INTEGER WEALTH GLOBAL

BASEL III - The Global Regulatory Framework for Banks

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What is Basel III.?

The Basel III (3) accord is a set of financial reforms that was developed by the Basel Committee on Banking Supervision (BCBS), with the aim of strengthening regulation, supervision, and risk management within the banking industry. Due to the impact of the 2008 Global Financial Crisis on banks, Basel III was introduced to improve the banks' ability to handle shocks from financial stress and to strengthen their transparency and disclosure.

Basel III theme

Basel III builds on the previous accords, Basel I and II, and is part of a continuous process to enhance regulation in the banking industry. The accord aims to prevent banks from hurting the economy by taking more risks than they can handle.

The Basel Committee

The BCBS was established in 1974 by the central bank governors of the Group of Ten (G10) countries, as a response to disruptions in financial markets. The committee was set up as a forum where member countries can deliberate on banking supervisory matters. BCBS is responsible for ensuring financial stability by strengthening regulation, supervision, and banking practices globally.

The committee was expanded in 2009 to 27 jurisdictions, including Brazil, Canada, Germany, Australia, Argentina, China, France, India, Saudi Arabia, the Netherlands, Russia, Hong Kong, Japan, Italy, Korea, Mexico, Singapore, Spain, Luxembourg, Turkey, Switzerland, Sweden, South Africa, the United Kingdom, the United States, Indonesia, and Belgium.

The BCBS reports to the Group of Governors and Heads of Supervision (GHOS). Its secretariat is located in Basel, Switzerland, at the Bank for International Settlements (BIS). Since being established, the BCBS has formulated the Basel I, Basel II, and Basel III accords.

Key Principles of Basel III

- **Minimum Capital Requirements**
  The Basel III accord raised the minimum capital requirements for banks from 2% in Basel II to 4.5% of common equity, as a percentage of the bank's risk-weighted assets. There is also an additional 2.5% buffer capital requirement that brings the total minimum requirement to 7%. Banks can use the buffer when faced with financial stress, but doing so can lead to even more financial constraints when paying dividends.

  As of 2015, the Tier 1 capital requirement increased from 4% in Basel II to 6% in Basel III. The 6% includes 4.5% of Common Equity Tier 1 and an extra 1.5% of additional Tier 1 capital. The requirements were to be implemented starting in 2013, but the implementation date has been postponed several times, and banks now have until January 1, 2022, to implement the changes.

- **Leverage Ratio**
  Basel III introduced a non-risk-based leverage ratio to serve as a backstop to the risk-based capital requirements. Banks are required to hold a leverage ratio in excess of 3%. The non-risk-based leverage ratio is calculated by dividing Tier 1 capital by the average total consolidated assets of a bank.
  To conform to the requirement, the Federal Reserve Bank of the United States fixed the leverage ratio at 5% for insured bank holding companies, and at 6% for Systematically Important Financial Institutions (SIFI).

- **Liquidity Requirements**
  Basel III introduced the usage of two liquidity ratios – the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The Liquidity Coverage Ratio requires banks to hold sufficient highly liquid assets that can withstand a 30-day stressed funding scenario as specified by the supervisors. The Liquidity Coverage Ratio mandate was introduced in 2015 at only 60% of its stated requirements and is expected to increase by 10% each year till 2019 when it takes full effect.

  On the other hand, the Net Stable Funding Ratio (NSFR) requires banks to maintain stable funding above the required amount of stable funding for a period of one year of extended stress. The NSFR was designed to address liquidity mismatches and will start becoming operational in 2018.

Impact of Basel III

The requirement that banks must maintain a minimum capital amount of 7% in reserve will make banks less profitable. Most banks will try to maintain a higher capital reserve to cushion themselves from financial distress, even as they lower the number of loans issued to borrowers. They will be required to hold more capital against assets, which will reduce the size of their balance sheets.

A study by the Organization for Economic Cooperation and Development (OECD) in 2011 revealed that the medium-term effect of Basel III on GDP would be -0.05% to -0.15% annually. To stay afloat, banks will be forced to increase their lending spreads as they pass the extra cost on to their customers.

The introduction of new liquidity requirements, mainly the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), will affect the operations of the bond market. To satisfy LCR liquid-asset criteria, banks will shy away from holding high run-off assets such as Special Purpose Vehicles (SPVs) and Structured Investment Vehicles (SIVs).

The demand for secularized assets and lower-quality corporate bonds will decrease due to the LCR bias toward banks holding government bonds and covered bonds. As a result, banks will hold more liquid assets and increase the proportion of long-term debts, in order to reduce maturity mismatch and maintain minimum NSFR. Banks will also minimize business operations that are more subject to liquidity risks.

The implementation of Basel III will affect the derivatives markets, as more clearing brokers exit the market due to higher costs. Basel III capital requirements focus on reducing counterparty risk, which depends on whether the bank trades through a dealer or a central clearing counterparty (CCP). If a bank enters into a derivative trade with a dealer, Basel III creates a liability and requires a high capital charge for that trade.

On the contrary, derivative trade through a CCP results in only a 2% charge, making it more attractive to banks. The exit of dealers would consolidate risks among fewer members, thereby making it difficult to transfer trades from one bank to another and increase systemic risk.

Criticisms

The Institute of International Finance, a 450-member banking trade association located in the United States, protested the implementation of Basel III due to its potential to hurt banks and slow down economic growth. The study by OECD revealed that Basel III would likely decrease annual GDP growth by 0.05 to 0.15%.

Further, the American Bankers Association and a host of Democrats in the U.S. Congress argued against the implementation of Basel III, fearing that it would cripple small U.S. banks by increasing their capital holdings on mortgage and SME loans.