The deleveraging paradigm

PAUL ALAPATT LOOKS AT THE CHANGES AHEAD AS BASEL III IS INTRODUCED.

Post the financial crisis a pressing need was felt for a new dimension to be introduced into the global capital and banking regulations. This time around the focus has been on strengthening global capital and liquidity and making the banking sector more resilient to the shocks it experienced in the recent financial turmoil.

The crisis had exposed a steady build-up of leverage in the banking sector and the potential impact that model risk and measurement error brought to the table. There is now an acceptance of procyclicality as an area that needs to be addressed through a regulatory framework to help support banks in their times of need by drawing upon their capital build up from good times. However, this approach can prove futile if there was excessive credit growth and instability brought about by systemic risk from other institutions.

Basel III envisages bringing about some far reaching changes to its current framework by making available a much broader toolkit, the most transformational being the way banks determine their capital reserve requirements to recover from losses. In this article, however, we will maintain our primary focus only on the new supplemental measure of 'leverage ratio'.

LEVERAGE RATIO Basel I and Basel II made it possible for banks to indulge in regulatory arbitrage. Basel I did not differentiate the inherent risk of default for an asset while Basel II downplayed the risk of securitisation. Taking advantage of this were banks which had an excessive build-up of off-balance sheet leverage all the while adequately meeting their Basel II Risk based capital ratios. Leading up to its bankruptcy Lehman Brothers boasted a Tier 1 capital ratio of 11% which is about three times the regulatory minimum prescribed at that time. The problem had been that with the onset of the financial crisis there had been a downward pressure on asset prices, which in turn pushed up

Box: Enhancements in Basel III

- Raise quality, consistency and transparency of the capital base
- Broaden risk coverage under the Basel capital framework
- Introduction of Leverage Ratio as a supplementary measure to the risk framework
- Introduction of Downturn Loss-Given Default (DLGD)
- Improved calibration of risk functions for regulatory capital requirements
- Push for stronger provisioning practices under accounting standards
- Global Minimum Liquidity Standard to reduce systemic risk

losses for banks and brought about a decline in value of the bank capital and led to a contraction in credit availability for banks.

The idea of a leverage ratio is fairly simple. It is to minimise potential regulatory arbitrage and to instill discipline on the leverage that a bank exposes itself to directly or indirectly. Initially the ratio is expected to serve as a supplementary ratio under Pillar 2 of the Basel II capital accord, but subsequently would be migrated to Pillar 1 treatment.

BASEL III ENVISAGES BRINGING ABOUT SOME FAR REACHING CHANGES TO ITS CURRENT FRAMEWORK BY MAKING AVAILABLE A MUCH BROADER TOOLKIT.

At the industry level the key impact the leverage will bring about is the clear identification of banks which are outliers. The ratio has been designed to be an easy-to-use and non-risk based measure, with a clear intention of being void of highly complex risk-sensitive capital measures which at times may overlook crucial grey areas in risk. One such significant grey area that was observed leading up to the financial crisis was that the leverage of banks was being spirited away to Special Purpose Vehicles and the prevalent risk-measurement models were unable to capture risk originating on account of counter-party concentration.

Some of the interesting elements discussed under this ratio by Basel are:

- Netting to be disallowed, both regulatory and accounting. This would apply to derivatives, repo style transactions and netting of loans against deposits. Alternatively a common set of regulatory netting rules can be applied as listed out in Basel II framework. Further on-balance sheet netting on account of physical or financial collateral, guarantees or credit risk mitigant purchased will not be allowed. If the Basel II framework were to be utilised for netting derivatives then the current exposure method would replace the accounting fair value approach.
- Rigorous Pillar 3 disclosures, to gain credibility and market acceptance as a transparent international measure.
- Develop consistency between capital and exposure measures. Total exposure would be net of provisions and valuation adjustments.
- Off-balance sheet items would be included using a flat 100% credit conversion factor. However, this can at times lead to an over-estimation of the bank's assets and therefore the leverage ratio. Additionally this could push banks to seek assets with higher risk-return.
- Securitisation exposures will make use of the corresponding accounting measurement.
- Derivative exposures to be computed as:
  - Credit – exposure to be at total notional value of the derivative; or
  - Other derivatives – either based on the sum of fair values of on-balance sheet positive values or additionally adjusting the sum with a potential exposure based on current exposure method.

A parallel run period has been announced to test a minimum Tier 1 Leverage Ratio of 3%, which will extend up to 2017. Based on the results of the test, final adjustments and appropriate calibration would be incorporated and subsequently migrated to Pillar 1 treatment on 1 January, 2018.

Though the leverage ratio along with the other mainstream capital ratios will be applied in full only in early 2018, the overall impact of Basel III would be of a greater capital burden on banks especially when the leverage ratio and the liquidity buffers are in place.

These Basel enhancements have been mooted based on European and US banks. What would be also important to scrutinise is how exactly these measures impact banks from markets which do not resemble the US and Europe, and whether Basel can address the most crucial question of systemic risk facing us in the aftermath of the financial crisis.

References: Strengthening the resilience of the banking sector [Dec 2009], Basel Committee on Banking Supervision.

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