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NEW CAPITAL FRAMEWORK FOR BANKS - BASEL III PART II

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SIB STUDENTS' ECONOMIC FORUM

FEBRUARY 2011

Theme No. 231 : NEW CAPITAL FRAMEWORK FOR BANKS – BASEL III PART II

What are the enhanced Capital Standards under Basel III?

Basel III stipulates capital ratio as 8 percent of risk weighted assets (RWA). Thus it may appear that there is no change in capital requirement from the Basel II which had also stipulated 8 percent of RWA. But Basel III raises quality of capital. There are three elements in the capital equation: the numerator showing capital, the denominator denoting risk-weighted assets and the capital ratio itself.

The total capital is composed of two parts, called as Tier I and Tier II. Tier I consists of common equity funds and preference shares. Tier II consists of long term debt, called as 'subordinated debt', which are payable after meeting other creditors' obligations, in case of liqudation. The component of tangible common equity capital is raised to 4.5 percent in the total capital ratio. Under the Basel II, the minimum tangible common equity capital requirement was 2 percent. The Tier I capital should form 6 percent as against minimum 4 percent stipulated in the earlier Accord. Thus, the share of Tier I capital and the share of common equity in the capital ratio have been enhanced causing a change in the quality of capital. Common equity has the highest loss-absorbing capacity and hence enhancement of the share of common equity will result in improvement in the quality of capital ratio itself. The component of Tier II capital will decrease to 2 percent from the earlier 4 percent of the RWA. The Tier I capital will have a loss-absorbing capacity on a "going concern" basis. –i.e. the financial institution is solvent. Tier II capital, mainly subordinated debt, will have loss-absorption capacity as a "gone concern" basis – i.e. following insolvency and liquidation. Thus the focus on tangible common equity and Tier I capital in the capital ratio is one of the breakthroughs of Basel III.

Regarding the denominator of the capital ratio – RWAs -, the Basel III substantially improves the coverage of risks relating to trading book, securitization products, counterparty credit risk on OTC (over-the-counter) derivatives and repos. The

banks had a substantial increase in these types of assets even though risk weighted assets had only modest increase. By covering many of these asset classes with higher risk weights, there will be a quantum increase in the calculation of risk weighted assets and thus resulting in higher capital requirements.

Thus, with enhancement in the quality of capital and expanded risk coverage of risk weighted assets, capital standards and ratios are strengthened under Basel III. Even though capital ratio is kept at 8 percent, owing to expanded coverage of asset class and risk weights, capital requirements will be substantially higher for internationally active banks.

What is meant by Capital Conservation buffer under Basel III?

In addition to the basic capital ratio of 8 percent, with sub-component of 4.5 percent of common equity capital, a capital conservation buffer of 2.5 percent in the form of common equity is also mandated under Basel III. Thus total capital ratio will be enhanced to 10.5 percent with a sub-component of 7 percent of common equity. Banks are to build buffers of capital in good times and these capital buffers can be used to absorb losses as the economy begins to contract. Therefore, banks are required to retain a higher percentage of the earnings towards capital. There will be restrictions on distribution of profits towards dividends, bonuses, share buybacks etc. for banks which do not keep capital conservation buffer, especially in periods of financial stress. Inclusive of capital conservation buffer in the form of equity capital, the component of tangible equity capital will form nearly 83 percent of the Tire I capital.

What is meant by 'Contracyclical Capital buffer' under Basel III?

The lessons from the recent banking and economic crisis prompted formulation of this capital requirement. This will arrest what is called as procyclicality behaviour of banks. In boom period, there will be higher credit growth and in stress period, there will be contraction of credit. This results in aggravating the cyclical process. Contracyclical capital helps in applying brake on credit growth in boom period. This also helps in more lending to take place in stress times. The Basel III recommends 2.50 percent of RWA as the Contracyclical capital buffer, in the form of common equity or other fully loss absorbing capital. Thus, the introduction of a Contracyclical capital buffer to mitigate procyclicality is an innovative feature of the new capital framework.

What are the objectives for incorporating 'Leverage Ratio' and 'Liquidity Standards" under Basel III?

Capital ratio is based on risk assessment of assets. But prior to the banking crisis, there was huge build-up of assets –on and off balance sheet – which were not adequately risk-measured. Thus total assets were a multiple of risk assessed assets. In order to address this situation, a leverage ratio has been introduced. This is a non-risk based ratio, i.e. assets are not risk weighted and should be 3 percent of the total assets to be met by Tier I capital. Thus leverage ratio supplements risk-based capital ratio. Further, leverage ratio will be included under Pillar I from 2018, thus making it a necessary minimum requirement for the individual banks. Liquidity crunch was stated to be the immediate cause of the bank failures. Liquidity Coverage Ratio (LCR) is proposed to ensure that high quality liquid funds are available for one month survival in case of a stress scenario. Global minimum standards for LCR will be effective from 2015. A Net Stable Funding Ratio (NSFR) will measure availability of more stable sources of funding on an ongoing structural basis. There will be more effective monitoring of maturity mismatches, concentration of funding, and availability of unencumbered assets. NSFR minimum standards will be effective from 2018.

How does Basel III cover systemic risks and extend to macro-prudential regulation?

Systemic risks emanate from the failure of the aggregate system and this requires macro-prudential regulation. Micro-prudential regulation looks into firm-specific risks, and the basic capital ratio covers these risks. But the recent banking crisis pointed towards some of the systemic risks such as excessive leverage, existence of 'too-big-to fail' institutions, imbalances in liquidity, procyclicality, the notion of 'too-interconnected-to fail' systems etc. It is broadly agreed that Systematically Important Financial Institutions (SIFI) should have higher loss absorbing capacity and more capital to reflect greater risks that they pose to the global financial system. This will be by way of systemic capital surcharge, contingent bonds convertible to equity, and bail-in debt. The exact quantum and quality of the capital will be decided by mid-2011.

Systematically Important Markets and Infrastructures (SIMI) also pose moral hazard. The failure of the liquidity system was owing to interconnectedness and the cascade effects generated by it. Basel III endorses central counterparty clearing houses for derivatives and recommends higher capital requirements for

bilateral OTC derivatives. The concentration of systemic risk will be minimized by effective supervision.

How does Basel III improve risk management and risk modeling of banks?
The banking crisis highlighted the inherent weakness of banks' risk management based on risk models. Risk measurements on value at risk (VaR) were based on normality assumption and did not account for stress events / tail events which may be rare but will have severe impact. Therefore, VaR approaches have to be supplemented by rigorous stress testing programmes that can better capture tail events / systemic risk events. Stress testing should be an integral part of the internal capital adequacy assessment process. Also, the regulators cannot solely depend on the internal risk models. The supervision of large banks will need to be more intrusive for validating bank's internal models.

How is the implementation of Basel III framework scheduled?

The Basel III capital framework, prepared by the Basel Committee, has been endorsed by the G20 leaders at the Seoul summit in November 2010. The implementation of Basel III standards will commence from January 1, 2013 and will be fully operational from January 1, 2019. This staggered implementation is meant to help banks to raise capital by internal surplus and external fund raising to meet the higher standards. The core capital ratio of 4.50 percent by way of tangible common equity should be reached by banks by January 1, 2015. Capital conservation and Contracyclical capital buffers of 2.50 percent each will have to be met by January 1, 2019. The Contracyclical buffer will be implemented according to national circumstances.

Basel Accords are voluntary agreements. The countries signing the Accord agree to implement the standards through national laws or regulations. There is considerable discretion in implementation of the rules by the individual countries.

Basel III is not a brand new capital frame work. **Basel III** is **Basel II** plus the lessons learnt from the recent banking and financial crisis. An enhanced capital framework under Basel III will engender a stronger banking structure, facilitating orderly economic progress for the nations.

Basel III Capital Framework

- Basel III is both a bank-specific and a systemic risk-based framework
- The focus is on tangible common equity, the highest-quality capital
- Capital conservation buffer will restrict profit distribution
- Contracyclical capital buffer is aimed at mitigating procyclicality – excessive credit growth in boom times and contraction of credit in bust times
- Leverage ratio has been introduced to monitor growth of total assets, as backstop to risk-based capital ratio
- Liquidity standards will be introduced to take care of short-term and long-term liquidity requirements
- Systematically Important Financial Institutions (SIFI) will have to meet higher capital standards – to address 'too big to fail'
- Systematically Important Markets and Infrastructure (SIMI) will come under effective supervision
- Rigorous stress testing will be required to supplement VaR (value-at-risk) models

Basel II & Basel III

(% of risk-weighted assets)

	Capital Ratio Components	Basel II	Basel III
i	Minimum Common Equity capital ratio	2	4.5
ii	Minimum Tier I capital ratio (including i)	4	6
iii	Tier II capital	4	2
iv	Minimum total capital (ii + iii)	8	8
v	Capital Conservation buffer by way of common equity	-	2.50
vi	Total common equity including Capital conservation buffer (i+v)	-	7
vii	Total Tier I capital including Capital conservation buffer	-	8.50
viii	Total minimum capital including Capital conservation buffer (iv+v)	-	10.50
ix	Contracyclical capital buffer	-	2.50

Additional capital for SIFIs under Basel III
Leverage ratio, under Basel III, will be under pillar I from 2018
Liquidity standards, under Basel III, will be effective from 2015 & 2018

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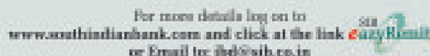

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