Basel 3

Post-Global Financial Order

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Here for good

Down memory lane

- 1974: The Herstatt collapse
- 1975: G10 forms a Committee on Banking Supervision
- 1982: Latin American debt crisis
- 1988: Basel 1 Accord
- 1997: Asian Financial Crisis
- 1998 - 2004: Basel 2 Policy evolution
- 2007- 10: Basel 2 implementation
- 2007-09: Western Financial Crisis
- 2009 Dec: Basel 3 consultation papers
- 2010 Dec: Revised Basel 3 proposals

Basel Accord (B1): Start of Capital Adequacy

- Banks with international presence are required to hold capital equal to 8 % of the risk-weighted assets
- Tiers of capital recognised
  - Tier 1: Equity capital
  - Tier 2: Subordinated debt
- Primarily focused on credit risk. Assets of banks were classified and grouped in four categories according to credit risk, carrying risk weights of zero (for example home country sovereign debt), ten, twenty, fifty, and up to one hundred percent (this category has, as an example, most corporate debt).

Basel 2: Measuring and Managing Risk

- Introduced **"three pillars"** concept
  - Pillar 1 minimum capital requirements (addressing risk)
    - credit risk
    - market risk
    - operational risk
  - Pillar 2: supervisory review
  - Pillar 3: market discipline to promote greater stability in the financial system
- Credit Risk under 3 models
  - Standardized approach
  - Foundation IRB "Internal Rating-Based Approach"
  - Advanced IRB "Internal Rating-Based Approach"
- Internal Capital Adequacy Assessment

Basel 2: Weaknesses

- Focus on measurement and not quality of capital
- Inadequate measure of risk in complex products
- Requirements are procyclical and amplifies business cycle impact
- Did not consider the impact of stress of the wider economy

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Basel 3: Quality of Capital & Liquidity

- Response to the crisis of past few years
- Raise quality and amount of capital and liquidity
- Introduce a leverage ratio
- Introduce a framework for countercyclical capital buffers
- Reduction of systemic risk

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Basel 3: Capital proposals

- Setting minima for Common Equity Tier 1, Tier 1 and Total Capital ratios

- Stricter Criteria for Tier 1 & Tier 2
- Harmonised Capital Adjustments

$$\text{Capital Ratio} = \frac{\text{Capital}}{\text{Risk Weighted Assets}}$$

- Enhanced Risk Coverage

-Securitisation
-Counterparty Credit Risk
-Trading book

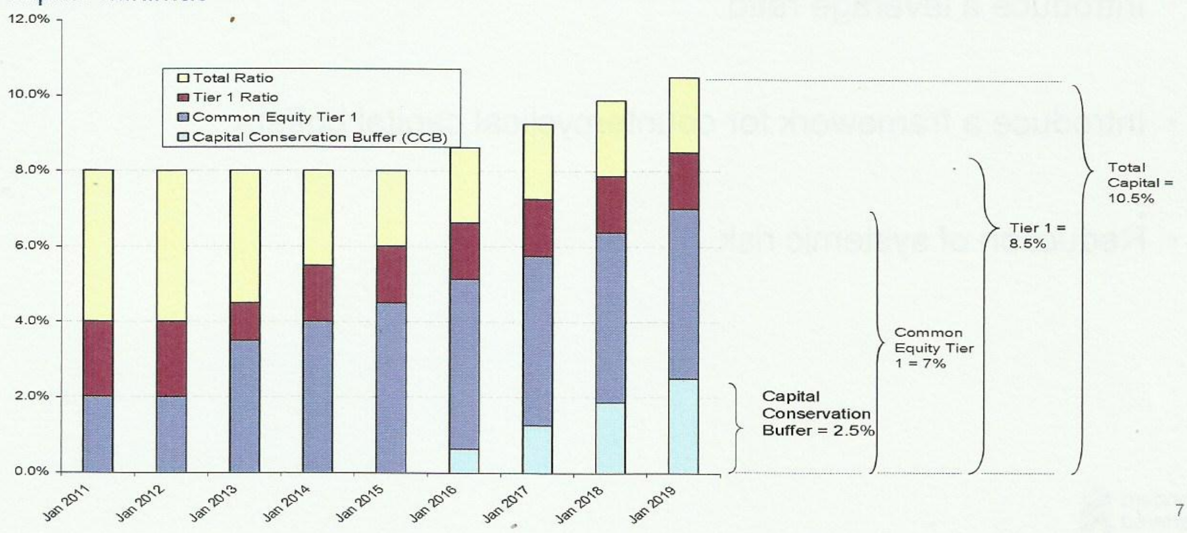
Also;

- Leverage Ratio
- Countercyclical capital framework
- Addressing Systemic Risk

Basel 3: Minima and capital conservation buffers

Capital	Details	Timelines
Common Equity Tier 1, Total Tier 1 and Total Capital ratios √ Adopted and levels specified	Minimum common equity Tier I, total Tier I and Total Capital ratios will be established • Core Tier 1 ratio at least at 4.5% • Tier 1 capital must be at least 6% • Total capital at 8% • Capital conservation buffer set at 2.5%	• Start from 2013 and progressively increased to specified levels by 2015 • Start from 2016 and progressively increased to 2.5% by 2019

Timelines on capital minimas



Basel 3: Capital definition and adjustments

Capital	Details	Timelines
Stricter criteria for Tier 1 and Tier 2 capital √ Adopted with critieria publised	• Innovative Tier 1 to be phased out • Only one category of Tier 2 - no further segregation b/w Lower Tier 2 and Upper Tier 2 • Tier 3 to be phased out • Key difference in proposed Tier 1 and Tier 2 – no incentive to redeem, increased loss absorption and coupon-deferral capability if institution is might become under stress	• Non qualifying instruments issued after Sep 2010 will not be grandfathered. Existing instruments will be recognised at 90% of total nominal amount in Jan 2013 and to decrease by 10% for each subsequent year
Capital deductions √ but with some minor changes to the deductions	• Equity tier 1 gets no benefit from deferred tax assets • Minority interests treatment gets some recognition to the extent of the risk that is recognized in the balance sheet • Revaluing own-debt does not boost equity tier 1 • Investments in subsidiaries deducted from appropriate capital to the type that is invested	• By **January 2013** • Deductions at - 20% from Jan 2014 - 40% from Jan 2015 - 60% from Jan 2016 - 80% from Jan 2017 and - 100% from Jan 2018

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Basel 3: Enhanced Risk Coverage

Capital	Details	Timelines
Counterparty Credit Risk and Securitisations √ Adopted with more clarifications published	• Incorporate stress into the Effective Positive Exposure (EPE) measurement • Bond equivalent of counterparty exposure to cover Credit Valuation Adjustment (CVA) losses • 1.25 multiplier for asset value correlations for large financial institutions (>US$25bn) • Increasing margin period of risk for collateralised counterparties to 20 days • Treatment of highly leveraged counterparties should reflect underlying asset PDs • Higher risk weights for resecuritisations • More rigorous own credit analysis of externally rated securitisations	By January 2013

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Basel 3: Leverage Ratio

$$\text{Leverage Ratio} = \frac{\text{Tier 1 capital}}{\text{On balance sheet + Commitments}} \geq 3\%$$

- Supplements the risk based framework with simple measure of leverage
- Introduce safeguards against model risk, arbitrage and other measurement errors
- Based on Tier 1 capital now instead of Common Equity Tier 1
- Parallel run period from 2013 to 2017; Disclosure from Jan 2015; Implementation by Jan 2018
- Commitments: Unconditionally cancellable at 10% Credit Conversion Factor (CCF); other commitments at 100% CCF

Basel 3: Countercyclical Buffer

Objective

- Create a buffer of capital to protect the *banking sector* from periods of excess aggregate credit growth
- Likely to be deployed infrequently

Buffer decisions and reciprocity

- Each jurisdiction is responsible for determining the buffer size (0-2.5%)
- Buffer size determined by location of exposure
- Implementation phased in from Jan 2016 to a maximum by Jan 2018

Buffer size

- Buffer size is determined through use of a credit/GDP guide and judgement
- Subject to an upper bound during periods of excess credit growth that increase system-wide risk (2.5%)
- Buffer add-on of zero at other times
- Buffer add-on decision announced 12 months in advance of its effective date (buffer release effective immediately)

Basel 3: Addressing Systemic Risk

- Basel Committee and Financial Stability Board developing an approach to manage Systemically Important Financial Institutions (SIFIs) consistent with the published objective that SIFIs should have a greater loss absorbing capacity than the minimum prescribed levels
- Approach could result in a combination of the following for SIFIs:
  - Capital Surcharges
  - Contingent Capital
  - Bail in debt
- Committee is also determining additional loss absorbency that global SIFIs should have. Expect to publish by H1 2011
- SCB view is that any singling out individual firms as G-SIFIs will only reinforce moral hazard because of market expectations of support, and attempting to treat the issue by requiring yet more capital will not address the underlying problem. The real challenge is how best to revive or resolve complex financial institutions that undergo significant stress or approach failure. Here the work that is in hand on developing a suitable resolution regime, Recovery and Resolution Plans and enhanced supervision, together with more effective Colleges of Supervisors, should prove to be a better tool kit.

Basel 3: Proposal on Liquidity

Liquidity	Details	Timelines
Liquidity Coverage Ratio √ but with recalibration downwards of some of the assumptions and inclusion of a larger pool of qualifying marketable securities. However, cap on inflows at 75% of outflows were introduced	· A 30-day **liquidity coverage ratio** to withstand potential disruptions (required level: >100%) Outflow · 5% and 10% for "Stable" and "Less Stable" retail deposits · 25% and 75% for non financial corporates deposits (dependent on whether there are operational relationships) · Takes into account commitment drawdowns, losses from valuation changes etc. · Wholesale funding maturing within 30 days Inflow · Primarily from those defined as stock of liquid assets: - 100% inflow on government securities in domestic currencies - 20% to 40% on corporate securities but under very restrictive conditions - Likely to exclude bank paper and own-name covered bonds - Also a portfolio of Level 2 assets restricted to 40% of the overall stock of liquid assets · Wholesale lending maturing within 30 days · Inflows capped at 75% of outflows to ensure that 25% of outflows is supported by liquid assets	· Start from **January 2015**. · QIS to be done based on end 2010 and mid 2011 data. · Reporting to local regulators expected in Jan 2012 · Possible revisions could be made by mid 2013

Basel 3: Proposal on Liquidity

Liquidity	Details	Timelines
Net Stable Funding Ratio X Some changes to the percentages but implementation will be pushed to 2018 Period in between will be used to calibrate further the levels	· A **net stable funding ratio** to ensure long-term liquidity stability (required level: >100%) Available Stable Funding (ASF) · 100% on capital and liabilities maturing > 1 year · 50% on non financial corporate deposits · 80% to 90% on retail deposits dependent on "Stable" and "Less Stable" · 0% on all others Required Stable Funding (RSF) · 0% on capital and liabilities maturing > 1 year · 5% on highly liquid securities (primarily government) · 20% on corporate securities under restrictive conditions and Level 2 assets · 50% on lending to non financial corporates < 1 year · 65% on residential mortgages and loans that carries less than 35% risk weighting under Basel II · 85% on lending to retail < 1 year · 100% on all others	· Start from **January 2018**. · QIS to be done based on end 2010 and mid 2011 data. · Reporting to local regulators expected in Jan 2012 · Possible revisions could be made by mid 2016

Implications

- Raises bar on capital levels and would increase margins on assets
- Markets to remain uncertain over capital and liquidity raisings
- Expect unintended consequences to the economy dependent on local competition, customers etc.

Key messages

- SCB continue to take a proactive stance to capital and liquidity management
- Harmonised implementation
  - Reinforce the need for a genuinely international approach to implementation
  - Timelines and levels by local regulators must be in line with Basel
- Trade Finance
  - Trade could be adversely impacted
  - Basel relooking at impact from Basel 3 and legacy Basel 2 issues wrt trade
- G-SIFIs (Global Systemically Important Financial Institutions)
  - Singling out G-SIFIs only introduces moral hazard
  - More capital does not resolve underlying problem