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BASEL Norms & Surveillance Methods

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ABSTRACT

Banking activities put forth a convoluted web, requiring careful control and supervision for the economy's health. Basel Accords I and II are endeavors at the global level so as to rejuvenate commercial banks and to overcome the shocks presumably to emanate owing to diversions in international markets. Furthermore, Basel III is conjointly in the offing momentarily and its application has commenced. Also, the propositions promulgated lately, called as 'Basel IV', comprehend updates in the manner banks forecast and work out their capital needs. As there exists no particular method to efficient corporate governance, the updated foundations of Basel Committee procure a scheme within which banks as well as supervisors should function. Between the years 1986 and 1995, approximately a third of the 3,234 savings as well as loan organizations in the US disrupted. This destructing chain of phenomenon made it expandingly evident that off-site surveillance was not at all enough to appropriately ascertain bank failure and therefore should not act as a backup for intermittent, periodic and timely on-site examinations. Therefore, this article portrays the exertion of Basel norms and Surveillance methods along with effective principles of good corporate governance and the ongoing situation of COVID-19.

I. INTRODUCTION

Commercial Banks play a crucial role in the operation of an economy. Post globalization, foreign banks have got into monetary pursuits in Indian scenario. As an outcome, banking activities put forth a convoluted web, requiring careful control and supervision for the economy's health. The Basel Committee - originally denominated as the "Committee on Banking Regulations and Supervisory Practices" - was formed by the Central bank Governors in the end of the year 1974, in the eventuality of deliberate turmoil in the field of international currency as well as banking markets (remarkably the "Breakdown of Bank of Herstatt in West Germany)."

The Committee, which has its headquarters at the famous Bank for the purposes of International Settlements in Basel was initially formed so as to advance economic solidity

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by way of enhancing the facets and standards of banking supervision globally, whilst serving as a platform for constant coordination among its member nations on the aspects of banking supervision. The very first meeting of the aforementioned Committee happened in the year 1975 (February), and such meetings have consistently been held thrice or more than that, in a year since then.

Basel Accords I and II are endeavors at the global level so as to rejuvenate commercial banks and to overcome the shocks presumably to emanate owing to diversions in international markets. Furthermore, Basel III is conjointly in the offing momentarily and its application has commenced. Banks come across a high degree of perils predominantly because of the fact that banking is considered to be one of the tremendously leveraged strata of an economy. In this regard, it is necessary for the banks to analyze the plan of action, either short or long term, which will aid in escalating the financial value in the long-run, while remaining in conformity with their risk-appetite. A well augmented and effective risk management scheme of a bank, will lead to high chances of success in the long term.

There are very less studies which have been executed so far in the field of risk management in banking area. As Basel II is quite a contemporary development and furthermore, Basel III is in the preliminary phase, a topic of this kind needs a constant study in respect of the changing nature of the banking scheme. This will in turn aid in evaluating the work which has been completed already, and its narrow purview, directing towards a certain requirement for further investigation. The propositions promulgated lately, called as ‘Basel IV’, comprehend updates in the manner banks forecast and work out their capital needs, with an objective of making after effects more equivalent across banks worldwide.

The “Basel Committee on Banking Supervision” (BCBS) put forward an application plan of nine-years, which permits substantial time for groundwork. The BCBS has also put forward certain reforms which are destined to help banks in becoming volatile, thereby constantly upgrading confidence in the banking mechanism. A five-year time frame would embark on January 1 2022, along with absolute implementation expected and predictable from January 1, 2027.

II. MEANING OF BASEL NORMS

Basel is one of the cities in Switzerland. It is the main office of Bureau of International Settlement (BIS), which stimulates co-operation amidst central banks upon a common objective of financial cohesion and common benchmark of banking norms. Basel guidelines accredits to extensive supervisory paradigm devised by this congregation of central banks –

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known as the BCBS, as aforementioned. Our country has accredited Basel accords for the banking mechanism. On some criterions the RBI has also laid down rigorous norms in comparison to the guidelines put forth by BCBS.

(A) BASEL I

In the year 1988, BCBS announced the capital measurement mechanism known as "Basel Capital Accord", also termed as Basel I. It targeted essentially on credit risk. It denominated capital as well as structure of risk weights for banks. Furthermore, the minimal capital requirement was settled at 8% of the actual **Risk Weighted Assets (RWA).** RWA refers to the assets carrying varying risk profiles, for instance; An asset boosted by collateral will definitely have lesser risk in comparison to personal loans, that have no collateral.[3]

i) Pillars of BASEL I are:

(1) Minimal capital requirement;

(2) Risk weighting;

(3) Target Standard Ratio;

(4) Transitional as well as Implementing arrangements.

Our country adopted Basel I norms in the year 1999. The two basic objectives of Basel I were:

- To make sure that there exists appropriate degree of capital in the global banking mechanism.
- To constitute increased degree playing field in any competitive domain.

(B) BASEL II-

Basel II standards, promulgated in the year 2004, is quite an exhaustive groundwork of banking administration when corelated to Basel I. It does not exclusively deals with the calculations pertaining to CRAR, but also consists of provisions for administrative review alongwith market discipline. [4]

i) Pillars of BASEL II are as follows:

(1) Minimum regulatory capital

(2) Supervisory review

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[3] Abhijeet Gondane, *Everything You Need to know about Basel Norms*, BANK EDUCATOR (Feb. 10, 2020, https://www.bankeducator.com/basel-norms/.

[4] Mohd. Arif Pasha, *BASEL Norms and Indian Banking Sector*, 7 IJB 78, 79 (2013).

(3) Market discipline [5]

- As per this, banks were actually required to advance and utilize **better risk management know-how** in supervising and handling all the three categories of risks which a bank confronts, viz. **credit, market, as well as operational risks.**
- **Market Discipline** has with time expanded the **disclosure requirements.** Banks have the imperative obligation to acknowledge and broadcast their CAR, risk exposure, etc to the RBI.

The following considerations of Basel II should be taken into account:

1. It subjugates the vulnerabilities of Basel I, thereby providing a bundle of comprehensive yardsticks.
2. It has been laid out to be a more contemptuous skeleton, which evidently resonates the intricacies of concurrent bank balance sheets.
3. The slightest CRAR of 8% is reserved as in the case of Basel I, however the risk weights are greater.
4. With a more skeptical **"Internal Ratings Based" (IRB)** method, banks with appurtenant ability could ascertain their risk weightings utilizing internal loan data and information instead of the standardized weightings as stated in the guidelines, and banks to compulsorily unveil their risk exposure, etc., to the RBI.[6]

(C) BASEL III-

Basel III issued in December in the year 2010 is regarded as third in the sequence of **Basel Accords**. Such accords deal with certain areas of risk management pertinent to the banking sector.[7] Therefore, we can say that Basel III is the global regulatory standard on bank capital adequacy, stress testing and market liquidity risk. Basel I and Basel II are the earlier versions of the same, and were less stringent. Thus, we can opine that Basel III is particularly a perpetuation of effort triggered by the Basel Committee on the aspect of Banking Supervision so as to advance the banking regulative framework as under Basel I and Basel II.

i) Pillars of Basel III Accord:

- Pillar-1 – Augmented Minimal Capital as well as Liquidity Needs

[5] CFI, *What is BASEL II*, CORPORATE FINANCE INSTITUTE (Jan. 19, 2020), https://corporatefinanceinstitute.com/resources/knowledge/finance/basel-ii/.
[6] GONDANE, *supra* note 1.
[7] Mandira Sarma, *Understanding Basel Norms*, 42 EPW 3364, 3365 (2017).

- **Pillar-2 – Intensified Supervisory Review Mechanism for Firm-wide Risk Management along with Capital Planning**
- **Pillar-3 – Advanced Risk Disclosure together with Market Discipline**[8]

According to Capital Regulations, majority of the modifications were put forth in Basel III over previous accords i.e. Basel I and Basel II - Additions like that of **Maintaining Better Capital Quality**, banks to have a grip of **2.5% of Capital Conservation Buffer.**

Additionally, retaining Countercyclical Buffer is of equivalent importance. Now, the fact that Basel III norms also involve a **Leverage ratio** in order to serve as a safeguard.[9] A scheme for the management of liquidity risk, was also recommended to be created. An advanced **Liquidity Coverage Ratio (LCR)** as well as a **Net Stable Funding Ratio (NSFR)** were therefore likely to be put forth in the year 2015 and 2018, respectively.[10]

III. Role of Corporate Governance with Basel norms

Effective and efficient corporate governance is analytical to the appropriate operations of the banking field and the economy altogether. As there exists no particular method to efficient corporate governance, the updated foundations of Basel Committee procures a scheme within which banks as well as supervisors should function so as to gain vital and explicit risk management together with decision- making, and, thereby in following this, boosting public confidence whilst upholding the security and integrity of the banking system.[11]

The revised bulk of framework supplements the practices published by such Committee in the year 2010. The revised set of guidance regarding this focuses upon the hyper critical significance of efficient corporate governance for the secure and effectual working of banks. It focuses on the necessity of risk governance as an articulation of banks' comprehensive corporate governance practices and working, thereby promoting the importance of strong boards as well as board committees altogether with efficient monitoring functions. More particularly, the revised principles:

- *broadens the supervision on the role pertaining to the board of directors with respect to overseeing the application of effective and efficient risk management mechanisms;*

[8] Sanjay Bulaki Borad, *What is Basel III*, E-FINANCE MANAGEMENT (Aug. 30, 2019) , https://efinancemanagement.com/sources-of-finance/basel-iii, last seen on 19/03/2020.
[9] Kaminsky, G L and C M Reinhart, *The Twin Crises: The Causes of Banking and Balance-of-Payments Problems*, 3 AER, 473, 500 (2014).
[10] SARMA, *supra* note 5.
[11] Ibid.

- *enunciating the necessity of the boards' consolidated proficiency as well as the duty of individual board members to devote enough time to their behests and to keep updated of developments in the banking sector;*
- *substantiating the leadership on the aspects of risk governance*
- *profer directions and supervision for bank supervisors in estimating the mechanisms used by certain banks so as to decide board members and also the senior management; and*
- *perceiving that compensation procedures form a major vital constituent of the governance.*

IV. Issues and Challenges

Present day enterprises are well-known for the division of ownership and supervision. It is, therefore essential, as the agency theory directs to possess a procedure by which the interest of the shareholders are safeguarded by the managers.[12] It is therefore evident that corporate governance play quite an important role. Nonetheless, Corporate Governance is conceptually distinct for banks. Corporate governance, thus, affects the pursuits of a greater cross-section of the stakeholders. Furthermore, it also has ramifications for financial balance and is one of the major factors which actuates the health of the mechanism and its capability to withstand economic shocks.[13]

Next issue is with respect to Board planning and layout so as to make sure that there is a tenacious internal supervision mechanism including internal as well as external audit procedures and other checks and balances. [14]

Third, supplementary steps should be taken into account in order to improve transparency and clarity by way of more disclosures/impartation of information regarding corporate governance. It is justifiably investigating the endeavors of some corporations to focus on their their annual reports on the aspects of corporate governance matters whilst making pertinent disclosures on each.[15]

Fourth, there is a necessity for a substantial culture of compliance and conformity at the apex of the management and it will be essential to take into account how management could actually respond in an accurate manner to ethical or reputational matters which come

[12] Masson, Paul and John Pattison, *Financial Regulatory Reform: Using Models of Cooperation to Evaluate Current Prospects for International Agreement,* 5 JEA 119, 136 (2011).
[13] Shleifer, A and R. Vishney, *A Survey of Corporate Governance*, 52 JF, 82, 90 (1997).
[14] Shyamala Gopinath, *Corporate Governance Towards Best Practices,* 20(18) RBIB 1105, 1108 (2014).
[15] Didar Singh, *NPA in India,* Financial Express, Nov. 8, 2018.

to their knowledge.[16]

Fifth, there is maybe a longing for consultative method to harmonise the ways recommended by the Ganguly Committee of the central bank and the Narayana Murthy Committee of SEBI.[17]

Lastly, corporate governance is not limited to commercial banks. It is crucial to broaden the above criterion of good corporate governance principles to cooperatives, PDs, NBFCs as well as other financial institutions.

V. Surveillance Methods

The National Bank Surveillance System (NBSS) refers to a computerized supervisory mechanism developed to gather data and assess the pecuniary persuance of national banks. Moreover, NBSS acts as an early warning system.[18] Its responsibility is to analyze banks displaying signals of financial distress, alerting regulators in order to make them take force and step in soon before the condition gets ugly. Its basic mechanism is its quarterly Bank Performance Report, that contemplates each and every bank to a cluster of its peers so as to advance an proper picture of how they are separately faring. Data is more often drawn from Call Reports, together with financial health updates which banks are duty-bound to file on a quarterly footing.[19] The off-site surveillance mechanism interprets and anticipates capitalization and equity ratios, alongwith other quantifiable data and information so as to attempt to apprehend which banks are in exposure of failure. Exquisitely, NBSS will caution the OCC of any existing red flags before it is very late. It has also made its entry after the breakdown of two major national banks in the early years of 1970s. [20]

Between the years 1986 and 1995, approximately a third of the 3,234 savings as well as loan organizations in the US disrupted. This destructing chain of phenomenon made it expandingly evident that off- site surveillance was not at all enough to appropriately ascertain bank failure and therefore should not act as a backup for intermittent, periodic and timely on-site examinations.

1.) Measures adopted by banks for application of best practices- Frugal norms in respect

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[16] Omkar Goswami, *The Tide Rises: Corporate Governance in India,* OECD Development Centre Discussion Paper (2015).

[17] GOPINATH, *supra* note 12.

[18] Daniel Liberto, *National Bank Surveillance System*, INVESTOPEDIA (Aug. 22, 2018), https://www.investopedia.com/terms/n/national-bank- surveillance-system.asp.

[19] Muskan S., *Monitoring of Credit by Banks*, ARTICLE LIBRARY (Aug. 5,2019), http://www.yourarticlelibrary.com/banking/monitoring-of-credit-by-banks/99196.

[20] Jessica Burton, *How Surveillance is Enhancing Bank Security*, PAYMENTS JOURNAL (Nov. 7, 2019), https://www.paymentsjournal.com/how- surveillance-and-ai-are-enhancing-bank-security/.

of income recognition as well as asset classification, alongwith capital adequacy have definitely been well incorporated by the our country's banking system. Moreover, keeping in line with the global best practice, commencing 31st March 2004, banks have adapted 90 days practice for the purposes of bifurcation of NPAs.[21]

2.) ALM and Risk Management Strategies - At the capabilities of the regulators, banks were speedily required to transmit the requirement for Asset Liability Management superseded by risk management mechanisms. Both these fields are overcritical for an efficient and effective overlook by the Board as well as the senior management that are put into force by the Indian banking mechanism on an absolute tight time period and the application review by the RBI. [22]

3.) The off-site surveillance method is also effective in supervising the movement of assets and its effect on capital adequacy and inclusive effictivity and appropriateness of managerial utilities in banks. Furthermore, the "Peer Group Comparison" as well as Prompt corrective action have also been taken into effect by the central bank as a component of basic principles for proper banking supervision and monitoring.

4.) The denomination of Basel III standing as one of the major priority fields for application and supervision is important. To regulate progress and evaluate the implementation and progress of Basel III and also its outcomes, drawbacks, the BCBS has laid the foundation for "Regulatory Consistency Assessment Programme" (RCAP) in 2012.[23]

5.) Pillars of e-surveillance preserving the banking sector are:[24]

- *Prevent Robberies*
- *Crime Inquisition and Survey*
- *Fraud Check*
- *Combating "Phantom ATM Withdrawals"*
- *Co-ordinate data and Information from number of Locations*
- *Integration/Alliance with Alarm Systems*

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[21] V. Leeladhar, *Corporate Governance in Banks,* 11(7) RBIB 1101, 1103-1104(2014).
[22] Ibid.
[23] FSB, *Monitoring of Basel III Norms*, FSB (Feb.20. 2020) https://www.fsb.org/work-of-the-fsb/implementation- monitoring/monitoring-of-priority-areas/basel-iii/
[24] Richard Canday, *12 ways banks use e-surveillance to fight crime and financial losses,* BFSI (Oct. 10, 2019), https://bfsi.eletsonline.com/12- ways-banks-use-esurveillance-to-fight-crime-financial-losses/.

VI. Conclusion and Suggestions

There has been an eloquent improvement in the administration of banks. Also, it was robustly felt that the economic catastrophe of the year 2008 could certainly have been detered, had the practices been rigorously in place. The amplitude of the banks to supervise risks, tighten commercial banking, absorb economic shocks, truncate NPA.

Basel norms definitely are a tenacious step in the aspect of streamlining, controlling and supervising the banking activities. Building accurate base of previous data is a vital for advanced practices to risk determination. This consideration needs to be urgently taken into picture. The Central Bank should pay more scrutiny to this principle, giving a lot of workable as well as comprehensive framework to the banks.

Basel II norms have been complied by all the banks before the extended deadline of March 2009.however the extent of implementation with respect to risk evaluation method is some sort of complete. There is deficiency in respect to expertise database, staff training, IT infrastructure and finances.IT networking needs upgradation in many cases. All these have resulted in varying pace in Basel implementations. Also inter and intra branches networking is also very complex in India.

Adhering to BASEL III norms is absolutely not an easy exercise for India's banking sector, which have to, as a result, expand capital, liquidity along with reducing leverage. This could in turn impact profit margins for our nations's banks. Additionally, Indian banks are required to meet both LCR as well as the RBI's SLR together with CRR norms. "It has been contemplated that Today's practices will free up functional capacity for banks as well as administrators since they reciprocate to the financial impact of Covid-19." "The panel will thus continue to supervise the effect of Covid-19 on the banking sector and administrators and answer as essential in systematization with the Financial Stability Board as well as various other standard-setting administrative bodies on cross-cutting matters."

The standards fostered by the GHOS will impede the operational timelines of all the left over Basel III guidelines until January 2023, encompassing the revised:

- leverage ratio along with G-SIB buffer
- homogenized outlook for credit risk
- IRB approach for credit risk
- operational risk structure
- CVA framework

- market risk scheme
- Disclosure requirements for Pillar 3

Instead of the present uncertainty encompassing Covid-19, and the impediments announced to the Basel III guidelines, GHOS members have enormously re-established their prospects of full, prompt and persistent implementation of each Basel III standard on a revised timeline.

Suggestions in these areas are as follows:

- The formulation of our country's banking sector
- Evaluating the zeal and alertness of Indian banks, be it public or private for the purposes of efficient application of Basel norms.
- A timely survey of literature, thereby indicating guidance for more research work.
- Evaluating the trends in CAR as well as NPA values altogether with recommending a modernistic index of performance.

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