Basel III market and regulatory compromise

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The Basel Committee on Banking Supervision was able to conclude its negotiations on the adoption of a strengthened capital framework in September 2010 following the financial crisis in international financial markets, which originally began in summer 2007. The final package of measures was published on 16 December 2010. The initial agreement was announced on 12 September 2010 almost exactly 2 years to the week following the closure of Lehman Brothers on 15 September 2008. This had triggered the collapse in global stock market prices and led to the consequent global recession that has caused so much economic damage over the past 2 years. The final arrangements are more remarkable in terms of their balance and moderation rather than for the time that they took to agree. The Committee had to attempt to agree to an intelligent and effective new set of global capital and liquidity standards against highly difficult and volatile market conditions, and continuous political and media pressure for global banks to be penalised almost to the edge of their survival or existence.

The package of revision measures adopted by the Committee has been informally (and then formally) referred to as Basel III following the Committee's earlier Basel I and II agreements. The Committee had already been working on amendments to the Basel II revised framework, which was produced in June 2004 to update its original July 1988 Basel I regime. Basel II introduced the three pillars based on a revised minimum capital framework (including credit risk standardised and foundation and advanced internal ratings based approaches, revised market risk rules and new operational

risk charges), the pillar 2 supervisory review process and pillar 3 market discipline based on mandatory and voluntary disclosure. Basel I had established the minimum 8 per cent requirement of capital to risk adjusted assets. This created the core tier 1 ratio of 2 per cent (of only fully paid-up share capital and retained earnings), a 4 per cent tier 1 ratio and a 4 per cent tier 2 ratio (with a minimum 2 per cent ratio for long-term 5 year subordinated debt). Capital requirements for international banks' securities activities were introduced under the 1996 Market Risk Amendment, which was incorporated in pillar 1 of Basel II. The Market Risk Amendment followed the earlier European Capital Requirements Directive (CAD) in 1993, which was replaced by the recast CAD in 2006 implementing Basel II in Europe.

The Basel Committee has issued over 20 papers in response to the financial crisis. Principles for sound liquidity risk management and supervision were endorsed in September 2008 with the Committee announcing a comprehensive strategy to address the fundamental weakness revealed by the crisis in November 2008. The Committee accepted that capital standards had to be increased in March 2009 with trading book enhancements being announced in July 2009. A comprehensive response to the crisis, including relevant design principles, were issued in September 2009 with a full consultation document on proposals to strengthen the resilience of the banking sector being published in December 2009. These were accepted by the Committee's Group of Governors and Heads of Supervision in July 2010 and finalised in September 2010. The Committee has also issued other papers on

compensation practices, corporate governance and cross-border bank resolution.

The final Basel III package is intended to strengthen the regulation, supervision and risk management of the banking sector. This is designed to improve the ability of banks to absorb shocks arising from financial and economic stress, whatever the source, improve risk management and governance and strengthen banks' transparency and disclosures. The micro-prudential regulation of banks is to be strengthened during periods of stress and a new macro-prudential approach adopted more generally to ensure that the sector as a whole can withstand wider risks and procyclical effects. The outline approach had been agreed in September 2009 followed by the substantive measures in December 2009. This was confirmed by the oversight group in July 2010 with calibration and transition arrangements being finalised in September 2010.

The key elements within the new measures are based on five fundamental reforms. Core tier 1 capital (equity and earnings) is more than doubled from 2 to 4.5 per cent. This is supplemented by an additional conservation buffer of 2.5 per cent, which raises the core tier 1 ratio to 7 per cent. Banks operating between 4.5 and 7 per cent will be subject to restrictions on dividend and bonus payments to protect capital from short-term dilution.

The Committee has also agreed on the creation of a further 0–2.5 per cent counter-cyclical buffer. This will only apply on an elective basis and during times of rising economic activity (a boom) to require banks to set aside additional capital to cover losses in the event of a subsequent downturn. A fourth level systemic group buffer of 1–2 per cent may also be imposed on larger banks or financial groups that generate identifiable systemic risks. The Committee would consider systemic mechanisms further at its November 2010 meeting. These provisions would take the total new minimum tier 1 ratio to 9 per cent (including the systemic risk buffer) and 11.5 per cent (including the counter-cyclical buffer).

The Committee separately confirmed in July 2009 to test a 3 per cent leverage ratio based on tier 1 capital although it would also consider using total capital and tangible common equity. It was also agreed in July that two new global common liquidity standards would be trialled including a minimum Liquidity Coverage Ratio and possible Net Stable Funding Ratio (NSFR). Concerns nevertheless remained with regard to the calibration of the NSFR.

This is an impressive package of reforms although it must inevitably represent a series of inherent regulatory, political and policy compromises. It is nevertheless balanced and informed and has avoided the aggressive and distortive over-reaction demanded by many political and media commentators.

Many have questioned the decision only to move to a 7 per cent minimum core tier 1 ratio with the United Kingdom, United States and Switzerland having been reported to have pressed for 9 per cent. Systemically important institutions will be subject to a 9 per cent minimum in any case with national authorities retaining discretion to impose higher standards in individual cases. This power was already available under Basel II pillar 2 before the crisis with many authorities simply having failed to exercise it. Many only imposed considerably higher ratios, and especially on small and medium sized institutions, after the crisis when banks were attempting to deal with the new substantial losses created by the unanticipated recession and collapse in residential and commercial property markets and consequent pressure on corporate and household income.

The creation of the conservation buffer with the tied limitations on dividend and bonus payments are intelligent and novel devices. Regulators are already assessing banks' compensation and dividend policies in terms of risk under their own codes of practice, many of which implement the Basel Committee's January 2010 methodology for compensation practices and March 2010 principles for enhancing corporate governance. The new conservation buffer conditions will impose an

additional discipline, in particular, to ensure that payments are only made from surplus profits. Payment packages for senior executives and the most talented staff should otherwise be left to market agreement, subject only to the additional transparency and disclosure obligations to be imposed at the national level. Remuneration in private markets should not otherwise be subject to central state direction.

The systemic group buffers also represent an intelligent compromise to allow authorities to impose additional capital requirements in respect of larger groups that create material systemic threats and potential liability under public support packages. Again, many authorities could have used their existing powers for this purpose but simply failed to do so until it was too late. The imposition of new systemic charges with the other initiatives already adopted, and especially with regard to pre-crisis internal resolution (the UK 'living wills' and the US 'funeral plans') and new post-crisis official resolution procedures, should avoid the need for any further discussion of bank levies. These are simply intended to generate income for deficit governments and obtain perceived political advantage from misinformed and misplaced public opinion.

The new leverage and liquidity ratios are also subject to testing and final calibration. Rather than impose any ill-considered new requirements in response to external pressure, the Committee has attempted to identify the most efficient and effective means of incorporating a larger non-risk weighted debt limit and minimum continuing liquidity reserve within the new framework. As with the capital ratios, this is not diluting or avoiding necessary obligations but simply ensuring that appropriate mechanisms are created that can secure their intended objectives without causing unnecessary market damage or market distortion elsewhere.

The other major but welcome compromise was on counter-cyclical capital buffers. Despite all of the clamour for new counter-cyclical charges, especially by politicians and economists across the world, and calls for the introduction

of aggressive of new counter-cyclical powers, the Committee has decided to leave this to national discretion and generally only to operate on an elective and sporadic (or almost occasional) basis. Authorities will be given power to impose additional counter-cyclical charges up to 2.5 per cent but only during periods of excessive growth. Despite the apparently universal consensus on the need for counter-cyclical measures, it is unclear whether regulatory and/or monetary authorities will be able to manage credit cycles through capital taxation. Economic cycles are natural, evolutionary and inevitable processes. Excessive or detrimental counter-cyclic effects may be targeted although it may prove to be wholly undesirable, or indeed possible, to attempt to interfere with cyclic flows directly.

The main concern that has arisen is with regard to the extended 8-year implementation period, which will last until 2018. Certain countries, and especially Germany, had called on the adoption of extended transitional arrangements especially to allow smaller banks to adjust their capital positions over time. This can be justified on the basis of the need to avoid any immediate increases in capital costs, which may cause further damage to lending and destabilise a slow global recovery. The Basel Committee and a joint Macroeconomic Assessment Group (MAG) with the Financial Stability Board had examined the issue and produced two reports in August 2010 on the interim and longer-term impact of introducing higher capital and liquidity requirements. Both reports confirmed that the higher standards would not materially reduce GDP and that the net benefits would outweigh the costs involved, but only on the assumption that implementation was extended over a minimum 4-year period. A one percentage increase in capital over 4 years would only reduce GDP by 0.2 per cent with a 25 per cent increase in liquidity having less than half the effect of the capital increase. The unnaturally long implementation period is still arguably unnecessary and unjustifiable although capital levels will still be

increased in stages during this period and national authorities can impose higher amounts at any time and especially on more systemically important institutions.

The markets generally welcomed the calibration agreement in September as the figures agreed were not as penal as many had expected. Most United Kingdom, United States and Swiss, as well as many Asian banks would easily qualify. Further balance sheet adjustment was expected for other European and Western banks. The residual threat was that national authorities may impose substantially higher standards on a discretionary basis with market related difficulties remaining for many banks in raising capital quickly. Deutsch Bank immediately announced a proposed €9.8 billion (US\$12.7 billion) issue. The Swiss authorities have also announced that they will impose a total 19 per cent requirement with 10 per cent common equity and a further 9 per cent convertible contingent capital. Other balance sheets will have to be restructured over time as earlier hybrid instruments (such as deferred tax credits) would no longer qualify for tier 1 capital purposes. Other commentators have questioned the inability of the new rules to deal with industry size and concentration despite the tripling of capital to be generated. Others have argued that capital levels should be raised to exorbitant 20 or 30 per cent levels on a non-risk weighted basis. The extended transitional period agreed also allows many banks to recapitalise using government injected liquidity rather than their own assets, although this is an inevitable result of the stimulus provided to support growth and recovery.

It has to be stressed that low capital levels within the major global banks did not cause the crisis directly. This only became an aggravating factor once the crisis had moved from an initial tightening of credit in the inter-bank markets to a full solvency crisis. This also only arose after the disclosed losses and bailouts at the giant US mortgage processors, Fannie Mae and Freddie Mac, and insurance company, American International General (AIG) and the Treasury

decision not to bailout the securities firm, Lehman Brothers. Capital adequacy was only then an aggravating rather than a causal factor in the crisis. Many banks' ratios were also not that low, and would have to have been increased very substantially and possibly to economically irresponsible levels to have protected them following the onslaught of the global market crash and subsequent recession. Official support will always remain necessary in the most extreme cases. It must also be stressed that the principal capital difficulties that arose were concerned with trading book and market risk cover on securities activities rather than credit risk and commercial banking with trading book capital rules having been increased by the Committee earlier.

More serious concerns arose with regard to liquidity cover although this was again not principally in terms of amount or level but the type of reserve or cover maintained. Many institutions had relied on credit rating agencies and were holding higher yielding AAA rated structured products in place of more traditional government gilts or bonds. This problem can be most easily dealt with by simply requiring banks to hold their core liquidity reserves in the form of exchange-traded rather than over-the-counter instruments. The issue of overdependence in short-term inter-bank markets is also only one of degree. Higher levels of short-term funding or other wholesale market dependence can be dealt with through arranging back-up credit lines and other alternative support facilities in the event of a shortfall. The crisis at Northern Rock was wholly avoidable both before and after its demise and bungled rescue arrangements.

The banks and markets have also already adopted many of the necessary measures required. Capital levels have been increased and debt levels reduced. Credit assessments have been tightened in light of the worsening credit conditions. Banks restocked their liquidity reserves at a very early stage using more traditional and safer but lower yielding government debt. The International Swaps and

Derivatives Association has also confirmed that more complex risk models have already been adjusted to incorporate the correlation and housing market default data that was missing before and caused so much over reliance.

It is essential to protect the natural operation and value of markets at the same time as limit potential sources of instability and wider loss. A simple trade-off nevertheless arises in all cases. Where banks are subject to substantially higher capital, liquidity and other regulatory costs, markets will grow more slowly and market users be subject to higher borrowing costs and lower credit amounts. This is a complex relationship and the authorities must secure the most appropriate balance between regulatory cost and economic and social benefit and advantage over time.

The new Basel III provisions represent an intelligent and balanced response to the crisis.

These will not prevent further instability, but they will substantially increase core capital and liquidity reserves to allow banks to withstand prolonged periods of difficulty. Future crisis can only be prevented through the continued improvement of risk management and pricing, strengthened governance, the introduction of effective resolution and support facilities for all systemically important institutions and the creation of new macro-prudential oversight regimes within economies. Government, businesses, households and society as a whole must also learn to borrow more intelligently and safely within our limits. We all have a responsibility in this regard.

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