Piecing B3 together

AN ACT BRIEFING LAST YEAR CONSIDERED THE WIDE-RANGING IMPLICATIONS FOR BANKS, TREASURERS AND SMALL COMPANIES, IN PARTICULAR, OF THE BASEL III PROPOSALS. **GRAHAM BUCK** REPORTS.

The phrase “the devil is in the detail” is often used when new legislation or regulation is under consideration. It doesn’t yet seem apt for the proposed package of amendments dubbed Basel III (B3) – too much of its content awaits clarification and its eventual impact is uncertain, while the direction is very clear.

The implications of the new regime – for treasurers, for the loan market and for the inter-bank money markets – were addressed in a recent ACT breakfast briefing. The ACT’s policy and technical director, John Grout, who chaired the briefing, said unwelcome developments included higher costs, more liquidity risk for corporates, and a possible drop in lending to the real economy. The impact of Basel III is also likely to be greater on this side of the Atlantic if the US, which has yet to implement Basel II, decides against following Europe down the same road. “Life will become tougher for us, while some of our competitors get an easy break,” said Grout

CHANGING BEHAVIOUR Speaker Chris Bates, head of financial services at law firm Clifford Chance, began the session by setting out the main objectives of the Basel III regime in changing the banks’ behaviour. Banks will need to hold more and better-quality capital to improve their ability to cope with losses; capital buffers should be developed in periods when conditions are good, so they can be used to absorb losses during periods of stress; there will need to be an improved assessment of the riskiness of assets; and an internationally harmonised leverage ratio should be established to constrain excessive risk taking and to act as a backstop.

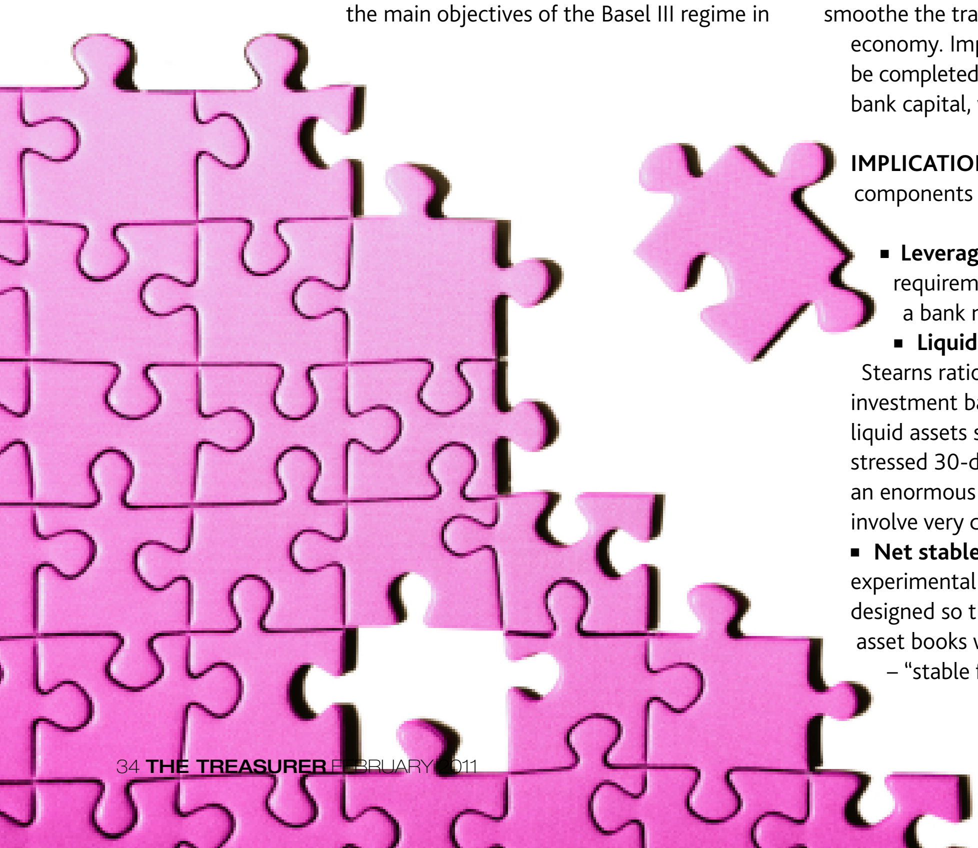
Even more important than these aims are the proposals for global liquidity standards to improve banks’ resilience to acute short-term stress and their long-term funding. Basel III will also herald stronger standards for regulatory supervision of the banks, their degree of public disclosure and their risk management.

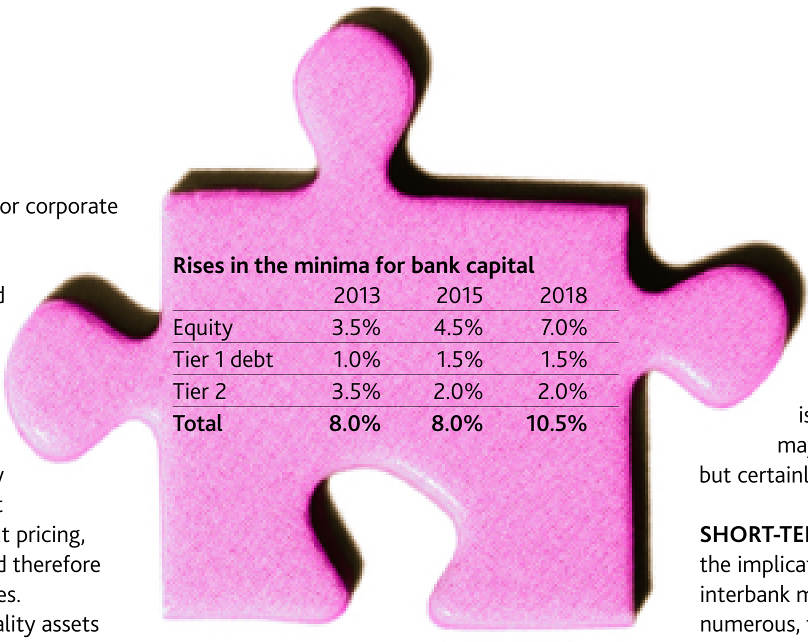
“The history of Basel III is such that there is no single piece of paper to summarise it in its entirety and a lot still remains to be done,” said Bates. Much of the detail should be resolved before the European Commission issues legislative proposals in April 2011, which will be followed by national implementation across Europe.

The new regime has complex phase-in arrangements designed to smoothe the transition and reduce its adverse impacts on the real economy. Implementation of Basel III begins in 2013 but will not be completed until 2018. The phases are reflected in the minima for bank capital, which rises as shown in the table opposite.

IMPLICATIONS FOR CORPORATE TREASURERS The other main components of Basel III are:

- **Leverage ratio.** Essentially a non-risk-sensitive capital requirement to restrict the absolute level of indebtedness that a bank may take on, expected to be 33 times tier 1 capital.
- **Liquidity coverage ratio (LCR).** Also dubbed the Bear Stearns ratio in recognition of the root cause of the US investment bank’s sudden demise. A bank must maintain a pool of liquid assets sufficient to meet expected net cash outflows over a stressed 30-day period. As Bates pointed out, the LCR “will have an enormous impact on the way that banks run themselves and involve very dramatic changes to their balance sheet structures”.
- **Net stable funding ratio (NSFR).** Described as a more experimental measure to cope with runs on a bank. The NSFR is designed so that banks have to fund the illiquid portion of their asset books with funding of more than one-year residual maturity – “stable funding”.





Rises in the minima for bank capital

	2013	2015	2018
Equity	3.5%	4.5%	7.0%
Tier 1 debt	1.0%	1.5%	1.5%
Tier 2	3.5%	2.0%	2.0%
Total	**8.0%**	**8.0%**	**10.5%**

The implications of Basel III for corporate treasurers were summarised by Kenneth Tan, director of GBM Global Portfolio at RBS. He said that Basel III was still evolving and that companies should "keep up to date and keep talking to your bankers".

He thought that large corporate borrowers were likely to maintain much of their clout when talking to the banks about pricing, and predicted the impact would therefore fall mainly on smaller corporates.

The unencumbered, high-quality assets that banks need to hold to meet liquidity needs for a 30-day period under a stressed scenario typically comprise cash, marketable securities issued by sovereigns, central banks and multilateral development banks, and corporate bonds and covered bonds rated at least A- or AA (subject to spread performance tests). However, the supply of bonds looks likely to diminish if European governments press ahead with plans to slash their budget deficits and if more quantitative easing follows as governments buy bonds to inject cash into the economy. Banks will need to hold 100% high-quality liquid assets for liquidity facilities compared with just 10% for credit facilities, so defining the purpose of a facility will become important.

Tan also cited Basel III's requirement for banks to set aside more capital to cover the counterparty risk on derivatives. This is likely to see prices rise in the already squeezed derivatives market. Corporates will have to choose between a bespoke OTC-traded derivative and a vanilla derivative, or decide not to hedge through derivatives at all.

THE EFFECT OF INCREASINGLY COMPLEX LIQUIDITY REQUIREMENTS Claire Dawson, managing director of the Loan Market Association (LMA), said that the LMA's dialogue with regulators to date had focused on liquidity and funding facilities. "The new liquidity requirements to be imposed on banks are extraordinarily complex, and possibly even more of an issue than the funding requirements," she suggested. "The new rules will undoubtedly result in higher lending costs for the banks, particularly for liquidity facilities. These are usually absorbed in the upfront costs or passed on to the borrower in the form of increased costs under the facility documentation."

Dawson believes that the use of loans as collateral is also set to grow in importance and raises several issues:

- Loans are not treated as liquid assets in the regulation but could they be used as collateral to obtain liquidity from elsewhere – eligibility as collateral for the Bank of England's discount window facility being an example?
- Is interbank funding likely to return to pre-credit crunch levels?
- Will a loan repo market develop?

"It's likely that Basel III, particularly the LCR, will have a significant impact in future on the cost of lending and also the availability of loan facilities – particularly committed liquidity lines," she added.

"Other issues likely to impact on the loans market include interbank funding and secured funding from central banks such as the Bank of England. The key message is that we're entering what may not be a brave new world, but certainly a complicated one."

SHORT-TERM INVESTMENTS While the implications of Basel III for the interbank money markets are numerous, four major issues need to be addressed, according to Nathan Douglas, secretary general of the Institutional Money Market Funds Association (IMMFA). He summarised the issues as:

- Will the interbank market disappear as a result of Basel III and, if so, where can assets be sourced?
- Will the split between prime and government funds depend on their duration?
- Will it be possible to have security, liquidity and yield together in the same product?
- Will investors placing their own deposits directly (an area that has already seen growth in the past 18 months) be a viable mass solution?

Douglas suggested that the impact on short-term investment strategies for corporates was twofold: first, categorising and allocating cash in terms of liquidity and security since there will be little demand from banks to take short-term deposits; and second, in predominantly targeting yield on longer-term investment.

"The question for treasurers is 'How long can I invest my money for and what yield can I realistically expect to achieve?'," he said.

NOT ALL DOOM AND GLOOM Introducing a panel question and answer session at the end of the briefing, Grout observed that the life of the corporate treasurer appeared destined to become very much more like that of a bank treasurer, and life would become significantly harder for medium-sized companies.

But as panel member Malcolm Cooper, National Grid's global tax and treasury director, pointed out: "Treasurers can't take the option of burying their heads in the sand. The impact of Basel III on the banks will be wide-ranging and huge, and they will have to raise staggeringly high amounts of new equity. There will also be considerable variation in how corporates respond."

It fell to Dawson to offer a parting glimmer of hope.

"Although Basel III may sound like doom and gloom, banks have traditionally been good at innovation and we can expect them to come up with new solutions," she suggested. "Working in new environments means that their products will have to change and there will have to be greater flexibility. But once people get used to it, the market should continue to deliver."

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