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BASEL II CAPITAL ADEQUACY FRAMEWORK IN THE LIGHT OF THE FINANCIAL CRISIS

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ABSTRACT: *These papers cover the discussion about the relevance of Basel II capital adequacy framework in the aftermath of the global financial crisis. This study covers in detail the affects of the Basel II on the financial institutions, the problems it carries and the suggestions that are needed to make improvements in it. The discussion covers in detail the impact of different factors on the global financial crisis, the reasons about their behavior and the most effect of the global financial crisis on the western banks as well.*

KEYWORDS: **Basel II, Capital, Framework, Financial Crisis**

INTRODUCTION

Basel II contains the recommendations on banking laws and regulations and these are issued by the Basel committee. Basel II was published in June-04. The Basel II has created international standards for the financial institutions. Banking regulators can use these standards at the time of creating regulations which show how much amount of capital a bank will put aside in order to save them from the financial and operational risk that they can face. These types of standards can protect banks from the risk of collapse. The purpose of these rules is that if there is greater risk to the bank then there will also be a greater amount of capital that will provide the banks safeguard in the time of financial risk (Banco de Pagos Internacionales-2006).

Capital Adequacy Framework

Whereas the capital is concern it is the key to any financial institution. In order to access the capital adequacy of financial institution, the Basel II capital Accord builds on the three pillars. One of them was to make the standard for the minimum regulatory capital that are more risk sensitive as compare to that of Basel 1, to make the effective process for the supervisory review and finally use the complete market discipline effectively by the enhanced market disclosure (Rowe, et al. 2004).

The minimum amount of capital is defined for the three different types of risk category. Different has its different effect and this is the one of main reasons to consider all of these risks such as market risk, credit risk and the operational risk. The credit is treated in more sophisticated way then earlier. The market risk was also treated in more sophisticated way and this risk remains unchanged. The new Accord purposes the capital requirement for the operational risk as well. In the situation where there are three risks and these all are very crucial and very important to deal with, the existing definition of the capital and the minimum requirement of 8% of the capital to risk weighted asset will be applied. Due to the nature of risk the main changes relate to the measurement of the underlying risk. According to the old Accord of 1988 the risk weights were assigned in such a way that made the distinction between corporations, banks and sovereigns. Under the new approach the banks has more option now to use one of the three different approaches (Rowe et al., 2004).

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The internal rating base in second and more sophisticated approach for the treatment of the credit risk. In the case of credit risk this presents a very important shift in the thinking of the regulators on the regulatory capital. If we see on the other side it is somehow a logical extension of the earlier precedence allowing the use of internal models for determining market risk capital requirements subject to the supervisory review and approval.

Capital Management and Basel II

The Basel II has presented the better way to control and dead with the risks that can have effect on the business. These risks can never be eliminated but these can be mitigated by the use of good strategies. As there are three different types of risks in the market so the financial institutions need to make the sophisticated analysis techniques to calculate regulatory capital and benchmark against economic capital amount and then perform the credit risk analysis as well. This is a very good way and can manage in well manner. The credit risk analysis is very important issue in the Basel II and by this approach the financial institutions can make the analysis of the risk and the problems that encourage those risks to overcome. This risk can be analyzed in such a way that the necessary information is gathered about the nature of risk and the cause that encourage it to establish in the course of the business of financial institution. This risk can cause of many problems for the financial institutions and can create many bad effects on the business and reputation of the financial institution. The good way and the most possible option in such a type of steps that are taken to manage the risk and these steps are taken very professionally. As the risk management process is very important and crucial to the success of any institution and especially for the financial institution so it is very important to deal with the risk management process very intelligently. This is why the development of the risk management practices is very good and very important for gaining advances for the Basel II (Rowe et al., 2004).

Leading Indicator of Financial Crisis

There are a lot of leading indicators that lead to the financial crisis. Financial crisis that affect the business of the entire world and create a lot of problems for the global economy. These financial crises not only effect the financial institutions but it affects the other businesses as well. The main effect of the financial crisis was on the financial institutions and these financial institutions have to suffer a lot. There were a lot of leading indicators of the global financial crisis that vary from country to country. These leading indicators include the weaker export revenue. As this is very important factor that shows that healthy position of the economy but at the time of global financial crisis it was the main factor which show the indications of the bad condition of the global economy. There was a great fall in the export revenue which affects a lot of businesses. The other main factor was the current account and the balance of payment. In the time of credit crisis this was the type of factor which was affected much in its field. Due to this problem the big disturbance was created in the shape of balance of payment. Due to the problem in the balance of payment the crisis in the economy was encourage to occur and this disturb the economy of the whole world very well. There is another very important factor that contributes in the crisis of global economic and is low investment and the growth rate. Due to the other factors that create the crisis in the global economy the investor become conscious as the other investment were destroyed in the horrible crisis of economy and this was the main reason of decrease in the investment and in turn decrease in the growth rate as well. This is not enough. The other factor was the lost of employment. Not only were the economic factors there some other social factors that become the leading factors of the financial crisis. Such factors include the social factors as well (Murray and Sy, 2009)

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Contributing Factors

The contributing factors are the factors that contribute well in the global economic crisis. In other words we can say that these are the factors which become the cause of the global economic crisis. As the financial institutions were earning much through the loans and due to the increased percentage of the interest they were able it invests a lot in the field of giving loans to the customers. Not very far away but very close to the start of the global financial crisis the financial institutions did a lot by assigning the loan to the customers and at that time it was easy for everyone to get a bank loan and by seeing their increased income the banks decided to invest much in the loan assigning system. This was a very bad strategy adopted by the banks at that time. They made a lot of investments in the whole world and later these loans were called as the bad loans as due to the bad loans the financial institutions were the leading in the way of bearing the loss. They have to bear a lot of loss and they have lost a lot of bad loaned as due to the financial crisis a lot of business were become bank defaulter. This is the one reason due to which they were not able to return loans to the financial institutions and then the financial institutions have to bear a lot of loss. The other factors that contribute well in the global financial crisis were the non-performing assets, market condition and securitization of loans. The non-performing assets played a one of the leading role in the causes of the global financial crisis. The market conditions are also an important contributing factor. At the time of global financial crisis the market conditions were not favorable for the new or the major investments and this was observed that the investments which were made at the time of such bad conditions were almost lost. The major part of the investments in that time was lost and at the same time it was very difficult for the financial institutions to find the reliable security against the loan. At that time the financial institutions were concentrating well on issuing the loans instead of making them secure by getting good securities and they have to bear a lot in the form of global financial crisis (Ely, 2009).

Attitude of Regulators

The attitude of the regulators matter a lot in this issue. The U.S Federal Reserve was restricted and they were not allowed to issue any further loans to the lenders. The main reason behind this issue is that they were in the condition that they issue a lot of loans to their customers at the time of global financial crisis. They have to bear a lot of loss in this matter and this is the main reason that they have to bear such a type of restrictions. They have then no emergency lending power and in this situation they were being audited by the government order. There were a lot of lost investments that Federal Reserve showed as the cause of the big global economic crisis. The bank of England is one of the leading banks in the United Kingdom (U.K.). The big banks were on the front to bear the credit crisis. This is the credit risk that they all have to bear at the time of the horrible global financial crisis.

Managing the Global Financial Crisis

As the global financial crisis is moved in such a bad way that they destroy a lot of business and most of them were the financial institutions. There were a lot of reasons for this and we have discussed a lot of them but there was also the issue to control the global financial crisis and man and manage it in such a way to secure the investment to some extent. The management of the horrible global financial crisis was a big challenge and some of the factors were helpful in that time of time of credit crisis all over the world. There were some of the options in the time of global financial crisis. Some of them were the deposit the insurance, bailouts and bankruptcies. The deposit of insurance is a secure way as in this way the investment is being secured and then the business or the financial institution and then they can easily invest somewhere as they have

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a y'-security of the insurance in this regard. The bailouts and the bankruptcies were also important.They decided to declare such clients as the bankrupt and then they took legal actions against those clients to recover the amount that they have to pay (Cai and Wheale, 2008).

Response of Regulators to Financial Crisis

The regulators play an important role to make the regulations for the financial institutions. At the time of the global financial crisis there were a lot of banks were crashed. The main reason was due to the poor rules and regulations that the financial institutions were following at that time. A lot of rules and regulations were followed by the banks which lead them to the condition of the global financial crisis. In such situations the regulators implement the legislations, rules and laws which have the potential to play a bog positive role in the time of the financial crisis. As the role of regulators was very important in that situation so they suggest some good changes in the current system and adopt some of the regulations that create some improvement in the global crisis conditions.

Problems with Basel II

Global financial crisis disturb the economy of all over the world and the blame was being given at that time to the Basel II. It was said that the Basel II was not able to control the conditions and mislead the system and allow the system to create the big problems for the business (especially financial institutions). In fact this was not good to blame the Basel II as it came into the operation in the year of 2008 and at that time the global financial crisis had created problems all over the world. The Basel II was prepared in accordance to the normal conditions but when it came into the operation then there were the totally different conditions and a lot of problems were found in the Basel II that need to be adjusted. There were some problems in the risk management system of the Basel II and it was not providing such guidance to the regulators of financial institutions that help them to make something better in the situation of global financial crisis and that problems were need to be adjusted in Basel III (Thomas et al., 2005).

Improvement and Suggestion in Basel II

As this has been discussed earlier in this study that there were some problems in the risk management system of the Basel II and in the realization of the capital that was very important in order to support the financial institutions in the time of any big loss. The main function of the capital for the financial institution is to cover the unexpected risk whether they are credit risk, market risk or any type of operational risk. There were some gaps for the credit risk in the Basel II and that problems were identified and suggested to improve. This was very important as due to these improvements the Basel II can create good guidance for the regulators to do well for the financial institutions and in the problem of financial crisis as well.

Western Banks and Global Financial Crisis

The global financial disturb the economy of the whole world but in a survey and according to the clear conditions it was found that the western banks were more involved in the global financial crisis and they have to bear more loss than others. Almost 80 banks in the America were closed due to this financial crisis and this is a big loss in this sector. There are a lot of reasons behind this but the main reasons are that they were much involve in the risky investments and they made a lot of such investments that were too much risky and create problems for them in the future. As The Royal Bank of Scotland (RBS) which is one of the largest bank made invest in ABN Amro and they face a lot of loss due to this investment. The main reasons are the insecure investments, large interest rates and unnecessary investments that

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become unrecoverable in the later period and involve the western banks in big problem. This is why they try to invest in the Islamic banking as they feel it very secure.

CONCLUSION

There are a lot of factors that become the cause of global financial crisis and it is concluded that the Basel II is not responsible for the global economic crisis. It just came into the operation in the year 2008 and has some problems in it that were not covering all the issues of the global economics crisis. This is the main reason due to which it had some problems and the suggestions were recommended for the further improvements in it according to the present situation of the market.

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