Basel III: Meeting the challenge of a new global regulatory environment
Background

In the wake of the 2008 financial crisis, regulators around the world have sought ways to manage systemic risk and ensure greater sustainability in the global banking system while at the same time providing the flexibility necessary for longer term growth. At the center of the global response is Basel III, the next generation of international banking accords designed to strengthen banks’ balance sheets by increasing capital requirements and liquidity ratios. The agreement follows months of negotiation among the central banks and officials of the 27 member countries of the Basel Committee on Banking Supervision, and is widely considered to be one of the most important reforms to emerge from the events of 2008.
Fundamental impact on compliance

In its most basic form, Basel III establishes tougher capital standards through more restrictive capital definitions, higher risk-weighted asset (RWA) ratios, additional capital buffers and higher requirements for minimum capital.

While the full implementation of Basel III won’t be complete until 2019, these reforms will fundamentally impact profitability and may well require the transformation of the business model of many banks around the world. As a result, some in the banking community have been quite vocal in their opposition to the new accords, while others in the industry and elsewhere, concerned about a repeat of 2008, have argued for faster adoption or even stricter requirements.

Like it or leave it, however, there’s little doubt Basel III is here to stay, and its impact will be felt far and wide. For the global economy, the challenges will be many: the banking sector could well see lower profitability, as measured by return on equity (ROE), while the cost of funding is likely to go up, affecting everything from trade finance to repo financing of securities positions.

At the same time, the balance of credit risk capital requirements will be impacted, as greater scrutiny by investors and counterparties regarding balance sheet usage takes hold, along with potential changes in acquisition rationale and activity. In fact, changes across the entire spectrum of banking activity, from increased competition for retail deposits to decreased investor appetite in the sector and beyond, could be on the horizon.

For individual institutions and the system as a whole, however, the real challenge is clear: getting Basel III right is infinitely preferable to repeating the process down the road, particularly after a new round of systemic shocks to the system as in 2008. For individual institutions, that very likely means re-examining core aspects of the organisation’s business model, as well as embracing the steps necessary to become compliant and identifying best practices necessary to minimise disruption to the business of banking.
The heart of the challenge

In many ways, Basel III was built on the pillars of Basel II, and seeks to address a simple fact: the 2008 crisis revealed how crucial the break down of the interbank market is, and demonstrated the difficulties many banks faced refinancing themselves in the midst of an unexpected credit event. As a result, Basel III aims to reduce the probability of bank failures by improving banks’ loss absorption capabilities by mandating more capital, more liquidity and lower risk.
Basel III gradually increases the minimum capital ratios a bank must maintain to include 4.5% share capital, 6% Tier 1 capital and 8% total capital, significantly higher than many banks’ current levels. As well, a bank’s conservation buffer will be gradually extended to a percentage of 2.5% from 1 January 2016 through 1 January 2019. Thus, by 2019, banks will ultimately have to hold 10.5% of their total capital expressed in risk-weighted assets. To ensure sufficient high quality liquid resources are available in case of a stress event, two liquidity standards are also being introduced, designed to ensure survival over a 30 day and longer term time periods. Basel III also introduces a minimum “leverage ratio”, calculated by dividing Tier 1 capital by the bank’s average total consolidated assets and sets the ratio in excess of three percent.

As a result of these rules, banks could soon face an environment with lower returns on capital and slower growth as capital conservation and optimisation become more critical to business planning and risk management. At the heart of this challenge lies the ability of banks to close current capital shortfalls to meet Basel III requirements. While many industry observers feel banks across the Asia Pacific region may be well positioned to meet the new standards through a combination of retained earnings, access to capital markets or help from the public sector—bolstered by news that geographies such as Taiwan, Malaysia and Hong Kong are well on their way to meeting requirements or putting in place final rules for local banks—banks in other areas may have a ways to go.

On the other end of the spectrum are banks from developed nations such as Germany, the UK and the United States. An April, 2013 report from the Bank for International Settlements, which oversees Basel III implementation, indicated that despite a delay in the initial deadlines of January, 2013, only 11 of the 27 countries with major financial centres around the world had put rules in place by the beginning of the year. News that German banks may need 14 billion euros to comply with Basel III capital requirements, along with warnings the nation’s biggest bank, Deutsche Bank, is “horribly undercapitalised”, suggest even banks in Europe’s economic powerhouse may struggle to catch up.

In the UK, lenders have been told they need to raise 25 billion pounds of additional capital, as plans exist to cover approximately half that amount currently. In the U.S., a number of influential policymakers and business leaders say large parts of Basel III are onerous and should be scrapped, maintaining that current capital requirements for US banks are already enough.

Nevertheless, there seems little likelihood that Basel III will truly be slowed down, as the legally binding framework is in place and the implementation of technical standards are already in motion. In fact, many banks around the world already hold more high quality capital than Basel III requires, and others are focusing on making sure they can comply with the new regime sooner rather than later.
A changing global landscape

Beyond capital requirements lies the unknown and possibly far reaching effect Basel III may have on the global economy moving forward. As the foundation for the global economic ecosystem, stricter capital requirements for banks will undoubtedly change the landscape for a range of industries.

Take trade finance, for example. For years, banks and companies alike have argued Basel III would have an outsized effect on trade finance, as the new regulations treat funding instruments as riskier than they really are. As capital and liquidity buffers under Basel III depend on the riskiness of assets, banks’ profit margins for trade finance products are likely to decline, leading them to either raise prices or to abandon those products altogether. A 2013 survey by Greenwich Associates of 300 European financial executives and found that 80 percent expect pricing on trade finance products and services to increase as a result of new capital requirements, even as European companies fund almost two-thirds of their Asian and North American trade through trade finance.\(^\text{11}\)

Already, there are indications that major suppliers of trade finance in Asia are pulling back in response to the new rules.\(^\text{12}\) An increase in trade finance costs and a lessening of willing participants could affect Asia deeply, where companies’ reliance on trade finance as a critical source of funding is higher than in developed markets. Although local Asian and Japanese banks may be willing to fill any gaps, the likelihood exists that alternative sources of financing will have to be found. One possibility is the development of trade finance vehicles for capital market investors, such as structured products or international trade finance funds. Public entities, too, such as central banks and development agencies, are likely to feel the pressure to step up.

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**Basel III Requirements**

- Minimum Total Capital
- Capital Conservation Buffer

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<th>Year</th>
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<th>Capital Conservation Buffer</th>
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The right path forward

In light of challenges Basel III represents, one reality for banks is clear: as the rollout for the new regulations takes hold, adopting a ‘wait and see’ approach to compliance is no longer an option. Further, the long transition period for Basel III—with the last of the new ratios not in place until 2019—can be deceiving. This holds particularly true in Asia, as many regulatory jurisdictions fully expect to impose the tougher standards years before the official deadline.

Further, banks must take the sheer scale and complexity of Basel III into consideration as they prepare for compliance. The CRD IV Directive, the part of Basel III that introduces provisions concerning remuneration, enhanced governance and transparency and the introduction of buffers, alone runs to more than 1,000 pages, with more than 200 reference points still to be determined. For banks, such complexity will require stricter data quality, more frequent reporting and greater aggregation of IT and supervisory functions, particularly around risk reporting and management.

From a compliance and risk management standpoint, a number of fundamental approaches should be adopted in preparing for the changed landscape Basel III will bring:

♦ Business models should be re-examined in accordance with new risk appetites. Higher capital requirements likely means less capital to lend, and thinner margins. As well, attaining greater short and long term liquidity and better withstanding stress must be driven and in line with the bank’s individual risk appetite.

♦ Banks must develop capital and liquidity strategies now. Despite the seemingly lengthy transition period, banks must begin anticipating changes in business models, product offerings and pricing strategies, along with evaluating the impact of Basel III on capital levels, liquidity positions and key financial metrics, to prepare for a new environment.

♦ Focus on maximising risk, capital and liquidity management process enhancements. Upgrading capital management governance and processes, including assessing how much capital is needed to cover material risks and what benchmark governance and processes are necessary to meet expectations, will be critical.

♦ Keep up to date with the latest regulatory developments. Understanding regulatory information as it is published and anticipating timetable requirements and needs is critical to developing a roadmap to reducing risk and identifying the right path to Basel III compliance.
A necessary focus

In the coming months and years, much is at stake for both institutions and the global economy as Basel III takes hold. As the world seeks to address the urgent need to have stronger capital standards for banks, many banks are already working hard to get ahead of the curve by meeting the new standards and getting ready for compliance. While there is no doubt a tradeoff between minimizing risk and ensuring banks can fund the necessary risks that fuel the world's economy, the sooner banks themselves can achieve compliance and get back to the business of finding better returns on equity, the better off everyone may be.

How can Accuity help?

Credit Risk is an online database of financial spread data, ratings and risk intelligence that is sourced directly, spread internally and delivered in a single, consistent and timely web based source to help you make informed and reliable credit risk decisions.

Regardless of whether a bank adheres to Basel II/III, they are required to publish their regulatory capital and capital ratios. Credit Risk solution provides key capital information published by banks globally. When onboarding and reviewing global banking counterparties, this information will help in determining if a bank is Basel III compliant.


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