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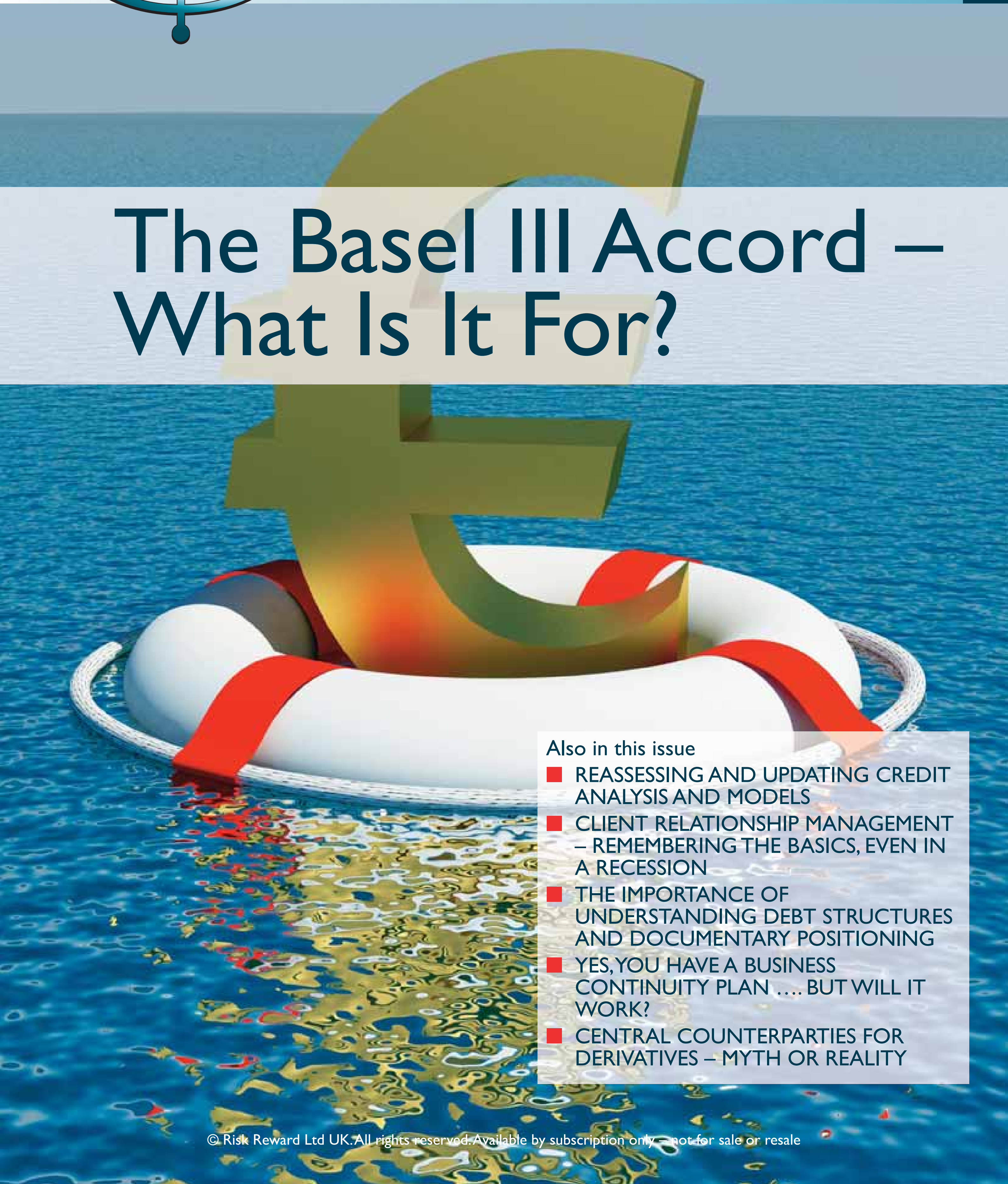
Q3 – 2010



The Basel III Accord – What Is It For?

Also in this issue

- REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS
- CLIENT RELATIONSHIP MANAGEMENT – REMEMBERING THE BASICS, EVEN IN A RECESSION
- THE IMPORTANCE OF UNDERSTANDING DEBT STRUCTURES AND DOCUMENTARY POSITIONING
- YES, YOU HAVE A BUSINESS CONTINUITY PLAN …. BUT WILL IT WORK?
- CENTRAL COUNTERPARTIES FOR DERIVATIVES – MYTH OR REALITY

THE BASEL III ACCORD – WHAT IS IT FOR?

Dennis Cox is the Chief Executive of Risk Reward Limited and chairs the Chartered Institute of Securities and Investment Risk Forum based in London. In the opening article of this update he briefly addresses the so-called Basel III Accord, the regulators response to the financial crisis and suggests how this might impact the industry.

At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements and fully endorsed the agreements it reached on 26 July 2010. These capital reforms, together with the introduction of a global liquidity standard, deliver on the core of the global financial reform agenda and will be presented to the Seoul G20 Leaders summit in November.

The Committee's package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. This reinforces the stronger definition of capital agreed by Governors and Heads of Supervision in July and the higher capital requirements for trading, derivative and securitisation activities to be introduced at the end of 2011.

The Detailed Requirements

The minimum requirement for common equity, the highest form of loss absorbing capital, will be raised from the current 2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period. So the great rushes that we have for new regulation enables an additional four years to elapse before these measures are introduced.

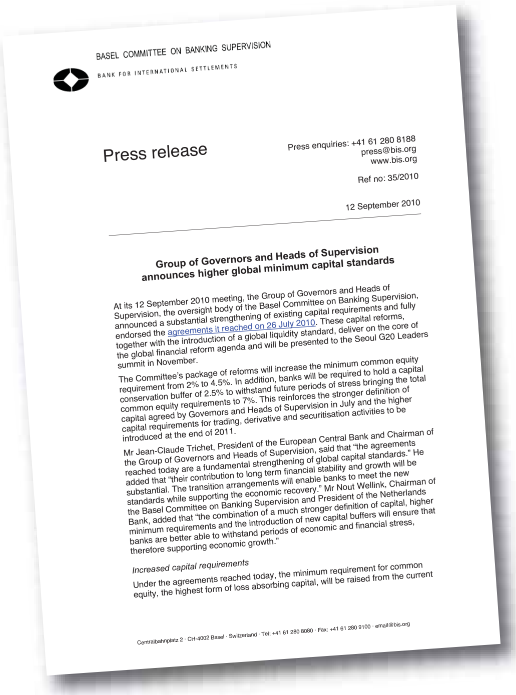
The paper also requires the maintenance of a capital conservation buffer above the regulatory minimum requirement be calibrated at 2.5% that must also be met with common equity, after the application of deductions. The objective of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions.

This of course is counter to the objectives and will just mean that firms are required to keep an additional level of capital to be held for a rainy day – when they will be unlikely to be allowed to use it.

A countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. Even though the rules as discussed in the last update make very little sense and will probably result in a zero capital increase, the rules have been implemented. While the purpose of the countercyclical buffer

THE BASEL III ACCORD – WHAT IS IT FOR? CONTINUED

is to achieve the broader macro prudential goal of protecting the banking sector from periods of excess aggregate credit growth, it is unlikely to achieve anything at all. For any given country, this buffer will only be in effect when there is excess credit



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Press release

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Group of Governors and Heads of Supervision announces higher global minimum capital standards

At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements and fully endorsed the agreements it reached on 26 July 2010. These capital reforms, together with the introduction of a global liquidity standard, deliver on the core of the global financial reform agenda and will be presented to the Seoul G20 Leaders summit in November.

The Committee's package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. This reinforces the stronger definition of capital agreed by Governors and Heads of Supervision in July and the higher capital requirements for trading, derivative and securitisation activities to be introduced at the end of 2011.

Mr Jean-Claude Trichet, President of the European Central Bank and Chairman of the Group of Governors and Heads of Supervision, said that "the agreements reached today are a fundamental strengthening of global capital standards." He added that "their contribution to long term financial stability and growth will be substantial. The transition arrangements will enable banks to meet the new standards while supporting the economic recovery." Mr Nout Wellink, Chairman of the Basel Committee on Banking Supervision and President of the Netherlands Bank, added that "the combination of a much stronger definition of capital, higher minimum requirements and the introduction of new capital buffers will ensure that banks are better able to withstand periods of economic and financial stress, therefore supporting economic growth."

Increased capital requirements

Under the agreements reached today, the minimum requirement for common equity, the highest form of loss absorbing capital, will be raised from the current

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growth that is resulting in a system wide build up of risk and it remains almost inconceivable that any country would admit to this having occurred.

These capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. In July, Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration. No I am not joking I did say 2017 and 2018. Of course by then the rules will have been replaced by a new set of rules.

What is the Point of the Changes

It is clear that the regulators had to reflect on the crisis and take action to deal with the public clamour for change. Of course the Basel II rules had not been fully implemented and did represent a partially flawed solution to the capital conundrum – but at the heart of the issue is what is the capital for? Is capital the best way to protect the global industry and if it is – should the capital be held by the banks?

I take the view that it is clear that requiring each bank to maintain capital to meet in some ways the demands on capital of a stress based failure cannot make any sense. It will only result in an inefficient use of global capital and the almost certain reduction in global activity. This in turn increases bank provisions for irrecoverable loans and will result in reduced bank profitability. The consequence can only be a requirement to raise additional capital or to increase the price of banking products.

Then there is always the question about whether additional capital in the banking sector would have averted the crisis. I can see no evidence to suggest that this is in fact the case. Remember we started with a liquidity crisis caused by an asset class (collateralised obligations) being undermined and consequently difficult to price, creating uncertainty. Capital will not change any of these issues – it will neither create liquidity nor reduce uncertainty in times of stress.

The good thing is that there is no real rush to implement these rules. The paper states that national implementation by member countries will only begin on 1 January 2013 although member countries must translate the rules into national laws and regulations before this date. As of 1 January 2013, banks will be required to meet the following new minimum requirements in relation to risk-weighted assets (RWAs):

3.5% common equity/RWAs;

4.5% Tier 1 capital/RWAs, and

8.0% total capital/RWAs.

The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. On 1 January 2013, the minimum common equity requirement will rise from the current 2% level to 3.5%. The Tier 1 capital requirement will rise from 4% to 4.5%. On 1 January 2014, banks will have to meet a 4% minimum common equity requirement and a Tier 1 requirement of 5.5%. On 1 January 2015, banks will have to meet the 4.5% common equity and the 6% Tier 1 requirements. The total capital requirement remains at the existing level of 8.0% and so does not need to be phased in. The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.

So we have a slowly increasing capital requirement heading out to 2015. Of course many banks already meet much of these requirements, but not always with sufficient common equity. There will be a requirement for some banks to raise more capital – but what is more likely to occur is that:

1) There will be further mergers of banks to create efficiency

2) Many banks will reduce their main lending activities to effectively try to shrink their balance sheets

3) Non-bank financial institutions will develop cost effective products which further undermine the position of the banks

4) The rules will be revised further as more people question the suitability of these changes.

If you look at Annex 2 of the paper you will note that it is not until 2019 that everything has been phased in. The good thing is that regulation does after not tend to last that long. Recognizing that Basel II went through a member of final version prior to the consolidated June 2006 final version, one wonders how many changes will be made to Basel III in the coming years.

Certainly since 2019 will probably be after the next crisis, by then we could expect to have a draft of Basel IV, or V...

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