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What is the role of Basel III in creating sufficient risk management in banking sector?

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Abstract

This paper attempts to investigate the reasons that lead bankers into establishing Basel III agreement and, second, to examine whether it would be able to bring about prudent risk behavior among banks. Basel III was the third set of regulations, following Basel I and Basel II, and was developed in response to the financial crisis. The measures developed by the Basel Committee on Banking Supervision aimed to reinforce banks liquidity, to protect the banking sector from systemic risks, as well as to solidify the regulation. Although most of the fundamental problems, that were responsible for the global financial crisis, had already been identified with Basel I and Basel II, Basel III did not offer solutions for many of them. In fact, Basel III inherited some of the weaknesses of Basel II, as the concept that banks should hold more capital against risky asset. Regarding the risk protection, the challenge was to reduce unforeseeable risks, whereas Basel III focused mostly on the foreseeable ones.

Keywords: Banking, Risks, Globalization, Crisis.

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Introduction

Given that the banks’ role is extremely difficult and complicated, it was quite obvious to consider that they should be directed by one bigger and central bank. Usui (2003) confirms that position arguing that bank regulators have recognized that sound corporate governance must exist for bank supervision to function well. More specifically, a central bank can affect short-term interest rates, the monetary base and can achieve important policy goals.

The responsibilities of the central bank were not always the same, but it was adjusted from the country’s need and regulations. For example, during the generation of the first central Bank of Sweden, named Riksbank, in 1668, its main role was to lend the government funds and to develop the payment system, while when Bank of England was founded in 1694, its main purpose was to mobilize money to fight the French (Amediku, 2011).

The beginning of the 19th century was marked by the establishment of Banque de France by Napoleon in 1800. Its role was to stabilize the currency after the hyperinflation of paper money during the French Revolution, as well as to aid in government finance (Bordo, 2007). On the other hand, the United States of America had two central banks until 1836, but neither had been provided by any financial power. Later in the same century, the central banks shifted their strategy towards financial stability, because of the many severe crises such as the major international crisis of 1873. In the same time, the United States of America had no central bank from 1836 until 1914 and experienced various financial crises followed by recession (Bordo, 2007).

The most important event in the beginning of the twentieth century was the creation of The Federal Reserve System which started operation in 1914. Its existence was reinforced by the Banking Act of 1933 which helped to eliminate the negative results the banking panics. However, the Great Depression created many expectations regarding the bank regulation not only in US but in almost every country. Amediku (2011)
underlines that since that, the purpose of bank regulation emerged to be the avoidance of financial crises as well as to protect small depositors, to control systemic risk and supervise measures such as capital adequacy and reserve requirements. As a result, there were no banking crises from the late 1930s until the mid-1970s anywhere in the advanced world (Bordo, 2007).

The increasing of deregulation and globalization, lead the banking systems into becoming more fragile (Caprio and Klingebiel, 1999). To improve crisis prevention and management, many countries were working to upgrade their bank regulation and supervision (Kunt et al., 2006). Under such pressure, central bankers from around the world gathered to create a universal body, named Basel Committee on Banking Supervision (BCBS), in Basel, Switzerland. Basel I was enforced by law in the Group of Ten (G-10) countries in 1992, requiring:

- Banks should maintain a sufficient capital (8% minimum) to cushion losses without causing systemic problems and also,
- They had to report Off-Balance Sheet Items such as Letters of Credit.

In response to the era’s need for better methods of risk quantification, a new capital adequacy framework has been initiated and is commonly known as Basel II (2006). In particular, according to Panagopoulos and Vlamis (2008) Basel II initiated:

- New methods for a more accurate estimation of the credit risk, that is the Standardized and the Internal Rate Based methods.
- Better allocation of marketing and credit risk by introducing several banking and trading books of assets.
- A new way of estimating CAR by taking into account banks’ exposure to Operational Risk as well.
In addition, Stolz (2002) highlights the important role that Basel II assigns to supervisors who control the banks’ compliance with these rules and take countermeasure in case of deviation.

**Basel III**

There were many weaknesses in banking regulations, which previous frameworks could not cure. Anyone acting as observer could see that the previous international minimum standards for bank capital were too low to manage the huge crisis of 2009. Byres (2012) analyzed the demands of the previous existing environment, referring the reasons that lead to Basel III:

First of all, the regulations that came from Basel I and Basel II were not sufficient enough to act as a constraint on the natural incentive within banks to increase leverage. That gap throughout the banking system, led to significant financial instability during the crisis.

Unlike the interval between 2000-2007 (the good years) during which banks having capital efficiency were trying to find ways to return capital to shareholders, the new and prioritized trend for the banks was to maintain a strong capital base, so as to avoid the high level of risk premia paid that have to be paid in weaker positions.

Moreover, there was a very rife trend which motivated banks into selling loans and issuing Standby Letters of Credit (SLCs). Particularly, central banks permitted banks to make relatively low-risk loans that would be unprofitable to finance with deposits, resulting to off-balance sheets activities not being motivated enough to increase leverage through “off balance sheet” activities (James, 1987).

Last, as a result of the crisis was the fragmentation of the financial system. Banks should cohere and react directly to avoid a patchwork of diverse national measures which act as a barrier to cross-border banking business. To maintain the global competition, it was necessary to implement internationally agreed standards.
Basel III requirements

Basel III aimed to both increase risk-weighted capital requirements and superimpose a non-risk-weighted leverage ratio. According to the published rules of Basel III as listed, the basic requirements were:

1. The levels of the capital that banks should maintain as a percentage of risk-weighted assets, was increased from 2% to 7% (Byres, 2012).

2. A capital conservation buffer of 2.5% of common equity Tier 1 will be held on top of the minimum capital requirements, bringing the total common equity capital requirements to 7%, while in times of stress, banks can use countercyclical buffer provided that, if they do so, earnings distributions such as bonuses and dividends are limited. These actions resulted into a) enforcing corrective action when a bank’s capital ratio deteriorates and into b) holding more capital in good times to prepare for the inevitable rainy days ahead.

3. Wherever needed, there should be additional requirements. For example, financial institutions that reflect greater risks to financial stability may include capital surcharges.

4. A minimum leverage ratio (capital to total exposures) of 3% will be tested, which should address concerns about leverage in the financial system and back up the risk-based requirements outlined above. This action ensured that banks will not become unduly leveraged on a non-risk-weighted basis.

5. The additional buffer of up to 2.5% of common equity should have to be built up in periods of rapid aggregate credit growth during which it aggravates system-wide risk.

Generally, Basel III adopted rules and requirements which improved risk coverage, particularly for illiquid trading activities, securitizations, off-balance sheet exposures and vehicles and counter-party credit exposures stemming from derivatives (Amediku 2011; Byres, 2012). It was the first time that bank’s liquidity risk
profile for both short and longer-term disruptions, was in the central focus of international standards regarding bank liquidity and funding.

**Is Basel III necessary?**

As mentioned before, Basel III examined the weaknesses that came from Basel I and II and tried to update many of the international standards according to the crisis demands and expectations. Thus, it is patently clear that Basel III was necessary, especially the proposals that had some very useful elements, as the leverage ratio, the capital buffer and the proposal which deals with pro-cyclicality through dynamic provisioning based on expected losses (Wignall and Atkinson, 2010).

Particularly, Basel III corresponded to the need for stability coming from the global crisis, raising minimum capital requirements and ensuring that other instruments that count as regulatory capital will genuinely be available wherever that is demanded. Acting in the era of crisis where banks fail in gathering cash and their target was to strengthen the capital base, Basel III offers the proper financial background to restore the financial health of banks so that they will willingly and actively deal with one another improving the general financial system (Byres, 2012).

In addition to the referred crisis results was the challenge to avoid a patchwork of diverse national measures ascension by the domestic markets rather by the global ones. To reinforce the cross-border banking businesses throughout the world, Basel III transparently determined which banks can expand and compete in the international marketplace.

**Will Basel III bring about prudent risk management in banking?**

Although Basel III was considered of being necessary as long as it positioned the banks to meet the new capital requirements, the provisions of Basel III have not fully addressed the factors that were responsible for the current financial crisis and the fundamental problems identified with Basel I and Basel II (Amediku, 2011). Undertaking risks is considered to be a common strategy for the banks when they aim to maximize

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returns. Basel III attempted to capture those risks in prudent manner but the developments in the financial system created new set of risks which the current framework might not encounter. Particularly, the modifications in the overall risk-weighted asset framework are criticized that could deal with more concentration issues (Wignall and Atkinson, 2010).

The risk management challenges required of Basel III’s rules, to provide support and engagement of multiple competencies across the organization so as to address impacts on people, process and technology. However, as Adamson (2012) refers, the laws and regulations being written to implement Basel III did not mention anything about size, structure, risk profile, complexity, or economic significance of a banking organization. To develop, maintain and improve the appropriate risk management framework that serves an organization, all of these factors must be taken into consideration.

In addition, the regulations of Basel III did not alter the risk weighting regime and thus, banks would continue to search for common equity against their risk weighted assets (Amediku, 2011). The contribution of the risk weighting regime and the liquidity proposal resulted in the bank’s preference for government debt paper and to the financial damage of the small and medium enterprises of the private sector.

Apart from the direct deficiencies in providing prudent risk management, there were also major shortcomings in ethical issues such as accounting manipulation, external auditors, and regulators (Amediku, 2011). Basel III has not addressed any of these issues so as to create a stabilized risk management regulatory architecture as well as it does not include provisions about the Shadow banking system determining whether it should be incorporated into the regulatory framework and, if so, how (Wignall and Atkinson, 2010).

Although Basel III paid close attention in addressing many of the significant risk management weaknesses, there are several developments that emerged during the last few years which, still, are not incorporated into regulations. For example, there should be regulations that obligate central banks to increase focus on effective crisis management, recovery and resolution measures so as to reduce both the probability and

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impact of a bank failure (Byres, 2012). Expanding that, they should, also, apply a more micro-prudential supervision to the banks, identifying and analyzing proactively the systemic risk. Both actions might have prevented panic situations that came from the financial crisis.

**Conclusion**

The aim of this paper is initially to investigate under which conditions Basel III processed and announced the new rules and regulations, second to examine whether Basel III was necessary and to end up concluding if it would bring about prudent risk management in banking. It is well known that crisis highlighted the many weaknesses in the regulatory structure that existed at that time. However, it has been a great effort that has been put in over the past few years to significantly overhaul the international regulatory architecture. Particularly, Basel III regulations made banks more resilient, reduced the reliance of the private sector on central banks, and help tackle the too-big-to-fail problem (Byres, 2011). Generally, the implementation of Basel III may well represent the most significant series of steps and challenges in managing risk.

However, many elements of the agreement remain unfinished and many factors that are responsible for Basel II failure have also jeopardized the recent efforts to raise international capital requirements in the form of ‘Basel III’ (Lall, 2009). Given the fact that Basel III did not alter the risk weighting regime and still, for example, allows banks searching for common equity against their risk weighted assets (Amediku, 2011), Basel Committee on Banking Supervision (BCBS) needs to monitor financial system development and risk, on a more regular basis. The complexity and demands of the banking world requires a flexible management solution that delivers speed, accuracy, and performance. Moreover, BCBS needs to examine shadow banking risks, to review whether external rating agencies implement the regulations and standards and to punish regulatory arbitrage.

The paper’s results also suggest that Basel III cannot be relied upon to deliver stability on its own, but banks should push on with the reform agenda to deliver full, timely and consistent implementation. As Adamson
(2012) refers, the road to achieve a mature risk-management model is a long and complex one and each bank should individually implement a well-defined risk management strategy that increase the likelihood of a well-structured implementation of a Basel Program.
References


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