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Basel III And Banking Supervision

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ABSTRACT
This paper consists of three parts. The first part discusses the background and content of the Basel III. The second part explores the differences between Basel III and Basel II over banking regulation.The third part of the paper explores the functions of the Basel III to reduce the risk of a global banking collapse.

KEYWORDS
Basel III; Banking Supervision; Basel III on Banking Supervision; Function of Basel III

1 Brief Introduction of Basel III

Basel Banking Supervision Committee, since the inception, released the "International Convergence of Capital Measurement and Capital Standards" (Basel I), "Capital Measurement and Capital Standards: a Revised Framework" (Basel II), and the "Basel III" which is consisted of a series of documents, and also a lot of other documents regulated. Indeed, these documents issued by the Basel Banking Supervision Committee don't belong to general international treaties, but the regulatory standards it accomplished have been widely practiced all around the world. With the continuous emergence of financial innovation, the concept of capital adequacy management of the Basel II has been Challenged. The occurance of the 2007 financial crisis made the issue of Basel IIexposed more. In response to the financial crisis, the Basel Banking Supervision Committee has developed a system of documents that establish new standards for to regulate bank, which belong to the Basel III (Tebogo, 2012). The Basel III is mainly composed of the following contents.

1.1 Basel III improved the regulation of capital which is the Basel II's first pillar

Basel III redefines the structure of capital, improving the quality of capital, it improves the framework coverage of risk capital, especially on the risk of trading account, the risk of asset securitization, the risk of off balance sheet tools, and risk of counterparty brought by financial derivative products; it introduced leverage as a complementary capital adequacy method; it makes the minimum capital requirement ratio higher.

1.2 Basel III improved regulatory standards as the second pillar of Basel II

Basel III proposed seventeen Principles of management of liquidity risk; it improved the practice of financial tool evaluation, enhancing the pressure of test status; it regulated the assessment methods of compensation standards and compensation principles; it improved the principles of corporate governance, and highlighted the importance of strengthening the supervision and coordination of the transnational.

1.3 Basel III improved information disclosure as the third pillar of Basel II

Basel III improved information disclosure requirements, increasing six aspects of information disclosure (Spina, 2013). They are information disclosure of securitization risk in trading accounts, information disclosure of transactions tools off balance sheet, information disclosure of internal assessment methods as well as other asset-backed commercial paper liquidity and securities, risk disclosure of re-securitization, risk disclosure of evaluation of securitization assets and risk disclosure of pipeline and warehousing securitization.

1.4 Basel III increased liquidity ratio standards

The Basel III proposed two indicators, so as to achieve the purpose of strengthening liquidity management. They are liquidity coverage ratio (which is short-term standard) and net stable financing ratio (which is long-term standard), .

1.5 Basel III increased reverse-cyclical capital releasing methods

In order to cope with the pro-cyclical problems, the Basel III proposed a reverse-cyclical capital releasing tool to mitigate the adverse effects on the macro-economy of the pro-cyclical function.

2 Development of Basel III: on Banking Supervision

There are many similarities between the old and the new Basel agreement. In Basel III the basic spirit of Basel II goes on, and it insists on the three pillars of the regulatory philosophy, and adheres to the capital adequacy ratio as a measure of bank risk (Dzhagityan, 2016). But when the global financial crisis occurs suddenly, the Basel II has revealed a lot of problems. So Basel III made the improvement as well as the perfection based on the Basel , especially on Banking Supervision.

Capital supervision is the consistent regulatory philosophy and core of the previous Basel agreements. To some extent, the Basel agreement is essentially an agreement on capital supervision. Capital supervision plays an important role in the Basel agreement. Because of this, the development and progress of banking supervision in Basel III compared with the previous two editions is mainly reflected in its development in the aspect of bank capital supervision. The Basel III is an effective supplement established on the basis of existing agreements, but compared with Basel I and Basel II , Basel III improved the capital regulatory standards, and expanded the capital regulatory risk coverage, and its requirements on bank capital are more stringent.

2.1 Firstly, Basel III added two new regulatory tools

The Basel III follows the regulatory framework of the Basel II, stressing the three pillars of supervision, namely, capital supervision, external supervision and market restraint (Avadanei, 2013). Meanwhile, it has added two major regulatory tools. The new regulatory mechanism of leverage rate supervision and liquidity supervision has been added to improve the regulatory framework of the original Basel agreement.

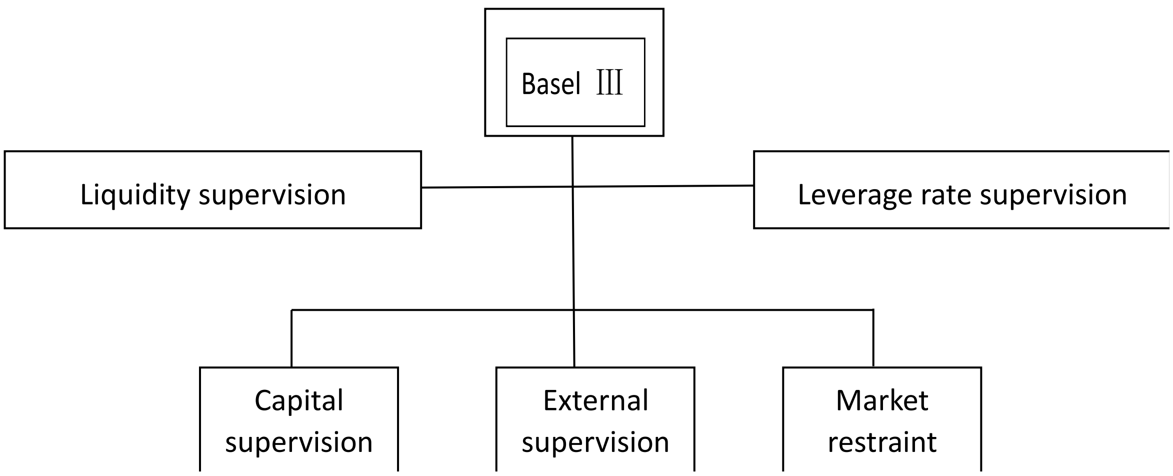

Figure 1 New Structure Of Basel III

2.2 Secondly, the capital composition is different

In the Basel II, the capital is divided into one-level capital (core capital), two-level capital (subsidiary capital) and three-level capital specially designed for market risk accrued. One-level capital is divided into equity capital and public reserves, in which equity capital includes common shares and non-cumulative preferred shares (Tomić, et. al., 2016). The Basel III divided capital into only one-level capital and two-level capital, and the three-level capital was abolished. One-level capital includes core one-level capital (common shares, retained earnings) and other one-level capital (preferred shares, other indefinite loss absorption tools).

2.3 Thirdly, Basel III adjust the focus of capital regulation

In the Basel III , capital pays special attention to common shares, and emphasizes that common shares play an important role in absorbing bank losses. Specifically, when the transition period (from 2014-01-01 to 2018-01-01) ended, the component elements of capital investment, such as mortgage servicing rights, deferred tax assets from timing differences (a total of more than 15%)and financial institutions is no longer in the common share capital (Kubat, 2014). Taking common stock as capital composition, it can guarantee the quality of assets more effectively. And this can solve the problem of increasing capital adequacy by way of transferring assets from inside balance sheet to off balance sheet, which is common for banks under the framework of BaselIand Basel II.

2.4 Fourthly, Basel III increased capital adequacy requirements

The Basel III improved the capital adequacy ratio, the lowest common shares (that is core one-level capital), increased to 4.5 percent, from 2 percent, and the one-level capital adequacy ratio raised to 6%, from 4%, and the total capital adequacy ratio was unchanged, which is still 8%. Specifically, for the bank's core one-level capital adequacy ratio from 2% must raise to 3.5percent in 2013-01-01, to 4 percent in 2014-01-01, and to 4.5 percent in 2015-01-01. Meanwhile, the one-level capital adequacy ratio requirements (including common shares and other qualified financial instruments) is from 4% to 4.5%, respectively 5.5%, 6% (Rubio & Carrasco-Gallego, 2016). The Basel III continued to pay attention to the micro supervision of capital requirements. Basel III has began to discuss the macro prudential supervision of banks. Basing on the original common stocks, it put forward 2.5 percent new retained buffer earnings and 0-2.5 percent reverse-cyclical buffer capital, which can prevent the economy from pro-cyclical phenomenon effectively.

Table 1 Comparing of capital adequacy ratio between Basel II and Basel III

	Basel III	Basel II
core one-level capital	4.5%	2%
one-level capital	6%	4%
retained buffer earnings	2.5%	Non
reverse-cyclical buffer capital	0-2.5%	Non
total capital	8%	

Source: (Ning,2012); Basel Ⅱ(2004) and Basel Ⅲ(2012).

2.5 Fifthly, in Basel III risk coverage is more comprehensive

The Basel II pays close attention to credit risk, operation risk, as well as market risk, but it ignores the control of risk about liquidity, say liquidity risk. The Basel III pointed to us two major quantitative indexes, liquidity coverage ratio (LCR) and net stable financing ratio (NSFR). The purpose is to reduce the liquidity risk problem. And this is to provides a specific operational method for liquidity risk capital estimation.

2.6 Sixthly, Basel III Emphasizes on macro prudential supervision, and its supervision concept is more scientific

Great changes have taken place in the supervision concept of the Basel III, from merely attending on micro capital supervision to the emphasis on macro prudential supervision, and it has established macro prudential supervision framework. Here, people divide macro prudential supervision into two dimensions, namely, time dimension and cross-sectional dimensions. The time dimension are mainly the leverage ratio, liquidity, reverse-cyclical buffer capital and other regulatory mechanisms, and this is mainly used to prevent pro-cyclical problems cumulated gradually over time (Daniela, 2013). The cross-sectional dimensions mainly include the pressure test and additional bank capital requirements for systemically importance. Cross-section dimension index rose by only concerning on a single bank risk level in the past to concerning on systemic risk of banks, and expanded its attention to greater relevant risk such as hedge funds and other non-bank institutions. The regulatory framework of the Basel III is more perfect and its regulatory concept is more scientific. The new Basel provides a better solution both to the reverse-cyclical problems and to systemic risk problems.

3 Function of Basel III: on mitigating against the risk of global banking crash

Ether Basel I or Basel II or Basel III, they all have important effect to maintain financial stability. One is that Basel increases bank liquidity because the bank's ability to withstand risks depends on the bank's capital adequacy ratio. The other is that Basel can prevent concentration risk, and the Basel II put forward related requirements for the management as well as measurement of supervision concentration risk. Additionally, Basel is conducive to the transparency of information disclosure, and the Basel II raised the issue of information disclosure in market discipline (Dzhagityan, 2016). However, the function of Basel III to mitigate against the risk of global banking crash is especially huge. Because Basel III gave more attention to leverage rate and macro prudential supervision. Meanwhile, the increase in capital supervision requirements can also effectively reduce leverage ratio, thereby preventing the occurrence of financial risks and preventing bank failures.

Leverage ratio can effectively identify the need for official departments to support banks. Lower leverage ratio is precisely the measure now highlighted. Leverage ratio also has the effect of macro prudential regulation, which prevents the excessive accumulation of leverage during the boom, and reduces the deleveraging process in difficult times. In addition, leverage can protect against the unintended consequences of a risk weighting system. When viewed from a specific point of view, many asset may exhibit low risk. However, the accumulation of low risk exposure on the whole system can pose a threat to broader financial stability (Spina, 2013). Before the financial crisis, some seemingly low-risk assets, including highly rated monetary sovereignty, AAA structured products, pledged repurchase agreements and derivative financial instruments, all might accumulate to higher systemic risks. Leverage ratio will help ensure that we cannot ignore the fact and that there is a wider range of capital to cover systemic risks (Spina, 2013). All this tells us that leverage ratio plays a signal role and a controlling role in controlling financial risks. It is the Basel III that raises capital regulatory requirements, thereby reducing leverage ratio. Therefore, the Basel III effectively reduces financial risks, prevents bank failures, and thus prevents the risk of global bank failures.

Additionally, Basel III changes capital composition and adjusts its focus to common shares capital, and this can tell the banks what is important and what should be expanded. Common shares capital as the core one-level capital can make the banks more stable in their operating, and can also prevent the banks to avoid supervision by transferring assets from inside balance sheet to off balance sheet, which can also gradually accumulate systemic risks. Basel III ' s attention to liquidity risk can protect banks away from a main reason to go crashing, even if its capital is adequate, which is obvious but is usually ignored.

Lastly, Basel III can effectively prevent banking crash to spread around nations. Just as I said above, the Basel III can prevent accumulation of systemic risks, both from the importance of leverage rate and macro prudential supervision and from the adjustment of capital composition. So, when a bank occurs banking crash, this is only an individual case, this can not represent the banking system, because there is no problem in systemic risks. Even if the failure is common in one nation, this is only the problem of the nation, because in other nations the systemic risks are small in banks. Their capital is adequate, and their banking system is healthy, there is no mechanism for financial crisis to spread to the other nations.

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