BASEL ACCORDS AND INTERNATIONAL FINANCIAL REGULATION: THE JOURNEY SO FAR*

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ABSTRACT

This paper presents an empirical research into the relevance of Basel Accords in International financial regulation. It adopts the two concepts of "Legitimacy" and "Efficiency" as parameters to justify the continued relevance of Basel Accords on the global financial landscape. Viewing from America to Asia, from Middle East to North Africa, from West Africa to Europe, this paper presents the impacts of Basel Accords as remarkably undeniable. The piece eventually climaxes on the succinct exposition on Basel III (which is the latest Basel Accord) revealing its potentials and possible impacts on the global financial system. Towards the end, the paper however drops a bombshell when it notes that Basel Accords cannot in themselves constitute a panacea to the global financial crisis. It therefore calls on all stakeholders to complement the efforts of the Basel Committee by playing their respective roles in safeguarding the global financial system. Basel Accords and International Financial Regulation: The Journey So Far ultimately presents itself as a 3D paper on international financial regulation.

BASEL ACCORDS AND INTERNATIONAL FINANCIAL REGULATION:

THE JOURNEY SO FAR

All over the world, no institution has shaped the economic development of any society more than the bank. It is therefore stating the obvious that any systemic crisis that rocks the banking system will undoubtedly spell doom for the whole economy. Every bank possesses assets equal to the sum of its liabilities and capital. A bank's capital can be viewed as the residual interest in its assets. If a bank's capital therefore decreases uncontrollably, the bank may become unable to satisfy its obligations and therefore become insolvent. Consequently, governments, regulators, bankers, economists, lawyers and indeed all stakeholders have consistently sought to reduce and possibly eradicate bank's insolvency, through capital adequacy regulation.

Fundamentally, bank's regulation exercise emphasizes the view that the existence of capital adequacy regulation plays a vital role in the long-term financing and solvency position of banks, especially in helping the banks to avoid systemic crisis and its negative impact on the economy[1]. Having a systemic banking crisis is better imagined than experienced. No doubt, depositors and shareholders would not have only gnashed their teeth, but would have also attempted suicide, if not for timely interventions by respective regulators in the banking crises that rocked countries like Jordan[2], Nigeria[3] and most recently, Ireland[4].

Many countries have indeed had their shares of banking crises[5], requiring major reforms to address weak banking supervision and inadequate capital. It has therefore been established that in addition to Deposit Insurance, official capital adequacy regulations play a crucial role in stabilizing the banking system and by extension, the economy. It then becomes imperative to realize that capital adequacy regime is one of the most important sets of rules and proposals in both International and domestic banking laws.

If capital adequacy regulation would constitute an effective legal regime in banking, then stakeholders believed that it needed to be really international in scope, since banking itself has become international. Unfortunately, despite the very expansive nature of international law, it becomes highly tedious to forge in this respect. Simply put, developing international law (hard law) can take years or even decades, given series of meetings to be held by sovereign states involved. Nonetheless, there was a need for an

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1. Murinde and Yaseen; The Impact of Basel Accord Regulations on Bank Capital and Risk Behavior: 3D Evidence from the Middle East and North Africa (MENA) Region, 2004.
2. The systemic financial and banking crisis that was brought about by Petra Bank's failure shook the Jordan economy to its foundations.
3. The sum of N620 billion (about USD 4 billion) was injected into eight banks in Nigeria as direct rescue package, while corporate governance was enhanced with appointment of new management teams for the affected banks.
4. A rescue package of EUR 85 billon has been made available to Ireland, EUR 10 billion of which will be used to stabilize and strengthen the banking sector.
5. Stefan Walter, Secretary-General, Basel Committee on Banking Supervision, in his Conference paper at Financial Stability Institute, Basel on 6th April, 2011 declared that "since 1985, there have been over 30 banking crises in Basel Committee - member countries" and that "… history has shown that banking crises have occurred in all regions of the world, affecting all major business lines and asset classes".

internationally acceptable capital adequacy regulatory framework that could address the imminent threats posed to the global economic governance, without having to wait for years or decades of evolving a hard law. In reaction to this, the Basel Committee on Banking Supervision[6] promulgated the Basel Accord of 1988.

Upon the promulgation of Basel Accord of 1988 (otherwise known as Basel I) the face and scope of international banking regulation changed forever. Today, the accords consist of Basel I, II and III. All three of them primarily pertain to minimal capital requirements every bank needs to hold in reserves, with Basel I starting out in 1988 with a basic focus on credit risk. Basel II first published in June 2004 (and later revised in 2006) aims at helping banks separate operational risk from credit risk, as well as quantifying both, and ensuring that capital allocation is more risk-sensitive. Basel III (which was published in 2010) introduces a more distinct definition of common equity, a framework for counter-cyclical capital buffers and different measures to limit counter party credit risks. Simply put, Basel Accords are a series of recommendations on banking and financial regulations, set forth by the Basel Committee on Banking Supervision.

Legitimacy of Basel Accords

Legitimacy can be defined as a situation by which a particular system becomes acceptable to a group of people to govern their affairs. In this case, the question that readily comes to mind is "Are Basel Accords adjudged legitimate in governing international financial system? A keen look at the developments around us will most convincingly answer this pivotal question.

Though the Basel Committee is relatively unknown, it has over the years, asserted its relevance and established its influence when it comes to International financial regulation. Apart from its significance in regulating bank's capital, the Basel Committee is redefining the field of international law. Most legal scholars would classify the Basel Committee as an "International Financial Regulatory Organization (IFRO)". Organizations like this do not meet the traditional legal definition of an "International Organization" which applies only to organization composed of states and established by treaty. IFROs[7] nonetheless, promulgate vital legal rules and have successfully pursued International cooperation. This is not less of a truth with the Basel Committee, as it has not only pursued international co-operation, it has graciously recorded substantial co-operation amongst sovereign states and international organizations.

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6. The Basel Committee, established by the Central Bank Governors of the Group of Ten countries at the end of 1974, meets regularly four (4) times a year. It has four main working groups which also meet regularly. The Committee's members are 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. Countries are represented by their Central Banks and also by the authority with formal responsibility for the prudential supervision of banking business, where this is not Central Bank. The present Chairman is **Mr. Nout Wellink**, President of the Netherlands Bank.

7. IFROs include Committee on the Global Financial System (GCFS), Committee on Payment and Settlement Systems (CPSS), International Accounting Standards Board (IASB), International Organization of Securities Commission (IOSCO), etc

It is remarkable to note that though the Committee's membership's strength is twenty-seven (27), over one hundred (100) countries have subscribed to Basel Accords as at date. Largely, Basel Accords have enjoyed a wider legitimacy than would be justified by somewhat doubtful legal status of their promulgator[8]. It can be said that this legitimacy is derived from the "prestige" and "the institutional power" of the Committee's members, but most importantly, the nature of the Accords as "Soft laws" and their beneficial provisions.

Soft law refers to a set of non-binding instruments, such as recommendations and resolutions of international organizations, declarations and "final acts" published at the conclusion of International conferences and even draft proposals elaborated by groups of experts[9]. The emergence of soft laws resulted from the inadequacy of hard law which cannot overcome deadlocks in international relations, which result from economic or political differences.

"Non-bindingness" is the most important feature of soft laws. Officially, the documents issued by the Basel Committee are therefore termed "Accords" which illustrate their political importance but divest them of binding legal authority. I sincerely opine that this feature of "non-bindingness" makes Basel Accords more popular among countries and strengthens their legitimacy. Illustratively, in adopting Basel Accords, after conducting a quantitative impact study and surveying the competitive landscape, China decided that it would apply Basel II's second and third pillars on Supervisory Review Process and Market Discipline respectively together with Basel I's Capital standard. United States on its own, decided to apply Basel II to the largest banking organizations. The foregoing selective compliances, which still keep these countries in the Basel system, were undertaken in the light of peculiar banking structures in the respective countries. This could only be possible with *Soft Laws* but not *Hard Laws*.

It should also be noted that since soft laws are non-binding, there is lack of possible threat to sovereignty of a state, then, any states that subscribe to Basel Accords today, may unsubscribe tomorrow, if it feels they no longer serve its good, without attracting any sanction. This therefore makes Basel Accords attractive and acceptable.

Furthermore on legitimacy, adherence to Basel principles is increasingly seen as an important element of lending decisions of International Monetary Fund and the World Bank. Though the IMF generally eschews requiring of voluntary codes in its conditionality agreements, in practice, the IMF does require the specific reform steps that, in effect, would bring countries into compliance with the Basel Core principles[10]. Moreover, countries often include adherence to the Basel principles in their Letters of Intent – the documents that govern the country policy reforms undertaken to obtain IMF funding. World Bank also uses adherence to Basel principles in its Financial Sector Adjustment Loans.

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8. The Basel Committee in anyway, does not posses formal supranational supervisory authority and its conclusions do not, and were never intended to have legal force.

9. A Hard Look at Soft Law, 82 AM.SOC'Y INTL.L.PROC.371-77 (1988) (remarks of Michael Reisman).

10. Basel Core principles otherwise called "Core principles for Effective Banking Supervision" are a comprehensive blueprint for an effective banking supervisory system developed by the Basel Committee, in close collaboration with many jurisdictions which are not members of the Committee, in order to promote sound supervisory standards worldwide.

In effect, it becomes obvious that Basel Accords have enjoyed considerable level of legitimacy amongst nations and international organizations.

Efficiency of Basel Accords in International Financial Regulation

It has been generally argued that the introduction of capital adequacy rules and allied regulations will normally strengthen bank's capital and thus improve the resilience of banks to negative shocks. This is what the Basel Committee seeks to achieve with the Basel Accords. I therefore invite you to journey with me on the anatomical analysis of Basel Accords and their impacts on the International financial system.

Basel Accords: An Overview

Basel I

Basel I essentially provided for just one option of measuring capital adequacy of banks. It gives an equal risk-weight to all corporate credits, whether high or low credit quality. However, this Accord fails to incorporate potential savings from loan portfolio diversification, as a result of its simple additive nature. It has also led to extensive regulatory capital arbitrage which adds to the riskiness of bank asset portfolios. Essentially the fact that risks facing banking institutions are forever changing and increasing beyond those related to credit, hence, makes Basel I highly inadequate. It is against this background that Basel II was brought into existence to make up for inadequacies of Basel I.

Basel II

Upon promulgation in 2004, Basel II finally came out consisting of three mutually reinforcing pillars.

Pillar 1: Minimum Capital Requirement: This imposes minimum capital requirements on credit, market and operational risks to reduce impact of losses on exposure.

Pillar 2: Supervisory Review Process: This imposes specific bank supervision to promote better risk management.

Pillar 3: Market Discipline: It promotes market discipline through greater public disclosure.

The three pillars constitute a complete package. This accord therefore cannot be considered fully implemented, if the three pillars are not in place. Minimum or Partial implementation of one or two of the pillars may not deliver an adequate level of soundness[11].

Following the international financial and economic crisis of 2007-2009 whereby regulatory and supervisory institutions *cum* instruments (including Basel II) revealed their weaknesses and apparent lack of resilience to shocks, the Basel Committee revised Basel II and formulated a new accord known as **Basel III**.

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11. The case of China, when it adopted only Pillars II and III of Basel II with Capital standard of Basel I was rather peculiarly strategic.

Basel III

Undoubtedly, Basel III is the latest Basel Accord and the best International standard that we have, to that extent, the Accord needs to be understood intimately and implemented fully. The summary of Basel III is as follows:

Increased Overall Capital Requirement: Between 2013 and 2019, the common equity component of capital (Core Tier 1[12]) will increase from 2 percent of a bank's risk-weighted assets before certain regulatory deductions to 4.5 percent after such deductions. The overall capital requirement (Tier 1 and Tier 2) will increase from 8 percent to 10.5 percent. Banks will also need to meet a new 2.5 percent capital conservation buffer, as well as a Zero to 2.5 percent Counter-cyclical capital buffer. This is to promote the build-up of capital buffers in good times that can be drawn down in periods of stress and prevent inappropriate distribution of capital respectively.

Narrower Definition of Regulatory Capital: Common equity will continue to qualify as Core Tier Capital, but most outstanding hybrid capital instruments (upper Tier 1 and Tier 2) must be replaced by instruments that are more loss-absorbing and do not have incentives to redeem. The distinctions between upper and lower Tier 2 instruments and all Tier 3 instruments will be abolished. All non-qualifying instruments issued on or after September 12, 2010, and all non-qualifying Core Tier 1 Instruments issued prior to that date, will be derecognized in full, from January 1, 2013, other non-qualifying instruments issued prior to September 12, 2010 will be phased out at the rate of 10 percent per year from 2013 to 2023 subject to certain exceptions.

Two New Liquidity Ratios: The first is the Net Stable Funding Ratio (NSFR) and the second is the Liquidity Coverage Ratio (LCR). The NSFR requires banks to hold certain ratio of Stable Capital to support its illiquid assets. The NSFR will be adopted by January 1, 2018. The LCR requirement necessitates banks to hold a pool of high quality liquid assets to equal or exceed highly-stressed cash outflows and will be adopted by January 1, 2015.

Increased Capital Charge For Banking and Trading Book Exposures: From December 31, 2010, re-securitization exposures and certain liquidity commitments held in the banking book will require more capital. In the trading book (i) From January 1, 2011 banks will be subject to new "stressed" value-at-risk models, increased capital charges and restrictions on correlation trading portfolio, increased capital charges for securitization exposures and (ii) starting from January 1, 2013, banks will be subject to substantially increased and expanded counterparty risk charges, including increased charges for exposures to other financial institutions. Generally, Basel III is more comprehensive in its scope and combines micro and macro-prudential reforms to address both institution and system level risks.

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12. Core Tier 1 is from a regulator's point of view, a measure of a bank or financial institution's strength. It is primarily composed of common stock and retained earnings (disclosed reserves).

Having given an overview of what the Basel Accords represent so far, there seems to be an urgent need to quickly examine their impacts (for now that of Basel I & II together). Immediately after this is done, there will be a return to the latest accord i.e. Basel III, to look at what it really holds in stock for the international financial system.

Basel Accords in European Union:

It is quite remarkable that ten (10) out of twenty-seven (27) members of the Basel Committee are members of the European Union (EU). It is therefore expected that most banks operating in member states of the EU would naturally abide by Basel core principles. For an instance, the UK banks Core Tier I ratios after the first half of 2010 were put as follows: Barclays- 10%, HSBC- 9.9%, Lloyds Banking Group- 9%, RBS Group 10.5% and Standard Chartered- 9%. This essentially is consistent with the overall capital requirement of 8% and Core Tier 1 ratio of 2% as stipulated by Basel II. This level of compliance can indeed be noticed manifestly across the EU.

Basel Accords in the United States:

In the *United States*, not only that the US Banking regulatory institutions issued two advance notices of proposed rule-making regarding negotiations on Basel core principles with a view to integrating them into national laws, the US successfully applied Basel II to the largest banking organizations, with appreciable efficiency level recorded in banking regulation.

Basel Accords in other Jurisdictions:

In Asia, *China* signed on to the Basel system after conducting a quantitative impact study and financial regulatory survey, by adopting pillars 2 and 3 of Basel II with Basel I's capital standard. Since then, the country has moved from a state of regulatory laxity and a little to no transparency, to a stable financial system afforded by Basel principles.

In the Middle East, the Central Bank of the *United Arab Emirates* on April 5, 1993 set the minimum capital to risk-weighted assets ratio of banks at 10%, which is 2% higher than the minimum level recommended by Basel II.

Saudi Arabian banks are arguably among the top-rated banks in the industry, based on capital adequacy, liquidity, provisioning norms and profitability. The *Saudi Arabian Monetary Authority (SAMA)* which is the Central Bank of the Country, set up a strong prudential system guided by Basel principles, which encouraged high levels of capital adequacy, liquidity and reserve requirements for all its banks. As at 2004, Capital adequacy had been put at 20%, Liquidity ratio at 50%, NPLs at less than 5% of Gross loans, Equity at 20% and return on asset at 2%.

For *Jordan*, following the systemic failure of *Petra Bank* in 1989 that prompted the Central Bank of Jordan (CBJ) to be very strict with capital adequacy, the CBJ is not prepared to witness a repeat of the financial and banking crisis brought about by the Petra Bank's collapse, hence, the regulator moved the capital adequacy ratio to 12% in 1999 and now stands at 22% as at date. CBJ therefore believed that Basel II capital adequacy ratio at 8% should be increased.

In *Lebanon*, Barque du Liban which is the Central Bank demanded commercial Bank to meet a minimum capital adequacy ratio of 8% in consonance with Basel principle, as at 1995. The regulator has since then consistently increased the capital adequacy ratio and has been put at 12.5% as at 2009.

In *Oman*, capital adequacy ratio has been put at 14% by its Central Bank in compliance with Basel's recommendation.

In North Africa, in *Morocco* precisely, Banque Al- Maghrib (Central Bank of Morocco) at the end of 2007 put the capital adequacy ratio at 10%, exceeding the Basel Committee's stipulation by 2%.

In West Africa, *Bank of Ghana* has also put the capital adequacy ratio for all banks at 10% and maintained same till date.

In *Nigeria,* though the *Central Bank of Nigeria* and *National Deposit Insurance Commission* (The agency charged with protecting insured depositors' funds) recently published "An Expression of Interest" to hire the service of a Consultant or firm of Consultants to formulate a roadmap for implementation of Basel II and III, the country however still has its capital adequacy ratio for banks at 10%. However , it is worthy of note that, the Central Bank of Nigeria has been making frantic efforts to stabilize its banking system and ultimately prevent the banking system from falling into a similar systemic crisis, like the country experienced in 2009.

After having made frantic efforts to salvage the rescued banks and put them back on their feet, the CBN ultimately hopes that its new macro-prudential rules, which are in consonance with Basel's principles would leverage amongst others on:

- Adjusting Capital adequacy and forward-looking capital requirements driven by stress tests.

-Prohibiting banks from using depositors' funds for proprietary trading, private equity or venture capital investment.

At the moment, there are on-going "business combinations" among the rescued banks, that are expected to lead to "Mergers or Acquisitions" and about eight of such are expected to be completed by the end of 2011[13]. These efforts are geared towards evolving a more resilient and stable banking system in Nigeria.

Notwithstanding some local differences in all the countries examined above, all of them have adopted the Basel Capital adequacy regulations[14].

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13. The Guardian (Nigeria) Tuesday, March 29, 2011, Vol. 28, No 11,780.

14. In order to a enable a far wider group of countries to be associated with work of Basel Committee, the Committee has always encouraged contact and cooperation between its members and other banking supervisory authorities. In many cases, supervisory authorities in non-member countries have seen it publicly to associate themselves with the Committee's initiatives. Contacts have been further strengthened by International Conferences of Banking Supervisors (ICBS) which takes place every two years. The last ICBS was held in Singapore in the autumn of 2010.

With all modesty, efficiency of Basel Accords, particularly Basel II, has not only be seen, but has manifestly been seen to have marked the International financial system.

However, there are some mind-boggling questions here. To what extent would the Basel Committee achieve appreciable degree of efficiency with Basel III? Are Basel Accords in themselves an end to international financial and banking crisis? Attempts will be made to offer possible answers to these questions or at the least, flood your mind with critical observations that may generate informed personal answers.

<u>Impacts of Basel III on Banking and Financial Institutions:</u>

- Under Basel III, systemically important banks[15] will experience even more financial audit than other banks and this distinction will not be taken lightly. To this, *Andrew Lim* of *Matrix Corporate Capital* opined that "transparency will come to the sector".

- The build-up of Capital buffers will provide for easy draw-down during stress, while counter-cyclical capital buffer will prevent inappropriate distribution of capital.

- Banks and financial institutions will now under Basel III, have to maintain a higher level of liquidity that should prepare banks for a likely downturn in the future. By this, banks will generally become more stable.

- Global economic recovery may also benefit from the long phase-in period, given the fact that, Basel III will not be fully implemented until January, 2019.

However, having stated some of the important contributions the Accord is expected to make to the global financial system, caution should also be taken in implementing Basel III, based on the following observations.

- On the face of it, it is expected that full implementation of Basel III should make banks more stable. It should however be noted that Implementation of Basel III will make most banking activities undertaken in the trading book more expensive. Banks will therefore generally increase interest rates, which will make interbank lending expensive and small and medium sized businesses will be pushed away from banks' loans. This will definitely reduce importance of banks in the real economy. Taking into account, in a banking system like that of Nigeria, whose regulator, CBN recently increased the Monetary Policy Rate from 6.5% to 7.5%[16], which increase would ordinarily inform consequential increase in lending rates, adopting Basel III (as it stands today) *hook, line and sinker*, may mean much tougher moment for small and medium sized businesses within such economy.

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15. The Basel Committee has developed a methodology that embodies the key components of "systemic importance" and they are Size, Interconnectedness, Substitutability, Global Activity and Complexity.

16. The reason advanced for the increase by the Central Bank Governor was the need to tighten inflation in the Country: *The Guardian (Nigeria) Tuesday, March 29, 2011, Vol. 28, No. 11,780*

- It should also be noted that the absence of separation of investment banking from commercial banking activities with commensurate regulations, is indeed a huge *lacuna* or omission in Basel III. It is therefore loudly advocated that "casino-like activities" be separated from the retail system that holds consumers' savings.
- Thirdly, the length of the phase-in period of Basel III which spans over a period of nine (9) years appears too long, and enough for another "bubble" to build up and burst before the new system is finally in place.

Conclusion

Lastly, as harsh it may sound, I consider it imperative to state here that Basel Accords are only a set of International Minimum standards intended to influence banking behavior, but cannot of themselves prevent a crisis. This has been proved, in fact, most recently in the case of Irish Banks where all of them passed a mass stress test of the banking sector (conducted on Basel principles) yet there was a systemic banking failure, in less than six months after the test. Notably, Bank of Ireland, one of the largest banks had a Core Tier Capital ratio significantly higher than the Basel II requirements.

Do I then think that Basel Accords are not necessary? No! If Basel Accords are not necessary, I wouldn't have remained a member of Basel II Compliance Professionals Association till date. If Basel Accords are not necessary, I wouldn't have flown about seven hours over the seas from Africa to deliver this paper here in Lecce, Italy. If Basel Accords are not necessary, I wouldn't have sacrificed sleepless nights to spill litres of ink analyzing efficiency of Basel Accords. I think Basel Accords are necessary and the international financial system needs them. However, what I think is not necessary is the "overrated messianic status" we sometimes confer on Basel Accords.

To this end, I earnestly desire that all stakeholders, to wit; regulators, bankers, economists, insurers and lawyers should come together and light up their torch of "collective sensitivity" to salvage our economic system from future crisis[17] by doing <u>all</u> that is required of their callings, including but not limited to complying with Basel core principles and other important regulations.

As I acknowledge with commendations, the past efforts and the on-going work[18] of the Basel Committee on some areas of Basel III, I humbly charge the Giant Club to keep on keeping on, until there is an emergence of a reasonably stable global economy, then, its path will be said, in the scriptural words, to be *as the shining light, that shines more and more, unto the perfect day*.

Thank you.

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17. Many crises are still lurking around the corner; even their causes are not predictable yet. All countries need only continue the process of building their capacities to absorb shocks-whatever the cause may be.

18. This includes work on Cross-Border Banking, Standards Implementation, Contingent Capital, Reduction of Pro-Cyclicality, Reviewing Large Exposures Rules, Ratings and Securitizations and Fundamental Review of Trading Book.