The new rules of basel iii : opportunities and challenges for banking sector

Finance

The implementation of Basel I and Basel II norms certainly helped in regulating the financial situation in several parts of the world (Balthazar, 2006). Basel, I and Basel II norms were initiated with the objective of establishing efficient financial practices in banking and other financial organizations (Pritchard, 2004). However, in the changing market scenario, the exposure of these financial institutions to risk has increased and several institutions collapsed during the global economic crisis. The collapse of the banking sector during the financial crisis in South East Asia in 1997 is the best example in this context. Australia also faced such type of economic recession and banks were exposed to market risk. Thus some more financial reforms are needed that can help the organizations to face the emerging new challenges efficiently. Hence, Basel III norms have been implemented by the Basel Committee on Banking Supervision (BCBS).

This essay will illustrate the opportunities to be created by Basel III norms that help in providing better financial risk management; it also will discuss the challenges or negative impacts of Basel III. Basel III emphasized developing risk resilience mechanisms that can be practiced in financial institutions including banks. Basel III norms also called for controlling the financial irregularities by implementing strict regulations. It provided financial protection to banks by following minimum adequate cash reserves that can sustain their financial needs for a minimum period of 3-4 months at the time of the financial crisis. The risk-bearing ability of the banks was also strengthened through the major financial regulations that are sufficiently dynamic in nature to respond to the market changes positively from time to

time (The Economist, 2010).

According to the norms of the Basel III, the banks are required to hold a minimum of seven percent of tier 1 capital, namely cash reserves and common stock which is a good jump from the present level of two percent. This is a very significant step to provide a higher risk-bearing ability to banks against the financial crisis. Similarly, the tier one capital is also a core measure of a bank's financial strength and by increasing this component, the risk-bearing ability of the banks would be enhanced tremendously. Tier 2 capital will be regulated for its sustainable growth and tier 3 capital will be removed completely according to Basel III norms. In addition, they have to improve the capital requirements for counterparty credit exposures which provide them better cushion to withstand financial shocks. At the same time, as per the norms of Basel III, the risk management of counterparty credit exposures and capital buffers have to be strengthened which would provide cushion at times of financial stress. This would result in higher immunity for the banks against interest rate risk and market risk in the future.

In consequence, the successful implementation of all these measures suggested in Basel III would certainly enhance the financial stability of the banks and reduce the need for the government bailouts during the financial crises. In contrast, the implementation of some clauses of Basel III has some potential disadvantages and banks have to face new challenges. For example, according to the Basel III agreement, the banks are required to hold a higher amount of capital reserves with themselves as a protection

against the financial risks involved with the longevity of their own debts and the risks that banks attach to different kinds of loans (Peston, 2010). This would certainly provide them better protection during the times of financial crisis, but at the same time, the profit margin of the banks and their investment opportunities will erode significantly (Black Swain Insights, 2010). This is because of the fact that the banks have a little amount to disburse in the form of loans to the customers and hence they may have to charge additional interest rates. In other words, the customers have to pay an extra amount of interest for the loans taken compared to the present period which may result in lower business volume and profit margins. Another challenge of the Basel III agreement is in the form of enhanced trade finance pricing and reduced volume of trade finance which may influence the global trade and global GDP negatively. In conclusion, Basel III norms mainly emphasized on various measures like enhancing the component of tier 1 capital, regulating the tier 2 capital, and removing the tier 3 capital for providing better financial stability to banks. They also stressed on maintaining adequate capital buffer to face any unforeseen financial crisis and better risk management of credit exposures of banks. However, Basel III norms may also result in some challenges like an increase in transaction charges, reduction in profitability, and enhanced trade finance pricing. As a result, although it is strongly suggested for the use of Basel III norms for counterparty credit exposures during the financial crisis, the Basel Committee fails to device some methods that deal with unexpected future events in response to the complexity of global economics. For example, when the Lehman Brothers bank has exceeded the Basel II and III

requirements, the Basel III norms couldn’t save it from bankruptcy. Hence, for achieving the maximum success from Basel 3 norms, the banking sector must emphasize the management practices for reducing the operational risks associated with the new Basel 3 capital accord (Gregoriou, 2009).