International Conference on Inter Disciplinary Research in Engineering and Technology 2016
[ICIDRET 2016]

ISBN	978-81-929866-0-9		**VOL**	01
Website	icidret.in		**eMail**	icidret@asdf.res.in
Received	18-December-2015		**Accepted**	30-December-2015
Article ID	ICIDRET002		**eAID**	ICIDRET.2016.002

Why will Basel III fail?

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Abstract: *This paper focuses on the evolution of global banking regulations set by the Basel Committee on Banking Supervision known as the Basel Accords. We argue that argue that both Basel I and Basel II have failed and we expect the same from Basel III. We believe Basel III will fail because of: i) path dependency on two previous failed accords, ii) delayed implementation, iii) strong pressure from bank-supported lobbyists and finally iv) strong influence of politicians. Rather than proposing new banking regulatory initiatives, we recommend imposing higher personal responsibility for bank managers, regulators and supervisors. As a result, Basel III will not prevent future crises from affecting the global banking industry.*

Keywords*:* bank, Basel III, regulation, supervision.

INTRODUCTION

This paper focuses on the evolution of global banking regulations set by the Basel Committee on Banking Supervision (BCBS). These key regulatory initiatives known as the Basel Accords encompass three main parts: Basel I, Basel II and Basel III. We argue that both Basel I and Basel II have failed and we expect the same from Basel III, a program of measures that will not prevent future crises from affecting the global banking industry. The paper continues as follows: in Section 2 we examine in more detail Basel I, and Basel II in Section 3 and Basel III in Section 4. Finally, Section 5 presents our conclusion and draws relevant lessons.

Basel I

As the world financial markets have become increasingly globalized in the last few decades, the international coordination of prudent regulations is needed. In 1988, the BCBS of central banks and banking regulators from the Group of Ten (G10) countries took the first significant step towards international regulation: It introduced global standards for regulating the capital adequacy of internationally active banks. This document is known as Basel I and its guiding principle was the idea that banks should have an adequate "capital cushion" to cover unexpected losses. The deadline for the implementation of Basel I rules were scheduled for the end of 1992. Furthermore, Basel I set out an 8% minimum requirement of capital to risk-weighted assets (RWA) for banks – known as capital adequacy (CAD) or the Cook ratio.

However, Basel I only reflected credit risk. As time elapsed, further risks have been reflected in Basel I, such as market risk added in 1996, operational risk as part of Basel II and liquidity risk as part of Basel III (see below). The Basel I standards have achieved a wide degree of acceptance, extending beyond the member countries of the Basel Committee, and have thus acquired a scope that extends even beyond internationally active banks. At present, the Basel Accords are implemented in both domestic and international institutions in over 100 countries. Despite its many achievements, it became clear that Basel I required a radical updates due to accelerating financial innovations and the development of new risk management techniques. In response to criticisms of Basel I, a number of changes were made, culminating in the final document of the new capital accord, Basel II that was released in June 2006 and implemented in January 2007.

Cite this article as: Petr Teply, Libena Cernohorska. "Why will Basel III fail?". *International Conference on Inter Disciplinary Research in Engineering and Technology (2016)*: 05-08. Print.

Basel II

Basel II focuses, among other things, on providing incentives for banks to enhance their risk measurement and management capabilities (i.e. both qualitative and quantitative requirements). By applying more risk-sensitive approaches, banks can make better and more efficient use of capital to cover their risks. Basel II differs from Basel I not only in the flexible options it gives banks for determining the capital requirements for the risks confronting them, but also in the inclusion of operational risk. Basel II allows each bank (usually with the consent of the regulator) to choose a method that is commensurate with its risk profile and capabilities.

The more sophisticated and accurate measurement of credit risk under the new Basel II rules should result in capital savings. These will be used to cover the newly included operational risk so that the total capital charge should remain unchanged according to original BCBS estimates. In the past the BCBS has conducted five quantitative impact studies to assess whether the BCBS has met its goals with regard to the revised capital framework. According to the results of the last study published in June 2006 (so-called QIS 5), which included data from 350 banks in some 30 countries during 2005, an aggregate drop of 6.8% in minimum required capital for participating banks compared with existing capital requirements was expected.

The overall objectives of Basel II

The overall three main objectives of Basel II were the following (BCBS, 2011): i) to continue to promote the safety and soundness in the financial system and, as such, the new framework should at least maintain the current overall level of capital in the system; ii) to continue to enhance competitive equality; and iii) to provide a more comprehensive approach to addressing risks. Furthermore, Basel II seeks to achieve the following objectives, see [5], [3]or [8]:

1. It moves away from the "one-size-fits-all" approach characteristic of Basel I to a more "menu-like" approach. Banks may choose from various options to calculate its capital requirements for market, credit and operational risk.
2. It considers that lending to banks or corporations may be more or less risky than to the Organization for Economic Cooperation and Development (OECD) sovereigns (in terms of credit risk) that result in different risk-weights for these subjects. For instance, under a standard method in Basel I all corporations had a 100% risk-weight, while under Basel II the risk weight of corporations will vary from 0% to 150% based on the company's credit rating.
3. It implemented operational risk into regulatory capital (capital requirements) respectively into the calculation of capital adequacy.
4. A bank could use its own internal rating models for the measurement of credit, market and operational risk, if a regulator approves the internal model used by the bank. Otherwise, banks have to adopt standardized approaches set by the BCBS.
5. Basel II closely links the regulatory capital requirements with the bank's risk profile; regulatory capital should converge with the economic capital of a bank.
6. In addition to the old "risk" pillar, two new pillars, the "Supervisory Review Process" and "Transparency and Market Discipline" have been introduced.

Criticism of Basel II

Although Basel II includes many improvements when compared to Basel I, criticisms of Basel II still exist. We present here only the points we consider as the most important, and for more detailed criticisms see [7] or [2], [6]:

1. Tendency towards procyclicality;
2. Lack of the explicit implementation of other risks;
3. An excessive use of external ratings;
4. An excessive prescription of the document;
5. Difficult quantification of operational risk;
6. A high challenge for regulators.

We argue that all three objectives of Basel II have failed, because:

i) Lower capital buffers of banks resulted in higher instability and fueled the global crisis that began in 2008 (e.g. Basel II lowered a risk weight for mortgages, which motivated banks to provide more mortgages thus significantly influencing the crisis; moreover, banks had no capital buffers against losses stemming from domestic government bonds, which caused problems for the banks in Spain and Greece in 2012).

ii) The regulation favored big international banks, i.e. de facto it lowered overall global competition (e.g. the market share of the TOP 10 global banks on TOP 1000 banks' assets increased from 14% in 1999 to 19% in 2007 and later to 26% in 2009 respectively).

iii) Internal bank models with poor assumptions failed and did not capture the true risks of banks (e.g. an assumption on normal distributions of stock market returns in value-at-risk (VAR) models or an assumption of a sustainable long-term increase in real estate prices in the US and the UK).

BASEL III

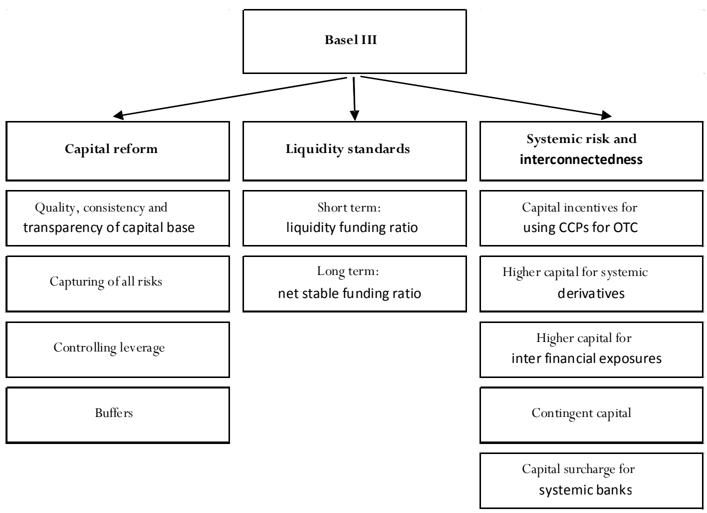
The overall objectives of Basel III

As demonstrated above, all the main objectives of Basel II have failed and the revision of global banking rules was needed in light of the global financial crises beginning in 2008. As a result, [1] issued a comprehensive set of reform measures known as 'Basel III' in order to strengthen the regulation, supervision and risk management of the global banking sector. Three main objectives of Basel III, that modify objectives set both in Basel I and Basel II, are as follows:

i) To improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source;
ii) To improve risk management and governance;
iii) To strengthen banks' transparency and disclosures.

Main components of Basel III

There are several new components of Basel III that can be grouped into three categories including: i) requirements for higher quality, constituency and transparency of banks' capital and risk management; ii) introduction of new liquidity standards for internationally active banks and finally, iii) a focus on systemic risk and interconnectedness (including procyclicality and regulation of OTC markets) – see Fig. 1.



Bank capital under Basel III

The first component of Basel III encompasses requirements for higher quality, constituency and transparency of banks′ capital and risk management. In terms of the CAD calculation, Basel III goes back to the Basel I basic formula while covering credit, market and operational risks included in all Basel I, Basel II, Basel II.5 and Basel III:

$$CAD = \frac{Basel\_III\_CAP}{RWA} \geq 10.5\%$$

Credit risk	Market risk	Operational risk
Basel I	Basel II.5	Basel II
Basel II	Basel III	

Figure 2. Main components of Basel III.

Note: CAD – capital adequacy, RWA – risk-weighted assets, Basel III CAP = Common Equity Tier 1 capital + Additional Tier 1 capital + Tier 2 capital + capital conservation buffer.

Criticisms of Basel III

Similar to previous Basel accords, Basel III was also originally proposed by the BIS with good intentions to change banks′ behavior (e.g. mandatory bail-in instruments instead of bail-outs by governments). These global rules are to be implemented into national legislation, which is out of control of the BIS, however. Put differently, every country can adjust its requirements based a particular situation in its domestic banking sector (e.g. reflecting the existence of zombie banks). Not surprisingly, some countries have pushed to increase capital and other ratios of their banks (e.g. Switzerland or the US) more than others (e.g. Japan or the European Union).

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Another criticism of Basel III comes from, for instance, in the context of effective regulation as a mission impossible discussed by [6]. Additionally, [4] highlights a flawed institutional process of creating Basel rules. Last but not least, [8] argue that Basel III will not prevent global markets from future crises and lists the following reasons:

i) Path dependency on two previous failed accords Basel I and Basel II,
ii) Delayed implementation,
iii) Strong pressure from banks-supported lobbyists,
iv) Strong influence of politicians (especially from G20 countries).

Conclusion

This paper focused on the evolution of global banking regulation set by the BCBS known as the Basel Accords. We argue that argue that both Basel I and Basel II have failed and we expect the same from Basel III, a program of measures that will not prevent the global banking industry from experiencing future crises. We believe Basel III will fail because i) path dependency on two previous failed accords Basel I and Basel II, ii) delayed implementation, iii) strong pressure from banks-supported lobbyists, and finally iv) strong influence of politicians. Rather than proposing new banking regulatory initiatives, we recommend imposing higher personal responsibility for bank managers, regulators and supervisors.

ACKNOWLEDGMENT

Financial support from The Czech Science Foundation (The Czech Science Foundation (projects under No. GA14-02108S, GA15-00036S and 16-21506S,), and University of Economics in Prague (project No. VŠE IP100040) is gratefully acknowledged.

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