e-Resources Module-VII

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BASEL-II AND THE EMERGENCE OF GLOBAL FINANCIAL CRISIS

The North Atlantic Financial Crisis of 2008 brought to fore the weaknesses of existing international framework for bank capital regulation and highlighted the critical need for a safe, strong, stable and sound banking system at the global level. For, in the present-day globalised world, emanating from the disorders of banking sector such crises spread very fast across the globe due to the underlying integration of financial markets. The net outcome is that in order to restore normalcy in the economy, a bail out package is called for which in turn imposes an unnecessary financial burden on taxpayers that is undesirable on any count. Thus, all attempts shall be made to plug the loopholes in the banking sector in time so that a financial crisis of this order does not even erupt in the first place. In this context, it is worth noting that though at the international level, the Basel Committee on Banking Supervision had already come up with Basel-II norms prior to the emergence of U.S. Sub-prime lending crisis, yet being essentially "work in progress" it largely failed to prevent the financial crisis of this magnitude. Some critics even went to the extent of blaming the risk sensitive capital regulation of Basel-II itself to be responsible for causing the global financial crisis. On closer examination, however, we find that the drawbacks of Basel-II framework for bank capital regulation could be a contributory factor in aggravating the global financial crisis, but it would be an over-exaggeration to hold Basel-II exclusively responsible for the emergence of the crisis itself.

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Starting with the collapsing of Lehman Brothers in September 2008, the world economy witnessed one of the biggest financial crises of modern times called the North Atlantic Financial Crisis or what is popularly known as the U.S. Sub-prime Lending Crisis. Whenever such crises occur, they call for a bail-out package for restoring normalcy in the economy, but the financial burden of such a bail out invariably falls upon the taxpayers which is undesirable on any count. In view of this, it becomes imperative to avert and prevent the occurrence of such crises in the first place.

As banking was at the root of this global crisis, it raised the basic question that were not any norms on banking supervision put in place that could prevent the occurrence of a financial crisis of such an enormous magnitude. In this context, it is worth noting that even at that time, there existed the Basel Framework at the global level that formulated guidelines on bank capital regulation. In fact, the Basel Committee on Banking Supervision at the international level had already come with Basel-I and Basel-II norms prior to the global financial crisis.

More specifically, as opposed to the "one-size-fits-all" approach adopted by Basel-I, the Basel-II Committee had introduced *risk sensitive capital regulation* for global banks in 2006 itself. Thus, when the U.S. Sub-prime lending crisis erupted, Basel-II was essentially "work in progress" and could therefore have largely failed to prevent the financial crisis of this order.

Some critics are, however, of the view that the risk sensitivity of Basel-II was itself responsible for the occurrence of North Atlantic Financial Crisis. To be specific, the main allegation levelled against Basel-II is that it did not impose additional capital requirements on banks in good times when they could have easily met them, but under stressed times, the Basel-II required banks to bring in more of capital when markets were not forthcoming to supply that capital. Consequently, the risk sensitivity embedded in Basel-II *de facto* became "pro-cyclical" thereby making banks fall into trouble that eventually landed the world economy into a crisis of high order.

The critics have even gone to the extent of claiming that the Basel-II norms demanded less capital against assets that could be easily sold and in whom positions could be readily unwound, which in turn encouraged banks to invest in complex derivative instruments and toxic products that eventually became the 'epicentre' of the global financial crisis.

Still another shortcoming of Basel-II, as pointed out by critics is that it essentially focussed on financial institutions at the individual level and thus, did not take into account the "systemic risk" that arises out of the interconnectedness among financial institutions and is instrumental in spreading fast the crisis like a contagion across financial markets. Likewise, the Basel-II was also blamed for not addressing the crucial issues of "leverage" and "liquidity risk".

On closer examination, we find that all these criticisms notwithstanding, the drawbacks of Basel-II framework for bank capital regulation could be a contributory factor in aggravating the global financial crisis, but it would be an over-exaggeration to hold Basel-II exclusively responsible for the emergence of the crisis itself.