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The Role of the Basel Accords in Mitigating Systemic Risk

Authors : Wassamon Kun-Amornpong

Abstract : When a financial crisis occurs, there will be a law and regulatory reform in order to manage the turmoil and prevent a future crisis. One of the most important regulatory efforts to help cope with systemic risk and a financial crisis is the third version of the Basel Accord. Basel III has introduced some measures and tools (e.g., systemic risk buffer, countercyclical buffer, capital conservation buffer and liquidity risk) in order to mitigate systemic risk. Nevertheless, the effectiveness of these measures in Basel III in adequately addressing the problem of contagious runs that can quickly spread throughout the financial system is questionable. This paper seeks to contribute to the knowledge regarding the role of the Basel Accords in mitigating systemic risk. The research question is to what extent the Basel Accords can help control systemic risk in the financial markets? The paper tackles this question by analysing the concept of systemic risk. It will then examine the weaknesses of the Basel Accords before and after the Global financial crisis in 2008. Finally, it will suggest some possible solutions in order to improve the Basel Accord. The rationale of the study is the fact that academic works on systemic risk and financial crises are largely studied from economic or financial perspective. There is comparatively little research from the legal and regulatory perspective. The finding of the paper is that there are some problems in all of the three pillars of the Basel Accords. With regards to Pillar I, the risk model is excessively complex while the benefits of its complexity are doubtful. Concerning Pillar II, the effectiveness of the risk-based supervision in preventing systemic risk still depends largely upon its design and implementation. Factors such as organizational culture of the regulator and the political context within which the risk-based supervision operates might be a barrier against the success of Pillar II. Meanwhile, Pillar III could not provide adequate market discipline as market participants do not always act in a rational way. In addition, the too-big-to-fail perception reduced the incentives of the market participants to monitor risks. There has been some development in resolution measure (e.g. TLAC and MREL) which might potentially help strengthen the incentive of the market participants to monitor risks. However, those measures have some weaknesses. The paper argues that if the weaknesses in the three pillars are resolved, it can be expected that the Basel Accord could contribute to the mitigation of systemic risk in a more significant way in the future.

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