

BASEL III & FINANCIAL STABILITY

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BASEL III & FINANCIAL STABILITY
A FRAMEWORK OF MONITORING THE BANKING ACTIVITIES



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BASEL III & FINANCIAL STABILITY

A Framework of Monitoring The Banking Activities

Acknowledgement

At first, I like to express my deepest gratitude to Allah for giving me the strength and the composure to finish the task within the scheduled time.

I would also like to express my gratitude from the core of my heart to my heart to my Mentor NUSRAT FARZANA, Assistant Professor of School of Business & Economics at United International University, who helped me in coordinating my entire project. Her consistent support and cooperation showed the way towards the successful completion of project.

And finally, I want to say that there might be some mistakes in this report because of my susceptibility. In this respect, I look for your generous suspect.

Letter of Transmittal

To,

Nusrat Farzana

Assistant Professor

School of Business & Economics

United International University

Subject: **Letter of calming the originality of the report.**

Dear Madam,

It's my pleasure to submit you my project report on "Basel III and Financial Stability".

I hereby declare that this project report has not been submitted by me before, for any degree, diploma, title or recognition.

I have great hope that, the report will meet your expectation and aid you in getting a clearer idea about the subject. Please do call me for any clarification regarding the report, if required.

Sincerely,

.....

Rehana Akther

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Supervisor's Declaration

This is to testify that the project report titled “ Basel III and Financial stability ” is prepared by Rehana Akther for the partial fulfillment of the BBA program with a concentration of Finance from United International University. This report is completed under my management and free from appropriation.

She is allowed to submit the report.

.....

Supervisor

Nusrat Farzana

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Abstract

Objectives: This study aims at implementing the Basel and monitoring this framework in banking sector.

Methodology: It is based mainly on secondary data. Findings reveal that over all Basel III practices of banks are unregulated due to lack of complexity and corruption of banking activities.

Findings: There are no consistent and regulated pattern for disclosure of such information of the banks. Virtually sustainable information is disclosed through descriptive basis but nominal part is monetary in nature. We need strong regulatory framework to develop the practices of disclosing financial impact of the concerned banks.

Implications: Necessary provisions should be made mandatory for the banks so that corruption might be easily controlled.

Key Words: Basel Committee on Banking Supervision, Basel III, Financial Stability.

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Chapter 1

Introduction

1. Introduction

The report topic is Basel III and financial stability: A comparative analysis for implementation monitoring. The function of regular of monitoring in this area is measured by the Basel Committee on banking supervision. It introduces the progress and outcomes of efficient banking positions and activities. This framework helps to monitor bank's progress to increase capital and liquidity to fulfill the minimum capital requirements. This system recovers how domestic capital, leverage and important bank regulations which are corporate internationally because of Basel III minimum standards. It reviews the calculations of capital ratios, risk weighted assets and other outcomes. Finally the banking sector becomes more efficient because of this framework.

2. Background of the study

One of the preliminary steps to completing a thesis is the background study for it. The background study for some thesis includes a review of the area being researched, current information surrounding the issue, previous studies of the issue, and relevant history on the issue.

The financial practices related to Basel has been researched by most of the researchers. Most of the articles can be used for financial activities. The paper examines the measurement of this framework which helped banking sectors to become more efficient. It selects the relevant financial reporting standards and examines their strengths and weaknesses. The study finds that the Global Reporting Initiatives guidelines are insufficient to monitor financial disclosure. The paper proposes a mandated separate statement of regulatory activities. The elements of the proposed statement are discussed.

3. Objectives of the study

The general objective of the study is to explore the financial practices in the banking sector. The specific objectives of the study are:

- To monitor the regulatory framework practices in developed and developing countries.
- To identity the real challenges of financial practices in the banking sectors of the worldwide.
- To measure the efficiency of the banking sector.

4. Methodology of the study

4.1 Data design

4.1.1 Data collection process

The report analyzes the regulatory framework of the banking sector in worldwide. All the data have been collected from secondary sources. Secondary sources are websites and articles.

4.1.2 Types of data

Primary: Primary data refers to the main data which has been gathered for the purpose in mind. It refers that the data are gathered from original source by someone and the way of this type of data collection is called primary data.

Those who are gathered the primary data, they have proper knowledge about the study. They use this type of data for the success.

Secondary: Secondary data has been gathered for another purpose. Secondary data can be used again and again. Secondary data can be articles, website etc. I use website for my secondary information.

Chapter 2

Literature review

1. Literature review

- To minimize systematic risk, and increase global financial stability, the Basel committee on banking supervision adopted some international themes which helped financial institutions become adequately capitalized, through stress testing which reduced leverage and promoted financial innovation (**Professor Robert Engle & Professor Douglas Diamond, 2011**).
- It was found that individual measures of systemic risk which predicted how much a stock expected to fall in a market downturn. It focused on wholesale funding and bank profitability during a crisis. They realized that short-term wholesale funding was a key determinant to cover up systematic risk. Short-term wholesale funding emerged as the most important systematic factor and the Basel committee proposed to introduce a net stable funding ratio and excessive exposure to liquidity risk. (**Acharya et al., 2012**)
- It was found that correct regulation that has been minimized the risk and impact of the financial crisis. They localized important components which helped to analyze the data and found that the impact of bank regulation and control on risk varies across banks. (**Barth et al. (2004, 2008)**)
- Financial construction and international intermediaries were the solution for the lender for the purpose of making and holding loans. This system became strong because it helped to fix up the problem of selecting differentiated value from borrowers. Basel III helped to find different approaches that have been minimized in developing countries capital flows and financial crises. (**Hayne E. Leland & David H. Pyle, In & Miles Kahler ed., 1998**).
- The Basel committee on banking supervision proposed bank capital and liquidity because it helped to implement changes in business models and product pricing. (**Standard & Poor's, 2010**)
- Basel III suggested that how the delegated bank deposits have been palliated the capability of banks to elicit rents from entrepreneurs. The bank funding and the deposits must be cooperated with each other so that banks charged more for their proper intermediation services and reduced liquidity formation. (**Diamond and Rajan, 2001**)
- Formation of liquidity and shifted risk were made the banks' existence. Liquidity formation measured the arrangement of financing to the real economy. Banks created liquidity on balance sheet financed properly liquid assets with liquid liabilities. When banks issued risk-free deposits to transform into risky loans, too maturity and currency which converted into other risks. (**Berger and Udell, 2009**)

2. Theoretical Framework

2.1_Risk

Risk takes on many forms but is widely stated as the chance an outcome or investment's actual return will differ from the forecasted outcome or return. Risk includes the feasibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a particular investment.

2.1.1 Systematic risk

Systematic risk refers to the whole market risk. Systematic risk is also called market risk. This risk covers the whole market risk not just specific area of an industry. No company can avoid this risk because it's totally unpredictable. This risk cannot be removed by diversification.

Systematic risk also prefers industry risk. Systematic risk prefers changes in interest, inflation, and economical recession that have the capability to affect the whole market. Public equities portfolio cannot be changed the positions of an industry in this risk.

2.1.2 Unsystematic risk

Unsystematic risk refers to the specific market risk. It does not cover the whole market. This covers the specific risk of an industry. It is also called specific risk or nonsystematic risk. This risk can be removed by diversification. Unsystematic risk does not prefer changes in interest, inflation and recession that have the capability to affect the specific area of an industry.

3.Importance Of BASEL

We already know that Basel is important to our banking because it has some criteria which make our banking sector efficient. So there are some usefulness of Basel for that reason banks are adopting this system which are given below-

- Basel helps to deal with the worthlessness in the leverage ratio as the measures of solvency.
- It helps to raised safety and soundness in the financial system.
- It helps to enlarge the free enterprise equality so that every financial system can be worked properly.
- Basel helps to form a broad approaches to tact risks.
- Basel develop approaches which helps to adequate capital to the degree of risk engaged in a banks positions and activities.
- Basel centre on internationally active banks which helped them to remove various levels of complexity and corruption.
- Basel measured a non-risk based leverage ratio to require as a backstop to the risk-based capital requirements.
- Under Basel banks have to maintain specific level of high quality of assets that remove the possibility of cash outflows.

Chapter 3

The Framework Of Implementation Monitoring The Banking Activities

1. BASEL

They are selected the Basel Accords as the BCBS maintains its administrative at the Bank for International Settlements in Basel, Switzerland and the committee generally meets there. The Basel Accords is a set of guidelines for regulations in the banking The Basel concerns to the banking supervision Accords (recommendations on banking regulations)—Basel I, Basel II and Basel III—declared by the Basel Committee on Banking Supervision Industry.

1.1 BASEL I

Basel I is the circle of deliberations by central bankers from near the world, and in 1988, the Basel Committee on Banking Supervision (BCBS) in Basel, Switzerland, bring out a set of least capital requirements for banks. Basel I, that is, the 1988 Basel Accord, is essentially concentrated on credit risk and proper risk-weighting of assets.

1.1.1 Components Of Basel I

1.Tier 1 capital ratio

Banks equity capital to its total risk weighted assets is balanced by tier 1 capital ratio. Bank maintains all risk weighted assets that are weighted by credit risk. Formulas for asset risk weights which agrees to the Basel committees guidelines.

The Tier 1 Capital ratio = Tier 1 Capital / all RWA

2.Total capital ratio

The ratio of Total capital to risk weighted assets (RWAs). Capital ratios determine the amount of a bank's capital in association to the amount of risk it is taking. The idea is that all banks must make sure that logical adjustment of their risk is protected by permanent capital. Banks must maintain a minimum total capital ratio of 8%

TCR = Total capital / RWAs

3. Leverage ratio

A ratio which considers how much capital comes from in terms of debt or loan or assesses the capacity of a company to gather it's financial liabilities.

Leverage ratio = total capital/average total assets

1.1.2.Problems of Basel I

The first Basel only centre on credit risk. It cannot focus on other kinds of such as operational risk and market risk. The credit risk calculations does not incur operational and market risk so that the banks cannot minimize this type of risk and there is a financial crisis in the banking sector. Also, the first Basel relies on the book values of the credit risk not on the market values. Day by day there are new financial instruments which has new book value and market value, because of Basel I market value can't be considered and there is credit exposure in the financial system.

1.2 BASEL II

The Basel II Accord was bring out initially in June 2004 and was planned to correct international banking standards that disciplined how much capital banks were needed to hold to guard against the financial and operational risks banks face. These regulations marked to make sure that the more significant the risk a bank is exposed to, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

1.2.1 Components Of BASEL II

Credit risk

Credit risk is the possible risk of loss following from a borrower's failure to compensate a loan or meet legal obligations. Traditionally, it refers to the risk that a lender may not receive the due principal and interest, which results in an disruption of cash flows and increased costs for collection.

Market risk

An investor who experiencing losses in terms of some factors that affect the financial markets overall performance because of their involvement is called market risk. Market risk cannot be removed by diversification. So it is called systematic risk.

VAR (Value at Risk) used commonly to assess the market risk but bounded over time as conditions change this is the same flaw found in the Variance Covariance and past Stimulation approach to calculating VAR.

Operational risk

A form of risk that sum up the risks a company or firm assumes when it attempts to operate within a given field or industry. Operational risk is the risk that is not essential in financial, systematic or market-wide risk. It is the risk continuing after determining

financing and systematic risk, and includes risks resulting from analysis in internal procedures, people and systems or external events.

1.2.2 Problems Of Basel II

In Basel II, there is no minimum leverage ratio so that the bank cannot expect to maintain average total combined assets. It also neglects the liquidity coverage ratio, for that a bank cannot hold sufficient liquid assets to secure total net cash outflows. Under Basel II, There has no net stable funding ratio so this accord does not measure available amount of solid funding to better the required amount of solid funding over a expended stress.

1.3 BASEL III

Regulation, supervision and risk management in the banking sector is developed by Basel III and it is designed to reforms the problems. In late 2009, the first version of Basel III was issued by Basel Committee on banking supervision. It gives almost three years to fulfill all requirements. Banks needs to maintain proper leverage ratio and capital requirements in terms of financial crisis.

1.3.1 Components Of BASEL III

- **Leverage ratio**

Basel III entered a minimum "leverage ratio". This is a non-risk-based leverage ratio and is defined by dividing Tier 1 capital by the bank's average total combined assets. The banks are expected to maintain a leverage ratio in excess of 3% under Basel III.

Financial leverage Formula = Total Debt / Shareholder's Equity

- **Liquidity requirements**

Basel III established two needed liquidity ratios.

- The "Liquidity Coverage Ratio" was assumed to require a bank to hold sufficient high quality liquid assets to secure its total net cash outflows over 30 days

Liquidity coverage ratio= Liquid assets / total net cash flows

- The Net Stable Funding Ratio was to need the available amount of solid funding to better the required amount of solid funding over a one-year period of expanded stress.

Net Stable Funding ratio=Available amount of stable funding / Required amount of stable funding > 100%

2. Country Exposure

2.1 Basel III and Developed Countries

Basel I which is implemented from 2001 over 100 countries. When these countries faced problems under Basel I, they implemented another new accord which is Basel II. But the financial crisis of the banking increased day by day. For that reason they finally introduced Basel III. As Basel III introduced to measure the financial stability of the banking, it relies on Basel II and wants to implement the minimum capital requirements so that Basel committee can achieve the risk sensitive framework. When the market risk has not been changed under Basel I, the cost of the credit risk has been increased. So, the banks have risk complexity.

In developed countries, Basel III introduced for their improvement. All the banks will need an proper capital adequacy process. There are some criteria so that Basel III is helpful for developed countries which are given below-

- Basel III helps developed countries to minimize their risk fundamentals.
- When Basel I and II cannot work properly, that time Basel III helps to recover the overall loss estimation methodologies.
- Because of risk minimization, there are adequate capital so that developed countries can run their operation properly.
- Basel III estimates proper capital policy and capital planning.
- By measuring more capital stability, Basel III improved the banks Z-score of the developed countries.

2.2 Basel III and Developing countries

Although Basel III implemented for developed countries by internationally active banks, other countries such as developing countries also implement Basel III for their international regulatory and competitiveness matters.

While developing countries adopts Basel III, there are some positive changes which are given below-

- There are new rules for measuring credit rating agencies.
- Developing countries require a regulatory standard that helps to meet their needs.
- This is important for regulators from developing countries to involve in a to engage in a discourse which will be either truly global, or will specifically something desirable the needs of the emerging economies.

- But there is a problem which includes lack of knowledge and expertise in developing countries can be introduced by the Basel committee. By improving technical skills in the employees and sharing funding between different countries, this problem can be solved. It needs to be the interest of the global financial system, so that domestic regulatory setup properly. Furthermore the function of credit rating agencies has been introduced in Basel III. It provides the functions of credit rating agencies which is not preferable for developing countries by depending on internal rating system. Unfortunately, many developing countries lack rating mechanism and capacity because of lower skills and technology expertise. If they are able to adopt proper technology and skilled expertise then Basel III will be helpful for them.

Chapter 4

Recommendations and Conclusion

Recommendations

1. Based on the discussion of this report, it is relatively less used because of proper skilled mechanism.
2. In developing country, Basel III is not helpful because of complexity and corruption. So, banks need to adopt this framework to remove corruption.
3. It proves that this framework helps to maintain financial stability which could increase the profitability of the banking sector.
4. Basel III is an emerging concept around the world.
5. Various studies revealed that regulatory framework for Basel III has not yet developed which can be applicable globally in general.

Conclusion

The Basel III ensures a positive changes in the capital and liquidity standards which was introduced an efficient financial stability in the economy. Finally Banks are survived internationally because of Basel III. It ensures the credit risk, market risk and operational risk. This framework consists the bank solvency, safety and soundness of financial system. Finally this framework helps to recover the complexity and corruption of the banking activities.

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GENERAL COMMENTS

Instructor

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