Basel Committee on Banking Supervision

A brief history of the Basel Committee

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The Basel Committee on Banking Supervision has its origins in the financial market turmoil that followed the breakdown of the Bretton Woods system of managed exchange rates in 1973. After the collapse of Bretton Woods, many banks incurred large foreign currency losses. On 26 June 1974, West Germany's Federal Banking Supervisory Office withdrew Bankhaus Herstatt's banking licence after finding that the bank's foreign exchange exposures amounted to three times its capital. Banks outside Germany took heavy losses on their unsettled trades with Herstatt, adding an international dimension to the turmoil. In October the same year, the Franklin National Bank of New York also closed its doors after incurring large foreign exchange losses.

In response to these and other disruptions in the international financial markets, the central bank governors of the G10 countries established a Committee on Banking Regulations and Supervisory Practices at the end of 1974. Later renamed the Basel Committee on Banking Supervision, the Committee was designed as a forum for regular cooperation between its member countries on banking supervisory matters. Its aim was and is to enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide.

The Committee seeks to achieve its aims by setting minimum standards for the regulation and supervision of banks; by sharing supervisory issues, approaches and techniques to promote common understanding and to improve cross-border cooperation; and by exchanging information on developments in the banking sector and financial markets to help identify current or emerging risks for the global financial system. Also, to engage with the challenges presented by diversified financial conglomerates, the Committee also works with other standard-setting bodies (see Annex C).

Since the first meeting in February 1975, meetings have been held regularly three or four times a year. After starting life as a G10 body, the Committee expanded its membership in 2009 and again in 2014 and now includes 28 jurisdictions (see Annex A). The Committee now also reports to an oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), which comprises central bank governors and (non-central bank) heads of supervision from member countries.

Countries are represented on the Committee by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The present Chairman of the Committee is Stefan Ingves, Governor of Sveriges Riksbank, Sweden's central bank. (See Annex B for a list of past Basel Committee chairmen.)

The Committee's decisions have no legal force. Rather, the Committee formulates supervisory standards and guidelines and recommends sound practices in the expectation that individual national authorities will implement them. The Committee encourages full, timely and consistent implementation of its standards by members and, in 2012, began monitoring implementation to improve the resilience of the global banking system, promote public confidence in prudential ratios and encourage a regulatory level playing field for internationally active banks.

International cooperation between banking supervisors

At the outset, one important aim of the Committee's work was to close gaps in international supervisory coverage so that (i) no foreign banking establishment would escape supervision; and (ii) supervision would be adequate and consistent across member jurisdictions. A first step in this direction was the paper issued in 1975 that came to be known as the "Concordat". The Concordat set out principles for sharing supervisory responsibility for banks' foreign branches, subsidiaries and joint ventures between host and parent (or home) supervisory authorities. In May 1983, the Concordat was revised and re-issued as *Principles for the supervision of banks' foreign establishments*.

In April 1990, a supplement to the 1983 Concordat was issued. This supplement, *Exchanges of information between supervisors of participants in the financial markets*, aimed to improve the cross-border flow of prudential information between banking supervisors. In July 1992, certain principles of the Concordat were reformulated and published as the *Minimum standards for the supervision of international banking groups and their cross-border establishments*. These standards were communicated to other banking supervisory authorities, who were invited to endorse them.

In October 1996, the Committee released a report on *The supervision of cross-border banking*, drawn up by a joint working group that included supervisors from non-G10 jurisdictions and offshore centres. The document presented proposals for overcoming the impediments to effective consolidated supervision of the cross-border operations of international banks. Subsequently endorsed by supervisors from 140 countries, the report helped to forge relationships between supervisors in home and host countries.

The involvement of non-G10 supervisors also played a vital part in the formulation of the Committee's *Core principles for effective banking supervision* in the following year. The impetus for this document came from a 1996 report by the G7 finance ministers that called for effective supervision in all important financial marketplaces, including those of emerging economies. When first published in September 1997, the paper set out 25 basic principles that the Basel Committee believed should be in place for a supervisory system to be effective. After several revisions, most recently in September 2012, the document now embraces 29 principles, covering supervisory powers, the need for early intervention and timely supervisory actions, supervisory expectations of banks, and compliance with supervisory standards.

Basel I: the Basel Capital Accord

With the foundations for supervision of internationally active banks laid, capital adequacy soon became the main focus of the Committee's activities. In the early 1980s, the onset of the Latin American debt crisis heightened the Committee's concerns that the capital ratios of the main international banks were deteriorating at a time of growing international risks. Backed by the G10 Governors, Committee members resolved to halt the erosion of capital standards in their banking systems and to work towards greater convergence in the measurement of capital adequacy. This resulted in a broad consensus on a weighted approach to the measurement of risk, both on and off banks' balance sheets.

There was strong recognition within the Committee of the overriding need for a multinational accord to strengthen the stability of the international banking system and to remove a source of competitive inequality arising from differences in national capital requirements. Following comments on a consultative paper published in December 1987, a capital measurement system commonly referred to as the *Basel Capital Accord* (1988 Accord) was approved by the G10 Governors and released to banks in July 1988.

The 1988 Accord called for a minimum capital ratio of capital to risk-weighted assets of 8% to be implemented by the end of 1992. Ultimately, this framework was introduced not only in member countries but also in virtually all other countries with active international banks. In September 1993, the Committee issued a statement confirming that G10 countries' banks with material international banking business were meeting the minimum requirements set out in the Accord.

The Accord was always intended to evolve over time. It was amended first in November 1991. The 1991 amendment gave greater precision to the definition of general provisions or general loan-loss reserves that could be included in the capital adequacy calculation. In April 1995, the Committee issued an amendment, to take effect at end-1995, to recognise the effects of bilateral netting of banks' credit exposures in derivative products and to expand the matrix of add-on factors. In April 1996, another document was issued explaining how Committee members intended to recognise the effects of multilateral netting.

The Committee also refined the framework to address risks other than credit risk, which was the focus of the 1988 Accord. In January 1996, following two consultative processes, the Committee issued the so-called *Market Risk Amendment to the Capital Accord (*or Market Risk Amendment*)*, to take effect at the end of 1997. This was designed to incorporate within the Accord a capital requirement for the market risks arising from banks' exposures to foreign exchange, traded debt securities, equities, commodities and options. An important aspect of the Market Risk Amendment was that banks were, for the first time, allowed to use internal models (value-at-risk models) as a basis for measuring their market risk capital requirements, subject to strict quantitative and qualitative standards. Much of the preparatory work for the market risk package was undertaken jointly with securities regulators.

Basel II: the new capital framework

In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord. This led to the release of the *Revised Capital Framework* in June 2004. Generally known as "Basel II", the revised framework comprised three pillars, namely:

I. minimum capital requirements, which sought to develop and expand the standardised rules set out in the 1988 Accord;

II. supervisory review of an institution's capital adequacy and internal assessment process; and

III. effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices.

The new framework was designed to improve the way regulatory capital requirements reflect underlying risks and to better address the financial innovation that had occurred in recent years. The changes aimed at rewarding and encouraging continued improvements in risk measurement and control.

The framework's publication in June 2004 followed almost six years of intensive preparation. During this period, the Basel Committee consulted extensively with banking sector representatives, supervisory agencies, central banks and outside observers in an attempt to develop significantly more risk-sensitive capital requirements.

Following the June 2004 release, which focused primarily on the banking book, the Committee turned its attention to the trading book. In close cooperation with the International Organization of Securities Commissions (IOSCO), the international body of securities regulators, the Committee published in July 2005 a consensus document governing the treatment of banks' trading books under the new framework. For ease of reference, this new text was integrated with the June 2004 text in a comprehensive document released in June 2006: *Basel II: International convergence of capital measurement and capital standards: a revised framework - comprehensive version.*

Committee member countries and several non-member countries agreed to adopt the new rules, albeit on varying timescales. Thereafter, consistent implementation of the new framework across borders became a more challenging task for the Committee. One challenge that supervisors worldwide faced under Basel II was the need to approve the use of certain approaches to risk measurement in multiple jurisdictions. While this is not a new concept for the supervisory community – the Market Risk Amendment of 1996 involved a similar requirement – Basel II extended the scope of such approvals and demanded an even greater degree of cooperation between home and host supervisors. To help address this issue, the Committee issued guidance on information-sharing in 2006. In the following year, it followed up with advice on supervisory cooperation and allocation mechanisms in the context of the advanced measurement approaches for operational risk.

Towards Basel III

Even before Lehman Brothers collapsed in September 2008, the need for a fundamental strengthening of the Basel II framework had become apparent. The banking sector had entered the financial crisis with too much leverage and inadequate liquidity buffers. These defects were accompanied by poor governance and risk management, as well as inappropriate incentive structures. The dangerous combination of these factors was demonstrated by the mispricing of credit and liquidity risk, and excess credit growth.

Responding to these risk factors, the Basel Committee issued *Principles for sound liquidity risk management and supervision* in the same month that Lehman Brothers failed. In July 2009, the Committee issued a further package of documents to strengthen the Basel II capital framework, notably with regard to the treatment of certain complex securitisation positions, off-balance sheet vehicles and trading book exposures. These enhancements were part of a broader effort to strengthen the regulation and supervision of internationally active banks, in the light of weaknesses revealed by the financial market crisis.

In September 2010, the Group of Governors and Heads of Supervision announced higher global minimum capital standards for commercial banks. This followed an agreement reached in July regarding the overall design of the capital and liquidity reform package, now referred to as "Basel III". In November 2010, the new capital and liquidity standards were endorsed at the G20 Leaders Summit in Seoul and subsequently agreed at the December 2010 Basel Committee meeting.

The proposed standards were issued by the Committee in mid-December 2010 (and have been subsequently revised). The December 2010 versions were set out in *Basel III: International framework for liquidity risk measurement, standards and monitoring* and *Basel III: A global regulatory framework for more resilient banks and banking systems.* The enhanced Basel framework revised and strengthen the three pillars established by Basel II. It also extended the framework with several innovations, namely:

- an additional layer of common equity – the capital conservation buffer – that, when breached, restricts payouts of earnings to help protect the minimum common equity requirement;
- a countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts;
- a leverage ratio – a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting (defined as the "capital measure" (the numerator) divided by the "exposure measure" (the denominator) expressed as a percentage);
- liquidity requirements - a minimum liquidity ratio, the liquidity coverage ratio (LCR), intended to provide enough cash to cover funding needs over a 30-day period of stress; and a longer-term ratio, the net stable funding ratio (NSFR), intended to address maturity mismatches over the entire balance sheet; and
- additional proposals for systemically important banks, including requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

In January 2012, the GHOS endorsed a comprehensive process proposed by the Committee to monitor members' implementation of Basel III. The *Regulatory Consistency Assessment Programme* (RCAP) consists of two distinct but complementary work streams to *monitor* the timely adoption of Basel

III standards, and to *assess* the consistency and completeness of the adopted standards including the significance of any deviations in the regulatory framework.

The Basel Committee has worked in close collaboration with the Financial Stability Board (FSB) given the FSB's role in coordinating the monitoring of implementation of regulatory reforms. The Committee designed its programme to be consistent with the FSB's *Coordination framework for monitoring the implementation of financial reforms* (CFIM) as agreed by the G20.

These tightened definitions of capital, significantly higher minimum ratios and the introduction of a macroprudential overlay represent a fundamental overhaul for banking regulation. At the same time, the Basel Committee, its governing body and the G20 Leaders have emphasised that the reforms will be introduced in a way that does not impede the recovery of the real economy.

In addition, time is needed to translate the new internationally agreed standards into national legislation. To reflect these concerns, a set of transitional arrangements for the new standards was announced in September 2010, although national authorities are free to impose higher standards and shorten transition periods where appropriate.

The strengthened definition of capital will be phased in over five years: the requirements were introduced in 2013 and should be fully implemented by the end of 2017. Capital instruments that no longer qualify as common equity Tier 1 capital or Tier 2 capital will be phased out over a 10-year period beginning 1 January 2013.

Turning to the minimum capital requirements, the higher minimums for common equity and Tier 1 capital were phased in from 2013, and will become effective at the beginning of 2015. The schedule is as follows:

- The minimum common equity and Tier 1 requirements increased from 2% and 4% to 3.5% and 4.5%, respectively, at the beginning of 2013.
- The minimum common equity and Tier 1 requirements rose to 4% and 5.5%, respectively, at the beginning of 2014.
- The final requirements for common equity and Tier 1 capital will be 4.5% and 6%, respectively, beginning in 2015.

The 2.5% capital conservation buffer, which will comprise common equity and is in addition to the 4.5% minimum requirement, will be phased in progressively starting on 1 January 2016, and will become fully effective by 1 January 2019.

The leverage ratio will also be phased in gradually. The test (the so-called "parallel run period") began in 2013 and will run until 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on review and appropriate calibration. The exposure measure of the leverage ratio was finalised in January 2014.

The liquidity coverage ratio (LCR) will be phased in from 1 January 2015 and will require banks to hold a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short-term stress scenario as specified by supervisors. To ensure that banks can implement the LCR without disruption to their financing activities, the minimum LCR requirement will begin at 60% in 2015, rising in equal annual steps of 10 percentage points to reach 100% on 1 January 2019.

The other minimum liquidity standard introduced by Basel III is the net stable funding ratio. This requirement, which takes effect as a minimum standard by 1 January 2018, will promote longer term funding mismatches and provide incentives for banks to use stable funding sources.

Further reading on the history of the Basel Committee

Basel Committee on Banking Supervision (2013): *Basel Committee on Banking Supervision (BCBS) Charter*.

Goodhart, C (2011): *The Basel Committee on Banking Supervision: A history of the early years 1974–1997*, Cambridge University Press.

Toniolo, G (2005): *Central bank cooperation at the Bank for International Settlements 1930–1973*, Cambridge University Press.

Annex A

Institutions represented on the Basel Committee on Banking Supervision

Members

Argentina:	Central Bank of Argentina
Australia:	Reserve Bank of Australia; Australian Prudential Regulation Authority
Belgium:	National Bank of Belgium
Brazil:	Central Bank of Brazil
Canada:	Bank of Canada; Office of the Superintendent of Financial Institutions
China:	People's Bank of China; China Banking Regulatory Commission
European Union	European Central Bank; European Central Bank Single Supervisory Mechanism
France:	Bank of France; French Prudential Supervision and Resolution Authority (ACPR)
Germany:	Deutsche Bundesbank; Federal Financial Supervisory Authority (BaFin)
Hong Kong SAR:	Hong Kong Monetary Authority
India:	Reserve Bank of India
Indonesia:	Bank Indonesia; Indonesia Financial Services Authority
Italy:	Bank of Italy
Japan:	Bank of Japan; Financial Services Agency
Korea:	Bank of Korea; Financial Supervisory Service
Luxembourg:	Surveillance Commission for the Financial Sector
Mexico:	Bank of Mexico; National Banking and Securities Commission (CNBV)
Netherlands:	Netherlands Bank
Russia:	Central Bank of the Russian Federation
Saudi Arabia:	Saudi Arabian Monetary Agency
Singapore:	Monetary Authority of Singapore
South Africa:	South African Reserve Bank

Spain:	Bank of Spain
Sweden:	Sveriges Riksbank; Finansinspektionen
Switzerland:	Swiss National Bank; Swiss Financial Market Supervisory Authority (FINMA)
Turkey:	Central Bank of the Republic of Turkey; Banking Regulation and Supervision Agency
United Kingdom:	Bank of England; Prudential Regulation Authority
United States:	Board of Governors of the Federal Reserve System; Federal Reserve Bank of New York; Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation.

Observers

Country observers

Chile:	Central Bank of Chile / Banking and Financial Institutions Supervisory Agency
Malaysia:	Central Bank of Malaysia
United Arab Emirates:	Central Bank of the United Arab Emirates

Supervisory groups, international agencies and other bodies

Basel Consultative Group

Bank for International Settlements

European Banking Authority

European Commission

International Monetary Fund

Secretariat

Bank for International Settlements

Annex B

Chairmen of the Basel Committee

1974–1977:	Sir George Blunden, Executive Director, Bank of England.
1977–1988:	Peter Cooke, Associate Director, Bank of England.
1988–1991:	Huib J Muller, Executive Director, Netherlands Bank.
1991–1993:	E Gerald Corrigan, President, Federal Reserve Bank of New York.
1993–1997:	Tommaso Padoa-Schioppa, Deputy Director General, Bank of Italy.
1997–1998:	Tom de Swaan, Executive Director, Netherlands Bank.
1998–2003:	William J McDonough, President, Federal Reserve Bank of New York.
2003–2006:	Jaime Caruana, Governor, Bank of Spain.
2006–2011:	Nout Wellink, President, Netherlands Bank.
2011–present:	Stefan Ingves, Governor, Sveriges Riksbank.

Annex C

Cooperation and support

Cooperation with other bodies

Cooperation with other standard-setting bodies and international financial institutions is important in supporting effective supervision and appropriate information sharing across industries and across international borders.

The Committee works with a range of bodies, the secretariats of which are hosted by the Bank for International Settlements (BIS). These include the Financial Stability Board (FSB), the International Association of Insurance Supervisors (IAIS), the International Association of Deposit Insurers (IADI) and the Committee on Payments and Market Infrastructure (CPMI). The IAIS and IADI focus on supervision in the insurance and deposit insurance sectors, respectively. The CPMI promotes the safety and efficiency of payment, clearing, settlement and related arrangements. The FSB promotes international cooperation across standard-setting bodies, international financial institutions, committees of central bank experts and national supervisory authorities.

In addition, the Committee works with standard-setting and related bodies based outside of Basel. These include the Financial Action Task Force (FATF) and the International Organization of Securities Commissions (IOSCO). FATF promotes effective implementation of measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. IOSCO is the global standard-setting body for the securities sector. The Committee also works closely with the International Monetary Fund (IMF) and the World Bank.

Between 1996 and 2015, the Basel Committee participated in a Joint Forum with the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. With its secretariat provided by the Basel Committee, the Joint Forum comprised an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. The Forum has now been superseded by bilateral and other arrangements for cooperation.

The Committee is a member or observer in various groups with relevance to accounting and audit standard setting and regulation. These are part of the International Financial Reporting Standards Foundation (IFRS Foundation), the International Federation of Accountants (IFAC), and the International Forum of Independent Audit Regulators (IFIAR).

Cooperation with non-member countries

To involve a wider group of countries with the work being pursued in Basel, the Committee has always encouraged contacts and cooperation between its members and other banking supervisory authorities. In 2009 and 2014, the Committee expanded its membership to include a number of non-G10 countries as members and observers respectively. In 2007, the Committee established the International Liaison Group (ILG), later renamed the Basel Consultative Group (BCG), as a forum for deepening the Committee's engagement with non-member authorities, international institutions and regional groups of banking supervisors on new Committee initiatives and other banking supervisory issues. Contacts have been further strengthened by the biennial International Conference of Banking Supervisors, the first of which was held in London in 1979.

In addition to the BCG, the Committee maintains close relations with a number of bank supervisory groupings. The Committee also supports the Financial Stability Institute (FSI), which the Committee established jointly with the Bank for International Settlements (BIS) to disseminate the Committee's standards. Through the FSI, the Committee ensures that non-member supervisory authorities are kept informed of the work of the Committee.

Basel Committee Secretariat

The Committee's Secretariat is provided by the Bank for International Settlements in Basel. The Secretariat is staffed mainly by professional supervisors on temporary secondment from member institutions. Prior to the formation of the FSI, the Secretariat organised annual supervisory seminars at the BIS for bank supervisors representing a wide range of jurisdictions. In addition, the Secretariat conducted several training courses annually at regional locations. The Secretariat now participates in seminars organised by the FSI and regional supervisory groups or other official organisations.