

# The Development of the Basel System

## STANDARDS AND REGULATION

Standards are intended to facilitate better-informed lending and investment decisions, improve market integrity, and reduce the risks of financial distress and contagion.

Often these standards have been developed after a crisis in the global financial markets. The development of these standards led to a set of globally accepted rules.

Table 1: Key Standards for Financial Systems<sup>1</sup>

Subject Area	Key Standard	Issuing Body
<b>Macroeconomic Policy and Data</b>		
Monetary, financial and fiscal policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies, on Fiscal Transparency	IMF
Data dissemination	Special & General Data Dissemination Standard (GDSD, SDDS)	IMF
<b>Institutional and Market Infrastructure</b>		
Insolvency	Principles and Guidelines on Effective Insolvency System	World Bank
Corporate Governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	IASC
Auditing	International Standards on Auditing (ISA)	IFAC
Payment and Settlement	Core Principles for Systematically Important Systems	CPSS
Market Integrity	40 Recommendations on Money Laundering	FATF
<b>Financial Regulation and Supervision</b>		
Banking Supervision	Core Principles of Effective Banking Supervision	BCBS
Securities Regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance Supervision	Insurance Supervisory Principles	IAIS

## BANKING SUPERVISION AND REGULATION

Many international financial crises have originated in weaknesses of the banking sector and through inadequate supervision. During the last 30 years, Central Banks and Regulatory Agencies have increasingly cooperated internationally to address these problems. They primarily aimed at creating a common framework for the valuation of bank assets with their associated credit risk. These standards have achieved widespread acceptance in developed and developing countries.

## THE BCBS

The Basel Committee on Banking Supervision (BCBS) is the most important forum for setting these standards. The BCBS consists of two representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The BCBS has its office at the Bank of International Settlements in Basel.

It was established in 1974 by the Group of Ten (G10). The G10 is made up of eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) which consult and co-operate on economic, monetary and financial matters. The Ministers of Finance and Central Bank Governors of the G10 meet once a year in connection with the autumn meetings of the Interim Committee of the International Monetary Fund.<sup>2</sup>

## CREATION OF THE BCBS

The emergence of the Basel System has to be understood in the context of macro-economics in the 1970ies.<sup>3</sup>

<sup>1</sup> Akyüz, Yilmaz (2002) Reforming the Global Financial Architecture, UNCTAD, p.32

FSF (2000). Issues Paper for Task of Implementing Standards, Financial Stability Forum, p. 19

<sup>2</sup> <http://www.bis.org/publ/g10.htm>

<sup>3</sup> Kapstein, Ethan B. (1994). Governing the Global Economy. Harvard University Press

## EURODOLLAR-MARKETS

The Eurodollar-Markets had emerged during the 1960ies and became very substantial in the 1970ies. Eurodollars are Dollar-deposits held outside the United States (Similar markets exist for other currencies but the Eurodollar-Market is most relevant market). Subsidiaries of American branches and European Banks created these accounts for several reasons:

- US Foreign Investment in Europe and Asia between 1950 and 1970ies (American Banks serving American companies in providing Dollar-denominated liquidity in Europe and Asia).
- European companies importing commodities priced in US-Dollars.
- Creating Dollar-Deposits outside of the reach of confiscation (for instance by Soviet Union)
- Escaping from capital restrictions on export of the Dollar (originally intended to reduce upward pressure on the dollar during the fixed exchange rate system).

The Eurodollar-Markets faced little regulation and was mainly situated in London. The lax regulation was in the interest of government. For the Americans, the Eurodollar-Market supported the position of the Dollar as a world currency. For the Europeans, the Eurodollar-Market provided liquidity to their international active firms.

The growth of this market threatened the Dollar-Gold-Parity. In 1971 this parity was given up and floating exchange rates introduced.

## CURRENCY VOLATILITY

The end of the Bretton Woods System of fixed exchange rates brought about large volatilities in the currency markets. Companies increasingly turned to commercial banks to hedge against the currency fluctuations. For the commercial banks, speculation in these markets could generate large gains but also large losses.

In order to meet the demands of customers for buying and selling foreign exchange, an interbank-trading system developed. This however made it more likely that a bank failure in one country would spread abroad. Two bank failures, the Herstatt Bank in 1974 and the Banco Ambrosio in 1982, convinced central banks that international cooperation and minimal standards were essential to prevent widespread distress in financial markets.

The Herstatt Bank Closure in June 1974 and the default on its debt made it difficult for especially small banks to obtain foreign exchange for their customers. German Banking Supervision authorities were criticized for not considering the international implications of the closure.

Four months later, the insolvency of the Franklin National Bank (the 20<sup>th</sup> largest bank in the US at that time) forced the Federal Reserve Bank to bail out the national and international obligations of the Franklin National Bank. Since Franklin was heavily involved in the Eurodollar-Markets, this policy response required cooperation between the major Central Banks.

The Central Banks agreed that they would act as a lender-of-last-resort, but at the same time created rules for providing temporary liquidity.

The Basle Concordat, approved in 1975 by the Central Bank governors and made public in 1981 (to avoid the Moral Hazard Dilemma of providing a "guarantee" for the market), laid down rules for common banking supervision:

- Authorities of the host and the parent country of a bank with a foreign branch should share supervision duties, with the primary responsibility for the host country.
- The solvency of foreign branches of banks would be the responsibility of the host country.
- Cooperation between host and parent authorities and the right to inspect banks should facilitate the transfer of information. Consolidated accounting of domestic and foreign bank branches were required to have a full picture of a bank's activity.

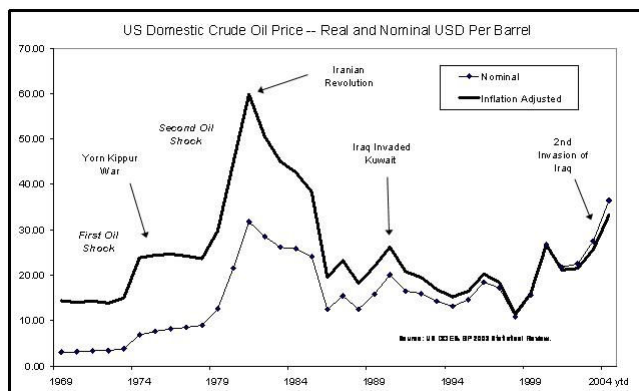
The cooperation of the Central Banks in 1975 did not address the regulatory problems of the Eurodollar-Market. This became clear in 1982 with the failure of Banco Ambrosio which was closed by the Bank of Italy protecting domestic debtors but

not protecting foreign debtors (especially in Luxembourg). The shock from the market turmoil after the Banco Ambrosio failure led to increased responsibility of parent countries for the foreign branches of their domestic banks.

## BASEL I

In 1988, the Basel Capital Accord was reached and created an international standard for risk assessment of commercial banks. Again, this must be seen against the macro-economic context of the time, most importantly the rise of Petro-Dollars in the 1970ies and the Debt Crisis in the 1980ies.

## PETRO-DOLLARS AND EMERGING MARKETS



The so-called petro-dollars were another source of liquidity which necessitated regulation of financial markets. The increase of oil-prices in 1973 and 1979 and the inelastic oil-demand of the developed world resulted in a transfer of income from oil-consumers to oil-producers. These funds were deposited with American and European Banks in the Eurodollar-Market and used to buy US-Treasury bills.

For the developing world, higher import bills and lower demand for their exports meant that the previous development based on cheap petro-dollars was threatened to be reversed. The financial

needs of the developing countries were met by the banks which channeled petro-dollars into the developing countries, but only after considerable lobbying by governments (especially the US) and governmental guarantees.

It was clear that the developing countries would not be able to pay back the loans made for oil-import for a considerable time. Official loans to developing countries through the IFM and World Bank, the establishment of an Oil-Facility at the IMF and the indications of a bail-out by Central Banks motivated commercial banks to provide the necessary loans.

Nevertheless, the commercial banks lending to developing countries was characterized by a mismatch of maturities and interest rates: short-term floating-rate deposits by OPEC countries funded long-term fixed loans to governments and state-enterprises in the developing world.

## DEBT CRISIS

The 1979 Oil crisis worsened the position for the developing countries and the risk situation of banks borrowing to these countries. Even further, in order to keep the inflation induced by high oil-prices under control, the US Government raised interest rates which in turn made it even harder for developing countries to repay their debts. Together with the increasing capital flight from developing countries, the trust of the markets in the developing countries eroded and made it more and more difficult for these countries to obtain loans.

The Latin-American countries were much more prone to a possible financial crisis because they engaged more in an import-substitution-strategy than in an export-led-strategy organized by the East-Asian countries.

In August 1982, the Mexican Finance Minister announced that Mexico would be unable to meet its interest payment obligation. To avoid a contagion throughout South-America, the Federal Reserve organized to a concerted effort to provide Mexico with liquidity. These loans, mainly through the IMF, imposed several conditions on the developing countries and helped to avoid a large distress in the financial markets throughout the 1980ies.

In addition to the short-term management of the debt-crisis, the Central Banks also formulated long-term-management-strategies in order to restore public confidence in the international financial markets.

## CAPITAL ADEQUACY STANDARDS

As early as 1984, the G10 discussed harmonizing Capital Adequacy Standards. Lower requirements for minimum capital allowed banks to gain a competitive edge against banks from countries with higher requirements for capital because they could charge less for their services. Central Banks wanted to avoid this “regulatory arbitrage” and create a level playing field for the commercial banks.

However, accounting system and laws were too different to expect a slow convergence without substantial concession by all sides.

The main issue was the introduction of weight-risked capital requirements. Each asset would be evaluated according to its risk and banks were obliged to hold more capital for riskier assets. Cash and government securities were given little weight. Loans were given more weight depending on the debtor (OECD vs. Non-OECD-countries).

At first, the Americans were skeptic in introducing risk-weighted capital requirements, but after the failure of the Continental Illinois (the eight-largest bank in the USA) in 1984, they turned to the Basel System. The Europeans had already partially introduced risk-weighted capital standards and were discussing proposals on how to harmonize capital standards in Europe.

However, negotiations in Basel did not proceed as fast as the Americans wanted. The Germans for instance argued that their universal banks were much better integrated in the German Economy and needed therefore lower capital requirement. The Japanese stressed the hidden reserves held by Japanese Banks, including real estate and corporate equities.

In order to speed up the negotiations in Basel, UK and US Regulators agreed to implement the “risk-weighted” capital standard for their markets. After a tripartite agreement with Japanese regulators, it also became eminent to the other members of the G10 that an agreement would be unavoidable.

## BASEL ACCORD

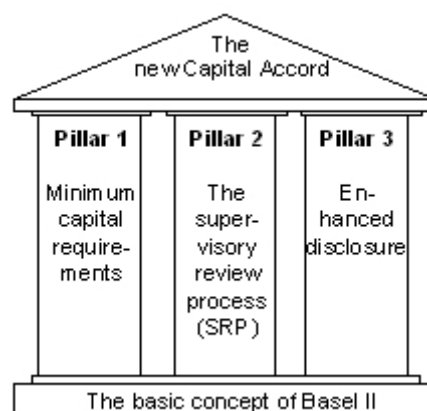
The agreement reached in 1987 by the G10 consisted of the following measures:

- A common definition of capital was reached, consisting of two tiers: 1) shareholder’s equity and other permanent and readily available assets 2) loan loss reserves, unrealized gain on market securities, hybrid debt-capital instruments and other more bound-assets.
- A minimum risk-adjusted capital adequacy of 8 percent was agreed, with at least 4 percent coming from the first capital tier.
- Different risk weights were assigned to assets: Cash and short-term government securities had a zero weight, long-term securities, municipal bonds and securities issued by countries outside the OECD were given weights between 10 to 100 percent, loans were given 100 percent weight.

## BASEL II

The Basel Accord has been amended throughout the 1990ies and changed in order to cover other banking risks as well.<sup>4</sup> The New Capital Adequacy Framework consists of three pillars:

- Minimum capital rules
- Supervisory review of capital adequacy
- Market discipline based on the provision of reliable and timely information



<sup>4</sup> Barth, James et al (2007). Rethinking Banking Regulation. Cambridge University Press

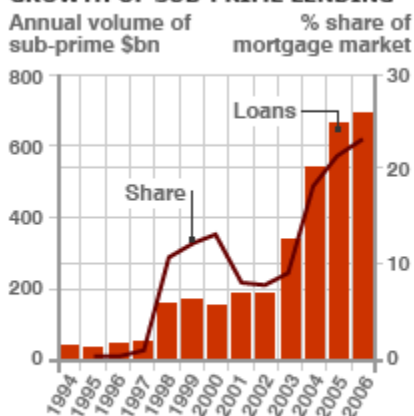
The first pillar deals with maintenance of regulatory capital calculated for credit risk, operational risk and market risk. The second pillar gives regulators much improved 'tools' over those available to them under Basel I. The third pillar greatly increases the disclosures that the bank must make.

## THE SUBPRIME CRISIS AND BASEL-SYSTEM

The Basel Accord has encouraged bank to push unrated loans off the balance sheets. Banks are required to hold less capital against rated positions than against unrated positions, making it optimal to invest in rated notes, rather than a comparable portfolio of unrated assets.<sup>5</sup>

Thus rating agencies become an essential tool to risk the default probability of assets – and are thus essential to determine the correct amount of capital held by banks. The current financial crisis has shown the weakness of the current rating system. Whether conflict of interests by the three main rating agencies (S&P, Moody's, Fitch) or simply missing information is at the heart of this weakness remains to be determined.

### GROWTH OF SUB-PRIME LENDING



SOURCE: Center for Responsible Lending /Inside Mortgage Finance

The subprime-crisis developed over the summer of 2007. Fueled by low interest rates in the US since 2001, housing credits were given to debtors with low income and little down-payment. The banks assumed that the prices of houses would remain high; the debtors assumed that interest rates remained low.

In order to prevent an overheating of the economy, the Federal Reserve raised interest rates in 2005. This eventually caused debtors to default on their loans and forced the banks to auction off the houses. The sudden appearance of large quantities of houses on the markets caused the prices of houses to drop considerably.

Yet the banks had not kept the subprime loans in their books. They merged them according to several risk classes and sold them again in the financial markets. These so-called Collateralized debt obligations (CDOs) were bought in large quantities by the speculative branches of large banks. These CDOs, although highly-profitable because of

the constant cash-flow in times of low interest rates, received rankings that did not represent the underlying risks. This was realized by the markets throughout the summer and fall of 2007.

Because banks could not easily identify how their subsidiaries were affected by the default of subprime credits and how much additional liquidity would be needed, the banks became increasingly wary to lend to each other through the Interbank lending market. The higher interest rates were passed on to the customers and made it more difficult for to raise funds, which in turn threatened to hamper the economic growth.

Despite a general positive outlook in the world economy, the current turmoil in the stock markets is partially caused because markets are trying to assess how individual companies are affected by the shortage of liquidity in the financial markets.

For Central Banks, especially for the Federal Reserve, the current monetary policy is very difficult. They want to avoid decreasing interest rates in order to fuel inflation, but want to revitalize the markets by providing liquidity. The essential problem is one of market confidence.

Given previous experiences with financial crises resulting from a lack of market confidence, new regulations and supervisory mechanisms coupled with announcements by Central Banks to provide considerable liquidity for temporarily distressed financial institutions could help to restore this market confidence.

<sup>5</sup> [http://www.thebanker.com/news/fullstory.php/aid/5348/Regulations\\_caught\\_red-handed\\_in\\_search\\_for\\_subprime\\_crisis\\_culprits.html](http://www.thebanker.com/news/fullstory.php/aid/5348/Regulations_caught_red-handed_in_search_for_subprime_crisis_culprits.html)