BASEL III REGULATIONS ON STRENGTHENING THE BANKING SYSTEM CAPITALIZATION

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Abstract:

The objective of future Basel III regulations is to improve the capacity of the banking sector to absorb economic and financial shocks, from whatever source, while reducing the risk of contagion in the financial sector to the real economy. One of the main reasons that the economic and financial crisis began in 2007 has become so severe was the fact that the banking sector in many countries increased by excessive debt. This was accompanied by a gradual erosion of the level and quality of capital base. At the same time, many banks did not have sufficient liquidity reserves. The banking system therefore was not able to absorb systemic losses from trading and lending. Neuralgic points of the banking sector were rapidly transmitted to the rest of the financial system and real economy, resulting in a massive contraction of liquidity and credit availability. Finally, the public sector had to intervene with bailouts, with a massive infusion of capital and guarantees, by exposing taxpayers to huge losses in the financial system.

Keywords: Basel III, capital adequacy, systemic risk

JEL classification: E59, F33, F36, F3, G21.

Introduction

Given the field of manifestation and the speed with which recent and past crises were transmitted around the world and the unpredictability of future crises, it is essential that all countries strengthen the capacity to defend their banking sectors, both to domestic and external shocks. In order to solve the deficiencies of the banking market, which occurred during the crisis, the Basel Committee has proposed to introduce a number of fundamental reforms that will change the international regulatory framework. The reforms are intended to strengthen the resistance to stress at player level, by new **micro-prudential** regulations. Reforms have also a **macro-prudential** accent by approaching risks at system level, because at this level risks have pro-cyclical and multiplier effect. These micro and macro-prudential approaches are interdependent, the higher resistance at the bank level reducing the risk of shock at the system level.

1. Strengthening capitalization

The committee proposes increasing the minimum capital ratios, with progressive introduction from January 1st, 2013. Until January 1st, 2015, banks will be required to meet the following minimum requirements in relation to risk weighted assets: 4.5% tier 1 equity, 6.0% tier 1 capital and 8.0% total capital. The committee proposes to introduce a framework to promote the conservation of capital and the establishment of adequate reserves.

New Basel III capital requirements

	Tier 1 Capital – Social Capital %	Tier 1Capital %	Total Capital %
Minimum	4.5	6.0	8.0
"Conservation" reserve	2.5		
Minimum + "conservation" reserve	7.0	8.5	10.5
Anti-cyclical reserve range	0-2.5		

Source: „Basel III: A global regulatory framework for more resilient banks and banking systems", Basel Committee, Dec. 2010

Establishing a capital reserve of 2.5% as a buffer will be added to tier 1 capital, with the progressive introduction starting from January 1st 2016, becoming totally founded in late 2018.

Basel III also introduces an anti-cyclical capital buffer to protect the banking sector in aggregate credit growth periods and to vary between 0% and 2.5%. The anti-cyclical capital buffer level will be determined by supervisory authorities in jurisdictions where borrowers are located, regardless the creditor's country of origin.

1.1. Improving quality of equity and transparency of capital base reporting

To this end, the main form of tier 1 capital must be the existing shares and retained earnings. Deductions for capital and prudential filters have been harmonized internationally and generally applied to the equity. The rest of tier 1 capital base should consist of subordinated instruments, with dividends/coupons distributed in a discretionary and non-cumulative way and have no maturity or incentives to be redeemed. Hybrid capital instruments with an incentive for redemption through step-up clauses (which are currently limited to 15% of tier 1 capital base) will be removed. In addition, tier 2 capital instruments will be harmonized, and so-called tier 3 capital instruments (which were available only to cover market risks), have been removed. Finally, to improve market discipline, it will be required a greater transparency on the capital base, with all elements of capital reporting and reconciliation with accounting reporting.

1.2. Improving risk management

Basel III standards will raise capital requirements for trading portfolio and complex exposures resulting from securitization. It will be introduced a value at risk (VaR) of capital requirement, under significant stress conditions over a period of 12 months. In addition, the Committee has introduced higher capital requirements for securitizations both in the banking business and trading portfolio. Unlike Basel II Regulations, new standards concern the review and monitoring process of Pillar 2 and broaden the Pillar 3 reporting area. Improving Pillar 1 and 3 must be implemented by the end of 2011, and the new standards applicable to Pillar 2 became effective starting from July 2009. The Committee will make by the end of 2011 a fundamental review of the trading portfolio regulations. This document also provides measures to strengthen the capital requirements to cover the exposures to counterparty credit risk of derivatives financial transactions, repo securities. The new reforms will also stipulate capital surplus required to support these exposures to reduce pro-cyclicality and to provide additional incentives to move extra stocks derivative contracts to a central counterparty. Thus, by new standards is intended to reduce systemic risk in the financial system. These measures also offer incentives to strengthen the management of exposures to credit risk of the counterparty.

To this end, the Committee will introduce the following rules:

- Banks will determine their capital required to cover counterparty credit risk using data subjected to stress. This approach will answer both concerns about reducing the capital cost in times of market volatility and concerns about pro-cyclicality. Also, this approach will promote a more integrated management of market risk and counterparty risk.

- Banks will be subject to a cost of capital for potential losses due to valuation at the market price (for example, the amount of credit adjustment risk) associated with a deterioration of the counterparty creditworthiness. Although Basel II Agreement covers the counterparty default risk, it does not address the amount of credit adjustment risk which, during the financial crisis, was a greater source of losses than those within the default.

- Committee will introduce stricter management standards for guarantees and initial margin. Banks with large exposures to illiquid derivatives to a single partner will have to apply for longer periods of initial margin in the process of determining capital requirements.

- To approach the systemic risks resulting from the interaction between banks and other financial institutions through derivatives markets, the Committee will work with the Committee on Payment and Settlement (CPSS) and International Organization of Securities Commissions (IOSCO) to determine stricter standards for central counterparties and financial markets. The necessary capitalization to cover the Bank's exposures to central counterparty (CPC), will be based in part on

CPC compliance with these standards and will be finalized following a consultative process by the end of 2011. The guarantees and bank exposures to the CPCs (marked-to-market), which meet these standards will be subject to a lower risk weightings (proposed to 2%), and the necessary capital to cover the exposures to CCPs will be also submitted to an analysis of risk sensitivity. These standards, together with the capital requirements for OTC bilateral exposures derivatives will stimulate banks to move their exposures to CPCs. To approach the systemic risk in the financial sector, the Committee recommends increasing the risk weights on exposures to financial institutions in relation to the non-financial corporate sector.

1.3. Supplementation of risk weighted capital requirement on leverage ratio

The Committee recommends the introduction of a requirement on leverage report (or leverage ratio) to achieve the following objectives:

1) limiting the leverage ratio in the banking sector (thus helping to reduce the risk of "de-leverage" which may have a destabilizing effect on the financial system and economy);

2) introducing additional safeguards (to prevent the risk of model in determining the necessary capital and wrong measurement of the risk weighted capital by introducing a transparent standard, independent of risk).

1.4. Reducing pro-cyclical effect and introducing anti-cyclical capital reserves role

The Committee introduces a series of measures to address pro-cyclicality and increase the resistance of banking sector to stress. These measures have the following key objectives:

1) preventing cyclical excesses on minimum capital requirements;

2) promoting provisioning based on estimates of future results;

3) preservation of capital to build capital reserves at the bank and the banking sector level, which can be used under conditions of stress;

4) achieving a larger macro-prudential objective of protecting the banking sector during periods of excessive credit growth.

The Committee wants a provisioning based on Expected Loss approach, proposed by IASB (International Accounting Standards Board) in its effort to improve international accounting standard IAS 39. The Committee supports this approach because it better captures the actual losses and is also less pro-cyclical than the current "Loss Realized" approach. This approach fits better in the Committee's effort to promote a conservative attitude in setting up the required capital and reserves over the minimum capital requirements that can be used in times of stress.

At the beginning of the financial crisis, some banks have continued to make large distributions of dividends, redeem shares or to provide generous payments to management, even if their financial condition and the perspectives for the entire sector were steadily deteriorating. This risky behaviour was encouraged by financial markets, which would be charged a reduction of dividends as a signal of financial weakness. Despite the reassuring signals, these banks and the sector as a whole became weaker during the crisis. Many banks quickly returned to profitability, but have not made efforts to rebuild their capital and support the return to lending activities. Taken together, these behaviours have led to increase pro-cyclicality of the system. To address this market failure, the Committee will introduce a framework that will provide supervisors with powerful tools to promote conservation of capital in the banking sector. The implementation of the framework through conservation capital standards agreed internationally will help to increase the resistance of the sector in the event of a recession and will provide the mechanism for rebuilding the capital during the economic recovery. In addition, the proposed framework is flexible enough to allow a series of bank responses to be in accordance with the standard.

The Basel Committee will introduce a regime that will adjust the range of capital reserves when there are signs that the credit growth is excessive. The aim of anti-cyclical capital reserves is to provide macro-prudential protection to the banking sector during the excessive aggregate credit growth.

1.5. Measures addressed to systemically important banks

While pro-cyclicality amplifies shocks over time, excessive interconnection of markets and systemically important banks of (credit institutions which meet simultaneously the criteria in BIS Methodology on size, interconnectivity, substitution, complexity and globalization worldwide), sent shocks to the international financial system and international economy. Systemically important banks would have to be able to absorb losses beyond minimum standards. Basel Committee and the Financial Stability Board are developing a better integrated approach to systemically important financial institutions, which could include combinations of higher capital requirements and safeguard plans.

2. Basel III Standards impact on bank capital adequacy ratios in several countries in Central and Eastern Europe

From the analysis of bank capital adequacy ratios in 6 countries in Central and Eastern Europe, it can be seen that the impact of Basel III regulations will not have a dramatic influence, although maintaining the assumption that tier 1 capital coincides with its own funds.

Capital adequacy ratios in CEE-2010

Country	*Current level %*	*Minimum level %*
Poland	*13,6*	*8,0*
Hungary	*12,6*	*8,0*
Czech Republic	*15,0*	*8,0*
Slovakia	*13,2*	*8,0*
Bulgaria	*18,0*	*8,0*
Romania	*14,3*	*8,0*

Source: Central Banks

However, the CEE region could be indirectly affected by the implementation of Basel III standards, by international active players in the region, which may be constrained in their growth strategies worldwide.

The capital deficit or funding constraints that could affect these international players, and also the limitations of intra-group optimal allocation of capital and financing (because of national boundaries) could end up punishing the border banking model, which was the base of the economic and financial convergence in Central Europe.

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