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# Analysis of Basel III and Risk Management in Banking

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**Abstract**
Over the years, financial institutions have always operated as channels for lenders and borrowers. In view of their activities, the banks and other financial institutions are able to accumulate surplus funds from these investors (individuals/organizations) and lend these funds to other investors with deficit funding thereby creating a fiduciary relationship between these two parties. The study analyzed and assessed the effectiveness of Basel III to manage risk in banking. To analyze their activities, the study assessed efficacy of risk assessment procedures and regulations proposed by the Basel Committee on Banking Service (Basel III) protect the interest of these parties. Potential risks ranging from credit risk, market risk and operational risk were analyzed. In view of the reforms proposed by Basel III, the framework has failed to address numerous issues. To address this menace in the banking sector, Basel III should not be held as the only conduit to resolve financial crisis, but there is the need to seek other systems in integrating specific government financial regulations with the provisions of Basel III.
**Keywords:** Banking, Basel III, Crises, Financial, Risk, operational.

## 1. Introduction

Over the years, financial institutions have always acted as conduits for their respective clients to invest their surplus funds and also lend funds whenever needed (Wolf, 2009; Tsana, 2008). This fiduciary relationship between banks and their clients has been characterized by number of challenges (Kerr & Nanda, 2008). These challenges range from credit risk, market risk, operational risk and financial risk (Mensah, 2012). To mitigate these challenges, number of legislation has been passed globally to ensure sanity between banks and their respective banks (Amediku, 2011). For instance, the United States passed the Glass-Steagal Act 1933 to separate commercial banks from investment banks. The motive behind this Act is to protect the interest of clients and the government by dissuading banks from engaging in acts such as conflict of interest and other unethical practices in the banking industry. In Ghana, the central bank was established purposely to supervise and regulate the operation of commercial banks and the financial activities of the country as a whole (Agyekum, 2011). In view of the services rendered by banks to organizations globally, it has become expedient to formulate uniform legislation to supervise and regulate their activities (Kupper, 2008). To achieve this feat, the Basel Committee has formulated a series of regulations to supervise and monitor the global banking operations (Basel Committee on supervision, 2009). Considering the fundamental challenges to contemporary global banking, the emergence of competition has further exposed banks and their clients to a number of risks culminating into the recent global recession (Lackritz, 2010). As a result of these practices, financial analyst asserts that management of financial institutions ought to manage their risk to mitigate any adverse exposure (Filipiak, 2009). The main objective of this paper is to discuss and assess the effectiveness of Basel III to manage risk in banking.

## 2.0 Risk Management in Banking

Risk is said to be inherent in every aspect of human life and activity and are mostly prevalent in the financial sector (Raghavan, 2003). The nature of banking generally exposes banks to risks ranging from credit risk, market risks and operational risk (Paul-Choudhury, 1998; Wilson, 1997) however, it must be noted that these risks are asymmetric to banks. The financial risk of a banking organization is the probability of a transaction culminating into a favorable or adverse outcome (Raghavan, 2003). To achieve a favorable outcome of events, banks are expected to manage their risk factors effective to minimize losses in order to maximize returns (Pandy, 2004). Risk management is the core function of every financial institution which involves discovering, measuring, monitoring and regulating of risk to ensure that managers of such institutions clearly understand risk; reconcile risk decisions with the firm's strategy and objectives; capital is sufficiently available to take risk; risk taken are compensated by expected payoff (Sawyer, 2009; Raghavan, 2003 & Morgan, 1996). Financial analyst asserts that risk management should be integrated into every aspect of the firm's operations.
In view of the services provided by banks, credit risk is one of the symmetric risks exposed to all banks. Credit risk is the probability that a customer/borrower may not be able settle it's short and long term financial obligation (Agyekum, 2011). Interestingly, when banks lend money to customers, there is always a possibility on the part of the customer defaulting in payment hence; the objective of credit risk management is to minimize the risk associated with loans and maximize the bank's risk adjusted rate of return (RAROR) by projecting and maintaining credit exposures within an acceptable benchmark. According to Raghavan (2003), credit risks

 

consist of quantity risk and risk quality. The quantity risk is simply the outstanding balance of the loan facility as at the default date whiles quality of risks, defines the rate of probable loss in the event of default. Consequentially, credit risk is basically a combination of default risk and exposure risk. Exposed ceiling, review of renewals, risk rating models and risk based pricing are some of the tools employed in credit risk management.
Apart from credit risk, another possible risk injurious to the operation of banks is market risk. Market risk is a probable loss that may accrue to a bank as a result of changes in variables in the market variables (ACCA, 2011). These risks culminate into losses or gains in earnings as a result of variations in interest rates, exchange rates, bond rates, equity/commodity prices (ACCA, 2011; Raghavan, 2003). Consequentially, market risks, impacts on on/off balance sheet positions as a result of movement in interest rates, equity, forex rates and commodity prices (Casu, Girardone, & Molyneus, 2006). To successfully measure, monitor and manage banks 'market risk, the existence of an effective market risk management system will provide comprehensive information for measure liquidity, interest rate exchange rates and commodity prices.
Another potential risk associated with financial institutions is operational risk. According to Tett (2012), the inability of management to access banks operational processes have a tendency of breaking down the internal controls of governance. It is normally characterized by human errors (Mishkin, 2000). Operational risk is the potential loss arising from failure or inadequate system such as internal controls, people or external events other than market and credit risk (Wilson, 1997). Consequentially, breakdowns in these systems could serve as a conduit for internal and external fraud, negative employment practices, adverse effects on product and services, unsatisfactory delivery to customers and other system failures (PWC, 1996; Wilson, 1997). The real cause of most financial scams and some form of credit and market risks are caused by operational risks (Raghavan, 2003). To safeguard banks from potential operational losses, management of banks ought to strengthen the internal controls and internal audit. These tools are some of the primary tools employed in a system to mitigate operational risks.

## 3.0 Global Regulations and the Basel Accord

Potential losses resulting from these risks have metamorphosed into the recent global banking crisis (Reinhart and Rogoft, 2009). Further effect was the adverse operational and financial consequence requiring most of these banks being bailed-out by their respective government. For instance, the US government approved $3 trillion to bail-out banks crippled by the 2008 financial crisis (Murphy, 2008).
The most severe effect on most of these banks culminated in the need to focus on developing a global financial regulation by international regulators (Schweder, 2011; Tsana, 2008). According to Borio and Filosu (1994), the outcome of the global crisis clearly indicated that global regulations and supervision among banks was imperative to harmonize specific border regulations and supervision. This strategy could integrate and avoid arbitrage in banking regulations (KPMG, 2012). To mitigate the outcome of financial crisis, countries globally and some international financial organizations have formulatedlegislators and policy guideline/standards. The aim of this legislature and standards is to develop standards and frameworks to supervise banks and other financial institutions to make them financially stable throughout the world (KPMG, 2012). One of these international organizations is Basel Committee on Banking Supervision (BCBS).
Long before the explosion of the 2008 global financial crisis, a committee of banking supervisory authorities of the G-10 countries mooted for the creation of standards to supervise and regulate the operations of banks in their member countries. In December 1992, Basel I, was developed by BCBS to strengthen banks financially by formulating provisions that will require banks to maintain a required capital base (Amediku, 2011). The main aim is to enable banks avoid losses through maintenance of a minimum capital adequacy and provide a harmonious field for banks globally (Raghavan, 2003). It provided for a minimum capital ratio of 8% from Tier 1 capital to be maintained by banks (PWC, 2011) however, the deficiency inherent Base I culminated into the birth of Basel II (Agyekum, 2011).
Basel II was developed and introduced in 2004 to regulate and supervise banks, review their processes and ensure market discipline. It is built on three thematic pillars thus the minimum capital requirement (pillar I), supervisory review processes (pillar II) and market discipline (pillar III) however, its implementation was stifled by challenges such as high cost of training staff, IT, discrimination among large and small banks, discrimination of countries in the transitional period (Laurens, 2012). As a result of these difficulties encountered at the implementation stage, it became difficult for banks without any prudent risk management to system to implement the provisions of Basel II (Gorton, 2009). These shortcomings reflected a clear evidence of provisional inadequacy in the Basel II accord hence; necessitating the formulation and introduction of Basel II.

## 4.0 Basel III and Risk management

The main brain behind the formulation of Basel III is to achieve two primary objectives thus; (i) make the banking more resilient by strengthening capital and liquidity regulations among the players in global banking; (ii) minimize systemic revolving risk to improve banks' ability to withstand any financial turmoil (BCBS, 2009).

 

To achieve these primary objectives, Basel III classified their proposal into three basic facets amidst seeking to address (i) capital reforms; (ii) short-term liquidity reforms and; (iii) improve stability in the financial system (BSBC, 2009; KPMG, 2011).

The snapshot of Basel III also is to address the crisis that befell financial institutions in the 2007 global crisis as a result inadequate regulatory provisions to fix fundamental banking risks that banks face. For instance, the 2007 financial crisis caused the massive losses to the US housing market as a result of the high risk associated with subprime loans which was only financed through assets supported by securitization (Lange, 2004). To fix these risks associated with credit , market and operational, the framework defined and provided a clear-cut mechanism to that effect (KPMG, 2011). The specific provision to mitigate liquid crisis was pegged at 30- days liquidity coverage ratio (LCR) by Basel III (BCBS, 2009) to strengthen and promote the short-term liquidity stability of banks (Janson, 2009). The LCR expect banks to hold adequate liquid, low-yielding assets to meet this target. To mitigate credit risk, the framework further increased the minimum capital requirement from 8 percent to 10.5 percent. Considering the capital inadequacy of banks that culminated into series of financial crisis (Murphy, 2008), the Basel III framework proposed a leverage ratio which provides that banks total assets should not exceed its capital by 33 times (KPMG, 2011). This measure could reduce lending by banks to strengthen their capital base (Janson, 2009) and also enable banks to have sufficient liquid assets to overcome any funding challenge (Murphy, 2008).

According to Laurens (2012), the potential effectiveness of the Basel III framework is to generally formulate regulations to mitigate future systemic risks associated with banking. To this effect, Basel III adds up to the existing regulations (Walter, 2009). The question posed by analyst is whether Basel III is really a panacea for resolving financial crisis judging from the implementational and supervisory challenges facing the framework (Varriale, 2011). This phenomenon is making the implementation very difficult considering the fact that framework does not wield the authority to enforce strict supervision but only provides an environment for corporation among its member countries (Laurens, 2012). It is worth noting that some member countries are yet to fully implement the requirement of Basel II (BCBS, 2009) thereby lagging behind the implementation of Basel III.

## 5.0 Conclusion

The losses suffered globally by banks are the results of limitations inherent in managing corporate risks (Amediku, 2011). This culminated into the 2007 global financial crisis (KPMG, 2011) giving rise to increase in credit without stringent standards because of excess liquidity; inadequate capital base and excess leverage (Murphy, 2008). To re-organize and meet the Basel III deadline, the world's 29 largest banks are expected to raise $566 billion dollars fresh capital or shed about 5.5 trillion in assets (Fitch, 2012). This attest to the fact that financial regulations have material effect on risk management in banking therefore, a balance between government regulations and Basel III in mitigating risk in the banking sector must be considered (Walter, 2009). According to Laurens (2012), government should focus on prudent supervision and less rigid regulations.

In view of the reforms proposed by Basel III, the framework has not been able to address issues relating to reliance on external rating, ethical issues in governance, manipulation of disclosures, high cost of implementation (Amediku, 2011; Janson, 2009). To address this menace in the banking sector, Basel III should not be viewed as the only conduit to resolve financial crisis (Lauren, 2012) but there is the need to seek ways in integrating specific government financial regulations with the provisions of Basel III.

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