A new regulatory landscape

BASEL COMMITTEE CHAIRMAN NOUT WELLINK OUTLINED THE BASEL II/III ERA IN A RECENT SPEECH. **GRAHAM BUCK** EXAMINES THE CONTENTS.

The tougher capital adequacy requirements of Basel III will take effect from January 2013 and be phased in over six years, but the banks must start work immediately to meet the rules of the new regime.

That was the uncompromising message from Nout Wellink, chairman of the Basel Committee on Banking Supervision, who recently addressed the 16th international conference of banking supervisors in Singapore with a speech on the new regulatory landscape.

The previous conference in September 2008 took place against a backdrop of major crisis. Yet the crisis has also presented an opportunity to instigate longer-term reforms and strengthen the resilience of banks and the financial system.

The Basel Committee is at the heart of the reform agenda. In preparing for "the next storm", it deemed a bank-specific approach to be inadequate in improving resilience. It also wanted to address system-wide risks.

The core of its bank-specific reform is stronger capital and liquidity regulation. It strengthened the Basel II framework in July 2009 and its subsequent proposals, signed off in September this year, further reinforced existing Basel II capital treatments. Those proposals also introduced global standards, such as a leverage ratio and liquidity requirements. The combined new capital framework and global standards package has been dubbed Basel III.

"With the benefit of hindsight, pre-crisis capital standards were too weak for the types of risks that were building up in the system," admitted Wellink. Many countries that adopted Basel II did so from 2008 onwards, when the magnitude of the problems had already been made clear, so "this was not a Basel II crisis".

Bankers, investors, rating agencies and supervisors all contributed to the crisis. For regulators, the level and quality of capital was a major weakness. Instead of backing risks with 8% of hard capital, many banks typically held 2%.

Capital rules governing trading book exposures were also deficient. Banks built up massive illiquid credit exposures in these portfolios, which the value at risk-based capital regime, with its 10-day liquidity horizon, wasn't designed for. The result was highly illiquid, structured credit assets in the trading book for which there was no market, which were impossible to value when liquidity broke down, and for which too little capital was held to protect against risks.

Other weaknesses included the dependence of many banks on wholesale funding to finance securitised, illiquid assets. Poor incentives and governance at the firm level plus a lack of transparency also made it all but impossible to understand a bank's exposures, or the quality of capital backing them.

The Basel Commission's response was, first, to fortify the capital base by improving quality, consistency and transparency. The definition of capital was strengthened from the global capital regime, and will be enhanced further by better risk coverage, the introduction of buffers and higher minimum capital requirements. On top of this comes the higher level of capital.

Second, it improved risk coverage of the regulatory framework.

So there was a toughening of the rules governing capital requirements for trading book exposures, complex securitisations and exposures to off balance sheet vehicles. The revised trading book framework, on average, requires banks to hold around three to four times the old capital requirements.

A further element, a supplementary leverage ratio, will contain the build-up of excessive leverage in the system and provide a further safeguard against attempts to subvert the risk-based requirements.

A minimum leverage ratio of 3% was agreed, effective from 1 January 2015. "For global banks with significant capital markets activities, this 3% calibration is likely to be more conservative than the current measures of leverage in place in some countries," said Wellink.

He added that the proposed liquidity framework was equally dynamic. As funding was in short supply during the crisis, it requires global minimum liquidity standards so banks can better resist short-term disruptions to funding access and correct longer-term structural liquidity mismatches on balance sheets.

The liquidity coverage ratio will require banks to have adequate high-quality liquid assets to withstand a 30-day "stressed funding scenario", while the net stable funding ratio is a longer-term structural ratio to address liquidity mismatches.

The liquidity coverage ratio will be introduced as a minimum standard in 2015 after an assessment period. The revised net stable funding ratio will also be tested ahead of its January 2018 introduction.

Added to these initiatives will be supervisory guidance on other important bank-specific initiatives such as stress-

testing, valuation, corporate governance, compensation, supervisory colleges, and high-level principles for financial instruments accounting.

The firm-specific approach will be backed by broader macroprudential measures to counter procyclicality, strengthen the system's resilience and address assumptions that some banks are "too big to fail".

Wellink said banks had to build up a strong buffer in good times, so the committee has introduced a capital conservation buffer. As a bank's capital levels near minimum requirements, the buffer will limit discretionary distributions such as dividend payments, share buybacks and bonuses.

A further proposal is a countercyclical buffer, to be imposed when national authorities believe credit growth threatens an excessive build-up of system-wide risk. The conservation buffer range would be increased by up to 2.5 percentage points more during such periods.

The use of "gone concern" contingent capital increases the contribution of the private sector in resolving future banking crises, and reduces moral hazard. The Basel Committee proposes that the contractual terms of capital instruments will allow them to be written off or converted to common shares if the relevant authority decides the bank is non-viable.

In addition to the leverage ratio, capital conservation buffer and countercyclical capital buffer, the Basel Committee is reviewing further means to reduce procyclicality. They include measures that address any excess cyclicality of the minimum capital requirements, and a proposal to operationalise an expected loss approach to provisioning proposed by the International Accounting Standards Board.

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While procyclicality amplified the crisis, so did excessive interconnectedness and the "too big to fail" issue. The Basel Committee and the Financial Stability Board (FSB) may back combinations of a capital surcharge, bail-in debt and contingent capital.

Other reforms will focus on risks outside the banking sector. The July 2009 Basel II enhancements addressed risk related to securitisations, resecuritisations and off balance sheet exposures such as structured investment vehicles.

Basel II and III would make the banking system much more resilient, Wellink said. The "much stricter" definition of capital itself constitutes a substantial increase in the minimum requirement. In addition, the capital requirement for trading, derivatives and interbank exposures will increase substantially, and the amount of common equity that banks need to hold will rise from 2% to 7%.

"A 7% requirement is substantially higher than the same number under the old standard, as one must factor in both the effect of regulatory adjustments to common equity and the higher risk-weighted asset requirements for trading and counterparty exposures," Wellink stressed.

The impact of the reforms has been assessed. In August the committee issued a report predicting that the transition to stronger capital and liquidity standards would have modest impact on economic growth. Another study on the longer-term economic impact concluded that benefits would result from increasing the minimum capital and liquidity requirements from current levels, by reducing the probability of financial crises and resulting output losses.

The new standards will rise in annual stages between 2013 and 2018, with the leverage ratio and liquidity standards phased in over the same period. But the committee is keen to accelerate progress for countries that have profitable banking systems and can do so without restricting credit.

"Banks should not be permitted to increase their distributions if they are still below the ultimate target but feel they can take their time to get there," said Wellink. "Banks can meet the new standards through earnings retention, capital raising, or reducing their riskier exposures that are not necessarily associated with the granting of credit to ultimate borrowers."

Whether all this would prove enough still depended on the effective implementation and enforcement of the tough new standards, he concluded. They would also have to keep abreast of financial innovation. But in the meantime: "We have provided a road to a much safer banking system."

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