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Basel III: tough but realistic

In November 2010, at the G-20 summit in Seoul, government leaders endorsed the more stringent bank capital and liquidity requirements, as proposed by the Basel committee. Although the new requirements are to be phased in gradually and will be less tough than initially proposed[1], the impact of the Basel III accord will nonetheless be considerable. The effects will be felt not only by banks but also by their clients and by the economy in general. More stringent rules are necessary to strengthen the resilience of the banking sector and to shore up confidence. Meanwhile, it is important to find the right balance between financial stability and economic growth, and to be alert to any other undesirable effects of Basel III.

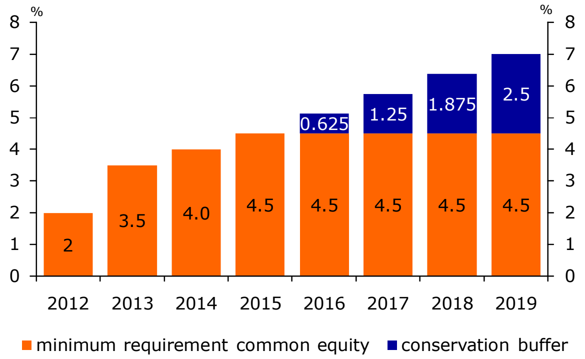
What does Basel III involve?

Basel III imposes more stringent international capital and liquidity rules on banks. These requirements are summarised below.

Higher minimum capital requirements and extra buffers

The minimum requirement for common equity[2] - the highest quality bank capital – will be raised on a phased basis from 2% to 4.5% of risk-weighted assets. In addition to this, a new conservation buffer of ultimately 2.5% will be required. This buffer will also be met with common equity (figure 1). During times of crisis, banks will be permitted to draw on the conservation buffer, provided they constrain bonus and dividend payments. The buffer is therefore not a real minimum requirement. However, banks will not want such a situation to arise, therefore in practice the minimum common equity ratio is actually 7%. In times of excessive credit growth, the minimum

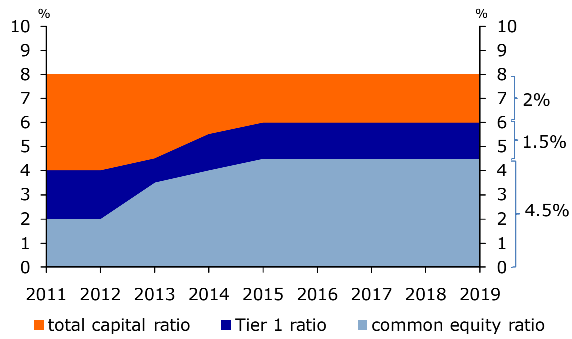
Figure 1: More *common equity*



Source: BCBS, Rabobank

common equity ratio is even higher. National supervisors may then demand a maximum countercyclical capital buffer of 2.5% in order to limit the accumulation of risks in the financial system. This new buffer will have to consist of common equity or other capital that is capable of fully absorbing losses. The minimum requirement for total Tier 1 capital will rise further from 4% to 6%, while the minimum total capital ratio remains at 8% (figure 2).However, in practice, these ratios are likewise higher on account of the conservation buffer (8.5% and 10.5%).

Figure 2: Composition capital base changes



Source: BCBS, Rabobank

Finally, in addition to the more stringent capital requirements for complex securitisations and the trading book that are due to take effect in late 2011, banks will also have to hold more capital in reserve for counterparty risk. This is the credit risk on derivatives transactions.

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[1] See Rabobank (2010a and b) for these proposals.
[2] *Common equity* (or *core Tier 1 capital*) is the first buffer to absorb unexpected losses and is always available. It consists of common shares (commercial banks) or member certificates/cooperative shares (cooperative banks) and retained earnings.

More stringent rules for the quality of capital
Capital is of high quality if it is really able to fully absorb losses. During the crisis, some elements of capital proved unable to fulfil this role. Basel III therefore imposes more stringent requirements on the quality of the various kinds of capital. For instance, in future, banks will have to deduct items such as goodwill from common equity instead of from the total of Tier 1 and Tier 2 capital. Currently, banks can publish high Tier 1 ratios while simultaneously holding little common equity. Furthermore, certain items, such as investments in other financial institutions are going to be deducted from common equity more quickly. Hybrid capital instruments will only be counted as additional Tier 1 capital if they meet strict requirements. Many existing hybrid capital instruments do not meet these requirements, and will be phased out over a ten-year period. Finally, supplementary Tier 2 capital[3] will be simplified, and the remaining Tier 3 capital (which under some conditions is used to cover market risk) is to be abolished.

Additional capital requirement for systemically important banks
The Basel Committee is currently considering an additional capital requirement for systemic banks[4]. Because of an implicit government guarantee, these banks might be inclined to take relatively greater risks and might have a competitive advantage on the funding market.

Contingent capital and bail-in debt
The Basel Committee is also investigating to what extent banks may fulfil the minimum capital requirements by using contingent capital and bail-in debt. These are bonds that are converted to shares, or that lose considerable value if a bank gets into financial difficulty. The idea is that bondholders then share in the pain, which would limit the burden for taxpayers and would increase market discipline. In the case of contingent capital, the trigger for this is fixed in advance – for instance if the bank's capital ratio should fall below a certain threshold. In the case of bail-in debt there is no fixed trigger, but investors have to contend with the possibility of write downs on their bonds. Rabobank has warned that bail-in debt could have a destabilising effect if a bank gets into difficulty (FT, 2010), as investors won't have any certainty about the extent of their losses.

Non-risk weighted leverage ratio
The introduction of a leverage ratio[5] should help to limit excessive debt accumulation by banks - one of the causes of the credit crisis. 2013 will see the start of a four-year observation period with a minimum leverage ratio of 3%. From that point on, the value of bank assets may not exceed 33 1/3 times the value of Tier 1 capital.

First ever international liquidity requirements
Basel III heralds the introduction of internationally harmonised liquidity requirements. Central to these are the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR requires banks to hold sufficient highly liquid assets[6] in order to absorb a possible outflow of funds for a thirty day period in a severe stress scenario. The NSFR requires banks to finance their assets with more (stable) long-term funds.

Impact of Basel III on the banking sector

Banks strengthening their balance sheets
Although the banks have beefed up their equity capital since the crisis[7], the levels

[3] Tier 1 capital absorbs losses of banks as a *going concern*, Tier 2 capital as a *gone concern*. (*Basel Committee on Banking Supervision*, 2009)
[4] Banks that because of their size, complexity and interconnectedness with other banks would destabilise the financial system and the economy if they were to collapse.
[5] The ratio of Tier 1 capital to non-risk weighted assets on and off the balance sheet.
[6] Cash, government bonds, high quality corporate bonds and covered bonds.
[7] In European banks, the Tier 1 ratio rose by 1.4% in the period 2006-2009 (OECD, 2010).

achieved are not yet enough to comply with the new capital requirements. However, it is difficult to estimate the precise amount of additional capital needed. Basel III proscribes not only more stringent capital requirements, but also a stricter definition of capital and more extensive risk coverage. Besides, the market will demand more than the bare minimum; tighter restricttions may be imposed by national supervisors; and the additional requirement for systemic banks is not yet known. A rough estimate tells us that European banks will need additional capital of some hundreds of billion euros (EBF/ IIF, 2010a). Accordingly, most Dutch banks will have to raise their capital buffers (DNB, 2010).

Of all the liquidity requirements, the NSFR will have the greatest impact. This requirement will be tested from 2015 and will take legal effect in 2018. At the moment European banks do not meet this standard (IMF, 2010). They will therefore have to raise more stable, long-term funds on the savings and capital market. Meanwhile, Basel III has been described as 'feasible' for the Dutch banking sector by experts including DNB president and chairman of the Basel Committee, Nout Wellink.[8]

Challenges to meeting the requirements
At the same time the transition to Basel III will not be easy. It will be quite a challenge to bolster the capital buffers by additional earnings retention, as is proposed by the CPB (2010). Profit margins will come under pressure due to the higher capital and funding costs and the lower yields associated with Basel III.[9] Reduced returns and lower dividend payments will in turn make it more difficult to raise new share capital.

Compliance with the NSFR will also be a challenge. The savings deposit market – certainly in the Netherlands[10] - is not large, and the capital market is populated by governments with major financing needs. Furthermore, there will be extra demand on these markets because 1200 bn euro of current long-term bank financing will mature in the coming years (ECB, 2010). These factors will push up the price of long-term funding. Partly to accommodate the banks in the transition to Basel III, the stricter require-ments will be phased in gradually. This would enable the higher capital requirements to be funded largely with retained earnings. However, it is likely that the planned lengthy transition period (2013-2019) will exist only on paper. The market expects - certainly from the major banks - that they will already meet the requirements by 1 January 2013 (front-loading). This will increase the pressure.

Basel III forces banks to make choices
Because capital and liquidity are in short supply, some banks will choose (or be forced) to shorten their balance sheet, for example by selling off assets, which will lessen their need for capital and liquidity. Most likely banks will reduce their involvement in riskier, capital intensive activities (such as investment banking) and will gravitate towards more retail banking. They will probably also curb their in-terests in other financial institutions, given that these only partly count as common equity. Some banks will dispense with their *'banque-assurance'* model, or will adopt it under a differrent guise, such as via a strategic partnership.

Effects on clients: positive and negative

Bigger buffers contribute to greater financial stability. This is essential for stable economic growth, which is also to the benefit of clients. However, greater certainty has its price. And Basel III will lead to higher interest rates on

[8] Parliamentary technical briefing on Basel III by N. Wellink, 10 November 2010.
[9] Equity capital is more expensive than debt, because investors demand a higher premium for the risk involved. Long term funding also costs more than short-term debt, with the risk of bail-in pushing the costs up further. And liquid assets have a lower yield.

[10] See Rabobank (2010b)

credit, because banks will pass on the higher capital and funding costs in their pricing. This is necessary to maintain profit levels, which in turn are required for building up capital.[11] The higher interest rates on bank loans, combined with tightness of capital and liquidity will put pressure on bank lending, and have a dampening effect on economic growth. Individuals and small companies will feel the pinch more than large corporations, who can go elsewhere for credit (for instance the capital market). These effects will be exacerbated by the NSFR, because for retail financing, banks have to keep more expensive, stable funds in reserve than for wholesale financing.

Unwelcome effects of Basel III?

While Basel III is intended to increase financial stability, doubts have been raised as to whether it might have the opposite effect in some respects. Because banks have to make enough profit to build up the required buffers, they could be inclined to take greater risks (ECB, 2010). There could also be an increase in regulatory arbitrage – the relocation of activities to less well regulated or even unregulated sectors. The higher the capital and liquidity requirements, the greater will be the incentive to 'game the system'. There are also fears that differences between banks will be amplified, if some banks try to be ahead of the posse, by frontloading. Not all banks will be in a position to do this, such as those banks that are or were heavily dependent on liquidity support from the ECB. If a disparity should develop between stronger and weaker banks, confidence in the entire sector will fail to grow. It is therefore important for supervisors to monitor and address these possible unwelcome effects of Basel III, as well as the negative consequences for bank credit lending and the economy.

[11] Here a difference can be found between cooperative and commercial banks. Cooperative banks add their profits to the reserves, and do not pay dividends. This is necessary because they can less easily raise capital than commercial banks.

Conclusion

Basel III contains stringent capital and liquidity requirements that are necessary to increase the resilience of banks and improve financial stability. However, this comes at a price: bank credit will be tighter and more expensive, which will dampen economic activity. Since Basel III cannot guarantee crisis prevention, it is important to find the right balance between greater financial stability and lower economic growth. In addition, supervisors should guard against the possibility that Basel III could lead to greater risk-taking in the financial system.

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