Banking Regulations: The Basel capital requirements and continuing conflicts with the Right to Development

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Basel Capital Norms - The Backdrop

- The Basel Committee on Banking Supervision - a committee of banking supervisory authorities.
- The objective of capital requirements – to apply a common approach to internationally active banks in different countries so as to reduce competitive inequalities between them.
- Basel Committee norms are non-binding and originally meant to raise the level of bank capital in the G-10 countries.
- But these have been implemented in many developing and less developed countries - Role of IMF's FSAP and IFI loan conditionalities. (In countries with high degrees of external financial liberalisation, these have been combined with market pressure).

Basel I (1) – The 1988 Basel Capital Accord

- The focus of capital requirements has been on protecting banks against credit risk.
- The idea is to force banks to hold more of their own capital, because common equity/shareholders' equity is the last to be compensated in liquidation and therefore is always available to absorb unexpected losses without triggering bankruptcy of the bank.
- But this makes investors want much higher returns.
- So, in order to dissuade banks from undertaking excessive risks, the riskiness of each class of borrowers is assessed and capital requirement is based on this risk assessment.
- Under Basel I, the minimum capital adequacy ratio (CAR) - the percentage of a bank's regulatory capital to its risk-weighted assets, was set at 8%.

Weaknesses of Basel I

- Widely criticised for regulatory biases that affected financing for development (Francis, 2006):
  - Encouraged pro-cyclicality in lending and exacerbated the pro-cyclicality in financial markets (Ocampo and Griffith-Jones, 2007); and
  - Also created an incentive towards short-term lending, which was brought out compellingly in the analysis of the late 1990s' financial crisis.
- Basel I also turned out to be too simplistic to address the needs of the banking system whose risk profile had undergone enormous transformation following financial liberalisation around the world.
- Did not take account of the risk weight of specific assets as opposed to categories.
- Further, regulatory capital was poorly defined.

1996 Amendment and Basel II

- The 1996 Market Risk Amendment introduced an explicit capital cushion for the market risks to which banks are exposed because of their trading in equities, debt securities, foreign exchange, commodities, options, etc.
- Allowed banks to use their internal rating models to estimate their market risks.
- The fully Revised Capital Accord that came into force in 2004 retained key elements of the 1988 Accord.
- But there is greater use of banks' internal assessments of risk as primary inputs in the calculations for regulatory capital.
- Capital coverage was expanded to include operational risk, in addition to credit risk and market risk.

Basel II – Three Pillars

- The first pillar describes the alternative approaches available for the calculation of minimum capital requirements for credit risk and operational risk.
- Pillar I proposes a much more sophisticated and detailed structure than Basel I, not only in the types of risks and the range of asset classes included for calculating capital requirements, but also in the methods used for risk weighting.
- Pillar II addresses the supervisory review process by national regulators.
- Pillar III describes the qualitative and quantitative disclosure standards that require banks to publicly disclose key information regarding their risk exposures and capital positions – aimed at improving "market discipline".

Basel II

- Two options for calculating credit risk, namely, the Standardised Approach (SA) and two Internal Ratings-Based (IRB) approaches.
- The SA is similar to Basel I for categorising bank assets according to their risk and then weighing them using fixed weights.
- However, the calibration of risk is based on the assessments by credit rating agencies.
- The IRB approaches measure credit risk using sophisticated formulas based on inputs of risk parameters determined internally by banks.

➢ Marked a clear shift to self-regulation by banks.

Basel II Weaknesses

- Given the huge importance of the credit ratings given to customers and countries, the use of the Standardised approach would imply an increased difficulty in accessing bank financing not only for unrated small- and medium-sized companies and banks, but also for the poorer countries.
- As higher regulatory capital requirements feed through into the pricing of loans, these changes would cause the interest rates on loans to lower-rated borrowers and developing countries to rise significantly.
- Most importantly, the issue of pro-cyclicality in financial markets was not dealt with.
- Basel II again focused only on risk of individual banks, and did not take account of systemic risk in any way.
- => global financial crisis

Basel III – Objective to increase financial stability

- Agreed upon in 2010.
- Perceived to address the shortcomings of Basel II exposed by the current financial crisis, namely:
  - underestimated the losses that capital should absorb;
  - forgot liquidity risk;
  - underestimated counterparty risk;
  - overestimated the efficacy of Pillar 1 in containing leverage;
  - did not consider the greater risk that SIFIs pose to financial systems;
  - did not pay enough attention to the pro-cyclicality produced by capital requirements (Tonveronachi, 2011).

Basel III – Building Blocks (1)

- So, Basel III aims to raise the quantity, quality, consistency and transparency of the capital base
- Narrower definition of regulatory capital – with greater proportion of common equity
- Strengthens the risk coverage of the capital framework (particularly with respect to counterparty credit risk exposures arising from derivatives, repos and securities financing activities)
  - Has led to an enormous proliferation in the number of risk weights and increased capital charges for most kinds of exposures
- Introduces an additional Capital Conservation Buffer that can be drawn down in periods of financial stress.

Basel III - Building Blocks (2)

- Introduces a Countercyclical Capital Buffer designed to address the concern that existing capital requirements are pro-cyclical.
- New leverage ratio: Aims to reduce the risk of a build-up of excessive leverage at the bank level as well as the systemic level .
- Two new liquidity ratios: Meant to promote short-term resilience to potential liquidity disruptions.
- A net stable funding ratio: Meant to encourage banks to use stable sources to fund their activities.
- Additional capital surcharges ranging between 1- 3.5% for systemically important financial institutions (SIFIs) given their growing systemic relevance.

Basel III Pillar 1 Capital Requirements (%)

(Figures in brackets are Basel II requirements)

	Common Equity Tier 1	Tier 1 (Common equity plus Other fully loss absorbing capital)	Tier 2	Total Capital
Minimum	4.5 (2.0)	6.0 (4.0)	2.0 (4.0)	8.0 (8.0)
Conservation buffer	2.5			(Pillar 2)
Minimum plus conservation buffer	7.0	8.5	2.0	10.5 (8.0+Pillar 2)
Countercyclical buffer range*	0 – 2.5			

Basel III - Increased overall capital requirement

- Between 2013 and 2019, the common equity component of capital (core Tier 1) will increase from 2% of a bank's risk-weighted assets before certain regulatory deductions to 4.5% after such deductions.

- Between 2013 and 2019 , the overall capital requirement (Tier 1 and Tier 2) will increase from 8% to 10.5% (adding the capital conservation buffer and the countercyclical capital buffer).

New Leverage and Liquidity Ratios

- A minimum 3% Tier 1 leverage ratio, measured against a bank's gross (and not risk-weighted) balance sheet.

- Two new liquidity ratios:
- A liquidity coverage ratio - To ensure that a bank maintains unencumbered, high quality assets that can be converted into cash to meet its liquidity needs over a thirty-day period.
- A net stable funding ratio – Aims to limit liquidity mismatches; Requires that "available" stable funding must be equal or greater than the "required" stable funding over a one-year period.

Overview of the Weaknesses in Basel III (1)

Basel III attempts to address some of the serious deficiencies of Basel II. However,

- The complex risk assessment methodology continue to rely on ratings generated by banks' internal models for the estimation of exposure to risk.
- But banks' exposures to other banks and other financial firms are often associated with non-transparent transactions whose potential risk is difficult to assess.
- As found under Basel II, internal models give scope for banks to assign favourable risk weights on riskier transactions through innovative financial instruments and accounting practices in order to reduce the average risk weight of a class of assets.
- Multi-functional banking allows this.

Overview of the Weaknesses in Basel III (2)

- As Kregel (2011) points out, while the risk-adjusted capital ratios under Basel II were meant to make riskier activities more expensive to fund, and thus less profitable and less attractive, they had a rather perverse result:
- First, this encouraged banks to expand their activities in the riskiest, highest-return activities in each particular risk category.
- Second, it encouraged banks to move as much as possible of their lending that had the highest risk weight off their balance sheets and into special-purpose vehicles (SPVs) that largely escaped regulation and reporting.
- This enabled them to achieve the required CAR without increasing common equity (the safest regulatory capital component), while actual risks in the system increased.

Overview of the Weaknesses in Basel III (3)

- Between 1999 and 2007, for the ten largest US banks, the risk-based capital adequacy ratio estimated in accordance with the Basel II rules remained at approximately 11 per cent. (Required CAR was only 8%).
- This figure was achieved by means of a shrinkage of the denominator of the ratio through the application of increasingly favourable risk weights to the assets (Cornford, 2012).
  - The numerator in the ratio, the regulatory capital, did not increase - the ratio of common equity to tangible assets was only 2.8 per cent in 2007 for the ten largest banks, just before the crisis.

Basel III – Does not take care of fundamental problems

- The refinement achieved in Basel II in risk categorisation (over Basel I) did not prevent the global financial crisis.

1. As long as multi-functional banking remains, the incentive to take on additional risks to make extra profits will remain.

- Any new regulations are limited by their inability to foresee future weaknesses in the system given that financial innovations are used to evade them.

2. There is continued reliance on "market discipline", which is misplaced: Given that SIFIs cannot be allowed to fail, the associated moral hazard means that there is no effective market discipline.

Capital adequacy requirements are not adequate as a crisis prevention measure

- Thus there is no guarantee that the higher, or more refined capital requirements imposed by Basel III will ensure reduced financial fragility and prevent another financial crisis.
- Countries facing financial crisis are observed to have experienced declines in economic growth, increase in poverty and erosion in several socio-economic and cultural rights achieved till then.
- While economic growth is not equated with development, " sustained economic growth is an indispensable component of the realisation of the right to development." (Report of the WG on the RTD on its Fifth Session, 2004).

Thus capital requirements are not adequate to break the 'cycle of rights violations'...

- Direct and indirect negative human rights impacts of financial and economic crises have been exacerbated by the subsequent policy responses of States – leading to a cycle of tax payer-financed bailouts of the private firms and subsequently, fiscal austerity measures to deal with inflated public debt arising out of these bailouts.
- The withdrawal of public expenditures on public investments and social support together with loss of jobs and livelihoods (with drop in GDP growth rates) have further severe negative impacts on the economic and social rights especially of the middle and low-income groups in society.
- Increase in poverty and inequalities.

Higher capital requirements also threaten to undermine financial inclusion

- At the same time, the significant increase in regulatory capital and implementation costs for banks under Basel III are expected to both decrease credit availability and increase cost of credit, as under Basel II.
- This will have disproportionately negative impacts on SMEs, traditional businesses, women with lack of access to assets, etc.
- Thus the higher capital requirements on banks will have an adverse impact on the progressive achievement of economic, social and cultural rights also by reducing the financial sector's ability to support work and livelihoods of the middle- and lower-income groups.

… and developing countries continue to suffer disproportionately

- The higher capital requirements under Basel III are thus not sufficient to put a break to the '*cycle of rights violations*' imposed on developing countries owing to the fact that they do not reduce the inherent increased fragility consequent upon financial liberalisation and multi-functional banking.
- Given the resource and capacity constraints of developing and low income countries, developing countries will continue to suffer dis-proportionately from the adverse impact of the higher cost of capital aimed at financial stability to account for the "greater financial sophistication" in the developed countries.

<= Linked to the inadequate representation of developing countries in the Basel Committee.

Capital Requirements and the Right to Development

- Realizing the right to development requires the realisation of all human rights, including economic, social and cultural rights.
- Achieving financial stability required for sustained economic growth can be seen as constituting progress in the realisation of the RTD, as long as no other right declines.
  - According to the Committee on Economic, Social and Cultural Rights, States must take care to ensure that their actions, including those designed to respond to the financial crisis, do not cause retrogression in the enjoyment of human rights.
- Thus higher capital requirements reflect the growing conflicts in achieving the development objectives of financial stability, inclusive finance and sustained economic growth under liberalised financial markets.

The way forward - more fundamentally

1. First, systemic change in financial sector operations through the structural separation of commercial banking and investment banking.

- This precludes the potential for innovative financial engineering from leading to pyramiding of risks and increase in systemic risks, which as we saw, affecting sustained economic growth, development financing and social spending.

2. Secondly, limit the scope for entry of foreign financial service providers into developing countries.

- The latter increases fragility and magnifies the problem of financial instability that trade in new financial services generate under liberalised capital accounts and financial markets.
- Limiting the scope for this is critical, because all countries with open financial sectors are affected by the volatile functioning of unregulated financial markets elsewhere, as crisis after crisis has shown.

The way forward - more fundamentally

- Since States have the primary responsibility for realising the right to development at the national level, it becomes crucial to retain the autonomy of national jurisdictions over any international regulatory framework that attempts harmonisation.
- The responsibility for inter-state cooperation from a rights-based approach then means allowing this national autonomy in banking regulations.

- THANK YOU!