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**THE NEW BACKBONE OF
BANKING: BASEL III
SYSTEM EVOLUTION**



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SUMMARY

This article analyzes the impact of Basel 3 standards on the banking system's development post-2008 financial crisis. Focusing on global implications and Azerbaijan's specific context, it discusses Basel 3's role in bolstering banking resilience through enhanced capital requirements, liquidity management, and risk mitigation strategies. Despite benefits like improved stability and confidence in the financial system, the article critiques Basel 3 for potentially overburdening smaller banks and incurring economic costs. It also outlines adoption challenges in Azerbaijan, such as regulatory complexities and resource constraints. The conclusion recommends tailored implementation strategies in Azerbaijan to reconcile global standards with local economic needs, ensuring banking sector strength and overall economic growth.

Keywords: Economic impact, financial stability, global banking supervision, regulatory challenges

JEL code: E50; E59

INTRODUCTION

The global financial crisis of 2008 revealed significant weaknesses in the banking sector's regulatory framework, prompting the need for more robust measures to ensure financial stability. In response to these vulnerabilities, the Basel Committee on Banking Supervision introduced Basel 3, a comprehensive set of international banking standards aimed at enhancing the resilience and stability of the global banking system. This article examines the tangible significance of Basel 3 standards in the progression of the banking system, highlighting their pivotal role in ensuring the security of financial institutions and the broader economy. Basel 3, formally known as "Basel 3: A global regulatory framework for more resilient banks and banking systems," represents a significant evolution of the Basel II framework. Basel 3 was developed in the aftermath of the 2008 financial crisis and consists of a set of guidelines, principles, and regulations designed to address the shortcomings of its predecessor and strengthen the global banking system. (BCBS, 2010).

METHODOLOGY

We conducted an extensive review of existing literature on Basel 3 standards, their historical background, key components, practical importance, criticisms, and challenges in adoption to understand the subject and identify knowledge gaps. Furthermore, we collected information from primary sources, which included official records, reports, and publications issued by regulatory bodies. We also referenced secondary sources, such as academic journals and well-respected news sources, with a particular emphasis on exploring the global and Azerbaijan-specific ramifications of Basel 3. The historical development of the Basel Committee on Banking Supervision, its transformation into a global regulatory authority, and the evolution of Basel standards from Basel I to Basel 3 to provide context was examined. Challenges specific to Basel 3 adoption in Azerbaijan, covering regulatory complexities, liquidity standards, macroprudential elements, credit information scarcity, and resource constraints has been examined. Key discoveries and suggestions are presented, with a focus on the need for a balanced adoption of these findings in Azerbaijan and the preservation of region-specific regulatory attributes to bolster vital economic sectors. This methodology ensures a comprehensive exploration of Basel

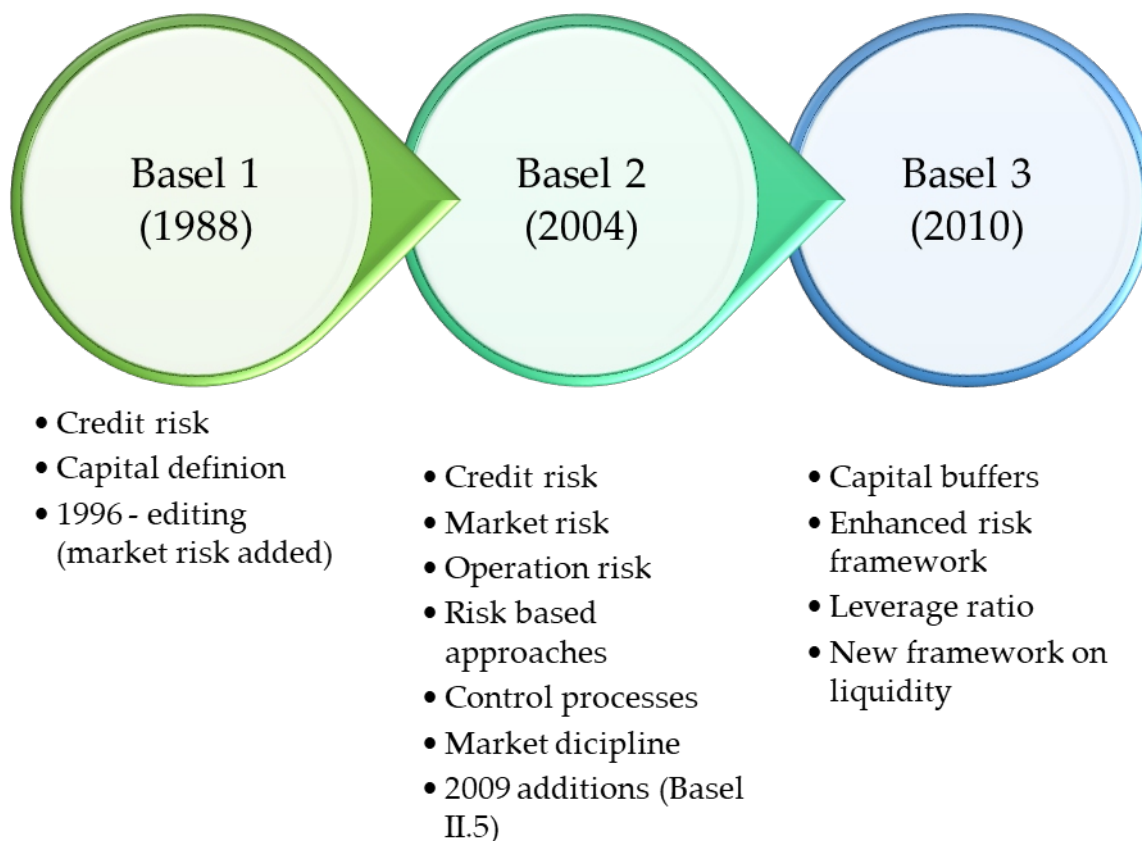
3's practical importance, considering historical context, key components, criticisms, economic implications, and specific adoption challenges in Azerbaijan, with practical recommendations for policymakers and regulators.

HISTORICAL BACKGROUND

The Basel Committee on Banking Supervision, commonly known as the Basel Committee, represents a pivotal international body in the realm of global banking regulation and supervision. Its inception can be traced back to the late 1970s, when the international financial landscape was marred by continuous crises, including the Bankhaus Herstatt incident in West Germany. These financial crises highlighted the urgent requirement for an all-encompassing and synchronized strategy regarding financial regulation and risk control. In response, the Basel Committee was founded in late 1974, with participation from the central banks of ten nations. It was created as a response to the challenges posed by the dismantling of the Bretton Woods system, which had been in place from 1944 to 1973. As the Bretton Woods system disintegrated, international financial markets became increasingly turbulent, necessitating the development of new structures to promote stability and resilience in the global banking sector. The committee held its first official gathering in February 1975, signaling the commencement of a series of meetings that persist to the present day. These gatherings take place at regular intervals, usually three to four times annually, and provide a forum for member nations to participate in sustained collaboration and discussion regarding banking oversight and financial regulation matters. The committee, initially known as the "Group of Ten" (G10), has evolved significantly over the years. In response to changing global dynamics and the increasing importance of international cooperation, it expanded its membership in both 2009 and 2014. Today, the Basel Committee comprises 45 institutions representing 28 countries.

The headquarters of the Basel Committee are located in Basel, Switzerland, housed within the Bank for International Settlements (BIS). This choice of location underscores the committee's international character and its commitment to fostering collaboration among central banks and regulatory authorities from various nations. A key goal of the Basel Committee is to strengthen worldwide financial stability. It strives to realize this aim by advocating for the implementation of top-tier banking supervision methods and resilient financial regulations. The committee serves as a vital forum for member countries to engage in regular cooperation and share best practices related to banking supervision. The membership of the Basel Committee consists of central banks and regulatory authorities responsible for overseeing banking activities within their respective jurisdictions. In addition to these members, the committee includes observer members from various institutions, such as central banks, regulatory authorities, international organizations, and other entities. This diverse composition ensures that a wide range of perspectives and expertise is brought to bear on the committee's activities. One of the most notable contributions of the Basel Committee to the world of finance has been the development of international standards for capital adequacy, collectively known as Basel I, Basel II, and Basel 3. Many nations and regions have embraced these standards, resulting in increased alignment of global banking regulations. They have also played a crucial role in improving the resilience of the global banking system and reducing the risk of financial crises. (BIS, 2013).

Graph 1. Evolution of the Basel standards



Source: Prepared by the author

KEY COMPONENTS OF BASEL 3 STANDARDS

Basel 3 brought in more rigorous capital requirements to guarantee that banks uphold a higher level of core capital, providing a greater capacity to absorb losses when facing economic challenges. The Tier 1 capital requirement was increased, and new capital buffers, such as the Capital Conservation Buffer and the Countercyclical Buffer, were introduced. Basel 3 focuses on improving liquidity risk management within banks. It introduced the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) to ensure that banks have sufficient high-quality liquid assets and stable funding to meet their obligations, even in times of market stress. Basel 3 introduced a leverage ratio to limit excessive borrowing and maintain a more conservative level of capital relative to a bank's total exposure. This functions as a protective barrier against excessive borrowing and plays a role in preventing financial institutions from reaching a size where their failure would have catastrophic consequences. The standards include measures to address counterparty credit risk, such as the introduction of the Credit Valuation Adjustment (CVA) risk capital charge, to account for potential losses from counterparty defaults. Basel 3 refined the market risk framework, incorporating more comprehensive risk measures and requiring banks to hold capital commensurate with their market risk exposure. (FSB, 2014)

PRACTICAL IMPORTANCE OF BASEL 3 STANDARDS

Basel 3 standards significantly contribute to the stability of the banking system by requiring banks to maintain higher capital buffers. This diminishes the chances of insolvency occurring during economic downturns and averts the chain reaction that can arise from the collapse of a major institution. The focus on liquidity risk management and capital adequacy encourages banks to adopt more prudent risk management practices. This guarantees that banks are more adequately prepared to withstand financial crises and lessens the dependency on government bailouts. Basel 3 standards have instilled greater confidence in the global banking system among

investors, depositors, and the public. The increased transparency and accountability promote trust in financial institutions.

Basel 3 standards create a level playing field for banks across the world by establishing uniform regulatory requirements. This prevents the manipulation of regulations to gain competitive advantages through lower regulatory standards. Basel 3's focus on reducing leverage and limiting interconnectedness helps mitigate systemic risk, making it less likely that the failure of one institution will trigger a widespread financial crisis. (De Pooter, M., Martin, R., & Pruitt, S., 2015)

CRITISISMS TO THE BASEL STANDARDS

The Basel standards primarily target large international banks and may not fully consider the circumstances of individual credit institutions. A study by Copenhagen Economics (CE) suggests that the finalized Basel 3 framework might bring more costs than benefits to the European economy. Despite European banks having substantial capitalization since the 2008 crisis, additional capital requirements are unlikely to significantly boost financial stability, according to research, including the International Monetary Fund (IMF). Before the onset of the COVID-19 pandemic, the European Banking Authority (EBA) estimated a capital deficit in Europe to be around EUR 124.8 billion, although it is expected that the actual capital levels will substantially exceed this projection. However, an increased reliance on relatively expensive equity capital will drive up borrowing costs for households and businesses, potentially causing a persistent reduction in GDP and job losses, especially for households and SMEs that lack access to alternative sources of funding. Considering these factors, CE suggests that the European Commission should reassess the implications of the reform package, not only focusing on short-term effects, through a new impact assessment, and perhaps consider postponing its implementation. Additionally, close monitoring of temporary measures adopted in other regions is essential to prevent competitive disadvantages. (EU, 2021)

ECONOMIC COSTS AND BENEFITS OF THE BASEL 3 FINALIZATION IN THE EU PRACTICE

The implementation of the Basel 3 finalization involves moderate short-term economic costs but promises substantial long-term benefits. In times of economic stability, it leads to a short-term reduction of 0.1% in GDP growth for a few years, after which these costs gradually fade. Completing the Basel 3 reforms plays a pivotal role in strengthening the overall health of banks. Despite the initial decrease in the Common Equity Tier 1 (CET1) capital ratio due to increasing risk-weighted exposures, this phase stimulates banks to bolster their capital reserves over time. As a result, by 2030, CET1 capital sees a remarkable 11% increase, reinforcing the solvency of the banking system and contributing to lower funding costs.

The introduction of EU-specific adjustments may serve to curtail short-term costs, but it's important to note that these changes can also dilute the long-term benefits by as much as 40%. Particularly noteworthy is the advantage extended to banks that rely on the internal ratings-based (IRB) approach for calculating risk-weighted assets. Finalizing Basel 3 ensures that IRB banks, in particular, undergo a more substantial improvement in their solvency, making them more resilient in the event of economic shocks. When considering modifications to the implementation of the output floor alongside EU-specific adjustments, it becomes apparent that these alterations do not lead to further reductions in short-term costs. However, they do have the effect of diminishing the long-term benefits.

When appraising these estimates, it's crucial to note that the fundamental assumptions are prudent or erring on the side of caution. For instance, the model operates on the premise that banks won't anticipate the phase-in of Basel 3 changes, though, in reality, they have ample time to prepare and adjust before the new rules take effect. Moreover, the examination is restricted to the most prominent banks in the euro area, and this specific focus may potentially overemphasize the overall cost estimates. Furthermore, the assumptions include the notion that banks will not

raise capital through equity markets or new share issuances, which could potentially underestimate the resilience of banks in adapting to Basel 3 requirements. (Budnik, K., Dimitrov, I., Groß, J., Lampe, M., & Volk, M., 2021).

BASEL 3 ADOPTION CHALLENGES

First and foremost, it is essential to note that the 2022-2026 Social-Economic Development Strategy envisages aligning the regulatory framework of all segments of the financial sector with international standards for financial stability. In this context, for the banking sector, the goal is set to achieve a positive dynamic annually in the share of 'compliant' ratings under the Basel principles until 2026, with the aim of exceeding 80 percent. (President.az, 2022)

At present, the Azerbaijani banking system ensures the consideration of the counter-cyclical capital buffer based on the Basel III standards. According to the 'Rules for Calculating Bank Capital and its Adequacy,' the Central Bank of Azerbaijan can apply a counter-cyclical capital buffer ranging from 0 to 2.5% on top of the Tier 1 capital and total capital adequacy ratios, in accordance with the economic cycle and the dynamics of the credit portfolio. The counter-cyclical capital buffer, as a macro-prudential tool, aims to prevent systemic risks resulting from excess credit growth in the banking sector and reduce sensitivity to cyclical processes. Credit-to-GDP gap is accepted as the main indicator for calculating the counter-cyclical capital buffer. When the credit-to-GDP gap varies between 2-10%, the counter-cyclical capital buffer is determined in the range of 0-2.5% correspondingly. Currently, the credit-to-GDP gap stands at 1.1%. (Mərkəzi Bank, 2023)

In addition to concerns about the effectiveness of Basel 3 in regulating major international banks, mega regulator in Azerbaijan may face specific obstacles when it comes to implementing these global standards. Basel 3 introduces an added layer of complexity and compliance costs, exacerbating the already challenging task of implementing Basel II. While Basel I consisted of a concise thirty pages, the full Basel 3 standards document sprawls over 1800 pages. Some components of Basel 3, such as the new capital definitions, capital conservation buffer, simple leverage ratio, and standards for domestic systemically important banks, are relatively straightforward to put into practice. However, other aspects, notably the macro prudential elements, introduce more intricate challenges. The incorporation of macro prudential standards is generally positively received by regulators in Azerbaijan. Nevertheless, these standards require adjustments to reflect the primary sources of systemic risk often found in the country, including external macroeconomic shocks like fluctuations in commodity prices, capital flows, and interconnections among banks.

Basel 3's liquidity standards are more intricate and are based on assumptions that may not hold in a country with less mature financial markets and banking systems like developing countries. As a consequence, revisions are essential to harmonize these standards with the unique local conditions. One significant impediment to the successful implementation of Basel 3 is the scarcity of comprehensive credit information. This information is vital for assessing the systemic importance of financial institutions and determining which banks should be subject to additional capital buffers, as per the D-SIB standard. Regulators in Azerbaijan have an authority and resources to effectively execute the macroprudential elements. (E-qanun.az, 2019) However, conducting macroprudential surveillance may face numerous practical challenges, including data collection and model specification for stress testing.

Moreover, it should be noted that Basel 3 may create incentives for banks to divert credit away from sectors crucial for inclusive economic development in the country. The implementation of these complex standards can also divert regulatory resources from other critical tasks, potentially leaving potential weaknesses in the regulatory system unaddressed. In summary, while Basel 3 aims to enhance financial stability and risk management, it introduces complexity and compliance challenges, particularly for regulators in Azerbaijan. It's vital to take into account the practical consequences and resource limitations during the adoption of these global standards, as complexity doesn't necessarily translate to a more resilient financial regulatory system, particularly in resource-constrained contexts.

CONCLUSION

In summary, the Basel Committee on Banking Supervision has a rich history rooted in the need for global coordination in banking regulation. The transformation from a limited association of central banks to a diverse and all-encompassing international institution underscores its enduring commitment to bolstering financial stability and advancing effective global banking supervision. Through its standards and cooperative endeavors, the committee remains instrumental in shaping the international financial landscape, with the goal of ensuring a more stable and secure global banking system. Basel 3 standards have had a profound practical impact on the development of the banking system, promoting financial stability, enhancing risk management, and increasing confidence in the global banking sector. These standards exemplify a united effort to prevent a reoccurrence of the 2008 financial crisis through the imposition of stricter regulatory requirements on banks. Despite presenting initial challenges for financial institutions, their enduring benefits in terms of a more resilient and stable banking system cannot be overstressed. Basel 3 has become a cornerstone in shaping the future of banking worldwide, ensuring that the industry remains robust and able to weather economic storms. However, Basel 3 is not without challenges and criticisms. It primarily targets large international banks, potentially overlooking the unique circumstances of smaller institutions. The economic costs and benefits of Basel 3 implementation, especially in the European Union, raise concerns about their impact on economic growth and lending costs. In the context of Azerbaijan, specific challenges, like regulatory intricacies and resource limitations, require thorough consideration. Therefore, as a results of analysis it is recommended taking into consideration certain considerations when applying Basel standards:

- Implement Basel 3 in the Azerbaijan with proportionate regulation, considering factors like bank size, business model, risk profile, and interconnectedness;
- Maintain regulatory elements specific to Azerbaijan that cater to sectors such as SMEs and infrastructure, as they are customized to meet the country's economic needs and strategies.
- Regulator should continually assess the impact of Basel 3 standards on the banking sector, making adjustments as necessary to balance financial stability with economic growth;
- Revisions are essential to harmonize these standards with the unique local conditions of the country;
- Collaboration among regulatory authorities in different countries can help harmonize implementation efforts and reduce regulatory arbitrage;
- Additionally, close monitoring of temporary measures accepted in other countries is critical to prevent competitive disadvantages;
- To address criticisms, regulator should enhance risk assessment capabilities, especially regarding smaller financial institutions, to ensure effective supervision and risk management.

By taking these recommendations into account, regulator can effectively address the challenges posed by Basel 3, all the while ensuring the strength and stability of the banking sector, contributing to the broader economic prosperity in Azerbaijan.

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BANKÇILIĞIN YENİ FUNDAMENTAL ƏSASI: BAZEL III SİSTEMLİ TƏKAMÜLÜ

Ayaz MÜSEYİBOV

XÜLASƏ

Bu məqalə 2008-ci il qlobal maliyyə böhranından sonra bank sisteminin inkişafına Bazel 3 standartlarının ümumi təsirini təhlil edir. Məqalədə bank sisteminin dayanıqlığını artırmaq üçün Bazel 3-ün əhəmiyyəti, artan kapital tələbləri, likvidlik idarəetməsi və riskin azaldılması strategiyaları vasitəsilə qlobal təsirlərə və xüsusi olaraq Azərbaycan kontekstinə xüsusi diqqət yetirilərək, müzakirə olunur. Maliyyə sisteminin sabitliyini və sektora inamı artırmaq kimi faydalarına baxmayaraq, məqalədə Bazel 3-ün kiçik banklara potensial olaraq aşırı tənzimləyici yük təşkil etməsi və iqtisadi xərclərə səbəb olma potensialı tənqid edilir. Həmçinin, Azərbaycanda müvafiq standartların qəbul edilmə çətinlikləri, məsələn, tənzimləmə sistemi mürəkkəblikləri və resurs məhdudiyətləri qeyd edilir. Nəticədə məqalədə Azərbaycanda qlobal standartlar əsasında və yerli iqtisadi ehtiyacların uzlaşdırılmış formada fərdiləşdirilmiş tətbiq strategiyaları tövsiyə edilir ki, bu da bank sektorunun gücünü və ümumi iqtisadi inkişafı təmin edə bilər.

Açar sözlər: iqtisadi təsir, maliyyə sabitliyi, qlobal bank nəzarəti, tənzimləyici problemlər

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