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Global Regulatory Changes to the Banking Industry after the Financial Crisis: Basel III

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Introduction

The enforcement of new regulations has traditionally been the governments' strategy to respond to episodes of financial stability. That was the case in, for example, the United States after the market crash that detonated the 1930s "Great Depression"[2], with the Glass-Steagall Act, which separated commercial banks from investment banks to eliminate the risk that a stock market collapse could generalize and affect the banking industry.

Many years later, the scandals of the Savings and Loans institutions, during the late 1980s, brought about more restrictive regulations on that sector; or the Enron, Xerox, Tyco and others' fraudulent scandals at the beginning of the 21st century that were at the origin of the Oxley-Sarbanes legislation. Recently, the "Subprime-Mortgages Financial Crisis" of 2007-2009, once again, provoked an encompassing financial sector regulatory revamp in major industrialized countries, home of the largest multinational banks, which were the intermediaries most affected by the crisis, provoking ripple effects across many other countries, and raising the odds that, for the first time, the financial industry's regulatory framework will finally achieve a supra-national status[3]. It would be a logical corollary to the enormous economic costs and the dramatic loss of confidence that resulted from the global financial crisis. An increasingly globalized financial industry desperately needs a full revamping of its regulatory framework.

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[2] The Glass-Steagall Act, named after the two legislator that authored it, separated the investment banking activity from the commercial banking in the United States of America, during more than half a century.

[3] One of the most recent encompassing initiatives to minimize not the probability but the cost of possible future banking crises has been the imposition of a special tax on larger banks, that for their large assets fall in the category of "too big to fail" in order to create a reserve that may be used to bail them out, instead of resorting to the taxpayers' pockets. ("Bank Tax gains momentum", Wall Street Journal, March 29, 2010)

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At a domestic level, the regulation and supervision of the financial industry is performed by government-sponsored agencies that enforce legally binding rules and principles of behavior. A violation of the regulation may result in penalties that go from simple pecuniary fines for minor infringements, to the loss of franchises in the case of institutions, or penitentiary reclusion in the case of individuals proved guilty of major offenses. The loss of a franchise may happen in a variety of forms, which sometimes disguise the true nature of the measure. For example, one possible case is when government authorities do not respond to bailout calls from institutions that have gone too far astray and have fallen into financial distress (Lehman Brothers in the United States, in 2008), or even the tacit or explicit expropriation of troubled entities in extreme cases (Northern Rock and Bradford and Bingley in the United Kingdom during 2008, although it was called "nationalization").

Since the Great Depression of the 1930s in which many financial intermediaries' franchises were lost, that kind of extreme episodes occurred only sporadically, although they were more likely to happen during severe recessions or periods of systemic stress[1]. However, during the recent 2007-2009 financial crisis, they became extremely frequent again. Several implicit "temporary" franchise expropriations, including different governments´ take-over of institutions (e.g. the cases of the Royal Bank of Scotland in Great Britain[2], the Bank of America and Citibank[3] in the U.S., Fortis Bank in Belgium, and Hypo Real Estate in Germany), made clear that the polemic doctrine of "too-big-to-fail" was, after all, acceptable under extraordinary circumstances, and that the stability of the banking system had the highest priority (Santillán-Salgado, 2014).

[1] The "Savings and Loans" crisis, which brought along the bankruptcy of a large number of S&L banking institutions and required extensive government involvement to bail-out and build a new institutional framework to deal with that crisis.

[2] In October 13, 2008, Royal Bank of Scotland announced that the British Government would take a stake of up to 58% in the Group. The aim was to "make available new tier 1 capital to UK banks and building societies to strengthen their resources permitting them to restructure their finances, while maintaining their support for the real economy, through the recapitalisation scheme which has been made available to eligible institutions. HM Treasury *(2008-10-13).* Treasury statement on financial support to the banking industry. Press release.

[3] In October 2008 the U.S. government was set to buy preferred equity stakes in Goldman Sachs Group Inc., Morgan Stanley, J.P. Morgan Chase & Co., Bank of America Corp. -- including the soon-to-be acquired Merrill Lynch -- Citigroup Inc., Wells Fargo & Co., Bank of New York Mellon and State Street Corp., and probably thousands of other banks. However, Bank of America, J.P. Morgan, Wells Fargo and Citibank were the largest recipients with 25 billion dollars each. During the first months of 2009, Citibank required additional resources. U.S. to buy Stakes in Nation's Largest Banks, Wall Street Journal, October 14, 2008. http://online.wsj.com/article/SB122390023840728367.html

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But government sponsored bailouts have a limit, as evidenced by the dramatic episode of the collapse of the venerable investment Bank Lehman Brothers, which was submitted to a "permanent franchise expropriation" in September of 2008. Lehman's bankruptcy[1] and liquidation after an intense lobbying effort to engage the Federal Reserve Bank and the Treasury of the United States, as well as number of large banks, to bailout that institution was fruitless, due to legal impediments.

In any case, it is unlikely that the new regulation or any other institutional measures will be capable of fully eliminating the risks of new asset bubbles bursting or other types of financial crises occurring in the future, but there are good reasons to believe that well internationally coordinated regulatory and supervisory framework can significantly reduce the probability of their occurrence and, at the same time, in a worst case scenario, to reduce the magnitude of their potential cost.

The financial system is exposed to "systematic risk" due to the series of complex links with all other sectors in the economy, which in the event of large financial intermediaries collapse, can detonate a chain reaction and impact many other intermediaries, and have vast effects on the stability of domestic and international markets. Logically, in any modern economy, the collapse of the financial system would destroy the fabric of the market economy and result in a generalized economic catastrophe.

From the point of view of the individual citizen, regulatory protection is necessary because there is asymmetry of information between the suppliers of financial products and savers. Regulation is necessary to guarantee the flow of information on the financial health of the financial products and services provider, in particular when "the pay-off to the customer is contingent on the continued health of the seller (e.g., in the market for deposits and insurance)" (Nier, 2009).

The last thirty years of the XXth century saw a dramatic increase in the relative size and geographical coverage of wholesale financial services firms. These financial groups also deepened their links with other productive sectors of the economy. The more globalized the world economy became, the more complex the functioning of global banks, managing their own multinational treasury and helping corporate entities to manage risks that naturally arise from global operations and from the continuous fluctuation of exchange rates, interest rates and commodities prices.

It is appropriate to cite information from the website of the Bank for International Settlements (BIS): "From 1993 to 2008 the total assets of a sample of what we call global systemically important banks saw atwelve-fold increase (increasing from $2.6 trillion to just over $30 trillion). But the capital funding these assets only increased seven-fold, (from $125 billion to $890 billion). Put differently, the average risk weight declined from 70% to below 40%. The problem was that this reduction did

[1] Lehman filed for Chapter 11 bankruptcy protection on September 15, 2008.

not represent a genuine reduction in risk in the banking system." (Bank for International Settlements[1])

The BIS responded to the new environmental conditions by promoting a profound revision of international standards to consolidate practices and reduce systematic risk. That effort was conducted by a Committee, whose secretariat is run by the BIS in Basel, Switzerland. It is integrated by several nations that after the 1974 liquidation of the Cologne-based Bank Herstatt decided to form a cooperative council to harmonize banking standards and regulations within and between all member states[2]. The core focus of BIS and, thus, of the Committee is, primarily, to regulate capital adequacy and minimize the risk of large multinational banks bankruptcy. However, it also encourages transparency through different rules and mechanisms. The ultimate goal of the Bank and the Committee is to have a "well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes" (Bank for International Settlements 2014).

Two Agreements (Basel I and Basel II) had already been developed and functional when the Financial Crisis (2007-2009) hit the global economy, and a third version is under development. We center this study's attention on the structure and functioning of the Basel III Agreement but, in order to set the background, we briefly discuss previous Basel I and Basel II. Finally, we present some comments on the meaningfulness and impact of the Basel Agreements worldwide, and offer our inferences on what will be the future of the world banking industry under Basel III.

The economic environment before the introduction of the Basel Agreements

During the 1980s, there was an increasing awareness that the largest international banks capital ratios were deteriorating, at a time that international risks were on the raise. That fact made the members of the Committee "resolved to halt the erosion of capital standards in their banking systems and to work towards greater convergence in the measurement of capital adequacy". The decision was strongly supported by the general agreement that there was a need for a comprehensive set of rules that "strengthened the stability of international banking system, and to remove a source of competitive inequality arising from the differences in national capital requirements". (Bank for International Settlements 2014)

The Basel Committee drafted its first version of quantitative and technical benchmarks, known as the Basel I Agreement, aimed to help harmonize banking supervision, regulation and capital adequacy standards, in 1988. However, before the Basel I Agreement existed, the commercial and investment banking businesses had become increasingly global. As national boundaries were frequently crossed by

[1] http://www.basel-iii-Agreement.com/

[2] Times

financial business entities, competitive inequities inevitably arose as each national regulatory authority defined adequate capital differently for those (banks) under its jurisdiction. That unevenness, which resulted in an unfair playing ground for many, was one of the main sources of inspiration for the creation of the Basel Committee on Banking Supervision (Culp 2006).

Basel I

The *Basel Committee on Banking Supervision* was formed with the primary concern to regulate banks capitalization levels on a global scale. A "consultative" paper was published in 1987, an included a capital measurement system, commonly referred to as the Basel Capital Agreement "primarily to strengthen the bank safety and soundness and level the international playing field". (Culp 2006)

The original framework published in 1988 evolved through time, and experienced several amendments. For example, in 1991, the Agreement was amended to give greater precision to the definition of general provisions which could be included in capital for purposes of calculating capital adequacy. There was an additional amendment issued in 1995, to recognize the effects of bilateral netting of banks' credit exposures in derivative products and to expand the matrix of add-on factors. The so-called "Market Risk Amendment to the Capital Agreement" focused on "capital requirements for the market risks arising from banks' open positions in foreign exchange, traded debt securities, equities, commodities and options", was introduced in 1996. (Bank for International Settlement 2014)

In 1999, the Committee proposed a new capital adequacy framework to replace the 1988 Agreement, culminating in the release of the New Capital Framework, which consisted of the following three pillars:

a) Minimum capital requirements, that develop and expand the rules set forth in the 1988 Agreement.

b) Supervisory review of an institution's capital adequacy and internal assessment process.

c) Effective use of disclosure as a lever to strengthen market discipline and encourage safe and sound banking practices.

Together with its substantive amendments, the Agreement specified minimum capital requirements for internationally active banks. Their main thrust was that banks should hold enough capital at all times, enabling them to weather losses related to different types of risks without imperiling the stability of the whole financial system.

Under the Basel I rules, the capital level that a bank must keep at all times to cover its credit risk was determined by the product of the book value of the risky

assets times a pre-defined risk weight. The rules to manage credit risks of off-balance-sheet assets were also included in the Basel I Agreement[1].

Basel II

A new version of international prudential regulation, known as the Basel II Agreements (2004), was drawn up as an improvement over the original Basel Agreement. The main points addressed were the need for risk-sensitive capital ratios, increasing risk mitigation practices by addressing both operational and credit risk separately, and lastly, seeking for more supervision and market discipline to reduce regulatory arbitrage.

The main objective of Basel II was to standardize international regulations with the purpose that national regulators can base on them for the design of their own laws and regulations (how much capital banks need to put aside to guard against diverse risks that banks face like market risk, operational risk and credit risk, etc.).

It offered more complex models for calculating regulatory capital. Essentially, the Agreement mandates that banks holding riskier assets should be required to have more capital on hand than those maintaining safer portfolios. Basel II also requires companies to publish both the details of risky investments and risk management practices. The full title of the Agreement is Basel II: The International Convergence of Capital Measurement and Capital Standards - A Revised Framework. The three essential requirements of Basel II were as follows:

a) Ensuring that capital allocation is more risk sensitive

b) Separating credit risks from operational risks and quantifying both.

c) Reducing the scope or possibility of regulatory arbitrage by attempting to align the real or economic risk precisely with regulatory assessment.

Basel II was based on a new set of "three pillars", as follows:

1. Minimum Capital Requirements

2. Supervisory Review Process

3. Market Discipline

The *Minimum Capital Requirements* can be considered quantitative and include the three main components of risk that a bank can face: credit risk, operational risk

[1] Commonly, in the categories of contingent claims or derivatives.

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and market risk. The operational rules present different methods (e.g. Standardised Approach, Basic Indicator Approach, Advanced Measurement Approach, etc.) which are specific for the calculation of each type of risk.

The *Supervisory Review Process* is more qualitative and deals with the regulatory response to the first pillar, giving regulators improved 'tools' (over those available to them under Basel I). It also provides a framework for internally dealing with all other risks a bank may face[1], which the Agreement groups under the title of "residual risk".

The third pillar, *Market Discipline*, aims to promote greater stability in the financial system by complementing the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Basel Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The Committee believes that such disclosures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.

In principle, banks' disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank. Under Pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. The Basel Committee believed that providing disclosures that are based on this common framework was an effective approach of informing the market about a bank's exposure to those risks and provides a consistent and understandable disclosure.

Basel II opened the door to a number of strategies that allow international banks to make risky investments[2], like, moving higher risk assets to unregulated parts of the holding company or, alternatively, transferring risks directly to investors through securitization and, for that reason, some voices have suggested that the Basel II Agreements were one of the major culprits of the 2007-2009 Financial Crisis. However, such an accusation is questionable since the Basel II principles were introduced in the European Union as recently as January 1, 2008, and by that time the world was already being shaken by the Subprime Crisis. Regarding its adoption in the United States, Agreementing to that country's legislative process, the Basel II principles were to be enforced until 2010.

However, it is illustrative to briefly review what several authors have written about this issue. For example, Danielsson et al. (2001) suggested that Basel II derived

[1] Such as systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk

[2] Like, for example, Collateralized debt obligations (e.g. Subprime Mortgage Backed Bonds).

regulations failed to address risk as an internal or endogenous factor. They argued that Value-at-Risk, Basel II's preferred measure of risk may destabilize the economy and induce a crisis fueled by itself. They also highlight the significant reliance of Basel II on credit agencies as measures used in credit risk assessment by banks for individual customers credit worthiness, and the lack of operational risk modeling due to the lack of adequate technologies and comprehensive data bases.

Cannata and Quagliariello (2009) suggest that among several other responsibilities attributed to Basel II in connection with the financial crisis, there are such aspects as the fact that the average level of capital required by the new discipline is inadequate; that the new Capital Agreement, interacting with fair-value accounting, has caused remarkable losses in the portfolios of intermediaries; that capital requirements based on the Basel II regulations are cyclical and therefore tend to reinforce business cycle fluctuations; that in the Basel II framework, the assessment of credit risk is delegated to non-banking institutions, such as rating agencies, which are potentially subject to conflicts of interest; that the key assumption that banks' internal models for measuring risk exposures are superior than any other has proved wrong; and, finally, that the new framework provides incentives to intermediaries to deconsolidate from their balance-sheets some very risky exposures. However, they recognized that in most cases it is not appropriate to link the current financial crisis to Basel II, and that some of the main drivers of the crisis simply cannot be entirely ascribed to the new regulation.

Finally, Fees and Hege (2005) suggests that relying on external Credit Rating Agencies is not the best alternative to credit risk measuring, and does not lead to efficient risk management practices or optimal capital requirements. If banks control their own portfolios' risk, they can increase its size and make the whole industry safer, by observing high credit quality standards.

The advent of the crisis was for many but a confirmation of the belief that there yet existed serious limitations in Basel II, instead of reevaluating the argument of an unfortunately inadequate timing in its implementation, as we mentioned earlier, the Basel Committee on Banking Supervision took for granted that the inability to anticipate what was coming and the extremely severe damages that could not be prevented were due to the imperfections of Basel II. But, even when there is no doubt that there were a number of improvement areas, it is also true that Basel II was a carefully crafted agreement. In its design process Committee members were careful to take into account many aspects affecting different parties and, for that reason, it was subject to extensive public consultations.

Basel III

Since the first signs of the financial crisis were noticed during the early months of 2007, and all along the following quarters, several national governments announced initiatives to implement extensive bailout measures and recovery plans backed up with

tax-payers money. The official language was very similar in all countries; extraordinary measures were required to avoid a systemic collapse that could endanger economic stability.

But it was until November of 2008, during the Global Finance summit that took place in London, that the most industrialized countries and the biggest emerging economies agreed on the implementation of a global financial reform to close loopholes in regulation and supervision. The G-20 leaders meeting celebrated that month in Washington, had the financial markets of the world economy as its central discussion topic, and was one of the most important events in the history of the measures adopted to achieve the recovery of international financial stability.

After the meeting, the G20 leaders endorsed a document called "Framework for Strong, Sustainable and Balanced Growth", in which they committed to a timetable to achieve specific objectives and initiated a new consultative mutual assessment to evaluate whether their policies would collectively deliver the desired objectives. The implementation of that effort was delegated to international organizations capable of developing in-depth studies to inform the Leaders on what the policy alternatives were, as well as their pros and cons.

They designated the International Monetary Fund (IMF) and the World Bank (WB) to perform multiple analyses, supported with inputs from other international organizations, including the Financial Standards Board, the Organization for Economic Cooperation and Development, the International Labor Organization, the World Trade Organization and the United Nations Conference on Trade and Development. The stated objective was to provide technical and conceptual foundations required to:

- Set out national and regional policy frameworks, programs and projections by the end of January 2010;
- Conduct the initial phase of a cooperative mutual assessment process, supported by IMF and World Bank analyses, of the collective consistency of national and regional policies;
- Develop a basket of policy options to deliver those objectives, for Leaders to consider at their Summit in June 2010; and,
- Refine mutual assessments and develop more specific policy recommendations for Leaders at their Summit in November 2010.

The declaration analyzed the main causes of the crisis, including:

a) an inadequate measurement of risk;

b) inappropriate due diligence procedures;

c) weak risk management practices;

d) and low standards in the placement of securities.

From the analysis and diagnosis of the crisis, it became obvious that the increase in the use of complex financial products and an excessive leverage of financial institutions were at the origin of the financial system's vulnerability.

The evidence consistently confirmed that in many countries, the regulatory framework, the supervisory entities and the participating institutions did not correctly recognize the magnitude of the economy's credit risk exposure, and that the authorities in charge of the execution of macroeconomic policies were significantly detached from reality, and did not give a timely response to the problems that affected the financial system.

Also, in November 2008, the Basle Banking System Supervisory Committee presented a comprehensive strategy to handle the lessons of the financial crisis. That strategy contained the guidelines for strengthening the three pillars of basil three, including the following subjects:

1. Strengthening the capacity to capture risk under the structure of Basle II, particularly for the treasury and the out of balance exposures.
2. Improving the Tier 1 quality of equity.
3. Evaluation of complementary measures to contain an excessive leverage of the banking system.
4. Introduction of international standard indices of liquidity risk.
5. Strengthening risk management and corporate governance in banks
6. Design and implementation of capital structure anticyclical mechanisms to reduce risks during periods of financial stress.

A few months later, during the G20 summit in London in April of 2009, the group issued a Declaration for the Strengthening of the Financial System, whose main topics included the extension of the mandate of the Financial Stability Forum, with the intention to strengthen its institutional base.

They created the Financial Stability Board (FSB), which would take charge of identifying and evaluating the vulnerabilities that can affect the stability of the financial system, at the same time supervising the necessary measures to handle them. The FSB would also be in charge of the coordination and exchange of information among those authorities responsible for the financial stability, as well as of monitoring the market developments and their implications for regulatory policies.

Other responsibilities included the compromise to advice on the best practices of regulatory standards, to support the planning process and to manage the crisis across borders, particularly regarding systemically important firms. To achieve those ends the FSB would collaborate with the International Monetary Fund on the implementation

of an early warning alarm, based on the timely identification of macroeconomic and financial risks, as well as on the development of the measures required to handle them.

From the banking industry perspective, even when the Basel III proposal immediately gained adepts, it is not clear that all affected parties find the new rules pleasing. While it took many years to develop the Basel II rules, the new Basel III version was finished in a very short time and apparently didn't have enough time for a careful evaluation of the potential effects of the new requirements that will be applied to banks' Balance Sheets.

There is no doubt that the Financial Crisis proved there was a need to reform the Solvency Ratio of Basel II, but a few threads remain loose like, for example, the possibility that given higher capitalization requirements, banking institutions will find it more difficult to provide an urgently needed credit support for the full recovery of the world economy.

It is true, however, that the Committee put in place a number of mechanisms that ensure that Basel III gets rigorously and consistently implemented worldwide, and that there is a plan for a gradual phasing-in, so that the banking sector can move towards more solid capital and liquidity conditions without loosing the ability to perform the important role it must play in the economic recovery process.

Besides, with respect to the leverage ratio, the Committee will evaluate if its design and calibration are appropriate over a full credit cycle and for different types of business models (Bank for International Settlements 2010).

Even while Basel II was not fully enforced at the time the Global Financial Crisis hit the markets, it seems unlikely its preventive mechanisms and rules could have kept under control the extension of the disaster. So, in the absence of an official statement in that sense, one can infer from the actions of governments and Central Banks that they found numerous areas of opportunity that deserved prompt and thorough attention. That is the most likely explanation of why Basel II was replaced by Basel III.

During the month of December of 2010, and as a follow-up of the G20 endorsement during their November Seoul summit, the Basel Committee issued the new Basel III rules text, which presented the details of the global regulatory standards on bank capital adequacy and liquidity agreed by the Governors and Heads of Supervision that integrated the Committee. The rules of Basel III contained the details of the new crisis-driven Basel III Framework, which encompasses both microprudential and macroprudential components, along with a time-table for their implementation (See Table 1).

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Table 1: Implementation dates for Basel III

(*All dates as of January 1st*)

	Phases	2013	2014	2015	2016	2017	2018	2019
Capital	Leverage Ratio	Paralel run 1 Jan 2013- 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pilar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				**4.5%**
	Capital Conservation Buffer				0.625%	1.25%	1.875%	**3%**
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	**7%**
	Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)		20%	40%	60%	80%	100%	**100%**
	Minimum Tier 1 Capital	5%	6%	.06.				**6%**
	Minumum Total Capital	8%						**8%**
	Minimum Total Capital plus conservation buffer		8.00%		8.625%	9.25%	9.875%	**10.50%**
	Capital instruments that no longer qualify as no-core Tier 1 capital or Tier 2 capital	Phased out over 10 year horizon beginning 2013						
Liquidity	Liquidity coverage ratio			60%	70%	80%	90%	**100%**
	Net stable funding ratio						Introduce minimum standard	

Source: Basel III Compliance Professionals Association (2014).

The new Basel III framework sets out higher and better-quality capital rules, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. It will mandate banks to shore up capital to meet tighter requirements, which can be attained by either raising additional capital or rationalizing their lending portfolios.

Incumbent stockholders usually prefer to avoid the first alternative in order to prevent the dilution of ownership, but is a possibility in extreme conditions; and changes in a bank's lending policies mean a profound transformation of the relationship with its corporate customers. No simple one-fits-all seems likely, but bankers must take this commitment seriously as so much is at stake.

The Basel III reform measures aim to a) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and, strengthen banks' transparency and disclosures. The reforms target:

A. Bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress.

B. Macroprudential, system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.

These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system wide shocks.

The execution of the framework is supported, similar to previous versions of the Basel Agreements, by three pillars: Pillar 1, which addresses three important issues: capital, risk coverage, and containing leverage; Pillar 2, that deals with Risk Management and Supervision; and, Pillar 3, focused on Market Discipline. In the following paragraphs we describe the three Pillars, and the Global Liquidity Standard and Supervisory Monitoring, which applie to all banks, as well as some special considerations regarding lobal systemically important financial institutions (SIFIs).

Pillar 1

a) Capital

i. Quality and level of capital: Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions.

ii. Capital loss absorption at the point of non-viability: Contractual terms of capital instruments will include a clause that allows-at the discretion of the relevant authority-write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hozard.

iii. Capital conservation buffer: Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Contraint on a bank’s discretionary distributions will be imposed when banks fall into the buffer range

iv. Countercyclical buffer: Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.

b) Risk Coverage

i. Securitisations

Strengthens the capitall treatment of certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitistion exposures.

ii. Trading book

Significantly higher capital for trading and derivatives activities, as well as complex securisations held in the trading book. Introducition of a stressed-value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account.

iii. Counterparty credit risk

Substantial strengthening of the counterparty credit risk framework. Includes: more stingent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivarives; and higher capital for inter-financial sector exposures.

iv. Bank exposures to central counterparties (CPPs)

The Committee has proposed that the trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposure to a qualifying CCP will be capitalised Agreement to a risk-based method that consistently and simply estimates risk arising from such default fund.

c) Containing Leverage

i. Leverage ratio

A non-risk based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.

Pillar 2

Risk Management and Supervision

Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activies; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.

Pillar 3

Market discipline

The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhances disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.

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In what respects to Liquidity, Basel III contemplates implementation of the Global Liquidity Standard and Supervisory Monitoring function by defining four measures:

a) Liquidity coverage ratio: the liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to whithstand a 30-day stressed funding scenario that is specified by supervisors.
b) Net stable funding ratio: The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.
c) Principles for Sound Liquidity Risk management and Supervision: The Committee\s 2008 guidance *Principles for Sound liquidity Risk Management and Supervision* takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organizations.
d) Supervisory monitoring: The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analyzing liquidity risk trends at both the bank and system-wide level.

Regarding the issue of Systemically Important Financial Institutions (SIFIs), Basel III contemplates that such institutions mus have higher loss absorvency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methogology that includes both quantitative indicators and qualitative elements to identify global systemically importan banks (SIBs). The additional loss absorbency requirements are tobe met with a progressive Common Equity Tier 1 (CET1) capital rquirement ranging from 1% to 2.5%, depending on a bank\s systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs. (Bank for International Settlements[1])

The global financial crisis and the euro area sovereign debt crisis was a strong motivation to introduce changes on bank capital regulation. Regulators strive to establish a more unified regulatory framework in banking, but implement uniform capital regulation around the globe appears to be a daunting task that has faced both practical difficulties as well as opposition from the financial industry.

A tempting question is whether the efforts by regulators and policymakers are warranted, given the current state of affairs in bank capital regulation. Two aspects of

[1] http://www.basel-iii-Agreement.com/

this question demand further scrutiny. First, if implementation of the outgoing (Basel I and Basel II) Agreements has resulted in a significant diversity of bank capital standards across different countries, this could undermine the level-playing-field objective that Basel III is trying to address. Second, documentation of the current state of affairs in bank capital standards across countries is valuable in its own right because any future change in standards that may occur as a result of new regulations can be measured against this benchmark.

Conclusion

While the discussion about the origins and consequences of the recent financial crisis will continue for many years to come, already at the present a number of national governments, regulatory agencies and international financial organizations, have taken the initiative and started the implementation of new regulatory frameworks as well as more robust supervision mechanisms of the financial industry.

The global financial crisis and subsequent recession revealed multiple problems with bank regulation. Some of the most critical were: First, the fact that, for a variety of reasons, banks demonstrated compliance with Basel capital standards yet accumulated excessive amounts of actual or effective leverage; for example, some institutions engaged in regulatory capital arbitrage on a massive scale, while others used over-the-counter derivatives to mask or distort their true leverage. Second, risks which were thought to have been adequately addressed actually inflicted crippling losses on many institutions. For example, liquidity risk emerged, quite unexpectedly, as one of the main drivers of financial contagion during this crisis.

In addition, unexpected changes in correlations across different sources and types of risk meant that estimated loss distributions were far too optimistic, relative to actual experience. And finally, the bank regulation framework neither prevented the emergence of Too-Big-to-Fail institutions, nor provided sufficient guidance for their orderly resolution when they went into financial distress. Only time will tell if the new Basel III rules were adequate to prevent a new global financial turbulence episodes.

At an international level, recent years have brought a large number of revisions and additions to the Basel capital standards, which are now referred to collectively Basel III. However, new regulations continue to appear at the national level simultaneously.

For example, the Dodd-Frank Act added several thousand pages of new bank regulation to the existing body of the United States banking industry regulations. It is also likely that significant new rules are still to come.

Recommendations contained in the Vickers Report in the United Kingdom[1], and

[1] Edmonds, Timothy. 2013

the Liikanen Report in the European Union[1], which aim to alter the structure of banking operations, may yield concrete regulations in the near future.

The new rules have generally augmented rather than displaced the existing set of bank regulations, which implies a dramatic increase in the number of written rules governing the banking system. Such a large increase in regulation would be well worth the effort if it were an effective remedy for the several problems described above. But there are many reasons to question whether this rules-driven approach to revising bank capital regulation will be effective.

Making new rules is often the quickest and politically expedient response to crises, so that societies tend to draft new rules without giving alternative approaches sufficient consideration. We believe that there are benefits in continuing a broad discussion of how bank capital regulation could minimize the chances of a new potential crisis. This paper is intended to encourage a continuing dialogue on these very important matters.

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[1] Liikanen, Erkki, et. al. 2012.

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