank is subject to market discipline and the regulator can also use market pricing information as an indicator of the bank's financial health.

Instruments and requirements of bank regulation

Capital requirement - The capital requirement sets a framework on how banks must handle their capital in relation to their assets. Internationally, the Bank for International Settlements' Basel Committee on Banking Supervision influences each country's capital requirements. In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accords. The latest capital adequacy framework is commonly known as Basel III. This updated framework is intended to be more risk sensitive than the original one, but is also a lot more complex.

Reserve requirement - The reserve requirement sets the minimum reserves each bank must hold to demand deposits and banknotes. This type of regulation has lost the role it once had, as the emphasis has moved toward capital adequacy, and in many countries there is no minimum reserve ratio. The purpose of minimum reserve ratios is liquidity rather than safety. An example of a country with a contemporary minimum reserve ratio is Hong Kong, where banks are required to maintain 25% of their liabilities that are due on demand or within 1 month as qualifying liquefiable assets.

Reserve requirements have also been used in the past to control the stock of banknotes and/or bank deposits. Required reserves have at times been gold, central bank banknotes or deposits, and foreign currency.

Corporate governance - Corporate governance requirements are intended to encourage the bank to be well managed, and is an indirect way of achieving other objectives! As many banks are relatively large, with many divisions, it is important for management to maintain a close watch on all operations. Investors and clients will often hold higher management accountable for missteps, as these individuals are expected to be aware of all activities of the institution. Some of these requirements may include:

- ✓ to be a body corporate (i.e. not an individual, a partnership, trust or other unincorporated entity)
- ✓ to be incorporated locally, and/or to be incorporated under as a particular type of body corporate, rather than being incorporated in a foreign jurisdiction
- ✓ to have a minimum number of directors
- ✓ to have an organisational structure that includes various offices and officers, e.g. corporate secretary, treasurer/CFO, auditor, Asset Liability Management Committee, Privacy Officer, Compliance Officer etc. Also the officers for those offices may need to be approved persons, or from an approved class of persons
- ✓ to have a constitution or articles of association that is approved, or contains or does not contain particular clauses, e.g. clauses that enable directors to act other than in the best interests of the company (e.g. in the interests of a parent company) may not be allowed.

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Financial reporting and disclosure requirements - Among the most important regulations that are placed on banking institutions is the requirement for disclosure of the bank's finances. Particularly for banks that trade on the public market, in the US for example the Securities and Exchange Commission (SEC) requires management to prepare annual financial statements according to a financial reporting standard, have them audited, and to register or publish them. Often, these banks are even required to prepare more frequent financial disclosures, such as Quarterly Disclosure Statements. The Sarbanes–Oxley Act of 2002 outlines in detail the exact structure of the reports that the SEC requires.

In addition to preparing these statements, the SEC also stipulates that directors of the bank must attest to the accuracy of such financial disclosures. Thus, included in their annual reports must be a report of management on the company's internal control over financial reporting. The internal control report must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting. Under the new rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report. Furthermore, the SEC added a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Credit rating requirement - Banks may be required to obtain and maintain a current credit rating from an approved credit rating agency, and to disclose it to investors and prospective investors. Also, banks may be required to maintain a minimum credit rating. These ratings are designed to provide color for prospective clients or investors regarding the relative risk that one assumes when engaging in business with the bank. The ratings reflect the tendencies of the bank to take on high risk endeavors, in addition to the likelihood of succeeding in such deals or initiatives. The rating agencies that banks are most strictly governed by, referred to as the "Big Three" are the Fitch Group, Standard and Poor's and Moody's. These agencies hold the most influence over how banks (and all public companies) are viewed by those engaged in the public market. In recent years, following the Great Recession, many economists have argued that these agencies face a serious conflict of interest in their core business model. Clients pay these agencies to rate their company based on their relative riskiness in the market. The question then is, to whom is the agency providing its service: the company or the market?

European financial economics experts – notably the World Pensions Council (WPC) have argued that European powers such as France and Germany pushed dogmatically and naively for the adoption of the "Basel II recommendations", adopted in 2005, transposed in European Union law through the Capital Requirements Directive (CRD). In essence, they forced European banks, and, more importantly, the European Central Bank itself, to rely more than ever on the standardized assessments of "credit risk" marketed aggressively by two US credit rating agencies – Moody's and S&P, thus using public policy and ultimately taxpayers' money to strengthen anti-competitive

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duopolistic practices akin to exclusive dealing. Ironically, European governments have abdicated most of their regulatory authority in favor of a non-European, highly deregulated, private cartel.
Large exposures restrictions - Banks may be restricted from having imprudently large exposures to individual counterparties or groups of connected counterparties. Such limitation may be expressed as a proportion of the bank's assets or equity, and different limits may apply based on the security held and/or the credit rating of the counterparty. Restricting disproportionate exposure to high-risk investment prevents financial institutions from placing equity holders' (as well as the firm's) capital at an unnecessary risk.

Activity and affiliation restrictions - In the US in response to the Great depression of the 1930s, President Franklin D. Roosevelt's under the New Deal enacted the Securities Act of 1933 and the Glass–Steagall Act (GSA), setting up a pervasive regulatory scheme for the public offering of securities and generally prohibiting commercial banks from underwriting and dealing in those securities. GSA prohibited affiliations between banks (which means bank-chartered depository institutions, that is, financial institutions that hold federally insured consumer deposits) and securities firms (which are commonly referred to as "investment banks" even though they are not technically banks and do not hold federally insured consumer deposits); further restrictions on bank affiliations with non-banking firms were enacted in Bank Holding Company Act of 1956 (BHCA) and its subsequent amendments, eliminating the possibility that companies owning banks would be permitted to take ownership or controlling interest in insurance companies, manufacturing companies, real estate companies, securities firms, or any other non-banking company. As a result, distinct regulatory systems developed in the United States for regulating banks, on the one hand, and securities firms on the other.

1.2. Why Banking regulations needed

Globalisation and financial innovation have over the last two decades or more multiplied and diversified the risks carried by the banking system. In response, the regulation of banking in the developed industrial countries has increasingly focused on ensuring financial stability, at the expense of regulation geared to realising growth and equity objectives. The appropriateness of this move is being debated even in the developed countries, which in any case are at a completely different level of development of their economies and of the extent of financial deepening and intermediation as compared to the developing world.

The Basel Committee has two main reasons for proposing its Basel framework:

- ✓ to strengthen international banking by boosting their capital requirements
- ✓ to remove inter-country competitive inequalities amongst G-10 banking institutions

At the centre of BASEL guidelines is an effort to estimate how much of capital assets of specified kinds should banks hold to absorb losses. This requires some assessment of likely losses that may be incurred and deciding on a proportion of liquid assets that banks must have at hand to meet those losses in case they are incurred. This required regulatory capital is defined in terms "tiers" of capital that are characterised by differing degrees of liquidity and capacity to absorb losses. The highest, Tier I, consists principally of the equity and recorded reserves of the bank.

Risk and BASEL

Banks face high risks primarily because banking is one of the most highly leveraged sectors of any economy. To tackle risk and function efficiently, there is a need to manage all kinds of risk associated with banking. Thus, risk management is core to any banking service. The ability to gauge risk and take appropriate action is the key to success for any bank. It is said that risk-takers survive, effective risk managers prosper and the risk- averse perish. The same holds for the banking industry. The axiom that holds good for all business is "No Risk No Gain".

A bank's real capital worth is evaluated after taking into account the riskiness of its assets. It was earlier hoped that the capital would provide banks with a comfortable cushion against insolvency, thereby ensuring market stability. In the wake of the introduction of prudential regulation as an integral part of financial sector reforms in India, there has been a growing debate as to whether capital adequacy requirements are the best means to regulate the banking system. From cross country experiences, there is some evidence of a positive association between capitalisation and risk assumption by banks due to the possibility that the one-size-fits-all CAR causes bank leverage and asset risk to become substitutes. At policy levels, this has driven research into alternative regulatory methods.

The higher the risk of loss associated with an investment the more of it must be covered in this manner, requiring assets to be risk-weighted. A 100 per cent risk loss implies that the whole of an investment can be lost under certain contingencies and a zero per cent risk-weight implies that the asset concerned is riskless.

Bank Failure

A bank failure occurs when a bank is unable to meet its obligations to its depositors or other creditors because it has become insolvent or too illiquid to meet its liabilities. More specifically, a bank usually fails economically when the market value of its assets declines to a value that is less than the market value of its liabilities. The insolvent bank either borrows from other solvent banks or sells its assets at a lower price than its market value to generate liquid money to pay its depositors on demand. The inability of the solvent banks to lend liquid money to the insolvent bank creates a bank panic among the depositors as more depositors try to take out cash deposits from the bank. As such, the bank is unable to fulfill the demands of all of its depositors on time. Also, a bank may be taken over by the regulating government agency if Shareholders Equity (i.e. capital ratios) are below the regulatory minimum.

The failure of a bank is generally considered to be of more importance than the failure of other types of business firms because of the interconnectedness and fragility of banking institutions. Research has shown that the market value of customers of the failed banks is adversely affected at the date of the failure announcements. It is often feared that the spillover effects of a failure of one bank can quickly spread throughout the economy and possibly result in the failure of other banks, whether or not those banks were solvent at the time as the marginal depositors try to take out cash deposits from these banks to avoid from suffering losses. Thereby, the spillover effect of bank panic or systemic risk has a multiplier effect on all banks and financial institutions leading to a greater effect of bank failure in the economy. As a result, banking institutions are typically subjected to rigorous regulation, and bank failures are of major public policy concern in countries across the world.

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Bank run and panic

A bank run (also known as a run on the bank) occurs when in a fractional-reserve banking system (where banks normally only keep a small proportion of their assets as cash), a large number of customers withdraw cash from deposit accounts with a financial institution at the same time because they believe that the financial institution is, or might become, insolvent; and keep the cash or transfer it into other assets, such as government bonds, precious metals or gemstones. When they transfer funds to another institution it may be characterised as a capital flight. As a bank run progresses, it generates its own momentum: as more people withdraw cash, the likelihood of default increases, triggering further withdrawals. This can destabilize the bank to the point where it runs out of cash and thus faces sudden bankruptcy. To combat a bank run, a bank may limit how much cash each customer may withdraw, suspend withdrawals altogether, or promptly acquire more cash from other banks or from the central bank, besides other measures.

A banking panic or bank panic is a financial crisis that occurs when many banks suffer runs at the same time, as people suddenly try to convert their threatened deposits into cash or try to get out of their domestic banking system altogether. A systemic banking crisis is one where all or almost all of the banking capital in a country is wiped out. The resulting chain of bankruptcies can cause a long economic recession as domestic businesses and consumers are starved of capital as the domestic banking system shuts down. According to former U.S. Federal Reserve chairman Ben Bernanke, the Great Depression was caused by the Federal Reserve System, and much of the economic damage was caused directly by bank runs. The cost of cleaning up a systemic banking crisis can be huge, with fiscal costs averaging 13% of GDP and economic output losses averaging 20% of GDP for important crises from 1970 to 2007.

Several techniques have been used to try to prevent bank runs or mitigate their effects. They have included a higher reserve requirement (requiring banks to keep more of their reserves as cash), government bailouts of banks, supervision and regulation of commercial banks, the organization of central banks that act as a lender of last resort, the protection of deposit insurance systems such as the U.S. Federal Deposit Insurance Corporation, and after a run has started, a temporary suspension of withdrawals. These techniques do not always work: for example, even with deposit insurance, depositors may still be motivated by beliefs they may lack immediate access to deposits during a bank reorganization.

1.3. What are Basel Accords

The Basel Accords refer to the banking supervision Accords (recommendations on banking regulations)—Basel I, Basel II and Basel III—issued by the Basel Committee on Banking Supervision (BCBS). They are called the Basel Accords as the BCBS maintains its secretariat at the Bank for International Settlements in Basel, Switzerland and the committee normally meets there. The Basel Accords is a set of recommendations for regulations in the banking industry.

1.4. Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1974. 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. The Committee frames guidelines and standards in different areas - some of the better

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known among them are the international standards on capital adequacy, the Core Principles for Effective Banking Supervision and the Concordat on cross-border banking supervision. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland. However, the BIS and the Basel Committee remain two distinct entities.

The purpose of BCBS is to encourage convergence toward common approaches and standards. The Committee is not a classical multilateral organization, in part because it has no founding treaty. BCBS does not issue binding regulation; rather, it functions as an informal forum in which policy solutions and standards are developed.

The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision (see bank regulation or "Basel III Accord", for example) in the expectation that member authorities and other nations' authorities will take steps to implement them through their own national systems.

The Basel Committee

Formerly, the Basel Committee consisted of representatives from central banks and regulatory authorities of the Group of Ten countries plus Luxembourg and Spain. Since 2009, all of the other G-20 major economies are represented, as well as some other major banking locales such as Hong Kong and Singapore.

The committee does not have the authority to enforce recommendations, although most member countries as well as some other countries tend to implement the Committee's policies. This means that recommendations are enforced through national (or EU-wide) laws and regulations, rather than as a result of the committee's recommendations - thus some time may pass between recommendations and implementation as law at the national level.

The Basel Committee is named after the city of Basel, Switzerland. In early publications, the Committee sometimes used the British spelling "Basle" or the French spelling "Bâle," names that are sometimes still used in the media. More recently, the Committee has deferred to the predominantly German-speaking population of the region and used the spelling "Basel", which is also a common spelling in English.

Organization

The Basel committee along with its sister organizations, the International Organization of Securities Commissions and International Association of Insurance Supervisors together make up the Joint Forum of international financial regulators

Member Countries

Committee members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland. However, the BIS and the Basel Committee remain two distinct entities.

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Groups

The Committee is sub-divided into groups, each of which have specific task forces to work on specific issues:

- ✓ The Standards Implementation Group (SIG)
  - ✓ Operational Risk Subgroup - addresses issues related to Advanced Measurement Approach for Operational Risk
  - ✓ Task Force on Colleges - develops guidance on the Basel Committee's work on supervisory colleges
  - ✓ Task Force on Remuneration - promotes the adoption of sound remuneration practices
  - ✓ Standards Monitoring Procedures Task Force - develops procedures to achieve greater effectiveness and consistency in standards monitoring and implementation
- ✓ The Policy Development Group (PDG)
  - ✓ Risk Management and Modeling Group - point of contact with the industry on the latest advances in risk measurement and management
  - ✓ Research Task Force - facilitates economists from member institutions to discuss research on financial stability in consultation with the academic sector
  - ✓ Trading Book Group - reviews how risks in the trading book should be captured by regulatory capital
  - ✓ Working Group on Liquidity - works on global standards for liquidity risk management and regulation
  - ✓ Definition of Capital Subgroup - reviews eligible capital instruments
  - ✓ Capital Monitoring Group - co-ordinates the expertise of national supervisor in monitoring capital requirements
  - ✓ Cross-border Bank Resolution Group - compares the national policies, legal frameworks and the allocation of responsibilities for the resolution of banks with significant cross-border operations
- ✓ The Accounting Task Force (ATF) - ensures that accounting and auditing standards help promote sound risk management thereby maintaining the safety and soundness of the banking system
  - ✓ Audit subgroup - explores key audit issues and co-ordinates with other bodies to promote standards
- ✓ The Basel Consultative Group (BCG) - facilitates engagement between banking supervisors including dialogue with non-member countries

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Certifications

Accounting, Banking and Finance
– Certified AML-KYC Compliance Officer
– Certified Business Accountant
– Certified Commercial Banker
– Certified Foreign Exchange Professional
– Certified GAAP Accounting Standards Professional
– Certified Financial Risk Management Professional
– Certified Merger and Acquisition Analyst
– Certified Tally 9.0 Professional
– Certified Treasury Market Professional
– Certified Wealth Manager

Big Data
– Certified Hadoop and Mapreduce Professional

Cloud Computing
– Certified Cloud Computing Professional

Design
– Certified Interior Designer

Digital Media
– Certified Social Media Marketing Professional
– Certified Inbound Marketing Professional
– Certified Digital Marketing Master

Foreign Trade
– Certified Export Import (Foreign Trade) Professional

Health, Nutrition and Well Being
– Certified Fitness Instructor

Hospitality
– Certified Restaurant Team Member (Hospitality)

Human Resources
– Certified HR Compensation Manager
– Certified HR Stafffing Manager
– Certified Human Resources Manager
– Certified Performance Appraisal Manager

Office Skills
– Certified Data Entry Operator
– Certified Office Administrator

Project Management
– Certified Project Management Professional

Real Estate
– Certified Real Estate Consultant

Marketing
– Certified Marketing Manager

Quality
– Certified Six Sigma Green Belt Professional
– Certified Six Sigma Black Belt Professional
– Certified TQM Professional

Logistics & Supply Chain Management
– Certified International Logistics Professional
– Certified Logistics & SCM Professional
– Certified Purchase Manager
– Certified Supply Chain Management Professional

Legal
– Certified IPR & Legal Manager
– Certified Labour Law Analyst
– Certified Business Law Analyst
– Certified Corporate Law Analyst

Information Technology
– Certified ASP.NET Programmer
– Certified Basic Network Support Professional
– Certified Business Intelligence Professional
– Certified Core Java Developer
– Certified E-commerce Professional
– Certified IT Support Professional
– Certified PHP Professional
– Certified Selenium Professional
– Certified SEO Professional
– Certified Software Quality Assurance Professional

Mobile Application Development
– Certified Android Apps Developer
– Certified iPhone Apps Developer

Security
– Certified Ethical Hacking and Security Professional
– Certified Network Security Professional

Management
– Certified Corporate Goverance Professional
– Certified Corporate Social Responsibility Professional

Life Skills
– Certified Business Communication Specialist
– Certified Public Relations Officer

Media
– Certified Advertising Manager
– Certified Advertising Sales Professional

Sales, BPO
– Certified Sales Manager
– Certified Telesales Executive

& many more job related certifications

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